



ASIC

Australian Securities & Investments Commission

Developments in the global regulatory system

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Introduction

Thank you for inviting me to address you tonight on developments in the global regulatory system.

It's lucky you've chosen an international topic for this short address! And that you didn't pick things like proposed reforms in super and financial advice and the prospect of competition for trading services. Unfortunately I couldn't cover those. As you may know, there's a federal election afoot. Such discussions (because of the caretaker conventions) are on hold (at least at my level) until the election has been decided.

But there is still plenty to talk about, especially what is happening on the international front. In many ways these issues are as important as what's happening here at home. They will, for example, have a direct impact on how Australian financial institutions operate overseas.

Financial Services Council (FSC)

Before I begin, may I congratulate the FSC on its new name and its expanded mandate. In July, the FSC announced that it would engage more actively on a broader range of issues, including economic policy in Australia. It did this—in part—in recognition of the growing importance of our financial services sector and its contribution to the economic future of this country.

Under this new mandate, we at ASIC look forward to a continued productive relationship with the FSC on policy and regulatory issues.

Background

Let me now move on to my topic.

Much has changed on the international regulatory front since the global financial crisis (GFC). Tonight I'd like to give you some background on these international developments and talk briefly and in general terms about what those changes might mean for Australia, particularly in the area of securities and investments regulation (which, of course, is within ASIC's mandate).

As the GFC was truly global in scope, it is important that the world's financial regulators should work together to see that it doesn't happen again. And it is also important for ASIC (with Treasury) to play a role with regulators in other jurisdictions in ensuring that responses are measured and reach the right balance between the protection of investors and maintaining the efficiency of our financial markets.

We continue to play a major role in the development of better regulatory measures through forums including the International Organization of Securities Commissions (IOSCO), the Financial Stability Board (FSB) and the Joint Forum. Our role is not just as members, but we are on the main committees and the key working groups of IOSCO. We chair the Joint Forum and we are joint chair of the IOSCO Task Force on Unregulated Markets and Products.

Our collaborative work through these groups has helped inform our approach to domestic regulatory issues. We do that with direct input to Treasury which is the Government's policy adviser in these areas.

Let me recap briefly on the work going on internationally.

IOSCO has focused on improving the regulation of markets, entities and activities that will contribute to global recovery: securitisation, hedge funds, credit ratings agencies (CRAs), over-the-counter (OTC) derivatives, and dealing with systemic risk in securities markets.

IOSCO's work has looked at how strengthened regulation can help to restore confidence in each of these areas. The guidance that it's developed has focused on increasing transparency (to both markets and regulators) and improving how risks are managed.

FSB: The Financial Stability Board oversees what standard-setters are doing on financial stability and provides guidance to the G20 on those issues. It is looking at ways of addressing the risks posed by systemically important institutions, building a resilient infrastructure for OTC markets, and designing approaches to monitoring and more broadly addressing systemic risk institutions.

The Basel Committee is looking hard at how to reduce risks posed by the banking sector. It is working to strengthen bank capital and liquidity standards.

The Joint Forum is a committee which I currently chair and which does work for the Basel Committee, IOSCO and the International Association of Insurance Supervisors (IAIS) on cross-sectoral matters. It is looking at a range of issues, including developing guidance about how financial conglomerates should be supervised to avoid a repetition of some of the high-profile collapses during the GFC.

IASB (International Accounting Standards Board): At the same time, progress is being made by the IASB and FASB on convergence in international accounting standards.

G20: Australia has been an energetic G20 participant. The Group (representation on which is at Finance Minister and Head of State level) is

keenly interested in better regulation and is looking forward to a progress report on many of these proposals at its November Summit in Seoul. The Seoul meeting will be crucial to setting the global reform agenda for a long time to come. A number of significant proposals (e.g. those of the FSB) will be debated and agreed at Seoul.

What does all this mean for Australia?

Let me now look more specifically at what all this means for Australia.

My focus in the time available will be on international regulatory reforms in the securities and investments area—that is, essentially the work done by IOSCO (as APRA and RBA have responsibility for the prudential areas covered by the IAIS, FSB and Basel). I want to make three points.

Point 1: What has been implemented so far in Australia has improved transparency and accountability.

The two examples are in the areas of short selling and credit ratings agencies.

