ASIC

Australian Securities & Investments Commission

ASIC hot topics

An edited version of a presentation by:

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Thank you for coming here today to hear about ASICôs Hot Topics. Iôve spoken in interesting places like Brazil, Taiwan and Korea, but Iôve never had to compete with the Pope before. So I assume that you are either all atheists or youôve decided to come and confess your sins to the regulator at lunch and then go and see the Pope.

My best actuary joke involves a fire in an office rubbish bin. Itôs a large office, probably in a place like a University. In rushes a physicist, a chemist, and an actuary. The physicist starts working on how much energy would have to be removed from the fire to stop the combustion. The chemist works on which reagent would have to be added to the fire to prevent oxidation. The actuary, on the other hand, starts setting fire to all the other bins in the office. ñWhat the hell are you doing?ò the others say. ñWell, we need a larger sample size to solve the problem,ò gasps the actuary.

1. Current economic and regulatory environment

Global economic climate

Looking at the global economic climate, itôs hot out there too! Take Fannie Mae and Freddie Mac, for example. Their direct and indirect liabilities are equal to roughly US$5 trillion or nearly 40% of US GDP (running at around US$14 trillion) or about 65 times their regulatory capital at the end of March 2008. To put this in some further context, the total US public debt is about US$9.5 trillion. These are huge numbers and it is little wonder that their current difficulties are having a global impact.

There are other broader economic factors as well. In real terms, the price of oil is now about 25% higher than in 1979 at the height of the second oil shock. Coupled with this we have rising commodity prices and rising inflation.

Global regulatory environment

We are seeing regulators being called on more than ever to act when markets appear not to be functioning properly. On Tuesday, the US Securities and Exchange Commission (**SEC**) moved to curb naked short selling in a list of 19 financial stocks, including the two mortgage giants.[1] This is an interesting move considering that the SEC only removed the óup-tick ruleô

[1] SEC press release 2008-143 *SEC Enhances Investor Protections Against Naked Short Selling* 15 July 2008.

last July, which was intended to prevent further downward pressure from short selling where a stock was already experiencing a sharp decline.

The SEC has introduced an initiative to use eXtensible Business Reporting Language (**XBRL**) for companies lodging financial data so that investors can search and compare information.[2] XBRL is like having each line item in a set of accounts tagged or bar-coded so that it can be found and used by software to help investors compare and interpret the information. For example, XBRL could be used to find and quickly compare the remuneration paid to the CEOs of the top 500 US companies (if thatǿs what you wanted to do). What the SEC is banking on is that the IT industry will develop lots of software (so-called ǵviewersǴ) to give retail investors the sort of horsepower to compare financial information that so far has only been available to the big end of town. If this is right, the impact will be substantial and it seems inevitable that other forms of disclosure will be dragged along with it. Australia is watching these developments closely through the Governmentǿs Standard Business Reporting initiative.[3]

As you might have read recently, Australia has signed mutual recognition arrangements with the securities regulators in New Zealand and Hong Kong allowing greater recognition of each otherǿs securities and mutual fund offerings. There is also similar work progressing with the United States.[4]

In response to the issue of short selling, the UK Financial Services Authority (**FSA**) introduced a rule requiring disclosure of significant short positions in stocks that are undertaking rights issues.[5] At the same time, Australia is working on the Corporations Amendment (Short Selling) Bill to enhance the transparency of covered short sales to the market.

The US and UK governments are also running separate inquiries into oil price derivatives to see whether speculators are behind the price rises in the physical market. The view of most market experts seems to be that the spot price is about the physical product, and not derivatives, and that the normal laws of demand and supply are driving the price rises and not speculators.

Following the collapse of Bear Stearns, there have been calls for greater regulation of investment banks. Weǿve also seen a push for greater transparency of over the-counter derivatives, such as credit default swaps. These events might therefore lead to another phase of regulatory change. The sorts of things that are being speculated on are that the US will re-

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2 SEC press release 2008-85 *SEC Proposes New Way for Investors to Get Financial Information on Companies* 14 May 2008.

3 This is a multi-agency initiative to simplify business-to-government reporting, see http://www.sbr.gov.au/.

4 See Media Release: SEC Chairman Cox, Prime Minister Rudd Meet Amid U.S. ï Australia Mutual Recognition Talks, Washington D.C. 29 March 2008, http://www.pm.gov.au/media/Release/2008/media_release_0150.cfm and http://www.sec.gov/news/press/2008/2008-52.htm.

