



**ASIC**

Australian Securities & Investments Commission

# **ASIC: Facing Regulatory Challenges in 2006**

**An Address by Jeffrey Lucy AM**

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**Australian Securities and Investments Commission**

**The West Australian Events Program:**

***Leadership Matters***

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Good Morning. I would like to thank The West Australian for both hosting these important events that simulate and drive leadership and also, for giving me the opportunity to address you in this forum.

This morning, I would like to discuss the theory of leadership in the regulator's context. Specifically, I want to address three questions:

- what are ASIC's priorities – what do we do and where do we fit in the Australian financial markets?;
- how do we cope with the environmental context in which we regulate?; and
- how do we drive change and bring strategic vision to those we regulate?.

### ***Leadership – A Regulator's View***

There are many theories of leadership in management literature. Some are based on personal characteristics and traits of leaders who develop and communicate a vision and then motivate and inspire others to achieve that vision. Others are based on particular leadership behaviours, such as setting clear goals and implementing action plans for clearing hurdles to achieve those goals. Yet others are based on contingencies and the need to respond to situations that arise, as they arise.

In my view, however, leadership involves all of these things, but also much more. It is about forming high-level strategy and creating sustainability – individually, organisationally and, across the market as a whole in the case of the regulator. As a regulator, I think the key to leadership is understanding the environment we operate in, anticipating circumstances before they arise and, most importantly, providing direction to others to initiate change and stay abreast of developments, whatever they may be, through thought leadership.

This morning, I would like to canvas how ASIC – as the national regulator and enforcer of corporate and financial services laws in Australia – goes about being such a leader and the types of challenges that we are currently facing in dynamic and constantly evolving financial markets.

### ***What are ASIC's priorities?***

As most of you will be aware, ASIC vigorously administers corporate and financial services laws in order to:

- enforce the laws of the Commonwealth;
- protect consumers, investors and creditors and promote their informed, confident participation in our markets; and
- of equal importance, maintain, facilitate and improve the performance of the financial system and the entities within it to enhance commercial certainty, reduce business costs and promote the efficiency and development of the economy<sup>1</sup>.

Of course, we cannot work to solely protect consumers or to solely facilitate business. We need to undertake our duties through carefully balancing each of these.

However, it is timely to remind you all that we cannot ever regulate to zero risk. Some consumers will continue to make poor financial decisions, even when they are informed, but they simply want to 'take a punt'. Likewise, businesses fail and will continue to do so, just as they have since 1841, when Australia experienced its first company collapse of the Australian Auction Company<sup>2</sup>. This occurred against the backdrop of the speculative boom of the 1830s where excessive lending and the ease with which people could obtain loans from banks and mortgage lenders fuelled an unsustainable property boom.

Does this sound distinctly similar to the environment that Australia is currently facing? I will leave that to you to ponder. What I want to highlight is the importance of being prepared, for that is what leadership is about. We need to understand the environment in which we operate and anticipate what lies ahead so that we can proactively manage how it might unfold.

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<sup>1</sup> *Australian Securities and Investments Commission Act 1998 (Cth)*, s1(2).

<sup>2</sup> Sykes, T., 1988, *Two Centuries of Panic: A History of Corporate Collapses in Australia*, Allen & Unwin Australia Pty Limited: Australia, Chapter 2.

### ***Our environment***

ASIC regulates in a national, local and, increasingly, global context. We regulate some:

- 1.43 million companies;
- 6,173 company auditors;
- 762 registered liquidators;
- 13 financial markets;
- 4 clearing and settlement facilities;
- 4,135 financial services businesses;
- 4,093 managed investment schemes; and
- credit providers operating under State and Territory laws<sup>3</sup>.

Australia-wide, we also protect a range of consumers, investors and creditors of corporations who hold a variety of financial products from deposit accounts and superannuation through to owning shares and investing in managed funds.

