



**ASIC**

Australian Securities & Investments Commission

# **ASIC compliance: How internal audit can strengthen the corporate governance framework**

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## Introduction

Thank you for the introduction and the opportunity to speak here today.

It is my pleasure to be speaking to you about this important topic. What I would like to cover today is:

- some context – information about ASIC’s strategic priorities and why ASIC focuses on ‘gatekeepers’
- who gatekeepers are, why they are important to us and, critically, the role we see internal auditors playing in the regulation of gatekeepers
- some specific regulatory issues that are of interest to ASIC and that may be relevant to your role as internal auditors.

I anticipate that my presentation today will take 20–30 minutes and I want to leave ample time for any questions that you may have.

## ASIC’s strategic priorities

As most of you may know, ASIC’s three strategic priorities are to ensure:

- confident and informed investors and financial consumers
- fair and efficient markets
- efficient registration and licensing.

As part of our strategy around ensuring confident and informed investors and financial consumers in our financial system, we carry out a number of important roles.

First, we have an important role around investor education. Making sure investors understand their responsibilities and simple concepts, like the risk–reward trade-off and diversification, is paramount.

Second, we say we will hold gatekeepers to account. I will speak more about that shortly.

Third, understanding consumer behaviour and how investors make decisions is also extremely important. That is one of the reasons we have a current focus on advertising of products and services. Again, more on that later.

## Gatekeepers

### Academic theory

Gatekeepers have been described as ‘reputational intermediaries’ who pledge their reputation capital to protect the interests of dispersed investors who cannot easily protect their own interests.

Gatekeepers can play an important role in:

- verification, certification, approval and recommendation of products and services offered to investors
- monitoring of compliance by entities and their management through their privileged access to information
- performance of a private supervisory role through the detection and deterrence of misconduct.

Of course, there are some issues with how the theory translates in practice. It is difficult to externally monitor a gatekeeper’s performance, so failures can go unchecked. The regulatory framework can also create or entrench a non-competitive environment, reducing standards of service. Poorly designed liability regimes can create a defensive environment in which gatekeepers minimise their role to reduce potential liability. Finally, multiple gatekeepers, each playing a limited role in shepherding a transaction or product through a range of hurdles, can lead to ineffective gatekeeping.

### ASIC’s view

#### So what does ASIC think of gatekeepers?

ASIC recognises that gatekeepers play a beneficial role in the regulatory system. This is because they help industry perform what can broadly be described as a self-regulatory or co-regulatory role. This sort of role was endorsed in the Wallis Inquiry. It’s also important to appreciate that many aspects of our law are self-executing and rely on gatekeepers complying with their regulatory requirements. So, to maintain investor confidence, it’s important that ASIC monitor their conduct closely. It is also important that gatekeepers themselves have strong internal audit and compliance functions.

Ideally, gatekeepers should be self-regulating, as they should have strong incentives to maintain their professional reputation and independence, since this is an essential aspect of their services. However, gatekeepers can also contribute to market failure – particularly when their incentives are misaligned, leading to conflicts of interest and failure to act professionally and independently. This is another important reason why ASIC focuses on this area.

Identifying who are the gatekeepers to the financial markets can be imprecise, but ASIC takes a wide view of the term. Even product issuers and executive directors can play a gatekeeping role at times, such as when they lend their name to a product or a disclosure to facilitate or enable it to be marketed to consumers. Broadly, we consider the term 'gatekeepers' includes advisers, auditors, directors, liquidators, custodians, product manufacturers and distributors, market operators, and brokers. So, in short, most of you here today play an important internal role in the regulation of gatekeepers.

### **What does ASIC look for from gatekeepers?**

So what does ASIC expect of gatekeepers that it regulates? What should you as internal auditors watch out for?

I'd like to answer that question at two levels. First, I will talk about the sorts of qualities we look for from gatekeepers at a very high level.

Then, in some following slides I will give some more technical detail about some specific areas of regulatory focus we have at the moment that you might want to consider as part of your internal audit role.

