# Parliamentary Joint Committee on Corporations and Financial Services

## Statutory Oversight of the Australian Securities and Investments Commission

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# Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the Parliamentary Committee's duties as follows:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

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# Abbreviations

| | |
|---|---|
| ACC | Australian Crime Commission |
| AFP | Australian Federal Police |
| ASIC Act | *Australian Securities and Investments Commission Act 2001* |
| ASIC | Australian Securities and Investments Commission |
| ASX | Australian Securities Exchange |
| AUASB | Auditing and Assurance Standards Boards |
| BOQ | Bank of Queensland |
| CBA | Commonwealth Bank of Australia |
| FOFA | *Corporations Amendment (Future of Financial Advice) Act 2012* |
| FRC | Financial Reporting Council |
| HFT | High Frequency Trading |
| IOSCO | International Organization of Securities Commissions |
| SMSFs | Self-Managed Superannuation Funds |
| Trio | Trio Capital |

# Chapter 1

## Introduction

1.1 The Parliamentary Joint Committee on Corporations and Financial Services was established by the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). Section 243 of the ASIC Act specifies the committee's duties, which include:

> (a) to inquire into, and to report to both Houses on:
>
> the activities of the Australian Securities and Investments Commission (ASIC)…or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed…

1.2 This report is presented in execution of the committee's duty under paragraph 243(a)(i).

1.3 As the corporate, markets and financial services regulator, ASIC is responsible for monitoring the integrity of Australia's financial system. Areas within the Commission's remit include promoting financial literacy and consumer education; corporate, financial services and consumer credit regulation; and the supervision of trading on Australia's licensed equity derivatives and futures market.

1.4 In inquiring into ASIC's activities, the committee seeks to determine whether ASIC is fulfilling its statutory responsibilities. In considering ASIC's performance, the committee has regard to section 1 of the ASIC Act, which directs ASIC to:

- maintain, facilitate and improve the performance of the financial system and entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy;
- promote the confident and informed participation of investors and consumers in the financial system;
- administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements;
- receive, process and store, efficiently and quickly, information given to ASIC under the laws that confer functions and powers on it;
- ensure that information is available as soon as practicable for access by the public; and
- take all necessary action to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.

## The public hearing

1.5 The committee held a public hearing on 3 December 2012 at the Wesley Conference Centre in Sydney. The committee first took evidence from Mr Elmer Funke-Kupper and Mr Peter Hiom, respectively the Chief Executive Officer and Deputy Chief Executive Officer of the Australian Securities Exchange (ASX). The committee then heard from ASIC officials including ASIC's Chairman, Mr Greg Medcraft.

1.6 This report principally reflects the evidence taken at the hearing. Witnesses who gave evidence are listed in Appendix 1. Copies of the Hansard transcript of the hearing have been tabled for the information of the Parliament, and are available on the committee's website.[1] Several questions were placed on notice. These questions, and the answers received, are published in Appendix 2 and are also available on the committee's website.

1.7 The committee thanks both ASX and ASIC officials for their time and contribution to the inquiry. This was the second appearance of ASX officials at an oversight hearing of the committee. In his submission to the committee, Mr Funke Kupper wrote:

> From ASX's perspective, I believe it is important to engage with the joint committee to give it an insight into the exchange and our understanding of the issues impacting on Australia's financial markets.[2]

1.8 The committee foresees that there will be future opportunities when it will be useful to take evidence from the ASX, particularly in relation to dark pools and high frequency trading (see chapter 2).

## Key issues and the structure of the report

1.9 This report deals with a range of matters that are of central concern to the ASX and ASIC, of particular interest to the committee, and of wider debate and conjecture in the financial community. The areas of discussion common to both agencies concerned 'dark pool' trading and high frequency trading. Chapter 2 of this report presents this evidence.

1.10 Chapter 3 of the report is focussed on ASIC's concerns with the quality of auditing in Australia, and overseas. These concerns have been ongoing. In its submission to this committee's inquiry into the collapse of Trio Capital in 2011, ASIC drew attention to its project aimed at developing a better understanding of compliance plan auditors and its future work plan to monitor auditors' approaches. Both ASIC and

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Oversight of ASIC*, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/asic/index.htm (accessed 24 September 2012).

2 Australian Stock Exchange, *Answers to questions on notice*, 17 December 2012.

the committee laid part of the blame for the collapse of Trio Capital with the failure of Trio's auditors to exercise their duties properly. In December 2012, ASIC's attention on the poor quality of auditing was refocused by the findings of its 2011–12 audit inspection report, and the role of the auditors in the collapse of the rural Victorian lender Banksia Securities Limited.

1.11 Chapter 4 of this report covers a number of other matters of interest to the committee. They are:

- the Commonwealth Bank of Australia's decision to settle further compensation costs with ASIC in the Storm Financial matter;
- the prospect of Australian Federal Police investigations into those who perpetrated the Trio Capital fraud, and the prospect of Trio Capital investors receiving compensation from these pursuits;
- ASIC's progress in consulting with stakeholders on guidance material relating to the Future of Financial Advice reforms; and
- the implications in terms of directors' continuous disclosure obligations of the High Court's judgments in the Fortescue Metals and James Hardie cases.

## Ms Belinda Gibson

1.12 Ms Belinda Gibson, Deputy Chairperson of ASIC, has indicated that she will not be seeking reappointment when her current appointment expires in May 2013. The committee acknowledges Ms Gibson's considerable contribution since joining ASIC as a Commissioner in November 2007. The Parliamentary Secretary to the Treasurer and the former Chair of the committee, the Hon. Bernie Ripoll, has also formally acknowledged Ms Gibson's work in the oversight of capital markets and supervision of exchange traded markets and brokers, and improvements in disclosure and corporate governance.[3] The committee would like to extend its thanks to Ms Gibson for her cooperative and informative contribution to the work of the committee. It wishes her well in her future endeavours.

3 The Hon. Bernie Ripoll, Parliamentary Secretary to the Treasurer, 'Departure of the Deputy Chairperson of the Australian Securities and Investments Commission, Belinda Gibson', *Media Release No. 57*, 19 December 2012, http://parlsec.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/057.htm&pageID=003&min=bfr&Year=&DocType (accessed 20 December 2012).

# Chapter 2

## High frequency trading and dark pools

2.1 The committee's ASIC oversight process provides—among other things—an opportunity to discuss publicly the regulator's views on matters of rapidly evolving domestic and global concern. At the December 2012 public hearing, those issues related to high frequency trading (HFT) and dark pools.

2.2 HFT uses sophisticated technological tools and computer algorithms to trade securities on a rapid basis. The buyer places a large block of orders, many of which are immediately withdrawn. The intent is to make a profit on small movements in the share price. HFT is generally conducted on the open stock exchange. The key for those operating an HFT strategy is to use faster technology than their competitors to get the best places in line when quoting to trade and to avoid trading when they choose.[1]

2.3 A dark market, or a 'dark pool', is where clients' orders are matched on a computer away from the public market. The trades tend to be smaller and more frequent. This form of trading has the advantage for buyers of very low brokerage fees and the ability to trade way from the scrutiny of the public market. Trading away from the public market means that high frequency traders cannot use the trading information to their advantage.

2.4 This chapter presents and considers the evidence provided at the public hearing by the Australian Securities Exchange (ASX) and the Australian Securities and Investments Commission (ASIC) on the need to regulate HFT and dark pools. Dark pools and HFT are a key area of international concern: they are a top priority for the International Organization of Securities Commissions (IOSCO).[2]

2.5 The questions of whether and how to regulate HFT and dark pools have been the focus of considerable public debate in recent times:

- ASIC and the ASX have publicly stated their concerns and positions on the need to regulate these types of trading;
    - both reiterated their views to the committee at the public hearing in December 2012;

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1 See Larry Harris, 'Stop the high frequency arms race', *FT Trading Room*, 27 December 2012, http://www.ft.com/intl/cms/s/0/618c60de-4b80-11e2-88b5-00144feab49a.html#axzz2HcGOlNxU (accessed 10 January 2013).

2 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 13.

- in November 2012, the government announced new rules on HFT and dark pools which are being introduced over the next 18 months;

- in December 2012, the Financial Services Council released a commissioned report by Baseline Capital focusing on issues related to technological change, and HFT and dark pools in particular; and
- Treasury is currently examining the licensing of dark pools and whether the current regime is adequate. It released an options paper in November 2012 and submissions closed on 1 February 2013.[3]

## The size of high frequency and dark pool trading

2.6 In a 'lit' market, the orders are displayed on order books and are therefore pre trade transparent. In a dark pool, orders are not pre trade transparent.[4] The ASX estimated that high frequency trading accounts for around 25 per cent of the value of activity on Australian markets (lit and unlit). The value of activity on unlit or dark markets has been 'as high as about 40 per cent but probably averages in the range of 25 to 30 per cent'. The ASX noted that this level is well below that in the United States, which can be above 50 per cent.[5]

## Current rules on dark pool trading

2.7 The ASX noted that there are currently some rules relating to dark pool trading. Mr Peter Hiom, Deputy Chief Executive Officer of the Exchange, explained that the rules:

> …relate to the size of the transaction. Over $1 million, there are very few rules that bind you. It can be between two consenting adults and it can be at any price. Once you get below $1 million then you have to do that transaction between the bid-offer spread in the lit market. The new rules around meaningful price improvement will require that to be meaningfully inside. So you cannot transact off-market at the same price as on-market below $1 million. Those rules are there today and they are going to be tightened up by that price improvement requirement.[6]

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3 Treasury, *Australia's financial market regime: Addressing market evolution*, http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Australias-financial-market-regime-Addressing-market-evolution (accessed 10 January 2013).

4 See 'Glossary of useful terms linked to markets in financial instruments', http://ec.europa.eu/internal_market/securities/docs/glossary_en.pdf (accessed 12 January 2013).

5 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 7.

6 Mr Peter Hiom, Deputy Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 8.

2.8 He added that while there may be an argument that there is a social benefit in all investors having access to a public price, there is a 'judgment call' in terms of market efficiency for transactions over a certain size. He explained that this is:

> …because the act of those larger transactions being put into the market could actually be destabilising if that transaction is too large. You allow those transactions to be executed away. Those rules have been in place for many years. It is just the introduction of technology that has allowed these other execution mechanisms to thrive.[7]

## New market integrity rules

2.9 On 20 November 2012, the government announced new market integrity rules to address risks emerging from developments in market structure, including growth in automated trading and the changing nature of dark liquidity. In a media release announcing the package, the Minister for Superannuation and Financial Services, the Hon. Bill Shorten MP, explained that the new rules provide for:

- direct control over trading algorithms, including 'kill switches' to immediately stop an algorithm if required;
- new extreme trading rules in cases of large price movements whereby there will be an immediate obligation on the market operators (Chi-X and the ASX) to enforce an extreme trading range for trade in securities;
- a requirement that dark pools offer meaningful price improvement over the lit market, with exemptions for block trades; and
- additional data reporting requirements to assist ASIC in performing market surveillance.[8]

2.10 The government announced that these obligations will come into force over a six to 18 month period: the extreme trading range rules applied for the ASX and Chi-X from November 2012; the meaningful price improvement rule will come into effect in June 2013; new market operator data reporting requirements will be introduced in November 2013; and kill switches in June 2014.[9]

2.11 ASIC Deputy Chairperson Ms Belinda Gibson gave the committee some context as to ASIC's involvement with these rules:

> …the first time we consulted on them was in late 2010. We had another consultation last year and we had always indicated that these were a

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7 Mr Peter Hiom, Deputy Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 10.