At the local level, our presence in Perth is significant. We have some 100 staff in our Perth office and are in the process of reconfiguring our office space – including an intended combined reception and service centre and state-of-the-art interview rooms – to allow us to streamline our processes and better serve you, our clients.

Western Australia is also home to one third of Australia's 1750 listed companies. Some 30% of all disclosure documents lodged with us and 70% of related party documents lodged with us are Western-Australia related. In 2005, prospectuses lodged with ASIC raised \$35 billion nationally, \$2.7 billion of which was related to Western Australian-based companies.

This is the overarching context in which we work as both a national and state-based regulator. We must, of course, also be attuned to the broader environment in which we work and the impact it has on wider economic conditions that ensure the maintenance of consumer confidence, the

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<sup>3</sup> Australian Securities and Investments Commission, *Annual Report 2004–05: Patrolling a broad territory*, pp44–45.

efficiency of Australian financial markets and the global respect for our market.

The OECD has recognised that there is a distinct connection between financial market regulation and economic growth. In its recently released report on economic policy reform, the OECD stated: 'regulatory settings that maintain excessively high barriers to competition in banking, or that provide too little protection for investors in securities markets, hamper the development of financial systems, resulting in weaker economic growth'<sup>4</sup>. I like to think that, given our broad remit to both protect investors and facilitate business, this balance is in our favour and, in fact, is a driver of Australia's strong economic performance over the last 14 years.

The Reserve Bank of Australia's most recent quarterly financial stability review<sup>5</sup> reminds us of how fortunate we are as a nation. There are clear indicators that economic conditions have been largely favourable from a financial stability perspective and, with the world economy continuing to expand strongly, the current environment of very low volatility may continue for some time.

However, the review also puts into train a number of key warnings, and these reflect some of the deep concerns that I hold, both in my capacity as an individual in the Australian economy, as well as in my capacity as Chairman of ASIC.

Most prominently is the concern that, with strong economic performance over extended periods, also comes risks of complacency from the perspective of individual consumers and investors and also organisations and the people that run them. The Reserve Bank's review recognises investor optimism that economic conditions will remain generally stable and the consequent willingness of some investors to take on more leverage and

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<sup>4</sup> Organisation for Economic Co-operation and Development, *Economic Policy Reforms: Going for Growth – 2006*, p115.

<sup>5</sup> Reserve Bank of Australia, *Financial Stability Review*, March 2006.

purchase a wider range of financial assets – over and above what they should.

The Reserve Bank explains this in the following terms: 'there continue to be a number of puzzles regarding the pricing of risk in the financial system...[W]hen economic outcomes are consistently favourable over a run of years, investors tend to underestimate, and thus underprice, risk'. In my own view, people are blinded to the fact that risk has gone up, as distinct from having gone down, because we have been riding an upward cycle for so long.

It is for this reason that we must step up to the mark as a leading regulator, anticipating the possibility of weaker economic conditions at some point in the future (as have historically followed boom periods) and being in a position to adapt to changing environmental circumstances as and when they arise.

### ***Exercising leadership***

Of course, we are already taking this course and exercising our duties with firmness, fairness and consistency to ensure that we drive change in, and bring strategic vision to, the industry. To do so as regulator, we do not deny our preparedness to take action against unacceptable or unlawful conduct. One point that I wish to stress here is that we should and do operate on the principle of 'without fear or favour'; we do not play favourites. Additionally, we most certainly do not take action unless we consider it is warranted and, if appropriate, can most probably be successfully litigated.

As you would have no doubt heard or read about in the press, last week we commenced civil proceedings against Citigroup Global Markets Australia (Citigroup).

Citigroup was an adviser to Toll Holdings (Toll) in its \$4.6 billion takeover bid for Patrick Corporation (Patrick), which was announced on Monday, 22 August 2005. In our investigation, we identified substantial proprietary trading – that is, trading on its own account – by Citigroup in Patrick

securities on Friday, 19 August 2005, the last business day before Toll announced its bid to the market.

