Question No: QON 1 and 2
Topic: Non authorised deposit-taking institutions

Question:

On 17 July 2017, the Treasury commenced consultation on a proposed power for the Australian Prudential Regulation Authority (APRA) in relation to the provision of credit by entities that are not authorised deposit-taking institutions (non-ADI lenders).

1. Noting the changes to APRA's powers, does ASIC have sufficient powers to address consumer protection and regulation of non-ADI lenders?
2. Can ASIC explain to the committee ASIC's role if changes to the Financial Sector (Collection of Data) Act are passed, allowing APRA to gather information about non-ADI's engaging in material lending activity whether it be their primary business or not?

Answer:

1. Noting the changes to APRA's powers, does ASIC have sufficient powers to address consumer protection regulation of non-ADI lenders?

ASIC administers the *National Consumer Credit Protection Act 2009*, which applies to businesses engaging in credit activities, regardless of whether the business is an ADI. This means that ASIC's powers in relation to the regulation of non-ADIs that provide credit are generally the same as its powers in relation to ADIs. There are a number of small exceptions. For example, ASIC is responsible for the oversight of non-ADIs' risk management systems, but APRA is responsible for the oversight of the risk managements systems of ADIs.

The ASIC Enforcement Taskforce is currently reviewing ASIC's regulatory toolkit and will report to the Government later this year. This review will examine the adequacy of ASIC's powers in relation to information-gathering, enforcement, licensing, infringement notices and penalties. The outcome of the review will be relevant for all ASIC's regulated entities, including non-ADI credit providers.

APRA's proposed new powers in relation to non-ADI lenders require APRA to consult with ASIC prior to making, varying or revoking a rule that applies to non-ADI lenders. This will allow ASIC to share its experience in regulating non-ADI lenders with APRA. Additionally, APRA's proposed rule-making power applies where it considers that an activity or activities engaged in by one or more non-ADI lenders in relation to lending finance materially contribute to risks of instability in the Australian financial system. Comparatively, ASIC's existing powers relating to the regulation of the conduct of credit providers are designed and intended to be used for consumer protection.

2. Can ASIC explain to the committee ASIC's role if changes to the Financial Sector (Collection of Data) Act are passed, allowing APRA to gather information about non-ADI's engaging in material lending activity whether it be their primary business or not?

ASIC's role as the conduct regulator for credit providers, including ADI and non-ADI lenders, should not change as a result of the proposed changes to the *Financial Sector (Collection of Data) Act 2001*. ASIC and APRA, as the 'twin-peaks' of financial services regulation in Australia, share information that may be relevant to the other's regulatory activities. ASIC and APRA's working relationship is documented in a Memorandum of Understanding between the two regulators.

The collection of additional information by APRA means that, where necessary, ASIC may request that this information be shared with ASIC to inform our regulatory activities in relation to non-ADI lenders.

Question No: QON 3
Topic: Enforcement Review Taskforce recommendation

Question:

The Enforcement Review Taskforce has made a recommendation that ASIC should have tougher powers to refuse a financial services license to a business it does not believe is fit and proper. Can ASIC explain to the committee how will this work in practice?

Answer:

On 19 October 2016, the Minister announced the ASIC Enforcement Review Taskforce and its Terms of Reference. The Minister stated that the Taskforce 'will assess the suitability of the existing regulatory tools available to ASIC to perform its functions adequately, whether there is a need to strengthen ASIC's enforcement toolkit and if so, what that might look like".

The Taskforce's position paper, "*Strengthening ASIC's Licensing Powers"* was released in June 2017. The paper acknowledges that the Government, in response to the Financial System Inquiry's final report, supported the recommendation that ASIC be provided with stronger regulatory tools in relation to the financial services and credit licensing regimes.

The paper states that, "The Taskforce has developed preliminary positions on a set of reforms aimed at enhancing the current regimes and achieving greater uniformity between the two regimes".

As indicated in the position paper, ASIC is required under s913B of the Corporations Act to have regard to a range of factors when deciding whether to grant an AFS licence. Currently, ASIC *may* suspend or cancel a licence if it is no longer satisfied of these matters (s915 of the Corporations Act).

The position paper proposed a number of positions including that ASIC *should* be able refuse a licence application if it is not satisfied that the controllers of the applicant are fit and proper and to take licensing action if it is no longer satisfied of this, including on a change of control (Position 1). The paper states that to achieve this it will be necessary to:

- enable ASIC to refuse to grant a licence (after offering a hearing) if it is not satisfied that the controllers of the applicant are fit and proper to control an AFS or credit licensee;
- following a change in control require licensees to provide ASIC with information to enable ASIC to assess whether the new controllers are fit and proper to control the licensee and confirmation that the licensee continues to be competent to provide the relevant services and comply with its licence obligations; and
- enable ASIC to suspend or cancel a licence if it is no longer satisfied that the controllers of a licensee are fit and proper to control an AFS or credit licensee.

The position paper also states that if the other positions in the paper are adopted "the test for assessing individuals in AFS licence applications will consider whether the person is 'fit and

proper' to hold the relevant position within the licensee, as for credit licence applications, rather than the test of 'good fame and character' that currently applies".

Please refer to pages 12-15 of the position paper for further details.

Submissions to the position paper closed on 26 July 2017. ASIC understands the Taskforce is still considering the issues and will report back to Government.

