ASIC
Australian Securities & Investments Commission

Lessons learnt from market volatility and sub-prime

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Opening

1. Thankyou for that welcome.

2. My first draft of this speech was a bit of an economics lecture – I decided that was a big call after lunch, to sophisticated investment advisers such as yourselves.

3. So I decided to take a more personal view of the topic – my lessons from sub-prime and market turmoil – if you like my reflections on ASIC's role and its response to market turmoil, both to date and looking forward over the next 6 months.

4. I joined ASIC as a commissioner on 5 November 2007 – which was about the peak of stock market prices, or the start of the decline. My friends tell me they cannot discern any causative association. For those of you who are superstitious, I have a 3 year term.

5. My initial role was to head the capital markets taskforce. That gave me responsibility to the Commission for all aspects of our capital markets – supervision of the ASX and other licensed markets, and oversight of market trading via our markets surveillance and enforcement teams. I have also been closely involved in our review of some of the major listed company collapses. I have learned a great deal about being a regulator in difficult times, very quickly.

My 4 lessons

6. I have cast my presentation today around 4 themes – shown on the screen. I will expand on each of these by reference to the recent market events.

7. My first lesson, which isn't really important enough for the permanence of a slide – don't ever think that joining the public service will lead to a major improvement in work/life balance. I now realise being a M&A partner in a major Sydney law firm was a doddle.

8. The serious big 4 lessons:

   First: Australia is very much part of the global economy and subject to its influences. As regulators we are part of the global regulatory community. In responding to market turmoil necessarily we will take some lead from the US and Europe, but we need to adapt for Australia's particular position.

Second: ASIC is a financial regulator. We supervise. We apply the rules in the Corporations Act and Regulations, but we can't just write new rules. We have to work with what we have. Those rules are, we think, sufficient, but we continue to monitor the position.

Third: ASIC has an important role in influencing the market. Participants are very alive to pronouncements about how we will apply the rules. That is a powerful tool and one to be exercised responsibly, but it must be exercised.

Fourth: ASIC is an organisation with enormous potential. We have great people. Our Strategic Review should result in ASIC moving closer to the market, and to all our stakeholders. We should be an even better regulator. At the close I will explain more about the Strategic Review and how IFSA members should see changes in ASIC's approach.

Overview of global market volatility

9. My first proposition is that sub-prime and the resultant market turmoil is a global problem. Each economy has different weak points, and each market has responded somewhat differently, but there are some common attributes. These next slides are a snapshot. I do not propose to speak to each slide, but rather scroll through them as backdrop to a very superficial review of the economic features which all financial regulators are contending with.

10. As you know, its not a happy story. What are some of the common attributes:

    - Steep decline in market capitalisation since November 2007.
    - Listed stock P/E multiples have fallen, particularly in Australia.
    - Reduction in funds available for lending, and attendant increase in lending rates.
    - Across the board fall in investment performance, leading to concerns about further negative market activity as investors switch to safer products.

11. The apparent catalyst for this market turmoil is the sub-prime lending crisis in the US, and to a lesser degree Europe. We have seen a breakdown in underwriting standards for sub-prime lending, with significant default rates. The problem went straight through to the global investment banks, as securitisers of the home loans, and packagers of the associated derivative investments. CDO's and CDS' are the least exotic of them. To compound the issue, the banks invested heavily in these products, for themselves and the investment funds they have promoted. The European banks were active in the US market, taking the problem over the Atlantic, and more recent announcements have disclosed one Australian bank with some exposure to CDO's issued in the US.

12. These investment banks have all taken enormous write-downs. The global investment banks have been criticised for poor risk management, including designing remuneration structures that did not adequately reflect risk. The credit ratings agencies have been criticised for inadequate analysis, poor treatment of conflicts and also for poor risk management. The regulators have been criticised for design of a prudential oversight system that encouraged securitisation and tolerated off-balance structures that permitted banks to minimise capital and liquidity buffers that could absorb market shocks like those that have been experienced.

13. The most immediate manifestation of turmoil in the Australian markets has been the collapse of a limited number (previously) significant corporations. I say limited in comparison to the 1987 collapse. The market has not looked positively on highly leveraged entities with complex corporate structures, that have required strong asset values to maintain debt funding. I refer here of course to Centro, Allco, ABC and most recently Babcock and Brown, all of which report regularly to the market on their ongoing discussions with their banks. In the ABC and Allco cases the very rapid share price decline was exacerbated by the release of significant amounts of shares onto the market by margin lenders to directors of the entities.