8 The Hon. Bill Shorten, Minister for Superannuation and Financial Services, 'Investors to benefit from new rules on high frequency trading and dark pools', *Media Release*, 26 November 2012.

9 The Hon. Bill Shorten, Minister for Superannuation and Financial Services, 'Investors to benefit from new rules on high frequency trading and dark pools', *Media Release*, 26 November 2012.

> minimum. Since then we have become more concerned about these things, and IOSCO has become more concerned, so we said, 'Let's look again at how these things are working in our market and whether there is a need to do more.' It is not a given that there is a need to do more.[10]

## ASIC's taskforces and options

2.12 Currently, ASIC has taskforces focussing on dark liquidity and high frequency trading. These taskforces are due to report to the government in March 2013. The Minister's media release announcing the new market integrity rules in November 2012 listed some options on HFT and dark liquidity that ASIC may suggest as part of its taskforces. In terms of dark liquidity, the media release stated the following options:

- whether the minimum order threshold for dark trading should be increased from $0;
- enhanced conflict management controls;
- rules for trade monitoring; and
- enhanced disclosure to clients.[11]

In terms of HFT, the media release flagged the possibility of:

- order to trade ratios;
- a minimum order size; and
- a review of tick sizes.[12]

2.13 ASIC Chairman Mr Greg Medcraft explained to the committee the Commission's general approach to considering HFT and dark pools:

> My view is that today we have been fairly pragmatic in our approach to both. We have said, 'Here are the big problems,' and we had those initial sets of rules. We are continuing to look at it here but also at what other regulators are doing elsewhere. We are taking a careful, pragmatic approach. We are all learning. We are still trying to work out the impacts on price formation in the market of both high frequency and dark pools. That is

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10 Ms Belinda Gibson, Deputy Chairperson, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 36.

11 The Hon. Bill Shorten, Minister for Superannuation and Financial Services, 'ASIC dark liquidity and high frequency trading taskforces', *Media Release*, 26 November 2012, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/078.htm&pageID=003&min=brs&Year=&DocType=. (accessed 31 January 2013).

12 A tick size refers to the minimum price movement of a trading instrument.

> why I do not think there is a simple solution. A solution will evolve with experience and research both here and globally.[13]

2.14 Ms Gibson told the committee:

> …the dark pool task force, or dark liquidity task force, has obtained a lot of information from the providers of the various venues. I think we continue to see about 25 per cent of the market is in dark liquidity venues, but that includes the ASX. There are now some 20 crossings markets and that also includes one or two other—ITG, Liquidnet—which are dark pools ordinarily. We are on track to issue our report in March…

2.15 The ASX was asked its view of these rules. Mr Funke Kupper responded:

> We think they are a very good start. They are some of the things we have been advocating, particularly the measure of meaningful price improvement, which we think is an important measure in relation to both high-frequency trading and dark pools. In addition, we welcome the fact that the task force that ASIC will put together will look at a number of other measures. We think some of those measures could work very well to put greater controls around markets, while we think others might be a little bit more dangerous. We will, of course, give all that input to ASIC and the minister over the next couple of months.
>
> I should say that these processes take an extraordinary amount of time in the way our markets work; therefore, we would like to think that, when the taskforce has done its job—March 2013 is the target date, if I am correct—ASIC and the minister can very quickly thereafter make decisions. Then we can implement the measures we think are necessary so as not to go through many more rounds of consultation, which tends to be the case in our market. We welcome the announcement and we welcome the task force.[14]

## ASIC and the ASX's concerns with HFT

2.16 The committee took the opportunity to discuss with both ASIC and the ASX the concerns they have with HFT. ASIC told the committee that the order to trade ratios in Australia were not as high as in the United States. Ms Gibson explained that in Australia, the average of orders to trade is about nine to one compared to the 100 orders to one trade that can be made in the US. She added:

> The people we know to be high-frequency traders are slightly more than that, but only slightly. I do not think many of them are up as high as 20 to one. Whether that is a product of the fact that we have a cost recovery regime and we recover our supervision costs, or whether we recover the

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13 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 36.

14 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 7.

> cost of our IT by reference to the number of messages—that is an impost, and quite a possibility of why it is low.[15]

2.17 ASIC also explained to the committee that the attributes of buy-side institutional algorithms and high frequency trading algorithms are similar. Ms Gibson noted that this was not surprising given that the buy side have needed to develop algorithms that deal with HFT algorithms. She emphasised that the key is to examine the problematic conduct, such as pinging and quote stuffing.[16] Ms Gibson told the committee that ASIC's taskforce is already having an influence: 'some trading activities that in the course of our reviews we indicated we did not like seem to have stopped already'.[17]

2.18 In terms of monitoring high frequency trading, Mr Funke Kupper noted that there is an obvious common interest shared by the ASX and ASIC. He told the committee:

> Of course, sometimes you come across new developments that touch on both, and I think high-frequency trading is one of those examples where the behaviour, if considered detrimental to the markets, can affect the fair, orderly and transparent nature of the market as well as market integrity. These are the kinds of things that we need to work on very closely together.[18]

2.19 The ASX recognised ASIC's lead role in the debate on high-frequency trading. However, it also noted that the ASX is a 'very active contributor' in this debate and has had 'quite a few discussions with ASIC'. It emphasised that the Exchange takes market integrity issues 'very seriously' and it will work cooperatively with ASIC to ensure that the best controls are in place.[19]

## ASIC and the ASX's concerns with and approach to dark liquidity

2.20 ASIC has previously outlined its concerns with dark pool trading to the committee. In an answer to a question on notice given to the committee in July last year, ASIC stated that it is concerned that:

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15 Ms Belinda Gibson, Deputy Chair, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 36.

16 Quote stuffing is where a bidder quickly enters and withdraws large orders to attempt to flood the market with quotes and cause competitors to lose their competitive edge in high frequency trading.

17 Ms Belinda Gibson, Deputy Chairperson, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 36.

18 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 3.

19 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 3.

> …if investor order flow in our market continues to migrate into the dark, it can create material negative externalities for the wider market by diverting liquidity away from pre-trade transparent venues, impairing efficient price formation, increasing transaction costs and allowing dark orders to jump the time-priority queue.[20]

2.21 In evidence to the committee, ASIC commented on some of its observations of the nature and the effect of dark pools in Australia. Ms Gibson noted that ASIC had seen some of the disclosures to clients of the broking firms about what is in their dark pool. She described the nature of these activities in the dark pool as 'less than optimal in terms of the presence of high-frequency trading, as an example, in terms of the existence of their proprietary desks in that pool'.[21] Ms Gibson also told the committee that ASIC is continuing to do research on whether the level of trading in the dark pool is having an effect on the lit market. She noted that ASIC is looking for evidence of this in the top 200 publicly listed companies.[22]

2.22 The committee asked the ASX to explain the danger to the investor if more trade moves off the ASX and into dark pools. Mr Funke Kupper identified implications for both the transparency of information and the efficiency of the lit market. As he told the committee:

> if your transactions do not get executed on a lit market, do you know under what…terms those get executed—both the commercial terms and the rules with which they get executed? What is the mechanism by which transactions get prioritised or matched, if you will, away from the exchange?
>
> …the most efficient marketplace is the one marketplace where everybody gets together to trade. It is generally true for markets, and it is true for financial markets as well. The moment you start to remove liquidity from that one market, that market becomes less efficient, and over time the spreads will go up. He estimated that, if 20 per cent of liquidity gets removed from the lit market, spreads will go up by up to one basis point. That does not sound like a lot, but it is about three times what we charge to trade. So one basis point is a lot in financial markets, because it gets multiplied by so many transactions. So it is both a transparency argument and an efficiency argument. It is one of the reasons we think the $25,000 threshold is significant, because it keeps the flow together, effectively.[23]

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20 ASIC, answer to question on notice, 20 June 2012 (received 26 July 2012).

21 Ms Belinda Gibson, Deputy Chairperson, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 37.

22 Ms Belinda Gibson, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 37.

23 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 7.

2.23 The committee also asked the ASX why a dark pool trade would not be an attractive proposition for a small investor if the investor could benefit from the broker's lower fee. Mr Funke Kupper gave the following response:

> The answer is that the saving relative to the total broker fee is small so, when you are talking about a materially lower fee, we can look at the most recent example, where I think nabtrade is charging $14.95 against ComSec $19.95. That is a $5 reduction, if I read the press correctly. We are half of 73c in all of that so, while theoretically this could passed on, I do not think it will make a difference.[24]

2.24 The ASX was then asked for its view as to why HFT is harmful. Mr Hiom explained that the concern is about the speed of trading that the new technology is providing. He told the committee:

> [it] is a question of degree. The debate in the market would be how fast is fast enough. I think that is where we are now in the process of working with ASIC in trying to understand where controls make sense. What used to be a fast trading market five years ago is a snail's pace, and what is now fast technology in two years' time will make it look slow.[25]

2.25 In this context, Mr Funke Kupper told the committee:

> What we are trying to work through with ASIC is how do we differentiate helpful high-frequency strategies, such as market makers whose liquidity we genuinely want in the marketplace, and how do we differentiate that from high-frequency trading behaviours that are more detrimental…That is not an easy thing to do, because they use very similar technology and algorithms.[26]

2.26 Mr Funke Kupper added that in terms of distinguishing between beneficial and predatory HFT strategies, one requirement could be a minimum order size. He explained:

> We know that higher frequency traders sometimes trade very small parcels, because what they try to do is be in front of the queue with very small parcels. So perhaps a minimum trade size where you have to trade a minimum of X-hundred dollars, for example, is a helpful way of differentiating more predatory behaviour from genuine investment behaviour.[27]

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24 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 8.

25 Mr Peter Hiom, Deputy Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 10.

26 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 10.

27 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 11.

### *Limits on a dark pool trade*

2.27 The ASX noted that ASIC had initially proposed a cap on dark pool trades of $50 000, while it had proposed a limit of $25 000. Mr Funke Kupper told the committee that some limit on a dark pool trade is needed to ensure the efficiency of the market:

> When you have an efficient financial market it is really important that the market that all investors have equal and unlimited access to is the most efficient central point where people trade. What we have seen overseas as a result of the absence of adequate measures is that a lot of trading has moved away from the one marketplace that everybody has access to on the same terms.[28]
>
> …
>
> The reason we advocated for the $25,000 threshold is to make sure we say in control of that as a regulator…but we feel strongly about it because it is important that the lit market remains relevant.[29]

### *'Meaningful price improvement'*

2.28 As noted above, the government has announced that a 'meaningful price improvement' rule will be introduced in June 2013. The rule will be that the price improvement must be at least one tick or at the mid-price.

2.29 ASIC has stated publicly that it sees a meaningful price improvement rule as important. In an answer to a question on notice from the committee taken in June last year, ASIC stated:

> The core element of our proposal is that trades in the dark (other than large block trades) should offer meaningful price improvement referencing the national best bid-offer. That is, dark trading of this type can only occur if the price of the trade is a meaningful improvement on the price that would have otherwise been obtained if the trade had been executed in the lit market. We think that this provides the right incentives to ensure that limited amounts of this dark trading takes place.[30]

2.30 The ASX told the committee:

> Meaningful price improvement tends to be a popular measure. We support meaningful price improvement provided the word 'meaningful' is truly meaningful. The way it has been defined by the minister as one tick or at

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28 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 3.