5 FSA press release FSA/PN/057/2008 *Financial Services Authority introduces disclosure regime for significant short positions in companies undertaking rights issues* 13 June 2008.

introduce Glass-Steagall in some form or move to have significant over-the-counter derivatives in more transparent, and possibly regulated, markets.

2. ASIC's strategic review

We have just conducted a strategic review of ASIC to reassess our priorities so that we are best placed to meet the challenges of the current climate.

What does it mean for the industry?

The aim is for ASIC to:

- better understand the markets it regulates;
- be more forward-looking in examining issues and assessing systemic risks;
- be much clearer in outlining to the market why it has chosen to intervene and the behavioural changes it is seeking;
- have a clearer set of priorities (principal priorities being retail investors and insider trading, market manipulation and disclosure).

How will we achieve this?

The changes ASIC is making to deliver these benefits are:

- additional investment in market research and analysis. We have already appointed an ASIC Chief Economist;
- appointing an experienced external Advisory Panel drawn from sectors of the economy to advise ASICôs Commission on market developments and potential systemic issues;
- abolishing the four current ósiloô directorates of ASIC and replacing them with 18 outward-focused stakeholder teams (eg for investment managers, investment banks, superannuation funds, financial advisers, retail investors and consumers and others);
- more senior-level recruitment from the markets (this recruitment is underway at the moment for a wide range of roles);
- appointing two more Commission members; and
- training up existing staff through industry secondments.

3. Swimming between the flags

One of the key priorities coming out of this review is helping retail investors build financial security through long-term investment. The Government has also just recently given the work of the Financial Literacy Foundation to ASIC. This work will be part of our retail investor initiatives and we are doing a business plan for that work at the moment.

One of the ideas coming out of our retail investor work is an image that we would like to use to describe using a combination of investor behaviour and financial products to help retail investors. It is called ósswimming between the flagsô. We want retail investors to understand when they are óswimming between the flagsôï investing in things like bank deposits, a balanced portfolio of ASX listed investments and investments with known risks or with professional advice on the one hand. And, on the other hand, when they are swimming outside the flags ï investing in riskier and more complex investments and beyond to unregulated investments and scams. We want to get across the message that if you are between the flags you are investing in a safer section of the market; there are lifeguards looking out for you. There is still some risk. You can still drown or be stung by a blue bottle or bitten by a shark, but it is not as risky as swimming outside the flags (which you are allowed to do) where you are more or less on your own.

We are looking at using this metaphor to improve investor behaviour, including a greater awareness of things like diversification, asset allocation and risk-adjusted return. Many of the severe losses suffered by retail investors in recent years have involved them swimming outside the flags without realising it. Over time, we want to embed this image into the consciousness of as many retail investors as we can.

4. Overseas retail investor themes

Another important theme will be to learn from the experiences of overseas markets and regulators. For this reason, Iôm just back from a short trip where I met with overseas regulators to discuss what they are doing in the retail investor space. This is a big topic, but Iôll just briefly mention a few of the things that came out of this trip.

A lot of the issues faced by overseas regulators that have an investor protection mandate are very similar. Lifting the standards of advisers and the conflicts created by industry structure feature strongly. Similarly, all of the regulators I spoke to were working in some way or other on financial literacy programmes while, at the same time, trying to measure their effectiveness.

'Treat your customers fairly'

The ótreat customers fairlyô principle developed by the UK Financial Services Authority is a powerful tool that we don't really have in our armoury. The principle is used, for example, to require that product issuers have systems in place to see that end-customers are treated fairly through the whole lifecycle of a financial product. This means taking some responsibility over what the distribution channel is doing. It is something we could think about in our system.

For example, having such a principle could deal with the situations where existing black letter rules are complied with, but the result for retail investors seems nonetheless óunfairô.

An example of this could be in the area of institutionally-owned financial dealer groups where the dealer is owned by a product issuer and profits from incentives like volume rebates from sales of in-house products. The dealer complies with the black letter requirement for disclosing this conflict in documentation like the Financial Services Guide and the Statement of Advice (often in the fine print), but all of its marketing materials make it look like the adviser is not aligned with the product issuer. The end result is most likely that the retail investor is unaware of this conflict of interest: an unfair outcome. An overarching principle such as the requirement to ótreat your customers fairlyô could improve this outcome without further detailed prescription.

