News from the regulator

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Australian Securities and Investments Commission

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Introduction

Good morning and thank you. I would like to thank Colin Neave and FOS for their kind invitation.

This is the first occasion I have had to speak to you since taking on the role of Chairman in May this year. I want to use this opportunity to set out the approach I intend to take as the new Chairman of ASIC.

Business as usual—ASIC's priorities

Having joined ASIC as a Commissioner in February 2009, I have seen how ASIC has developed and changed under the direction of Tony D'Aloisio. Under my Chairmanship, ASIC will focus on three key priorities:

Firstly, *confident and informed investors and financial consumers*. Within this, we have three areas of particular focus, which I will speak more about today:

1. education is key;
2. gatekeepers; and
3. consumer behaviour.

Our second key priority is *facilitating fair and efficient financial markets*.

And thirdly, ASIC will focus on *ensuring efficient registration and licensing of our stakeholders* with particular focus on small business.

The main factors guiding our approach to setting priorities are:

- our legislative responsibilities;
- systemic or regulatory risk;
- the expectation gap between what stakeholders expect and what ASIC is doing; and
- government policy objectives.

The key drivers we use to achieve our priorities are:

- engagement with industry and stakeholders;
- surveillance;
- guidance;
- education;
- deterrence—we will continue to focus on taking big cases and pursuing wrong doers; and
- policy advice.

The important role of FOS

Before going on, I would like to take a moment to pay tribute to the great contribution that FOS makes to protecting investors and financial consumers. Accessible, fair and independent dispute resolution is a hallmark of our financial services and credit regimes. Indeed, our system is the envy of other industry sectors and overseas jurisdictions.

At ASIC, we really value the excellent working relationship we have with FOS, and its expertise in accessible, fair and independent dispute resolution.

Promoting confident and informed investors and financial consumers: Going beyond disclosure

This leads me to the first matter I would like to talk to you about today: ASIC is undertaking a variety of initiatives to promote confident and informed investors and financial consumers and ensure consumers get a fair deal.

Before the last few years of global financial turmoil, we thought that all we needed to correct the information asymmetry between investors and issuers was disclosure. However, there is now an increasing recognition that disclosure is not always enough on its own.

Some products are more complex than others, and the risks associated with them are more difficult to understand. Even dealing with relatively simple products requires investors and consumers to have a certain level of financial literacy. After a certain point, investors also need to rely on the good faith and integrity of those they deal with, particularly the ‘gatekeepers’ of the financial services system. During the global financial crisis (GFC), this faith was, in some cases, found wanting.

Disclosure is a necessary part of providing financial services to retail investors and consumers in a responsible way, and this will not change. Nevertheless, we should also look at ways of making the financial services system work better for retail investors and consumers.

Obviously, ASIC has a significant role to play in leading this. However, we are also encouraging others to take an active role in helping retail investors and consumers get a fair deal and make appropriate decisions. This includes issuers, advertisers, and other gatekeepers—we all have a role to play.

I will now look in more detail at some of our key areas of focus in promoting confident and informed investors and financial consumers.

Education for confident and informed consumers

Firstly, education.

Financial literacy means understanding money and finances and being able to confidently apply that knowledge to make effective decisions.

ASIC is a significant source of independent information for retail investors and consumers. We like to provide this information through a number of different channels, so there is always a convenient way for people to access it.

New media provides us with a wonderful opportunity to expand our communication. Not everyone wants to access information in this way, but for those who do, it can be direct, immediate and personal.

We have recently launched our new consumer website, MoneySmart. We hope it will provide retail investors and consumers with the information and tools they need to make effective decisions. As you would expect, you can find written articles on MoneySmart, but also audio and video clips on everything from budgeting to reverse mortgages. You can follow MoneySmart on Twitter and Facebook. In fact, as I am talking to you right now, members of the MoneySmart team are tweeting key points from this speech to our followers.

