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Australian Securities & Investments Commission

Institutional self-regulation: what should be the role of the regulator?

An address by Jillian Segal, Deputy Chair of the Australian Securities and Investments Commission, to the National Institute for Governance Twilight Seminar, Canberra, 8 November 2001.

Introduction

Thank you for inviting me to join you today.

There is no doubt that the recent collapses of HIH, One.Tel, Harris Scarfe, and of course more recently Ansett, have refocussed the community's attention on issues of corporate governance, self-regulation and the role of the regulator.

Following the Wallis report in 1997, we have seen many changes to the Australian regulatory landscape. These not only include the establishment of ASIC and APRA, but the many changes to the Corporations Law (now known as the Corporations Act). In some cases, particularly in the area of fundraising, the shift has been away from prescription to relying on disclosure. In other areas, such as the Managed Investments regime, an emphasis has been placed on compliance systems. In one sense, these changes represent shifts to greater self-regulation within a framework oversighted by the regulator.

However, self-regulation is not without its difficulties. The widespread problems in the mortgage investment industry around Australia, which ASIC is currently

investigating, can be seen as an example of an industry where self-regulation through Law Societies and finance broking organisations did not produce a satisfactory outcome for investors.

You are all no doubt aware that, in August 1999, the Minister for Financial Services & Regulation, the Honourable Joe Hockey, established a Taskforce on Industry Self-Regulation in Consumer Markets, to inquire into and advise on aspects of self-regulation in Australia. The Taskforce was chaired by Professor Berna Collier, whom I am very pleased to say joined us on the 5th of November this year as a full-time member of ASIC.

The Taskforce reported to the Government in August 2000 following two rounds of consultation with business and consumer representatives around Australia, outlining the nature and extent of self-regulation in Australia. It set out good practice principles for self-regulatory schemes, many of which will be reflected in the features or conditions for successful self-regulation, which I will discuss a little later.

Today, I will cover ASIC's views on self-regulation in the financial services industry, and how we see our role as the corporate regulator in the present climate of corporate collapses and law reform. In discussing these issues, I will touch on some of our recent experiences, particularly in relation to FSR and the role of external dispute resolution schemes, corporate governance, disclosure, and the role of auditors – issues that are highly topical at the present time. I believe these issues are likely to become even more topical in the context of discussions about self-regulation into the future.

ASIC's views on self-regulation

One of the difficulties with an analysis of self-regulation is deciding on what the expression means. ASIC recognises that there is ongoing debate over the precise definitions of terms such as "self-regulation", "co-regulation", and "quasi-

regulation", as well as debate over where various forms of regulation fit in the regulatory spectrum. I do not intend to discuss such definitional issues today, except to say that the expression "self-regulation" is used by ASIC to refer to regulation where there is substantial industry-level involvement in the development or implementation of the regulation, and where the regulatory arrangement is adopted and funded by industry. Examples include:

- The regulation of the exchanges by ASX and SFE, which obviously is backed by ASIC regulation under the Corporations Act;
- Industry dispute resolution schemes such as the Australian Banking Industry Ombudsman;
- Codes of conduct such as the General Insurance Code of Practice; and
- Industry guidelines and practice notes such as the Australasian Investor Relations Association's (AIRA) *Best Practice Guidelines for Communication between Listed Entities and the Investment Community*.

Given this context, it is clear that a "one-size-fits-all" approach to self-regulation in the financial services industry would not be appropriate in light of the diversity of participants and regulatory issues in this industry, and given the rapidly changing nature of the industry. However, I would like to emphasise two points about self-regulation that, from a regulator's perspective, we see as critical.

- The first is that *for self-regulation to be effective, it needs to be properly integrated into the overall regulatory framework* – that is, it needs to dovetail with the law and the regulator's policies – not repeating or confusing requirements, but assisting and possibly extending them in some areas. As you would appreciate, the regulator relies on self-regulatory schemes to cover many day-to-day complaints and industry issues that it would otherwise not have the capacity to deal with. If self-regulatory schemes are inconsistent with the underlying principles of the overall regulatory framework, or do not operate within the parameters

clearly laid down by the law, then the fundamental purpose to be served by self-regulation may be defeated and consumer welfare may be compromised.

