

Chapter 3

ASIC's responsibilities: education, protection and integrity

ASIC Initiatives

3.1 At the committee's oversight hearing, ASIC Chairman, Mr Greg Medcraft, gave a summary of the Commission's achievements against the priority areas in its strategic framework. ASIC's key strategic priorities are:

- confident and informed investors and financial consumers
- fair and efficient financial markets; and
- efficient registration and licensing.

Confident and informed investors and financial consumers

3.2 In terms of the first priority area, the committee heard that ASIC had acted to issue a warning the previous day (24 November 2011) against hybrid securities and unsecured notes. The intent was to inform investors of the disproportion between risk and returns when investing in companies with well-known brand names.¹

3.3 ASIC told the committee of its success with the MoneySmart website. In early November 2011, the website had won the award for best government website with over a million visitors to the site. Large numbers accessed the associated mobile phone application, Twitter and Facebook. Of even greater significance was the claim that over 90 per cent of those who accessed the website had followed up with some action in relation to their finances.²

3.4 ASIC also told the committee of its actions holding gatekeepers to account. There had been 17 enforcement outcomes over the previous six weeks, including six criminal convictions initiated by ASIC. ASIC had issued a consultation paper to investigate research houses with a view to rating them in the same way that agencies are rated.³ In addition, ASIC informed the committee that it had released a regulatory guide on prospectuses with the aim of informing consumers and influencing their assessments of financial products.

1 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 9.

2 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 9;
Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 25 November 2011, p. 13.

3 ASIC, *Consultation Paper 171: Strengthening the regulation of research report providers (including research houses)*, 16 November 2011,
[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp171-published-16-November-2011.pdf/\\$file/cp171-published-16-November-2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp171-published-16-November-2011.pdf/$file/cp171-published-16-November-2011.pdf) (accessed 15 February 2012).

Fair and efficient financial markets

3.5 In terms of ASIC's priority of fair and efficient financial markets, ASIC noted that it is monitoring ASX technology following a recent outage, and is reporting on ASX licensees.⁴ From these inquiries, ASIC identified nine areas needing attention. ASIC's report breaks these areas into three major categories:

1. Licensees [should] have sufficient resources, including technological resources, to properly operate their markets and clearing and settlement facilities....
2. ASX Group's ongoing obligations to monitor and enforce compliance with its operating rules.
3. The development of a set of performance measures agreed between ASIC and ASX Group that take account of ASX Group's changed role in ... supervision of ...market operating rules...⁵

3.6 Mr Medcraft also described the case of MF Global, which had been placed in administration. ASIC has been actively involved in assessing its impact. and in pursuing regulations regarding client moneys.

ASIC is meeting regularly with the administrator, Deloitte, and working with the ASX to ensure an orderly unwinding of futures positions. We are advised that the proceeds of any client futures and CFD position closeouts will be put into a trust account for disbursal once the administrator has reconciled positions and funds. ASIC has been in discussion with international regulators to determine the impact of MF Global's overseas entities on the Australian business. Issues raised in relation to client moneys have clearly been a major focus.⁶

3.7 In the context of the commencement of Chi-X trading and the new ASX order book, PureMatch, ASIC has released a consultation paper in relation to high frequency and algorithmic trading.⁷ This paper states:

Equity markets globally are undergoing considerable change. They are now overwhelmingly electronic, and predominantly automated. Technology has increased the speed, capacity, automation and sophistication of trading for market operators and market participants. It has also opened the door for new types of market participants with innovative trading strategies.

26 High-frequency traders (HFTs) are becoming more prevalent. Feedback ASIC has received from the industry and comments in the press suggest

4 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 10.

5 ASIC, *Report 265 Market assessment report: ASX Group*, 23 November 2011, p. 16–17, [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep265-published-23-November-2011.pdf/\\$file/rep265-published-23-November-2011.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep265-published-23-November-2011.pdf/$file/rep265-published-23-November-2011.pdf) (accessed 15 February 2012).

6 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 10.

7 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 10.

that HFTs may now account for 15–25% of equity market turnover in Australia.⁸

ASIC's annual report

3.8 In terms of ASIC's recently released Annual Report, the committee was interested in the allocation of resources against ASIC's objectives. The Chairman told the committee that in terms of staff allocation, there was roughly equal balance between deterrence and stakeholder teams with half the frontline personnel being engaged in deterrence.⁹ Mr Medcraft noted that market supervision was working well with a particular focus on prosecuting cases of insider trading.¹⁰

3.9 The committee queried the table on page 87 of the Annual Report titled 'major deterrence outcomes', which indicated a drop in the number of illegal schemes shut down.¹¹ Mr Warren Day indicated that it was hard to draw conclusions on the number of these schemes given that complaints would only be made once a scheme began to fail investors. He distinguished between 'unregistered managed investment schemes' and criminal fraud, the latter being in the purview of the police.¹²

3.10 The committee asked ASIC to comment on the distinction between fraud and failure. Mr Price referred to the principles of the Wallis inquiry¹³ to define market failure as:

...someone who is operating their business honestly but, because there are flaws in the logic behind how they want to make money or because of changed market circumstances or because they do not have the expertise to run the business law, or for a variety of other reasons, there is a failure of that particular business entity.¹⁴

On the other hand, he defined the key element of fraud as 'intentional wrongdoing'.

