AIMA* Australian Hedge Fund Forum

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Key messages:

- ASIC's three key outcomes
- Benefits of ASIC's focus for the industry
- Increased engagement with industry

ASIC's 3 key outcomes:

- Confident and informed investors

  - Education

  - Gatekeepers

  - Consumer behaviour

- Fair and efficient markets

  - Market supervision and competition

- Efficient registration and licensing

  - Particular focus on small business

Factors guiding our approach:

- Legislative responsibilities
- Identification of systemic or regulatory risk
- Stakeholder expectations
- Government policy

  - G20

  - TFUFE report

  - IOSCO Standing Committee on Investment Management

  - US and EU developments

Our regulatory tools to achieve outcomes:

- Engagement with industry and stakeholders
- Surveillance
- Regulatory guidance

  - CP 147 Improving disclosure

  - CP 140 Increasing RE financial requirements

- Education
- Deterrence – Trio enforcement results
- Policy advice

  - Trio PJC inquiry

  - Shorter PDS regime

  - AFSL eligibility: must vs may

Introduction

Good morning everyone.

One hundred and twenty-three days into my term as Chairman of ASIC, I want to talk about where our attention has been and will be in the oversight of the hedge fund sector. Our approach is shaped by:

- ASIC's three key outcomes;
- external influences (such as Government policy and international developments); and
- the regulatory tools at our disposal to achieve our priorities.

ASIC's 3 key outcomes

Consistent with ASIC's strategic framework, we will focus on three key outcomes.

The first key outcome is to *promote confident and informed investors and financial consumers*. There are three aspects to this outcome: education, gatekeepers and consumer behavior. I will start with education.

1 **Education.** Empowering investors to take responsibility for their investment decisions remains core to our system. We need to educate investors to understand the concept of diversification and the interaction between risk and reward.

ASIC's launch of the new MoneySmart website will play an important role in financial consumer education. For instance, there is a section on hedge funds. We have also prepared Information Sheets advising investors about frozen funds. The internet is a powerful tool and in addition to websites, we are using new media, such as YouTube, Facebook and Twitter, to communicate our messages to the public.

We are also focused on lifting the quality of disclosure provided to investors. The March 2011 Morningstar Report on the global funds industry rated Australia equal 15th out of 22 countries. We rated poorly on disclosure of portfolio holdings, fund performance, identity of portfolio managers and frequency of shareholder reports. Most of these issues were also considered in CP 147 on improving hedge fund disclosure which we released in February this year.

2 Another important aspect of our drive to promote confident and informed investors is a focus on **gatekeepers**. I use gatekeepers in the

widest sense of the term, to include, for instance, financial advisors, responsible entities, auditors, and research houses.

ASIC's investigation into Trio is an example of poor disclosure, certainly, but a more striking example of the failure of gatekeepers.

Investors depend on gatekeepers doing their job properly. We want to encourage co-regulation where industry and regulators work towards common objectives.

3 Our final area of focus is on **consumer behavior**. This involves recognising how investors make decisions. Advertising plays a critical role and its use outside the PDS needs to be considered. For instance, new media has given industry more interactive channels through which product distributors can reach consumers. Care must be taken when advertising to ensure the product is appropriate and suitable for the target audience.

The **second key outcome** ASIC will focus on, is *promoting fair and efficient markets*. We do this through market supervision, the oversight of market competition and our supervision of corporate governance.

Our **third key outcome** is the *efficient registration and licensing of our stakeholders*. In this, we will have a particular focus on small business.

Factors guiding our approach

The main factors guiding our regulatory approach are:

1 **Our legislative responsibilities** – These are set by the Parliament and include improving the performance of the financial system and promoting market integrity. They also include performance of the many functions and duties conferred on us under the Corporations Act, such as registration and licensing.

2 One aspect of our responsibility to improve the performance of the financial system is the **identification of systemic or regulatory risk**. In light of the Financial Crisis we, and other regulators, have a heightened appreciation of the role securities regulators can and should play in promoting resilience in our capital markets. We were very concerned about the freezing of redemptions and collapse of many funds across the wider managed investment sector including some hedge funds during the Crisis. Some of the actions that ASIC took included facilitating hardship claims and rolling withdrawal offers.

3 **Stakeholder expectations** – ASIC recognises that while hedge fund investors have concerns, managers also have concerns. If Australia's financial system is to enjoy the many benefits hedge funds bring in terms of price discovery, liquidity, innovation and portfolio diversity we

need to manage these sometimes competing but legitimate concerns. I think greater dialogue and more transparency are important to achieving this.

4 **Government policy** – ASIC will take account of Government policy, including its commitment to the G20 process. You will be aware that the G20 called for greater oversight of hedge funds in November 2008. The issue was then referred to IOSCO for its consideration.

The IOSCO hedge fund task force published its report on 'Hedge Fund Oversight' in June 2009. The report called for:

- registration of hedge funds;
- oversight of hedge fund operations, such as record-keeping, conflicts management and valuation processes;
- more fulsome investor disclosure;
- more detailed reporting to regulators by managers and prime brokers, principally to monitor potential systemic risk;
- greater information sharing between regulators; and
- further regulatory work to ensure that hedge fund managers have adequate capital.

IOSCO's Standing Committee on Investment Management is also examining whether there is a need for the development of regulatory principles on fund liquidity, redemption policies and asset valuation more generally. Given our recent experience of funds freezing redemptions, these are development we will monitor with interest.