At a high level, the essential content of the principles we are looking for is neither complicated nor technical. We expect gatekeepers to act with honesty, diligence, competence and independence (i.e. to manage their conflicts).

Honesty means: do not lie or mislead, do not steal others' money, do not knowingly abuse your position or exploit the trust of the investing public.

Diligence means that advice, decisions or actions must be properly considered and appropriate in the circumstances.

As an example of principles around competence, all Australian financial services (AFS) and credit licensees must meet legislative and regulatory requirements for training, licensing, registration and conduct. Licensees are responsible for ensuring that they understand and comply with these requirements.

Finally, as an example around independence, AFS licensees and credit licensees must have adequate arrangements for managing conflicts of interest that may arise in relation to the provision of financial services or credit services by the licensee or its representatives. The conflicts management obligation generally involves controlling, avoiding and disclosing conflicts of interest.

## Current issues

### Advertising

Now let me turn to specific areas of ASIC focus that may be of interest.

As I have mentioned, ASIC seeks to promote confident and informed financial consumers. This includes recognising how they make decisions in real life, and ensuring that communications about financial products help effective decision making. An important part of this is acknowledging the role that disclosure and advertising plays in this process.

At a time when consumers are making more financial decisions than ever before, the environment in which they are making those decisions is becoming increasingly complex. We know that advertisements are an important source of information to consumers. They are also an important way for promoters to raise awareness of their financial products and services in the market, and thereby generate competition.

Advertising therefore holds many potential benefits for both industry and consumers. However, if these benefits are to materialise, promoters must give clear, accurate and balanced messages when promoting financial products.

This year we released Regulatory Guide 234 *Advertising financial products and advice services (including credit): Good practice guidance* (RG 234). This guide sets out good practice guidance to help promoters comply with their legal obligations to not make false or misleading statements, or engage in misleading or deceptive conduct.

We regularly review advertising, including internet advertising, and we contact companies with any identified issues. Since July 2010, ASIC's actions have resulted in well over 100 advertisements across the financial services sector being withdrawn or remedied in response to concerns about poor practices and potentially misleading or deceptive conduct.

The outcomes we will aim for when confronted with advertising that breaches the law will involve potentially stronger penalties than we have sought in the past. Powers at our disposal include issuing stop orders and public warning notices, and seeking civil pecuniary penalties.

Some areas that we have identified in the past of particular relevance include:

- the need to ensure that comparative advertising compares 'like with like'
- ensuring that any special conditions on promotional offers are disclosed in a sufficiently prominent manner in the main text of the advertisement

- ensuring that any qualifications to headline claims are clearly disclosed in the advertisement.

So a few questions for you to ponder might be:

- What processes are in place to settle advertising where you work?
- What is the assessment you use to ensure advertisements are not misleading or deceptive?
- Is there a checking mechanism against the examples and guidance that ASIC has released to reduce the risk of regulatory issues?

## Continuous disclosure

Another area that internal auditors of listed entities might consider is around how continuous disclosure issues are handled.

ASIC sees continuous disclosure by listed companies as a bedrock of market integrity. It is essential to two of ASIC's priorities: fair and efficient markets, and confident and informed investors.

ASIC understands that disclosure issues can sometimes be very difficult, and judgement calls are required.

Updated guidance about continuous disclosure, particularly in the age of instant communication and social media, will help companies make the right calls. That's why we are pleased ASX Limited has substantially re-written its guidance dealing with continuous disclosure and released it for public consultation.<sup>1</sup>

While there are many messages for companies in the revised guidance, there are a couple of key messages that ASIC thinks are particularly important. These include:

- Companies need to be prepared to act quickly to respond to continuous disclosure issues, by having established policies and practices. Obviously, those policies and procedures may need updating in light of ASX's final guidance on this topic.
- It is important for companies to know what information about them the market is trading on. This may require monitoring of major sources of news and information, which in some cases will include significant social media sites that regularly include postings about the company's shares.
- Companies need to apply the listing rule requirements consistently, whether it is good or bad news required to be disclosed.

