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PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

**Oversight of the Australian Securities and Investments Commission**

WEDNESDAY, 12 OCTOBER 2011

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**PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES**
**Wednesday, 12 October 2011**

**Members in attendance:** Senators Stephens and Thistlethwaite and Mr Fletcher, Mr Ripoll and Mr Tony Smith.

**Terms of reference for the inquiry:**

To inquire into and report on:

Oversight of the Australian Securities and Investments Commission

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**Committee met at 16:53**

**CHAIRMAN (Mr Ripoll):** I declare this public ASIC oversight hearing of 12 October open, and I welcome Mr Chaaya from the corporate governance and financial services expert area, Corrs Chambers, Westgarth. This afternoon's committee hearing is being conducted into the Australian Securities and Investments Commission. Under section 243 of the Australian Securities and Investments Commission Act 2001, the Parliamentary Joint Committee on Corporations and Financial Services is required to oversee the functioning of ASIC. This hearing is part of that oversight. This afternoon the committee will hear from Mr Michael Chaaya, partner in Corrs Chambers, Westgarth; and from ASIC representatives.

I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. This gives special rights and immunities to people who appear before the committees. People must be able to give evidence without prejudice to themselves. Any act that disadvantages a witness as a result of the evidence given to a committee may be treated by the parliament as a contempt. It is also a contempt to give false or misleading evidence to a committee. Parliament has resolved that an officer of the Commonwealth shall not be asked to give opinions on matters of policy and shall be given a reasonable opportunity to refer those questions to other officers. If a witness objects to answering a particular question, the witness should state the ground upon which the objection is taken and the committee will have regard to that claim. I welcome our first witness, Mr Chaaya. If you would like to make some opening remarks, we will go from there.

**Mr Chaaya:** I will begin by passing on my gratitude to the committee for inviting me to speak here today. I understand that the invitation stems from a paper that I prepared and presented to a global audience in Berlin in May this year, copies of which I have made available to the secretary of the committee, Tim Bryant. I would like to table that as part of my presentation today. I plan to speak for about 20 to 25 minutes, but I am more than happy to take questions throughout the course of my presentation and at the conclusion of my remarks.

I thought it might be useful to give you some context in terms of the base upon which I think I will be able to share some insights with you. As you know, I am a legal practitioner in financial services. I have practiced in the field for about 14 years now. I am currently a partner at Corrs Chambers Westgarth. I practice in financial services with a real focus on wealth management and corporate governance. The areas of the industry that I have most insight into are the superannuation, funds management, both life and general insurance and a little bit of tax work as well. Throughout my career I have also enjoyed some secondments to some organisations that you no doubt would be familiar with, AMP being one of them, BT Financial Group being another, and also a fairly long secondment to the MLC and National Australia Bank in Melbourne a few years ago. The entities that I have advised over the course of my career straddle both what I describe as the retail sector and the superannuation space of the industry and corporate super fund markets. A lot of what I am going to share with you today is essentially informed by my interaction with those sector and clients that are represented by them. It would also be remiss of me not to acknowledge Daniel Hobbs from my team at Corrs, who did some tremendous work in helping me prepare for the presentation today. Without any further ado and with your indulgence, Chairman, I would like to proceed with the presentation.

**CHAIRMAN:** Please do.

**Mr Chaaya:** Without wishing to insult the committee's intelligence and more just to set the scene of where I will be coming to in terms of some commentary about ASIC's role and financial services regulation, I thought it would be useful to recap in a quick snapshot the fact that we do live with a twin peaks model in Australia. The key regulators that many of us are interacting with on a regular cycle in the industry are both APRA and ASIC. They essentially form the peaks that we talk about, but they are also referred to as a two-pillar form of functional regulation, where we talk about prudential regulation being represented by APRA on the one hand and market supervision being represented by ASIC on the other.

It is also important to appreciate that, so far as the role of each of those regulators is concerned, we are talking about a very different landscape. ASIC has jurisdiction over some 1.77 million companies, something like almost 5,000 financial services licensees—and I will come back to talk about that—and 16 financial markets. In APRA's case it is just over 5,000 regulated institutions, but those institutions are themselves responsible for almost $4 trillion held by those regulated entities. Any talk of ASIC or APRA needs to contemplate the role of the secondary regulators. They would not refer to themselves as secondary regulators, but in the grand scheme of things most of the academic and industry commentary would refer to them as such.

One of the themes I want to develop later on in my presentation is that, when it comes to assessing the role of a regulator like ASIC, you need to put in context what the expectations are that we place upon them as a regulator.

From my perspective as a practitioner in the field, it seems to me that we often underestimate what those expectations are. There is what some commentators refer to as an expectation gap. If I think about my practice area, which is a large part of the prudential market—so the super fund trustees, the managed investment schemes and the insurance companies—it is not just a piece of legislation that they have to think about when it comes to understanding their regulatory obligations. Yes, you have the statutes that are in place, which are well known to this committee, no doubt. You also have an increasing tendency for regulations to back up those statutes which also play a very important role. There are certainly common-law obligations that those entities also have to comply with. On top of that, you have what the regulators produce in the way of their own regulatory guidance, whether they are prudential guides, class orders or simply information statements that they produce for the industry.

I am not going to talk too much more about this, other than to highlight that we do have a very rich history of a large volume of regulation in financial services in Australia. If I wanted to, I could have gone much further back than 1997 and dated it back to the Campbell inquiry in 1981, which kicked off, I guess, what we saw in terms of the deregulation of financial services, not just in this jurisdiction but indeed globally. One of the common criticisms that are levelled at the regulators I think stems from frustration, more than anything else, with the overwhelming volume of regulation that exists in this industry. It comes from governments of all political persuasions—it is not a criticism of any one particular party—and I do note that attempts have been made in the past through things like the Banks Taskforce, which was charged with responsibility for reducing the regulatory burden on business. Efforts such as that have been made to try to ease the burden and cut down on the red tape, but to this day I can honestly say that there are many clients of mine and indeed others in the industry who would maintain the view that it is a heavily overregulated industry. I do not know what the answer is. There are some things I might proffer to the committee in a moment that you can take on board as suggestions, but I do not have a magic wand that says, 'This is how we're going to fix that problem.'

To give you a sense of that, even in the most recent reforms that are relevant to the industry that I work in—namely, the Stronger Super reforms that followed the Cooper review, by Jeremy Cooper—we still saw comments from some of the peak industry bodies, IFSA and ASFA, such as those that I have extracted and shared with you on the slide here. So the FSC, the Financial Services Council, previously known as IFSA, made the comment that APRA and ASIC need to work more closely to ensure that any overlap is minimised and, where that overlap does exist, that the requirements of the regulators are consistent. I can give you many examples of where that still remains a very pertinent issue. ASFA maintain the view that each regulator has different goals and is implementing different legislation. Even within that, I would say there is a legislation that is common to both that is actually interpreted slightly differently by the regulators—and no one regulator seems to have a holistic view of the entire operations of a super fund.

So why do the problems remain, despite governments' best attempts to weed out these issues and instil investor confidence in our financial services system? One of the first points I would make on that front is that communication between the regulators still exhibits some areas for improvement, from my own experience. A classic example of that is in the area of breach reporting, where entities that are licensed on both the prudential front and the ASIC front are still required to report their breaches of those licences to independent regulators in a duplicitous manner.

There is also considerable regulatory overlap. ASIC requires entities that carry on any sort of a financial services business to hold an AFSL. APRA also requires super entities to hold what is known as a registrable superannuation entity licence. Each licensing system has its own requirements, including certain disclosures to be made. One of those happens to be the breach reporting example I gave you. Needless to say, compliance with those requirements comes at a heavy cost for industry participants. In the case of superannuation, it is ultimately borne by investors and, against the backdrop of what we have seen in recent times, in terms of the FoFA reforms and the push for stronger super to bring down the cost of investment in superannuation, I think it is only pertinent that we remind ourselves that there are other ways we can bring those costs down as well. I mentioned a moment ago some commentary around the expectation gap. I think it is safe to assume that there genuinely is a gap and that that gap exists between what ASIC's role is or is perceived to be and what its various stakeholders think it is or should be. I do not think too much attention has been paid to that in the past. As a consequence of things such as a global financial crisis, urgent or pressing goals of a regulator seem to take precedence over less pressing, less urgent but equally important goals. What you have is a clear disjunct between what the regulator seems to think is its role in the market versus what its stakeholders might expect it to be. Whether that stakeholder happens to be the government of the day, shareholders in a listed company or investors in a managed investment scheme, it does not really matter. I think that gap still exists.