Now, a YouTube clip from ASIC on choosing the right home loan may not be likely to ‘go viral’ any time soon. But, for the person who needs that information, and who is able to access it in an immediate and engaging way, it may represent the motivation they require to improve their financial position.

A final important program is the Helping Kids understand Finance initiative. This involves embedding financial literacy in the national school curriculum from Kindergarten to Year 12.

The gatekeepers

Next, on gatekeepers.

‘Gatekeepers’ are the intermediaries who provide or assist in providing investors and financial consumers with the information they need to navigate the financial world. Gatekeepers collect, evaluate, advise on and endorse information about companies, assets and investments. They are involved at all parts of the value chain. They include financial advisers, lawyers, auditors, custodians, actuaries, research houses, credit rating agencies and independent experts, and those involved in the product approval process.

Investors and financial consumers rely on gatekeepers to act with the utmost integrity. Where gatekeepers fail in their role, this can have a serious consequence for retail investors and financial consumers, as we learned in the last few years.

At ASIC, we have been working with our international counterparts, the Australian Government and Treasury to consider areas where we can improve the regulation of gatekeepers. I will outline five of these areas.

1. Enhanced financial resource requirements

Firstly, an important aspect of protecting retail investors is ensuring that Australian financial services (AFS) licensees have adequate financial resources to conduct their business.

We are currently reviewing the financial resource requirements we set for licensees. You may have seen that we recently consulted on proposals for responsible entities (REs), and OTC derivative issuers.

ASIC is not a prudential regulator, and our financial resource requirements are not designed to prevent insolvency in all cases. However, the financial resource requirements we set for AFS licensees are designed to help licensees minimise their operating risk over a one-year horizon, based on three principles:

- firstly, ensuring that licensees meet expected operating risk through undertaking cash forecasting over a one-year period. This can help detect issues early enough to address them;
- secondly, preparing licensees to meet unexpected operating risk by holding an adequate minimum level of assets in reserve; and
- finally, ensuring that licensees have adequate liquidity, by holding a certain proportion of those reserves in cash or cash equivalents, and the rest in assets that are liquid.

Unfortunately, the nature of investing involves taking on some market risk—this will never change. However, it is harder for investors to assess whether a business is exposed to operational risk through insufficient financial resources. We are working to make our financial resource requirements more robust to reduce this source of risk, guided by the three principles I have just outlined.

2. Credit rating agencies

Secondly, on credit rating agencies (CRAs). The advice given by such information providers is relied on by the entire financial services industry, including retail investors—through the institutions they deal with, or the funds they invest in that rely on ratings. Since the GFC, the international trend has been to increase regulation of CRAs.

In Australia, CRAs have been required to hold an AFS licence since the beginning of last year, and comply with the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies since last July. Yesterday, we also released a consultation paper with proposals for CRAs to lodge an annual report with ASIC about their compliance with the IOSCO Code requirements, including around the management of conflicts, staff competency, and their ratings methodologies.

This work forms the basis for ensuring confidence in the ratings process.

3. Future of Financial Advice reforms

Next, as I'm sure you're aware, the Government has announced possibly the largest reform of the financial advice regime since it was introduced. ASIC is working closely with Government and Treasury on this.

These reforms address concerns about the quality of financial advice given to retail clients, focusing on three main areas:

- firstly, restoring confidence and trust in financial advice. Reforms here include a prospective ban on conflicted remuneration structures, including commissions and volume-based payments, and soft dollar benefits exceeding $300 in value. The Government has also announced the introduction of a statutory 'best interests' duty so that financial advisers must act in the best interests of their clients;
- secondly, raising levels of competence in the industry. ASIC has just consulted on a new professional development framework for advisers, including a proposal that any individual who provides personal or general advice to retail clients on Tier 1 products should pass a national exam, undertake a regular knowledge update review and undertake a one-year period of supervision when entering the industry;
- finally, reviewing professional and ethical standards in the industry. ASIC is working with an advisory panel, made up of consumer and industry representatives, to develop recommendations about further developing professional and ethical standards for financial advisers.

