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ABBREVIATIONS

AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
ABO	Australian Banking Ombudsman
ACCC	Australian Competition and Consumer Commission
AFIC	Australian Financial Institutions Commission
AFMA	Australian Financial Markets Association
ASC	Australian Securities Commission
ASCPA	Australian Society of Certified Practising Accountants
ASX	Australian Stock Exchange
CALDB	Companies Auditors and Liquidators Disciplinary Board
CASAC	Companies and Securities Advisory Committee
COFS	Council of Financial Supervisors
CSP	Corporations and Securities Panel
EEC	European Economic Community
FIBV	Federation of International Bourses de Valeurs
FPA	Financial Planning Association
ICA	Institute of Chartered Accountants
IFA	Investment Funds Association
IMRO	Investment Management Regulatory Authority
IOSCO	International Organisation of Securities Commissions
ISC	Insurance and Superannuation Commission
NBFI	Non-Bank Financial Institutions
NCSC	National Companies and Securities Commission
OECD	Organisation for Economic Development
OTC	Over-the-Counter

PIA	Personal Investment Authority
RBA	Reserve Bank of Australia
SFE	Sydney Futures Exchange
SIB	UK Securities and Investment Board
SIS	Superannuation Industry (Supervision) Act 1993
TPA	Trade Practices Act

FINANCIAL SYSTEM INQUIRY - TERMS OF REFERENCE

Mission

The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.

Specifics

1. The Inquiry will report on the results arising from the financial deregulation flowing from the *Inquiry into the Australian Financial System* ("Campbell Report") published in 1981. This will involve examining and reporting the consequences for:

    (a) the choice, quality and cost of financial services available to consumers and other users;

    (b) the efficiency of the financial system including its international and domestic competitiveness;

    (c) the economic effects of deregulation on growth, employment and savings;

    (d) the evolution of financial institutions and products offered by them and the impact on the regulatory structure of the industry.

2. The Inquiry will identify the factors likely to drive further change including:

    (a) technological and marketing advances;

    (b) international competition and integration of financial markets;

    (c) domestic competition in all its forms;

    (d) consumer needs and demand.

3. The Inquiry will make recommendations on the regulatory arrangements and other matters affecting the operation of the financial system (including prudential and other regulations made by the Reserve Bank and other bodies) as will:

   (a) best promote the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness;

   (b) ensure that financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation;

   (c) provide the best means for funding the direct costs of regulation;

   (d) establish a consistent regulatory framework of similar financial functions, products or services which are offered by differing types of institutions.

4. The Inquiry in its consideration of financial system regulation may not make recommendations on, but will take account of:

   (a) the objectives or procedures of the Reserve Bank in its conduct of monetary policy;

   (b) retirement incomes policies;

   (c) the regulation of the general operation of companies through corporations law;

   (d) policies for the taxation of financial arrangements, products or institutions.

5. In carrying out its investigations, the Inquiry may invite submissions and seek information from any persons or bodies.

6. A final report is to be provided to the Treasurer no later than 31 March 1997.

CHAPTER ONE

OVERVIEW

The ASC

1.1. The ASC began operations on 1 January 1991 and is responsible for the administration of the Corporations Law throughout the Commonwealth, States and Territories. In performing its role, the ASC strives to:

- maintain, facilitate and improve the performance of companies and of the securities and futures markets, in the interest of commercial certainty, reducing business costs and the efficiency and the development of the economy;
- maintain the confidence of investors in securities and futures markets by ensuring adequate protection for such interests;
- achieve uniformity throughout Australia in how the ASC performs its functions and exercises its powers;
- administer the national scheme laws effectively, with a minimum of procedural requirements;
- receive, process and store documents lodged with the ASC efficiently and quickly, and ensure that those documents are publicly available as soon as possible; and
- take enforcement action to give effect to the national scheme laws.

1.2. The ASC is thus required by its mandate to be both a business facilitator and an investor protector in carrying out its functions. The ASC also has a dual regulatory role: corporate regulation and market regulation. The Inquiry's Terms of Reference exclude the regulation of the general operation of companies through the Corporations Law. The ASC's role under the Corporations Law in relation to financial markets involves:

- the regulation of securities and futures markets;
- fundraising by business enterprises;
- managed funds;
- licensing of intermediaries;
- modifying and providing exemptions from the Corporations Law in line with legislative policy;

- advising the Minister on the operation of the law and proposals for statutory change; and
- enforcing corporate and securities laws.

1.3. Accordingly, the ASC's role in financial market regulation encompasses the primary market for securities, the secondary markets (which provide liquidity and pricing) and the derivative markets (which enable efficient risk transfer). While an important focus of this regulation is on the protection of individual investors, there is also a broader public interest in markets that are sound, orderly and free from misconduct.

Forces for change

1.4. In the mid 1990s the ASC considers there is a transition occurring: a transition to a world where more individual Australians will be actively involved in managing the risks of personal long term market investments. These investments will be made in an emerging international market with fewer institutional, product and geographic boundaries.

1.5. Accordingly, investors will face a shift from a world where they had limited involvement in or choice between financial products, and experienced little competition as to price or other product attributes. Investors will face a world where all Australians will be increasingly involved in providing for their own retirement income, where they will need to become more sophisticated about understanding and managing risk; and where they will be faced with a greater array of products and services marketed more actively by financial intermediaries. Regulatory arrangements for this new marketplace must actively support both investor participation and product innovation in a cost-effective way.

Regulatory objectives: promoting confidence

1.6. The ASC recommends that the Inquiry should set as a key objective for financial market regulation the promotion of confidence in the integrity of our financial markets, market participants and their systems. This means:

- confidence that investors have available the information to make informed investment decisions and that intermediaries do not place their own interests above those of the investors for whom they act;
- confidence that market prices are reliable and the markets are free from misconduct, are transparent and operate fairly; and
- confidence that the legal, operational and system infrastructure of our markets is sound.

Regulatory principles

1.7. The ASC is of the view that the current regulatory system is basically sound. However, current market trends provide both opportunities and challenges for current regulatory arrangements in a number of areas. The ASC considers that there are opportunities to both strengthen and simplify current arrangements. Any changes in administrative arrangements which are made should be primarily focused on key principles designed to reinforce regulatory responsiveness to market innovation rather than merely re-arrange structures.

1.8. The ASC considers that regulatory expertise and issues of style and culture of regulation are more important than changes in administrative structures in delivering effective regulatory outcomes. Accordingly, the ASC recommends the Inquiry endorse the following principles for regulation of financial markets:

- focusing on identifying regulatory risks and performance outcomes;
- emphasising the international nature of financial market activity;
- ensuring flexibility in the setting and delivery of regulation;
- promoting a higher level of commercial and market expertise, skill and experience within regulators;
- promoting independent and accountable administration;
- promoting open and transparent policy and administrative processes;
- promoting effective and timely remedial and enforcement capacities; and
- promoting cost-effective and service-orientated delivery of regulation.

Focusing on identifying regulatory risks and performance outcomes

1.9. Regulatory requirements should address the specific regulatory risks which arise in relation to particular financial products or services (the term regulatory risks includes the risks of losses to investors because of insolvency, conflicts of interest and incompetence). In future there is likely to be a greater range of financial products and services available. The ASC does not consider it appropriate to adopt a "one-size-fits-all" approach regardless of the regulatory risks involved.

1.10. Wherever possible, the law should specify desired outcomes and principles of regulation. It should not merely set prescriptive rules. Section 1022 of the Corporations Law on prospectuses is a good example of regulation based on principles. It is based on the principle that investors and their advisers should be given all the information they need for making an informed investment decision.

Emphasising the international nature of financial market activity

1.11. There must be a strong emphasis on the international nature of financial market activity. This means an increased focus on developing regulatory standards which are harmonious with comparable overseas jurisdictions. It also means that effective cooperative relationships must be in place with foreign financial market regulators because of the growing number and complexity of financial market transactions which cross international borders.

Ensuring flexibility in the setting and delivery of regulation

1.12. It is clearly not possible to prescribe all the regulatory requirements in detail in legislation. The new regulatory regime must retain sufficient flexibility to enable regulators to tailor regulatory requirements to the needs of particular situations. A regulatory regime which is not flexible will not work. The ASC has facilitated numerous commercial transactions through the use of its discretionary powers. If the ASC had not possessed the power to modify the operation of the law, a large range of commercial transactions would not have proceeded without additional cost to business.

Promoting a high level of commercial and market expertise, skill and experience within regulators

1.13. Given the ever-increasing complexity of financial market transactions it is essential that regulators are able to attract and retain high-calibre staff with commercial and market expertise. The ASC considers that there would be considerable benefits if staff could be recruited outside Public Service employment constraints. This would enable the financial market regulator to be modelled as a professional services organisation rather than as a bureaucratic agency.

Promoting independent and accountable administration

1.14. It is essential that the regulator administer regulation in an independent non-partisan manner. This is especially the case in the area of enforcement action. At the same time it is important for all parts of the regulatory system that there is appropriate public accountability of the regulator when it performs its regulatory functions.

Promoting open and transparent policy and administrative processes

1.15. In times of rapid market change it is particularly important that regulators remain in touch with financial market developments. They must be located where the markets actually operate. To avoid the risk that regulators who are close to the market actually become "captured" by the group they are seeking to regulate, it is also essential that the policies and processes of regulators are transparent and open to public scrutiny.

Promoting effective and timely remedial and enforcement capacities

1.16. To promote public confidence in the financial markets, it is essential that an integrated regime for enforcement continue. Enforcement is the mechanism by which market abuses are detected and remedied. The public regards enforcement as the key focus of a financial market regulator. The ASC recommends that the Inquiry adopt the principle that effective enforcement is a key focus of financial market regulation. The ASC also recommends that the law be amended to enhance the effectiveness of its enforcement role.

1.17. A financial market regulator must possess a full portfolio of regulatory tools which can be employed in a timely fashion to combat market misconduct.

1.18. Fragmenting regulation into separate bodies (whether statutory or self-regulatory), splitting of wholesale and retail market regulation or separating the investigation and enforcement functions from market regulation runs the risk of detracting from the ability to deliver the effective enforcement outcomes demanded by the community.

Promoting cost-effective and service-orientated delivery of regulation

1.19. The ASC recommends that the emphasis on cost-effective regulation should be a key principle underlying the regulatory system. All regulators should have in place appropriate mechanisms for compliance cost and performance assessment.

Distinction between prudential and market regulation

1.20. The ASC considers that a different style of regulation is required for the prudential regulation of institutions compared to market regulation with its concerns relating to disclosure and the conduct of market participants, markets and clearing houses. This needs to be reflected in any regulatory arrangements.

Structure of regulation

1.21. The ASC is of the view that there is no one best way in which administrative arrangements can be structured and that all alternatives bring their own advantages and disadvantages. The ASC favours an incremental approach that builds on existing legislation and regulatory bodies and recognises there will continue to be a mix of institutional and functional regulation.

1.22. This includes using the existing national scheme for corporate and securities regulation to the maximum extent possible. The national scheme laws have overcome the practical limitations on the Commonwealth's constitutional power to implement changes in the area of corporations and securities regulation.

1.23. In this regard, the advantages of an integrated companies and market regulator should be recognised. Many overseas jurisdictions have separate bodies performing the functions of corporate regulation and financial market regulation, or have split market regulation into a range of agencies. This leads to considerable difficulties, particularly in the area of enforcement.

1.24. The ASC considers that any changes in regulatory arrangements should be based on practical considerations, designed to ensure effective delivery of regulatory outcomes and be subject to a cost-benefit evaluation.

Some limitations of importing overseas models without local adaptation

1.25. The ASC also considers that while overseas models can assist our current arrangements, some caution needs to be exercised in attempting to transplant these directly into an Australian context. Most regulation has developed in response to specific market developments and it is important to understand how the formal and informal mechanisms of regulation operate to produce specific regulatory outcomes in a particular jurisdiction. Formal regulatory arrangements never operate in isolation from the particular institutional and market structures of which they are an integral part.