In our proceedings, we allege that Citigroup did not have in place adequate arrangements for managing conflicts between its own interests and the interests of its client, Toll, and further, that Citigroup engaged in proprietary trading on the basis of inside information, directly against the interests of its client.

Among the orders and declarations we are seeking are:

- orders requiring Citigroup to put in place adequate procedures for dealing with conflicts of interest, which are underpinned by their duties, including their fiduciary duties as advisers;
- injunctions restraining Citigroup from trading in securities on its own account, while acting for clients to whom they owe duties in relation to those securities; and
- orders that Citigroup pay a pecuniary penalty.

This is a significant case that raises very important issues for the securities industry; first, having adequate arrangements for managing inside information and second, dealing with conflicts of interest. It is also one in which the ASIC Commission has a strong interest.

Unfortunately, Western Australia also offers no shortage of cases for us at the moment; a trend I hope does not continue going forward. Today, I would like to mention, in particular, the significance of our actions against Fortescue, Sons of Gwalia and Westpoint.

Early last month, we issued civil penalty proceedings against listed company Fortescue Metals Group Limited (Fortescue), which is developing a project to mine iron ore, and its CEO, Mr Andrew Forrest. In our proceedings, we are alleging that Fortescue engaged in misleading and deceptive conduct and failed to comply with its continuous disclosure obligations when it announced various contracts with Chinese entities in August and November 2004. In particular, we allege that Fortescue did not disclose that the

parties had not reached a concluded agreement on fundamental aspects of the relevant projects, but merely agreed that they would jointly develop and agree on such matters in the future. We are also alleging that Mr Forrest was knowingly concerned in these matters and that he breached his duty as a director to exercise care and diligence by failing to ensure that Fortescue complied with its obligations. This case is important because it reflects the importance of market disclosure in ensuring fair markets and confident market participation.

As you will be aware, ASIC commenced an investigation into Sons of Gwalia (subject to a deed of company arrangement) in February 2005, following discussions with the administrator, Ferrier Hodgson. ASIC is investigating a number of allegations in relation to alleged breaches of directors' duties and corporate governance issues. We have been liaising closely with the administrator in relation to a number of issues and our investigations are ongoing. Nonetheless, the matter is of considerable significance to us because it highlights the need to have proper internal governance controls in place, as well as appropriate external audit controls.

I would now like to turn to one particular enforcement matter being run from our Perth office that is permeating literally every facet of ASIC as an organisation – from Enforcement to Compliance and Consumer Protection – as well as so many of the areas that we regulate; that is, ASIC's action and investigation into the Westpoint Group.

As has been reported over the last few months, ASIC has commenced a number of legal proceedings against Westpoint. These proceedings were taken to protect investors and creditors and to stop new investors from investing money to prop up the failing business. Most recently, ASIC also obtained interim asset freezing and other restraining orders against four directors of Westpoint and a number of companies associated with Mr Norman Carey last Friday.

Since November 2005, we have commenced 26 proceedings against 22 companies and individuals in the Westpoint Group. In the asset freezing

action that ASIC commenced last week, interim orders were made in ASIC's favour, although the final result is yet to be determined. 14 of the other proceedings have been finalised with orders in ASIC's favour. The other actions have been discontinued because the defendants subsequently complied with ASIC's orders or, alternatively, have come under the control of insolvency practitioners.

However, as I told the Senate Economics Committee in Canberra on 16 February 2006, ASIC's work on the Westpoint Group is just beginning and is now fully resourced. ASIC continues to investigate the conduct of a number of officers and related entities in the Group, as well as the licensed and unlicensed advisers who promoted the Westpoint investment and professional advisers. The scope of ASIC's inquiries and investigations is extensive, covering close to 50 individuals or entities.

I have personally written to the relevant Australian financial services licence holders and industry associations requesting their assistance in dealing fairly and promptly with compensation claims by clients and ASIC has issued 35 compulsory notices to licensees seeking specific information about Westpoint. We have also issued directions to those licensees requiring them to provide monthly reports to ASIC about how they are dealing with clients' complaints and losses.