Question No: QON 9-13
Topic: Mortgage brokers

Question:

9. What is ASIC's response to claims made to the media by the Finance Brokers Association that banning commissions for mortgage brokers may lead to brokers being driven out of business, a concentration of power in the banks and a rise in interest rates?

10. What changes to commissions for mortgage brokers would ASIC like to see?

11. CHOICE and other consumer groups have suggested that all commissions should be banned. Does ASIC foresee any difficulties with banning all commissions?

12. An article dated 15 July 2017 that appeared in the *Weekend Australian* claimed that brokers and lenders are negotiating to create a self-regulation scheme between them and that they have tentative tacit support for this from ASIC and by extension the Government.4 Has ASIC provided tacit support for such a self-regulation scheme?
a. If so, why?

13. What is ASIC's opinion on the Australian Financial Group's claim that rather than change commissions for brokers, banks should do more to prevent customers borrowing more than needed?

Answer:

9. What is ASIC's response to claims made to the media by the Finance Brokers Association that banning commissions for mortgage brokers may lead to brokers being driven out of business, a concentration of power in the banks and a rise in interest rates?

As we have not proposed that mortgage broker commissions be banned we have not undertaken detailed analysis about the impact such a ban would have. We also note that the precise impact of any ban will depend on how it was framed, how the market and consumers respond, and any other regulatory changes that are made.

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10. What changes to commissions for mortgage brokers would ASIC like to see?

ASIC's proposals in REP 516 around commissions are that:

- The standard commission model (upfront and trail commissions) can be improved. The current model has the potential to encourage brokers to place consumers in larger loans, as commission amounts are generally calculated based on the size of the loan. We have suggested that this risk could be reduced by changing the standard commission model so that brokers are not incentivised purely on the size of the loan.
- Industry should move away from other bonus commissions and bonus payments: volume and campaign-based commissions and bonus payments to lenders' staff have the potential

to contribute to poor consumer outcomes and may place smaller lenders at a competitive disadvantage.

- Industry should move away from soft dollar benefits, which are widespread. These can encourage poor consumer outcomes and place smaller lenders at a disadvantage.

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11. CHOICE and other consumer groups have suggested that all commissions should be banned. Does ASIC foresee any difficulties with banning all commissions?

See our response to question 9 above.

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12. An article dated 15 July 2017 that appeared in the *Weekend Australian* claimed that brokers and lenders are negotiating to create a self-regulation scheme between them and that they have tentative tacit support for this from ASIC and by extension the Government.4 Has ASIC provided tacit support for such a self-regulation scheme?

a. If so, why?

Following the release of ASIC REP 516, representatives from the lending and mortgage broking industries have set up an industry forum to discuss ASIC's proposals.

ASIC welcomes proactive steps taken by the industry to understand and address the issues raised in ASIC's report and to work together on providing input to possible solutions and changes for the industry.

We note the Minister's recent announcement that the Government will take into account the mortgage industry's forum process when finalising its response to the Review.

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13. What is ASIC's opinion on the Australian Financial Group's claim that rather than change commissions for brokers, banks should do more to prevent customers borrowing more than needed?

All home loan providers are required to comply with the responsible lending provisions in the *National Consumer Credit Protection Act 2009* (the National Credit Act). Under these provisions, credit licensees are required to make an assessment of whether the proposed credit contract will be unsuitable for the consumer after having:

- made reasonable inquiries about the consumer's requirements and objectives;
- made reasonable inquiries about the consumer's financial situation; and
- taken reasonable steps to verify the consumer's financial situation.

Licensees must assess a credit contract as unsuitable if the consumer is likely to be unable to comply with the financial obligations under the contract, or could only comply with substantial hardship, or if the contract will not meet the consumer's requirements and objectives.

In recent years ASIC has undertaken significant work to support and encourage lenders to comply with their responsible lending obligations, particularly around home loans. ASIC continues to take action against lenders and intermediaries where we are concerned that they have not met their obligations.

Notwithstanding the responsible lending obligations, ASIC's REP 516 shows that there are changes that can be made to remuneration structures in the home loan industry to reduce potential conflicts of interest and thereby further improve outcomes for consumers.

Question No: QON 17
Topic: Fair and efficient markets

Question:

17. a. Can ASIC explain the difference between a retail and a sophisticated investor?
b. What is the test to determine whether an investor is sophisticated?

Answer:

a. Investors under Chapter 7 of the Act (Financial services and markets)

Under the financial services laws, an investor is presumed to be a retail client, unless they meet the definition of a wholesale client. Therefore, investors are classified as either retail or wholesale.

Sophisticated investors are a form of wholesale client unless specifically identified as retail in the *Corporations Act 2001* (the Act). There are differences between how a retail investor and a wholesale or sophisticated investor are treated depending on the financial services or products being provided to the investor, and therefore what sections the Act apply.

The key reason for the distinction between retail and wholesale or sophisticated clients is to identify the group of consumers in most need of regulatory protection. The rationale is that wholesale or sophisticated clients are better informed and better able to assess the risks involved in the financial products and services in which they are engaging.

However, sophisticated clients may not always have the requisite knowledge of complex financial services, such as derivatives, to evaluate the risks associated with an investment in these products. As such, the Government's recent client money reforms purposefully defined 'retail clients' to include clients who are sophisticated retail investors (as set out in section 761GA) to ensure these clients have the benefit and protection of these reforms.

