ASIC
Australian Securities & Investments Commission

Working in a regulated environment

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Good morning. Thank you for the invitation to present at your Summer School today. It is a pleasure to be here in Perth. For better or worse, you state is very much a focus for ASIC. Your resource industry is an economic powerhouse for those of us confined to the east coast. You are significant users of our capital markets, and our Emerging Mining and Resources stakeholder team is kept very busy here. The relatively high wealth of many individuals, and perhaps a less conservative approach to risk of those individuals, does attract the more aggressive purveyors of financial products. We have 3 active deterrence teams at work here.

I will approach this session's topic "Working in a Regulated Environment" by providing some insights into the scope for ASIC to influence behaviour in the marketplace within the current regulatory framework. How does ASIC approach its task as a regulator of the markets? I will do this with reference to two particular objectives for ASIC this year:

- improving protection for the retail investor; and
- assuming responsibility for market supervision later this year.

Background – Australia's regulatory model

First some background on Australia's regulatory model and ASIC's role. Regulation of our financial markets is based on proper disclosure. This can be traced back to the Wallis Inquiry which reported in March 1997. At the centre of the Wallis Inquiry was the view that the efficiency of the capital markets would be enhanced by not mandating capital requirements for participants, other than the systemically significant banks and insurers, that would be prudentially regulated by APRA. Generally, the markets only needed quality disclosure and enforcement of proper market conduct for their operation. It is no coincidence that this model lines up with those operating in the major markets of North America and Europe, with whom we compete for capital.

A regime was introduced for ASIC to regulate markets through conduct and disclosure regulation. By way of example, conduct regulation includes the rules designed to ensure industry participants with Australian Financial Services licences behave with honesty, fairness, integrity and competence. Disclosure regulation includes the rules that require accurate and timely continuous disclosure, to overcome information asymmetry between investors. The Corporations Act also mandates ongoing regular corporate reporting, which is supplemented by the requirements of the ASX Listing Rules for listed entities.

Under these policy settings issuers and their directors are responsible for the quality of information provided. Investors have a right to receive "good"

information, and "only" good information, but they must be responsible for the decisions they take having received that information.

ASIC's role is to oversee the quality of information that is provided, but it is not tasked with, nor resourced for, monitoring every transaction that occurs, and every disclosure document that is issued (only some of which must be lodged with ASIC). We can, and do, establish and encourage good practices. We do conduct market surveillance of disclosure practices and we must take action if we identify illegal practices. I will touch on some of the strategic issues we face in conducting litigation a little later on.

ASIC does not aggressively seek law reform, but we will advise Government in the event that we identify a clear gap. As an aside, a case in point is the recent announcement by Minister Bowen that the penalties for the markets offences of insider trading and market manipulation will be substantially increased and that ASIC will have power to approach a magistrate for authority to conduct telephone intercepts for these offences.

Of course we do participate in policy discussions about the regulatory model. We have a policy division whose role is to make submissions to parliamentary inquiries and respond to Treasury consultation papers. Another example of the policy work we do is our involvement in the International Organisation of Securities Commissions. IOSCO is the peak international securities regulatory body, representing some 115 securities and investments regulators. IOSCO has been working on issues arising out of the Global Financial Crisis that are relevant to securities and investments regulation, to a large extent under the direction of the collected G20 Ministers. Issues include the broad areas of credit rating agencies, short selling, hedge funds and securitisation. It is important that these issues have a global response. This means that we must align the position we take with that of the major markets with which we compete for capital. Our position on licensing credit rating agencies is perhaps the best current illustration.

Protecting the Retail Investor

Each year ASIC sets itself some overriding thematic objectives that drive the identification of the areas and issues we will focus on across the organisation. Two objectives, which are the themes of my discussion today, are "protecting retail investors" and "promoting market integrity". The two merge as we address good disclosure, and I wish to turn to this area now.

The GFC has exposed some important issues for the Australian market, particularly for retail investors. Investors have lost money in a number of prominent failures. For example, in Perth we have seen the collapse of Great Southern.

There are three broad issues that we have identified for attention:

- the quality of disclosure to the investor by the issuer;
- the ability of investors to understand the proposal and see the advice they receive in the right perspective, that is, understand the adviser's interest in promoting a particular product; and
- the quality of advice to the investor.