29 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 6.

30 ASIC, answer to question on notice, 20 June 2012 (received 26 July 2012).

> the mid is we think meaningful. We would not want to see that watered down.[31]

## Committee view

2.31 The committee is particularly interested in developments in the nature, impact and regulation of HFT and dark pools. Notwithstanding the indications that these trends are neither as pronounced nor as harmful as in the United States, the committee strongly supports ASIC's work through its two taskforces. It awaits the findings of these taskforces with interest.

31 Mr Elmer Funke Kupper, Chief Executive Officer, Australian Securities Exchange, *Committee Hansard*, 3 December 2012, p. 4.

# Chapter 3

# Concerns with the quality of auditing, and other related matters

## Introduction

3.1 Another key theme of the December 2012 public hearing concerned the role of auditors. In his opening statement to the committee, ASIC's Chairman, Mr Greg Medcraft, raised concerns with the quality of auditors' performance in Australia.[1] In part, the Chairman's comments were made in the context of auditors' role in the recent collapse of the Victorian debenture issuer Banksia Securities Limited. However, Mr Medcraft also identified broader concerns with the auditing industry based on ASIC's audit inspection report for the period 1 January 2011 to 30 June 2012. The report found that there has not been an improvement in audit quality since the last report, for the 18 months to 31 December 2010. Indeed, there had been an increase in instances where auditors did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated.[2]

## ASIC's concerns with auditing quality and 'professional scepticism'

3.2 At the public hearing on 3 December 2012, Mr Medcraft foreshadowed the findings of ASIC's audit inspection report, due for release the following day. He told the committee that while ASIC's previous inspection report found that 15 per cent of the survey sample was inadequate, that figure had increased in the 2011–12 report. The Chairman provided the following interpretation of this result:

> …last year I indicated that a level of 15 per cent was already far too high in terms of having problems where it really was inadequate evidence to support an audit opinion. I think clearly we expect as a country that that number should be substantially less than 10 per cent and, in terms of audit quality, significantly less. These results, I find, being a former auditor and chartered accountant, very disappointing and frustrating. I consider what we are seeing now as second strike for the audit sector and it is clearly one I

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1 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12.

2 ASIC, *Audit inspection progress report for 2011–12*, December 2012, p. 4.

> think the profession should consider itself on notice: it needs to lift its game.[3]

3.3 The report presented the following data and observations:

> We found that, in 18% of the 602 key audit areas that we reviewed across 117 audit files over firms of all sizes, auditors did not obtain sufficient appropriate audit evidence, exercise sufficient scepticism, or otherwise comply with auditing standards in a significant audit area. While the financial reports audited may not have been materially misstated, in these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement…
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> Some audit firms inspected need to improve their quality control systems…
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> Further, we believe there are a number of actions that audit firms should consider to improve and maintain audit quality…[4]

3.4 In the report, ASIC identified three broad areas requiring improvement by audit firms. These relate to:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- the extent of reliance that can be placed on the work of other auditors and experts.[5]

3.5 Concerned with these findings, the committee asked Mr Medcraft to explain what he believed was reason why many in the auditing profession were failing to deliver on the quality of work expected. He responded:

> We have talked to the firms about it and, clearly, it is a lack of scepticism. I think the institute would acknowledge that scepticism is a big issue in the audit firms and being critical. You are there as an auditor and you are meant to be sceptical about seeing what is presented to you.
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> It is a global problem. I think it probably comes down to a cultural problem in the profession. I can tell you that at IOSCO, at the global level, it is also troubling. I do think it has to go to, clearly, the training and the types of people that are coming into the profession. It is the belief that that is part of the issue. From my point of view, if we have a further deterioration next year, it builds a case for change. One in five is a very significant level. This

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3 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12. See also ASIC's audit inspection findings for 2011–12, *Media release 12/301*, 4 December 2012, http://www.asic.gov.au/asic/asic.nsf/byheadline/12-301MR+ASICs+audit+inspection+findings+for+2011-12?openDocument (accessed 24 January 2013).

4 ASIC, *Audit inspection progress report for 2011–12*, December 2012, p. 4.

5 ASIC, *Audit inspection progress report for 2011–12*, December 2012, p. 4.

> is not a statistical outlier. This is one in five. This is about audit quality. I think the profession has to throw everything it can at it in the next 12 months to get that number to start trending down, otherwise we really are going to need to think about what else can be done.
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> There has been talk about rotation of audit firms, that bringing in a fresh set of eyes may be a solution. It is back to the profession itself to lift its game, frankly. It is a serious problem, and they recognise that.[6]

3.6 ASIC Commissioner Mr John Price also noted that the decline in auditing quality is evident in various international jurisdictions as well as in Australia. He suggested that in terms of arresting this decline, broader use of the larger firms' training programs would probably be useful. Mr Price also drew the committee's attention to the current economic cycle where 'companies are under cost pressures, and that is being passed on to auditors'. However, he added:

> I think companies need to realise and accept that they do need to pay a bit more for a quality audit and that a quality audit is important for market integrity issues more broadly.[7]

## The Banksia collapse

3.7 In May 2012, ASIC raised concerns in relation to certain disclosures made in the financial statements and prospectus of the rural Victorian finance company Banksia Securities Limited. As a result, in June 2012, Banksia released a supplementary prospectus.[8]

3.8 However, in October 2012, Banksia was placed into receivership. The active accounts of thousands of retail investors in debentures were frozen. The same month, ASIC established an internal taskforce to examine the failure of Banksia and the regulation of the wider Australian and listed debenture sector. The taskforce, headed by Mr Price, has made some early recommendations to Treasury.[9]

3.9 The committee understands that Banksia's receiver, McGrathNicol, is (at the time of writing) investigating potential breaches of the law by the auditors. Mr Anthony McGrath was reported as saying:

> There were a set of accounts that were signed off in September that said the company was in a surplus position to the tune of $24 million," Mr McGrath

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6 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 20.

7 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 20.

8 McGrathNicol, *Banksia Securities Limited, Receivers and Managers' report to debenture holders*, 7 December 2012, p. 20.

9 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12.

> said. "Today, we are telling debenture holders that they are in deficit of around $200-$300 million - that's quite a significant change.[10]

3.10 At the public hearing, Mr Medcraft's opening statement commented on the Banksia collapse in the context of the role of auditors. The Chairman drew the committee's attention to the fact that the auditors had signed off the accounts of Banksia in September 2012, only a few weeks before the group collapsed. He noted that ASIC had identified Banksia as a 'high risk' and had done 'a surveillance some months ago' to bring the matter to the attention of the trustee. However, he added that:

> It was not really our job to go in and detect these things—you have gatekeepers called trustees and auditors—but we are trained to be proactive to the extent of the funding we have available to us, both in terms of going and looking and trying to be proactive publicly where we see problems.[11]

3.11 Mr Medcraft again emphasised that the system—through its use of gatekeepers—is meant to be 'self-executing'.[12] It relies on disclosure and the important role of gatekeepers. ASIC's role is one of surveillance. In the context of debentures, the Chairman told the committee that ASIC had been expressing its concerns publicly 'for some time' that these investments are 'high risk'.[13] He argued that there is a need to 'lift the regulatory intensity' to ensure that consumers can be confident and informed when they are investing in these 'shadow banks'.[14]

## The committee's previous concerns with auditors

3.12 In its May 2012 report into the collapse of Trio Capital, the committee pointedly criticised the role of the Trio's auditors, WHK and KPMG. The report stated:

> It is of concern to the committee that auditors' approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist. Further, an auditor's assessment of a compliance plan and the work of the compliance committee as 'effective' essentially only means that they exist. Clearly in the case of Trio, the requirement for

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10 Georgia Wilkins, 'Negligence and conflict claims in Banksia collapse', *Sydney Morning Herald*, 15 December 2012.

11 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 21.

12 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 21.

13 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 22.

14 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12.

> the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.[15]

3.13 In its submission to the inquiry, ASIC was also highly critical of the auditors' role and outlined areas for future regulatory consideration. These are:

- the obligation of auditors to report on the adequacy of compliance plans;
- whether a particular compliance plan measure achieves its objectives;
- reliance on other auditors;
- audit independence and competence declarations;
- how the auditor satisfies themselves that the responsible entity has complied with its obligations in all material respects as required under ASAE 3100;[16] and
- audit approach and testing methodology.[17]

3.14 The committee's report endorsed ASIC's suggestion of an approval process for compliance plan auditors so that the regulator has the powers to remove or impose conditions on such approval. It also supported ASIC's proposal to review the effectiveness of compliance plans and, if necessary, require more detail to be provided in these plans.[18]

### *Auditors of SMSFs*

3.15 ASIC has recently been given responsibility for the registration of auditors of self-managed superannuation funds (SMSFs).[19] ASIC Commissioner Mr Greg Tanzer told the committee:

> Auditors will be subject to an obligation to register from July 2013 and to meet the competency requirements ASIC will set, on which we are currently consulting. The registration that you are speaking of, from 31 January 2012, is a voluntary preregistration. Auditors are able to register with ASIC from 31 January in anticipation of the date by which they are

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15 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. xxii.

16 See Auditing and Assurance Standards Board, *Standard on Assurance Engagements ASAE 3100 Compliance engagements* http://www.auasb.gov.au/admin/file/content102/c3/asae_3100_9-09-08.pdf (accessed 31 January 2013).

17 ASIC, *Submission 51 to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the collapse of Trio Capital*, p. 42.

18 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. xxiii.

19 *Superannuation Laws Amendment (Capital Gains Tax Relief and Other Efficiency Measures) Act 2012*

> required to be registered, which is 1 July. We are currently developing the competency requirements…We expect to issue an information sheet in the next little while which will set out the process for registering from 31 January and to be accepting those registrations from that date.
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> …The competencies are currently out and being consulted on. In fact, we started consulting with the audit bodies a couple of months ago. The standards are very much based on the competency standards that the joint accounting bodies put out back in 2008. The consultation period finished on 30 November, just last week. We expect to finalise those in the next week or so.[20]

3.16 On 10 December 2012, ASIC released guidance to assist auditors of SMSFs to register. In January 2013, it released a guide explaining how to apply for registration as an approved SMSF auditor, the types of registers of SMSF auditors maintained by ASIC and the transitional arrangements for the registration of existing approved auditors of SMSFs.[21]

3.17 Also in December, ASIC released proposed competency standards for approved SMSF auditors. ASIC explained that these standards are based on pre-existing standards issued by The Institute of Chartered Accountants in Australia, CPA Australia and the Institute of Public Accountants. The standards also apply to members of the Superannuation Professionals' Association of Australia to ensure continuity in requirements for most SMSF auditors.[22]

3.18 The committee also notes that the voluntary preregistration process for SMSF auditors was established on 31 January 2013. An ASIC officer was quoted in a media release as saying:

> This is a key step in the Stronger Super Reform process. The register and associated competency standards will improve the quality of SMSF audits.

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20 Mr Greg Tanzer, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, p. 18.