The distinction between each investor class in financial services laws is important, given the emphasis on consumer protection. The level of regulation is much higher when dealing with retail investors. For example, when providing advice and dealing with retail clients, a retail client must be given disclosure documents such as a product disclosure statement, a financial services guide, a statement of advice and a general advice warning, if appropriate.

Australian financial services (AFS) licensees that provide financial services to retail clients have additional obligations in relation to compensation (ASIC Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees*) and dispute resolutions (ASIC Regulatory Guide 165 *Licensing: Internal and external dispute resolution*).

Licensees are required to have in place compensation arrangements, consisting of either adequate professional indemnity insurance, or an alternative arrangement specifically approved by ASIC. An internal dispute resolution procedure and membership of an external dispute resolution scheme that accepts complaints about the financial services provided must also be in place for the benefit of retail clients. Financial advisers who

provide advice to retail clients are also subject to minimum training requirements (ASIC Regulatory Guide 146 *Licensing: Training of financial product advisers*). The educational, training and ethical requirements for financial advisers who provide advice to retail clients regarding investment, superannuation and life insurance will increase due to the *Corporations Amendment (Professional Standards of Financial Advisors) Act 2017*, which commenced on 15 March 2017.

Note: A financial service is provided to a person as a retail client unless subsections (5), (6), (6A) or (7) of 761G of the Act apply, or section 761GA provides otherwise, in which case an investor is considered a wholesale client.

Investors under Chapter 6D of the Act (Fundraising)

The concept of a retail investor is also relevant to offers of securities under Chapter 6D of the Act. Generally, an offer of securities for issue must be made using a regulated disclosure document such as a prospectus, to help retail investors assess the risks and returns associated with the securities, and make informed investment decisions.

In comparison, sophisticated investors have historically been considered more likely to be able to evaluate offers of securities, and section 708(8)-(10) of the Act, when read together with the regulations discussed in part (b), permits offers of securities to be made to sophisticated investors without regulated disclosure.

On this basis, sophisticated investors are provided with the ability to invest in wholesale investment opportunities that other retail investors are not able to access.

b. *What is the test to determine whether an investor is sophisticated?*

As noted above, a 'sophisticated investor' under the financial services laws is a type of wholesale client, unless specifically identified as a retail client (e.g as in the client money reforms referred to above). While the tests for whether a person is wholesale or sophisticated are broadly the same for financial products and offers of securities, there are some differences in how they are labelled or described.

Financial products

For the purposes of offering a financial product or a financial service, a wholesale client is a person who satisfies one or more of the following tests in s761G of the Act

1. The person has obtained an accountant's certificate within the preceding two years, stating that the client has, or controls:
    i. Net assets of at least $2.5 million; or
    ii. Gross income for each of the last two financial years of at least $250,000;
2. The price or value of the financial product to which the service relates is at least $500,000;
3. The person is a 'professional investor' (as defined in s9).

Specific tests apply for general insurance products, superannuation and retirement savings account (RSA) products and traditional trustee company services (s761G(5), s761G(6) and s761G(6A).

A person will be a sophisticated investor when a licensee is satisfied on reasonable grounds that the client has previous experience in using financial services and investing in financial products that allows the client to assess the merits and value of the product or service, the risks associated with holding the product, the client's own information needs and the adequacy of the information provided by the licensee and the product issuer.

The licensee must give the client a written statement setting out their reasons for being satisfied that the client is a sophisticated investor. The client also needs to acknowledge, among other things, that they have not received disclosure documents that would usually be given to a retail client.

This test will not apply if the relevant financial product is a general insurance, superannuation or RSA product and/or is used in connection with a business (s761GA).

Securities

Similar tests also apply to determine when disclosure is required for the offer of securities under Chapter 6D.

For the purposes of offering securities, a sophisticated investor is a person who satisfies one or more of the following tests (s708(8) of the Act and reg 6D.2.03 of the *Corporations Regulations 2001*):

1. A person or entity has obtained an accountant's certificate within the preceding six months, stating that the client has:
    i. Net assets of at least $2.5 million; or
    ii. Gross income for each of the last two financial years of at least $250,000;
2. A person or entity that is controlled by a person or entity that meets the requirements of (i) and (ii) above;
3. A person or entity who invests where the purchase price of the product is at least $500,000.

Disclosure with an offer of securities is also not required in the following circumstances, which are similar to the wholesale and sophisticated investor tests in Chapter 7:

1. A person is a professional investor (s708(11)); or
2. The offer is made through an AFS licensee and the licensee, as with Chapter 7, is satisfied on reasonable grounds that the person has previous experience in investing in securities that allows them to assess the merits and value of the securities, the risks associated with accepting the offer, their own information needs and the adequacy of the information given by the person making the offer.