Doubts about benefits of a single regulator for both market and prudential regulation

1.26. Clearly there is potential for some savings made through a "merger" of all regulators into a single regulator, as well as some coordination benefits. However, as with all mergers, there is no guarantee that those savings will be realised, and often considerable management time must be committed to merger issues resulting in a medium term increase in inefficiencies. At this time, we have no details on what the potential savings might be, or, more importantly, what the costs of change might be, and further substantial study should be undertaken before this option could be realistically considered.

Structure of prudential regulation

1.27. Prudential regulation is concerned with the supervising the solvency of institutions and with the stability of the financial system as a whole, including the payments system. The ASC can understand that there would seem to be some arguments for combining all current prudential activities of the RBA, AFIC and ISC into a single prudential regulator. Accordingly, the ASC is not well placed to assess whether the benefits, including economies of scale and scope, of a single prudential regulator would outweigh the advantages of specialist expertise of the current individual prudential regulators in this area.

Support the coordination role of the Council of Financial Supervisors

1.28. Financial conglomerates are of increasing importance both domestically and internationally. In Australia financial conglomerates account for 75 per cent of domestic financial assets.

1.29. The issue of the oversight of financial conglomerates has been considered domestically by the Council of Financial Supervisors (COFS) and at an international level within the Joint Forum of Securities, Banking and Insurance regulators. The ASC is represented on both these bodies.

1.30. The ASC supports the current arrangements for the oversight of conglomerates on a solo plus basis (that is, prudential regulation of the parent supported by appropriate regulation of the various subsidiaries) and for COFS to continue to monitor international developments in this area.

1.31. The role of COFS in coordinating system wide issues relating to supervising financial conglomerates, risks to system stability and other matters of regulatory consistency should be supported by the Inquiry.

Market regulation

1.32. In the area of market regulation the ASC makes the following recommendations:

- There should be a consistent product disclosure obligation.
- The ASC is opposed to a separate consumer regulator for financial services.
- There should be a single regulator for financial advisory services.
- There should be a more consistent and coherent regulatory regime for managed funds.

- Regulatory overlaps should be removed.
- Market regulation of clearing houses should continue.
- Wholesale and retail market regulation should not be split.
- There should be minimum disruption to current international arrangements.
- The role of professional bodies should be enhanced while avoiding the difficulties of formal self-regulation.
- Support current initiatives which are of direct relevance to the Inquiry's Terms of Reference.
- Adequate funding and an emphasis on cost-effectiveness is required.

Consistent product disclosure obligation

All investment products to have clear and comprehensible disclosure

1.33. The ASC recommends that a consistent, mandatory disclosure obligation should apply to all investment products offered to retail investors.

Disclosure obligations currently differ

1.34. At present the regulation of the initial point-of-sale disclosure document differs significantly according to the nature of the investment product. For securities (including unit trusts) there is a prescribed outcomes approach to initial point-of-sale disclosure with the primary onus falling on the issuer to determine and satisfy the information needs of investors. For life insurance products and superannuation, there is a greater emphasis on a prescribed content approach to disclosure.

Disclosure differences are costly and appear unhelpful

1.35. These differences in disclosure obligations impose unnecessary costs on issuers who issue products under more than one disclosure regime. These differences in disclosure obligations also affect investors. It is vital that retail investors be supplied with clear, comprehensible disclosure in a form which enables retail investors to assess and compare different investments. This is particularly important in an era likely to:

- herald an increase in direct marketing of investment products;
- lead to more product blurring; and
- lead to greater involvement by retail investors in investment markets.

Regulation of disclosure based on outcomes not content

1.36. A disclosure regime should be considered which focuses on the desired outcomes of disclosure and on the effectiveness of disclosure documents in communicating the desired information, not merely on prescribing the technical matters to be contained in product selling documents. Under this suggestion, the disclosure obligation would require the product issuer to provide clear, comprehensible and comparable information in a format which enables an informed investment decision to be made by retail investors. The disclosure obligation would specify key areas to be covered in the disclosure.

1.37. These key areas would include at least the following matters:

- the investment risks associated with the investment product;
- the rights attaching to the investment product;
- the consideration payable by investors, including fees and charges;
- the extent to which public or private insurance or guarantee arrangements are in place (in the case of capital-backed products); and
- the nature of the disclosure document. The document should enable investors to understand that it is a selling document, and does not involve a recommendation that the product is suitable for the investor's particular needs or objectives.

1.38. Before implementing this proposal, however, further investigation of several issues would be required. This includes investigating whether it is feasible to formulate a general disclosure test to cover all investment products and whether there are better ways of achieving comprehensible and comparable product disclosure.

No separate consumer financial services regulator

1.39. The ASC does not support the establishment of a new and separate consumer protection regulator for financial services.

1.40. The key reason is that financial market regulation must balance the needs and interests of consumers and business. While it may appear that the interests of consumers and business should coincide in the long term, in the short to medium term they do not always do so. For example, consumers may seek more information than business would willingly be prepared to provide in the absence of regulation. Further, while incompetent operators would probably be excluded from the market in the long term due to market forces, in the short to medium term such operators may attract business and thereby adversely affect the reputation of the Australian capital markets. Accordingly, there is a clear need for regulatory arrangements which take into account, and reconcile in a balanced manner, the competing needs of consumers and business.

1.41. The ASC opposes the introduction of a separate consumer regulator for other reasons as well:

- it would add to the number of regulators and therefore runs the risk of creating further gap and overlap issues as the structure of the industry changes;
- it is unclear what functions a consumer regulator would be responsible for, and how the scope of its regulatory responsibilities would be determined; and
- it would result in a split in wholesale and retail market regulation. The consequences are dual regulation for entities involved in both areas, difficulties in clearly defining the boundaries and possible fragmentation of enforcement activity.

Single regulator for financial advisory services

1.42. The ASC recommends that there should be a single regime administered by a single regulator for all financial advisory services. This should be based on the Corporations Law and the recommendations contained in the ASC's Good Advice Report. While these proposals are currently being pursued as far as practicable through cooperative arrangements between the ASC and ISC, a single regime would allow the proposals to be implemented in a more efficient and cost-effective manner.

Regulation should apply to all financial advisory services

1.43. The present regulation of financial advisory services regulation is, in some areas, fragmented and inconsistent. To overcome these problems, the regulation of advisory services should extend to any advice provided to consumers about a financial transaction involving securities, futures, superannuation, life insurance and deposits or deposit like bank/financial institution. There should also be provision for extending regulation to similar advisory services (eg negative gearing advice) by regulation rather than legislative amendment.

Continuing role for industry and professional bodies

1.44. The ASC supports the continuation of an active role for industry and professional bodies in the delivery of regulatory outcomes in the financial services industry. The ASC also supports the recognition in the law of the regulator's ability to delegate, under supervision, to such bodies. However, the ASC has reservations about making any further formal delegation of regulatory powers in this area at this stage.

An efficient complaints resolution system is essential

1.45. The ASC recommends that there should be consistent coverage of consumer complaints relating to financial advisory services. The ASC considers that the regulator of financial advisory services should work closely with the current schemes to promote consistent coverage across all financial advisory services and to encourage the development of a complaints clearing house service.

More consistent and coherent regulatory regime for managed funds

Different regulations are costly

1.46. The current regulation of investment-linked managed funds is not consistent and coherent. Rather, it is split according to whether the product is a public unit trust or investment company (in which case it is regulated by the ASC) or an investment-linked life insurance or superannuation product (in which case it is regulated by the ISC). Different regulatory standards are applied to these different products, although the operational risks are broadly the same in all cases.

1.47. The ASC understands that this causes problems for industry as it leads to unnecessary costs being imposed on product issuers who wish to offer various investment-linked managed fund products, particularly unit trusts and superannuation. This is because more than one regulatory compliance system must be set up and administered. These costs are passed on to consumers. The differing regulatory standards also impede competition, which affects the international competitiveness of the Australian managed fund industry.

1.48. The ASC recommends that the current regulatory arrangements should be reviewed with a view to providing a more coherent and cost-effective regulatory regime for investment-linked managed funds.

Market regulation for investment-linked managed funds

1.49. The ASC considers that market regulation is the appropriate form of regulation for investment-linked managed funds. Investors in investment-linked managed fund products face the risk that the value of the underlying assets of the fund may fall, thereby causing loss. While investors accept this risk, they demand that their funds are managed competently, that the manager avoids conflicts of interest, and that the risk of system failures and fraud are minimised. A consistent and coherent regime of market regulation should be implemented to regulate these operational risks, which are common to all investment-linked managed fund products.

Options for future regulation

1.50. There are several options for the future regulation of unit trusts and superannuation. Each option has advantages and disadvantages. Practical considerations and industry views should be taken into account in determining the most cost-effective option. The ASC considers that the new regulatory regime for managed funds should build on existing structures as far as possible. In practical terms, this means utilising existing ASC and ISC administrative arrangements.

1.51. The ASC considers that, subject to industry views about transitional and implementation issues, the preferable option is to build on existing national scheme laws and ASC infrastructure, including its enforcement capabilities.

Remove regulatory overlaps

1.52. The ASC recommends that the overlap between s52 of the Trade Practices Act and ss995 and 996 of the Corporations Law be removed.

1.53. At present, this regulatory overlap means that issuers preparing prospectuses or advertising an issue of securities must comply with two laws designed to achieve the one basic objective - to prevent misleading or deceptive conduct. In cases where the Corporations Law applies, s52 of the Trade Practices Act should not apply.

1.54. Another example of regulatory overlap arises in the application of competition policy to stockmarket and futures market rule amendments. The current dual approval process by the ACCC under the Trade Practices Act and the Minister under the Corporations Law imposes significant additional costs on ASX and SFE market development projects. Better coordination between the two regimes could reduce these costs. One option for consideration would be for the ASC to assume the role of approving rule changes in place of the Minister. This approval process would involve consultation with the ACCC.

Continue market regulation of clearing houses

1.55. The ASC recommends that securities and derivatives clearing houses continue to be subject to authorisation and regulation as part of the market regulatory regime. This is because of the important role they play in the operation of these markets. However, the Council of Financial Supervisors (COFS) should play an active co-ordinating role in areas where there are possible prudential or system-wide issues involved.

Avoid splitting wholesale and retail market regulation

1.56. The ASC considers that the Corporations Law provides an appropriate regime for regulating wholesale markets. There would be few advantages and many disadvantages in splitting wholesale and retail market regulation into separate agencies. The ASC does support the need for continuing emphasis on ensuring that requirements for retail transactions are not inappropriately applied to the wholesale markets. In the latter case, the focus of regulation should be upon ensuring orderly markets and preventing misconduct. The regulator should be given sufficient powers to ensure that regulation is not applied inappropriately to the wholesale markets.

Minimise disruption to current international arrangements

1.57. The international reputation and good standing of the ASC is currently high. Effective enforcement and regulatory action relies on the network of formal and informal arrangements developed over the last six years with overseas regulators. It will be important to safeguard these arrangements in any proposals for change.

Enhance the role of professional bodies but avoid the difficulties of formal self-regulation

1.58. The role that professional and industry bodies play in delivering regulatory outcomes should be enhanced, but at the same time we should learn the lessons from overseas and avoid creating a complicated formal fragmented self-regulatory structure.

Support current initiatives

1.59. There are a range of current initiatives of direct relevance to the Inquiry's Terms of Reference which the ASC recommends should be supported:

- the Corporations Law Simplification program;

- the CASAC review of derivatives regulation;
- ASC initiatives on electronic commerce;
- simpler managed fund prospectuses; and
- the current ASC/ISC harmonisation of financial advice requirements.

Adequate funding and emphasis on cost-effectiveness

1.60. There needs to be a stronger emphasis on regular assessment of regulatory outcomes and cost-effectiveness of the regulatory system. All regulators should be required to have appropriate mechanisms in place for assessing compliance costs and for assessing performance.

1.61. The regulatory system must be adequately funded to enable it to meet community expectations. The regulatory system needs to be adequately funded through a mechanism which insulates the regulator from funding variations unrelated to specific regulatory policy decisions.