21 Australian Securities and Investments Commission, 'Registration of registered superannuation fund auditors', *Regulatory Guide 243*, January 2013, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg243-published-24-January-2013.pdf/$file/rg243-published-24-January-2013.pdf (accessed 31 January 2013).

22 Australian Securities and Investments Commission, 'ASIC releases SMSF auditor registration guidance and competency standards', *Media release*, 10 December 2012, http://www.asic.gov.au/asic/asic.nsf/byheadline/12-308MR+ASIC+releases+SMSF+auditor+registration+guidance+and+competency+standards?openDocument (accessed 31 January 2013).

> The ability to identify registered SMSF auditors is critical in underpinning confidence for SMSF trustees.[23]

## Committee view

3.19 The committee shares ASIC's concern at the apparent decline in auditing standards in Australia. Auditors play a crucial role as gatekeepers of the Australian financial system. When they fail to exercise the requisite professional scepticism in their work, investors and superannuants can suffer significant consequences. The Trio Capital experience is but one example. The failure of auditors to raise the necessary flags to avert corporate collapses results in lower investor confidence.

3.20 The committee commends ASIC for its work to date to identify some of the dimensions of the low quality of auditing work in Australia, and to highlight publicly the need for improvement. It is incumbent on professional associations, standard setting bodies such as the Financial Reporting Council (FRC) and the Auditing and Assurance Standards Board (AUASB), and the large auditing firms to reaffirm a commitment to the highest professional standards and to take action to remedy areas of weakness. The committee strongly supports efforts to this end.

3.21 The committee will continue to closely monitor developments in this area. As the committee has previously noted, it is concerned that there is a divergence between auditors' statutory requirements and the actual performance of their duties. It also continues to be concerned that auditing standards are falling below the public's expectations of the profession.

3.22 The committee intends to call the AUASB and the FRC to attend the first oversight hearing of 2013. At that hearing, it intends to discuss with these bodies ASIC's concerns with the application of professional standards. The committee will seek the FRC's advice about the work of the FRC Audit Quality Taskforce and the AUASB's views on Australia's adherence to the standards established by the International Auditing and Assurance Standards Board.

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23 Australian Securities and Investments Commission, 'SMSF auditor register is here', *Media release*, 31 January 2013, http://www.asic.gov.au/asic/asic.nsf/byHeadline/13-013MR%20%20SMSF%20auditor%20register%20is%20here?opendocument (accessed 31 January 2013).

# Chapter 4

# Updates on Storm Financial, Trio Capital, the Future of Financial Advice reforms, and the Fortescue and James Hardie cases

4.1 The final chapter of this report covers a number of issues of particular interest to the committee relating to topical and significant matters before the Australian Securities and Investments Commission (ASIC).

## Storm Financial

4.2 In November 2009, the committee tabled its report into financial products and services in Australia. Chapter 3 of that report focused on the collapse of the Queensland-based company Storm Financial. The committee considered Storm's business model and the role of the Commonwealth Bank of Australia (CBA). The CBA was widely criticised for its management of margin calls on Storm Financial clients.[1] At a public hearing in September 2009, a representative of the CBA told the committee:

> we are not proud of the bank's involvement in some of the issues faced by those customers … customers can be assured that, where we have done wrong, we will put it right … Both before and since that announcement we have been taking action to put wrongs right. First, our customer assistance program established with customers on the ground in Townsville and, second, our innovative resolution scheme.[2]

4.3 ASIC had planned to take action in the Federal Court against the Commonwealth Bank, Macquarie Bank and the Bank of Queensland (BOQ) for unconscionable conduct in lending money to clients to invest in Storm Financial. Shortly before the trial was set to proceed, the CBA agreed to settle with ASIC through a compensation package providing an extra $136 million to Storm Financial investors. This payment is to be made in addition to the $132 million that the CBA had provided to Storm investors through its resolution scheme. ASIC noted in a media release following the announcement:

> CBA's $136 million of additional compensation is intended to ensure that each CBA investor (or investor group) who takes part in the settlement will

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services*, November 2009, pp 36–43.

2 Mr David Cohen, Commonwealth Bank of Australia, *Official Committee Hansard*, Sydney, 4 September 2009, p. 57. Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services*, November 2009, p. 46.

> get compensation of approximately 55% of that part of their total loss allocated to CBA under the ASIC compensation model. This calculation takes into account the compensation CBA already provided to investors under its Resolution Scheme. In determining the aggregate amount of compensation, allowance has also been made for the period that has elapsed between the time that Storm investors suffered loss and the time of receipt of compensation.[3]

4.4 In evidence to the committee at the December 2012 hearing, ASIC Chairman Mr Greg Medcraft summarised the regulator's actions against the CBA, Macquarie Bank and the BOQ in the Storm Financial collapse. He explained that the September 2012 settlement:

> …ends our court action against CBA. We believe that that was a timely, fair and certain outcome from the investors who borrowed from CBA. We welcome the initiative of CBA to come to that agreement with us to actually not put investors through a long, costly and legal process. Many of these people who have lost money are elderly, and a long and costly court case was not a particularly good outcome for many of them.
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> The proceedings are still moving ahead against Macquarie Bank and Bank of Queensland and they are moving towards completion early in the new year as are those against the Storm founders, the Emanuel Cassimatis. We also have our court action on behalf of Storm investors on behalf of the Dawe family—that is ongoing. As I said, the compensation is on top of the $132 million already provided by CBA to the Storm investors. I just remind you that the forensic accountants that we are working with estimates the aggregate losses suffered by Storm investors were about $830 million. We believe already the recovery is quite significant.[4]

4.5 The committee asked ASIC about the role of class actions in pursuing compensations for Storm Financial investors on the one hand and Trio Capital investors on the other. Mr Medcraft replied that in relation to Storm Financial, 'the class action people thought they could do a better job than ASIC'.[5] He described class action as an 'efficient market mechanism'. In terms of ASIC's current position on Storm, however, the Chairman told the committee: 'We are very open to settling with Macquarie Bank and the Bank of Queensland'. When asked of the prospect of this

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3 Australian Securities and Investments Commission, 'ASIC and CBA reach Storm Financial settlement', *Media release*, 14 September 2012, http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/12-227MR%20ASIC%20and%20CBA%20reach%20Storm%20Financial%20settlement?opendocument (accessed 20 January 2013).

4 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, pp 12–13.

5 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 19.

occurring, he added: 'I would hope that the fact that CBA have settled would be reasonably persuasive'.[6]

4.6 The committee asked ASIC on notice to provide the costs of the Storm case, including the cost of the forensic accountant. On notice, ASIC responded:

> In view of the pending litigation in which ASIC is involved arising from the collapse of Storm Financial, ASIC does not consider it appropriate to comment on the cost of the Storm case at this point in time.[7]

***Committee view***

4.7 The committee commends ASIC for its work to reach a settlement with the CBA on compensation costs for the victims of Storm Financial. It notes ASIC's hope that Macquarie Bank and the BOQ will do the same and that the outcome is both timely and fair for investors. The committee will continue to seek data from ASIC on its costs in the Storm case, and hopes to receive this information once court proceedings are finalised.

## Trio Capital

4.8 Chapter 3 of this report detailed aspects of the role of auditors in the collapse of Trio Capital. At the December oversight hearing, the committee raised a number of other matters in relation to the collapse of Trio that deserve scrutiny.[8]

4.9 One of the committee's key concerns in its May 2012 report into Trio's collapse was that investors in self-managed superannuation funds (SMSFs) do not have sufficient warning that they are not covered under section 23 of the *Superannuation Industry (Supervision) Act 1993* in the event of theft and fraud. The committee recommended that:

> …the guidance material provided by the Australian Taxation Office for Self Managed Superannuation Fund investors clearly state the difference between the protections and compensation arrangements for investors in funds regulated by Australian Prudential Regulation Authority as distinct from the limited protections available to Self Managed Superannuation Fund investors.[9]

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6 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 19.

7 Australian Securities and Investments Commission, *Answer to question on notice*, received 19 December 2012.

8 The government has not yet responded to the committee's recommendations in its report into the collapse of Trio Capital.

9 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, Recommendation 4, p. xxvii.

4.10 The committee asked ASIC whether it has made efforts to warn SMSF investors about the risks of fraud and theft. ASIC Commissioner Mr Greg Tanzer replied:

> In relation to self-managed super fund investors there are a range of materials that we make available through the MoneySmart website. In particular, we have adopted the view that was taken by this committee about wanting to be very clear about the fact that investors in self-managed super funds do not get the backstop protection of the availability of compensation in the event that the minister certifies it should be payable if there is fraud, and losses occasioned as a result of fraud. This is the Trio situation…
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> In addition to that, ASIC has been quite active in the past in working out the appropriateness of advice to switch into self-managed super funds. In particular, we are currently refreshing some research that we have done in the past about what we think is an indicative balance that a person might need in order to make a purely economic decision just based on the costs of running a self-managed super fund.[10]

4.11 The committee also emphasised the need for criminal investigations into the perpetrators of the Trio fraud. It recommended that:

> …the Australian Federal Police, in cooperation with the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority, pursue criminal investigations into—and, where applicable, criminal sanctions against—the key figures responsible for defrauding investors in Trio as a matter of high priority.[11]

4.12 At the December 2012 hearing, the committee asked ASIC for an update on how its investigations into Mr Jack Flader and his associates were progressing. ASIC noted that it had received a number of international requests, was 'in the process of reviewing those materials' and had spoken to 'a number of persons both onshore and offshore'.[12] Further, it told the committee that it is liaising with both the Australian Federal Police (AFP) and the Australian Crime Commission (ACC) in its investigations:

> …we have referred information to the AFP and are awaiting their response. We have been in a regular dialogue since we referred the matter to the AFP and we understand that they will shortly respond to us in relation to whether they propose to undertake any investigation of their own or what they propose to do. We have also been in a dialogue with the ACC in relation to

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10 Mr Greg Tanzer, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, p. 19.

11 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, Recommendation 11, p. xxix.

12 Mr Chris Savundra, Senior Executive Leader, Enforcement, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 16.

> Mr Flader, but despite a substantial amount of further work and we are committing substantial time and resources to this matter, by no means has our investigation come to an end but there is nothing at this stage which alters our view despite the further evidence that we have as expressed in June this year, which is based on the evidence we currently have we currently see there being insufficient evidence to prove a breach by Mr Flader of Australian law.[13]

4.13 ASIC told the committee that while the AFP had not yet commenced an investigation, it is currently assessing a referral to decide whether to investigate. From ASIC's viewpoint, it has provided 'all the information that we think is appropriate and that they [the AFP] have requested'.[14] In an answer to a question on notice, ASIC noted that it had referred material concerning Trio and Mr Flader to the AFP on 22 June 2012. A meeting was held between ASIC and the ACC on 20 June 2012.[15]

4.14 On the prospects of returning money to affected investors, ASIC asserted that it had committed significant public funds to the Trio investigation and to claims on behalf of others to recover compensation. However, it had formed the view that those claims are not 'financially viable' given that there is no one with the resources that is likely to be found liable. As the Chairman put it:

> I expect that if there had been some money somewhere, the class-action litigators probably would be on to it, frankly, given that they are pretty efficient at tracking down deep pockets. In a way we have been looking, but another point you might want to emphasise is that the class-action lawyers would probably have gone after, as a group, if they thought there was some money somewhere. You have not seen any class action taking foot.[16]

4.15 The committee asked ASIC whether it still believed that the moneys lost from the ARP Growth Fund—as opposed to those lost from the Astarra Strategic Fund—were as a result of negligence, rather than deliberate wrongdoing. ASIC responded:

> I think what we said is that the causes of the losses in relation to the ARP Growth Fund are different to those for the Astarra Strategic Fund and that our view is that, in relation to the ARP Growth Fund, the cause of the failure was product failure resulting from the financial crisis. That is not to say, however, that we have not identified along the way conduct-related issues. But, as to whether those conduct issues caused the loss, we remain of the view that the fundamental cause of the ARP growth investors' loss is

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13 Mr Chris Savundra, Senior Executive Leader, Enforcement, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 16.