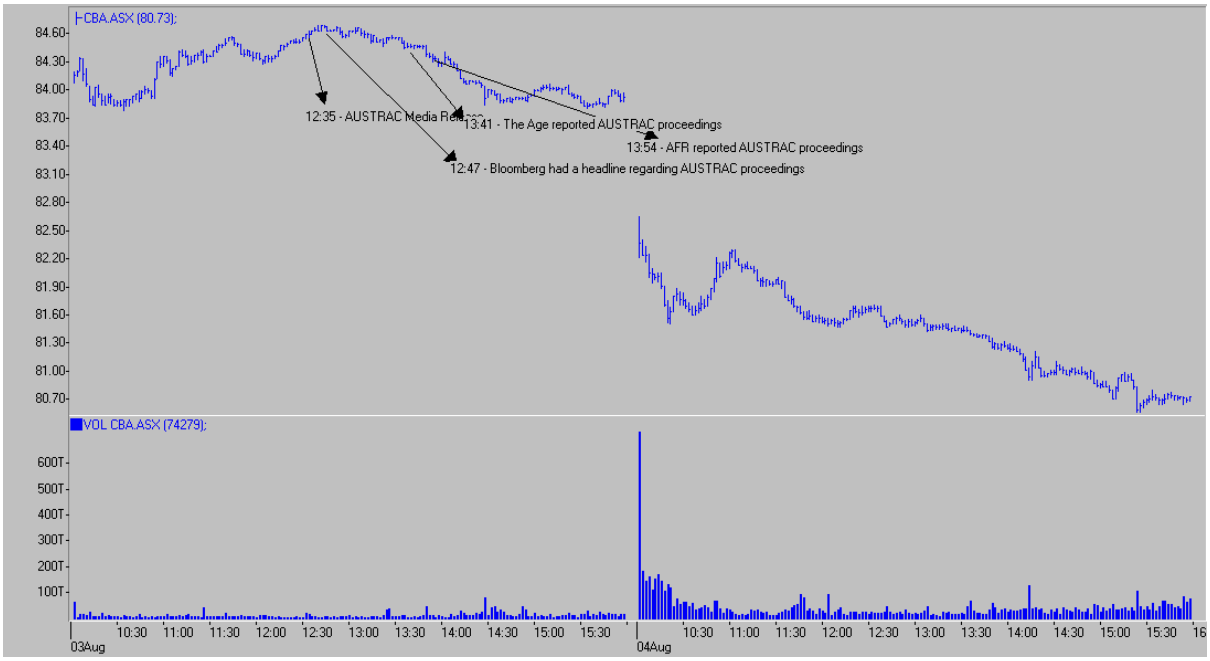
    The licensee must give the person a written statement setting out their reasons for being satisfied of these matters. The person also needs to acknowledge that they

have not received disclosure documents that would otherwise be given when an offer of securities is made (s708(10)).

Question No: QON Com 18-26
Topic: Fair and Efficient Markets

Question:

On 3 August 2017 AusTrac published a media release on its initiation of civil penalty proceedings against the Commonwealth Bank. AusTrac lodged its documents with the Federal Court at 9.39 am on 3 August 2017. In the lit ASX market on the following day the share price fell and trading volume increased substantially as shown in the graph below.



18. Would ASIC please explain to the committee the extent of trading that occurred in dark markets, between AusTrac court lodgement and announcement and the price and volume changes on the lit markets?

Answer:

AusTrac lodged its documents with the Federal Court at 9.39am on 3 August 2017. Whilst CBA did not make a formal company announcement on the ASX Market Announcements Platform (MAP) until 12:09:32pm on 4 August, it did make a media release in response to the legal action on its website prior to 1:54pm on 3 August – the media release was quoted in an AFR article at 1:54pm - the time of lodgement is being confirmed with CBA.

Table 1 below shows the aggregate trading volume on 3 and 4 August 2017 as well as between AusTrac court lodgement and announcement (from 3 August 2017 to 12:09:32pm on 4 August). Dark trading accounted for between 18.41% and 20.47% of total volume traded. A

smaller percentage of between 0.89% and 5.27% of dark trading occurred at special block size (i.e. over $1 million per trade).

Table 1 – CBA Trading Volume and Proportion of Dark Trading

CBA	3rd Aug 2017	4th Aug 2017	9.39am 3 Aug to 12:09pm 4 Aug 2017
Total Value Traded	236,008,943	808,981,366	586,015,550
Dark Trading	48,310,893	148,897,788	109,656,557
% of Dark Trading	20.47%	18.41%	18.71%
Special Size Dark	2,100,000	42,662,162	19,163,376
% of Special Size Dark	0.89%	5.27%	3.27%

In the lit market by mid-afternoon on 3 August 2017 the AUSTRAC action was widely reported in the media. Whilst the share price fell marginally throughout the afternoon, CBA's share price closed only 26c or 0.3% lower at $83.97. (On 3 August - NAB closed 7c or 0.07% higher [essentially flat], WBC closed 5c or 0.16% lower [essentially flat] and ANZ closed 6c or 0.2% lower [also essentially flat]. The entire banking sector was quite flat on the day.

CBA's share price traded sharply lower on elevated volume after opening on 4 August following extensive media coverage focussing on the size of potential civil penalties and providing details compliance and operational failures which form the basis for AUSTRAC's statement of claims.

Question:

19. Would that trading have materially affected the lit market price if it had occurred on the lit market?

Answer:

Below block size dark trading in Australia must execute with meaningful price improvement to the current best bid/ask quote on the lit market. That is they can only occur within the bid/ask spread, at prices meaningfully better that the bid/ask prices. Most dark markets reference prices on the lit market and improve upon that price within the spread. Trades that occur in the dark typically are typically done by parties that wish to minimise their impact on the market.

On the other hand block sized special crossing can occur off-market at prices outside of the quoted bid/ask spread. Most of the special crossing occurred at close to the last traded price with a few that traded outside of the spread. The deviations to the contemporaneous quote were not large.