- **Short selling:** Short selling was seen by many as having contributed to financial market instability during the GFC and was restricted or banned in many developed countries. Australia in late 2008 banned naked short selling and for covered short selling we provided a ‘circuit breaker’ (banning) for a period which was progressively removed as market confidence improved. The Government followed this action with new rules for the reporting of short sale transactions and of short positions, and continued the ban on naked short selling with limited exceptions (e.g. a short sale resulting from the exercise of exchange-traded options).
- **CRAs:** The GFC also highlighted issues with the use and quality of ratings issued by credit rating agencies. In Australia, CRAs have been required to hold an Australian financial services (AFS) licence since the beginning of this year and to comply with the IOSCO Code of Conduct for CRAs since last month. This is a crucial step forward in restoring confidence in the ratings process. CRAs that provide financial services to retail clients, like other AFS licence holders, need to have an internal dispute resolution procedure and be part of an external dispute resolution scheme (administered by FOS). From a policy perspective, it is important that retail investors have the same recourse against CRAs (in resolving disputes) as they have from other licensed providers.

To date, these are the main areas in the securities and investments markets where reform in Australia has followed reform being considered at an international level. Other proposed reforms such as the Government's response (prior to the election) in relation to financial advisers is more a response to the domestic issues which, while connected, were not a direct result of the GFC or of international regulatory developments.

Point 2: Potential changes which are known and in the pipeline will, if adopted by Government, lead to change more at the margins than in fundamental respects.

It is fair to say that the international regulatory agenda is still developing. However in relation to those proposed changes that we know of, the implications for Australia (if adopted) should not lead to significant regulatory changes.

The proposed regulation of securitisation and hedge funds and developments in derivatives are three key examples.

- **Securitisation:** In September 2009, IOSCO released principles which go to things such as 'skin in the game' and improved disclosure for investors. ASIC (with Treasury and APRA) continues to work with industry to determine whether and to what extent retention requirements and disclosure standards for securitisation may be appropriate to our markets. In the United States and Europe, a 5% skin in the game requirement is being introduced (on the 'buy' side in Europe and on the 'sell' side in the United States).

What we are seeing in securitisation is that the proposed IOSCO regulatory changes should enable investors to better assess (through greater transparency) creditworthiness and credit risk. Commercially, investor attraction and investment in these products is more complex than that—just how investors assess the risk/reward premium and create new demand for these markets remains unclear.

- **Hedge funds:** IOSCO has also recommended high-level principles for the supervision of hedge funds, including the monitoring of hedge funds and their counterparties to detect systemic risks.

Hedge funds provide benefits to financial markets (e.g. market liquidity and risk distribution), but for regulators they pose two key risks: leverage or credit risk, which can systemically impact on banks, and market risk, which, with aggressive sell-downs, can impact on confidence in securities markets. IOSCO has adopted six principles and other bodies (e.g. the FSB) are assessing the systemic issues.

The impact of these changes in Australia is being assessed by ASIC and Treasury but, subject to a constructive level of cooperation by Australian hedge funds, they are unlikely to result in significant changes domestically. The relatively small size of Australia's hedge fund industry is unlikely to have systemic implications and a significant number of the IOSCO principles are already embodied in our MIS (managed investment scheme) legislation.

- **Derivatives:** In the area of OTC derivatives (credit default swaps and so on), the G20 and IOSCO and other bodies are moving towards:
 - pushing the clearing of OTC derivatives trades through a central counterparty (CCP) where possible;
 - encouraging exchange-trading of derivatives;
 - higher capital requirements for non-centrally cleared contracts.

In Australia, the initial response through APRA, ASIC and RBA has been to encourage the use of trade repositories for OTC derivatives. This will provide important information to the regulators. Just how we respond to the international developments is still under discussion, although one would envisage Australian participants making use of CCPs and exchange-traded markets which develop internationally.

So you can see that these other 'known' changes will need to be assessed and policy decisions made. Even if made along the lines IOSCO has suggested (which is a matter for Government) they do not go to significant reform in Australia.

Point 3: A number of other issues are being discussed internationally which—should they turn into IOSCO proposals—could have a more significant impact on the Australian markets if they are adopted by Government.

Let me expand on this.

IOSCO's work in the last two years has been about responding to the immediate issues flagged by the GFC. That has led to the proposals which I have just covered. However, work is now turning to whether more fundamental reform is needed. Let me outline two such issues that IOSCO is beginning to debate:

- **Suitability duty:** The first is whether retail investors should not be allowed to invest in complex retail investment products and whether a 'suitability duty', if you like, should be imposed on product manufacturers. In theory, the aim of a suitability duty would be to curb

the sale of highly sophisticated or risky financial products to unsophisticated investors and, in effect, prevent retail investors from getting in over their heads.

I recently canvassed this issue in an opinion piece in *The Age*. As I said in that article, there is a significant public policy issue—the extent to which retail investors should be protected.

- **Point of sale disclosure:** The second issue to mention is the distinction between the sophisticated and unsophisticated investor. We have this distinction in our law. What has highlighted this as an issue is that most of the losses from the GFC were at the wholesale or ‘sophisticated’ level. For example, the IOSCO recommendations on securitisation are as much aimed at the wholesale level as the retail level. A question IOSCO is assessing is whether the distinction should be maintained or changed.