Why I think problems remain in the regulatory industry centres around some good ideas that we have had in the past in terms of financial services regulation but poor execution of them. Part of that has stemmed, if you like, from those reforms in the past not being properly considered in terms of their interaction with other acts or existing obligations. The best example I can give you of this, and I am sure you are well aware of it, is the introduction of financial services reforms in chapter 7 of the Corporations Act. As recent as this morning, the shadow Treasurer, Mr Hockey, conceded that, even though he was the minister responsible at the time for those reforms, there is in fact a lot of unfinished business there. He conceded that what we have ended up with in terms of chapter 7 of the Corporations Act is not necessarily an ideal solution for industry. I can only concur with those sentiments and say that you would be hard-pressed to find anyone in the industry who would disagree. The FSR regime, such as it is today, is highly complicated. It really is a bit of a maze. Even the most talented of us amongst the legal profession are challenged from time to time in understanding the true legislative intent of that particular chapter. Don't just take it from me. I took the liberty of extracting one of my favourite quotes in this area from an academic Professor Jordan, from the University of Melbourne. With regard to the Corporations Act, she says:

There is no dispute; it is unlovely and unloved.

Chapter 7 of the Corporations Act is what I am referring to. She goes on to say:

Complex, ungainly—

badly drafted—

internally inconsistent, conceptually troubled; the Corporations Act 2001(CA 2001) is a mishmash of old law, ad hoc amendments, provisions pulled willy-nilly from different legal systems, statements which are not law at all, ideological posturing, and drafting styles that swing wildly from the colloquial to the technical. Despite massive efforts at law reform in the last fifteen years, and continuous tweaking, the CA 2001 remains, as Sir Anthony Mason found it, indigestible and incomprehensible.

I can only concur with those comments with regard to what I explained to you a moment ago about the feedback shared with me by a number of clients in the industry. Whilst she refers to the Corporations Act at large my commentary is essentially refined to chapter 7, which is the FSR chapter and associated regulations which in and of themselves are a complex maze and are what I would describe in other contexts as a very difficult web that, once you find yourself stuck in, you cannot seem to get yourself out of. I want to turn briefly and move away from a discussion of what my thoughts are in terms of regulatory design and some of the challenges that we face to focus more specifically on ASIC and then come to some concluding remarks on what I believe are some challenges that lie ahead. It is apparent from the very brief analysis of, at least, Commonwealth budget statements that the funding for ASIC, as far as specific projects are concerned, has been very targeted. This slide here illustrates that, over the last four budget periods, some of those budget allocations that have been made are for some very significant initiatives, the most significant of which in recent times is ASIC being asked by the government to assume responsibility for the ASX market supervision role, which previously was undertaken by the ASX.

Just to juxtapose the specific funding against ASIC's annual report and what they see as their operating expenses, you will see that in 2008-09, close to $300 million is an indication of operating expenses for ASIC which, on the previous year 2007-08, represented an eight per cent increase. Then we have a fairly marked increase on that figure, to $387 million in 2009-10. That represented an increase of 31 per cent on the previous figure of $295 million. I do not put this up here to suggest to you that we are necessarily giving ASIC too much money. It is quite the opposite. What I am suggesting to you is that it is only appropriate that, when we are expecting more of our regulators, that we actually are in fact placing adequate resources and funding with them so they can discharge those expectations appropriately, so we do not end up with a much larger disjunct in terms of that expectation gap.

That is the point I make in that bullet point there. It is important that ASIC continue to receive the funding it needs to administer new regulations. We need to ensure that those resources are there to enable that monitoring and enforcement role by the regulator.

Just by way of some concluding remarks, how should financial services regulation be carried out? I mentioned at the outset that I do not necessarily have a magic wand here but, if you were to ask me what are my thoughts, they would look something like this. I would certainly suggest that better regulation, as opposed to simply more regulation, is the way to go. That is not to suggest that we can do without regulation entirely. In my paper you will see I make reference to the fact that in the nineties decade this parliament itself produced more legislation than the Commonwealth government had produced in the first 90 years since Federation.

All this debate you see in the industry about red tape and regulatory overkill and a cumbersome system that we are having to navigate in terms of just financial services regulation is real. Not all of that regulation I am referring

to in the nineties is obviously financial services regulation; you make laws on a range of things, including, thankfully, this morning, the carbon tax. I suspect that if you take pause and you look at what that actually translates to in terms of impact on industry, ultimately what a regulator can achieve in terms of regulating appropriately does create some significant challenges.

Equally important is to consider what regulation is essential. A really good example of this—and I do not say this because of the chairman whom we are before today—but the FoFA reforms which are about to hit the industry are a great example where the government of the day took the time to follow up on a significant report that this committee put together about the need to ensure our financial planning world responded adequately to what the investors they deal with and an industry that they actually represent expected of them.

There are many in industry who would argue that it has been a very slow and painful process. I would counter that criticism by suggesting that what we ended up with is actually a very considered piece of legislation that has meant that all stakeholders in the picture, whether they are financial planning bodies, financial planners themselves, wealth management companies, investors, governments, industry groups have all had ample opportunities to air their voices, if you like, in terms of what that legislation should look like. But my point on this particular issue is that that is not always the case. Not every piece of financial services legislation that we have ended up with or that we expect ASIC or APRA to regulate has had the same considered approach. In terms of consistency, that almost speaks for itself, but it is about making sure that we see a level of consistency in the regulatory approach. Whenever we get to the point where, so long as we have the twin peaks system, we have APRA and ASIC taking the same view of the world on things that they actually have some common interest in, the reality is that from an industry perspective that would be an ideal that is worth aspiring to.

In understanding the global setting that we are working within, it is no surprise that our efforts as a nation to make Australia a financial services hub are starting to gain some traction. I was fortunate enough recently to be in Hong Kong attending an inaugural pensions fund forum which was put together by ASFA, and it was amazing to see the amount of interest that was expressed there not only in the financial services and products that are available here in Australia but, more importantly, for today's purposes, in our regulatory system and our regulators and how they go about doing their business of regulating our industry. In an increasing global financial market for financial services it would be prudent for us to continue to look offshore and understand the dynamics of those global markets that we operate within when it comes to setting the parameters for our own regulators, particularly as we embark upon things like the Asia Region Funds Passport and other initiatives that the government is pushing for in freeing up our financial services markets. We need to be mindful that that in and of itself will obviously then change the expectations of our regulators when we are opening up our markets to an offshore scenario.

In that global setting, I would add a word of caution in terms of avoiding the tendency to overregulate as a knee-jerk response to a crisis like the GFC. Indeed there is a lot of speculation at present about a GFC mark 2. I am not an economist and certainly not qualified to comment on the merits of such speculations. Suffice it to say that if we do see anything like a GFC embarked upon again then we do need to make sure that our system is ready to respond. We are fortunate, and it would be remiss not to recognise, that world wide we have been hailed as a model of best practice in our prudential regulation and indeed our securities and markets regulation. That is not to say we did not have issues. We had more than our fair share of investors lose out in managed investment schemes in the agribusiness world and the like, which failed miserably. But if we do simply overregulate we risk introducing unnecessary regulation, which can clearly have some negative effects.

The second last point I would like to make is about appreciating the significance of what I describe as a clear difference between regulatory failure, market failure and supervisory failure. Too often some of the media commentary that sits around the role of our regulators, and some of the attention that is drawn to investments that have gone pear-shaped, tends to blur the distinctions which exist between these different types of failures. What I am describing here as a regulatory failure is essentially where our system for regulation as it is implemented or put in place by government simply did not regulate the area adequately or efficiently. Market failure is what I describe as essentially a failure in market structure, be it some sort of deficiency in market rules, market products or participants or their behaviour. Thirdly, and relevant for today's purposes, supervisory failure emerges where you have the failure to carry out adequate supervision on the part of the regulator. That can arise by way of a failure to communicate between regulators, and we saw that quite clearly when HIH collapsed in the 1990s. Even the best regulatory model in the world will not help you in responding to and remedying shortcomings in supervision by those charged with the responsibility to supervise the sector. Another way of putting that is that regulation without adequate supervision is actually hopeless and supervision without adequate regulation simply creates a toothless tiger or high-levels of market uncertainty.

I will leave my comments there. I am happy to take any questions from the committee members. I appreciate it was a very broad palette that I canvassed, but I am more than happy to entertain any questions on any of those thoughts.