It is difficult to say for certain the exact impact of migrating the dark trading on to the lit market during the relevant two days. Given the large size and liquidity of CBA shares, it is

unlikely that lit market prices would be materially affect if the below block size dark trades had occurred on the lit market.

However, the fundamental purpose of dark trading is for parties to avoid pre-trade transparency and minimise price impact. There are literature associating the execution of large orders with heightened intraday volatility. Had block sized dark trading been done on the lit market, the price impact would depend on how the large order was managed and executed. Whether the parent orders were sliced into appropriate child orders and submitted into the market in and orderly fashion.

Question:

20. Did prices in dark markets fall substantially prior to the lit market falling?

Answer:

No, below block size dark trading in Australia must execute with meaningful price improvement to the current best bid/ask quote on the lit market. That is they can only occur within the bid/ask spread, and not diverge from lit market prices. In fact they typically reference the prices on the lit market and contribute little to price discovery given the lack of pre-trade transparency and pricing restrictions. We did not observe a systematic price decrease for block size dark trades substantially prior to lit markets. In fact it would not be abnormal for block size dark trade prices (as well as lit market prices) to have a slight downward bias given the negative press regarding CBA.

Question:

21. To what extent were sophisticated investors including large institutional investors able to avoid losing money on CBA shares following the AusTrac court lodgement and announcement, by exiting their positions through dark markets, before the lit market price fell?

Answer:

Dark market prices typically closely reference lit markets. The potential for sophisticated investors including large institutional investors to avoid losing money on CBA shares following the AusTrac court lodgement and announcement, by exiting their positions through dark markets, before the lit market price fell is very limited. Price discovery in both lit and dark markets depend on the volume, directional bias and urgency of parties trading in the markets.

Question:

22. Would ASIC please provide the committee with some analysis of trading in derivatives related to CBA shares between the AusTrac court lodgement and announcement and the share price falling on lit markets.

Answer:

OTC Derivatives

We used the OTC derivative data to review the trading in Contracts For Difference (CFDs), swaps, forwards and OTC options for the timeframe in question and found no suspicious trading in OTC derivatives over CBA.

A review of the CFD trading over CBA shares for the period showed that the largest sale by an individual account was only for $42k in face value, and this was to close out an existing long position for a profit of just $230.

With regards to OTC swap trading over the period, there were significant positions in CBA opened between "Qube Fund Ltd" and JP Morgan and also between "QT Fund Ltd" and JP Morgan, for $3.5m and $486k respectively. The activity, however, appears to be the rolling over of existing positions.

The OTC derivative data also showed no significant OTC option or forward positions opened over the period in question.

Exchange Traded Derivatives

Exchange traded options (ETOs) and warrant trading was analysed and no anomalous activity was detected.

CBA options volume pre-12:35pm on 3 August was average relative to preceding days with the majority of trades executed being of small value and consistent with normal retail turnover (average trade size of $3,282). The number of call options traded outnumbered puts by 3 to 1.

Options volumes began to build post-12:35pm, mostly concentrated towards the end of the trading session, as information relating to the AusTrac lodgement was disseminated by news vendors and became widely available in the public domain.

On August 4th, options volumes were heavy from the commencement of trading.

Date		**CBA Options Contracts Traded**		
		Calls	Puts	Total
Aug-01		2559	1213	3772
Aug-02		1092	2732	3824
Aug-03	pre-12:35	1756	615	2371
	post-12:35	3414	2344	5758
	total	*5170*	*2959*	*8129*
Aug-04	pre-12:09	9625	6039	15664
	post-12:09	16765	13047	29812

total	*26390*	*19086*	*45476*

Warrant trading volumes were light for the specified period and did not raise suspicion.

Question:

On 20 July 2017 ASIC released a consultation paper on a revised licence regime for domestic and overseas market operators. The media release relating to this outlined that the proposed regime would introduce a two-tiered market licence regime, based on a risk-assessment approach.

Answer

23. In relation to the revised license regime:

a. **How and in what timeframe will existing exemptions be closed and brought under the new two-tiered licensing arrangements?**

In the consultation paper, ASIC proposed commencing discussions with exempt markets to transition into the licensing regime, once the revised regulatory guidance is finalised and published. We are planning to finalise the regulatory guidance over the second half of 2017 and early 2018.
We have proposed using a streamlined and expedited process for the transition to the licensing regime. This may be possible because the exempt markets are already subject to sufficiently equivalent regulation in an overseas jurisdiction such as the European Union or the United States.

b. Will all current license exemptions be removed as part of the process and, if not, what type and how many exemptions will remain?

In the consultation paper, ASIC proposed that now that the licencing regime can accommodate a range of different market models, the market licence exemptions will in future only be given in rare and exceptional circumstances. As we said in the draft regulatory guide, we will only advise the Minister that an exemption should be granted in rare and exceptional circumstances. We also said in the draft regulatory guide that we will consider advising on an exemption appropriate if we think there is no public benefit in regulating the market under Pt 7.2 of the Corporations Act 2001 (for example, where the regulatory outcomes of market licensing are not relevant to the market venue or are achieved without regulation under Pt 7.2 of the Corporations Act; or where the cost of regulation significantly outweighs the benefits of those outcomes).
Therefore as a starting point, we will discuss with all exempt markets the case for transitioning to the licensing regime. We recognise there may be exceptional cases where it is appropriate for an exemption to be maintained and will continue to consider potential cases in consultation with industry.

c. How will ASIC's surveillance and monitoring activities differ across the two-tiers?

