ASIC

Australian Securities & Investments Commission

ASIC in 2014: Areas of focus and expected changes to the regulatory landscape

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Introduction

It's a real pleasure to be addressing so many governance, compliance and risk professionals. You are not only important gatekeepers for your organisation, but you also play a role in upholding the resilience of our financial system.

Today, I wanted to speak on an area of focus for ASIC – that is, responding to the challenges posed by financial-innovation driven complexity. Before I speak about financial-innovation driven complexity, I thought I'd provide a brief overview of ASIC.

About ASIC

ASIC has a growing regulatory remit in financial services and markets. We operate in a dynamic and complex environment. In this environment, we remain committed to achieving our strategic priorities:

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

A key force in shaping our current environment is market-based financing, which we largely regulate. It's seen as a key source of funding economic growth in the coming decades.

When I think about what's ahead, I see three challenges for ASIC in this environment:

- *Structural change*: The shift of savings out of the banking sector into superannuation.
- *Financial innovation-driven complexity*: The focus of my speech today. The regulatory challenge is to assist industry in harvesting the opportunity from innovation in products, markets and technology, while mitigating the risks to our strategic priorities.
- *Globalisation*: A consistent and non-duplicative regulatory approach facilitates business across borders. We must also be mindful of the risks it creates, including increased opportunities for global misconduct.

While these are all challenges, they also present opportunities to fund economic growth. We need to harvest the opportunity and mitigate the risk.

I am also Chairman of the International Organisation of Securities Commissions (IOSCO). Interestingly, these challenges are also challenges at the global level, and they present a global opportunity to harvest the opportunity to fund economic growth, while mitigating the risk.

Financial-innovation driven complexity

Constant innovation is the touchstone of financial services. I see financial innovation-driven complexity in three key areas for ASIC:

- products
- markets
- technology.

Let me briefly unpack each of these areas. I will then talk about what they mean for compliance professionals.

Products

A good example of innovation-driven complexity in financial products is hybrids. We highlighted this in our report on hybrid securities,[1] released in August this year.

ASIC is focusing on the sale of hybrids for three key reasons:

- *Possible misleading conduct in selling hybrids*: For example, spruiking the returns of hybrids without being upfront about the risks involved.
- *Lack of institutional liquidity*: There has been a lack of institutional investor interest in hybrids in Australia. By way of contrast, there has been greater take-up by institutional investors in overseas jurisdictions where – as a rough guide – spreads are 20–30% wider in offshore markets. A good retail bond market needs to be underpinned by a good institutional bond market – this underpins liquidity. Having institutional investors is important for the stability of the market, as retail investors leverage off this base liquidity. Lack of institutional investor support is a concern which underpins liquidity.
- *Self-managed superannuation fund (SMSF) risk*: Two-thirds of the 75,000 investors in hybrids are SMSFs. This is concerning if those investors are depending on regular payments from their hybrid investment, or that their investment will be redeemed after a short period – with hybrids, this is not always the case.

[1] Report 365 *Hybrid securities* (REP 365).

As we noted in our recent report, there are four main areas where we are working to mitigate these concerns:

- labelling of hybrids (e.g. capital notes)
- increased surveillance
- investor education
- a media campaign on the risks of investing in hybrids.

Hybrids present new opportunities for business, especially for those that need to raise regulatory or rating capital. However, the risk to investors, particularly retail investors, needs to be understood.

Investors may suffer loss when hybrids are written down or converted. For example, in Spain international media reports suggest that 62% of subordinated debt issued by Spanish banks is held by retail investors. As an example of the losses that these investors may experience, in November 2012 it was reported that holders of €6.5 billion in hybrid debt issued by the Spanish bank, Bankia, experienced write-downs of between 14%–46%. Combining these two figures, it could suggest that roughly €4 billion of this debt was held by mum and dad investors. In fact, many bought the hybrids on the recommendation of an adviser from their local bank branch. These advisers were strongly encouraged by Bankia to sell hybrids.

Markets

The next area where I see financial innovation-driven complexity is in financial markets. In recent years, we've seen the rise of dark liquidity and automated trading globally, including high-frequency trading.

This poses new risks and issues as crossing engines, high-frequency trading and other automated forms of trading are part of 'the new normal'. We can manage these risks and issues with appropriate regulation and a measured response. ASIC has done a lot of work in this space and made new market integrity rules to address the market's concerns. We will continue to monitor these issues, to ensure our response continues to be appropriate and measured. This is a challenge, but we don't want to restrict too much of the opportunity.

Technology

Advances in technology have led to the rise of cybercrime in the financial system globally. The estimated global cost of cybercrime is US$110 billion per year. In Australia, each major cyber intrusion is estimated to cost an organisation an average of $2 million.

I consider cybercrime to be the next black swan event.

Regulators need to start thinking about how to address the risks to the financial system that cybercrime poses. In particular, ensuring adequate risk management arrangements are in place for key participants in the financial system to ensure they are cyber-attack resilient.

So what does financial innovation-driven complexity mean for GRC professionals?

Good compliance is good business. A robust compliance, risk and governance framework has the potential to boost an organisation's bottom line. It can result in:

- better quality information to management
- operational efficiencies being identified
- protection of the reputation, or 'brand,' of your organisation.

I can personally vouch for these benefits from my own management experience.

Policies and procedures alone are not enough. They are meaningless if they are not backed up by supervision and review, and reflected in the organisation's culture.

To illustrate this, I will briefly talk about what this means for the three areas of complexity I mentioned earlier – financial products such as hybrids, markets and technology.

Products

Let's start with hybrids. Apart from the right policies and procedures, an organisation that issues hybrids needs to:

- Supervise brokers, advisers and other client-facing staff to ensure that client communication is balanced and consistent with the prospectus.
- Regularly review their processes to ensure that regulatory, reputational and other risks are appropriately managed. For example, in Spain, commentators noted that the failed hybrids issued by Bankia caused the bank serious reputational damage with its retail clients.
- Ensure that it has a culture that deals honestly with clients and is upfront about the risks of hybrids, including those I mentioned earlier.

Markets

For financial markets, the complexity created by automated order processing (AOP) systems – such as crossing systems and those for high-frequency trading – means that getting policies right will not always be straight forward.

It is vital that a compliance professional:

- understands the technology
- is able to identify discrepancies between the way the system is working and how it is intended to work
- ensures that the governance framework covers policies and procedures for the development, testing and monitoring of AOP systems.

Once these things are in place, supervision, review and cultural change can follow.

Technology

And lastly, technology.

I mentioned before that regulators should start thinking about rules to ensure adequate risk management arrangements are in place so organisations can be cyber-attack resilient.

Risk management arrangements are also critical for GRC professionals – particularly risk professionals. Risk managements systems must be granular enough to guarantee outcomes.

Conclusion

In summary, financial innovation-driven complexity of products, markets and technology will continue to raise challenges for securities regulators and GRC professionals.

To meet these challenges, we all need to be forward looking and pro-active.

Industry can play its part through self-regulation, better practices and having a forward-looking and proactive approach.

At ASIC, we need to ensure that financial innovation does not outpace regulation, or compromise our strategic objectives of confident and informed investors, and fair and efficient markets.

For GRC professionals, your task is to ensure that when your organisation is harvesting the opportunities innovation brings, that:

- risk are mitigated
- the right policies and procedures are in place

- most importantly – that these are backed up by appropriate supervisory arrangements, review, and the right organisational culture.