**CHAIRMAN:** You would be aware of the Trio Capital collapse, into which the committee currently is inquiring. You said you have examined trustee governance arrangements in Australia and have identified gaps in communication between, and the responsibilities of, Australian regulators. From your background and attachment A that you have provided, can you give us some sense of how that might play a role with Trio, or if it should play a role with Trio?

**Mr Chaaya:** This will not be a question that I object to answering, suffice to say that, given my firm had a role to play in acting in that matter, I will be limited to what I can say about Trio per se. However, I can give you some commentary about what I think ASIC's role in recent times has meant for the industry at large, not necessarily commenting otherwise on whether they have done the right thing, or not, in Trio's case.

It has become quite apparent that the successes, if you like, of ASIC in recent years in prosecuting matters like the James Hardie case and the Centro decision—and possibly Trio, if that happens to be one of the successful cases—have meant more than just sending a strong message to the listed entities in this country. By that I mean there are directors around board room tables of non-listed entities—I am thinking here about financial planning groups, super fund trustees and directors of responsible entities that are not listed—who take just as much notice of those decisions as directors of a listed company.

The top 200 of ASX listed entities are all told, 'You had better take notice of what has happened in the James Hardie decision or the Centro case because ASIC is coming down hard on directors and its expectations of directors'. If that message is getting out to the listed marketplace that is great, but it is actually going beyond that and it is a good thing that it is. It makes our job as a legal adviser that much easier when a client appreciates that. It is not always as subtle as that. Sometimes it takes a bit cajoling and some advice to get them to appreciate that, 'Although you are not a listed entity in this case and it was about a listed entity, this still has a lot of relevance for you' because the stuff that ASIC regulates regarding directors' duties under section 180 of the Corporations Act applies to a director of a charity as much as it applies to a director of a listed company.

Without answering your question about Trio, I think what you see is that—and this is coming to the point about communication between regulators—the action that is being taken by ASIC in those sorts of contexts is being picked up by the regulators such as APRA and entities that are being regulated by APRA but not ASIC with those listed versus non-listed distinctions taking just as much notice.

**CHAIRMAN:** Can you clarify that? You have identified gaps in communication and you also said responsibilities. What are those gaps? What can give us that gives us a better understanding of where those holes are?

**Mr Chaaya:** The gaps essentially would be at a very fundamental level of the regulators' understanding of the context within which a particular operator or a regulated entity might be operating. The point at which the regulators go inquiring about that context is almost too late. There is an information asymmetry about the market conditions that may have led to that to begin with. That is a classic example and one that is quite often referred to. It then begs the question: can a regulator do anything more to fix up and bring that asymmetry to a more symmetrical position and have an alignment of that information. You then end up with the counter criticism that if you expect that then you can expect more burden to be placed on those entities which are regulated to feed that information at an earlier stage. It is quite a fine balancing act in understanding how much is sufficient to avoid that information gap, so that by the time it comes to some sort of enforcement or supervisory action by a regulator, it is not the case that they do not have enough and have to go out and get more and by the time they get that information it is too late—too much has happened. It is about feeding the regulators with sufficient information to allow them to be proactive, not reactive.

**CHAIRMAN:** Is this a case of information already coming forward that is just the filling-out-of-forms-type information which provides really no information?

**Mr Chaaya:** Precisely. You would find that not every industry participant would agree with me that there is capacity for them to even give more information because it might be a case of them having to give away trade secrets, or saying a little bit too much, which would then not reflect as favourably upon them as it should, for argument's sake. There is this real tension between what is an adequate amount to provide a regulator to make sure they are going to be able to do their job properly and not be in a position where they find themselves in the dark or in a gap scenario but also not compromising the commercial integrity of the entity that they are regulating by insisting on them basically pulling out everything from day one.

**CHAIRMAN:** Does that rely completely on a trust factor—that is, that the people providing the information provide accurate information?

**Mr Chaaya:** In good faith and accurately, absolutely.

**CHAIRMAN:** So where an entity is deliberately trying to provide false information there would be no real way to test that, unless there was something else—

**Mr Chaaya:** Some sanction that attached to them providing false information, I dare say.

**CHAIRMAN:** I mean in terms of identifying, if we are looking at it from a regulatory and supervisory perspective. Earlier you said there are 1.7 million organisations that ASIC, for example, has to take care of. It obviously receives a lot of information.

**Mr Chaaya:** Absolutely.

**CHAIRMAN:** If one of those organisations decided to provide, let us say, not completely accurate or completely full information, how would a regulator go about determining that in the first place? Or how should or could a regulator go about determining that and have some sort of a flag that says, 'Okay, we have a problem here'?

**Mr Chaaya:** It could be done on a number of levels. One might be some sort of threshold based on the size of the entity, its market presence and the significance of that information. If it happened to be slightly inaccurate, would it send the market into an absolute frenzy? If we relied on it, giving us some sort of false sense of security, and it turned out two years later that it was actually inaccurate, had we known it was something different we may have been doing some sort of surveillance behind the scenes.

Another illustration of that is the recent activity on insider trading that ASIC has pursued. For a long time there has been almost a level of complacency amongst market participants about the ability of the regulator to successfully prosecute insider trading. The evidence for that has been the lack of any prosecutions or the very small number historically. The minute ASIC strikes and the chalkboard mark says, 'Bang, we finally got one,' there is this massive hysteria amongst the markets saying, 'Oh, these laws are real and ASIC can use them and we can actually have a successful prosecutions.'

I remember being called up by a journalist on the afternoon of one of those cases being handed down and asked to comment, expecting me to act in an alarmist fashion. My simple response was, 'That's their job.' If they are executing their job, shouldn't we be congratulating them to some extent? And what is wrong with weeding out the rogue elements of an industry? I do not have any problem with that. If anything, we ought to be giving ASIC a pat on the back for that, not letting the market labour under some sort of false illusion that it is okay to do what they have been doing to date.

That is not to say that the incidence of insider trading is somehow rife in the Australian market. But what I am suggesting is that the market has responded by realising that ASIC is serious about this and that there are powers that they have available to them to take enforcement action.

**Mr TONY SMITH:** I just have some general questions. In this paper you gave in Berlin and in the course of your introductory remarks you made a couple of statistical references to the level of regulation and the volume for the 1990s being as much as the first 90 years. I am interested in your perspective on whether that is a common thing in similar jurisdictions, given we have a federal system. Another more general question—and you can take them together—is: who does it better, do you think, when you look around the world at comparable governing systems?

**Mr Chaaya:** I might deal with your second question first. Just in terms of comparative analysis on the international front, it is safe to say that, whilst we certainly do not consider ourselves the financial centre of Europe or the US by any stretch, we are often compared to the likes of the British regulator and the British market in terms of the FSA there. What is of interest—if the committee is unaware—is that there has been a strong push in recent years for the FSA to actually rewind what they have done in terms of having a single regulatory approach—that is, one regulator with different divisions looking after different parts of their market—and moving closer towards the system that we have in Australia, the twin peaks model. I am on the record as saying that I have some reservations about the twin peaks model, but my firm view is that the twin peaks model that we have works far better than what we see in jurisdictions like the UK in terms of the FSA model. The way in which our regulators here in Australia responded to the GFC is probably the best example I can give you of that on a comparative front.

Similarly, in the US you would seriously need to be a rocket scientist to have even a vague understanding of the way in which they regulate their financial services industry.

**Mr TONY SMITH:** That was fairly apparent!

**Mr Chaaya:** Yes. Obama's legislation which came in as a consequence of the GFC was designed to streamline the regulation of financial services entities there following the collapse of Lehman Brothers and a range of other entities in the financial services space in the US. That was a fairly tacit recognition of the fact that they have to do a lot more to get anywhere near the level of confidence that we have here in terms of our regulatory system. So, if I were to base it on those two jurisdictions alone, we clearly come out on top.

The other thing that we do really, really well is that, as a nation, we are not afraid to showcase our skills and our tools here. On the international field, in terms of groups like IOSCO, the international organisation of securities regulators, I know that representatives of our regulators, both APRA and ASIC, go off to those sorts of forums and do a really good job of showcasing our system. That is not to suggest that they paint this utopian picture that everything is hunky-dory, but they are not afraid of showcasing it to the point where other regulators take notice and say, 'Oh, that's interesting.' I saw a really good example of that in Hong Kong only a few weeks ago, where the pensions regulator in Hong Kong are seriously looking at APRA to help them understand how they can get anywhere near the semblance of stability that we have got here.

On your first question, about regulation and whether we do it any better, I would have to say to you: every nation suffers the same criticisms that we do in terms of the volume of regulation.