14 Mr Chris Savundra, Senior Executive Leader, Enforcement, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 17.

15 Australian Securities and Investments Commission, *Answer to question on notice*, received 17 December 2012.

16 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 17.

> product failure as a result of the financial crisis. Our inquiries in relation to the ARP Growth Fund are ongoing. I can state publicly now, given that court proceedings are on foot, that the liquidators of Trio propose to examine Mr Gresham on 10, 11 and 12 December, and ASIC proposes to participate in those proceedings. Our investigations are ongoing in relation to both ARP and Astarra, and we have received and continue to receive a considerable volume of information from overseas regulators. We also continue to speak with a number of witnesses both onshore and offshore.[17]

### *Committee view*

4.16 The committee urges ASIC, the AFP and the ACC to continue their lines of inquiry into the perpetrators of the Trio Capital fraud. At the next oversight hearing, in March 2013, the committee will seek an update from ASIC on the December 2012 examination of Mr Tony Maher (formerly Mr Paul Gresham). It is also interested to inquire into correspondence that ASIC may have had with the AFP and the ACC on matters relating to the Astarra Strategic Fund.

4.17 The committee is also interested in ASIC's view on a bill (into which the committee recently tabled a report) that would increase capital holding requirements for dual-regulated entities.[18] Trio was a dual-regulated entity: it was both a licensed superannuation fund trustee and the responsible entity for several managed investment schemes. These entities are subject to oversight by both ASIC and APRA. If the bill is passed, dual regulated entities will be required to meet the Corporations Act's adequate resources and risk management systems requirements, although risks that relate solely to the operation of a regulated superannuation fund by the entity will be excluded.[19] The committee is keen to seek ASIC's views on the need for, and possible effect of these amendments.

## Future of Financial Advice

4.18 The committee's 2009 inquiry into financial products and services led to the introduction and passing of legislation last year to reform the financial services industry in Australia. In the Future of Financial Advice (FOFA) legislation, the government adopted five of the committee's recommendations directly, with four recommendations supported in principle and only two not supported. In its February 2012 report into the provisions of the FOFA bills, the committee stated:

> As in the 2009 inquiry, the committee's principal interest in examining the FOFA legislation is to ensure better outcomes and protections for consumers of financial products and services. It believes that the legislation

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17 Mr Chris Savundra, Senior Executive Leader, Enforcement, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 16.

18 Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Bill 2012. The committee tabled its report into the provisions of this bill on 5 February 2013.

19 Schedule 1, items 4 and 5.

> will achieve that aim. The FOFA Bills will not only enhance consumer protections, but promote the professionalism of the financial advice industry. For too long, the industry's standards have suffered from lax regulation and an inadequate focus on the needs and interests of clients. The FOFA reforms will significantly address these inadequacies, principally through the annual fee disclosure, opt-in and conflicted remuneration provisions. The costs of implementation and compliance for the industry will be far outweighed by the benefits to consumers from high quality advice and transparency in charging fees.[20]

4.19 The FOFA bills contained four key issues that were carefully considered in the committee's report. These required financial advisers to:

- provide a fee disclosure statement to a client when charging advice fees for longer than 12 months, and a fee disclosure statement and a renewal notice to a client when charging advice fees for longer than 24 months (the *'opt-in'* requirement); and
- act in the *best interests* of their clients and put their client's interests ahead of their own when providing advice;
- provide *scaled advice*—or advice about one issue, or a limited range of issues—where the adviser must act reasonably and base the decision to narrow the advice on the interests of the client; and
- ban the payment and receipt of certain remuneration which has the potential to influence the financial product advice given to retail clients (*conflicted remuneration*).

4.20 Since its report last year, and particularly since the parliament passed the legislation on 25 June 2012, the committee has used the oversight process to gain regular updates from ASIC on its progress in providing stakeholders with guidance on FOFA. At the December 2012 hearing, the committee asked ASIC to comment on the draft paper on the approval of conduct that obviates the need for the opt-in requirement. ASIC Commissioner Mr Peter Kell told the committee:

> We have been having some fairly intensive discussions with some of the organisations that have indicated they will either definitely or potentially submit codes, so the nature of the consultation there is tending to be more intensively focused on those organisations. I will give you an example: the Financial Planning Association, who have very clearly signalled that they intend to put their code forward for approval.
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> So our discussion with them has included ensuring that, as they develop their own code, they adequately consult with their members and other stakeholders on what sort of requirements should be in place around the

20 Parliamentary Joint Committee on Superannuation and Financial Services, *Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, February 2012, p. 149.

> 'obviate the need' issue[21] and how they engage with their clients on an ongoing basis to make sure that those clients know what they are getting and that they are paying for a service that they find valuable.
>
> Beyond that, we have also signalled a couple of other issues in that paper that represent a variation to what has been our traditional policy, if you like. One is whether we ought to be open to a narrowly focused code that deals primarily just with the opt-in issue or whether we should stand by our normal approach of requiring a broader code that covers behavioural standards across the range of an adviser's activities, and the other issue in this area was whether we would consider an entity specific code. Again, we have signalled that it would be a significant break from our traditional approach in this area and that there would be some significant challenges, but we thought that, given that it has been raised with us, we might as well consult on it.[22]

4.21 The committee also asked ASIC to comment on the consultation process on its draft paper on conflicted remuneration.[23] Mr Kell responded:

> There is no doubt that this paper has generated more response than our other consultation papers so far, which in some ways is not surprising—it does go to the heart of remuneration structures. There are some issues that have generated particularly strong interest in the paper so far. One is the way in which employee remuneration under FOFA is dealt with and the way in which conflicts under these sorts of arrangements are dealt with. We are currently giving consideration to the feedback we have got there.[24]
>
> …
>
> Some stakeholders, some industry participants, have indicated that they would like to see that opportunity for conflicted remuneration in that space limited as far as possible; others have said that they need to accommodate different ways of remunerating their employees within their current business model.
>
> We have received around 30 submissions so far. We have held a series of roundtables with industry groups, consumer groups and others, and a range of individual one-on-one meetings.[25]

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21 The 'obviate the need' issue refers to the 'opt-in' requirement in the FOFA legislation.

22 Mr Peter Kell, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 30.

23 Australian Securities and Investments Commission, *Consultation Paper No. 189—Future of Financial Advice: Conflicted Remuneration*, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp189-published-28-September-2012.pdf/$file/cp189-published-28-September-2012.pdf (accessed 20 January 2013).

24 Mr Peter Kell, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 29.

25 Mr Peter Kell, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 30.

4.22 The committee also raised concerns that the conflicted remuneration provisions in FOFA may apply to investment firms which operate for non-retail clients as well as retail clients. These services typically operate on the basis of a bonus structure over and above a base remuneration structure for their portfolio managers.[26] ASIC allayed these concerns in a written answer on notice:

> Under the Corporations Act, a benefit is only conflicted remuneration if:
>
> - it is given to a financial services licensee, or a representative of a financial services licensee, who provides financial product advice to persons as retail clients; and
> - it could reasonably be expected to influence the choice of financial product recommended to retail clients or the financial product advice given to retail clients.
>
> The conflicted remuneration provisions do not apply in relation to services provided to wholesale clients. This position is reflected in our proposed regulatory guidance on the conflicted remuneration provisions.
>
> From our consultations with industry, we consider that industry understand this.[27]

4.23 ASIC told the committee that it intends to release a final guide on conflicted remuneration and the approval of Codes of Conduct for exemption from opt-in requirement 'early in 2013'. The committee understands that these final guidances will be released in February 2013. The final guidance on the 'best interests' duty (Regulatory Guide 175) and giving general advice and scaled advice (Regulation Guide 244) was released on 13 December 2012.[28] The final guidance on fee disclosure (Regulatory Guide 245) was released on 25 January 2013.[29]

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26 Mr Paul Fletcher MP, *Committee Hansard*, 3 December 2012, p. 29.

27 Australian Securities and Investments Commission, *Answer to question on notice No. 5*, received 19 December 2012.

28 Australian Securities and Investments Commission, *Licensing: Financial product advisers—Conduct and disclosure*, Regulatory Guide 175, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-175-published-13-December-2012.pdf/$file/rg-175-published-13-December-2012.pdf (accessed 31 January 2013).

Australian Securities and Investments Commission, 'Giving information, general advice and scaled advice', December 2012, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-244-published-13-December-2012.pdf/$file/rg-244-published-13-December-2012.pdf, (accessed 31 January 2013).

29 Australian Securities and Investments Commission, *Fee disclosure statements*, Regulatory Guide 245, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg245-published-25-January-2013.pdf/$file/rg245-published-25-January-2013.pdf (accessed 31 January 2013).

### *Committee view*

4.24 The committee welcomes the progress that ASIC has made in releasing and finalising guidance material on the key aspects on the FOFA reforms. It awaits final guidance material on the key issues of conflicted remuneration and the codes approval exempting advisers from the opt-in duty. The committee is keenly aware of the sector's interest in this phase of the consultation process.

4.25 The committee will monitor with interest the progress of ASIC's FOFA workshops in February and March 2013.[30] It looks forwarding to discussing with ASIC the outcomes of this consultation process at the next oversight hearing.

## Directors' duties and continuous disclosure requirements

4.26 There have been two important recent legal judgments relating to actions taken by ASIC against company directors for allegedly failing in their duties of accurate market disclosure.

- In October 2012, the High Court found that Fortescue Metals Group founder Mr Andrew Forrest had not misled investors when he claimed to have 'framework agreements' with Chinese entities to build an iron ore project in the Pilbara.
- In May 2012, ASIC won a case on appeal in the High Court with a finding that seven former non-executive Directors and the company secretary of James Hardie had breached their duties in approving a misleading Australian Securities Exchange announcement.