1.62. At a time of increasing pressure on public resources, a genuine user-pays funding system should be introduced for market regulation to supplement the budget allocations on which the ASC and other regulators are at present dependent. Any new funding mechanism should recognise the need to recast the burden of regulatory cost for smaller entities and that revenue sources should be better aligned with activity.

CHAPTER TWO

THE FINANCIAL SYSTEM - THE REGULATORY CHALLENGE

SUMMARY

In the mid 1990s the ASC considers that in the mid 1990s there is a transition occurring: a transition to a world where more individual Australians will be actively involved in managing the risks of personal, long term, market investments. These investments will be made in an emerging international market with fewer institutional, product and geographical boundaries.

Regulatory arrangements for this new marketplace must actively support both investor participation and product innovation in a cost-effective way.

Recommendation

- The ASC recommends that support for investor participation and product innovation in our financial markets can best be achieved by:
    - building on the strengths of the current corporate and markets regulatory regime;
    - encouraging a style of regulation that is responsive to market innovation;
    - adopting a consistent framework for product disclosure; a single regime for all financial advice to retail investors; a more coherent and cost-effective regime for managed funds; and better coordination of financial services and competition regulation;
    - supporting current initiatives for: simplifying the Corporations Law: implementing the CASAC review of derivatives regulation; and implementing ASC initiatives on electronic commerce, simpler managed funds prospectuses and ASC/ISC harmonisation of financial advice requirements;
    - ensuring adequate funding for the regulatory system so it can meet community expectations. This would include implementing user-pay options and introducing a mechanism which insulates regulators from funding variations which are unrelated to their policies; and
    - promoting a greater emphasis on cost-effectiveness in the setting and delivery of regulatory outcomes.

The regulatory challenge in the mid 1990s

2.1. The ASC was established by the Australian Securities Commission Act 1989 as the national regulatory body for companies and securities. It was set up in response to broad community concerns that the previous co-operative scheme for corporations and securities regulation did not have adequate powers, funding and administrative capability to detect and deal with the corporate and market abuses that had tarnished the reputation of the Australian financial system.

2.2. A major task of the ASC, after commencing effective operations in January 1991, was to investigate the corporate collapses that occurred in the late 1980s (ASC Annual Reports). While the Campbell Committee Report resulted in desirable deregulation of the Australian financial system, it had some unintended adverse consequences and costs. The ready availability of credit from some banks before they properly understood the risks of a deregulated environment and before they had appropriate credit procedures in place was a contributing factor to the corporate collapses that occurred after the 1987 stock market crash.

2.3. In a large part the formation of the ASC can be seen as a response to the transitional difficulties faced by investors, institutions and markets in adjusting to the newly liberalised environment of the mid 1980s. These transitional costs were significant. One broad estimate of the cost is $20 billion not including the costs of investigations, prosecutions and other private and public costs incurred by those involved (Sykes 1994).

2.4. In the mid 1990s the ASC considers there is another transition occurring: a transition to a world where more individual Australians will be actively involved in managing the risks of personal, long term, market investments. These investments will be made in an emerging international market with fewer institutional, product and geographical boundaries.

2.5. As the ASC sees it, the regulatory challenge facing Australia in the mid 1990s is to successfully manage this new transition so as to support greater investor participation and product innovation. In contrast to the 1980s, it will be important that the regulatory system delivers outcomes which match community expectations. This is important if the regulatory system is to minimise abuses and failures that threaten the confidence of users in the integrity of our financial markets.

Significant changes since the Campbell Report in 1981

2.6. Since the Campbell Committee Report, there has been significant change and development in our equities, debt and derivatives markets; growth in the managed funds industry, and the emergence of a financial advice industry.

2.7. We now have a single national equity market (following the formation of the Australian Stock Exchange from seven regional exchanges in 1987) and the replacement of floor trading with the SEATS system in 1990. The abolition of fixed commission in 1984 led to increased competition in the stockbroking industry. In 1987 ASX brokers were permitted for the first time to be 100 per cent foreign owned. The Australian equity market ranks number 11 in terms of capitalisation (Allen Consulting Group 1996).

2.8. While there has been an increase in direct share holdings by individuals (from around 16 per cent of all Australians in 1991 to around 20 per cent in 1994), around 70 per cent of trade in Australian equities in 1995 was controlled by institutional investors. This reflects the growing importance of insurers and fund managers in controlling financial assets in the financial system (Allens Consulting Group 1996, RBA 1996).

2.9. Globalisation has affected Australian equity markets. It is estimated that foreign investors control 32 per cent of Australian market turnover (Allen Consulting 1996). In addition, it is estimated that around 25 per cent of all transactions in Australian listed equities are conducted on offshore exchanges (ASX Annual Report 1995).

2.10. There has been significant growth in equity markets in the Asian region where established stock markets and sound regulatory and market infrastructure are regarded as essential to economic development.

2.11. There has also been rapid development in both exchange traded and over-the-counter derivative markets as the demand for risk management products by institutions has increased. The Sydney Futures Exchange is the 13th largest futures market in the world with average daily turnover increasing from $0.07 billion in 1985 to $44 billion in 1995. The Australian market is now ninth largest for foreign exchange and sixth largest for interest rate exchange-traded futures contracts (RBA 1996).

2.12. Australian markets have participated in the worldwide explosion in OTC derivatives trading in foreign and interest rate futures, forwards, swaps and options. As at March 1995, derivative contracts outstanding worldwide totalled US$1,200 billion. Of these, 97 per cent were foreign exchange and interest rate contracts with an average daily turnover of US$60 billion. Banks are the main OTC market participants, responsible for 80 per cent of outstanding principal positions in derivatives, ranging from 82 per cent in foreign exchange to 38 per cent in equity and stock index derivatives.

2.13. The increasing importance of institutional fund managers has also led to growing demand for risk management products and there has been a rise of financial service conglomerates with banking, funds management, broking, advice and related business units. In 1995, 39 per cent of the assets of Australian fund managers were controlled by insurance groups, 25 per cent by banks and 36 per cent by other entities. This compares with total financial assets, where banks control 56 per cent, insurance groups 23 per cent and others 21 per cent (RBA 1996).

2.14. The growth in managed funds and other investment products has increased the number of sales people involved in distributing financial products and those providing financial advice. At 1 January 1996 there were 1,447 licensed securities dealers, 240 licensed securities advisers, and 25,000 individual representatives acting as proper authority holders. These figures compare with 824 dealers, 112 advisers and 4,144 individual representatives in 1981.

2.15. Individual representatives are part of large dealer networks which are becoming increasingly concentrated, with over 50 per cent of individual representatives authorised by two per cent of license holders. Moreover, of the top 30 dealer networks, 22 are associated with financial services conglomerates. Six are associated with the four major trading banks, seven with insurance companies and nine with ASX members (internal ASC data 1996).

Changes in our regulatory structures since 1981

2.16. As financial markets have developed over the last 15 years, legislation and regulatory structures have been put in place in response to perceptions of actual, or feared, misconduct in particular areas and in recognition of the advantages of uniform national regulation:

- the Futures Industry Code was enacted in 1986 in response to concerns about bucketshops and similar practices in the sale and trading of futures contracts;
- the ISC was established in 1987 as the single regulator of the superannuation and insurance industries;
- the ASC was established by the Australian Securities Commission Act 1989 as the single regulator of companies and securities;
- AFIC was established in 1992 as the single regulator of non bank financial institutions (NBFIs), most significantly, building societies and credit unions;
- the Council of Financial Supervisors (COFS) was established in 1992 on the recommendation of the 1991 Parliamentary Inquiry into Banking and Deregulation, to facilitate closer coordination between RBA, ISC, ASC and AFIC; and

- the Superannuation Industry Supervision (SIS) Act was enacted in 1993 to strengthen supervision of superannuation funds.

2.17. The ASC is of the view that the current regulatory structure is basically sound. The major self regulatory and professional bodies are playing an increasingly important role in promoting a culture of compliance, and participants in our capital markets are in general taking a more responsible approach to maintaining high standards of corporate and market behaviour. However, a number of key changes are now emerging that provide both opportunities and challenges for current regulatory arrangements.

Financial system faces a new transition

2.18. While the changes in our capital markets following liberalisation in the 1980s have been significant, the direct impact on individuals and institutional structures has until recently been relatively limited (COFS 1996). However, in many ways the financial system is entering a new transitional period in two key respects.

Consumers managing financial risks

2.19. First, more Australians will need to understand and manage financial risk as they increasingly become consumers of long-term market investments.

2.20. An aging population in Australia and other advanced industrial countries is creating pressures for public policy to focus more on individuals providing their own retirement incomes, while creating a pool of world-wide savings seeking profitable investment outlets (McKinsey 1994).

2.21. Individuals will face a wider array of products and markets. Individual investors are already beginning to move out of deposits, defined benefit pensions and capital backed products into financial products where investment returns are based on the endeavours of those managing those funds.

Geographical, functional and institutional restrictions disappearing

2.22. Second, these individual investments will be made in a world where:

- geographic restrictions are disappearing;
- functional frontiers are expanding in new products and services; and
- institutional partitions are being removed.

2.23. Market structures are beginning to change. There is an increasing emphasis on financial product distribution and sales, especially by banks, with an associated emphasis on distribution and fee income generation rather than interest from traditional balance sheet activities. Banks are increasingly merging their different product ranges into integrated financial services firms. Although less rapid than many overseas countries, the growth in Australian collective pooled savings vehicles, fuelled by recent policy developments in superannuation, is set to continue as a major growth area (AIMA 1996).

2.24. At the same time the process of disintermediation, as markets replace some of the functions undertaken by intermediaries, will continue to accelerate. This process is facilitating the unbundling of services and the emergence of new specialist financial service providers, such as mortgage specialists, to challenge incumbent organisations in key business areas. Domestic and international competition from traditional and non-traditional financial service participants is increasingly facilitated by the role of information and communications technology. This technology is dramatically lowering costs and barriers to entry across the spectrum of financial services.

2.25. Accordingly, investors will face a shift from a world where they had limited involvement in, or choice between, financial products, and where they experienced little competition as to price or other product attributes. Individual investors will face a world where all Australians:

- will be increasingly involved in providing for their own retirement incomes;
- will need to become more sophisticated about understanding and managing risk; and
- will be faced with a greater array of products and services marketed more actively by financial intermediaries.

2.26. The new marketplace of products and services will be less defined by current institutional, distribution or geographical boundaries. The new marketplace will bring the benefits of continuous innovation in financial products and services tailored to differing consumer needs. Regulatory arrangements for this new marketplace must actively support both investor participation and product innovation in this emerging environment. Regulatory arrangements must give this support in a cost-effective way.

2.27. In responding to these challenges the ASC recommends that support for investor participation and product innovation in our financial markets can best be achieved by:

- building on the strengths of the current corporate and markets regulatory regime;
- encouraging a style of regulation that is responsive to market innovation;

- adopting a consistent framework for product disclosure; a single regime for all financial advice to retail investors; a more coherent and cost-effective regime for managed funds; and better coordination of financial services and competition regulation;

- supporting current initiatives for: simplifying the Corporations Law: implementing the CASAC review of derivatives regulation; and implementing ASC initiatives on electronic commerce and simpler managed funds prospectuses;

- ensuring adequate funding for the regulatory system so it can meet community expectations. This would include implementing user-pay options and introducing a mechanism which insulates regulators from funding variations which are unrelated to their policies;

- promoting a greater emphasis on cost-effectiveness in the setting and delivery of regulatory outcomes.

Building on the strengths of current regulation

Maintaining an integrated national corporate and securities scheme

2.28. It is important not to underestimate the benefits that have resulted from the national integrated corporate and markets regulatory scheme now in place in Australia. Compare these benefits to the difficulties faced prior to 1991 in Australia and the difficulties that continue to be important issues in some other major jurisdictions. For example, Australia has not witnessed the regulatory turf battles between different futures and securities regulators that marked the responses in the US to innovation in new market instruments (Romano 1996). Nor do we have the dual state and federal regulatory requirements for regulating financial advice and operating and selling mutual funds that are only now the subject of concerted effort to create a single Federal regime in the US.