**Mr TONY SMITH:** That is what I was going to ask you. Is there a Michael equivalent sitting before a congressional committee in Washington at the moment saying, 'In the last decade of the last century,' telling a similar story?

**Mr Chaaya:** Not that I am aware of. I think the person who creates that magic wand, who says, 'This is the fix-it you can have for your financial services system,' is going to be very, very successful.

**Mr TONY SMITH:** You think it is probably fairly similar?

**Mr Chaaya:** It is a universal issue. If you were to break it down to certain nuances, you could find, for example, that with some parts of our regulation the UK example is slightly better or with some parts of our securities regulation we do it better, for argument's sake. But, when I was in Berlin earlier this year presenting the paper that you have before you, there were lawyers from all over Europe, Canadian lawyers, American lawyers and even lawyers from South Africa, and everybody had the same level of frustration with the volume and the pace of financial services legislation in their home jurisdictions. But we can take some pride in the fact that, when it comes to looking at some sorts of models of best practice, they do often turn to Australia and say, 'How does ASIC do it?'

**Mr TONY SMITH:** In fairness, you would obviously concede that the volume of products has massively expanded since the 1950s.

**Mr Chaaya:** Absolutely, and that is a very, very important point. The rise in the complexity of our system, following on from the deregulation of the markets throughout the eighties, has been exponential. It really has. I have noticed that just in the nature of advice that we give clients in terms of the investment climate.

**Mr TONY SMITH:** That would be a good window.

**Mr Chaaya:** The types of investment options that are available these days were not even conceived of five years ago, let alone 10 years ago.

**Senator THISTLETHWAITE:** One of the issues that, as a member of this committee, I am trying to grapple with is the dilemma that we have in looking forward, specifically related to Trio. We have received evidence from a lot of people who lost money associated with the scheme who were in self-managed super funds. A lot of them were in their 60s and 70s, had been members of industry funds in the past, had not been happy with the returns they had been getting at some point in time and had opted for a more aggressive approach to their investments. A lot of them took advice from financial advisers and accountants but still lost a lot of money. So there is quite a bit of sympathy for them in that respect. But on the other hand there is a view that says: 'These people took themselves out of the industry fund approach and out of the regulated environment—they should have been aware of the risks. It is not the role of government to regulate much of that if people choose to make that decision.' I am keen to know what your view is on what approach this committee should be taking in respect of that. Specifically, do you think there is a need for regulation to provide protection for those people who do set up their own self-managed super funds? Will the FoFA reforms deal with those issues? Is there an increased role for ASIC or even APRA?

**Mr Chaaya:** I think when it comes to the area of self-managed super funds, we do need to appreciate, as I set out in one of my earlier slides, that they actually fall outside the APRA/ASIC regulatory model. They are clearly

regulated by the ATO and that was a conscious decision made by the previous government to help, if you like, with the burden that APRA was beginning to feel in terms of regulating an increasing number of these funds. I do not know where the figure stands now, but, at the last count that I saw, there were in excess of 350,000 self-managed super funds—probably closer to 400,000.

**Senator THISTLETHWAITE:** The figures we have say 447,000.

**Mr Chaaya:** APRA is due to publish its data in a few months for the most recent reporting period and that will give us a more accurate picture. But there are lots of them, suffice to say. You are quite right when you say that there is a school of thought which suggests that, if you are going to embark upon a self-managed super fund arrangement, you are telling yourself and those around you that you want to take responsibility for your investments, you want to direct where they go and you want to be held responsible for them. That is a valid view and it sits comfortably within the SMSF framework, in terms of them having, by definition, fewer than five members in their fund, every member being a trustee and every trustee being a member. They are, if you like, looking after their own destiny so far as retirement income is concerned. But where I think that falls down miserably—and we have seen it certainly in instances like Trio and elsewhere—is that there is too much faith placed in these products by those who invest in them themselves. They are often poorly advised, if at all.

So in answer to your question about whether FoFA will assist, certainly the theory suggests that they way we structured the FoFA reforms, assuming they are implemented as suggested under tranche 1 and tranche 2 by Minister Shorten, means that they will make a difference—I would like to think so, absolutely. Upping the ante and the expectations on financial planners when it comes to advising all investors, not just self-managed super fund investors, should translate to those investors being better informed. If they are not necessarily best suited to a highly geared strategy or a very risky investment portfolio, they would be on notice of that very early on and they will not end up in scenarios such as they found themselves in with Trio, for example.

But that may not be enough and what you need to couple that with is the very strong message that comes out of other reforms currently on the horizon, such as the Stronger Super reforms, which make it clear that the audit requirements for self-managed super funds will be increased and that the expectations of self-managed super fund trustees—the trusteeship of those funds—will also be increased. I am not of the view that we need to set the benchmark quite low and that we need to have low expectations; I think they need to be improved upon. If we instil that level of confidence in trusteeship of SMSFs, I think we are bound to see an improvement if you tack onto that, if you like, the strength of the FoFA reforms and the expectations placed on advisers, telling them what they should and should not be doing in terms of investment.

**Senator STEPHENS:** Thank you very much for your presentation. I just wanted to go to this issue that you raised regarding regulation, where you said, 'Not more regulation—better regulation and consistent regulation.' This probably sounds like a foolish question, but to what extent has that overlapping or conflicting regulation been mapped in the landscape so that we have some starting points for improving the regulatory environment that are going to make the most difference?

**Mr Chaaya:** I am happy to take that on notice and come back to you. I can cite a couple of references off the cuff of academics I know who have done mapping exercises, but they all seem to be in fairly contained form. For example, in the managed investment schemes market there is a very good paper by Dr Pamela Hanrahan, who is currently the ASIC regional commissioner of Queensland, that goes to some lengths to understand the history of regulation of managed investment schemes in the last 20 years and where there is that regulatory overlap, if you like, and differences in approach by ASIC over those decades. I can take on notice, if you like, whether that mapping has taken place.

In terms of superannuation, I could talk for hours of instances where I see super fund trustees grappling with this challenge of having to respond to ASIC on the one hand and APRA on the other hand, and sometimes responding in almost identical fashion but just having to do it twice. It almost seems pointless. We have seen continuous attempts by governments of both political persuasions to refine, if you like, chapter 7 of the Corporations Act to ease that burden, but it quite often comes at the cost of understanding the true issue. So you almost end up with this patchwork of bandaid solutions but no real cure. But I am happy to take that on notice and come back to the committee with some further evidence if I can find it.

**Senator STEPHENS:** What is your biggest wish for change? If there was one thing that you could change, what would it be?

**Mr Chaaya:** I think I alluded to that in my opening remarks, but one of the messages I wanted to leave the committee with was that, if we are going to pursue some of these reforms—and I hope we will because they are important; as Senator Thistlethwaite mentioned in the context of Trio in the SMFS space, there is a seriously

strong case for those reforms—then let us not lose sight of the fact that with those reforms comes an increased expectation of regulatory activity and supervision, so we need to make sure that we adequately provide for that in terms of resourcing the regulators in question. Whether it is the ATO, ASIC or APRA—whoever it may be—we need to ensure that resourcing.

That is obviously easy for me to say in the financial services industry as an advocate and champion of the industry. I respect the fact that as a government and parliament you are looking at a much broader agenda and one that has to balance competing claims from the health sector, the manufacturing industry and a range of other competing industries. It is not as simple as saying, 'We're going to give ASIC and APRA an uplift in their budgets of 50 per cent.' I totally respect that; the message is simply: if we are going to push for these reforms and make a promise to investors that we are improving the system, let us not do it in a half-hearted fashion; let us go all the way and give the adequate resources to make sure that we can back those reforms up with proper resourcing.

**Mr FLETCHER:** I am sorry that I missed your presentation, but I have had a quick look at your very interesting article. You talk about the overlap and duplication between APRA and ASIC or at least the risk thereof and you talk about some of the other regulators that also have a role, for example the role of the ATO in relation to self-managed super funds. I am interested in the implications of that when it comes to enforcement activities and pursuing breaches. Is that an area where you think the multi-polar regulatory system creates particular difficulties?