- The second, related, point is that *self-regulation must have vigorous and active accountability mechanisms*. The old-style model for self-regulation of "set and forget" is not viable going forward. If accountability is not in place, then the risk is not just that self-regulation will be ineffective, but that it may be harmful as industry and regulators devote resources elsewhere on the assumption that self-regulation is working. If this occurs, the existence of self-regulation would be counter-productive.

ASIC considers that mature industries are probably the most suitable for some dimension of self-regulation. There is general recognition that industry self-regulation can be more flexible and less costly for both business and consumers than direct government involvement. ASIC is of the view that industry self-regulation can play a valuable role in conjunction with legislation and other regulatory mechanisms. For example, ASIC believes that self-regulation can and should play an important "risk identification" role within the overall regulatory framework – the information generated under such a model, can help identify problem areas with industry practice, consumer knowledge, and government or regulator policies before they become bigger problems.

Effective self-regulation can also offer the following benefits:

- It utilises the expertise of the regulated;
- The consent of the regulated is more likely to be secured as it has the ability to enlist the support and input of stakeholders within the industry;
- It is particularly flexible and adaptable, therefore being most suited to monitor and deal with market and technical innovations – we have experienced this particularly in the e-commerce area where new developments, such as electronic payment systems and aggregation

services, are evolving rapidly and the only people who can constructively specify the parameters of effective regulation are the industry members themselves; and
- It offers consumers the benefits of economies of scale, which can be derived from collective monitoring by a self-regulatory scheme – a collective interest within the regulated industry is likely to ensure that minimum standards as well as public confidence are maintained, and that the potentially less scrupulous do not gain a "free-rider" advantage based upon the public's image of the regulated industry.

However, it also needs to be recognised that there are significant risks associated with industry self-regulation, including ineffective or inefficient regulation, and inadequate compliance monitoring and enforcement. Gaps and overlaps can emerge in the coverage of various products, services, sectors and industries.

The limitations of self-regulation include:

- It may lack credibility and public confidence;
- It may lack effective enforceability;
- It can prove to be anti-competitive in nature by creating inefficient barriers to entry;
- It can be subject to "regulatory capture" – that is, the danger that the industry comes to serve only the interests of the self-regulator;
- It may prove to be "fair-weather" regulation – in other words, regulation which is incapable of withstanding tough times, and which breaks down under stress such as when market conditions change, meaningful reforms are proposed, or conflicts of interest arise between the aims of industry members and self-regulatory objectives; and
- The "free-rider" problem – this may emerge when industry members choose not to join the self-regulatory scheme, or when industry members

join the self-regulatory scheme, but choose not to properly adhere to the agreed rules.

It is also important to ensure that self-regulation does not in itself become a burden to industry with onerous compliance costs, particularly for small businesses. In this regard, it is necessary to minimise the anti-competitive potential of industry self-regulatory schemes by ensuring that the barriers to entry that such regulation establishes are warranted, and do not stifle competition amongst industry participants.

In this environment, we consider that for self-regulation to be effective, certain key conditions usually need to be in place. These include:

- **A common industry interest** – industry self-regulation will only work effectively where there is a critical mass of common interest, but one that does not drive anti-competitive outcomes;
- **A viable industry association(s) or industry commitment** – for self-regulation to be effective, the industry association must be able to harness the common interest, enlist the support and input of other stakeholders such as relevant government agencies and consumer organisations, and manage the self-regulatory scheme. The industry association must also be capable of delivering sufficient resources to support the self-regulatory scheme, and effective compliance and enforcement mechanisms;
- **Wide industry coverage** – one of the basic lessons from self-regulation in Australia and abroad is that full industry coverage makes for more effective self-regulation. This may be easier to achieve in an industry with fewer and larger organisations, as the problem of "free riders" is less apparent;
- **A competitive market** – self-regulation is more likely to be effective in a competitive market as it will lessen the risk of such regulation becoming an anti-competitive structure;

- **Clear objectives developed with stakeholders –** the self-regulatory scheme should be developed in partnership between industry, the regulator and consumer organisations;
- **Promotion and review** – the self-regulatory scheme should be properly promoted (this ensures that customers are aware of the existence of the scheme and the mechanisms for lodging inquiries or complaints). To remain flexible, the self-regulatory scheme should also be regularly and independently reviewed for efficiency and effectiveness. This should involve input from all stakeholders.