2.29. Our regime also avoids many of the enforcement difficulties of the fragmented UK system where sanctions within the FSA are based on actions only against authorised persons. This is a matter that the Chairman of SIB, Sir Andrew Large, has recently highlighted as a key limitation on the ability of the UK financial system to take effective action to ensure clean markets that are free from manipulation and abuse (Large 1996).

Retaining a focus on promoting overall market and corporate integrity

2.30. A key change in ASC activities from its predecessors has been a move to create a culture of market focussed regulation, supervision and enforcement. The ASC is keen to avoid a retreat of the regulatory system into "paper checking" at the expense of enforcement, compliance and business facilitation activities. The importance of creating the right culture within the regulatory system is a theme upon which the ASC has strong views and is commented on further in this submission.

Ensuring that funding reductions in regulation do not impose hidden costs on business

2.31. While there are no doubt potentially some savings for business from efficiency gains in the process of regulation, at some stage funding reductions will cause declines in service standards. For example, in areas such as the ASC's consideration of discretionary relief, the speed at which new policy can be developed to respond to changing market conditions or the time it takes to complete enforcement action. These changes will only impose hidden cost burdens on business or reduce confidence in our markets.

Maintaining our international reputation and good standing

2.32. The ASC has increasingly regarded international involvement in standard setting and establishing co-operative market surveillance and enforcement arrangements as a key part of its regulatory activities. In part, this has been important in building closer relationships with other regulators, including those in our immediate region. Any changes to the current structure should seek to build and enhance upon these arrangements and relationships built up carefully over the last six years.

Focus on style of regulation not just administrative structures

2.33. While it is possible to identify the general trends driving change in our financial system, it is more difficult to predict their specific impact on market activities and structure. Such predictions are fraught with uncertainty even for market participants themselves. Accordingly, the ASC considers that it is important to focus on the style of regulation necessary to support investor participation and product innovation in the emerging financial market environment, and not just on the administrative structures of regulation.

2.34. The experience of the ASC as a body formed out of nine separate organisations with distinct cultures and approaches is that the creation of a market and service culture within the regulator is the key to achieving balanced and effective regulation. In the ASC's experience changing the regulatory culture of an organisation takes a considerable investment in senior management commitment and resources, and takes time to achieve.

Strengthening and simplifying current regulation

2.35. It is clear in a number of areas that the blurring of product and institutional boundaries will serve to exacerbate some of the gaps and overlaps in regulation of similar services and products under current regulatory arrangements. This will be especially important in those areas where retail investors will be exposed to the financial system through the operations of fund managers, point-of-sale disclosure, the provision of advice on investment products and opportunities and access to an effective complaints resolution mechanism.

2.36. The ASC considers that there are opportunities to both strengthen and simplify the regulatory regime for the benefit of both investors and market participants by adopting a consistent framework for product disclosure; a single regime for all financial advice to retail investors; a more coherent and cost-effective regime for managed funds; and better coordination of financial services and competition regulation.

2.37. These proposals and recommendations are expanded upon in subsequent chapters of this submission.

CHAPTER THREE

CONFIDENCE IN THE INTEGRITY OF OUR FINANCIAL MARKETS

SUMMARY

This chapter sets out the ASC's views on the importance of achieving confidence in the integrity of our markets as the means of promoting both investor participation and market innovation. The objectives and approach to regulating the conduct of market operators and participants ("market regulation") are discussed and contrasted with the institutional focus of prudential regulation. In a number of areas the two types of regulation overlap, particularly because of the increasing emphasis at an international level on ensuring that the basic infrastructure of financial markets is soundly based.

The ASC considers that there are no clear distinctions between regulation of exchange and OTC markets and their participants, and "consumer" regulation. Both focus on the conduct of market participants and there are important connections between the primary market for securities, secondary markets (which provide liquidity and pricing) and derivative markets (which enable efficient risk transfer). While an important focus of regulation is on protecting individual investors, there is also a broader public interest in ensuring that markets are sound, orderly and free from misconduct. Regulating conduct involving retail investors requires a different emphasis from that applying to wholesale markets.

Recommendations

- The ASC recommends that the Inquiry should set as a key objective for market regulation the promotion of confidence in the integrity of our markets, market participants and their systems:
    - confidence that investors have available the information to make informed investment decisions and that intermediaries do not place their own interests above those of the investors for whom they act;
    - confidence that market prices are reliable and the markets are free from misconduct, are transparent and operate fairly; and
    - confidence that the legal, operational and system infrastructure of our markets is sound.

- The ASC recommends that securities and derivatives clearing houses continue to be subject to authorisation and regulation as part of the market regulatory regime because of the important role they play in the operation of these markets, but that the Council of Financial Supervisors (COFS) should play an active coordinating role in areas where there are possible prudential or system-wide issues involved.

- The ASC recommends that the current approach of COFS members in adopting a solo plus approach to supervising financial conglomerates in Australia should be supported by the Inquiry. The ASC recommends support because the COFS approach is consistent with international standards.

- The ASC recommends that disclosing prudential, insurance or guarantee arrangements for financial products should be part of the point-of-sale disclosure framework in Australia.

- The ASC recommends that the Corporations Law provides an appropriate regime for the regulating wholesale markets. There would be few advantages and many disadvantages in splitting wholesale and retail market regulation into separate agencies. The ASC supports the continuing emphasis on ensuring that requirements for retail transactions are not inappropriately applied to the wholesale markets. The focus of regulation for the wholesale markets should be on ensuring orderly markets and preventing misconduct. The regulator should be given sufficient powers to ensure that regulation is not applied inappropriately to the wholesale markets.

- The ASC supports the recognition in the law of the regulator's ability to delegate regulatory functions, under supervision, to industry and professional bodies. This delegation should be accompanied by authority to establish appropriate performance standards for those regulatory functions, ability to monitor performance and capacity to take effective action where those standards are not being met. However, the ASC has reservations about any further formal delegation of regulatory powers at this stage.

Market regulation: objectives and approaches

3.1. As institutional, product and geographical boundaries become blurred, the key task for regulation is managing the transition to a future world where competition will be more intense and investors will be exposed directly and indirectly to investment markets. This future world will provide greater choice and opportunities for all classes of investors, but it will also demand of them the ability to better understand and manage investment risk.

3.2. This chapter describes the ASC's views on what results the community should be able to expect from modern financial market regulation, and what approaches are most likely to meet those expectations so that investors can be confident in the integrity of our markets, and saving and investment is encouraged. Later chapters set out the main attributes of a market regulation regime that is responsive to the rapid pace of change, fosters innovation and increasingly reflects the importance of cost-effectiveness in the setting and delivery of regulatory outcomes.

3.3. Issues of taxation are outside the matters upon which the Inquiry can make recommendations. However, it is important for the Inquiry to note that the influence of the current tax regime on the structure and conduct of our financial markets is pervasive and this is directly reflected in the day to day regulatory activities of the ASC in a wide variety of ways. This impact of the current taxation regime on ASC regulatory activities includes:

- the implications for the ASC's information database of the proliferation of tax-driven trust structures for commercial activity;
- the investor protection issues that result from investment vehicles typically promoted at financial year end for tax shelter purposes (This year the ASC ran a specific campaign seeking to alert potential investors to some of the problems in this area)
- the complexity of some of the transactions that become the subject of investigations or that require relief from the technical requirements of the law;
- the added complexity to prospectus disclosure and other investor information arising from products structured to benefit from particular tax treatment (for example, the recent emergence of stapled securities); and
- the problems in the financial advice area because of the changing tax status of certain products.

Objectives of market regulation

3.4. It is possible to identify the following broad objectives of regulation of the financial system:

- ***Soundness of the Financial System*** - minimising systemic or interconnection risk either at a local or more general level.
- ***Market Efficiency and Integrity*** - ensuring that market, clearing and settlement processes and market intermediaries operate in a way that are clean, fair, transparent and efficient.

- ***Individual Customer Protection*** - ensuring that individual customers are not subject to unfair sales practices or to abuse from breaches of fiduciary type arrangements; losses due to fraud, recklessness or negligence by those with whom they deal are minimised; and investors are provided with sufficient information to enable them to make informed investment decisions.

- ***Competition Policy*** - promoting competition while achieving other objectives.

3.5. These objectives remain relevant today. A regulatory regime focussed on market integrity is the most effective mechanism for delivering the level of market efficiency and integrity, and individual customer protection, that the community is entitled to expect of its regulatory system.

3.6. The remainder of this chapter is devoted to a description of: what is meant by market integrity; the relationship between investor confidence and market integrity; how regulation focussed on market integrity differs from regulation that is primarily prudential in character; and a number of issues relating to the interaction between market and prudential regulation.

3.7. Regulation focused on market integrity should as a minimum:

- encourage investors to take appropriate risks on the basis of good quality disclosure;

- ensure that market providers and participants behave properly; and

- result in good quality advice, fund management and dealing services for retail investors.

Two types of risk-based regulation

3.8. As a broad generalisation, financial system regulation seeks to address two basic categories of risk:

- the risk that particular institutions will, because of poor financial performance or insolvency, be unable to meet financial claims made upon them. Because of the nature of those claims, the institution's failure to meet those claims may have an adverse affect on the financial system as a whole; and

- the risk that exposure of a customer to legitimate market risk of a financial product (a particular asset or class of assets) will also carry with it operational risk. This is because of the fraudulent, careless or self interested conduct of product providers, market operators or intermediaries (Mayer 1995).

3.9. The first class of risks is addressed by capital standards and prudential regulation, that is regulation directed towards ensuring as far as possible the financial performance of the institution and its ability to meet particular contractual claims. Normally, institutions subject to this form of regulation have claims that result in a mismatch between the institution's assets (normally long term and illiquid) and liabilities (normally short term), or that are long term in nature (such as claims relating to long term insurance contracts). Prudential regulation, by focussing on regulating institutions and the risks to which they are financially exposed, attempts to deliver against the legitimate public expectation that institutions that have mismatches between assets and liabilities, or a preponderance of long term claims, should not normally be permitted to fail to meet those retail customer claims.

3.10. Regulation that addresses the second class of risk is sometimes referred to as regulation of "business conduct" (Mayer 1995). It focuses on the risks that might arise from the conduct of any of a variety of participants who provide financial services for:

- the channelling of household savings into investment;
- the matching of buyers and sellers of financial claims;
- the execution and processing of financial payments and other transactions;
- the undertaking of principal transactions by financial entities;
- providing advisory services to clients; and
- the marketing and selling of financial products and services to individual investors.

3.11. A focus on financial markets as a network of economic, commercial and legal relationships - a functional perspective - is becoming more important because of the increasing trend towards "commoditisation" of transactions; the trend to the unbundling of financial products and services into their constituent economic, risk and value components; and the blurring of boundaries between once separate institutions, products and market sectors. This will increasingly include the blurring of distinctions between end users and financial institutions as technology changes the way these services and functions can be delivered.

3.12. This view of the world in terms of the conduct of and relationships between market participants is reinforced by the ASC's practical enforcement experience. Successful investigation into misconduct involves tracing the various commercial and legal inter-relationships involved. Effective enforcement action involves the capability to take action and obtain remedies against all those involved in causing the mischief, regardless of their characterisation in terms of institutional or functional status.

3.13. The ASC's day-to-day practical experience in responding to complaints, assessing market referrals, dealing with creditors of "phoenix" companies and a wide range of other matters suggests that it is not practical to rely entirely on conceptual models of markets that suggest that there is very little role for regulatory activity. This does not accord with the ASC's experience over the last six years.

Market integrity and investor confidence

The importance of confidence

3.14. Section 2(b) of the ASC Act 1989 charges the ASC to undertake its functions in such as way as to promote confidence in the integrity of the Australian securities and futures markets. This emphasis on confidence as a key value in financial market regulation is shared with many other securities regulators:

CONFIDENCE IN MARKET INTEGRITY

"Promote user confidence in the efficiency and fairness of Hong Kong's securities and futures markets so as to support their continuing development, especially in relation to capital formation for the China region" Strategic Objective of the Hong Kong Securities and Futures Commission, 1996.

