ASIC

Australian Securities & Investments Commission

ASIC's focus post 11 March 2004

A presentation by Berna Collier, Commissioner, Australian Securities & Investments Commission, to the Investment and Financial Services Association, Sydney, 17 March 2004

Welcome to the world post-FSRA transition. Today I'll address our position on a number of regulatory matters, including what life looks like post March 11 and also cover some of the issues that have emerged in Financial Services over the past year.

For the past couple of years we have had a major focus on implementing FSRA , as have you. Can I take this opportunity to acknowledge the meaningful dialogue we have had with IFSA over that period. I believe FSRA has been a good example of how the regulator and industry can consult and hopefully improve the position of all parties while maintaining the Government's intent in the legislation. However, all of us have also had to attend to 'business as usual' matters. For us that has meant regulating under the old law and dealing with issues as they emerged.

One of the key issues we have had to look at over the past few months concerns the managed fund abuses which were evident in the US toward the end of last year.

As you would expect, ASIC wanted to ascertain whether issues such as late trading, market timing and indeed the provision of fund information on a preferential basis were present in the Australian market. Accordingly we wrote to some 70 fund managers representing more than 90% of the market (by value) to enquire about these practices. Our selection of responsible entities to approach was based on, among other things, knowledge of funds through intel/surveillance and IFSA information. We selected the biggest funds according to retail exposure and also a selection of smaller funds through internal intel. The selection was not risk-based as it is a ***review*** as distinct from an investigation (as I think was pointed out by IFSA in its subsequent circular to its members). We did not look for SEC fund connections – we simply wanted to get the largest coverage of funds we could, to give us a bigger picture.

To be more specific, we are inquiring about issues such as :

- Whether funds are priced so that investors pay fair value when they enter and exit
- Whether information is disclosed broadly in an appropriate way
- Questions about whether there have been any approaches to deal preferentially in, e.g. a late trading context, to accept trading after the late closing period.

We have now received responses from those fund managers and work continues in analysing them.

I cannot emphasise this enough this afternoon. ***Our work in analysing the responses is not yet complete***. I assure you that when we are ready to release information, IFSA will be our first call. I acknowledge the IFSA Standards, especially Standard No 8 Scheme Pricing which emphasises the importance of forward pricing as distinct from historical pricing.

However, I can only offer a few general comments today.

First, it does appear to be the case that features of the Australian marketplace such as forward pricing, and buy/sell spreads have mitigated against the worst excesses evident in the US. The impact of the buy/sell spread – that is, resulting in a notional transaction cost represented by the discounted exit price – is not generally in place in the US. As I said, I think this means that the practices in the US are less likely to occur here.

Secondly, to be more competitive in a large market, the US had created "no load funds", allowing short-term investors to enter without cost. (Contrast our buy/sell position I just mentioned). Rules proposed in the US by the SEC to deal with this issue may sound familiar to you. They include :

- A mandatory 2% fee to be charged on short-term investors
- Independent directors on the board
- Improvements in the disclosure regimes – particularly fees and arrangements funds have with other parties and
- Enforcement actions, including criminal actions with million dollar compensation outcomes.

The fact is that these measures are largely in play in Australia already, which means it is unlikely we will be implementing them.

I also note this morning's press that Bank of America and FleetBoston Financial Corporation will pay a combined $US195 million in penalties and $US320 million in restitution to settle the charges relating to mutual fund trading. This is the fourth settlement thus far in the mutual fund probe that commenced 6 months ago. The SEC needs to formally approve the deal.

Thirdly, many of the US problems were caused by funds allowing certain investors to get inside information on asset purchases, thereby encouraging such parties to engage in late trading. Our survey tentatively suggests this is not an issue in Australia, although it is something we will look for in surveillances.

Finally, the New Zealand Securities Commission has announced on 13 February that they would be following our approach in obtaining information from local fund managers. Canada and the UK had conducted reviews of their domestic practices, with minimal results.