Disclosure to the market

As you would appreciate, given the nature of our regulatory regime, a focus for ASIC in terms of protecting retail investors is improving the quality of the disclosure from issuers.

The Corporations Act sets out a comprehensive disclosure regime from the IPO, through the annual reports, to the material that shareholders must be given when there is a company transforming event, such as a takeover or related party dealing. The continuous disclosure regime sits over these formal documents. While the regime is broad, it is no longer prescriptive about the content of documents. Rather it requires inclusion of "everything investors and their

advisers reasonably require to make an informed assessment of the investment". Unfortunately, the trend has been to generate long and detailed documents that run to hundreds of pages. The requirement for "clear, concise and effective" documentation has not improved the position.

Let me interpose here just what I think "clear, concise and effective" means. Documents must be readable – if they are lengthy, there must be a clear road map to enable the readers to select the information they need to make a sensible investment decision. They must be understandable. The content must be clear and relevant to the investment decision at hand. The risks must be put up front and in one place.

I have gathered a list of the kinds of issues we often encounter in reviewing prospectuses lodged with us. These are set out in more detail in a paper I delivered last year – the reference is in the paper you have. As an aside, these comments can apply to almost every type of disclosure document we see at ASIC.

The paper is available at:
http://www.asic.gov.au/asic/asic.nsf/byheadline/AIRA-Annual-Conference-Dec2009?

The key issues (complaints) are:

- First, poor disclosure of the investment proposition – What is the financial product offered? What is the business model of the issuer? Is it sustainable?

- Risk disclosure that is buried, or bears no real relationship to the actual risks associated with the particular investment. How often do you see a ranking of risk in a prospectus in the first few pages of the document? We expect a company's board to identify risks and rank them by reference to possible

impact and likelihood of occurrence. Would this not be useful to an investor?

- Over-use of jargon and glossaries, where understanding each page necessitates flicking to a definition somewhere else in the document. This is particularly poor (even reprehensible) when the definition contains material qualifications.

- Omission of material information. There is often a lack of information about the fundamental assumptions underlying a particular statement.

- Less than plain statements about the benefits that promoters, significant shareholders and executives stand to make out the company or the float transaction itself. Are these people also customers or lenders or borrowers to the company, even on what the promoters think are arm's length terms? An investor should know this.

In response to these problems with disclosure, ASIC is doing a lot of work to identify the "must haves" of offer documents, focusing on product types. You will continue to see a series of ASIC releases that address particular products. Last year we issued papers on unlisted debentures and listed debt products.

Technically ASIC has the power to write prescriptive requirements for these offer documents. We use this power sparingly, but you will see us being more active where we see a clear need. Let me give you an example. ASIC has been working to facilitate the issue of debt products that can be quoted on the ASX and so available to retail investors. That will promote fund raising by Australian business, and make a reliable fixed interest product available to the retail sector. This will enable portfolio diversification for that sector, a gap that the GFC exposed. The Corporations Act presently requires a full prospectus for quoted debt issues by a listed entity. ASIC proposes to permit a short form prospectus for this type of product, but to require some specific additional information that a short form prospectus would not otherwise require – particularly about key

financial indicators of the performance of the entity relevant to the debt product. These must be updated to the market for the life of the product. In addition, we propose that information presently required only to be given to ASIC and the trustee for debenture holders is made available generally through the ASX platform. ASIC has proactively examined the needs of the market and proposes a model that improves the quality of information that an investor in debentures would ordinarily receive. We are also working with the legal professional to develop a pro forma disclosure document. We see great advantage in a standard model to enable ready comparison of products.

More information on this proposal is available in Consultation Paper 126 Facilitating debt raising released 7 December 2009.
http://www.asic.gov.au/asic/asic.nsf/byheadline/Consultation+papers?

Another less mandatory way for ASIC to influence the quality of disclosure is to provide guidance to the market about our expectations, establishing the standards we propose to regulate to. An example is our "if not, why not" disclosure requirements for unlisted property trusts and unlisted debentures:

- Regulatory Guide 45 "Mortgage schemes - improving disclosure for retail investors"; and
- Regulatory Guide 46 "Unlisted property schemes - improving disclosure for retail investors".

http://www.asic.gov.au/asic/asic.nsf/byheadline/Regulatory+guides?