I have already mentioned the final two conditions:

- **Integration into the regulatory framework** – the scheme should operate clearly and harmoniously with the law, the regulator's policies and with other self-regulatory schemes. That is, it should complement other forms of regulation in the industry;
- **Accountability, compliance and enforcement** – the self-regulatory scheme must encompass effective accountability and governance, it must have effective compliance monitoring and enforcement mechanisms, be underpinned by efficient dispute resolution processes, and ensure adequate education of scheme members regarding their obligations.

The Taskforce recognised that self-regulation may not be appropriate in all circumstances, and that other forms of regulation may provide more cost effective outcomes in certain cases. As well, community cynicism regarding industry regulating itself may lead to a distrust of self-regulatory schemes unless such schemes operate effectively and consumers have confidence in them.

As with other forms of regulation, market developments and other changes in the industry environment can affect the conditions underpinning effective self-regulation. For example, if industry's common interest changes over time then

self-regulation may break down or become counter-productive, in which case other forms of regulation may be more appropriate.

In summary, self-regulation offers significant benefits. However, these benefits are not automatic. The self-regulatory scheme needs to be assessed, not in isolation, but using similar criteria to other forms of regulation. The elements for its success – such as accountability, enforceability, coverage, clarity & flexibility – are similar to criteria used for assessing other forms of regulation.

What should be the role of the regulator in an era of corporate and institutional self-regulation ?

Let me now turn to what we think ought to be the role of the regulator in the context of corporate and institutional self-regulation.

I believe that the regulator needs to work with self-regulatory schemes to ensure that self-regulation works effectively. As I mentioned earlier, ASIC relies on self-regulatory schemes to cover many day-to-day complaints and industry issues that it would otherwise not have the capacity to deal with. To give an example, the three biggest external dispute resolution schemes in the finance sector handle many thousands of queries and complaints each year that ASIC is not equipped to deal with. Nevertheless, we need the co-operation of such schemes to report systemic problems to us so as to ensure that they do not work in isolation, but help ensure the system as a whole is effective – for example, if one of ASIC's policies is not being complied with, this may show up in complaints to an external dispute resolution scheme. It is essential that the loop is closed and ASIC is informed of the non-compliance.

It is therefore essential that the regulator have the capacity to work with industry and consumer organisations to produce effective self-regulation. Some examples of work ASIC has done (or may do in the future) in this area include:

- Assisting in the process of developing schemes – for example, the Electronic Funds Transfer Code of Conduct (EFT Code) and submissions on the Banking Code – this includes providing information and advice designed to ensure that the schemes are properly integrated into the regulatory framework, that they operate harmoniously with each other and that they address relevant regulatory issues;
- Approving codes of practice under the FSR legislation;
- Approving complaint resolution schemes at present and under the FSR legislation; and
- In some cases, monitoring compliance with the code.

Importantly, the regulator must also be capable of timely intervention where self-regulation is not working.

FSR and the role of ADR schemes & Codes

Let me now turn to FSR and the role of ADR schemes & Codes.

You are all no doubt aware of the passage of the Financial Services Reform Bill through the Senate on the 23rd of August this year, which is now scheduled to commence on 11 March 2002. This legislation probably represents the most significant corporate law reform experienced by the financial services sector in Australia – it provides a new regime for the regulation of financial products and services, and aims to enhance consumer protection by ensuring financial safety and market integrity.

A key requirement under this legislation is for all licensees who deal with retail clients to belong to ASIC approved dispute resolution schemes. We see this as a very positive step forward for consumers, and also as recognition of the significance of these industry schemes in the regulatory landscape. It is in effect an acknowledgement that such schemes, the oldest of which was set up barely a

decade ago, have become a key feature of life in the financial services market and a key consumer protection safeguard.
ASIC has set out an approval policy for such schemes that ensures appropriate dispute resolution standards and also takes into account legitimate differences across the finance sector.