4.27 ASIC raised both the Fortescue and James Hardie cases in its opening statement to the committee.

### *The Fortescue case*

4.28 ASIC commenced proceedings against Fortescue in the Federal Court in March 2006, alleging that because the framework agreements with Chinese companies would not be enforceable under Australian law, Fortescue had engaged in misleading or deceptive conduct. ASIC also alleged that Fortescue and Mr Forrest had contravened the continuous disclosure requirements of the Corporations Act by not correcting the false or misleading information. Mr Forrest had thereby allegedly failed

30 See 'ASIC FOFA Workshops', http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+FOFA+workshops?openDocument (accessed 31 January 2013).

to discharge his duties as a director of Fortescue with the degree of care and diligence required by subsection 180(1).[31]

4.29 In October 2012, the High Court upheld the appeals of Fortescue Metals and Mr Forrest against the 2011 decision of the Full Court of the Federal Court. The High Court found that Fortescue's statements about framework agreements were not misleading or deceptive to investors. It found that there was no evidential basis for assuming that a person hearing or reading the statements would understand that the parties had entered into agreements that would be enforced according to Australian law. Accordingly, the High Court further found that Fortescue and Mr Forrest had not failed to meet their obligations under the Corporations Act.[32]

4.30 The High Court's finding was based on the facts of the case itself, rather than a changed interpretation of the existing law. As ASIC's Chairman told the committee:

> The Fortescue decision was a decision on fact, not a decision on law. It basically said, 'Well, it wasn't misleading.' The reason that the ASX delayed their guidance on continuous disclosure was that they expected that there could be a decision on law. But it was not a decision on law, it was just on facts, so it really has not changed the law.[33]

4.31 The committee asked ASIC to comment on how the High Court's decision would affect the Commissions' approach to litigation in the future. Deputy Chairperson, Ms Belinda Gibson, responded by noting that ASIC had been advised of a strong prospect of success throughout the preparation of its case:

> As with any litigation we bring there is a series of litigal rules which require a decision where, broadly speaking, we have reasonable prospects of success. In the Fortescue case we had external counsel briefed at each point in the proceedings, and had advice that gave us that affirmation. We also had an external law firm give that advice.
>
> In the case of the Court of Appeal we spoke to other counsel as to whether we were on the right track in going to the Court of Appeal. We take our responsibilities there very seriously. We have lawyers examine it. I suppose it is fair to say that with a case that runs all the way to trial, it is unlikely that one side thinks they are destined to lose. Otherwise, they are not contested. We had relatively strong advice at all points in the process.[34]

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31 John Andrew Henry Forrest v Australian Securities and Investments Commission & Anor, High Court of Australia, 2012 HCA 39, 2 October 2012, http://www.hcourt.gov.au/assets/publications/judgment-summaries/2012/hca39-2012-10-02.pdf (accessed 20 January 2013).

32 John Andrew Henry Forrest v Australian Securities and Investments Commission & Anor, High Court of Australia, 2012 HCA 39, 2 October 2012.

33 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 32.

34 Ms Belinda Gibson, Deputy Chairperson, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 33.

4.32 Mr Medcraft expanded that by going to court, there is a chance you are going to lose but parties think they are going to win. He told the committee:

> In relation to cases, we have now set out publicly in our enforcement guide why we take on cases and why we do not. We look at the cost versus the public benefit. We look at the amount of harm or loss or the significance of the matter. We also look at the availability of evidence. Often it is lack of evidence that is the reason we do not take on a case, even if a lot of people have lost a lot of money. If the evidence is not there, you do not take the action, unfortunately. You might not even do an investigation.[35]
>
> Finally, you look at whether there is any alternative course of action. Clearly, if we can get an outcome that does not mean going to court then we will try to get that outcome. We do enforceable undertakings, for example. What we end up with is an out of court settlement, like in the CBA case. We always look at alternate courses. But at the end of the day we have made it really clear that no-one is too big for us to take on. The government gives us $30 million a year for our enforcement special account. We have accumulated reserves and built a war chest so that we are in a strong position to take action. It is important to talk softly and carry a large stick. Basically, Australians would not expect anything less. If going to court is the way to solve an issue and we cannot do it any other way, we are not frightened to go to court. It is important to send that message, frankly: 'It doesn't matter who you are, we will take you on if that's the only way we can sort out a problem.' That is what is expected now.[36]

4.33 ASIC again emphasised to the committee at the December hearing that it views disclosure by listed companies as 'the bedrock of market integrity and fundamental to fair and efficient markets'.[37] It has emphasised the importance of companies being prepared to act quickly to respond to continuous disclosure issues, by having established policies and practices.[38] The committee welcomes ASIC's and the ASX's ongoing emphasis on continuous disclosure and the release of a

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35 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 33.

36 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 33.

37 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 13.

38 See Mr John Price, Commissioner, Australian Securities and Investments Commission, *Continuous disclosure, A speech to the Chartered Secretaries Australia Annual Conference*, 3 December 2012, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/continuous-disclosure-speech-published-3-December-2012.pdf/$file/continuous-disclosure-speech-published-3-December-2012.pdf (accessed 20 January 2013).

substantially rewritten draft Guidance Note 8 Continuous disclosure: Listing Rules 3.1–3.1B (GN 8).[39]

### *The James Hardie case*

4.34 The James Hardie case dates back to February 2001 when the company released an ASX announcement stating that it had established a foundation to compensate sufferers of asbestos-related diseases who had claims against two of James Hardie's former subsidiaries. The announcement claimed that the 'Foundation has sufficient funds to meet all legitimate compensation claims anticipated'.[40]

4.35 ASIC commenced proceedings in 2007 against seven former non-executive Directors and the company secretary and general counsel Mr Shafron. It argued that the Directors approved the ASX Announcement at a board meeting in February 2001 when they knew or ought to have known that the Foundation did not have sufficient funds. In terms of Mr Shafron, ASIC alleged he attended the board meeting and should have advised the board that the announcement 'was expressed in too emphatic terms' in terms of the funding.[41]

4.36 ASIC's evidence focussed on board minutes approved by the Directors to establish that they had approved the misleading ASX Announcement. The Directors argued that the board minutes were incorrect and that they never approved the ASX Announcement. The Supreme Court of New South Wales found that the Directors had approved the ASX Announcement, that it was false or materially misleading, and that the Directors and Mr Shafron had failed to discharge their duties with the degree of care and diligence that a reasonable person would exercise in their circumstances. This decision was overturned by the NSW Court of Appeal on grounds that ASIC had failed to prove that the ASX Announcement had been approved at the Board Meeting. However, the High Court overturned this decision, finding that the board minutes were sufficient proof that the ASX announcement was approved at the Board Meeting.[42]

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39 Australian Securities Exchange, 'Guidance Note 8 Continuous disclosure: Listing Rules 3.1–3.1B' http://www.asxgroup.com.au/media/GN_8_Consultation_Paper.pdf (accessed 20 January 2013).

40 Corrs Chambers Westgarth, 'ASIC secures High Court victory against James Hardie directors', 4 May 2012 http://www.corrs.com.au/publications/tgif/asic-secures-high-court-victory-against-james-hardie-directors/ (accessed 20 January 2013).

41 Corrs Chambers Westgarth, 'ASIC secures High Court victory against James Hardie directors', 4 May 2012.

42 Corrs Chambers Westgarth, 'ASIC secures High Court victory against James Hardie directors', 4 May 2012. See also High Court of Australia, *Australian Securities and Investments Commission v Meredith Hellicar & Ors [2012] HCA 17, 3 May 2012* http://www.hcourt.gov.au/assets/publications/judgment-summaries/2012/hcasum17_ASIC_v_Hellicar.pdf (accessed 31 January 2013).

4.37 ASIC's Chairman reflected on the High Court's decision by emphasising the clear message it sends on the need to provide the market with accurate information. He told the committee:

> The matter reinforces the importance of companies providing the market with correct and accurate information and that directors must engage with the most important announcements. There has been widespread public analysis of the James Hardie matter that has already resulted in an improved board process in relation to announcements.
>
> Since the original decision in 2009, we have clearly seen a very significant engagement more broadly by directors with disclosure in terms of announcements, so we believe it is a timely reminder in terms of accuracy of statements that are made. Again, I have always emphasised I believe the general level of corporate governance in this country is actually very, very good, but these are timely reminders.[43]

4.38 In contrasting the High Court's James Hardie and Fortescue decisions, Mr Medcraft explained that the James Hardie finding was important 'because it was a decision on law'. He identified its significance in terms of clarifying that company directors are expected to check, and are responsible for the accuracy of significant statements made to the stock exchange.[44]

## Concluding comment

4.39 The committee recognises the breadth and the complexity of the issues that ASIC must deal with on both a day-to-day basis and as part of its medium to long-term strategy. The various matters discussed in this report attest to the challenging and diverse roles of Australia's corporate regulator, and the importance of it providing stakeholders with clear guidance based on sound principles.

4.40 There are various issues of continuing interest to the committee that were not canvassed at the December 2012 oversight hearing. There are other issues of committee interest—notably ASIC's investigation into the hoax ANZ press release relating to the funding of Whitehaven's Maules Creek and the enforceable undertaking given to ASIC by Macquarie Private Wealth—that have occurred since the hearing. Future oversight hearings will examine these matters.

4.41 The committee is satisfied with ASIC's focus, activity and judgment on issues of market integrity, the role of gatekeepers, financial literacy, the explanation of the FOFA laws, the supervision of exchange-traded markets and matters of corporate governance and continuous disclosure. Clearly, there are ongoing challenges in each of these areas that will require the careful attention of ASIC and market participants.

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43 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 13.

44 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 32.

The committee does highlight the significant efforts that ASIC has made to date in each of these areas. It looks forward to further updates on how its forward work program is progressing.

**Ms Deborah O'Neill MP**
**Chair**

# Appendix 1

## Answers to questions on notice

**Received from the Australian Securities and Investments Commission on 18 December:**

**Question on Notice #1**

**Page 17**

**Mr FLETCHER:** Mr Savundra, you said that you had referred the matter to the AFP. When did that happen?

**Mr Savundra**: I cannot recall the date precisely but it certainly occurred after the parliamentary report was delivered. We had had requests for information via the AFP prior to that time but certainly—

**Senator BOYCE:** You had made requests or they had requested you

**Mr Savundra:** We had made international requests for information through the AFP. Prior to the report we had not sought to formally refer the matter to the AFP for investigation.

**Mr FLETCHER:** And the Crime Commission?

**Mr Savundra:** I will take that on notice, if that is okay.

**ANSWER**

The Australian Securities and Investments Commission (ASIC) referred material concerning Trio Capital Limited (in liquidation) and Jack Flader Jr to the Australian Federal Police (AFP) on 22 June 2012. ASIC initially approached the Police about this referral on 15 June 2012.

In respect of the Australian Crime Commission after initial contact a meeting was held between ASIC and the Commission on 20 June 2012.

We have reviewed our records and have confirmed that a number of Interpol requests have been made through the AFP since October 2009. These requests were made to assist ASIC with our Trio investigation.

**Question on Notice #2**

**Page 18**

**Senator BOYCE:** Are you able to give the costs of the Storm case, including that of the forensic accountant?

**Mr Medcraft:** I will take that on notice.

**Senator BOYCE:** If we could have a breakdown of the costs of the case to ASIC.

**Ms Gibson**: I think we would probably prefer not to provide that in a public forum, just because at some stage there will need to be some discussion about outcomes of the case and costs.

**Senator BOYCE:** That was going to be my next question: have costs been awarded or not awarded?

**Mr Medcraft:** In the case of Storm it is still in court at the moment, but we can confidentially give you the number.

**Ms Gibson:** I am not sure.

**Mr Medcraft:** We will take it on notice.

**ANSWER**

In view of the pending litigation in which ASIC is involved arising from the collapse of Storm Financial, ASIC does not consider it appropriate to comment on the cost of the Storm case at this point in time.

**Question on Notice #3**

**Page 25**

Banksia debentures

**Mr FLETCHER**: Is debenture secured over specific assets?

**Mr Price**: Yes, a floating charge.

**Mr FLETCHER**: Is it mainly commercial property or residential property or a mix?

**Mr Price**: I might take that question on notice. It is a bit of a mix, but I think it is mainly commercial property, just from memory.