**Mr Chaaya:** It does. If I can use a very basic example which relates to super funds, most trustees of super funds in Australia happen to be corporate entities and in the business of financial services, which translates to them being required to hold an Australia financial services licence, so in addition to ordinary corporate registration requirements that ASIC imposes they need to be an AFSL holder. At the same time, from a prudential perspective, APRA requires them to hold an RSE licence as a registrable superannuation entity. Those licensing requirements in and of themselves could certainly be streamlined and improved upon. As a consequence of holding those licences, there are parallel breach reporting requirements. We have seen some improvement in terms of breach reporting that exists for, say, a super fund trustee where you can in some instances report to one regulator and in some instances that regulator can pass that on to the other regulator. There is certainly room for improvement on the breach reports. Quite often there are instances where clients of mine and other players in the industry have a very risk averse attitude to compliance activity. They will report any breach, however minor it may seem. When it comes to discharging, in an appropriate fashion, the regulatory obligations as a licensee, it means having to go down the ASIC path as well is the APRA path. So you do have the duplicity and regulatory overlap.

Perhaps the ASIC representatives who follow me can confirm this for you, but I cannot speak with any authority about whether, when it hits the regulators, there is room for them to devise a way to exchange that information in a transparent fashion.

**Mr FLETCHER:** Have you seen models around the world which deal better with the issue of overlap?

**Mr Chaaya:** With the UK model, where they have a single regulator in place—the FSA; it is not a 'twin peaks' model—the design means that the information and symmetry is not always there, because it goes into just the one portal and comes out of that one portal. You are not dealing with two different regulators. By virtue of the design of the regulator, that issue might be less apparent in that jurisdiction. Notwithstanding that advantage from the FSA's perspective, there are other reasons why the FSA model falls down. Before you joined us, Mr Fletcher, I made the point to your colleagues that there is a strong push at the moment to move away from a single regulator in the UK and move to something more akin to what we have here in Australia.

As for the US, it is anyone's guess. That is a dog's breakfast of regulators. If there is a breach, I do not think anyone quite understands what they are meant to do with it to begin with, let alone report it.

**Mr FLETCHER:** Reading your paper caused me to reflect upon the fact that the organisational arrangements we have now are predicated upon some differences in the types of entities and the types of products or services they are providing. The impact of that on consumers is that you need a certain basic level of knowledge to even understand the differences. Have you given any thought to that issue?

**Mr Chaaya:** Absolutely. My own clients struggle with this challenge themselves. If I am dealing with a conglomerate which happens to have a life insurance business, a superannuation business, a funds business, as well as a banking business, each of those market segments that they are in is regulated in a very different fashion. They may have a prudential flavour about them, but there are nuances to each of them. A very basic, everyday banking product may have a checklist of one to 20 and a managed investment scheme may have a checklist of one to 100, for argument's sake, from the same regulator. It comes down to whether you believe in designing

regulation based on functional lines or you design regulation based on what the industry or the market necessarily dictates in terms of spitting out products. Each of those models necessarily has pros and cons attached to it. It is a very live issue. Another good example of that is in the self-managed super fund space where essentially their retirement savings are like the retirement savings of any other superannuation investor in this country who is in a large master trust. It just so happens that if you are in an SMSF you are regulated by the ATO, but if you are a member of the AMP master trust you are actually regulated by APRA. It leads to different regulatory results, in terms of compensation that may be available to you if things go pear shaped, for argument's sake.

**CHAIRMAN:** Mr Chaaya, thank you for giving us your paper. Also, thank you for your contribution today. I am only pulling it up here in the interests of time as we have ASIC here as well.

**Mr Chaaya:** I completely understand that.

**CHAIRMAN:** I would certainly be interested in following through on our discussions. I will have the secretariat contact you and we can perhaps pursue another avenue and talk a bit further. Again, thank you very much for your time.

**Mr Chaaya:** It was my pleasure. Thank you for the invitation.

**ADAMS, Mr Mark, Senior Executive Leader, Australian Securities and Investments Commission**

**BELL, Ms Rosanne, Senior Executive Leader, Australian Securities and Investments Commission**

**DWYER, Mr Michael, Commissioner, Australian Securities and Investments Commission**

**MEDCRAFT, Mr Greg, Chairman, Australian Securities and Investments Commission**

**PRICE, Mr John, Senior Executive Leader, Australian Securities and Investments Commission**

[17:50]

**CHAIRMAN:** Welcome, Mr Medcraft and other officers from the Australian Securities and Investments Commission. I will dispense with reading all of the things I am meant to normally read out, as I think ASIC are experienced enough and they understand the rules. We will take it as read that we all understand what we need to do.

**Mr Medcraft:** Deputy Chairman Gibson sends her apologies. This morning walking in Rushcutters Bay she broke her ankle. She is probably going to lodge a complaint with Woollahra council!

**CHAIRMAN:** Thank you. We send her our best wishes. Mr Medcraft, if you would like to make some opening remarks.

**Mr Medcraft:** Yes, if I may, Chairman. I wanted to update the committee on ASIC's activities since we last appeared on 24 June 2011. As has been mentioned, with me is Commissioner Dwyer and senior executive leaders John Price, Rosanne Bell and Mark Adams. I am pleased to appear in front of the PJC again and I also want to acknowledge the important work the committee has been doing on Trio Capital, which is an issue that has obviously affected many investors and we recently participated in.

In terms of the update against delivery of our strategic framework, which I have provided the committee with previously, I would like to give you an outline of how we are going against the outcomes that we targeted. Just to remind you, they are: confident and informed investors and financial consumers; fair and efficient financial markets; and efficient registry and licensing. I will address it under each of those topics.

Firstly, under confident and informed investors and financial consumers, we have said that education is key. In n terms of education I will comment on three points starting with the Mortgage Health Campaign. We kicked that off last month. It is aimed at promoting new tools that we have on MoneySmart. The campaign, as you may have seen, was received very well in print, radio, television and online across the country over last month. The objective of that campaign is to ensure people are managing their mortgage and their finances effectively. In fact, in addition to what we did in the media, we did seminars targeted at areas which were under high mortgage stress throughout the country. We can comment more about that if you like during the discussion.

The second initiative since we saw you last is that we are about to release a new retirement guide, which is obviously focused on those approaching or in retirement. That guide will focus on, for example, things like how much you need to retire, entitlements and Centrelink, super withdrawals, estate planning, and investments to avoid. That complements what we already do on MoneySmart in retirement area, but it provides a paper guide as well for those that need paper as opposed to online.

The third area in terms of education was taking up one of the recommendations of the committee from the last time we met, which was on Australian financial services licensees and what a licence means and what it does not mean. We have now, as I think I said we would do, changed our website. I have a copy here if it interests anybody. It now spells out exactly what a AFSL does mean, but also what it does not mean in that we do not endorse a company and that it does not mean working with an AFSL holder means that you cannot lose money. In addition to changing the website, we have also issued an advisory. Again, basically advising companies not to use AFSLs as a formal promotion. Finally with our product issuers we have again been focusing in terms of surveillance making sure that they are not using the existence of an AFSL as some form of guarantee or endorsement. That is just a follow-up from the last committee. In the second area, under informed investors and consumers, I mentioned gatekeepers. The key thing relevant to this committee is what has happened with Trio since we last met. On 12 August, as you all know, the former investment manager, Shawn Richard, was sentenced to three years nine months on two counts of dishonest conduct. The former Trio chairman, David Andrews, entered into an EU with ASIC preventing him from acting in any financial services for nine years; two former directors of Trio, Keith Finkelde and David O'Bryen also entered into EUs banning them for four years. The investigations on Trio are continuing. This is in addition to a list we have provided you with of other outcomes in relation to Trio over the last 12 months.

Another key outcome in terms of gatekeepers is clearly what happened in the Centro decision. Clearly for directors the key aspects of that decision are threefold: one is that directors need to be sceptical, to question the information provided to them and test the views presented to them. That is what is expected. Secondly, on accounting knowledge, it pointed out that directors are expected to be able to read a set of financial statements and have some sort of basic understanding of accounting. If not, they probably need to retrain or get some training. Finally, an important principle is about accountability and control. Directors are perceived by shareholders to be actually responsible for the affairs of the company. You can delegate but it is also important that you make sure that you control effectively and you do not rely blindly on what you are told. That was a very important outcome in terms of clarifying the law.

Finally, in terms of one of the aspects under informed investors and financial consumers, is consumer behaviour. Since we saw you last we have issued a consultation paper in relation to advertising. That was issued on 31 August. What fundamentally was said in that consultation paper is that we want ads to be accurate, balanced and help consumers make appropriate decisions—and to reflect the way consumers make decisions. We have said that advertisers need to not just highlights the upside, but also the downside of financial products. We have focused that particular consultation paper at those that prepare the advertising material, which I think is quite important—not just at the compliance people that exist in particular financial services firms. They are some initiatives we have taken since we saw you last in that consumer and investor area.

