ASIC

Australian Securities & Investments Commission

Our markets: A regulatory update

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Australian Securities and Investments Commission

G100 dinner

24 September 2014

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Introduction

Good evening and thank you very much for inviting me to speak today. Today I will focus on just a few of the key areas of our current work that I hope will be of interest to you, namely:

- the deregulation work currently being undertaken by ASIC;
- our surveillance work in both the financial reporting and audit areas;
- our report on the handling of confidential, market-sensitive information; and
- some key observations about ASIC's submissions to some recent inquiries.

Deregulation work

We are continuing to work towards reducing the compliance burden of individuals and businesses to support the Government's $1 billion red-tape reduction target. Measures that we have implemented between September 2013 and now have resulted in annual compliance cost savings of tens of millions of dollars.

Examples of our work that have delivered compliance cost savings include:

- providing waivers or relief from the law where there is a net regulatory benefit in doing so;
- promoting recognition of Australian laws to allow substituted compliance for international requirements that would otherwise apply to Australian businesses;
- engaging with our stakeholders to improve our guidance and communication, including the launch of a new online hub for small business;
- updating of the application process for Australian financial services licences; and
- simplifying business names registration.

In April, we published Report 391 *ASIC's deregulatory initiatives* (REP 391), which outlined some additional areas we plan to work on to further reduce the regulatory burden on individuals and businesses. These include:

- streamlining ASIC forms;

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- discussing some possible legislative changes with Treasury, informed by the views of our stakeholders;
- removing barriers that inhibit innovation in disclosure;
- harmonising ASIC market integrity rules;
- improvements to auditor resignation requirements to allow more flexibility for public companies; and
- strengthening our engagement and communication with our regulated population.

We received a number of submissions on the report—many of these also proposed additional deregulatory ideas, which we are in the process of examining. We are particularly grateful to the G100 for its submission on this topic.

Most relevant to the G100, we believe that consideration could be given to several opportunities to simplify financial reporting and audit requirements. Briefly, the main areas that we have identified are:

- *Moving ASIC's relief for wholly owned subsidiaries into the Corporations Act*

  We provide relief from the requirement for companies to prepare and lodge financial reports if:

  – they are the wholly owned subsidiaries of another company that lodges consolidated financial reports;

  – the companies enter into deeds of cross-guarantee; and

  – certain other conditions are met.

  While this relief provides a substantial compliance cost saving to those entities that rely on it, the use of deeds means that the relief provided in our class order is complex. This complexity could be reduced by incorporating the relief directly into the Corporations Act and making changes to the insolvency provisions of the Act to remove the need for deeds of cross-guarantee.

- *Simplifying the requirements for reporting by proprietary companies and public companies that are not disclosing entities*

  There may be opportunities to rationalise and simplify the relevant criteria for the preparation, lodgement, accounting standards and audits for these proprietary companies and public companies that are not disclosing entities. This may involve increasing size tests and could be relevant to companies in large groups. Further research would need to be undertaken to ascertain the impact of any changes on different groups of companies.

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- *Ability to move detailed remuneration reports to a separate document*

  It may be appropriate to consider allowing companies to include summary remuneration information in annual reports and cross refer to a separate document containing the remaining remuneration information. That document could be lodged with ASIC and made available on the company website.

- *Streamlining the processes for resignation of auditors*

  We intend to release a revised regulatory guide concerning the resignation of auditors before the end of 2014.

  Our current policy is to consent to the resignation of an auditor at the next annual general meeting, unless there are exceptional circumstances. We will change this policy so that auditors may resign at any time, unless there is some evidence (such as disagreements with management over accounting treatments) to suggest that we should not give consent to the resignation. Consent would be conditional on market disclosures about the details of both the resigning and incoming auditor, and the reason for the change.

  This would more closely align with the approach in the United States and would allow more flexibility for public companies.

While it is not an ASIC initiative, we also welcome various industry measures to address some of the concerns about the complexity of financial reports, such as the preparation of 'streamlined' financial reports.

Streamlining involves:

- reordering the notes to the financial report, including relocating accounting policy notes with the relevant balance sheet and income statement notes, and giving more prominence to the more important disclosures for the company;
- removing any duplicate material and outdated material; and
- removing any immaterial information.

We believe that these are positive initiatives and we will be interested in feedback from investors and other users of financial reports on the new format.