8 ASIC, *Consultation Paper 168 Australian equity market structure: Further proposals*, 20 October 2011, [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/cp168-published-20-October-2011-2.pdf/\\$file/cp168-published-20-October-2011-2.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/cp168-published-20-October-2011-2.pdf/$file/cp168-published-20-October-2011-2.pdf), (accessed 15 February 2012)

9 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, pp 10–11; ASIC, *Annual Report 2010-11*, pp 10-12.

10 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 11.

11 ASIC, *Annual Report 2010-11*, p. 87.

12 Mr Warren Day, Commissioner, *Committee Hansard*, 25 November 2011, pp 11–12.

13 *Financial System Inquiry Final Report*, Stan Wallis, Inquiry Chairman, Commonwealth of Australia, 1997, <http://fsi.treasury.gov.au/content/FinalReport.asp>, (accessed 1 February 2012).

14 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 25 November 2011, p. 12.

3.11 In the same vein, ASIC's Deputy Chairman, Ms Belinda Gibson, explained failure as negligence leading to loss and fraud as knowingly taking property by dishonest means.¹⁵

3.12 ASIC representatives told the committee that the Commission's emphasis is on applying disclosure regulations so that potential investors have access to the business model and can judge the potential success or risk of an enterprise. They also suggested that portfolio level disclosure, whereby the underlying fund is accessible to potential investors, would be an improvement in the system.¹⁶

Committee view

3.13 The committee commends the high level of deterrence activity completed by ASIC. It remains interested in the relationship between ASIC and the ASX and encourages ASIC to follow up on those matters it has recently identified.

3.14 The committee also commends ASIC on the successful development of its MoneySmart website. It encourages ASIC to continue to strengthen its educational unit. The committee is interested to gain further information from ASIC on specific educational activities and flags this as a topic for examination at a subsequent hearing.

3.15 The committee notes that the problem of distinguishing between market failure and criminal fraud is implicit in much of the material discussed with ASIC (see chapter 2). It recommends that ASIC officers research this topic with a view to understand, define and deal with these issues. In this context, the committee notes its previous alerts about market reliability in the areas of liquidity, price discovery, non-transparent trading and indirect brokering. It suggests that these areas also be considered by ASIC in responding to recommendations 2 and 3 of the current report.¹⁷

ASIC's administration

3.16 At the November oversight hearing, ASIC responded to a range of issues related to market integrity and consumer protection.

Resources

3.17 The committee asked ASIC about the allocation of its revenue. ASIC noted that its appropriation funding for the 2011–12 year is \$323.5 million plus own source revenue of another \$23 million, which comes from unclaimed moneys and internal sales of goods and services. Money collected by ASIC through company registration

15 Ms Belinda Gibson, Deputy Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 12.

16 Mr John Price, Senior Executive Leader, Mr Peter Kell, Commissioner, Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, pp 12–13.

17 Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of Australian Securities and Investments Commission Report*, August, 2011, p. 8.

fees amounts to about \$550 million, which is allocated to consolidated revenue.¹⁸ Mr Medcraft and Mr Day stressed that the government—not ASIC—sets these fees or the associated late fees. They drew attention to ASIC's 2010–11 *Annual Report* which outlines revenue against outcomes approved by parliament, and which shows that the bulk of non-taxation revenue comes from registration.¹⁹

3.18 Committee members were concerned about the imposition of high late fees.²⁰ In a response received just before this report went to print, ASIC questioned the validity of annualising late fees as an interest rate. It was explained that:

late fees are prescribed by the Corporations (Review Fees) Regulation 2003'...[and] are indexed each year...based on any increase in the Consumer Price Index for the previous March quarter...The current annual review fee for a proprietary company is \$226.50 and the second [final] late fee is 127% [of \$226.50].²¹

The role of the Chairman

3.19 The committee was informed of the process of Mr Medcraft's appointment as ASIC Chairman, as well as his previous roles. He described his previous position at Societe Generale in New York:

Globally I was responsible for the advisory structuring side of securitisation for Societe Generale. I was not responsible for the sales, syndicate and trading of securitised debt products. I had teams in something like 12 countries around the world: in Latin America; Canada; the United States—in a number of cities in the United States; and in Europe—in London, Paris, Frankfurt, Milan, Madrid and Moscow. It was a very broad business around the world. We focused on structuring securities in the residential market—the real estate market, commercial mortgage market, consumer asset classes—and we also had a large conduit management business as well globally. In those markets in Europe at the time I think we were No. 1 in securitisation. [I was in charge of] advising and structuring of securitisations,... not sales, syndicate or trading of securitised debt products. That was actually run by another part of the bank.²²

3.20 The committee noted that public confidence in the position of Chairman is central for the integrity of ASIC's oversight function.²³

Frozen Funds

18 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, pp 13–14.

19 ASIC, *Annual Report 2010–11*, pp 22–23 and p. 145.

20 *Committee Hansard*, 25 November 2011, p. 15.

21 See response to questions on notice no. 2 in Appendix 2.

22 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 17.

23 *Committee Hansard*, 25 November 2011, p. 18.

3.21 The committee continues to seek updates on frozen funds and requested that ASIC supply figures about the amount of money in frozen funds. This information has been provided as an attachment to Appendix 2.

3.22 The committee is interested in investors' ability to access frozen funds and the steps taken to relieve hardship. Mr Medcraft explained that a fund is frozen when it is 'unable to realise 80 percent of [its] assets within the period that is specified in the scheme's constitution'.²⁴ Legally the fund may then decide to freeze in order to protect its money.

3.23 ASIC has been actively engaging with this matter. It has put in place mechanisms through which members can apply to make up to four withdrawals per year in mortgage funds. It has liaised with funds to recommend winding up when it appears to be in the investors' best interests. ASIC informed the committee that it is to issue a new regulatory guide which gives information and standards concerning redemption rights, asset liquidity and withdrawal of illiquid assets. It has also communicated with Treasury about amending the Corporations Act to improve protection for investors.

3.24 The committee was also reminded that fund members themselves have rights to pursue grievances against fund managers. ASIC noted that in other countries, fund managers might reduce their own fees in such situations.²⁵

Improving product disclosure

3.25 The committee was given further information on ASIC's actions on product disclosure. Australian law does not oblige disclosure at the portfolio level. Mr Medcraft claimed that Australia is well behind best practice in countries such as the United States, where such disclosure is routine and easily available with current technology. ASIC has raised this issue with the Financial Services Council and Superannuation Funds of Australia, which are now working on developing industry standards with portfolio-level disclosure.²⁶

3.26 In terms of related party transactions, the committee was told that the regulatory guide put out by ASIC deals with related party transactions. However:

24 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 19.

25 Mr Greg Medcraft, Chair, ASIC, Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 25 November 2011, pp 19–20.

26 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 21.

[I]t is frankly more about the substantial shareholders and the directors and their associates and how much they might be getting out of a particular transaction. So there might be some value leakage to those who control the entity. Ownership would be just one attribute of a related party one.²⁷

3.27 ASIC acknowledged that many past problems have originated in related party transactions, mainly loans to directors.²⁸

Financial literacy of directors

The Centro decision has raised the issue of minimum understanding required by directors to exercise proper due diligence with financial data. In the Centro decision, the Federal Court of Australia held that directors of Centro Properties Group and Centro Retail Group failed to exercise the required degree of care and diligence in approving financial reports without:

- reading, understanding and giving sufficient attention to the content of the reports relating to liabilities and the disclosure of relevant guarantees;
- inquiring with management, the Board Audit and Risk Management Committee
- having errors in the reports corrected, or
- following procedures required under the Corporations Act in relation to who may sign financial reports.²⁹

3.28 ASIC representatives reported that their conversations with company representatives indicated that the decision was generally well received and that it would be unlikely to lead to a flight of directors. ASIC Deputy Chair Ms Belinda Gibson noted that while all directors do not need to be accountants, they should at least understand core concepts like solvency and debt obligations.³⁰

Market Competition and Chi-X

3.29 At the time of the hearing, Chi-X had been operating for about three weeks. The committee was told that the Chi-X order-to-trade ratio is significantly higher than

27 Ms Belinda Gibson, Deputy Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 21.

28 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 22.

29 *Australian Securities and Investments Commission v Healey (No 2)* [2011] FCA 1003 (31 August 2011), Middleton J, para 1, <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2011/1003.html?stem=0&synonyms=0&query=Brian%20Healey> (accessed 15 February 2012).