As there are many investors who have been involved in, or affected by, the collapse of the Westpoint Group, ASIC has created a special site for Westpoint on our ASIC website and has already posted two information bulletins advising investors and other interested parties of the progress of our actions to date. We have also issued regular media releases advising on the outcomes of formal court action and, where possible, have outlined the scope of our investigations. This will continue to be a focus for ASIC and we expect to issue a further information bulletin next week.

As well, last Friday, we wrote to all known investors in Westpoint who may have lost money in Westpoint's mezzanine companies, seeking their participation in completing a questionnaire about how they came to invest

in Westpoint. This is the first time ASIC has taken such a step. The questionnaire appears on ASIC's website and can be completed on-line. We encourage investors to participate because their responses will be invaluable for ASIC, not only for our investigatory purposes, but also in helping us decide what action may be necessary to assist investors to recover their money.

There are several aspects regarding the Westpoint collapse that are very worrying for ASIC. The Westpoint Group – comprised of over 50 companies – was involved in property development through a complex web of finance, development and construction companies. The finance companies promoted high yield promissory notes and it appears that these investments were marketed to investors wanting a 'secure' income at interest rates above cash rates.

High yield investments, of course, have been of concern to ASIC for some time. We have been issuing consumer and investor warnings since at least 1998, either in the context of enforcement action or more general warnings guiding investors to be wary.

The Westpoint model was based on mezzanine finance only investments, rather than a spread of investments. The problem with mezzanine finance is it is a second level of finance that only gets paid out after secured lenders in the event of failure. ASIC became concerned about this model in 2003 when it commenced an investigation.

In 2004, we commenced proceedings against two companies in the Group, arguing that they were illegally operating outside the *Corporations Act*. ASIC sought a court ruling that the two Westpoint companies were promoting a financial product and operating a managed investment scheme. Advised by its lawyers, Westpoint had structured its fundraising based on the issue to investors of promissory notes, which are similar to an IOU, unsecured and offering little protection.

This was a test case for ASIC involving the Westpoint Group and was an attempt by ASIC to bring these structures within the regulatory boundaries of *Corporations Act*; this would have the effect of Westpoint companies requiring an Australian financial services licence and accompanying compliance programs, liquidity buffers, audited accounts and financial disclosure.

A number of procedural orders were made during the course of this matter, including the requirement that we send a *pro forma* letter, as prepared by the Supreme Court of Western Australia, to investors in these two Westpoint companies about concerns in relation to their investments; that is, that the litigation underway might somehow affect their rights as investors and that investors might therefore, seek to become involved in the litigation. We complied with this court order and sent these letters, but did not receive any response from investors willing to support our court action.

While the Court made findings on a numbers of legal issues in November 2004, the proceedings were not concluded by the time of ASIC's recent investigation and appeals remain on foot. However, these legal rulings raise important issues for ASIC concerning its jurisdiction and the case itself is a good example of ASIC testing the boundaries in complex matters.

One of the key issues for ASIC is, therefore, how did so many mum and dad investors get involved in Westpoint?

One of the first tasks for ASIC has been to focus on assisting investors. Unfortunately, in many cases, it will take some time before investors will know how much of their original investment will be repaid. ASIC will work with the liquidators and administrators of the Group and licensed entities to monitor payments to investors.

We will also take action against unlicensed advisers and, where appropriate, licensed advisers who promoted these schemes. We will continue to focus on those who were involved in the management of the companies in the

group, including related entities. In terms of taking action, we are looking at all possible options within our regulatory and legislative jurisdiction.

The Commission is committed to working through this matter and have allocated appropriate internal and external resources. I am also taking a personal interest in the investigation.