Financial reporting surveillance

Of course, as well as facilitating business, ASIC has an equally important role in enforcing the law. Our work in undertaking financial reporting, audit and other surveillance—such as around the handling of confidential information—is an example of that.

ASIC's proactive reviews of the financial reports of listed entities and other public interest entities continue to identify matters such as inadequate impairment of assets and inappropriate accounting treatments.

Our risk-based surveillances have led to material changes to 4% of the financial reports previously reviewed for reporting periods ended 30 June 2010 to 30 June 2013.

From July 1 this year, ASIC has commenced publicly announcing when, following contact by us, a company makes material changes to information previously provided to the market. As a result, directors and auditors of other companies will be more aware of ASIC's concerns and hopefully can avoid similar issues.

ASIC's audit inspection findings

In June 2014 we issued our most recent ASIC audit inspection program report, covering the results of audit firm inspections completed in the 18 months to 31 December 2013.[1]

The report noted that, while audit firms had made good efforts to improve audit quality, these efforts were yet to be reflected in our risk-based inspection findings.

During 2013, ASIC welcomed the response of the largest six audit firms to our request to prepare action plans to improve audit quality and the consistency of audit execution.

In our view, in 20% of the 454 key audit areas that we reviewed on a risk basis of over 107 audit files of firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 18% for the previous 18-month period.

While the overall level of findings has not yet improved, the largest six audit firms only finalised action plans to improve audit quality for 30 June 2013 year ends, and these plans are yet to have full effect.

Our findings do not necessarily mean that the relevant financial reports audited were materially misstated. Rather, in our view the auditor did not have a sufficient basis to support their opinion on the financial report.

We have identified three broad areas requiring improvement by audit firms:

[1] Report 397 *Audit inspection program report for 2012–13* (REP 397).

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- appropriate reliance on the work of other auditors and experts.

Many of ASIC's findings related to accounting estimates (including impairment of assets) and accounting policy choices.

As well as working with the firms, we are also working with other audit oversight regulators and securities regulators internationally on strategies to improve firm audit quality. We have also suggested improvements to the auditing standards and made suggestions to the professional accounting bodies concerning their quality review and training programs.

We also issued Information Sheet 196 *Audit quality: The role of directors and audit committees* (INFO 196) earlier this year to assist directors and audit committees in their role in supporting audit quality in areas such as the appointment of auditors, setting fees and ongoing assessment of audit quality. We encourage audit committee chairs to ask their auditors for the findings from ASIC audit firm inspections relating to the audit of their companies.

Confidential information report

Another area of focus in 2014 is our continuing work on the handling of confidential, market-sensitive information by listed companies.

In May this year, we released a report on the handling of confidential information.[2] This report details ASIC's review of the challenges faced by listed entities, analysts and advisers when handling confidential, market-sensitive information in the context of briefings and during corporate transactions. The report also makes recommendations for listed entities and their advisers.

We consider that analyst and investor briefings can be a key risk area for selective disclosure of market-sensitive information. Selective disclosure may sometimes occur—despite the listed entity having well-documented policies on how to conduct briefings and interact with analysts and institutional investors—because these policies are not fully understood or followed. So it is vital that key officers are properly trained about their continuous disclosure responsibilities, and that listed entities try to make access to briefings as broad as possible to help avoid breaches of the law.

[2] Report 393 *Handling of confidential information: Briefings and unannounced corporate transactions* (REP 393).

In relation to unannounced corporate transactions, our review found that most of the listed entities at the smaller end of the market rely heavily on advisers to determine how to handle confidential, market-sensitive information about a transaction like a capital raising. Delegation of responsibility to third parties in this area has risks.

For example, we were concerned by the timing and number of soundings conducted before the announcement of the capital raising, or before a trading halt had been requested. Soundings can be a significant risk area for leaks and insider trading. Advisers and listed entities should have frank discussions about the conduct of soundings and also use trading halts to manage the information leakage risks that soundings create.

Going forward, we are undertaking a targeted review in relation to briefings of sell-side analysts, by looking at the kind of information analysts have access to immediately prior to a material change in their reports.

We will also continue enforcement action against insider trading, and against listed entities that fail to comply with their continuous disclosure obligations.

Financial System Inquiry and Senate inquiry

Finally, I wanted to address a number of issues we have raised in the context of recent inquiries relevant to ASIC and the broader financial system.