Codes, on the other hand, are not mandatory under FSR. This reflects the desire to allow appropriate flexibility in the ways in which industry players meet their obligations under FSR. Some may see Codes as playing a useful role in helping to meet FSR requirements, others may look to other mechanisms such as ASIC's own policy statements. ASIC has the power to approve Codes, and in doing so we will have a clearer picture as to which Codes will serve a regulatory role under FSR and what this role might cover.

ASIC envisages Codes primarily as a means of "fleshing out" existing, but perhaps uncertain, legislative obligations and establishing guidelines for "best practice". Merely "restating" the law is not a good role for Codes. A Code (mandatory or non-mandatory) can provide industry participants with a "template" for conduct or guidelines for "best practice", which the regulator and the industry may regard as adequate and reasonable compliance with the law. In that way, the Code can remove uncertainties about what will be adequate compliance, and can therefore facilitate business.

However, Codes are not always the most appropriate response to a problem and even where they may be appropriate, they need to meet the criteria I have set out previously, including broad industry coverage and support, transparency, accountability and enforceability.

It is interesting to speculate that the future of Codes may rest with more "functionally" based schemes than those purely based on the membership of one industry. The EFT Code is a good example of this – it is a self-regulatory

mechanism with coverage across several industries that is based on the activity in question rather than traditional industry boundaries.

Disclosure

Let me now turn to disclosure.

Corporate financial disclosure and continuous disclosure have been key priorities for ASIC over the last 12 months. Over this period, ASIC has had to intervene on issues of disclosure too often and our focus on disclosure will need to continue.

My view is that we are still fighting the war on "disclosure". I believe the problem is that prompt disclosure is not an integral part of our corporate culture. Many companies seek to avoid disclosure unless they receive legal advice that it is absolutely required.

To improve disclosure, we need to appreciate that unless investors have confidence in the integrity of the market, we will have difficulties in attracting and maintaining investor support for our markets. We need to address the underlying attitudes towards disclosure, and above all, we need a commitment from all market participants towards changing those attitudes and developing a "culture" of voluntary disclosure and compliance, supported by effective regulatory sanctions against those who offend. Self-regulation has a role to play in this picture.

ASIC has worked hard over the last 18 months to improve disclosure practices and promote investor confidence. For example, the *"Heard it on the Grapevine"* discussion paper and resulting better disclosure principles (released in August 2000) suggest principles that companies should comply with in order to ensure equal investor access to information and to promote better communication between listed companies and investors. While I would not wish to comment on

any particular matter in detail here, I do believe that these principles are now quite well known and investor concern has now focussed on ensuring equal access to information as there is a much stronger focus by the investor, the media and ASX on market disclosure obligations and particularly on selective analyst briefings.

A number of other industry bodies have also recently published similar guides following the release of our principles. As I mentioned earlier, AIRA, for example, recently released its *Best Practice Guidelines for Communication between Listed Entities and the Investment Community* (2 August 2001) designed to enhance communication standards, assist compliance and improve the equality of access to information. AIRA's best practice guidelines cover areas such as disclosure policies, the roles and responsibilities of a listed entity's communications officer, authorised spokespersons, recommendations regarding the dissemination of announcements, one-on-one meetings with investors and broking analysts, group briefings, conference calls, web-based communications, analyst reports and forecasts, broker-sponsored investor conferences, trading halts and dealing with the media. This is an example of self-regulation that we will be following with interest.

ASIC encourages industry associations to co-ordinate their views and self-regulatory guidelines on good disclosure practices, and provide meaningful assistance to corporations.

Corporate governance more generally

While disclosure is an important aspect of corporate governance, and very often a reflection of the culture of compliance of the corporation, the focus more recently has been on the more general aspects of corporate governance.

Last week, I delivered a speech at a conference convened by the Australian Institute of Company Directors on "Governance & Disclosure". As you can

imagine, the recent corporate collapses figured prominently in each and every one of those speeches.