"Integrity and fairness are vital for successful markets" Statement by the London Stock Exchange in its 1995 Annual Report.

"The overall objective is to assure fair and orderly markets providing investors with a level playing field and the assurance of regulatory integrity" Key Principle of the Federation of International Bourses de Valeurs (FIBV), 1996.

OECD STATEMENT 1993

"Regarding markets in securities issued by private entities, most OECD governments believe that it is in the public interest to maintain markets for investments which have the confidence of the public and to which the public is willing to commit its savings.

This does not mean that such regulation seeks or should seek to remove risk, for risk-taking is a critical function of a market economy and investors must be free to determine the degree of risk they wish to accept.

Nevertheless, investors must be fully informed of the nature of risk and protected from fraudulent, deceptive or manipulative practices. Additionally, the investor is normally expected to assume only the risk inherent in his own investment, rather than additional risks associated with the possible insolvency or misconduct of an intermediary.

A closely related goal of securities regulation is to ensure that operation of the markets are conducted under predictable, understandable and transparent rules that do not give special advantage over the general investing public to those possessing privileged information or having special connections to investors, issuers of securities, or market intermediaries, for example, information concerning prices at which assets are sold as well as fees and commissions related to securities-related business must be matters of public information. Furthermore, rules should be established governing the use and release of information which may affect the market for specific securities." (OECD 1993 Arrangements for the Regulation and Supervision of Securities Markets in OECD Countries, pp 17-35)

3.15. Confidence supports the key function of a trading market in providing liquidity and therefore enabling the sale and purchase of financial instruments at lower cost or reducing the time required to undertake a transaction at a desirable price. Increased liquidity lowers a firm's costs of capital and attracts investors to the capital market (Amihud and Mendelson 1988) or enables lower cost risk management. Liquidity is therefore crucial to the primary capital raising process.

3.16. Market liquidity has a positive externality in that "order flow attracts order flow" while the reverse is also true in that "thinness attracts thinness". An efficient market relies on the assumption that no one participant has undue market power to be able to distort the price or volume:

> *"It is of the essence of the economic function of a securities exchange that it is a free market - free of the artificiality of manipulation (the laying of the hands on the scales) as it is free of the unfairness of insider trading (playing with a marked deck)." (Loss 1983, p984)*

3.17. When this confidence does not exist, investors might withdraw from the market rendering it illiquid and undermining its function as the provider of price information. It is not generally economic for most investors to individually monitor the quality of markets as others will free ride on this activity, making individual monitoring by many investors socially inefficient.

3.18. Accordingly, in the ASC's view a key attribute of efficient, internationally competitive capital markets for Australia is that users have confidence in the overall integrity of the financial markets, their participants and systems. Confidence is particularly important for a small capital market like Australia facing increasing competition from other market centres in the region and elsewhere. In many ways reputation and confidence are a key competitive asset for the Australian capital market.

Market integrity - the key to investor confidence

3.19. As the primary statutory securities and futures markets regulator in Australia the ASC sees market integrity as essential to confidence in Australian financial markets. "Market integrity" in this context means integrity of markets, market participants and systems. It includes:

- markets being sound, orderly and transparent;
- users being treated fairly;
- the price formation process being reliable;
- markets being free from misleading, manipulative or abusive conduct (ASC Policy Statement 100, SIB 1995, FIBV 1996).

3.20. The ASC also sees the way professional intermediaries conduct their businesses as having a substantial effect on overall market integrity, especially in two areas:

- transactions as principals in OTC securities and derivatives markets; and
- sales and advice practices involving retail investors.

3.21. It is difficult to place a value on this intangible asset of "market integrity". However, a reputation for integrity is hard won, but easily lost. This is demonstrated by the consequences for Australia's international reputation following the corporate losses of the 1980s or the difficulties until recently of managed funds in overcoming the concerns of investors following the property trust collapse of the early 1990s. The activity of sharp market operators, systems failures, occurrence of fraud, or groups of investors surprised at the outcomes of investment decisions because of poor quality or inadequate information will quickly damage the confidence of users.

3.22. A concern about lack of integrity can result in negative spillover effects for reputable Australian markets, issuers and market participants given some of the inherent difficulties faced by investors in assessing the quality of participants and market processes. The influence of concerns about market integrity can be seen in the impact that recent allegations about price fixing and other dubious market practices are currently having upon the reputation of the NASDAQ market in the US. Likewise, the experience of the ASX second board markets in Australia in the 1980s illustrates how lower regulatory standards that enable abuses to occur can have adverse consequences for market liquidity and loss of confidence that affects even reputable firms listed on those markets. The ASC considers that these events have important lessons for proposals for less regulation in markets and capital raising activities in the area of SMEs.

Recommendation

- The ASC recommends that the Inquiry should set as a key objective for market regulation the promotion of confidence in the integrity of our markets, market participants and their systems:
    - confidence that investors have available the information to make informed investment decisions and that intermediaries do not place their own interests above those of the investors for whom they act;
    - confidence that market prices are reliable and the markets are free from misconduct, are transparent and operate fairly; and
    - confidence that the legal, operational and system infrastructure of our markets is sound.

Confidence that investors can make informed investment decisions

3.23. The normal starting point for financial market regulation is that risk taking is at the heart of our financial markets. Regulation is not designed to guarantee the success of the investment opportunity or reduce the investment risks of a particular financial claim.

3.24. Rather, regulation is designed to ensure that investors are properly informed of the investment risks involved. Investors are protected against risks relating to unfair sales and advisory practices, fraud, negligence system failures or other abuses and risks where disclosure is not an adequate or efficient regulatory solution.

3.25. It is important to be aware of the limits of disclosure as a regulatory technique. For example, there is often a trade-off between the complexity and length of disclosure information and its comprehensibility for retail investors. Disclosure is also not an effective measure to prevent fraud or mismanagement or to protect investors against complex system and operational risks in netting and other arrangements involved in modern market transactions. Despite these limitations, however, disclosure-based regulation and sensible risk taking is at the heart of the financial market regulatory regime in Australia and most other major jurisdictions.

3.26. The Director of the SEC's International Division has, for example, described the philosophy of the US securities regime in these terms:

> *"The philosophy underlying the US system is simple and straight forward. At its most basic level, the system is addressed to honesty and fairness. One can summarise the obligations of the law in three axioms: (a) Do not lie; (b) Disclose fully; and (c) Deal fairly." (M Mann 1992)*

3.27. Along with encouraging disclosure, market regulation also aims to prevent investors from being subject to high pressure and other forms of abusive sales practices and to ensure that they have access to competent, unbiased advice when required. Regulation is also concerned that professional intermediaries honour the obligations to their customers (those on whose behalf they deal) and their counterparties in OTC markets (those with whom they deal).

Confidence that market activities are free from abuse

3.28. In the ASC's view, there are clear connections between regulation of market activity, regulation of market intermediaries and "consumer" type regulation where the latter is characterised as concentrating on the relationship between individual customers and market intermediaries in areas such as disclosure, sales practices, dealing, advice and management of investor funds. These connections reflect the important inter-relationships between the primary market for securities, the secondary markets (which provide liquidity and pricing) and the derivative markets (which enable efficient risk transfer). While an important focus of regulation is on the protection of individual investors, there is also a broader public interest in markets that are sound, orderly and free from abuse.

3.29. Regulation of securities and derivatives markets in various jurisdictions has developed in response to particular problems of market abuse and conflicts of interest, but most developed regimes now have broadly similar objectives and approaches. In Australia, federal regulation of the securities markets developed in the 1970s in response to concerns about a range of market abuses recorded in the Rae Committee Report in 1974 and the futures industry in the mid 1980s.

3.30. Market regulation is designed to address key areas of risk to investors, other than those inherent in an investor's investment decision, and to ensure that this regulation is effectively enforced. The main provisions contained in Chapters 7 and 8 in the Law are set out in Appendix 7. Market regulation is designed to support the free operation of markets and includes:

- prohibitions against market misconduct including false and misleading information, market manipulation and insider trading;
- regulation to ensure market intermediaries are fit and proper, competent, and free from conflicts of interests and to ensure proper reporting and handling of assets held on behalf of clients;
- market information and disclosure about the entities whose securities are traded, trading interest and market processes;
- effective clearing and settlement procedures to enable secure clearing of market transactions, the completion of contracts and, in the case of securities, the transfer of title;
- appropriate compensation arrangements;
- arrangements to ensure that market operators run markets that are fair and free from abuse; and
- the safekeeping and proper use of customer funds provided to an intermediary as part of the purchase or sale of an investment or for investment management purposes.

3.31. The regulator must also be able to effectively detect, investigate and take enforcement action where misconduct occurs, as well as establish regulatory standards and supervise market participants' conduct. An effective enforcement capacity is essential to encourage compliance with regulatory standards and to act as deterrent to breaches of those standards. This is discussed further in Chapter 5.

Confidence that the market infrastructure is sound

3.32. There are, however, some aspects of financial market regulation which relate to the overall soundness and orderly operation of markets and market intermediaries. These have been the subject of international attention following events such as the market break of 1987, problems faced by a number of large intermediaries and more recently the collapse of Barings and problems in the UK metals market. This has led to a view that:

> *"..... the rising importance of securities markets in the financial systems of OECD countries, the growing concentration in the securities industry, the effects of new technologies, the nature of the risks now being borne by securities market intermediaries and the links between the securities market and the banking and payments system all suggest that the occurrence of serious misfunctions in the securities markets would have the potential to destabilise the entire financial system." (OECD 1993, p38)*

3.33. Concerns of this kind result in some of the same techniques used in prudential regulation - especially capital standards - being applied in regulation designed to enhance the overall stability of financial markets and their participants.

3.34. Securities regulators and securities and derivatives exchanges impose capital requirements on market participants to ensure the maintenance of an orderly market. In futures and derivatives markets, margining, position limits and other risk management procedures are implemented to protect the clearing house which in many jurisdictions is a counterparty to every transaction. In a securities trading context, the implementation of net settlement of payment and delivery obligations means that the failure of one participant has important flow-on consequences for others in the settlement and trading process. This is compounded in cross-border transactions. A recent report by the Committee on Payment and Settlement Systems on Cross Border Securities Settlement highlights the potential risks in custody, back-to-back settlements and cross-system settlements because of the complexity of the relationships now involved.

3.35. The market requirements for margining, capital requirements, fidelity and guarantee arrangements are also designed to protect the integrity of an orderly market place. Market requirements enable the risk exposure of fidelity funds or clearing house guarantees to be properly managed (see Moody's 1995 for a recent analysis prompted by some of the clearing risks following the collapse of Barings) rather than ensuring that market participants remain solvent. While in some sense prudential in nature, they are integral to the efficient and orderly operation of these markets.

3.36. Recent international and domestic attention has been aimed at strengthening the basic operational and legal infrastructure of both domestic and international securities markets. These changes will help markets to better withstand disruption, minimise system failure, legal or other risks and encourage market operators and participants to strengthen their internal management procedures and controls.

3.37. The ASC has been actively involved in, and has been contributing to, this work at an international level through its involvement in IOSCO and the Joint Forum on Supervision of Financial Conglomerates. Recent IOSCO work in this area includes an emphasis upon:

- internal management controls for the derivative activities of securities firms;
- examination of value-at-risk models for capital adequacy;
- mechanisms to enhance communication between market authorities or related cash and derivative markets in periods of market disruption;
- principles for memoranda of understanding;
- default procedures and large reporting requirements for market authorities; and
- ongoing joint work with the Committee on Payment and Settlement Systems on a disclosure framework for securities settlement systems.

3.38. The IOSCO Technical Committee and Basle Committee, have recently set out eight principles to guide international regulators' actions in this area and there has been significant work carried out following the collapse of Barings by industry based groups such as the Financial Integrity Task Force on these issues. The ASC and domestic exchanges have been actively involved in these deliberations.