What about the impact on Australia from legislative changes in other jurisdictions?

Aside from these issues, we also need to examine what is actually being implemented in other markets and how those changes can impact on Australia and its global capital flows. Much of the push of international bodies is ‘principles-based’. The devil is in the detail of what is implemented.

Last month, for instance, US President Obama signed the Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 into law. The Act makes sweeping changes in a number of areas, including regulatory architecture and the regulation of banks, credit ratings agencies, hedge funds and OTC derivatives markets. The detail of these changes will be worked through by regulators in coming months as they draft over 300 sets of rules.

In Europe, tough measures have been agreed on to regulate CRAs. Tougher regulation is also proposed for hedge funds and OTC derivatives markets.

We will need to understand the impact these different approaches may have for Australian businesses operating in other markets. We will also need to assess the arbitrage risks to our markets that may arise from these differences. Let me give two examples.

- **CRAs in the EU:** There is a concern, for example, that the EU’s approach to the regulation of CRAs could be an issue for firms using ratings by Australian-licensed CRAs to market products and raise funds in Europe. From 1 June 2011, ratings issued by Australian-licensed

CRA's will only be accepted for use in the EU if the European Commission determines that Australian CRA regulation is equivalent to the EU's CRA regulation. An assessment of Australia's CRA regulatory regime is under way, with the Committee of European Securities Regulators (CESR) expected to provide its advice on equivalence later this year.

- **Derivatives in the US:** The move in the United States towards the clearing of OTC derivative transactions by central counterparties (CCPs) or the reporting of OTC trades to trade repositories could also have implications for Australian counterparties in the near future. At present there are no Australian CCPs centrally clearing OTC derivatives, and it is unclear whether Australian counterparties will be able to meet entry and ongoing requirements to participate in offshore CCPs. Whether and how the Dodd–Frank requirements in the United States will apply to Australian market participants will be an issue. This will be made clearer when the SEC and CFTC develop the supporting rules over the next 12 to 18 months.

ASIC (with Treasury) is carefully reviewing these developments.

Further potential impact—absence of underlying philosophy

In addition, we are now seeing the start (which ASIC has been at the forefront of encouraging) of a re-think of the fundamental underpinning of the international regulatory framework. Why do we need that? For the simple reason of making sure that we do not overreact to the immediate problems. It is a way of checking that we maintain the proper balance between investor protection and efficiency and innovation of our financial markets which are so important to economic prosperity.

Let me expand:

Much of the economic underpinning to regulation in the last 20 to 30 years has come from the theories around the 'Efficient Markets Hypothesis'. In Australia this is seen in the work of the Wallis Inquiry, whose recommendations underpin much of the Corporations Act. Overseas you have concepts of 'principles-based' regulation, 'light-touch' regulation and so on. Essentially, let the markets operate, with rules around disclosure and intervention only to prohibit certain unfair practices (e.g. insider trading).

The GFC has highlighted that a number of assumptions in these theories need to be retested or assessed more closely. For example, it may well be that, contrary to conventional wisdom:

- markets don't self correct;

- market participants are not necessarily individually or collectively rational—all participants, both retail and professional/wholesale, act with biases and we've learned that professional investors can make as many mistakes as retail investors;
- disclosure may not be adequate in overcoming information asymmetries and conflicts of interest;
- we cannot always rely on gatekeepers.

We would benefit from a fundamental re-think of the conceptual framework and operational assumptions that should be applied to post-GFC securities regulation. This is necessary both to avoid such a crisis occurring again and to ensure our post-GFC actions are effective on a global scale.

Work to re-test these assumptions also has a more immediate impact. It enables us to test the economic and market impact of the changes currently being implemented in the United States and Europe. These will provide (because of the size of those markets) an important guide to regulation in other markets.

ASIC has worked to set up an IOSCO working group on systemic risk to pursue this re-thinking. Our Chief Economist has prepared and published an important paper on the role of the regulator which is on our website and has been very well received overseas.

Conclusion

I hope this gives you a good idea of some of the international developments in securities and investments regulation. As you can see, there is a lot happening at the international level as countries strive to 'right the ship' after the GFC.

From an Australian perspective, we have fared better than most and the changes we have adopted to date have resulted in greater transparency and accountability. Other possible changes are at different stages of development, although at first review they should not involve significant change (if adopted).

Increasingly global markets, though, mean there is a greater need than ever before to monitor developments in other jurisdictions, and there are some areas of concern emerging in the way the United States and Europe are implementing these reforms. ASIC is active in this space. And we will continue to be an important player at this critical time of reassessment and change in securities and investments regulation here and abroad.

Thank you.