Global regulatory response

14. The various national financial regulatory agencies have been collaborating at a number of levels on a response to the financial position we find ourselves in. Some of these are shown on this slide. ASIC is an active participant in IOSCO, the International Organisation of Securities Commissions. We have

a lead role in the working party established to review the position of credit rating organisations. Many of the standing committees are looking at issues emerging from financial turmoil.

15. I will speak shortly about the Financial Stability Forum, as the lead cooperative institution. Interestingly the Institute of International Finance produced a report dealing with critical issues in April 2008, finalised in July. This is a committee for the leading investment banks and investing companies. There are a number of proposals there for these companies to improve their game, as it were. The focus is on transparency and compensation, risk and liquidity management, valuation and ratings agencies. A common theme you will see. I think the global business community is keen to say that it will improve its practices and perhaps does not need too much more supervision. This is not what the regulators are saying.

16. The most prominent of the international regulatory responses has been from the Financial Stability Forum, which is a committee of the major national financial stability organisations in North America, Europe, Hong Kong, Japan and Australia. IMF, the World Bank, BIS and OECD are members, along with associations like IOSCO, the Basel Committee on Banking Supervision and the International Accounting Standards Board. The Forum was formed in April 1999 to promote information sharing and collaboration. Its report on the financial turmoil was issued in April, and provides a road map for more work.

17. The next slides outline the key elements of the FSF recommendations. There are five categories:

    - Strengthened prudential oversight of capital, liquidity and risk management.
    - Enhancing transparency and valuation.
    - Changes in the role and uses of credit ratings.
    - Strengthening the authorities' responsiveness to risks.
    - Robust arrangements for dealing with stress in the financial system.

18. The Reserve Bank is a member of the Financial Stability Forum. On 2 June, 2008 the Treasurer outlined Australia's response to the recommendations of the FSF. It included a table highlighting the action that the four Australian financial authorities will undertake to address each of the five areas identified.

Work is allocated, as it were, to each of the four primary financial regulators - APRA, ASIC, the Reserve Bank and Treasury. We have lead responsibility for working with market participants to mitigate the risks arising from remuneration policies. We also have the responsibility for reviewing the role of the credit ratings agencies, and OTC infrastructure. We are working closely with the other regulators on a number of areas.

19. For completeness, I should note that the four institutions I have just mentioned together form the Council of Financial Regulators. That organisation meets regularly to discuss matters of common interests in the financial economy and capital markets. The other important institution for the capital markets is the ASX. We are the supervisor of the ASX, and together ASIC and ASX supervise the operation of the stock market.

ASIC's role

20. This leads me to a discussion about ASIC's role here in Australia in regulating markets that exhibit financial turmoil. Of course ASIC has its own separate response agenda looking at specific market supervision issues. As I have said, the primary manifestation of turmoil to date has been some dramatic falls in share prices, particularly for the highly leveraged listed vehicles with complex business models. There has also been a marked increase in complaints about illegal market conduct – insider trading, market manipulation, late disclosure of information to the market and the spreading of false rumours.

21. I have had much cause to dwell on what ASIC is expected to do, or more to the point to have done. Its rare that reading the Saturday business sections leaves me feeling warm and hugely appreciated. I say that somewhat tongue-in-cheek. More seriously, and this is my second lesson for today, ASIC is not a lawmaker, and cannot manage every business.

22. Our role is to supervise the market by administration of the Corporations Act and Regulations. We have referrals of power under some other legislation, such as the Superannuation Industry (Supervision) Act, but the Corporations Act is the primary one. The Act and the Regulations are an enormous and complicated beast to master. I spent a lot of time in my previous life avoiding Chapter 7 of the Act but have taken to reading it in the evening as it is such a fundamental part of our regime. I know it is dear to all of you too.

23. ASIC does not have the power to just amend the Act or the Regulations. We do have some powers of modification and waiver, which we exercise in a prudent manner. Some financial regulators have quite generous rule making powers. The FSA and SEC are cases in point and you have seen those powers exercised on short selling in recent weeks. We have less power. We are very comfortable with our position. The Commission's stance is that we have an extensive set of rules and we need to make those work as best we can in this difficult financial environment in which we find ourselves. We are not seeking additional powers, though of course we will keep the situation under review, as we are bound to under the ASIC Act. Amendment of the law is a policy matter, and properly for the Government. We of course are engaged in regular discussions with Government about policy issues. IFSA

and its members are also engaged in dialogue with those same government bodies.