These are significant reforms intended to bring about real changes in the way financial advice is currently provided. Once implemented, it will be a priority for ASIC to identify and address any avoidance mechanisms that have the potential to undermine their positive effects.

4. The product approval process

The fourth area is the product approval process. Here, financial services providers are literally gatekeepers in that products would not reach retail clients without their support. They have an opportunity to help retail investors and consumers, for example, by scrutinising new products to see if they are likely to be suitable for their intended target market.

ASIC is currently considering whether there are systemic issues that might be addressed through industry-wide best practice standards. We are consulting directly with AFMA on achieving this.

5. Providing adequate compensation for retail investors and consumers

Finally, when things go wrong for investors and financial consumers through licensee misconduct, they often suffer losses and may require financial compensation.

Currently in Australia, the main compensation mechanism for consumers is professional indemnity (PI) insurance. However, PI insurance has some limitations as a compensation mechanism—for example, it is generally not available in cases of insolvency.

Where we can, ASIC will take action to recover compensation for investors in failed entities. However, this will not always be possible.

We recently commissioned research on the social impact for investors of not being fully compensated when they suffer financial loss because of a licensee's misconduct. Investors in the study group suffered both the immediate impacts of financial hardship, and persistent effects of anger and stress lasting well beyond the failure of their investments. The majority of these investors reported that they no longer had any confidence in the financial services system.

Importantly, the report found many investors weren't aware of their right to approach an external dispute resolution (EDR) scheme—often because the licensee, under financial pressure or even implicated in misconduct, failed to pass on this information to them. ASIC will continue to work with FOS to ensure we make investors and financial consumers aware of their rights when something goes wrong. Nevertheless, in many of these cases, the complete collapse of the product had meant that there were few funds left to compensate investors, even if they had been successful through EDR.

It is clear that uncompensated monetary loss as a result of licensee misconduct can lead to deep and lasting social impacts. We welcome the Government's recent consultation on the issue of a statutory compensation fund to step in where other compensation mechanisms have failed. We encourage you all to make a submission.

While the Government has responded through these important legislative reforms, we would also encourage those within industry to lead a debate about how gatekeepers themselves can take on more responsibility. Where they do so, there is also less need for regulatory intervention—self-regulation has an important role to play.

Consumer behaviour

The final aspect of promoting confident and informed investors and financial consumers is recognising how they make decisions, and ensuring communications about financial products facilitate effective decision-making.

This is particularly of concern in the case of complex products where these are marketed to retail investors. Retail investors can struggle to understand the structure and associated risks of such products, and often falsely conclude they are similar to more familiar methods of investing, such as trading directly in shares.

Receiving appropriate, professional financial advice can assist retail investors to make effective decisions; however, one thing we have learned through consumer research is that retail investors don't always seek this out. They are often motivated to think about investing after they see advertising. They often approach product issuers directly.

There is no one solution to this issue, but a combination of efforts is required, focusing on three main areas:

- best practice in advertising;
- effective communication of risks; and
- product suitability.

Best practice in advertising

An important part of this is good practice in advertising. As I mentioned, our experience has told us that advertising is a very active part of investors' and consumers' decision-making processes—often more so than formal disclosure documents.

We will shortly be consulting on best practice guidance for advertising financial products and services. Later on, we'll be consulting on a second document that deals with credit products and services.

These documents will provide very practical guidance about how the legal provisions relating to misleading and deceptive advertising apply in various situations, and what we think represents balanced and informative advertising. They will contain 'real world' examples, and we hope that they will be useful for all sectors of the industry, including product designers, advisers, and publishers of advertising.

We would like those preparing advertising to actively work to present a balanced understanding of the product or service, including its risks. It is also important they take into account the kind of audience likely to see the advertising, according to the medium they are using. They should ensure that advertising is not targeting an audience for which the product is unlikely to be suitable.