I repeat – our work in this respect is not yet completed. Our analysis of the responses received continues, and I am not in a position to flag what the final outcome will be.

In terms of process, there are some entities to which we will go back for further information. Also, in our usual compliance program, these issues will feature in in our visits to fund managers. We will look at the practices in place and what evidence there may be of any misconduct.

I'll turn now to FSRA implementation, one week in.

FSRA implementation

I thought it may be of interest to you to present some stats up front, as to what the licensed financial services industry looks like. As at midnight on 10 March 2004, we had issued 3738 licences. Of this figure, 953 were full applications, 1875 were streamlined, 909 composite and one qualified. A register of all licensees is available on our website (for those of you who are keen – use the Search under Services on the left hand menu bar on the ASIC website, or open the FSR page and go to Searching our Databases. This is clearly however **very** new on our website – post 11 March 2004!).

The industry distribution of approved licensees is as follows:

- General Insurance 24%
- Financial Advisers 20%
- Managed Funds 15%
- Market Dealers 14%
- Life Insurance 13%
- Superannuation 6%
- Deposit Takers 4%

- Conglomerates 3%

By far the largest number of licensees (44%) is based in NSW, with 27% in Victoria, 13% in Qld, 9% in WA and a smaller representation across SA, Tasmania and the ACT.

We have considered over 1,000 FSR-related applications for relief and issued approximately 80 FSR-related class orders during the two-year transition period. We have granted both class order and individual relief to enable the new regime to apply appropriately, having regard to the breadth and diversity of financial services and financial products captured by the new regime. Where relief has been granted it has been on conditions that aim to achieve similar market integrity and consumer protection outcomes. We expect to continue to receive relief applications in connection with FSR implementation issues throughout the coming months.

As a result of FSRA transition, many of you will now be either an Australian Financial Services (AFS) licensee or an authorised representative, or you may be operating in a restructured business environment. A reminder however…if you need an AFS licence but don't obtain one, or you haven't become an authorised representative for another AFS licensee, you are **not** able to legally carry on a financial services business now (post March 11). If you do continue your business without the appropriate licence or authorisation, you expose yourself to numerous offences, fines and possibly imprisonment. Operating illegally from now may also make it difficult for you to obtain an AFS licence in the future. I point the lawyers among us to section 913B (1)(b) *Corporations Act* which requires ASIC to grant a licence where ASIC has no reason to believe that the applicant will not comply with obligations that will apply if the licence is granted. Where an entity has acted illegally it may raise a question in ASIC's mind as to the ability of the applicant to comply. Therefore, not meeting the standards set may expose your businesses and your industry to unnecessary risk that may impact on your future viability.

More broadly – I note that a good way to avoid over-regulation is for the industry to keep lifting its standards. As a general rule, I think it is fair to say it is less likely for governments to intervene in a well-run industry with high standards.

Ongoing compliance

For those of you who are licensed, you will be aware that the FSR regime comes with ongoing compliance obligations you need to satisfy. These include maintaining your organisational capacities, notifying ASIC of changes to licensee details, , compensation arrangements and dispute resolution processes and authorised representatives, reporting breaches and meeting disclosure requirements.

How are we checking compliance?

One of our key regulatory responsibilities is ensuring (to the best of our ability) a compliant industry. Our immediate priority over the next 6 months is to ensure that there are no persons operating a financial services business without a licence. There are a number of categories within this group :

- Persons who held a licence under the old regime who have not transitioned but who continue to operate a business – we will be applying to court to close these people down
- New applicants who have had their licence applications rejected but are operating a financial services business – we will be asking these people to cease operating until they have obtained a licence
- Persons who did not hold a licence under the old regime but who need a licence post transition (including some superannuation trustees) – we will be encouraging these people to obtain a licence immediately.

Our next priority will be to target high-risk licensees for surveillance. We will be doing this by

- reviewing the detailed material applicants have lodged with ASIC,
- looking at any complaints history
- taking into account trends from the complaints resolution scheme and
- relying on information and intelligence from industry.