**Mr FLETCHER**: The other aspect to that question, on notice, is what is the proportion of established property and property under development?

**Mr Price**: Again, I will take that on notice.

**ANSWER**

The Banksia Securities Limited loans by underlying security type (based on value):

• 22% was commercial property,

• 46% was residential property,

• 9% was industrial property,

• 18% was rural property and

• 5% was other property.

The Cherry Fund Limited (CFL) loans by underlying security type (based on value):

• 36% was commercial property,

• 21% was residential property,

• 6% was industrial property,

• 34% was rural property and

• 4% was other property.

(Source 7.3.2 on Pg 19 of Receivers' Report dated 7 December 2012)

There are 128 Banksia Securities Limited loans with an aggregate value of $147 million with internal loan classifications which incorporate a development element of "construction", "land bank" and "vacant land". This equates to approximately 28% of the Banksia loans by value as possible property development.

There are no CFL loans classified "construction", "land bank" or "vacant land" indicating there are no development loans.

**Question on Notice #4**

**Page 26**

Banksia investors

**Mr Price**: It is an important point generally. One of the other things that the task force is doing is to consider if there are any breaches of the law. Obviously if we do find anything we will seek to hold people to account.

**Mr Medcraft**: We will look at directors; we will look at auditors; we will look at trustees. Basically we will look at all the gatekeepers, as we always do, including financial advisers.

**CHAIR**: So what are the consequences for—

**Mr Medcraft**: Sorry; the sad thing was—how much superannuation money was in—

**Mr Price**: A little over $100 million, off the top of my head, in superannuation money was—

**Senator BOYCE**: How many people?

**Mr Price**: I will need to take that on notice.

**ANSWER**

There are 843 different Super Funds (SMSFs) with investments totalling $112 million as at the date of appointment on 25 October 2012. (Source Receivers Profiling Sheet dated 27 October 2012)

This equates to 17.26% of the total $652 million investors funds by value.

**Question on Notice #5**

**Page 29**

CP 189 – FOFA: Conflicted Remuneration

**Mr FLETCHER**: I want to go to the paper that you have recently put out, Consultation Paper 189 Future of Financial Advice: Conflicted remuneration. A concern has been raised with me that this is likely to apply to investment firms which operate for non-retail clients as well as retail clients. Is that ASIC's understanding of the scope of the paper and the scope of these remuneration arrangements?

**Mr Kell**: No. I will take it on notice to check on that but, no, that is not our understanding.

**Mr FLETCHER**: To expand on the concern, it has been put to me that this firm and other firms in the investment management market serving non-retail clients typically operate on the basis of a bonus structure as well as a base remuneration structure for their portfolio managers. A driver of bonus amongst other things is the amount of additional funds under management that they are able to secure. They are concerned that that remuneration structure will no longer be open to them if the arrangements in paper 189 come into effect.

**Mr Kell**: It is a little hard to provide a definitive answer on an example like that off the bat so we are happy to take it on notice and get back to you quickly. Generally, it is not intended to apply in a purely wholesale context.

**Mr FLETCHER**: Is that are concern that has been raised with you on the consultation process?

**Mr Kell**: Again, I could check on that. It certainly has not been prominent in the responses to the paper to date to my knowledge.

**ANSWER**

Under the Corporations Act, a benefit is only conflicted remuneration if:

• it is given to a financial services licensee, or a representative of a financial services licensee, who provides financial product advice to persons as retail clients; and

• it could reasonably be expected to influence the choice of financial product recommended to retail clients or the financial product advice given to retail clients.

The conflicted remuneration provisions do not apply in relation to services provided to wholesale clients. This position is reflected in our proposed regulatory guidance on the conflicted remuneration provisions.

From our consultations with industry, we consider that industry understand this.

**Question on Notice #6**

**Page 31**

Discretionary trusts

**Senator BOYCE**: Leading on from what you were just talking about, the issue has been raised that it may be possible to define a discretionary trust that operates a family business as a financial product. Has that issue ever been raised with you? If so, how?

**Mr Tanzer**: I have to take that on notice, Senator.

**ANSWER**

As you are aware, ASIC deals with particular matters as they arise, including considerations of whether something falls within the definition of a financial product under the Corporations Act 2001. While we are unable to comment on specific entities, I advise that it does not appear from our records that this issue has been raised with ASIC in any formal sense.

**Question on Notice #7**

**Page 34**

MF Global – client money

**Mr FLETCHER**: I want to ask some questions about MF Global. It is reported that a number of Australians have had their balances in accounts with that international broker frozen following its collapse in the US. How actively is ASIC involved in efforts to recover those moneys?

**Ms Gibson**: There are two positions. Firstly, the MF Global subsidiary in Australia is being wound up. I thought that there was some money in the course of being released from the local broker. I do not know about the position of Australians with funds in the US or UK fund directly. Some of the moneys that were invested here went through to London. There is some money frozen there. We are in constant dialogue with the receivers. The receivers are seeking to negotiate a situation with the US administrators to extract some money that is held in London.

**ANSWER**

The issues in these types of external administrations can be very complex, with a mix of competing interests, and often require court intercession as was the case with MF Global Australia Limited (MFGA). MFGA was one of the largest futures brokers and providers of contracts for difference (CFDs) in Australia. Due to significant financial difficulties faced by its US-based parent, administrators were appointed to MFGA on 1 November 2011. MFGA subsequently went into liquidation on 2 March 2012.

Since the collapse of MFGA, ASIC has continued to monitor and engage with the liquidators of MFGA, as appropriate, including;

• obtaining regular updates on the progress of the administration and liquidation of MFGA;

• monitoring the various court applications to access the legal and policy implications; and

• engaging with the liquidators on disclosure to clients and creditors, including on issues associated the liquidators' remuneration and costs.

The liquidators of MFGA instituted representative proceedings to obtain court orders regarding the distribution of client monies and amounts recovered from clearing houses and counterparties. Representatives of various categories of claimants appeared in these proceedings. On 29 August 2012 Justice Black of the NSW Supreme Court handed down his decision in these proceedings.[1] Following the

1 MF Global Australia Ltd (in liq) [2012] NSWSC 994

decision, the liquidators of MFGA commenced a first partial distribution to clients on 31 October 2012. To date approximately $201 million (or an average of 63 cents in the dollar) has been distributed to clients and a further distribution is expected after Christmas.

There had been a dispute between MFGA and MF Global UK Limited (in special administration) (MFGUK) over approximately $36 million held by the ASX. This had been the subject of separate proceedings in the Federal Court. On 14 December 2012 the liquidators of MFGA announced they had reached an agreement with the special administrators of MFGUK to settle this dispute.

Relevantly, the dispute has been settled on the basis that:

• MFGUK will receive an amount of GB£400,000 (approximately AU$592,680); and

• MFGA will receive the balance of the disputed funds, being approximately AU$35.2 million.

The liquidators of MFGA anticipate receiving the funds from ASX shortly and will look to make a

further distribution to clients (specifically, futures clients) as soon as practicable.

**Mr FLETCHER**: It is reported that, although the clients were told that their moneys were going into a so-called client segregated account, they actually went into a pooled account and, when the firm collapsed, that became part of the pool of assets that creditors tried to recover against. Is that right?

**Ms Gibson**: I had thought that when the money was frozen that this was the subject of much discussion, although I might have to come back to you on notice about this. It has been to court and tested before Justice Black. He gave quite a long judgment in working out how the moneys that are available are to be divided up between the various classes of investor. Whether money is in a client segregated account is one of the criteria.

**ANSWER**

At the time of its collapse, MFGA held a substantial amount of funds in client segregated accounts. As an Australian financial services licensee and market participant MFGA was required to keep 'client money' in a client segregated account, separate from its own funds. Under the Corporations Act, moneys held in client segregated accounts are held in trust. However, the Corporations Act does not require a licensee to maintain a separate account for each client. Additional funds were subsequently able to be recovered from clearing houses and counterparties with which MFGA had open positions. Justice Black found the client segregated accounts maintained by MFGA should be grouped into four pools, representing the four product lines of MFGA (namely, futures, CFDs, online FX and margin FX). In addition, his Honour found that amounts recovered from clearing houses and

counterparties were, on receipt by MFGA, to be held on trust under Chapter 7.8 of the Corporations Act. Accordingly, the funds recovered from counterparties are only available for distribution to the relevant client pool and not for general distribution to other creditors.

**Mr FLETCHER**: I am interested in understanding whether clients of MF Global are in a different position to clients of an Australian broker that they used to transact on the ASX or whether they are in exactly the same position.

**Ms Gibson**: We would need to take that on notice to give you a fully correct answer.

**ANSWER**

Under the ASIC market integrity rules, brokers holding client funds to trade on Australian futures markets are required to place those funds into a segregated account. As a market participant, MFGA adhered to this requirement. The clearing of MFGA futures trades was conducted by MFGUK. Clearing is a capital intensive business and it is common for one entity in a group, with a large capital base, to be a clearer in multiple markets for number of trading participants in the group. There had been a dispute between MFGA and MFGUK over the funds held by the ASX at the time of MFGA's collapse, however this dispute has now been settled.

>>>>>>>>.

**Mr FLETCHER**: There was a suggestion in one of the press reports that a particular difficulty was that ASIC had granted an exemption to MF Global to allow it to use its British business as the market participant in Australia. Is that right or not?

**Ms Gibson**: I would need to take that on notice. I am not sure whether we or the ASX would have done that. If the problem was clearing participants, then probably the ASX would have done that.

**ANSWER**

MFGUK, an entity regulated by the UK Financial Services Authority, had been granted an exemption by ASIC from the requirement to hold an Australian financial services licence for certain financial services it provided to wholesale clients. The Corporations Act contemplates the granting of such exemptions.

The decision was made by the ASX to allow MFGUK to be a Clearing Participant.

**Mr FLETCHER**: All right. That was all I had.

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**Question on Notice #8**

**Page 34**

Financial advice and the super cap

**Senator BOYCE**: I have had a couple of people complain to me about not receiving the best advice from their financial service providers or advisers, which has caused them to go over the cap on superannuation. Has that issue been raised with you? If so, what is ASIC thinking about that?

**Mr Kell**: We are aware of the issue and the fact that the change in the level of the cap means that advisers should be revisiting the strategies and arrangements that were put in place prior to July this year. First and foremost, it is an issue about which the ATO has been providing educational material and information to investors. That material talks about the cap and how they can manage that. We have not been receiving a significant number of complaints about this, but I will take it on notice to check whether we have had any. I will also check on whether we have referred any of those to the Financial Ombudsman Service for them to look at the quality of the advice that has been provided. At this stage, it has not been a big issue in terms of complaints that have come to us. We are aware of it. We think that it is the sort of issue that, as a matter of course, should be captured in knowledge d skills updates for financial advisers. We would like to see it incorporated into the training that advisers get.

**ANSWER**

ASIC has not received a significant number of complaints from consumers who have received advice that has caused them to exceed the concessional contributions cap. ASIC has, in fact, received 1 complaint and 2 breach notifications regarding excessive contributions to date in the 2012 calendar year. Both breach notifications were in respect of the conduct of one financial adviser.

One of these matters is being considered at the Superannuation Complaints Tribunal and the other two were managed through the relevant Australian financial services licensee's dispute resolution framework.