Our expectation is that the financial services industry will strive to do more than simply meet the minimum requirement of not being misleading or deceptive—they will actually take a role in ensuring that advertising helps investors and consumers to make decisions that are appropriate for them.

Effective communication on risks—'if not, why not' and new media

We also think that product issuers have a role to play in improving their communication to investors and consumers.

Part of this is improving formal disclosure documents. We have now used the 'if not, why not' model of disclosure for a number of products, including debentures and interests in mortgage schemes. The purpose of this approach is to:

- understand the issuer's business model;
- understand risks and stresses that might occur.

We ask issuers to state whether they undertake certain practices to mitigate risks and if not, why not.

However, communication about risks should not be limited to formal disclosure documents. Product issuers should consider harnessing new media, so that different investors and consumers can access the information in a way that best suits them. In this area, Scott Pape, creator of the Barefoot Investor website, provides a great example of how new media such as vodcasts and twitter can provide an engaging and useful way of providing financial information, and others could learn from this.

Of course, like advertising, this also requires care to ensure that information is clear, concise and effective, and does not target an audience for which the product is not likely to be suitable. ASIC would be happy to engage in a direct dialogue with industry on how this can best be done.

Product suitability for retail investors

We would also like to raise the question of whether issuers can do more to ensure products are not unsuitable for retail investors.

For example, one disclosure benchmark we have proposed for over-the-counter contracts for difference (OTC CFDs) is about ensuring investors are ready to trade. To meet the benchmark, OTC CFD issuers need to assess investors against a set of criteria that addresses their understanding of and experience with trading—for example, whether they understand the concepts of leverage and margins.

We are not asking issuers to step into the role of advisers and determine whether their product is appropriate for each investor. Nevertheless, issuers can play an important role in ensuring that only investors who have a sound understanding of the features and risks of the product can open an account and begin trading.

There are also benefits for issuers in carrying out some preliminary checks on prospective investors. Those investors who thoroughly understand the features and risks of the product are less likely to get into difficulties when trading. Complaints are less likely to make their way to FOS.

We know that FOS is particularly concerned about the issue of OTC CFDs, and highlighted this product in their Annual Review. We welcome the robust comments FOS has made on this issue. While we are currently pursuing options available to us under the current law to better regulate these products, should we feel that additional mechanisms are required in future, we will pursue these, including requests for law reform if necessary.

Clear guidelines for enforcement

So far, I have spoken to you about ways we can reduce the risk of things going wrong. Prevention is better than cure. However, the reality is that, while we would like to prevent things from going wrong, sometimes they do. Our enforcement activities will remain a cornerstone in delivering our key outcomes.

We also understand that sometimes things go wrong in compliance, despite good intentions. We know that those of you in industry would like us to engage in dialogue with those who are honestly trying to comply with the law, rather than always taking action first.

We acknowledge these concerns.

We are currently considering whether we should publish guidance on how we approach our compliance and deterrence role. However, this is not a straightforward issue and will need further thought. For example, this guidance would necessarily only provide an indication of how we might act, and every case is different. Would such high-level guidance actually be helpful?

One thing that I can say to you is that, when we are assessing misconduct, we will distinguish between businesses that are genuinely trying to comply with their obligations, and those that are not.

Among other things we will look at is the business's compliance systems. Are they robust, or lacking in substance? Is the incident a one-off or the sign of systemic problems? Having good compliance systems is fundamental to good practice in financial and credit services.

Conclusion

I think you can see from what I have talked about today, ASIC will continue to work hard to meet our priorities over the next few years:

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

However, as I have told you today, everyone involved in the financial services industry also has a role to play in assisting retail investors and financial consumers to get a fair deal.

Product issuers, gatekeepers and other licensees, and those responsible for preparing advertising should all look at what they can to meet their responsibilities.

And ASIC will also play whatever role we can to assist with this.

Thank you.