At the most informal end of the spectrum we seek to generate discussion in the marketplace about desirable practices. I suppose my presentation here today is an example of this.

Financial Literacy

The quality of disclosure is just one aspect of protecting retail investors. As I mentioned earlier, our current regime requires investors to be responsible for the decisions they take after receiving the information. Many Australians do not yet

have the knowledge to enable them to make properly informed decisions. Financial literacy is therefore another important priority for ASIC.

The real focus for ASIC here is capacity building. We aim to empower people with enough knowledge to be able to make confident choices. We do not expect, nor think we can teach, consumers and investors to know everything about the myriad of complex financial products on the market. However, we do seek to assist in terms of helping investors understand when they should take steps to find out more, and where they can do so. A key message is not to invest in a product you do not understand. Some of the major international banks would have done well to heed this advice in the run up to 2007.

Our financial literacy work is approached though two primary streams of work.

- First, we deliver financial literacy programs through existing educational pathways:
  - in particular through the schools where financial literacy education is now a requirement for all Australian school children from kindergarten to year 10;
  - through higher education – particularly through the vocational education sector;
  - through employer and union sponsored programs: and
  - through community based programs run by the community sector.

- Secondly, we seek to ensure that Australians have easy access to the information and tools they need to make good financial choices. We do this through our FIDO website (which receives around 1.5 million visits per year), our publications program and public seminars. In December 2009 we launched our "Investing between the Flags" guide which sets out the basic principles of investing. We are also producing product specific guides to assist investors. As a case in point, when we issued the consultation paper Facilitating Debt Raising we also produced the Corporate Bonds Investor Guide available on FIDO.

http://www.fido.gov.au

Financial Advisers

The third area of concern in protecting retail investors is the quality of investment advice they receive.

The responsibilities of financial advisers has been the subject of much discussion (and not for the first time) since early 2008. The Parliamentary Joint Committee charged with ASIC oversight conducted a detailed review of the adviser industry last year and ASIC submitted an extensive submission to the inquiry.

ASIC's position was that overall the current financial services licence regulatory regime has delivered benefits to the Australian economy and retail investors. However, we also noted that recent collapses have raised the possible need to reassess the policy settings. ASIC's role was to assist the Government by providing advice based on its regulatory experience. As part of this process we did identify a number of possible options for reform. The most significant of these reforms were:

- clarifying the standard of care for advisers by ensuring they act in the best interests of their client; in other words imposing a statutory fiduciary style duty to act in the best interests of clients and, where there is a conflict between the interests of the adviser and the client, to prefer the interests of the client; and
- preventing remuneration structures that may create conflicts of interest that adversely affect the quality of advice.

The Committee tabled its final report in November 2009. One of the key recommendations of the PJC was ASIC's suggested reform of an explicit fiduciary obligation on advisers.

This duty would have two impacts on the quality of advice provided. First, it would require advisers to act in the best interests of clients when recommending strategies or products. Currently advisers are required to provide advice that is appropriate to their client in light of their client's personal circumstances, where advisers have complied with their obligations to "know their client" and "know their product". One area of concern for us is that, under the current obligations, advisers attempt to characterise their advice as general so they do not have to comply with the "know your client" rule.

Secondly, by clarifying that advisers are in a fiduciary relationship with their client, mere disclosure of conflicts of interest may not be enough to obtain the informed consent of their client to their profiting from the client's investment.

Currently advisers are required to "manage" conflicts of interest. This is usually done by disclosing conflicts and remuneration models to the client somewhere in the voluminous package given to them, which may be read and but most likely is not, and often are not well understood. There are two elements here:

- does the client realise how much of their investment is paid as commission to the adviser; and
- does the client understand that there are other products which pay less to the adviser but may be better?

In our view disclosure may not be sufficient to ameliorate the impact of conflicts. An additional legislative requirement to put the interests of clients first where there is a conflict should lead to a higher quality of advice.

Conducting Litigation

It would be remiss of me here not to mention a fourth area where we take action to assist retail investors. ASIC will take loss recovery action for investors in appropriate instances, generally where a large class of investors with similar types of complaints have suffered loss. For example:

- Opes Prime: ASIC played a vital role in the $250 million settlement for Opes clients. The mediation approach taken here with the administrators avoided costly litigation;

- Westpoint: ASIC has achieved a number of settlements in relation to various Westpoint financial planner matters:
  - PIS for approximately $5.9 million;
  - Bongiorno for approximately $2.6 million; and
  - State Trustees for $13.5 million.