We will ALSO be taking into account the findings from the 151 verification visits we carried out in the past 12 months, which highlighted a number of deficiencies. In many cases the matters that cause us concern are not particularly complex: they are straightforward, basic compliance activities that have not been attended to. Examples include

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- compliance measures not documented.
- poor internal dispute resolution processes
- cash flows not produced on a regular basis

Other things we may look for are incomplete record-keeping, absence of breach registers and no formalised risk management procedures and there being no documented complaint procedures. We also need to be satisfied that compliance manuals are up to date and that all directors of a licensee are informed on compliance issues (this latter is a best practice recommendation which stems from our Organisational Capacities Policy Statement PS 164.43 "Compliance Measures").

Breach notification – our approach

We have made it clear that we will take into account whether an entity is genuinely attempting to comply with the law. Where we consider non-compliance is deliberate, we will treat such breaches seriously and will use all the regulatory options available to us, including court action and licence revocation. This goes both for companies that continue to operate while unlicensed and those that fail to meet the responsibilities and obligations imposed by the Corporations Act.

Under the Corporations Act (s 912D - as amended by the FSR Amendment Act 2003) a financial services licensee must judge whether to report a breach or likely breach to ASIC as 'significant' having regard to the following factors:

- the number or frequency of similar previous breaches
- the impact of the breach or likely breach on the licensee's ability to provide the financial services covered by the license

- the extent to which the breach or likely breach indicates that the licensee's compliance arrangements are inadequate
- the actual or potential financial loss to clients or the licensee arising from the breach or likely breach.

…and any other matters that may be prescribed by regulation. (At the moment there are no others.)

Rectification of the breach and/or compensation to clients does not necessarily mean that the breach is not significant. However these matters might affect ASIC's response, and we may wish to test whether the breach has in fact been rectified and the compensation was in fact adequate. Other factors that might affect our response would be the extent to which the licensee is open and cooperative with ASIC.

In order to meet its obligation to report significant breaches we would expect licensees to maintain a register of all breaches identified and to document the reasoning behind their judgement as to whether a particular breach is reportable or not.

ASIC plans to issue breach notification guidance shortly.

Ongoing consultation

We have worked closely with industry in preparing for and understanding FSRA. Our Chairman has recently confirmed that we will continue to consult with industry and consumer groups over the next 12 months as the FSRA beds down.

This interaction with industry and consumer groups immediately following the end of the transition period will focus on identifying and, where possible, giving further guidance and appropriate relief. In addition, we will continue to provide support to market participants through its FSRA Project Office.

Industry impacts

I'd like also to consider today the wider state of the industry in general. I have always held the view that Australia has a leading edge regulatory system. This is endorsed by

the number of countries that look to us for guidance on how new and innovative systems of regulation pan out. Twin peaks was an example of this.

The high standard of our regulatory system and increasing globalisation has made Australia even more attractive to overseas business. Unfortunately, it can also work the other way - Australian operators who are having trouble meeting our requirements or doing business here, look offshore. This creates regulatory challenges for us, to ensure Australian consumers are protected, or are at least aware of the absence of protections in these circumstances. For example, in the current insurance market, an increasing number of hard-to-place insurance risks are being underwritten by unauthorised foreign insurers (UFIs). By nature these entities are not prudentially supervised by APRA. To ensure that Australian consumers are informed of any risks associated with insurance intermediaries placing business with UFIs, we have conducted a surveillance campaign reviewing the activities of a number of insurance intermediaries.

Are we up for further reform? We understand that Government is looking to bed down the FSRA regime and give it time to deliver what is expected of it, before considering further reforms. This is probably a relief to you!

Now that March 11 has past and we are committed to the FSRA regime, our financial services focus turns to business as usual. For ASIC, this means identifying and focusing on areas of particular risk and impact on consumers.

Addressing risk areas is critical when we look at the direction in which industry is traveling. In particular, the amount of funds involved is increasing rapidly.