The nature of this matter highlights the importance of consumers seeking licensed financial advice, understanding the nature of their investments and diversifying their financial investments having regard to risk. They need to ask themselves:

- when dealing with a scheme that is unregistered, why is that scheme not registered?; and
- what are the protections in place?

Of course, the Westpoint matter also provides a timely reminder to financial advisers to meet their legal obligations by providing appropriate advice, based on a proper understanding of the needs of their client.

We have undertaken considerable and specific work with both consumers and the industry in order to get these messages across. ASIC at all levels, including the Commission, has been extremely active in endeavouring to obtain high levels of press and other coverage in providing consumer warnings and key messages regarding investments. There have literally been dozens of such articles carried in the press in all states and territories under ASIC's name.

And it is to this aspect of leadership in the regulator's context that I now turn – the need to build partnerships with all of our stakeholders to give effect to the change that we are driving and the vision we are espousing.

### ***Building partnerships***

Above all else, we need to be fair and appropriately transparent in our dealings with industry and consumers. We recognise the importance of

building established partnerships with our stakeholders to achieve outcomes in the interests of all.

Nationally, including in Perth, we consult regularly with industry associations, consumer representative bodies and, as appropriate, industry participants and consumers themselves. We also routinely engage in regional liaison committee meetings and hold stakeholder functions, such as the dinner that I held with about ten Perth-based directors in July last year.

All of these measures assist us in providing leadership. Most recently, for example, we were actively involved in assisting in the development of an industry initiative aimed at raising standards – that is, the Financial Planning Association's ('FPA') conflicts of interest principles. We commend this approach; it clearly exemplifies the benefits of combining different perspectives of thought leadership to current and important issues.

However, yet another aspect of leadership that I would like to draw on today is the need for a commitment to learning from our present actions and continuously aiming for improvement.

One of the key challenges that I see in the year ahead is assessing how we are consulting and whether it is working. The questions we are asking ourselves are:

- is what we are doing in the way of consultation effective?; and
- more importantly, how can we do it better?

To this end, we are in the process of looking at improving our transparency and accessibility and, in doing so, reviewing our industry liaison mechanisms and developing new means of industry liaison as a way to work towards better regulation. Last week, we took the step of being overtly 'contactable' by putting an organisational chart onto the ASIC website under 'About Us', which has the names and phone numbers of those ASIC staff that you might need to reach. In the financial services sector, we are also in the process of rolling out a new consultative committee in the major capital

cities, which are based on a liaison model first trialled in Perth last September.

At the Commission level, we are establishing Business Consultative Panels in Sydney and Melbourne that are intended to identify emerging risks and trends in the market, in a somewhat similar fashion to what our Consumer Advisory Panel does.

Of course, we would not be a leader if we were not able to remain progressive. We trust, therefore, that our initiatives in these areas will go some way to assisting us to better understand market perceptions and, ultimately, to ensure that we stay abreast of development in a manner that allows us to effectively lead industry and consumers through whatever environmental context we are faced with.

### ***Concluding remarks***

In closing this morning, I want to reiterate that regulation is a complex balancing act and, I am the first to admit, we cannot do it alone. The markets we regulate are seeing growing trends of complex and sophisticated products. They are compared against other international markets and, as the financial regulator, we must play our role in ensuring confident participation in them.

At the same time, no one wants regulation for the sake of regulation. Of most significance in this context at the moment is the work of the Regulation Taskforce established by the Federal Government. The Prime Minister is yet to make this Taskforce's findings public. However, we clearly recognise the benefits of this initiative and are, ourselves, committed to reducing any unnecessary and unproductive regulatory burden on business, which does not necessarily protect consumers or promote their informed and confident participation in the markets.

This morning, I am again calling for the collaboration of both industry and consumers to build sound partnerships to make it work for the financial system in its entirety. While Australia has engaged an unprecedented,

prolonged period of prosperity, we cannot relax as the regulator of a confident, reliable and informed financial market. And we must all play the role of leaders in ensuring that this outcome prevails in the interests of all Australians.

**Ends**

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