24. This section has been talking about what ASIC does not do. There is just one other thing I want to touch on – ASIC is an oversight body. We do not sit in the boardroom. We are not as well placed as the directors of companies, or directors of responsible entities, to assess business models or to determine how to attract investment or carry out a business plan. That is not our job. I sometimes feel great pressure to explain how it is that ASIC could ever let a company become insolvent and cause loss to creditors, staff and investors. The ASIC Act does not establish us as an underwriter of business models. Our priority is with ensuring there is: (1) proper governance by the business operators; (2) proper disclosure and accounting; and (3) that conflicts of interests are appropriately handled. Our objective is to ensure consumers and investors have the best opportunity to participate in a fair manner in the economy.

25. Whilst ASIC is not a law maker, and not a financial underwriter, we do have very strong powers to influence the market. The fact that I am speaking to you here today, and Jeremy Cooper and Mark Adams are speaking in other rooms, clearly indicates that ASIC's view is an important one. One of the outcomes of my Capital Markets Taskforce Review is that ASIC needs to be a more public regulator. I had discussions with both the SEC and FSA about their manner of regulation. I think if you look at their websites you will see a strong dialogue with the market, both in terms of seeking commentary and providing guidance. We will look to be more active in our discussions with the market in the coming months. One of the outcomes of the ASIC wide Strategic Review (which I will come to at the end of this presentation) is that there will be more ASIC leaders available to engage with the market, and our major priorities will be very clear.

Guidance to the market

26. This presentation today is about my personal lessons. My first lesson in giving guidance to the market came in February and March this year. You will see on this slide the four announcements that we made to the market at the time share prices were falling about, and there was considerable discussion about whether the cause was short selling, perhaps fuelled by predatory trading that was either manipulative, or followed the spreading of

false information, or both. These announcements were intended to inform the market about those laws, and how ASIC and ASX will apply those laws in the context of a new(ish) market condition.

27. In a rising stock market, where there is ready availability of loan funds, companies would not expect a difficulty in refinancing. It is thus less likely that debt rollover exposure would have been price sensitive and disclosable to the market. In a falling market where loan funds are tight, and banks are sceptical, the fact of a rollover to a financial institution is more likely to be price sensitive, certainly where the discussions are clearly difficult. In that instance the market should be informed. I would say that has been a sound proposition for directors since RAMS' funding difficulties in July of last year.

28. The spreading of false rumours to push down prices, to the profit of short sellers, is illegal. The spreading of false rumours to push up prices is also illegal. Perhaps false rumours have abounded for some time? In March the markets were alive with stories of false rumours being spread in conjunction with the stocks that were most steeply falling; more so than normal. ASIC and ASX commenced an extended surveillance exercise to investigate the type of trading that was going on in the market. The review is ongoing. I expect it will be some months before we reach firm conclusions about illegal trading. I can say that we have found some practices which are colourable and possibly illegal, which we are taking up with the relevant persons.

The next 6 months

29. I would like now to look ahead, and to talk a little about a few specific areas in capital markets which ASIC will be focusing on in the six months. Of course, the list is not exhaustive. Item 5 is managed investment schemes. In the last year ASIC has rolled out a comprehensive guide for issuers of unlisted and unrated debenture products. We have recently issued consultation papers on unlisted mortgage and property funds. ASIC is reviewing a number of sectors in the managed investment scheme industry to see how their businesses' operate and just how the markets should be informed about the business models. You can expect more from us in this area over the next 12 months. It is perhaps self-evident to say that where a MIS is in financial difficulties we will want to focus management on liquidity and redemption practices, valuations and the difficult issue of change of responsible entity.

30. You may have noticed throughout this paper a constant theme – the role of credit rating agencies. The Financial Stability Forum is undertaking an extensive review exercise. The SEC and the European Commission have recently announced their reviews. IOSCO has a project. ASIC and Treasury are working on a project. There have been questions raised as to quality of the ratings process, particularly where ratings agencies have a conflict of interest in terms of the connection of fees to ratings outcome or product issue success. There is a wider market issue about the extent to which investors rely on the ratings agencies for their investment decisions and whether the level of diligence and discussion undertaken by the agencies warrants this reliance. There is an interesting question about changes in ratings mid-term and the level of review that ratings agencies undertake on an ongoing basis. This is a substantial industry study for ASIC and Treasury. We will provide the report to Government.

31. Listed investment vehicle reconstructions. In recent months it has become clear that a number of securities are trading on the market at a significant discount to the published asset backing, particularly the listed investment vehicles that are engaged in infrastructure or other long term projects. We are starting to see transactions that respond to this gap. In some cases there have been privatisations or substantial buy-backs. Activist shareholders have recently emerged in Australia, seeking a buy-back at superior prices, or a winding up. We expect there will more transactions if this gap in values persists. ASIC will be looking closely at these transactions, which do commonly require some form of ASIC relief or approval. There are three things in particular we will focus on.