BASLE/IOSCO Joint Statement of April 1996

Introduction

The Halifax Summit Review of International Financial Institutions (the Communique) identifies issues of critical concern for supervisors and market participants in the financial services sector. Globalisation of capital markets, integration of financial services and the exponential rate of technological and financial innovation, including notably the increased use of derivative products, permit significant enhancements to risk management procedures. They also pose the challenge of potentially greater risk. The ability of markets and their supervisors to respond flexibly to firms' failures and other disruptions is encouraging. Nevertheless, regulators cannot afford to be complacent. Close international cooperation is crucial to continued success in meeting the challenge of the future.

Responding to the Challenge

The Basle Committee on Banking Supervision (the Basle Committee) and the International Organisation of Securities commissions (IOSCO) recognise that the process of globalisation and innovation leads to more efficient allocation of capital and contributes to economic growth. Both organisations share the common goal of improving the quality of supervision worldwide and responding to financial market developments in a timely, effective and efficient manner. However, they remain aware that efficient global markets may accelerate the transmission of financial disturbances. The occasional failure of individual market participants is an unavoidable feature of an efficient market system. The ultimate objective of supervision cannot be to avoid all such failures.

In pursuit of their common goal, the Basle Committee and IOSCO have identified the following eight major principles which will guide their efforts and which their members agree to promote:

- *cooperation and information flows among supervisory authorities should be as free as possible from impediments both nationally and internationally;*
- *all banks and securities firms should be subject to effective supervision, including the supervision of capital;*
- *geographically and/or functionally diversified financial groups require special supervisory arrangements;*
- *all banks and securities firms should have adequate capital;*
- *proper risk management by the firm is a prerequisite for financial stability;*
- *the transparency and integrity of markets and supervision rely on adequate reporting and disclosure of operations;*
- *the resilience of markets to the failure of individual firms must be maintained;*
- *the supervisory process needs to be constantly maintained and improved.*

The Basle Committee and IOSCO are fully resolved to work actively together, as they have been doing, to promote these principles.

Market regulation and prudential regulation

3.39. In contrast to regulation focussed on market conduct, prudential regulation is focussed on minimising risks relating to financial performance of particular contracts and the solvency of particular institutions. Historically, banking has given rise to particular prudential issues because of the particular nature of the contractual promise involved in a deposit, the mismatch between the asset and liabilities of a bank's balance sheet, and the banks' key role in the payment system (Llewellyn 1996a).

3.40. There are, however, a number of potential areas of interrelationship between market regulation and prudential regulation. The ASC considers that:

- as a general principle, the activities of financial intermediaries offering investment-linked products should be subject to "business conduct" style of regulation rather than prudential regulation;
- there are only limited benefits and some problems in treating aspects of market regulation (for example, capital regulation of market participants and the regulation of clearing houses) as part of a separate prudential regime;
- the extent of any insurance or underwriting (private or public) should be more explicitly disclosed to investors in view of the increasing trend to generalised financial service firms distributing a wide range of products; and
- the supervision of conglomerates should be undertaken on a solo plus basis as proposed by the Council of Financial Supervisors.

3.41. Conceptually the techniques of prudential regulation can be regarded as a mechanism to manage the risks involved in "underwriting" the financial performance of an institution (even where this is formulated not in terms of a guarantee against losses but as a mechanism to minimise those losses to investors) and involve:

- monitoring to ensure that the institution's net worth does not fall below a specified amount;
- restricting the entity's assets so that it does not take on excessive risk; and
- charging risk based premiums depending on the riskiness of the guarantee involved (Merton and Bodie 1992).

3.42. In assessing where prudential regulation should apply to particular institutions or activities, a distinction can be drawn between financial claims that involve some form of capital or similar performance-backing, compared to those where the return on the claim is investment-linked and managed on a best endeavours basis (COFS 1996).

3.43. There are a range of issues to consider when looking at whether the Government should prudentially regulate specific financial claims or institutions, and if so, which ones and on what basis. Questions are raised about the appropriate scope of institutionally-based prudential regimes such as those administered by ISC, RBA and AFIC for deposits, traditional insurance contracts and similar forms of capital-backed claims.

3.44. As well as the nature of the financial claim involved and expectations of investors, other relevant considerations as to whether an institution should be subject to formal government prudential regulation include:

- the availability of private sector mechanisms to carry out, or to be a substitute for, the monitoring or asset restrictions required;
- the existence of effective and low cost mechanisms to enable the holders of financial claims to exit and switch investments on the basis of information about institutional solvency;
- whether the claim is held by sophisticated or coordinated agents;
- community expectations as to the degree of safety of their funds;
- specific social policy objectives in areas such as retirement and saving policy; and
- systemic impact of the failure of the institution where it is unable to repay the financial claims on the terms held out to those who hold them (Dewatripont and Tirole 1994).

3.45. There are several complex issues involved when determining when public prudential regulation is appropriate and the ASC as a market regulator is not necessarily well placed to provide definitive recommendations in this area. Ultimately, the extent of prudential regulation probably depends on community expectations about the extent of the protections provided and an assessment of both the direct and indirect costs of extending the protective net to a wider range of institutions and products. It seems clear that under current community expectations, institutions providing deposits and long term risk insurance should be able to meet their obligations. They should, therefore, be subject to prudential supervision. In other cases there may need to be more reliance on private arrangements and greater sophistication in the assessment of risk by customers.

Financial conglomerates

3.46. The offering of different types of products by an institution or within the financial conglomerate raises issues of whether it is possible to separate certain products from the other activities of the institution. Separating products may raise practical issues as well as the public's expectations about which products should receive the protections of prudential supervision.

3.47. Financial conglomerates are increasingly important both in Australia and overseas and raise issues of the approach to prudential supervision of the entities involved. The supervision of financial conglomerates has been under active discussion within the Council of Financial Supervisors and at an international level over the last couple of years. The 1995 COFS Annual Report provides details of the operation of financial conglomerates in Australia and show that 30 conglomerates control about two thirds of the assets of the Australian financial system. That report discusses some of the supervision issues involved.

3.48. The ASC is also a participant in the deliberations of the Joint Forum on financial conglomerates of securities, banking and insurance regulators that is examining the issue of the regulation of conglomerates at an international level. This group was formed to progress the initiatives set out in the "Supervision of Financial Conglomerates" report by the Tripartite Group under the auspices of the Basle Committee, IOSCO and the International Association of Insurance. The Joint Forum is developing a set of principles and practices for the international supervision of financial conglomerates.

3.49. The Tripartite Group expressed the view in its report that:

> *"The rapid growth of conglomerates which cuts across the banking, securities and insurance sectors, raises questions as to whether the traditional approach to prudential regulation is still appropriate. The Tripartite Group very quickly came to the unanimous view that, while solo supervision of individually regulated entities should continue to be the foundation for effective supervision, there is a need for the various supervisors to establish a coordinated approach to supervision so that a prudential assessment can also be made from a group-wide perspective. This is essential in order to provide supervisors with a realistic insight into a group's risks and the respective capital coverage, it also enables supervisors to prevent, or at least to assess the extent of, any excessive or double gearing." (Tripartite Group 1995, p16)*

3.50. A range of different approaches continue to be examined at an international level in relation to the supervision of financial conglomerates. The ASC supports the general thrust of the approach articulated by the Tripartite Group to complement supervision of capital and risk management systems of individually regulated institutions with a group-wide assessment (sometimes referred to as "solo plus"). This is consistent with the current positions of both COFS and IOSCO. COFS has agreed to guidelines for the supervision of financial conglomerates that are designed to implement this "solo plus" approach and council members are seeking legislation to enhance their ability to share information. In March 1996 COFS members agreed on an approach on holding company structures under which one council member would act as convenor for each conglomerate with a holding company. The appointment of a convenor would be a matter for the Treasurer on the basis of joint recommendations from the relevant supervisors.

Recommendation

- The ASC recommends that the current approach of COFS members in adopting a solo plus approach to supervising financial conglomerates in Australia should be supported by the Inquiry. The ASC recommends support because the COFS approach is consistent with international standards.

Issues in market regulation

3.51. The market regulation described above raises a number of issues that in the ASC's view the Committee will need to consider. These issues are discussed in the rest of this chapter. The most important of these are:

- the extent to which regulation of wholesale ("professional") markets should differ from that applying to public markets accessible by retail investors;
- the extent to which prudential objectives and techniques should be part of market regulation, especially in relation to:
  - disclosure about the nature of regulation to which products or activities are subject;
  - settlement and clearing of financial markets;
- the role of professional and industry bodies in self-regulation and delivery of regulatory outcomes.

Wholesale and retail market regulation

3.52. The extent and type of regulation that is appropriate for the wholesale and retail sectors is different. The objective of regulating the wholesale markets is to ensure that the market infrastructure is sound and that markets are free from abuses. There is, accordingly, less need for detailed individual disclosure requirements and other conduct rules required at the retail end of the market. Retail market regulators are designed to redress the imbalances of information or issues arising from the fiduciary nature of the funds management and advice relationships that often exist.

3.53. In a number of areas the Corporations Law recognises that different requirements should apply. For example, the mandatory prospectus disclosure requirements do not apply to transactions of $500, 0000 or above or where the net worth of a customer is $10 million or above. In the area of futures, the ASC has created a safe-harbour for OTC transactions with "sophisticated" counterparties. It has recommended law reform to remove some of the conduct requirements on intermediaries providing advice to sophisticated categories of customers.

3.54. However, recent events such as the collapse of Barings, revelations about the losses at Daiwa, some of the customer disputes experienced by Bankers Trust and the current investigations into market manipulation of the copper market reinforce the importance of conduct requirements aimed at maintaining orderly markets and creating a culture of compliance in wholesale markets. It also shown the importance of enhancing the capacity of regulators to take action in cases of misconduct and to implement measures designed to prevent a re-occurrence of the problems.

3.55. The ASC considers that there are two limitations to proposals to separate the regulation of wholesale and retail activity for two reasons. First, the same institution may be engaged in transactions in both the wholesale and retail markets.

3.56. Second, there are important links between the wholesale OTC markets and the public markets. A number of investigations in Australia and overseas have examined the impact of transactions in the fixed interest or other wholesale markets on the public derivatives and equity markets. The growth in institutional fund managers also means that wholesale market activity directly influences the returns of retail investors held in managed funds.

3.57. Accordingly, the ASC does not support the creation of separate wholesale and retail market regulators as is sometimes suggested based. This suggestion is often based on the current UK regime. Such a separation would result in market participants being subject to an additional regulator, unless they were to restructure their businesses into clearly wholesale and retail components, create difficulties in defining the boundaries in any simple and clear way, and reduce the capacity to take effective enforcement action where market misconduct crosses market boundaries.

3.58. The ASC considers that current arrangements remain appropriate. These are that the Corporations Law sets the framework and the professional associations, such as AFMA, develop within that framework programs designed to increase the competence of participants, establish clear and transparent market conventions, strengthen codes of conduct, encourage internal risk management procedures and generally put in place measures designed to create a culture of compliance.

Recommendation

- The ASC recommends that the Corporations Law provides an appropriate regime for the regulating wholesale markets. There would be few advantages and many disadvantages in splitting wholesale and retail market regulation into separate agencies. The ASC supports the continuing emphasis on ensuring that requirements for retail transactions are not inappropriately applied to the wholesale markets. The focus of regulation for the wholesale markets should be on ensuring orderly markets and preventing misconduct. The regulator should be given sufficient powers to ensure that regulation is not applied inappropriately to the wholesale markets.

Disclosure

3.59. Disclosure has an important part to play in complementing traditional prudential regulation, as recent domestic and overseas developments relating to derivatives disclosure has highlighted. Disclosure is regarded as an important part of both the prudential and market regulatory frameworks because:

- well informed investors, depositors, customers, creditors and counterparties provide an important discipline on firms to implement proper risk management;
- it assists individual counterparties to make better assessments of the overall risk profile of counterparties; and
- it assists regulators by providing a clearer view of the overall level of activity in the market (IOSCO 1995).

3.60. In addition, the increasing wide range of different products distributed by institutions to take advantage of the marketing benefits of the particular institutions "brand name" or distribution networks highlights the importance of clearly disclosing to investors the nature of the institutional or public underwriting of the various financial products. This would help avoid the creation of inappropriate investor expectations, for example, that all products offered by a prudentially regulated institution are subject to the same level of protection. In many ways investor expectations may become self fulfilling if governments find it too difficult to not meet community expectations if a collapse occurs and investors funds are lost.