In the area of fair and efficient financial markets, there are two aspects. One is market supervision. Since we saw you last we issued our first infringement notice from the Markets Disciplinary Panel on 30 September to Pattersons. We can talk about that if it is of interest. The Markets Disciplinary Panel, as a reminder, is a peer group body that has power to issue infringement notices and accept EUs.

Another very important thing in relation to market supervision that is very topical around the world and in Australia at the moment is high-frequency trading. We clearly are aware of the broader market changes and the impact of high-frequency trading. I think it is important to acknowledge the increased role of technology in trading and the efficiency benefits but also the import is of managing what is a very key regulatory risk. ASIC does not have any tolerance for any form of market misconduct, including market manipulation, irrespective of whether it originates from HST or participants. To that end we are monitoring very carefully high-frequency trading and algorithmic trading activity as part of our surveillance function. Also what we are looking at is global developments. There was a lot of discussion at the recent meeting of the IOSCO Technical Committee, which I attended in Madrid. Very high on the agenda is high-frequency trading and how that needs to be managed in terms of evolution. As I say, we are continuing to have global discussions about high-frequency trading. Market competition is the second aspect. Obviously we are working closely with Chi-X. This week there will be significant decisions from us in relation to Chi-X proceeding. I think it is fair to say that I believe it is progressing according to plan.

Finally in terms of our objectives, there is efficient registry and licensing. That is led by Rosanne Bell, who is here today. There are three aspects to that. In terms of upgrading our external portals, we are looking at upgrading our lodgement system so that when somebody goes to complete an online lodgement there will be a lot more pre-filling of data so that lodgement will become a lot easier. Secondly—this is a very important issue that is coming very soon—in terms of free searches of ASIC databases, people will be able to search across the databases in one single, simple search. The other aspect of searching is that very soon we are going to launch paid searches, which currently can be done only through brokers or by coming directly into ASIC. That will be launched, I believe, early in the new year. Is that correct?

**Ms Bell:** Yes.

**Mr Medcraft:** The key aspect of this is that, first of all, parties will be able to search directly rather than going through brokers. More importantly, it will be cheaper than going through third parties. At the moment, an extract through a broker might cost $25, whereas directly it will cost $9. So it is important in terms of service delivery. The final issue in terms of registry is the national business names program. Again, in terms of efficiency, what we are looking at there is being able to make a single application covering both a business name and an Australian business number in one application. So again it is focused on efficiency.

That concludes my opening comments, Mr Chairman. I am ready to take your comments.

**CHAIRMAN:** Thank you very much, Mr Medcraft, for your opening comments and also for the submission you have given us. One of the questions I asked the previous witness, Mr Chaaya, was about this issue of information. We understand there are 1.7 million corporations and organisations under the responsibility of ASIC. It is an enormous number. I cannot imagine that every single one of those is a fully functioning business, and I would be very interested to hear your response in terms of the breakdown—even rough numbers—of how many

are properly recognised businesses, corporations and organisations and how many are just people holding an ABN for work purposes. A taxi driver who is required to hold an ABN is clearly not a business and is not recognised as one. I would be very interested in the split of the 1.7 million. ASIC obviously relies heavily on information provided to it through forms that are filled out to apply for licensing, particularly in terms of an AFSL or other licences. I would have to assume that it is based almost completely on trust—there is an enormous trust element in terms of the information that is provided—that it is accurate and properly reflects people filling out those forms correctly. So my question is around that information, the integrity of that information and how ASIC can work towards, or is working towards, following through on early detection of people who might either inadvertently or deliberately mislead ASIC in the information they provide.

**Mr Medcraft:** Rosanne, would you like to respond to that question?

**Ms Bell:** To start with the one about the company population, we do have approximately 1.8 million companies.

**CHAIRMAN:** It has gone up. That is all right. It was 1.7 million this morning.

**Ms Bell:** It is rough, but it is growing. It grows annually on a net basis. We know whether those companies are public companies or proprietary companies. We know that there are very few public companies—maybe 20,000 out of the 1.8 million—so we know that the remaining companies are proprietary companies. We could provide you with a more detailed breakdown at another time of the different subsets in that. The third point I would make is that one of the requirements for holding a licence is that the entity has, generally speaking, obtained professional indemnity insurance. In my experience the professional indemnity insurance industry is very, very good at assessing where risk is. Obviously where there are concerns there is also that overlay whereby if someone cannot get insurance for the business they want to carry out then you might start asking yourself why that is the case.

**CHAIRMAN:** That is an interesting point you raise. I want to make particular reference to Trio in terms of how a licence is granted. I accept what you are saying—that it is that snapshot of that particular point in time. When a circumstance arises in which that organisation is meeting all its requirements but later changes director by director or even changes ownership, is there a process to re-evaluate, revalidate or make re-application, given the significant change in the cultural direction, ownership direction or directorship of that particular entity?

**Mr Price:** My experience here is a couple of years old, but my recollection is that the answer to that question would be no, because when you think about the volume of changes in ownership or personnel you are talking about very, very large numbers. That is not to say that those sorts of things would not be taken into account in thematic compliance work that ASIC is doing. It might be a relevant factor in terms of risk targeting for some surveillance type of action.

**CHAIRMAN:** Perhaps I could just ask you to follow on from that theme. Is there a process by which, if a significant change in an organisation—for example, somebody buys an AFSL rather than applies for one—the regulator would look at that specifically? Are you informed of that? Is there a process? And, if there is not, what more could we do? Is there some sort of mechanism?

**Mr Price:** There is a mechanism that comes to mind that is quite relevant. If a licensee is so dependent on the skills and expertise of a particular person, we will often place on the licence what is called a 'key person requirement'. That is, they can have their licence so long as X stays and if X is to leave then someone with suitable skills to replace X needs to come on board. That is one practical example.

**CHAIRMAN:** Just to clarify: in essence, there is no mechanism or formal process. It really is the case that if an AFSL holder changes or a licensed organisation changes ownership and that ownership is by somebody who is not based in Australia then the culture could change and the direction of the company could change. There is no way for ASIC to really ascertain that or know that. It poses a moral-hazard question in terms of how a corporation operates with that continuing licence but under a very different organisation than the one that applied for the licence in the first place.

**Mr Price:** You are right, I think. I am not aware that ASIC does regular checks when there are those changes in ownership. The other thing to bear in mind, though, is that in terms of ongoing compliance there are requirements for licensees to each year lodge both financial reports and an audit of their compliance arrangements. That is where an external gatekeeper in the system, if you like, steps into the process. For managed investment schemes there are also compliance committees and compliance auditors—although, for the reasons we set out in our Trio submission, we think that particular mechanism is perhaps not operating as well as parliament might have intended it to.

**CHAIRMAN:** Following the same theme, I am very interested that through the process of the Trio inquiry and other processes there has been a significant amount of criticism about the quality of information that is provided to ASIC through the forms that are available. Some people have said—I have not said it, but some have—that it is really just a licence in form filling. It is really an application for form filling itself; it does not actually provide hard data or information that is overly useful or that really measures anything in particular. Given that it is a soft regulatory system you might understand how that is the case. Does ASIC specifically disagree? Also, are you looking at that? Are you asking: what is the information that is coming in? What does it really give us in terms of a clearer picture of who we are licensing?

**Mr Price:** I would not necessarily agree with those criticisms. From my experience, when someone is in the process of getting a licence, along with the form itself we always ask for and we always assess quite carefully three key documents. The first document is the financials around the entity that is operating, because obviously you do not want to let someone into the system and then they get into a situation where they cannot operate and there is a disorderly wind-up. That creates risk. The second thing we always ask for is information about key people and their experience associated with the licence. That is quite important to us. The third thing we always ask for and we always carefully look at is basically an explanation of what the business is. Those three documents, in my experience—which, as I say, is a couple of years old now—are considered by relatively senior people in the licensing team. If you cannot understand someone's business model, that should be ringing alarm bells in terms of how is this person making money. You look carefully at the people skills and experience needed to operate the business, and we want to make sure that they are capitalised enough to keep operating the business without suddenly ceasing and causing systemic risks.

**Mr Medcraft:** One of the things we have pointed out previously is that, despite all the things Mr Price has said, we basically must grant a licence at the end of the day, so we do all that assessment but it is quite hard to refuse a licence unless we think that a potential applicant will breach the law. What Mr Price says is quite correct and we will do that assessment, but it is a matter of what happens then.