ASIC has a range of litigation remedies available to it. The most serious is criminal prosecution for breach, which may result in imprisonment or fines. The Commonwealth Director of Public Prosecutions conducts this litigation for us.

ASIC may elect to seek civil penalty orders in appropriate circumstances. Civil penalties can result in an order for the defendant to pay up to $200,000 (and five times for a corporation). ASIC also has the power to seek compensation orders and disqualification as directors orders. As noted, we can also bring claims for damages under section 50 of the ASIC Act.

While civil penalty proceedings are heard by a civil court without a jury, the seriousness of the consequences creates heightened obligations on ASIC. The proceedings are not the same as civil trials between private interests. This is evident in two respects.

- The standard of proof – the Corporations Act states this standard is the "balance of probabilities". Of course the criminal law test is "beyond reasonable doubt". The case law says that the presumption of innocence and the need for exactness of proof are attracted to civil penalty claims, effectively requiring the court to be reasonably satisfied that the facts have occurred. Practically, this is very close to the criminal standard of proof.

- Penalty Privilege - this longstanding common law privilege operates to excuse a person from being compelled to answer a question or produce a document if this could expose them to a penalty. The effect is that the defendant does not have to provide evidence or give an indication of their case until ASIC's case is closed before the court, and so ASIC cannot respond to the point.

It is important to note that ASIC, as a Commonwealth agency, is bound by the Rules of the Model Litigant, a policy administered by the Attorney-General's Department. The obligations include acting honestly and fairly in handling claims and litigation, dealing with claims promptly, and making an early assessment of ASIC's prospects of success. The rules also provide that ASIC should not undertake appeals unless we believe that we have reasonable prospects for success, or the appeal is otherwise justified in the public interest.

Recently ASIC has lost some significant civil penalty proceedings related to directors duties. However, it is important to note that ASIC has also had some significant victories: for example our proceedings against the former directors of James Hardie, the Somerville case on phoenix schemes, and the liquidator Arif who was banned for life, in addition to the Opes Prime and Wespoint cases mentioned earlier. We will continue to pursue these types of cases in the future where appropriate.

We take action where we believe there has been a significant failure of duty, and it is in the public interest to take action. Factors in the public interest include the deterrent impact, the need for clarification of a legal position and loss recovery.

I can assure you that ASIC does not undertake litigation lightly. The present Commission is actively engaged with the conduct of their major cases. We take the advice of the independent bar, and external solicitors where they are engaged, on prospects for success, taking into account all available evidence. We monitor the position during the course of the trial as evidence emerges.

If we have that advice that there are reasonable prospects of success, and we are of the view it is in the public interest to bring an action, then it is difficult for us not to proceed given our obligations as a regulator.

Market Supervision

The second area that I am using to illustrate the range of issues and decisions for a securities regulator is market supervision.

The Government determined to appoint ASIC to take responsibility for the supervision of Australia's domestic licensed markets later this year. Legislation was tabled before Parliament in February in The Corporations Amendment (Financial Market Supervision) Bill 2010. It is largely enabling. We are in dialogue with ASX about the transfer of this supervision responsibility. We have worked closely to date and expect to continue as supervision of market conduct will always be a shared responsibility.

Taking on market supervision is a challenge for ASIC. This is a new regime and we will have new responsibilities that require new capabilities. ASIC has to build a flexible model that has the respect of the market, and can develop into a framework for regulation in a market where there is competition for market services.

Our opening proposition on market regulation and supervision is to establish our objectives:

- market integrity;
- balancing the costs of integrity against possible detriment to market efficiency;
- reducing systemic risk; and
- investor protection – for investors to be confident and informed to participate in the markets.

It is many years since market trading took place on the stock exchange floor between individuals. Technology is now a major capital cost of successful investment houses. This feature gives rise to some complex issues for the market to consider, and the balance is constantly changing. The GFC has stimulated a significant re-analysis of the markets overseas. In January the SEC published a very thoughtful Issues Concept Release on the structure of equity markets. Its purpose is a wholesale review of the market settings for the major stock exchanges in a competitive environment, noting the myriad of alternative trading systems and traders that feed into the New York Stock Exchange and NASDAQ. The paper notes the SEC's five criteria for its market structure (set out in its empowering legislation) to promote competition, while minimising adverse effects of fragmentation, strong investor protection, and to promote capital formation.