3.61. In the US, the rules relating to the sale of Mutual Funds by Banks, for example, require explicit disclosure that such mutual funds are not subject to federal deposit insurance. This disclosure avoids investor confusion about the risks attached to the different products. Likewise, under EEC law, deposit guarantee schemes exists and a bank must provide information to consumers of banking products about the existence of these deposit guarantee schemes.

Recommendation

- The ASC recommends that disclosing prudential, insurance or guarantee arrangements for financial products should be part of the point-of-sale disclosure framework in Australia.

Settlement and clearing

3.62. The importance of the integrity of the settlement and clearing process, proper attention to risk management procedures and transparency of these process to market users will be more important in the near future. This is because the location of trading is increasingly difficult to determine in an electronic cross-border trading environment.

3.63. There are also a number of important coordination issues in regulating and operating the capital and margin requirements of markets and clearing houses across a range of markets and jurisdictions. Financial market clearing and settlement systems and payment systems will become more integrated as we move to a comprehensive cross-border delivery versus payment environment.

3.64. A number of these important cross border and risk management issues were highlighted in the collapse of Barings as a result of trades undertaken on the SIMEX market in Singapore. These issues have been addressed by the recommendations of the Futures Industry Association task force and in initiatives on large exposures and default procedures by IOSCO. A key initiative has been the information sharing agreements between major futures exchanges and key regulators which both the ASC and SFE signed in mid 1996.

3.65. At an international level, banking and securities regulators are examining the risks in clearing systems. This work is part of a more general process of examining the infrastructure of market processes in a global environment, establishing international best practice standards and procedures and in promoting greater levels of transparency about market processes generally. As noted above, this remains an important priority in the current international regulatory effort for market regulators.

3.66. Clearing houses are subject to credit risk and a clearing house default has serious consequences for the orderly conduct of markets. Clearing houses do not require the intensive monitoring traditionally associated with regulating other forms of prudentially supervised institutions. Clearing houses themselves seek to manage their risk credit exposure by implementing a range of risk management procedures such as capital requirements for clearing members or other market participants, segregation of client and house positions, sophisticated risk based margining systems, position risk and large exposure reporting requirements. These are usually complemented by the capital reserves or insurance available to the clearing house itself.

3.67. In effect, clearing house operators act as private monitors of the activity of the markets and market participants. In the case of the equity and futures markets this role is recognised in the Corporations Law in the authorisation and rule approval processes required.

3.68. While such operators should be subject to "fit and proper" authorisation and review of financial and operational adequacy, both initially, and on an ongoing basis as currently occurs, there is a moral hazard risk if these institutions were subject to greater levels of direct prudential regulation. It also appears from the recent Moody's special report on Clearing Houses (Moody's 1995) that private sector monitoring arrangements are emerging in this area. There are also potential gap and overlap problems if they were regulated separately from the markets with which they are associated.

3.69. There are, however, some general issues of domestic coordination between market regulation and prudential regulation, especially relating to the oversight of conglomerates and the interface with the payments systems that should be addressed. The ASC recommends that the Council of Financial Supervisors play a more active coordinating role in this area.

Recommendation

- The ASC recommends that securities and derivatives clearing houses be subject to authorisation and regulation as part of the market regulatory regime because of the important role they play in the operation of these markets, but that the Council of Financial Supervisors play an active co-ordinating role in areas where there are possible prudential on system-wide issues involved.

Enhancing the role of professional bodies

3.70. The ASC considers that professional bodies can play an important role in the delivery of regulatory outcomes in the financial services sector. Most jurisdictions have a mixture of statutory and other forms of regulation. While there are common features in most jurisdictions, the exact mix of statutory and self-regulation tends to have developed from the specific history of each jurisdiction.

3.71. The ASC's views on the issue of self-regulation and the role of professional bodies have been set out in its Good Advice Report on licensing. In general, the ASC is supportive of industry and professional bodies playing an active role in the setting and delivery of best practice standards to industry participants. It considers that the activities of bodies such as the Financial Planners Association, Australian Financial Markets Association, ASX, SFE and organisations in the accounting, auditing and other areas as make an important contribution to effective regulation. The ASC sees a strong continuing role for professional bodies in encouraging higher level individual and organisational competencies and promoting a culture of compliance.

3.72. However, the ASC views the role of professional and industry bodies and statutory regulation as complements, not substitutes. The ASC also has reservations about creating a formal structure of self-regulatory organisations beyond the current arrangements involving the SFE and ASX. This reflects the ASC's views of the current state of industry bodies and also the lessons that can be derived from debates in the UK ten years after a formal self-regulatory structure was implemented with the creation of the Financial Services Regime in 1986.

3.73. One of the difficulties in this area is that the terms "self-regulation" and "self-regulatory organisation" are often used in different ways. In this submission the ASC uses the term "self-regulatory organisation" as a private body that has received a formal grant or delegation of regulatory authority by a government or government authority. As a consequence, it is required to meet specific standards and incurs obligations in consideration of the delegation of authority. Self-regulation has two key elements:

- the primary policy makers within the organisation are themselves practitioners; and
- the self-regulatory organisation is funded by those market participants rather than market funds (International Capital Markets Group 1992, p25).

3.74. The benefits of self-regulation have been summarised as that:

> *"at best, direct regulation of complex business through the machinery of government.... divides black from white with a buzz saw when the many variations of grey call for a surgeon's scalpel. Although appropriate provisions on registration and fraud prevention furnishes an indispensable foundation for an adequate system of control, they must be supplemented by regulation on an ethical plane." (Loss 1983, p684)*

3.75. However, in all jurisdictions, the limits of self-regulation (because of the issues of self interest) have been recognised and are addressed by the regulatory framework. These limitations are compounded by divergence of economic interests by members of the SRO in the face of competition and change, the possibility for inflexibility as market boundaries blur and broader public policy issues in the context of national and international markets.

3.76. It is also important to learn the lessons from overseas experience. In the UK the self-regulatory structure established on the basis of the then existing professional bodies in 1986 has been the subject of recent scrutiny and reform to deal with the fragmentation, coordination and enforcement limitations that resulted. This process of review is reflected in the report by Andrew Large on making the two tier system work by rationalisation of industry bodies into three major SROs. It has also been the subject of further scrutiny in a recent Treasury and Civil Service Committee report (House of Commons 1995).

3.77. Recent developments in the UK signal a clear shift away from a self-regulatory model with increasing discussion of a single integrated Financial Service regulator (along the lines that already exists in Australia with the ASC) to overcome the fragmentation issues. The current front line regulators in the UK are no longer regarded, or consider themselves, to be self-regulatory organisations. The Treasury and Civil Service Committee report characterised the regulatory bodies as effectively statutory regulatory agencies with practitioner input. The Securities and Futures Association, which regulates the wholesale markets, has recently formalised this shift by changes to its internal structures reflecting a move away from self-regulation. There are also debates in the US about the role of the National Association of Dealers because of recent concerns about the adequacy of the regulatory oversight of the NASDAQ market.

3.78. The ASC considers we should learn from these developments and be cautious about creating a formal structure of self-regulation that has proved problematic in other jurisdictions which are looking at current arrangements in Australia as possible models for themselves. The ASC considers the aim should be less, rather than more, fragmentation in current statutory arrangements. The creation of a formal structure of self-regulation beyond that which currently exists will also bring costs to both the ASC, the professional bodies and market participants. This is because any formal self-regulatory structure would need to build in appropriate mechanisms for standard setting, monitoring and review for the organisations involved. The ASC is not convinced that, at the current stage of development of our regulatory system, these costs are warranted by the benefits to be gained in terms of improved regulatory outcomes.

3.79. In the ASC's view, most regulatory benefits can be delivered by a continuation of the current activities of the professional bodies in contributing to the formulation of regulatory policy, development of industry best practice standards, contribution to improved competencies and promotion of a culture of compliance. In its Good Advice Report on licensing reform, the ASC encouraged greater involvement by industry and professional organisations in the achievement of regulatory outcomes and articulated the ASC's objectives as follows:

- the ASC utilises industry knowledge to significantly improve ASC surveillance targeting and quality, and to incorporate commercial imperatives into ASC surveillance processes and decision making;
- the industry increases its knowledge of, and involvement in, regulatory issues, including the costs, scope and limits of ASC sourced regulation and opportunities for outsourcing ASC regulatory processes;
- there is identification and shared knowledge of best practice to promote continuous improvement in compliance and business support systems; and
- the industry is seen to take some responsibility for regulatory effectiveness and there is growing community acceptance of this.

3.80. The ASC is looking to industry organisations to play a more active role in setting standards and creating a strong culture of compliance throughout the industry. It is examining what activities these bodies can deliver more effectively than a statutory regulator on a case by case basis. In the case of licensing, for example, the ASC expects the benefits of a greater role for professional bodies at both the retail and wholesale end of the markets to include:

- competency requirements (licensing preconditions) will be reflected in industry standards which are recognised by the ASC;
- industry bodies will have responsibility for ensuring (through monitoring) that their members have adequate compliance and business support systems, and as a consequence, industry organisations become more attractive to non-members;
- the ASC is able to realign its resources away from direct surveillance of securities advisers, in favour of greater effort (along with industry) in investor education; and
- there is a community of interest and mutual benefit between industry groups and the investing community.

Recommendation

- The ASC supports the recognition in the law of the regulator's ability to delegate regulatory functions, under supervision, to industry and professional bodies. This delegation should be accompanied by authority to establish appropriate performance standards for those regulatory functions, ability to monitor performance and capacity to take effective action where those standards are not being met. However, the ASC has reservations about any further formal delegation of regulatory powers at this stage.

CHAPTER FOUR

RESPONSIVE FINANCIAL MARKET REGULATION

SUMMARY

This chapter discusses the importance of achieving the appropriate style of regulation to support investor participation and product innovation. The appropriate style of regulation is market regulation which has eight key attributes which underlie the ASC's recommendations in specific areas of regulation such as managed funds, financial advice and disclosure and its views on the administrative structures required to deliver effective regulation, discussed in subsequent chapters.

Recommendation

- The ASC recommends that the Inquiry adopt the following eight principles for market regulation.
    - A focus on identifying regulatory risks and on performance outcomes.
    - An emphasis on the international nature of financial market activity.
    - Flexibility in the setting and delivery of regulation.
    - A high level of commercial and market expertise, skill and experience within the regulator.
    - Independent and accountable administration.
    - Open and transparent policy and administrative processes.
    - Effective and timely remedial and enforcement capacities.
    - Cost-effective and service orientated delivery of regulation.

Importance of regulatory style

4.1. The ASC considers that it is important to focus on the style of regulation to support investor participation and product innovation rather than focus merely on administrative structures. Regulatory arrangements should encourage a style of regulation that is responsive to market innovations. The ASC's own experience is that achieving an appropriate regulatory culture takes considerable investment in time and effort.

4.2. The ASC wholeheartedly agrees with the comments in a recent report by a visiting UK academic that "concentrating on issues of institutional structure has the danger of assuming that changes to institutions solve problems. There is a danger that concentrating on institutional structure diverts attention from the issues that really matter: the style and substance of regulation" (Llewellyn 1996b).

4.3. In this chapter the ASC outlines the key attributes of responsive financial market regulation (referred to in later chapters as market regulation). These form the basis of the recommendations in later chapters on specific regulatory issues in the areas of managed funds, disclosure and advice. They also form the basis of the ASC's views about the administrative arrangements required to ensure effective delivery of regulatory outcomes.

4.4. The ASC considers regulation that is responsive to innovation in market structures and encourages investor participation has the following eight key attributes:

- A focus on identifying regulatory risks and on performance outcomes.
- An emphasis on the international nature of financial market activity.
- Flexibility in the setting and delivery of regulation.
- A high level of commercial and market expertise, skill and experience within the regulator.
- Independent and accountable administration.
- Open and transparent policy and administrative processes.
- Effective and timely remedial and enforcement capacities.
- Cost-effective and service orientated.