ASIC's surveillance and monitoring of market activities across the two tiers will be risk-based. In considering what surveillance and monitoring is required and appropriate for each market or each class of market, ASIC will look at the business model of the market or class of markets, and the risks presented by the features of the business model. This means our surveillance and monitoring activities will depend on the nature of the market, not just whether it is in tier one or tier two. This approach is similar to the one taken in international markets like the UK, European and North American markets. The adoption of a tiered risk based approach in Australia will bring the Australian approach more closely in to line with the approach in other important financial centres.
For example, if a licensed tier two market is a start-up market, ASIC's surveillance and monitoring activity for this market would be commensurate with the level of activity on that market and as such, would be expected to differ from our surveillance and monitoring activity for a tier two market with higher trading volumes. Other factors that will affect our assessment of risk include the nature of participants on the platform, whether those participants are trading on behalf of retail investors, and the types of products traded on the platform.

d. What surveillance and monitoring will ASIC undertake for crowd-sourced funding markets?
ASIC's surveillance and monitoring of crowd-sourced funding (CSF) markets will depend on the nature of the CSF secondary market.
Secondary markets for securities issued under a crowdfunding offer have been slow to develop in overseas jurisdictions that permit crowdfunding, and have taken different forms including: markets that permit trading only at specified periods (periodic auctions); and markets that are only available to existing shareholders (that is, do not allow any new investors to participate, or which only permit existing shareholders to purchase more shares). ASIC therefore has not prescribed a regulatory model for CSF markets at this point, but we continue to engage industry in our consideration of this issue.
ASIC has met with existing licensed market operators that are considering offering a secondary market for CSF issued securities. If existing licensed market operators choose to offer a CSF market under their existing licence and their existing business model (e.g. central order book with continuous trading and intermediated with market participants), the monitoring and surveillance of that market would not be too different to the existing monitoring and surveillance conducted by ASIC.
However, if the model is quite different (e.g. offered through a separate legal entity and separate market licence, peer-to-peer, periodic auctions, etc) the level of monitoring and surveillance of the market would be potentially reduced. In considering what surveillance and monitoring is required and is appropriate for CSF markets, ASIC will look at the model proposed to be offered, and the risks presented by the features of the model. The overarching policy objective will be to support innovation in an environment that also provides investors with appropriate information to position them to make investment decisions and manage their risks.

Question

24. In response to questions on notice received in January 2017, ASIC indicated that a different level of supervision exists for exempt markets as participation in such markets is

restricted to professional/sophisticated investors meaning that retail investors are not directly exposed to risks in exempt markets.
However, there have been reports in the media and in a media release from ASIC that sophisticated investor certificates have been misused and provided to retail investors. For example, ……. is alleged to have used trust structures to allow retail investors to be classed as sophisticated. This meant that those retail investors received offers to purchase shares without a disclosure document or prospectus.
Noting this, is a different level of supervision still suitable for retail markets and markets that are supposed to be restricted to sophisticated/professional investors?

Answer

The question appears to align 'sophisticated investors' with 'professional investors'. These are defined terms in the Corporations Act, and are quite distinct groups. Exempt professional markets are only permitted to have professional investors who are trading on behalf of other professional investors. Exempt professional markets are **not** permitted to have sophisticated investors on the markets.
While sophisticated investors (as explained in Q17) may be individuals that are classed as sophisticated, professional investors are defined to only include professional financial services firms and major institutional investors. The definition is set out in section 9 of the Corporations Act and covers entities such as:

(a) a financial services licensee;

(b) a body regulated by APRA, other than a trustee of a superannuation fund, an approved deposit fund, a pooled superannuation trust, a public sector superannuation scheme;

(c) a body registered under the Financial Corporations Act 1974 ;

(d) the person is the trustee of a superannuation fund, an approved deposit fund, a pooled superannuation trust, or a public sector superannuation scheme (all within the meaning of the Superannuation Industry (Supervision) Act 1993) and the fund, trust or scheme has net assets of at least $10 million;

(e) a person that controls at least $10 million (including any amount held by an associate or under a trust that the person manages);

(f) a listed entity, or a related body corporate of a listed entity;

(g) an exempt public authority;

(h) a body corporate, or an unincorporated body, that: carries on a business of investment in financial products, interests in land or other investments, and for those purposes, invests funds received (directly or indirectly) following an offer or invitation to the public (within the meaning of section 82), the terms of which provided for the funds subscribed to be invested for those purposes;

(i) a foreign entity that, if established or incorporated in Australia, would be covered by one of the preceding paragraphs.

Question

25. Will the two tiered market approach under a revised licensing regime limit the misuse of sophisticated investor certificates?