Margin lending

Most jurisdictions impose some sort of restriction on retail margin lending ï eg a maximum LVR, mandatory diversification and so on. The Commission does not support this kind of prescription, but it is interesting to see how retail investor margin lending is regulated overseas.

5. ASIC's push to facilitate greater use of technology

Importance of online disclosure

I mentioned XBRL earlier, and that I thought technology was going to play an increasingly important role in financial services disclosure. For example, online disclosure can ‘ask’ the reader questions to assess whether they understand the risks of an investment. Investors can watch a multimedia presentation, rather than just reading text and can use calculators and other online tools, such as a tool that illustrates the concept of diversification. They can access the information that interests them and effectively make other less relevant information disappear with the click of the mouse.

We think that all of these scenarios are technologically possible right now. When we talk about online disclosure, we are not just talking about putting a paper document on the web, we are talking about online disclosure that is interactive, engaging and, where possible, personalised.

ASIC wants to open up the regulatory settings so that industry can pursue these ideas if they are commercially viable.

Our consultation paper

We put out a consultation paper in April this year, mostly with the aim of stimulating discussion.[6] We also proposed relief to enable super funds to put their annual reports online as the default method of delivering the reports to their members. This is similar to the approach taken for companies. Following recent law reform, companies can now deliver their annual report to shareholders by posting it on their website.

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6 ASIC Consultation Paper 93: *Facilitating online financial services disclosures,* released in April 2008.

We received over 30 formal submissions to our paper, the majority of which were very supportive of online disclosure, but asked us to go further. Many super funds said they wanted to put their annual report on their website for the 07/08 reporting period. This lead to our media release on *Less paper in super*.[7]

'Less paper in super'

We announced a no-action position where a super fund delivers its annual report by posting it on its website as the default method of delivery, provided that it complies with certain conditions, similar to the approach taken for company annual reports, including that members can elect to receive a hard copy annual report.

We also imposed an additional condition that super funds who take advantage of our no-action position provide their members with information on longer-term returns in the periodic statement. For the 07/08 reporting period, super funds have the practical option to comply with this condition by giving their members a FIDO leaflet prepared by ASIC with their periodic statement.

We have also issued a guide encouraging all funds to provide personalised or generic 5 and 10-year returns to members in the member benefit statement.[8]

Submissions received and the next steps

Other respondents to our consultation paper want us to take a similar approach for other generic financial services disclosure documents, such as PDSs and Financial Services Guides (i.e. to enable providers to use the Internet as a default for disclosure of generic information).

Most of the submissions saw the potential for cost and efficiency savings, as well as the opportunity to provide better disclosure to their investors.

7 ASIC Media Release 08-128 Less Paper in Super, released on Friday 20 June.

8 ASIC Regulatory Guide 191: *Superannuation: helping investors look at longer-term returns—ASIC's best practice guide*, July 2008.

6. Superannuation end-benefit estimates

The issue of how to engage investors is particularly important in the area of super. Many people have little idea of how much they will end up with at retirement and whether this will meet their needs. We think further work is required to educate consumers about what they need to do now to have a comfortable retirement.

In this area, we welcome the Instituteӳ Discussion Paper on *Outstanding Issues for Benefit Projections and Online Calculators* released in April 2008.

ASIC is considering how to improve information to investors about their super through projections and calculators. The Commission has not reached a final position on these issues, but we are most likely to issue a discussion paper on it quite shortly and look forward to discussing these issues with the Institute and its members further.

Just before I take your questions, I would like to give you an illustration of how important this work might be. The preliminary findings of an unpublished University of California, Los Angeles (**UCLA**) study[9] indicate that showing employees the outcome of different levels of contributions they could make to their s401(k) plans now on the amount accumulated by retirement increased contribution levels by as much as 10.9%.

But we could go even further ï the study found that showing employees a visual depiction of the expected lifestyle in retirement (ie a mansion or a small apartment or a cardboard box), increased contributions even more ï by as much as 14.5%.

Clearly, there is much we can achieve together here.

9 This research is still in progress and being conducted by Professor Shlomo Benartzi (UCLA), Dr. Sheena Iyengar (Columbia Business School) and Dr. Alessandro Previtero, (UCLA). These preliminary findings were presented to the 2008 ASIC Summer School by Arun Abey, Executive Chairman, ipac, and General Manager Strategy, AXA, in February 2008.