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<sup>1</sup> ASX Limited, *Review of ASX Listing Rules – Guidance Note 8 Continuous disclosure: Listing Rules 3.1–3.1B*, consultation paper, 17 October 2012.

- If an announcement proves to have been wrong, it may be necessary to update the market to ensure the market is fully informed of material information.

If you work for a listed company I'd encourage each of you to think about how these issues are dealt with in your company.

## Handling confidential information

A somewhat related issue to continuous disclosure is about confidential information. How confidential information is handled by companies both within their own organisations and externally with advisers and other service providers is an important issue for companies.

Loss of confidentiality of market sensitive information can have serious implications including possible continuous disclosure and insider trading problems.

The Chartered Secretaries Association (CSA) and Australian Investor Relations Association (AIRA) have released a document, *Handling confidential, price-sensitive information: Principles for good practice*.<sup>2</sup> It sets some principles to enable entities to better manage the confidentiality of their information, and therefore enables the disclosure of that information to the market at the time of their choosing. I commend those principles to all of you. I'd encourage all of you to think about how your organisation protects confidential information and whether it adheres to the 'need-to-know principle'.

## AFS licensees

I just wanted to also quickly mention some further current issues that may be relevant to internal auditors in the financial services sector before I move to what may be some future issues.

The first issue is around how client money is handled within firms. Client money is money paid by investors to an AFS licensee in connection with a financial product or the provision of a financial service. Client money is held in a compliant account and receives statutory protection in the event of the issuer's insolvency or ceasing to carry on business.

ASIC has conducted a risk-based review of client money handling – commenced in December last year – of 40 issuers' practices, particularly focusing on the over-the-counter (OTC) derivative market.

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<sup>2</sup> CSA and AIRA, *Handling confidential, price-sensitive information: Principles for good practice*, guide, 26 October 2010.

In the first half of its review, ASIC found that:

- eight issuers failed to pay client money into a properly designated trust account, when no exception applied
- six issuers failed to pay client money into a compliant account on the day it was received or within one business day.

These basic areas of non-compliance have caused us concern, and we will release a further report shortly on where we think improvements can be made.<sup>3</sup>

Another important issue that ASIC has reviewed recently is risk management systems in the funds management sector.

As a result of that work, ASIC expects to consult on developing good practice guidance on risk management systems for responsible entities and may consider proposals such as:

- regular reviews of risk management systems and, in any event, reviews of these systems when market shocks occur
- forward-looking analysis of resource adequacy
- succession planning and independent monitoring to address key person risk and the risk of over-reliance on external compliance and risk management consultants
- quantitative or actuarial analysis for stress testing risks on an ‘if not, why not?’ basis.

## Future issues

Now is my chance for some speculation about what may be issues for internal auditors to focus on in the future.

Law reform initiatives are important in this area, with major reforms such as the Future of Financial Advice (FOFA) reforms and the Stronger Super reforms due to commence soon. While ASIC adopts a facilitative approach to compliance for major law reforms, in recognition of the significant change that often needs to happen, we do expect that people are making genuine efforts to comply with new laws as they are introduced. Therefore, it may be an area for internal auditors to give attention to after the reforms commence.

The other thing I would highlight is a Parliamentary Joint Committee (PJC) Inquiry report into the collapse of Trio Capital, which covers various aspects of the financial services industry.<sup>4</sup> While the Government is yet to respond

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<sup>3</sup> Report 316 *Review of client money handling practices in the retail OTC derivatives sector* (REP 316).

<sup>4</sup> PJC, *Inquiry into the collapse of Trio Capital*, report, May 2012.



to that inquiry, there are some important areas that may warrant further attention. These include things like:

- the ‘selling’ of interests in self-managed superannuation funds (SMSFs), and whether people really understood what they were getting into
- some weakness in the compliance framework for managed investment schemes and, in particular, compliance plans, compliance audits and compliance committees
- whether there is an over-reliance on research houses by those giving advice
- the need for both regulators and the private sector to be mindful of outlying investment returns, and whether that might suggest wrongdoing in some cases.

I’d be happy now to answer any questions you might have.