Answer:

ASIC's surveillance and monitoring of market activities across the two tiers will be risk-based. In considering what surveillance and monitoring is required and appropriate for each market or each class of market, ASIC will look at the business model of the market or class of markets, and the risks presented by the features of the business model.
Factors that will affect our assessment of risk include the nature of participants on the platform, and whether those participants are trading on behalf of retail investors, including retail investors that are sophisticated investors because of s761GA of the Corporations Act. While sophisticated investors are generally high net worth individuals, like other retail clients, they may not always have the requisite knowledge of complex financial products to evaluate the risks associated with an investment in these products. We recognise this and our surveillance and monitoring will depend on the nature of the market, not just whether it is in tier one or tier two, or whether the clients using the market are classified as retail or sophisticated. This approach of assessing the features and risks of a market's business model would help to mitigate the risks posed by any misuse of sophisticated client certificates. This approach is consistent with the approach taken in other major international market places. We note this approach would be consistent with the Government's recent client money reforms which purposefully defined 'retail clients' to include clients who are sophisticated retail investors (as set out in section 761GA) to ensure these clients have the benefit and protection of these reforms.

Question:

26. Can ASIC provide the committee with an explanation of hybrid securities and any issues associated with such securities? Why have hybrid securities not been banned for retail investors in Australia like they have in the United Kingdom?

Answer:

What are hybrid securities?

Hybrid securities combine 'equity-like' and 'debt-like' characteristics and the nature and the risks of these securities can be difficult for investors to understand.

The two most common legal forms of security from a retail investment perspective are debt and equity. With a debt security (e.g. a vanilla corporate bond), the investor lends money to the issuer, and the issuer agrees to make regular interest payments and repay the principal on a fixed date in the future. With an equity security (e.g. an ordinary share in a listed company), the investor becomes a member of the company and from that membership enjoys voting rights, any dividends that are declared, and the right to participate in any surplus if the company gets wound up, but only after creditors are repaid.

In most cases, the legal form of a security aligns with how that security is treated for accounting purposes: a bond will be recognised in a company's accounts as a liability, while shares will be recognised as equity. Certain tax consequences, such as the deductibility of interest payments, or the ability to frank dividend payments, are usually also consistent.

Hybrid securities combine both 'equity-like' and 'debt-like' characteristics. While their legal form remains a bond or a share, this mix of characteristics places them on a spectrum between 'pure' equity and bonds: see Figure 1.

Hybrid securities are known by a variety of names, including subordinated notes, capital notes and convertible preference shares.

While there is enormous variation between particular hybrid securities, they typically share a number of characteristics:

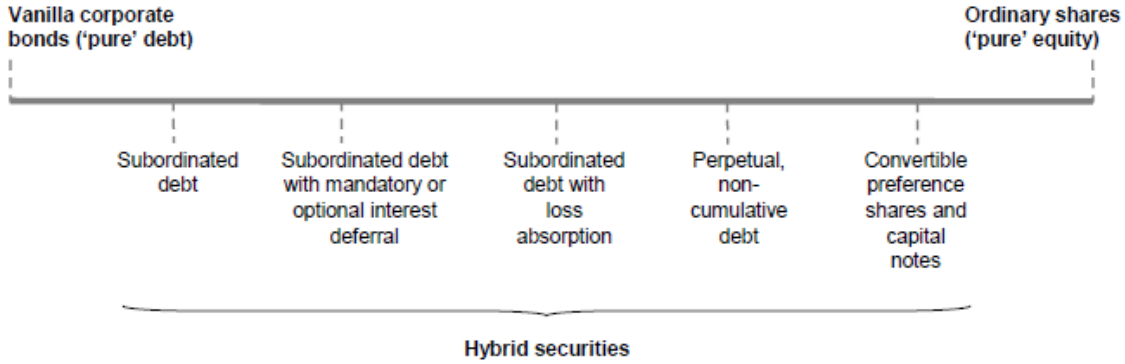
(a) they are issued by well-known companies, banks and insurers;

(b) they are actively sold to retail investors through networks of brokers and financial advisers;

(c) they promise regular interest payments at rates several percentage points higher than those paid on bank term deposits or vanilla corporate bonds; and

(d) they have complex and unique terms of issue.

Figure 1: Hybrid securities on a spectrum between 'pure' debt and 'pure' equity



In August 2013, ASIC published Report 365 *Hybrid securities*, from which the above extract is drawn. REP 365 discussed offers of hybrid securities in the Australian market since the global financial crisis, and in particular, the extensive issuance from November 2011 to June 2013. The report also described ASIC's work with hybrid issuers and their legal advisers to improve prospectus disclosure, and the results of a review of selling methods used for a sample of hybrid offers, to encourage the appropriate use of non-prospectus sales documents and to observe the distribution networks used.

Issues associated with hybrid securities

The complex terms of hybrid securities, and the particular risks these terms present, can be difficult for investors to understand, and test the limits of a disclosure-based regulatory regime. Focusing particularly on hybrid securities issued by banks, which represent the majority of hybrids issued to retail investors in recent years, these risks depend largely on the likelihood that the hybrid securities will, according to their terms of issue, be required to convert into ordinary shares in the bank. Academic research suggests investors are unlikely to be able to assess the chance of such a conversion occurring,[1] and where it does occur, it may result in investors receiving shares that are worth less than their initial investment in hybrids.

Behavioural analysis and regulatory experience support only modest expectations about retail investor understanding of these products. Coupled with pricing complexity and the difficulty in assessing the probability of conversion occurring, it is unrealistic to seek to rely on disclosure and/or educational initiatives to prevent investment in hybrids by those for whom they are unsuitable.

These issues are not limited to hybrid products but have been highlighted in particular by ASIC given the limited options for retail investors searching for yield in a low interest rate environment and the size of the hybrids market.

Why have hybrid securities not been banned for retail investors?