IFSA's website tells us that the Australia's funds management industry manages more than $691 billion for over nine million Australian investors, in superannuation and non superannuation managed investments (unit trusts) and life insurance products. This figure represents an increase of 2.8% over the last quarter and ranks Australia as the fourth largest funds management market in the world.

According to APRA's statistics, in September 2003 there were 277,690 separate superannuation entities in Australia managing $548.5 billion in assets on behalf of 25.4 million member accounts - an increase of $17.1 billion (3.2%) from the previous quarter.
In January 2003m, Treasury estimated the following growth projections: $1.0 Trillion by June 2012, $1.2 Trillion by June 2015 and $1.6 Trillion by June 2020. Consolidation across corporate, industry, public sector and retail superannuation has resulted in a decline in number of these funds, in recent years. The numbers of small funds, however, has grown.

When we are talking of growth in funds of this size, it is only natural that superannuation and the quality of investment advice are priorities for ASIC. For these reasons, our focus over the next six to twelve months will be on reviewing practices in relation to superannuation, improving the quality of investment advice to consumers, and continuing to raise standards in relation to the disclosure of fees and charges.

The possible implementation of superannuation choice legislation, or at least portability, will again bring the competence and practices of advisers under scrutiny. Central to the performance and repute of the advice sector in the next twelve months and beyond, is improvement in the quality of advice. We are also looking at other superannuation issues, in particular, how it is sold and how fees, charges and returns are disclosed. We have recently issued our report on Eligible Rollover Funds and will soon report on our campaign into superannuation complaints schemes.

Reports on other campaign outcomes will be released progressively over the next year, as campaigns are completed.

Fees and charges disclosure across all sectors of the industry remains a priority. We have undertaken significant work in this area already, including the release of our model for fees and charges disclosure and our contribution to the development of industry disclosure models such as IFSA's templates for Product Disclosure Statements and

Financial Services Guides. The Parliamentary Secretary to the Treasurer announced last week that he had taken steps to resolve a 'long standing impasse' over simple fee disclosure for investment based financial product (Press Release 008 – 10 March 2004). The PST has asked IFSA and AFSA to present an agreed single figure fee disclosure model to the Government, within one month. It is the Government's intention to then prescribe a regulation incorporating the agreed model in relevant disclosure documents. If no agreement is reached, the Government will move forward with its own model, based on achieving the best consumer outcome.

Our campaign work going forward into 2004/5 will have a balance between product manufacturers and distribution arms. Again, good advice will be a theme of most campaigns.

International issues

In addition, new issues that impact on our regulatory role will continue to arise. International investment scandals such as market timing abuse and late trading caught our attention late last year, and we commenced a review of domestic practices. These issues have also attracted national media attention and industry and the media will no doubt continue to track our actions on this front throughout the year.

We also know that there are consumer expectations of ASIC in areas such as property investment advice. We face legislative limitations in how we can deal with this type of issue, but will continue to input into the work the Ministerial Council on Consumer Affairs is doing in this area, to arrive at improved regulation.

We expect that FSRA has helped licensees raise their business to a standard that will help maintain the integrity of both the industry and individual business through upgraded compliance systems and trained, efficient and knowledgeable staff. We expect to see a correlating improvement in standards of advice, conduct and disclosure and believe that the FSR regime, while increasing protection for consumers, will help build an even more professional industry. ASIC will be working to lift the standard of financial advice and conduct by means of our compliance focus on advice and

disclosure. ASIC will continue with extensive surveillance and compliance campaigns and sharpen their focus.

It will be interesting to take stock of where the industry sits now that FSRA transition has ended. Add to this increased globalisation in the industry, which will also impact on what the industry does and how it distributes its products. These factors will also impact on how ASIC regulates the industry.

Conclusion

We at ASIC value the contribution IFSA makes to the debates in the financial services and funds management arena. We also value our working relationship with you, including the consultations we had with you in areas such as fees. 2004 looks likely to be a busy and interesting year – we look forward to continuing our relationship and dialogues with IFSA over this time.

Thank you for your attention today.