Two key issues that I wanted to mention are:

- ASIC's approach to regulation and our regulatory toolkit; and
- ASIC's views on self-regulation and co-regulation.

ASIC's approach to regulation and our regulatory toolkit

Historically, the economic philosophy that underpins Australia's financial regulatory regime is that markets drive efficiency, and they operate most efficiently when there is minimal regulatory intervention.

However, we have all witnessed the harm caused by assumptions that all investors and financial consumers will always act rationally. For example, our experience shows that disclosure is not the disinfectant it was once thought to be. In many instances of financial failure, consumers:

- did not understand the level of risk they were taking on;
- thought they were bearing lower risks than the actual risks of the product or strategy; and
- ended up bearing more risk than they could manage.

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Many regulators around the world are now looking to behavioural science to better understand how investors really behave. People are prone to significant and systematic behavioural biases. Specific attributes of financial products—such as their complexity, risk, uncertainty and long-term nature—can also accentuate people's natural inclination to rely on their behavioural biases.

Appreciation of these behavioural considerations provides opportunities to design regulatory tools that take into account consumer behaviour and decision making, and that allow regulators to target market-improving actions.

Although disclosure is necessary for arming investors and financial consumers with key information to guide decision making, the limitations of disclosure mean that it alone has not always been sufficient to enable consumers to make informed decisions and purchase products and services that meet their needs.

Internationally, regulators are moving beyond traditional conduct and disclosure regulation towards regulatory tools that can better address the problems investors and financial consumers experience in financial markets. For example, in the United Kingdom, the Financial Conduct Authority (FCA) has a spectrum of 'product intervention' powers that enables it to address problems seen in specific products.

Similarly, there may be opportunities in Australia to broaden the regulatory toolkit available to regulators to address the types of problems investors and financial consumers experience in financial decision making.

Ways to enhance disclosure

I have mentioned some of the limitations of disclosure. Despite this, we think that disclosure can become more effective if we are focused on presenting information in ways that make it more useful to investors and financial consumers.

Traditionally, disclosure regulation focused on mandating what information about the financial product must be disclosed by product issuers, rather than how the information can best help investors understand the product. This has sometimes resulted in lengthy disclosure documents that are costly and may not best help investors understand financial products.

To that end, in submissions to the Financial System Inquiry we have suggested that the effectiveness of disclosure may be enhanced by:

- combining disclosure with tools that help investors better understand financial products (e.g. generic education material and optional investor self-assessments);

- providing information in layers, so that investors can access the various chunks of information at a point when it is most meaningful to their decision making; and
- harnessing new media (such as video and audio content, calculators, animations and drop-down menus) to deliver information in digestible chunks and in more engaging ways.

Access to proportionate penalties for corporate wrongdoing

Another aspect of effective regulation is achieving outcomes that act as a genuine deterrent to misconduct.

To this end we recently released some research on penalties for corporate wrongdoing in Australia and we welcome debate on this important issue.[3]

ASIC's perspectives on self- and co-regulation

A second theme from ASIC's submissions to recent inquiries discusses our perspectives on self-regulation and co-regulation.

There are many examples of self-regulation in the form of industry codes, professional codes and specific standards or guidelines operating in the financial services industry (e.g. the Australian Bankers' Association's Code of Banking Practice, the Insurance Council of Australia's General Insurance Code of Practice, and the ePayments Code).

Effective self-regulation or co-regulation can have a number of advantages. Compared to government and government regulators, industry may:

- have greater knowledge of the conduct of industry participants and may be better placed to craft regulatory solutions and undertake appropriate monitoring;
- be able to respond to emerging regulatory problems in a more timely and flexible manner; and
- be in a position to more efficiently allocate the cost of regulation.

However, self-regulation and co-regulation models also have limitations. For example, these models may:

- lack credibility and public confidence;
- lack effective enforceability;
- be anti-competitive by creating barriers to entry;
- break down under stress; and

[3] Report 387 *Penalties for corporate wrongdoing* (REP 387).

- be ineffective if not applied across the whole industry or if there are members who do not adhere to the rules.

I think it is important to remember that the financial services industry is not an area of low risk to consumers. Many sectors of the industry are diverse, and in some areas there have been entrenched problems with the quality of products or services being provided.

I do believe that care needs to be taken to balance the benefits of self-regulation against the risks that consumer protection and industry standards may be compromised.

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