## Received from the Australian Securities Exchange on 18 December:

### ASX Further Response to Questions from the PJC

**Question 1**

"Would it be possible to get, on notice – I do not necessarily want to know the days – the meetings and the topic that is discussed at those meetings?"

**Answer 1**

Regular monthly meetings are held between ASX and ASIC representatives on:

a) Business Development, Operations and Technology matters discussion topics cover current business, technology and operational issues, including:
   - ASX Business initiatives
   - ASIC initiatives and regulatory issues
   - Matters relating to the operation of the markets and clearing and settlement facilities
   - ASX participants
   - ASX and ASIC technology
   - Changes to the operating rules and
   - Consultations and submissions
b) Compliance related matters discussion of current compliance related issues, including:
   - Run off case management
   - Information requests
   - Rule overlap or other rule issues
   - Referrals
   - Participant co-ordination and
   - Participant capital monitoring

**Question 2**

"The MOU with ASIC – has it got a term to it? Does it have to be renegotiated?"

**Answer 2**

There is no term. The MOU is ongoing.

**Question 3**

"The memorandum of understanding that you have reached indicates that ASIC has capacity to advise the Australian Securities Exchange of a potential breach of the ASX operating rules, but it is limited by the Privacy Act and section 127 of the ASIC Act. Does the ASX receive from ASIC sufficient information to address breaches of its operating rules? Given the transfer of responsibility for supervision of the stock market from ASX to ASIC, should section 127 of the ASIC Act be reviewed to consider the ASX among entities which ASIC may provide confidential information to?"

**Answer 3**

The regular meetings outlined in Question 1 (above) together with daily discussions between ASX Compliance and ASIC staff and specific meetings/discussions relating to particular incidents/events/issues provide forums for ASX to obtain any relevant information from ASIC that ASX does not otherwise obtain itself through its operational or compliance activities. Also, ASIC has this year released information to ASX pursuant to section 127 to enable ASX to pursue enforcement action against ASX participants.

In relation to the question about section 127 of the ASIC Act being reviewed, we believe this is not necessary for ASX Group licensees. However, it could be helpful if the Securities Exchanges Guarantee Corporation (the trustee of the National Guarantee Fund) was included in the list of bodies corporate in Part 1 of Schedule 3. SEGC has statutory powers under section 892D to require production of documents or statements to assist it in determining a claim for compensation in respect of a broker, but these powers do not apply to ASIC. The inclusion of SEGC in the list in Part 1 of Schedule 3 will facilitate cooperation between SEGC and ASIC in relation to the sharing of information. This is particularly important now that broker supervision functions have been transferred to ASIC.

**Question 4**

"Could you provide on notice some examples from the US market where the level of high frequency trading and dark pools activity has had very negative outcomes of the kind we are seeking to prevent?"

**Answer 4**

Below are reports/extracts of high frequency trading and dark pool activity:

**The US flash crash date and summary of what occurred**

*On May 6, 2010, the prices of many U.S.-based equity products experienced an extraordinarily rapid decline and recovery. That afternoon, major equity indices in both the futures and securities markets, each already down over 4% from their prior-day close, suddenly plummeted a further 5-6% in a matter of minutes before rebounding almost as quickly.*

*Many of the almost 8,000 individual equity securities and exchange traded funds ("ETFs") traded that day suffered similar price declines and reversals within a short period of time, falling 5%, 10% or even 15% before recovering most, if not all, of their losses. However, some equities experienced even more severe price moves, both up and down. Over 20,000 trades across more than 300 securities were executed at prices more than 60% away from their values just moments before. Moreover, many of these trades were executed at prices of a penny or less, or as high as $100,000, before prices of those securities returned to their "pre-crash" levels.*

*By the end of the day, major futures and equities indices "recovered" to close at losses of about 3% from the prior day.*

http://www.sec.gov/news/studies/2010/marketevents-report.pdf

**The BATs and Facebook IPOs dates and summary of what occurred**

BATS experienced a serious technical failure on Friday, March 23, 2012 which caused it to withdraw its own IPO.

*BATS experienced a system problem in our attempt to open the BATS ticker symbol for the first time on Friday morning. We failed to roll into continuous trading with our new BATS ticker immediately following the opening auction. In effect, our newly issued stock did not begin trading as it should and was halted before it ever started trading.*

*Technology implementations are prone to failures and unexpected outcomes, even after going through rigorous testing. Every market center and every trading participant has experienced technical issues in their history. Our historical reliability has been very strong, with 99.9% uptime on our primary BATS BZX Exchange over the last 3+ years. On Friday we were under the brightest spotlight imaginable … opening our own stock on our own exchange for the first time ever. It doesn't get much more public than that.*

*Our listing Exchange has an obligation to operate and maintain fair and orderly markets. In the ordinary course, when an exchange experiences a technical problem, normal trading in the affected securities resumes once the technical problem is resolved. This situation was unique, however, because the affected security was our own. After fixing the software module that failed, and rolling it back into production, we were faced with how the market would react to a re-opening of our stock after the failed first start. Had the delay been only a few minutes, the restart process would*

*have possibly been manageable. But after 2 ½ hours had transpired, we determined that this was a material event that had eroded investor confidence in our own stock and made the timely resumption of fair and orderly trading unlikely. As a result, we pulled the IPO and unwound all auction executions.*

http://www.batstrading.com/resources/newsletters/CEO_Newsletter_25Mar2012.pdf

Facebook

*On May 18, 2012, Nasdaq experienced system difficulties during the Nasdaq Halt and Imbalance Cross Process (the "Cross") for the FB IPO. These difficulties delayed the completion of the Cross from 11:05 a.m. until 11:30 a.m…*

*As a result of the system difficulties, however, certain orders for FB stock that were entered between 11:11:00 a.m. and 11:30:09 a.m. in the expectation of participating in the Cross*

*– and that were not cancelled prior to 11:30:09 – either did not execute or executed after 1:50 p.m. at prices other than the $42.00 price established by the Cross. (Other orders entered between 11:11:00 a.m. and 11:30:09 a.m., including cancellations, buy orders below $42.00, and sell orders above $42.00, were handled without incident.) System issues also delayed the dissemination of Cross transaction reports from 11:30 a.m. until 1:50 p.m. At 1:50 p.m., Nasdaq system difficulties were completely resolved…*

*As a result of these unique circumstances, Nasdaq is proposing to accommodate members for losses attributable to the system difficulties on May 18, 2012 in an amount not to exceed $62 million.*

https://www.sec.gov/rules/sro/nasdaq/2012/34-67507.pdf

**Knight Capital malfunction date and summary of what occurred**

*Knight Capital Group Provides Update Regarding August 1st Disruption To Routing In NYSE-listed Securities*

*As previously disclosed, Knight experienced a technology issue at the open of trading at the NYSE yesterday, August 1st. This issue was related to Knight's installation of trading software and resulted in Knight sending numerous erroneous orders in NYSE-listed securities into the market. This software has been removed from the company's systems.*

*Clients were not negatively affected by the erroneous orders, and the software issue was limited to the routing of certain listed stocks to NYSE.*

*Knight has traded out of its entire erroneous trade position, which has resulted in a realized pre-tax loss of approximately $440 million. Although the company's capital base has been severely impacted, the company's broker/dealer subsidiaries are in full compliance with their net capital requirements. Knight will continue its trading and*

*market making activities at the commencement of trading today. The company is actively pursuing its strategic and financing alternatives to strengthen its capital base.*

http://www.knight.com/investorRelations/pressReleases.asp?compid=105070&releaseID=1721599

**Other issues or incidents in the US**

*Flash order controversy at Direct Edge. Direct Edge withdrew the practice of flashing customer orders to their liquidity providers before routing unfilled orders to other venue in 2011.*

**Number of dark pools operating in the US**

*According to Mary Schapiro there are 15 public exchanges, more than 30 dark pools, 3 electronic communication networks (ECNs), and more than 200 internalizing broker-dealer.s*

**Proportion of off market trading in the US**

*According to Fidessa, 32% in FY13.*

| Category | Venue | Trade Type | Turnover (m USD) | Volume | #Trades | Av.Value | Av.Size | Share |
|---|---|---|---|---|---|---|---|---|
| Lit | | | 1,445,753 | 44,206,071,177 | 134,896,038 | 10,718 | 328 | 67.61% |
| | NYSE | | 393,475 | 9,714,162,410 | 13,531,731 | 29,078 | 718 | 18.4% |
| | NASDAQ | | 318,901 | 9,571,351,246 | 31,570,926 | 10,101 | 303 | 14.91% |
| | NYSE Arca | | 209,651 | 6,811,632,958 | 22,307,368 | 9,398 | 305 | 9.8% |
| | BATS | | 176,397 | 5,496,586,465 | 22,087,767 | 7,986 | 249 | 8.25% |
| | EDGX | | 132,249 | 4,455,134,317 | 13,451,741 | 9,831 | 331 | 6.18% |
| | BATS Y | | 71,252 | 2,483,289,809 | 11,610,883 | 6,137 | 214 | 3.33% |
| | NASDAQ BX | | 49,368 | 2,104,647,976 | 8,800,601 | 5,610 | 239 | 2.31% |
| | EDGA | | 46,604 | 1,846,067,134 | 7,401,899 | 6,296 | 249 | 2.18% |
| | NASDAQ PSX | | 22,309 | 889,379,397 | 2,016,258 | 11,065 | 441 | 1.04% |
| | Chicago Stock Exchange | | 9,416 | 287,543,634 | 8,830 | 1,066,402 | 32,564 | .44% |
| | CBSX | | 8,412 | 300,054,926 | 1,437,718 | 5,851 | 209 | .39% |
| | NSX | | 5,990 | 177,551,651 | 421,865 | 14,199 | 421 | .28% |
| | NYSE Amex | | 1,728 | 68,669,254 | 248,451 | 6,956 | 276 | .08% |
| OTC | | | 692,736 | 23,790,111,602 | 48,823,187 | 14,189 | 487 | 32.39% |
| | OFF/Q | | 595,249 | 20,610,679,054 | 40,083,949 | 14,850 | 514 | 27.84% |
| | OFF/N | | 59,856 | 1,878,320,732 | 8,701,693 | 6,879 | 216 | 2.8% |
| | Boat xoff | | 36,836 | 1,215,342,959 | 37,423 | 984,303 | 32,476 | 1.72% |
| | Euronext OTC | | 796 | 85,768,857 | 122 | 6,522,177 | 703,023 | .04% |

**Proportion of retail flow executed on lit exchanges**

*Internalisation is also thought to account for almost 100% of all retail marketable order flow. Retail internalization is driven by the purchase of order flow by wholesale OTC market makers from retail brokerage firms. This practice enables broker/dealers to "preference" those orders that are profitable to arbitrage and route unwanted orders to other market centers*

Dark Pools, Internalization, and Equity Market Quality, CFA Institute 2012

# Appendix 2

## Public hearings and witnesses

### Sydney, 3 December 2012

*Australian Securities Exchange*

Mr Elmer Funke Kupper, Chief Executive Officer
Mr Peter Hiom, Deputy Chief Executive Officer

*Australian Securities and Investments Commission*

Mr Greg Medcraft, Chairman
Ms Belinda Gibson, Deputy Chairman
Mr Peter Kell, Commissioner
Mr John Price, Commissioner
Mr Greg Tanzer, Commissioner