This review is available at:
http://www.sec.gov/news/press/2010/2010-8

It provokes a discussion of the balance between the interests of the long term investor against that of the professional trader, whose trading is now dominant in volume terms. It looks at the market benefits of features such as high frequency algorithmic trading and dark pools. All of this is very relevant to ASIC's current market design plans, and will need to be addressed in the near term.

The scheme of the legislation is to create a new regulatory framework that permits maximum flexibility. Markets are changing rapidly, and they have enormous importance for the condition of our economy. We need to be able to respond to events very quickly. A very clear example is short selling. In September 2008 the world's major markets suffered dramatic price declines, perhaps exacerbated by short selling. The US and European regulators banned short selling in financial stocks late on the evening of 19 September, just after we had determined to introduce rules requiring daily reporting of short selling. We felt the position of our market, in terms of exposure and time zone, compelled us to ban short selling in all stocks over that weekend.

The new market integrity legislation creates a structure that authorises ASIC to make rules for the markets. These rules are subject to approval by the Minister and will be tabled in Parliament. At the moment ASX makes the rules but they are subject to disallowance by the Minister – who considers ASIC's advice. The structure is therefore not greatly different in terms of parliamentary oversight of the critical structures that govern our markets.

ASIC will make rules that go to the integrity of the market and will supervise those rules. For example these include rules relating to manipulation and front running. ASX (and the other licensed exchanges) will continue to make operating rules for their exchange and the rules for listing entities on their exchange. The draft rule split will be available for consultation shortly. We and ASX are very conscious of the need to ensure clarity and certainty for the market. We are not making significant textual changes at this stage, so as to make the transition to ASIC supervision as easy as possible in the short time frame that is contemplated.

ASIC will establish a disciplinary panel, based on the ASX Disciplinary Tribunal for professional markets and like tribunals overseas. The panel will, as a formal matter, be a delegate of ASIC in making decisions about breaches of the new market integrity rules. It is important to draw on the expertise in the market. So much of what happens on the market must be consistent with customary and acceptable practice. Also it is important for there to be continuity for the stability of the market. That is very important to market integrity.

The new structure proposes that a breach of ASIC's market integrity rules can attract civil penalties determined by a court (either State or Federal). The potential penalties include fines (maximum $1 million) and a range of other penalties that will be detailed in the regulations. ASIC expects that these will include disgorgement of profits, suspension of individuals and compulsory training programs. The fines are similar in amount to those which the ASX Disciplinary Tribunal can apply.

The new structure proposes that the infringement notice regime for continuous disclosure will be adapted for the market integrity rules. If a rule is breached, then ASIC could elect a court hearing for a civil penalty, but more likely would choose to seek an infringement notice from the Panel. Maximum penalties are 60% of the civil penalty (ie a maximum of $600,000). The recipient can elect to pay the notice and comply with the terms, which can include disgorgement of profit and other elements. In the event of non payment then ASIC must decide whether to take it to court or proceed through its powers to supervise licensees. ASIC will announce whether a notice is issued, and whether or not it is paid.

A party can also elect to "settle" an issue by enforceable undertaking to ASIC, before infringement notice proceedings. The scope for negotiation is clearly greater at this stage, though to ensure consistency of decision making and the involvement of the market in the process, we propose that the settlements will need to be approved by the Panel, at least at the outset.

I should be clear here – all penalties that are paid, including settlements, go to the Commonwealth as consolidated revenue, not to fund ASIC's activities. There will be no funding imperative in our deterrence activities.

Closing

I shall close now. To recap:

- ASIC has a wide range of powers available to it to influence market conduct, but those powers are within a setting of proper disclosure, not registration and review.
- We have set ourselves objectives to which we direct the exercise of our powers. Protecting retail investors is a very important one.
- We use a variety of approaches to influence conduct in the market. One is to impose mandatory requirements, but we also seek to engage with the

investment industry and their advisors (such as you here today) to assist in developing better practices.