As we have seen, when a company collapses, the perception amongst the public is that there has been a breach of the law. While each year we experience approximately 7000 corporate collapses, increasingly significant collapses are being referred to the corporate watchdog, and it is fair to say that a number of major collapses recently have directly affected many Mums and Dads – air travel, communications and insurance products are all utilised by the average household.

Clearly, these types of failures have a significant impact on the level of confidence that investors have in our markets. It is not surprising, therefore, to read about calls by some sectors of the community for some form of regulatory intervention. It is interesting to note that some of the speakers at the AICD conference warned against the danger of more prescription and regulatory intervention in responding to the collapses of the past year. While we agree that there should not be unnecessary intrusion into the market, public sentiment is such that we need to undertake mechanisms to enhance consumer and business confidence. Naturally, we appreciate the community's concerns and believe that the need for investor protection means there is strong public interest in some form of response from the regulator.

ASIC has repeatedly acknowledged that the best governed of companies can still succumb to competitive and economic forces, and that corporate failure does not *necessarily* imply poor standards of governance. In fact, generally, our standards of corporate governance have been regarded as a benchmark by many of our trading partners. Having said that, it is important not to be complacent about governance. We must continue to be vigilant in identifying problems and seeking to improve the integrity of our corporate environment.

In this regard, I think we should give close consideration to issues of director training. Training is often at the heart of industry self-regulatory schemes, and is the most obvious example of an industry led "barrier to entry" that can actually improve market outcomes. It is rather ironic that we spend large amounts of money (not to mention time) in developing and training our staff, yet we spend very little on similar programs for those who are in control of our corporations. As I stated at the AICD conference, I believe more consideration needs to be given to board training and assessment, ideally by companies themselves, but there is also scope for industry groups to play an active role in this area. ASX guidance or other industry standards, as self-regulatory mechanisms, may be the appropriate machinery to encourage such training. In this way, the essential element of compliance and enforceability may be built into this area of self-regulation.

Another issue related to board/committee structures and roles, as well as policies/ procedures, relates to audit. The question of audit independence is a key issue in governance debates at present.

The role of auditors and audit independence

There is no doubt that the recent events surrounding the collapse of high profile companies have refocussed our attention on the role and performance of auditors. As you would be aware, Professor Ian Ramsay's report on audit independence was released only a few weeks ago into the public arena. This report is an important contribution to the current debate within the community about how we can enhance standards within the profession and reform audit practices. Issues of international guidance and standards in this area, as well as oversight of Audit Committees by an industry regulatory body such as an Audit Supervisory Board, are raised by Professor Ramsay and deserve very careful attention. Some of these suggestions combine elements of self-regulation with a regulatory framework. ASIC is also in the process of conducting a survey of Australia's top 100 companies in order to derive better information about current audit practices

and other related work. We hope to be able to release this information shortly and contribute further factual data to inform the debate.

I should point out that while we acknowledge the importance of an "independent" audit, we do not believe that "audit independence" is the only issue of relevance.

There appears to be some uncertainty within the community about what exactly an auditor is expected to do. Consequently, I believe the debate about audit reform needs to be approached from a broader perspective, namely one that seeks to enhance not only audit independence, but also the community's understanding of, and expectations from, the auditing profession. Investors need to ask themselves how rigorous and investigative they want corporate audits to be and, most importantly, what they are prepared to pay for them.

Audit cost is certainly a key issue, which needs to be reconsidered. Businesses appear to be placing less value on an audit and are less willing to expend resources on it while, at the same time, investors appear to be placing greater reliance on the "checking" process of audit. We believe this "gap in expectations" is a key issue that needs to be debated.

Conclusion

Let me conclude by saying that while we support self-regulation in financial services markets, we think it needs to meet certain core criteria to work well. If effective, it offers benefits to industry and consumers, but it must be consistent with the overall regulatory framework and accountability must be strong.

Communication is critical in this context. Good regulatory outcomes, whether legislated or self-regulatory, depends on the government, industry and consumers being prepared to communicate and thus adapt the regulatory structure.