

The Importance of Market Integrity

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Paper Summary

Abstract

Maintaining market efficiency and integrity are central objectives of exchanges around the world. A large volume of academic research has assessed the success of exchanges in meeting the first of these objectives. However, to date there is little empirical research assessing exchange success in enhancing market integrity. Using a unique dataset, this paper redresses this issue. Market licence obligations require the Australian Stock Exchange (ASX) to maintain a fair, orderly and transparent market and to maintain adequate supervisory arrangements. Independent research assessing the effectiveness of ASX supervisory arrangements is largely absent. This paper redresses this issue by examining alleged market manipulation on the ASX during the period 1989 to 2002 using ASX Surveillance data. Evidence presented indicates that improved detection methods, enhancements to ASX Market Rules (MR), education campaigns and other initiatives have improved broker behaviour and industry compliance over time. This has enhanced the integrity of the Australian equity market.

The Australian Regulatory Framework

ASX market licence obligations require that the ASX do everything possible, within reason, to ensure a fair, orderly and transparent market. To manage the risks associated with operating a financial market and to achieve compliance with its licence obligations, the ASX has developed a comprehensive regulatory structure. ASX Surveillance performs a pivotal role in ASX market supervision through continuous monitoring of market activity in all listed securities. ASX Surveillance refers matters alleging breaches of ASX Market Rules to Investigations and Enforcement (I&E) and breaches of the Corporations Act to the Australian Securities and Investments Commission (ASIC), for further action.

Self-regulation of Exchanges

Despite conflicting views on the most appropriate model of exchange regulation, an exchange should have significant incentives to self-regulate its listed entities and participants. Pritchard (2002) indicates that poor market integrity deters uninformed liquidity, increasing trading costs and decreasing market efficiency. This further reduces liquidity. As exchanges generate their income from turnover, an exchange will ensure market integrity as this maximises turnover. In addition, in an increasingly competitive global equity market, liquidity will migrate to those markets where integrity and efficiency is high. Therefore, if integrity is poor, liquidity and exchange profits will suffer, and profits are a significant objective in the era of exchange demutualisation.

Limited independent evidence exists on the effectiveness of ASX self-regulation of its listed entities and participants. This may lead to inaccurate perceptions and arguments concerning the most effective regulatory model to ensure market integrity.

This paper provides independent evidence on the effectiveness and extent of ASX market supervision over time. This analysis will highlight strengths and weaknesses in the current regulatory structure and examine the rigour with which the ASX has enforced its Market and Listing Rules over time.

Data and Results

ASX Surveillance Referrals were examined over the period, July 1989 to December 2002, and the information they contain was entered into a database. The focus of this paper is to analyse all ASX Surveillance Referrals that allege market manipulation.

An analysis of these Referrals reveals the following:

- There is no evidence of significant variations in the number of ASX Surveillance Referrals produced over time.
- There is a decrease in the length of time an alleged manipulator is operating in the market.
- There is a decrease in the number of Trading Participants involved in alleged market manipulation.
- Fewer Market Rules are being Referred to I&E as a result of improved broker compliance.

Opportunities for improvement are also evident. Little improvement is observed over time in alleged market manipulation by Directors, substantial shareholders and Director related parties. However, ASX has recently responded with Listing Rule 3.19A and 3.19B. These Listing Rules require companies to disclose information in relation to directors' interests and holdings. Therefore, the results also indicate that the process of maintaining and enhancing market integrity must continue.

The results indicate that Market Rule enhancement and enforcement, demonstrations of the surveillance process to brokers and education campaigns have improved industry compliance over time. In addition, the results reveal that market supervision is a dynamic process. ASX Surveillance focus changes depending on the market cycle, broker behaviour and current market concerns. One example is internet broking. This presents a new avenue for manipulators. The ASX has responded with Market Rule 13.3.1 which requires internet brokers to apply order filters on their automated order processing systems. However, the ASX is unable to regulate individuals placing orders through automated order processing systems. Regulating the conduct of individuals is the responsibility of an external regulatory body.

Conclusion

This paper extends the limited evidence available on the outcomes of self-regulation in the Australian equity market. The ASX has the ability to codify manipulative trading activities in its Market Rules and the mandate and incentive to enforce those rules. As a result, it appears to have made an impact in one area of market integrity by effectively limiting market access to manipulators. Specifically, ASX Surveillance efforts have reduced the number of brokers involved in alleged market manipulation. The time alleged manipulators are in the market has also decreased and individuals now find it increasingly difficult to find a broker willing to execute their manipulative trades.

Market integrity appears to be an essential element in ASX's business model. Significant resources are committed to ensuring market integrity and the integrity of the market has been enhanced as a result. In addition, there is no evidence of a change in the intensity of this supervision post October 1998, the date the ASX demutualised and became a listed entity. This indicates that the ASX is not conflicted in its role as both market operator and regulator. Increased media and political interest in market integrity since demutualisation has arguably increased ASX efforts to regulate effectively.

The current market integrity debate, while important, is limited in perspective. Market supervision is multi-faceted and a more complete picture needs to be articulated. Evidence presented in the paper may help sharpen perceptions on market integrity and improve breadth and accuracy of comment. The integrity of the market is at stake and the economic consequences of suboptimal regulatory decisions are significant in today's increasingly competitive and global equity markets.