**Mr FLETCHER:** In what proportion of cases have you refused to grant a licence?

**Mr Price:** It is a fairly low proportion but I would have to take that on notice. I think an equally valid consideration is in what proportion of cases did we amend the licence conditions or require extra things to occur. It is not unusual in the process of dealing with a licence applicant for us to say that we think they need more experience in a particular area and they need to go away and find someone else who is going to work with them to provide that experience.

**Ms Bell:** Another common outcome will be a withdrawal of an application, so if someone can see a refusal coming they will choose to withdraw the application or amend the application or do something else to avoid that official rejection.

**Mr FLETCHER:** If you refuse, can that be challenged under ADJR or other administrative law?

**Mr Price:** A refusal of a licence leads to appeal rights to the AAT.

**Mr FLETCHER:** On the merits?

**Mr Price:** On the merits is my recollection, yes. My experience of AAT matters is that the AAT is quite rightly mindful of the fact that in circumstances where we refuse a licence or indeed seek a banning of someone, that affects their livelihood. It has been very rare for us to win on that.

**Ms Bell:** The general process is after our staff are minded to refuse an application, there is an internal hearing within ASIC by an independent delegate from within ASIC. They will review an application and then if they determine to uphold the refusal decision, the appeal channel is through to the AAT.

**Mr FLETCHER:** How often is it that people will appeal a refusal?

**Ms Bell:** It is very rare but it is really rare because there are very few that end up with refusals.

**Mr FLETCHER:** The Trio experience, which I think Mr Ripoll was referring to earlier, as you know involves a change of ownership. When there is a change of ownership, does that trigger any review of the licence status or does the licence stay on foot?

**Mr Price:** It is my recollection that the licence stays on foot. I would need to check, but I think there is a notification requirement.

**Mr Medcraft:** There is a notification requirement—there is a reference to notification of change of ownership.

**Mr FLETCHER:** But there is no formal requirement for a new application?

**Mr Price:** No, we do not have an approval power. I am not sure anybody would, unless it was a very strange circumstance of something that brings in the Foreign Investment Review Board.

**Ms Bell:** I would add, though, that if there is a change of ownership it often leads to their having to come back and ask to have their licence varied. Often it is because of what John mentioned before—there is a key-person condition, and therefore the key person has changed. Where that happens, our licensing staff will often take it as an opportunity to review the licence. If the licensing staff are seeing any emerging issues or risks, they have an opportunity to refer that through to other parts of ASIC for further surveillance or activity.

**Mr FLETCHER:** I am conscious of the fact that we spent time looking at the facts in the case of Trio. That is an instance where the system went wrong. But of course if you focus only on instances where the system went wrong, you can get a distorted picture. Can you put the argument for the merits of the system we have now? You say that there is, in essence, a presumption that you will grant the licence. Is it ASIC's experience that, on balance, that is the right approach?

**Mr Medcraft :** In my submission to you about Trio I think my fundamental proposition was that the system we have is a good system, but I think fundamentally it needs some tweaking to make it tighter. I went through and looked at the value chain of that system, starting with the granting of the licence. I think that is in discussion. We see that as a system in credit. I think it works better because there are a lot more people whom we have either refused or persuaded not to apply. I think we actually said that the compliance committees need to be looked at to make that system work more effectively. I also think that we said that the audit of compliance committees needs to be looked at more carefully. The other thing I mentioned was portfolio level disclosure in terms of being able to see what the underlying assets are. I think the system we have is fundamentally a good system. It has been road tested. We pointed out some areas where we perhaps need to think about change to tighten some of them. Mr Price, do you want to add to that? Did that cover the main areas?

**Mr Price :** No. I think the three key areas we mentioned last time were the compliance arrangements around managed investment schemes, the disclosure issue for underlying assets and—if my recollection is right—the issue of research houses. ASIC is doing some further work around research houses.

**Mr Medcraft :** I think the other one we mentioned was custodians—thinking about whether custodians need to do more due diligence in terms of who they take on, both initially and then ongoing. So I think the value chain needs to be looked at.

**Mr FLETCHER:** I have a couple of questions picking up those issues and informed by some of the things that witnesses in the Trio inquiry have put to the committee. First, is there scope for monitoring of reported financial results of managed investment schemes to flag results that are too good to be true? To expand on that, we asked that question of Morningstar, I think. They argued that they believed they could craft an algorithm that would highlight results that seemed too good to be true. I would like ASIC's view on that and whether, if that is plausible, there is a role for a regulator there.

**Mr Medcraft :** One of the criteria for identifying hedge funds for surveillance was whether results that we used in a logarithm were too good to be true. So we already use that in our surveillance. I think I have mentioned before that, in fact, we were in the process of undertaking surveillance on the sector at the same time that information came in on Trio. Those criteria were used; we took the criteria from the Madoff case, plus we added some others, and Trio was at the top of the list. We are in the process of actually getting more information from them in addition to what then came in to us.

That is an element. There are other elements in terms of surveillance of hedge funds that are quite important in perhaps indicating that there are some problems. Return is one of them. We could probably give you some idea—we have to be careful about what we tell you in terms of how we are going to look at it. They are the general criteria. Do you want to comment?

**Mr Price:** Sure. I would start off by saying, and Michael Dwyer can also speak to this, is that ASIC also has an accounting surveillance project. I think we reviewed the financial statements of about 500 listed companies, including managed investment schemes. Often that does result in changes to accounts. That is the first point.

The second point I would make is that I suppose—

**Mr FLETCHER:** Sorry, can I just understand that?

**Mr Dwyer:** This is a financial reporting program which we conduct. We review the financial reports of listed, unlisted and managed investment—

**Mr FLETCHER:** And so that.

**Mr Dwyer:** That would identify breaches of accounting standards, for instance, or other areas that our investigators thought needed further investigation in those financial entities.

**Mr FLETCHER:** Then you would speak to the company or the scheme?

**Mr Dwyer:** Yes, we would talk to the company and satisfy ourselves in relation to any breaches of accounting standards or corporations law.

**Mr FLETCHER:** I think Mr Price said that in some of those cases that has led to a restatement of the accounts—is that right?

**Mr Dwyer:** Correct.

**Mr Medcraft:** Yes. Sorry—just back onto the headphones. In terms of our surveillance we have probably 15 or 20 key indicators that would indicate issues to us. They have actually proved to be quite valid because Trio was at the top. Returns is one of them but there are other aspects which you may think of that might indicate where there may be issues. For example, responsible entity for hire is sometimes something we focus on. We have a whole surveillance project on responsible entities for hire, for example.

**Mr FLETCHER:** Could you just expand—I am not quite sure what you mean by responsible entity for hire?

**Mr Medcraft:** Responsible entity for hire is a party like the people who ran Trio, where basically they are the responsible entity but they actually do not take do not take the investment management function—that is to another party.

**Mr FLETCHER:** Right.

**Mr Medcraft:** All their main business is really just to be a responsible entity that people can go to and say, 'Look, we need a responsible entity but we will be appointed as investment manager'.

**Mr FLETCHER:** Right, so they are effectivel renting out their status?

**Mr Medcraft:** Correct. And just in fairness, there are some very large entities that are responsible entities for hire and which run very good businesses. We actually do focus on some of the smaller ones.

**Mr Price:** To your question, with the accounting surveillance project we look at 500 entities. There are about 2,200 listed entities and there are about 5,000—I think, off the top of my head—managed investment schemes. We do need to take a risk based approach.

As to whether you could have an algorithm that would pick up these sorts of things, personally, I am a little bit sceptical. I have seen lots of algorithms in the regulatory world over the years and they do not always operate as you might think.

**Mr Medcraft:** But as I said, for hedge funds return is one of the things we do look at.

**Mr Price:** Yes.

**Mr Medcraft:** It is a very important risk indicator, so it is something that we use for hedge funds.

**Mr FLETCHER:** One of the other issues that was put to us—not expressly, but which emerged from some of the evidence—was the process by which the custodian which agreed to be involved in Trio was not one which seemed to involve a terribly rigorous due diligence process on their behalf. They might put it somewhat differently, that is perhaps my impression of what was said. Additionally, the scope of their responsibilities seemed very narrowly defined. The question that that prompts me to ask you is: do you think there is a misunderstanding on the part of investors as to the role that a custodian performs and, if so, does that therefore raise the question of, for example, whether in a PDS there ought to be an explicit statement as to what a custodian does and does not do?