30 Ms Belinda Gibson, Deputy Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 23.

that of ASX, with algorithmic trading and high-frequency trading. In response to Chi-X, ASX would be opening a new platform with maker-taker pricing.³¹

3.30 In its background paper on competition in exchange markets, ASIC defined maker-taker pricing:

[It] provides a rebate to persons who submit passive orders (e.g. with a limit price) and charges a fee to persons who submit aggressive orders (e.g. market orders). ...there has been some concern that it may create pricing inefficiencies and distortions.³²

3.31 ASIC representatives noted that the amount of poor algorithmic trading had recently been reduced but that it is a matter ASIC is closely monitoring and which may require stricter regulation. ASIC has issued a discussion paper and is evaluating the situation, rather than making immediate recommendations.³³ It is benefiting from observing how competition has emerged elsewhere in the world.³⁴

Misleading advertising

3.32 On the matter of advertisements for financial products, particularly for insurance and contract for difference (CFD) products, ASIC informed the committee that it was not its responsibility to vet advertising. It did note, however, that the Commission has had extensive experience applying regulations as to whether advertisements are misleading. There have been some occasions when infringement of the regulatory guide led to court action.³⁵

3.33 In general, ASIC takes an educational approach to advertising. It has produced a consultation paper and is in regular contact with suppliers.³⁶ ASIC seeks to inform advertisers of the potential risks to them of attracting inappropriate

31 Mr Greg Medcraft, Chair, and Ms Belinda Gibson, Deputy Chair ASIC, *Committee Hansard*, 25 November 2011, p. 23.

32 ASIC, *Background paper: ASIC'S regulatory framework on competition in exchange markets*, 29 April 2011, p. 6, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/11-87MR-backgrounder.pdf/\\$file/11-87MR-backgrounder.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/11-87MR-backgrounder.pdf/$file/11-87MR-backgrounder.pdf) (accessed 15 February 2012)

33 ASIC, *Consultation Paper 168 Australian equity market structure: Further proposals*, 20 October 2011, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp168-published-20-October-2011-2.pdf/\\$file/cp168-published-20-October-2011-2.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp168-published-20-October-2011-2.pdf/$file/cp168-published-20-October-2011-2.pdf), (accessed 15 February 2012)

34 Mr Greg Medcraft, Chair and Ms Belinda Gibson, Deputy Chair, ASIC, *Committee Hansard*, 25 November 2011, pp 22–24.

35 Mr Greg Medcraft, Chair and Ms Belinda Gibson, Deputy Chair, ASIC, *Committee Hansard*, 25 November 2011, pp 24–25.

36 ASIC, *Consultation Paper 167 Advertising financial products and advice services: Good practice guidance*, 30 August 2011, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp167-published-30-August-2011.pdf/\\$file/cp167-published-30-August-2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp167-published-30-August-2011.pdf/$file/cp167-published-30-August-2011.pdf) (accessed 15 February 2012)

investors. It believes recent moves towards standards for advertising financial products have demonstrated the effectiveness of these discussions. Mr Kell also claimed that these discussions have led to 'significant changes to those ads.'³⁷

ASIC database and search tools

3.34 At the previous oversight hearing ASIC described how enhanced database searching was in the process of being introduced on its website. This project addresses the third strategic priority area of having efficient registration and licensing with a focus on small business. The committee was told that the project, ASIC Connect, was almost complete and it was hoped that it would go live by early in 2012. Mr Medcraft stressed that the online function would allow small businesses to pay directly online for registration at \$9 rather than paying \$36 for a broker.³⁸ Mr Day asserted that the service would potentially grow the database once people experienced the business and customer connections that it makes possible.³⁹

Committee view

3.35 The adequacy of ASIC's resources will continue to be monitored by the committee. It will continue to consider the allocation of ASIC resources, particularly that a good balance between deterrence and education is maintained.

3.36 Since the bulk of ASIC's non-taxation revenue comes from business registration fees, which some claim to be too high, the committee would appreciate further information on the process and principles by which the government sets registration fees.

Recommendation 4

3.37 The committee recommends that the government provide the basis on which company registration fees are set and an explanation as to the process of determining late fees.

3.38 The committee emphasises the importance of education to reduce poor investment decisions, to promote responsible company governance and to facilitate transparent product description. For this reason, it will be pursuing ongoing updates on the uptake of new administration and database systems, as these are integral to ASIC's educational role.

3.39 The committee acknowledges that the Centro decision has triggered greater engagement with accountancy principles in boardrooms. It encourages ASIC to continue emphasising these issues in its discussions with directors. The committee

37 Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 25 November 2011, p. 25

38 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 25 November 2011, p. 26.

39 Mr Warren Day, Commissioner, *Committee Hansard*, 25 November 2011, p. 26

also suggests that ASIC pursue its work on portfolio level disclosure and take action where appropriate to encourage this practice.

Senator Sue Boyce

Deputy Chair