ASIC does not currently have the power to ban hybrid securities or other complex products from being sold to retail investors. The legislative settings in Australia are generally very permissive, and allow most securities and financial products to be sold to retail investors, as long as regulated disclosure is also provided.

ASIC has considered whether its current tools are sufficient to address the risks posed to retail investors by complex products, and what other approaches could be adopted to improve investor outcomes.

ASIC's submissions to the Financial System Inquiry, in April and August 2014, looked at ways to enhance disclosure, but also at ways to move beyond disclosure to a more flexible regulatory toolkit. As part of the Government's response to the FSI, *Improving Australia's Financial System 2015*, the Government accepted the FSI's recommendations to introduce:

- design and distribution obligations for financial products to ensure that products are targeted at the right people (FSI recommendation 21); and
- a temporary product intervention power for the Australian Securities and Investments Commission when there is a risk of significant consumer detriment (FSI recommendation 22).

In December 2016, the Government released a proposals paper seeking feedback on the implementation of these measures: *Design and Distribution Obligations and Product Intervention Power*.

ASIC supports the Government’s work to create new accountability obligations for entities that issue or distribute financial products and to strengthen consumer protection by introducing product intervention powers.

Both reforms represent a fundamental shift away from relying exclusively on disclosure to drive good consumer outcomes, and are central to achieving the FSI's fairness objective for the financial system.

In March 2017, ASIC provided submissions to this effect in response to the proposals paper. ASIC has provided, and continues to provide, support to Treasury in connection with these proposals.

The proposed Product Intervention Power is still being developed, with details around the products captured, whether any products are excluded, and the conditions to ASIC exercising

the power, yet to be finalised. If the power becomes law, and bank hybrids fall within the scope of the power, ASIC would need to consider whether the preconditions to the exercise of the power were met before taking any regulatory action to intervene in any way in relation to hybrid securities.

Question No: QON 27-29
Topic: Sell-side research

Question:

ASIC announced on 30 June 2017 that is has commenced consultation on proposed guidance for sell-side research.

27. What is the timeframe for implementation of the guidance?

ASIC is currently seeking feedback on our proposals to provide further guidance on managing conflicts of interest and material, non-public information involving sell-side research. The submission date was 31 August but a number of extensions were granted to 15 September 2017 (see Consultation Paper 290: *Sell-side research*). Our proposals supplement our current guidance in Regulatory Guide 79 *Research report providers: Improving the quality of investment research*.

If the decision is made to issue new guidance, following consideration of all submissions, it is expected that new guidance would be published by end of December 2017. A period of 6 months transition will be provided before firms are required to comply with the guidance.

28. What is ASIC's response to the Stockbrokers and Financial Advisers Association's claim that members are already bound by the association's best-practice guidelines for research integrity and do not need further guidance and regulation?

The Securities Institute and the Securities and Derivatives Industry Association *Best Practice Guidelines for Research Integrity* are designed to assist members manage potential conflicts of interest that may affect the integrity of research and investment recommendations. The Guidelines do not bind members. They set out 10 broad principles as 'ethical benchmarks' relating to the management of conflicts involving research.

Between September 2014 and June 2016, ASIC conducted a review of the way licensees manage conflicts of interest between its research and corporate advisory activities (see Report 486 *Sell-side research and corporate advisory: Confidential information and conflicts* (REP 486)).

We examined the policies, procedures and practices of both large and mid-sized licensees and a sample of transactions, and found some poor and inconsistent practices in managing conflicts of interest and the handling of material, non-public information. Areas of concern included how the research function was structured and funded, insufficient separation of research and corporate advisory activities and the disclosure of conflicts of interest.

Following the release of REP 486 we met with parties involved in the capital raising process, including market participants, investment banks, independent research house, buy-side fund managers, independent corporate advisors, lawyers and industry associations. A theme emerging from these meetings was the desire from industry for more detailed guidance from ASIC on how licensees should meet their obligations to manage conflicts when preparing research, than was currently set out in RG 79 *Research report providers: Improving the quality of investment research* (RG 79). The guidance in RG 79 is expressed at a high level of generality and applies to different types of research. We expect that the proposed supplementary guidance will help licensees involved in sell-side research and corporate

advisory to comply with their general obligations under the Corporations Act 2001 to manage conflicts of interest and handle material non-public information.

29. What is ASIC's response to Stockbrokers and Financial Advisers Association's claim that any guidelines that are too prescriptive could have unintended consequences such as less research on Australian companies and stocks?

The draft regulatory guidance seeks to enhance the quality and independence of research by setting out measures designed to reduce the prospect of pressure being placed on research analysts by their firm's corporate advisory teams to support corporate transactions. Research that is unbiased and reflects the professional judgement and expertise of the research analyst is essential to the integrity of our financial markets and to the quality of financial advice provided to investors.

We have sought feedback on our proposals to provide further guidance on managing conflicts of interest and material, non-public information. In particular, we have been keen to fully understand and assess the financial and other impacts of the proposals set out in Consultation Paper 290: *Sell-side Research*.

We acknowledge the Stockbrokers And Financial Advisers Association (SAFAA) as a key stakeholder, and have previously consulted with it, and its members, on our proposed regulatory guidance for sell-side research. We have given consideration to feedback from SAFAA and other industry bodies and firms on the likely compliance costs, the likely effect on competition, and any other impacts, costs and benefits.