**Mr Medcraft:** Yes. In our submission we did point out that there clearly is an expectation gap between what is legally required of custodians and what investors expect of custodians to safeguard their investment. The idea of explaining it better in the PDS is good. Another thing I mentioned at the inquiry was that there perhaps needs to be an industry standard developed in due diligence not only on taking on board new clients but also on monitoring them on an ongoing basis. I think there is more to be done in this area. It is quite interesting what has happened in Europe in terms of custodians. Do you want to comment, Mr Price, on the new European law?

**Mr Price:** I regret to say I am not as familiar with it as I should be.

**Mr Medcraft:** My understanding is there is a lot more legal obligation on custodians. Is that correct?

**Mr Price:** That is absolutely right. I think one interesting question and one question we are pursuing at the moment with some of our fellow regulators is the extent to which other laws and, in particular, the laws that AUSTRAC administer effectively place an obligation on custodians to carefully monitor what is happening.

**Mr Medcraft:** And to report suspicious behaviour or activity of their clients.

**Mr Price:** That is possibly an area the committee may wish to consider—that is, the extent to which custodians are required to report suspicious activities. Certainly, for the laws that AUSTRAC administer, there are those reporting requirements but it is just a question of how far those extend.

**Mr Medcraft:** My recollection of this is the Europeans have gone one step further and imposed much heavier obligations on custodians. We can provide that information to the committee if it interests you. What is clear is that the nomenclature custodian implies to many investors a high level of—

**Mr Price:** It is a very reassuring kind of word.

**Mr Medcraft:** I do think that, having been in the capital markets for years, it is not just an Australian problem; the nomenclature of custodians is a global problem. When something goes wrong, investors turn to the custodians and say, 'What were you doing?' It is a bit of a global issue in terms of the expectation gap. The gap between the two is not normally highlighted until something goes wrong.

**Mr FLETCHER:** I want to ask a couple of questions in other areas. What is the latest picture of frozen funds?

**Mr Medcraft:** I will give you an update of where we stand. If you recollect, when they were actually frozen there were 87 funds, amounting to $25.3 billion. At that time $14.8 billion of that was in mortgage funds, say, $15 billion. There were 13 property funds amounting to about $5 billion, so $15 billion plus $5 billion is $20 billion. There was nearly $6 billion in cash enhanced funds and, finally, one hedge fund at half a billion dollars. That all adds up to around $25½ billion. As at the end of June, the frozen funds amounted to $17.2 billion. There was $10 billion approximately in mortgage funds, $4 billion in property funds and $3 billion in cash enhanced funds, which is a total of $17 billion, and a little bit in hedge funds. Of that $17.2 billion, approximately $5.2 billion of funds have been restructured with member approval. So they are delivering perhaps partial repayments or they are being wound up. For example, I think the CFS mortgage fund is being wound up. Basically that is the current status.

In relation to the timing of returns, clearly you need to look at either the maturity of the underlying assets or the liquidity of the underlying assets. In the case of the prime mortgage funds, it relates largely to the maturity of the underlying loans. Most of the loans were two to five years old, so the moneys are flowing in gradually over 60 months. In relation to some of the property funds, the problem is either that they were development funds—the properties were still being developed—or that there is an issue about liquidity generally in the commercial property market. Some of the cash enhanced funds were invested in things like CDOs. Again, they are being unwound over time.

**Mr FLETCHER:** Does ASIC have a view as to roughly how much of that $17.2 billion is in funds where there is a liquidity problem but where investors will get back 100c in the dollar in due course versus ones where they are likely to get less than 100c in the dollar?

**Mr Medcraft:** We could come back to you but, generally speaking, the prime mortgage funds that are invested in normal, commercial mortgages have been returning pretty well 100c in the dollar over time. In relation to some of the others, again you need to look at what the underlying assets are and how they are managed. If you want to liquidate assets in the current market you are probably going to liquidate them. So it really depends. Most of the prime mortgage funds are winding down over time. They are releasing 100c in the dollar but they may be doing it on a quarterly basis, a monthly basis or whenever cash comes in.

**Mr Dwyer:** I suggest that the return will depend very much on the state of the economy continuing and the value of those assets continuing to be sufficient to pay over a period of two to five years, say.

**Mr Medcraft:** But I think the most important thing that has come out of the crisis in respect of the frozen funds is that, for example, where we are issuing new guidance for mortgage trusts, investors really have to understand these are not liquid funds in the same way that deposits are. That is what we have to make sure of—that investors properly understand the liquidity of those funds.

**Mr FLETCHER:** In relation to what you are saying about searches being available otherwise than through a broker, have you given much thought to the classes of people who are seeking information? In other words, who are the customers for searches, and can you increase your customer numbers and revenue by making the product more accessible?

**Ms Bell:** To give you some background, we get something like 67 million hits on our register a year, so it is highly searched. The vast majority of those searches are currently free searches conducted through our website. However, there is a prospect of some 40 million new paid searches potentially coming online. Although we are

unable to estimate the exact impact on demand of bringing it directly online, we would anticipate an increase in demand over time simply because it is easier to search and it is cheaper.

So we anticipate that there will be a large appeal to the smaller business users, the people who perhaps want to sit at home at night, log on and do a quick search of ASIC's website—people who may otherwise think again if they want to use a third party. I would just note that we will continue to encourage the value adding of the information brokers, because in many instances they will combine our data with other data to add value to it or they will provide services over and above what ASIC provides. So we will watch with interest to see what happens to demand.

**Mr Medcraft:** But, Mr Fletcher, on your point, I think what is interesting for small business is that it does allow you to actually go and check the counterparty you are dealing with much more easily. What is it, $9 to do an extract? That is the forecast number, isn't it?

**Ms Bell:** Yes. And I think you mentioned before one of the key advantages of a new service, which is the ability to search for individuals and the ability to look across ASIC registers. At the moment, you might need to do several searches to really track down what ASIC knows about a party, whereas in future it will be a lot easier to do that through a single process.

**Mr Medcraft:** My personal view is that it will actually help small business a lot—

**Ms Bell:** Yes.

**Mr Medcraft:** Rather than having to go through a broker to find out about a party, which again is just another administrative chore, a small business can go online and cross-check who the director is et cetera. I am quite excited; I think it is a great value-add, what we are doing, and it will come sometime in—

**Ms Bell:** It will come this financial year and it will come in advance of our taking on responsibility for the National Business Names Register—because, in itself, having that register will increase the demand for searching in ASIC, as that will virtually double the size of our registers.

**Mr Medcraft:** We are always happy to do a demonstration.

**Ms Bell:** Yes, we have a demonstration if you would ever like to see it.

**CHAIRMAN:** We would be happy to see it.

**Ms Bell:** We could come back tomorrow.

**Mr FLETCHER:** I would certainly be interested, and I am sure other committee members would be.

**Mr Medcraft:** I think it is really good for small business.

**Mr FLETCHER:** I have a practical question about the retirement guide. Is that a document or a seminar?

**Mr Medcraft:** It is a document so it will be available both electronically and on paper to supplement what we have on MoneySmart already. In terms of your comment about seminars, we do do a lot of work in regional areas and cities on the issue of retirement, right around the country. When we do our engagement with regional commissioners, what they do a lot of the time is target, for example, areas where there are large retiree communities; actually, it is part of our engagement. At the moment, one of the things that we talk about with them is our 'swimming between the flags' booklet. What we will be doing now, obviously, is to have the retirement guide in addition to that.

**Mr FLETCHER:** If I can conclude with one more question, back on Trio: my recollection from the last hearing is that ASIC expressed the view that, while you thought there was fraud in Astarra Strategic, you did not think that was the case in relation to the ARP Growth Fund. Is that right? I do not have my detailed notes in front of me, but I think that is right.

**Mr Price:** Yes, we do see the circumstances between the two funds as being somewhat different, and I think that is reflected in the testimony that we gave in public.

**Mr FLETCHER:** Is there ongoing work on that question, or is it a firmly concluded view?

**Mr Medcraft:** We have funded the liquidator in the case of ARP to undertake further investigations, as I understand it, through the Assetless Administration Fund. So at this stage that is the major course of action in what we are doing for ARP—and, hopefully, making sure that there is a concluded view. I think the most important thing about ARP is that the investors get closure, and we are trying to facilitate that through the Assetless Administration Fund. I have met with the ARP investors, as I said previously, and I do really feel that they just want to get closure in terms of what happened to their money.

**CHAIRMAN:** Okay. There are no further questions from the committee. I declare this hearing closed and I thank you for your participation. The committee has resolved that answers to questions on notice should be returned by Friday, 28 October. The committee is now adjourned. Thank you very much.

**Committee adjourned at 18:45**