While on the subject of international developments, we are aware that in both the US under the Dodd-Frank Act and in the EU under the Alternative Investment Fund Managers Directive, very prescriptive hedge fund regulation is being implemented. While our approach needs to be informed by emerging international regulatory norms – to guard against arbitrage and to secure mutual recognition – our preferred approach is to focus on equivalence in outcomes rather than equivalence in mechanisms.

The Crisis focused international and domestic attention on the activities and regulation of hedge funds. While it remains unclear what role hedge funds did play, the Crisis was not a 'hedge fund crisis', and they may well have been more victims than villains.

Certainly the Crisis and more recent events have raised regulatory concerns about:

- investor protection (e.g. the Madoff scandal in the US and Trio in Australia);
- market integrity (such as insider trading); and
- systemic risk (with many funds forced to sell illiquid assets in collapsing markets to meet margin and redemption calls contributing to further declines).

One thing that was clear as the Crisis unfolded was that hedge funds had largely passed below regulatory radars and regulators needed to address this lack of attention.

Our regulatory tools to achieve our priorities

So, how do these considerations interact to shape our thinking on hedge funds? Let me address this by reference to each of ASIC's six regulatory tools.

1 **Engagement with industry and stakeholders** – ASIC needs to understand the sector better to understand the actual and potential risks it poses. It will do this in two ways:

a. **Dialogue with industry** to better understand industry dynamics, fund structures, the role of service providers, valuation practices, liquidity and conflicts management, etc. We also hope to gather intelligence on badly run funds, suspicious trading and ineffectual gatekeepers.

b. **Information sharing with other regulators**. There is global recognition of the need for broader cooperation between regulators. An example of our work in this area is the bilateral information sharing arrangements we have put in place with the SEC and FINRA in 2010.

Another example is the systemic risk survey we undertook of our larger funds in late 2010. While our principal object was to understand the potential systemic risks to our market, our survey was part of a wider exercise undertaken by other members of the IOSCO hedge fund task force. We shared aggregated summary data not only with APRA and the RBA but with IOSCO too, which reported global findings to the Financial Stability Board in July this year. This survey will ultimately be undertaken annually.

ASIC also works closely with APRA to ensure a coordinated approach to the regulation of dual regulated entities, as was the case in Trio.

2 **Surveillance** – ASIC conducts reactive surveillances when an issue arises. However, we are also highly focused on risk-based, proactive surveillance to check compliance and mitigate possible issues. We are currently reviewing the valuation practices of a sample of hedge fund operators. Of particular interest to us will be the treatment of hard-to-value assets.

3 **Regulatory guidance** – ASIC issues guidance in the form of ASIC Regulatory Guides, Information Sheets and Reports. Of relevance to hedge funds we have recently issued:

- CP 147 on improving hedge fund disclosure and proposing disclosure benchmarks; and
- CP 140 on increasing the financial requirements for responsible entities (REs) to address REs for hire.

4 **Education** – As Ientioned earlier, ASIC has a strong focus on investor and financial consumer education. But we also educate market participants on how to comply with their legal obligations, to enable them to fulfill their duties as gatekeepers.

5 **Deterrence** – We deter illegal activity through civil, criminal and administrative enforcement actions. Notable results in relation to ASIC's Trio investigation include:

- Shawn Richard, Astarra/Trio's investment manager, has been sentenced to a total of three years and nine months imprisonment for two charges of dishonest conduct;
- A further five directors that were part of Trio's investment and risk and compliance committees have entered into enforceable undertakings banning them from managing companies and providing financial services for 34 years in total; and
- ASIC suspended the AFS licence of Seagrims, the South Australian financial advisor network, and its two directors were banned from providing financial services for three years. They had advised 970 clients to invest in Astarra/Trio.

6 **Policy advice** – Where there is a gap in the law or it needs strengthening, ASIC will provide policy advice to Government. Of current interest is:

a. The **Parliamentary Joint Committee inquiry into the collapse of Trio** was established with particular reference to the appropriateness of information and advice provided to consumers and the quality of information available via the PDS. ASIC made a number of submissions on potential or planned reforms last week to the PJC. These included that the Government might consider requiring asset level disclosure consistent with the ‘Stronger Super’ reforms and setting more detailed requirements for compliance plan auditing.

b. **Shorter PDS regime.** Many hedge funds may qualify to opt in to the shorter PDS regime because they can liquidate 80% of their portfolios in 10 days, notwithstanding the complexity of many of their strategies and structures. We are concerned that the shorter PDS regime does not allow the level and type of disclosure required to promote confident and informed decision making by investors to invest in hedge funds. We sought feedback on this issue in CP 147, and have raised it with Treasury and before the PJC.

c. **AFSL eligibility: must vs may** – ASIC proposed to the Financial Products and Services Inquiry in 2009, and again to the PJC last week, that ASIC be given the power to refuse to grant a licence where it has reasonable grounds to suppose that a licensee may, rather than will, breach its licence conditions. We also recommended giving ASIC the power to ban persons involved in another's breach of licence conditions.

Conclusion

I hope this gives you a better understanding of what ASIC has been doing and what we are working towards in the hedge fund sector.

Greater regulatory focus on the hedge fund sector is a post-Crisis fact of life, but should not be viewed by the sector as a bad thing. Indeed, it will benefit the sector as it will improve local investor confidence, promote market integrity and increase the confidence of international pools of capital to invest in hedge funds in this market.

Engagement with industry is critical to ensuring we work together to identify and address local market issues while imposing the lowest compliance burden possible in the attainment of our regulatory objectives.

In closing, I encourage you to get involved with industry associations, such as AIMA, with which we have a very constructive dialogue. This will ensure we are across the widest spectrum of industry perspectives so that ASIC can more effectively regulate this important sector.