    (1) Directors and RE's have a duty to act in the interests of all security holders. Often there will be a conflict of interest in these transactions, because the scheme promoter is either a manager or a substantial investor, or bidder. We will be looking closely at how conflicts of interests are handled, and whether directors and RE's appear to be observing their statutory and fiduciary duties. Providing arms length valuations and independent experts reports as to value will be of great assistance in our assessment, and that of the market.

    (2) Materials supporting these transactions tend to be complex. We want to see that information is provided in a readily accessible form. Directors should be frank about alternatives to the proposed transaction, and the possible benefits of the transaction to the person proposing it. It goes

without saying that accurate valuation will be critical. Valuation issues are difficult in this market, particularly for illiquid assets. This is an area where undue conservatism could be contrary to the interests of the independent investors. Again, disclosure of valuation methodology will be important. Of course timing of disclosure is important. Announcement of a devaluation should not be delayed until a restructure proposal can be negotiated.

(3) The final point on this slide is the role of activist hedge funds. We are aware of discussion in the market about some investors collaborating to put a restructure proposal to an exposed financial entity, to realise immediate cash or assets, either through buy-backs or winding up. The Corporations Act has detailed requirements about disclosure of substantial shareholdings. It also prohibits associates collectively buying more than 20% of an entity. Our surveillance side of the business is actively looking for misconduct of this type.

32. As it is 7 August and financial results for the year to 30 June are due out in the next few weeks I have added a slide on the issues which our accounting team will be most focussing on. Lee White, our Chief Accountant, issued a media release to the market in early July which outlined in more detail ASIC's focus. Valuation accounting will be important. Correct treatment of off balance sheet entities will be important. In light of events earlier this year correct classification of debt as current or long term will be important.

33. Finally it would be remiss of me, as head of the Capital Markets Taskforce, not to refer to our market surveillance and enforcement activities. Those activities have stepped up since the start of the year, in cooperation with the ASX, and will continue. A new project for ASIC this year will be a review of listed entities' analysts briefings that accompany results announcements. These are very informative for investors, as they have forward looking statements. We will be looking to see these briefings are available to all investors, and that the content accords with the law. We would expect forward looking statements to be clear about assumptions and risks.

34. One of my priorities on joining ASIC was to look at our capital markets enforcement process. How we deal with referrals of suspicious transactions and how we can improve our assessment and, where warranted, our enforcement activities. I have spoken on other platforms about the steps we have taken and will be taking in the next 12 months to improve our business

in this area. There certainly has not been any lack of suspicious transactions to pursue. The enquiry and investigation process to bring a matter to trial is a lengthy one. It is rigorous. It must be exhaustive – that is only fair to prospective defendants. I feel great pressure from the media to "do something" about behaviour which on the face of it appears culpable. Quick results would be good, but these are not matters to be improperly hurried. I think that you will already have seen that ASIC is a more active supervisor of the markets. We are talking to more market participants. We are issuing more notices. One thing I would like to encourage all of you to do is to work with us on this exercise, and to encourage your colleagues to do so. A fair market that is respected for its integrity is a very valuable asset for Australia. I do believe that most participants act properly, lawfully and ethically. It is inevitable that some do not, particularly in times of market stress. You are closest to the markets and you are most likely to see that conduct. If we can have open, prompt dialogue with you about suspicious transactions then our processes will be quicker and easier for everyone who is not guilty.

Strategic Review

35. In closing I would like to discuss a new, or at least different, ASIC. In May we announced the results of a year-long strategic review, and restructure. ASIC will appoint an external advisory board to assist the Commission understand the market and its trends. ASIC will replace its four current market-facing directorates with 12 outwardly focussed stakeholder teams covering the financial economy, and 6 specialised enforcement/deterrence teams. As investment advisors you will interact with many teams – investment advisors, super funds, corporations and small caps, and accountants, would be the main ones I expect.

36. As a result our stakeholders, including yourselves will see an ASIC that better understands the market it regulates and one that is more forward-looking in examining issues and assessing systemic risks. Stakeholders can expect ASIC, its regulator, to better articulate why it has chosen to intervene and the behavioural changes it wants the market to make. You will also see that ASIC has a clear set of priorities. We look forward to introducing our revitalised team to you, and our new priorities.

Conclusion

37. These have been my 4 personal lessons about ASIC in conditions of market turmoil. I should say, despite the work/life balance thing mentioned earlier, I am enjoying the position. Its certainly challenging. The people at ASIC are uniformly keen. They are talented. We are together getting closer to the markets every day, and that will be to the gain of the financial industry. I would (I think) be happy to take questions.