Focus on key regulatory risks and on performance outcomes

4.5. Chapter 3 describes the importance of regulators focusing on the relevant regulatory risks and on clearly identifiable outcomes. This is linked to the issues discussed below about the need to specify regulatory requirements in terms of desired outcomes and the importance of ensuring that success in achieving these outcomes is regularly assessed. The ASC has begun to express its own major regulatory programs in terms of the types of regulatory risks faced by investors, desired outcomes and to design performance indicators to best measure achievement of these outcomes.

4.6. A focus on regulatory risk ensures that the appropriate regulatory technique is applied and that supervision and regulatory activity is based on an assessment of high risk areas with a lighter regulatory intensity in low risk areas. This requires the regulator to be able to use market intelligence and to undertake risk assessment appraisals based on an understanding of the relevant transactions, markets and participants involved.

Emphasis on the international nature of financial market activity

4.7. The increasing international nature of financial market activity requires an international focus by regulators in setting their regulatory standards and in undertaking international enforcement activity. Appendix 10 provides details of the ASC's international enforcement, mutual recognition and harmonisation and technical assistance activities.

4.8. In areas such as capital standards, financial accounting and derivatives disclosure, recent international activity has established, or is establishing, internationally accepted standards for regulation. It is clear, for example, that there is increasing interest in setting internationally accepted accounting standards to reduce costs and promote international capital raising activity.

4.9. Australia has a fundamental choice: it can seek to position itself as a low regulatory standard and low cost jurisdiction, or it can aim to be broadly consistent with international standards. In the ASC's view, Australia cannot afford to be too far out of line with internationally accepted standards of regulation if our markets are to be recognised or market participants are to gain recognition in other jurisdictions.

4.10. The ASC also has many Memorandums of Understanding with regulators in other countries. This means the ASC can obtain information for enforcement purposes. Recent market investigations involve a range of transactions which impinge on markets in Australia, but involve activities and regulators in other jurisdiction. The increase in cross border activity will only increase the importance of these international arrangements.

Flexibility

4.11. Financial markets are subject to significant changes and regulators must be able to respond in a timely, creative and flexible manner. This requires regulation to be tailored to individual circumstances and to be adjustable to accommodate changing market developments. The flexibility to do so has two key elements:

- regulatory requirements to be based as far as possible on general principles and standards rather than prescriptive requirements; and
- the discretion of the administrator to modify and exempt from inappropriate requirements where necessary.

4.12. The ASC supports recent trends to simplify the law by the use of general principles that spell out the outcomes the regulation is designed to promote. This style is embedded in s1022 of the Law which sets down a general requirement for disclosure rather than a set of detailed prescriptive content requirements.

4.13. The Corporations Law also includes a number of important discretions which are used extensively in some areas to modify the strict technical requirements of the Law. This allows the ASC to respond to new circumstances in a way that does not lessen the protections contained in the legislation. The extent of this activity by the ASC or its value to the commercial community in facilitating commercial transactions is often not appreciated. In each case the use of the discretion removes what would otherwise have been a strict technical requirement of the Law to enable commercial transactions to proceed. Details of the extent of the use by the ASC of its discretionary powers are contained in Appendix 5.

Merger of RTZ and CRA

The recent merger of RTZ and CRA provides an example of the use of the ASC's discretions to facilitate a significant commercial transaction. The aim of the applicant was for the approach in Chapter 6 of the Law to apply to the combined organisation as a whole but this was inconsistent with the technical terms of the takeover provisions. The modification and exemption powers of the Corporations Law were able to be used to implement this major transaction in a way that was designed to accord with the regulatory policy of the Law. A range of other modifications were also required to accommodate the novel nature of the proposed merger arrangement which had to comply with both Australian and UK regulatory requirements.

4.14. It is clear that a key cost of regulation is increased by rigid requirements that are unable to be adapted to changing market circumstances. For example, the ASC has not been able to amend the licensing provisions to remove some obligations on intermediaries dealing with sophisticated customers as proposed in its Good Advice Report proposals. The ASC has, as part of those proposals, sought legislative amendments to provide it with such a discretion.

High level of expertise, skill and experience

4.15. A market regulator needs to be able to attract and retain high quality staff with expertise and knowledge of market and commercial practices. The ASC considers that the regulator should be staffed and structured along lines more akin to a professional services organisation than a traditional public sector department.

Independent and accountable

4.16. It is essential that the regulator administer regulation in an independent non-partisan manner. This is especially the case in the area of enforcement action. At the same time it is important that there is public accountability of regulators' performances.

4.17. In the case of the ASC, it is an independent government agency with a three Member Commission accountable to the Treasurer. It is also subject to general oversight by the Parliamentary Committee for Corporations and Securities.

Close to the market

4.18. It is essential that the regulator be located close to, and actively interact with, market and commercial participants. The regulator needs to be in touch with current market developments through regular day-to-day contact and interaction with market participants. The regulator also should seek to build on market mechanisms and use market compatible incentives to achieve regulatory outcomes wherever possible. The move to the use of firms' own internal models in assessment of capital adequacy is an example of regulators working with market participants to develop regulatory approaches based on developments occurring in the market itself.

4.19. Being close to the market also gives the regulator a unique insight into the practical problems that arise in the administration of the law and for compliance by market participants in a changing environment. The ASC's market research shows that the business community expects the regulator to play an active role in shaping the Law so practical implications are addressed at an early stage in its formulation (Appendix 4).

Open and transparent policy and administrative processes

4.20. In the same way that "sunlight is the best disinfectant" for securities markets, a securities regulator must promote openness in its policy and administrative activities. A securities regulator must also actively involve market participants and investors in the formulation of its policies.

4.21. An open and transparent approach is essential for perceptions about independence from major vested interests. It also actively ensures that the regulator remains in touch with market developments and involves practitioners and market users in the formulation of its responses on key policy issues.

Effective and timely remedial and enforcement capacities

4.22. If regulation is to succeed in deterring misconduct and create a culture of compliance, it must be supported by the ability to detect, investigate and enforce the standards. The importance of having a full range of investigation and enforcement capabilities is discussed in Chapter 5.

Cost-effective and service orientated

4.23. Regulators need to pay greater attention to issues of service standards and cost-effectiveness in setting regulatory standards and in their regulatory activities. These issues are examined in Chapter 6.

CHAPTER FIVE

EFFECTIVE ENFORCEMENT

SUMMARY

Enforcement is the mechanism by which market abuses are detected and remedied. Its aim is to promote public confidence in the financial markets. The public regards enforcement as the key focus of a financial market regulator.

Enforcement is becoming more complex in today's financial environment. The growing complexity of financial market transactions which often cross international borders means that effective cooperative relationships must be in place between financial market regulators, exchanges and industry bodies.

A financial market regulator must possess a full portfolio of regulatory tools which can be employed in a timely fashion to combat market misconduct.

Fragmenting regulation into separate bodies (whether statutory or self-regulatory), splitting of wholesale and retail market regulation or separating the investigation and enforcement functions from market regulation runs the risk of detracting from the ability to deliver the effective enforcement outcomes demanded by the community.

Recommendations

- The ASC recommends that the Inquiry adopt the principle that effective enforcement is a key focus of financial market regulation.
- The ASC recommends that the financial market regulator should have the ability to enter into effective cooperative relationships with other regulators, exchanges and industry bodies.
- The ASC recommends that the financial market regulator should possess adequate enforcement powers, including a full portfolio of enforcement responses.
- The ASC recommends amending the law to enhance its enforcement capabilities:
    - to expressly provide that written records of examinations conducted by the ASC are admissible in proceedings for alleged contravention of national scheme laws;
    - so that the laws of evidence are made uniform throughout Australia;

- to be given express power to provide, subject to conditions imposed by the ASC, a copy of a record of examination to an examinee's lawyer, and a copy of a tape of the examination to the examinee and to their lawyer;
- to allow for a compelled answer by an accused to be available for use when the person has contradicted it at his or her trial;
- to allow the ASC to accept legally enforceable undertakings in relation to compliance with national scheme laws and matters over which the ASC has jurisdiction;
- to allow for a management banning order to be sought once it has been established that a person has breached a civil penalty provision, whether or not subsequent criminal proceedings may be pursued; and
- to protect from liability those people who provide investigative assistance or information to the ASC on a voluntary basis.

Effective enforcement is a key focus of market regulation

5.1. Enforcement is the mechanism by which market abuses are detected and remedied. If a financial market regulator does not possess an effective enforcement capability, it must rely on industry goodwill to ensure that proper standards of market conduct are observed. While most industry participants are keen to comply with the law, there will always be a small minority who intentionally or recklessly fail to comply with the law. When consumers suffer loss as a result of these contraventions, public confidence in the industry is affected. Effective enforcement is therefore essential to ensure that public confidence is maintained.

5.2. The importance of effective law enforcement was recently demonstrated in a survey conducted on behalf of the ASC (Appendix 4). This survey showed that the public views enforcement to be the single most important role or function of a corporate and markets regulator.

5.3. It must be stressed that enforcement is not designed to review or "second-guess" the making of legitimate business decisions. Rather, enforcement is designed to ensure honesty and fairness in business. The ASC's enforcement philosophy is based on these principles.

5.4. Effective enforcement involves three stages. First, there is market monitoring which involves considering public complaints and other ongoing assessment activities. Secondly, where it seems that a contravention may have occurred, an investigation may be undertaken to gather evidence to determine whether any enforcement action should be pursued. The third stage which may arise is the bringing of enforcement action, which raises the issue of the enforcement responses available to the regulator.

Market monitoring is designed to promote public confidence

5.5. The market monitoring aspect of the enforcement process is designed to promote public confidence in the financial markets. It does this by seeking to prevent market abuses. The first priority of the ASC is to help business comply with the law. Market monitoring also seeks to detect possible past contraventions of the law, for example, if there is high volume buying or selling immediately prior to a public disclosure of information this may indicate, upon further analysis, some market irregularity.

Enforcement is becoming more complex

5.6. Contraventions of corporate law are frequently committed by means of apparently legitimate and extremely complex commercial arrangements. Many of the arrangements that have been or are under investigation by the ASC are unique, but they often share common characteristics. Some of the typical features include:

- arrangements that are highly structured, and involving hundreds of individual transactions, with professional advisers used at all stages of the arrangements;
- transactions that cross over state and national borders;
- complex corporate structures or groups that have interlinked shareholdings or debts. Some of these may be incorporated or have assets outside Australia, or in jurisdictions which do not have cooperative arrangements with Australia for sharing information, or whose laws impose secrecy obligations which inhibit information gathering;
- the frequent use of "cover-up" strategies, including nominee corporations or trusts, or devices such as blind trusts or bearer shares;
- arrangements involving hundreds of thousands of documents recording a myriad of individual transactions;
- arrangements involving numerous financial or other intermediaries; and
- stakeholders (such as investors, creditors and company officers) whose interests are often in conflict.

5.7. Many business arrangements which utilise these structures are, of course, legitimate and lawful. The point the ASC is making is that these structures and techniques are also employed for illegitimate reasons because they are relatively difficult to investigate.

Investigation powers are essential

5.8. The second stage of enforcement identified in paragraph 5.4 is the investigation which is designed to gather evidence to facilitate recovery of investor funds or other appropriate action. Adequate investigation powers are crucial for the financial market regulator. The regulator must be able to respond quickly by insisting on the production of documents and the ability to examine individuals. Much of the ASC's effectiveness in this area depends on the extensive compulsory information gathering powers that were given to it under the national scheme laws enacted at the beginning of the 1990s. These powers were deliberately constructed as a set of techniques that could successfully be used to investigate matters of the commercial and factual complexity which characterise corporate and market activity in Australia today.

Recommendation

- The ASC recommends that the Inquiry adopt the principle that effective enforcement is a key focus of financial market regulation.

Cooperative arrangements are crucial

5.9. The growing complexity of financial market transactions which often cross international borders means that effective cooperative relationships must be in place between financial market regulators, exchanges and industry bodies. In particular, arrangements must be established so that information which is useful from a market monitoring viewpoint can be shared.

5.10. To assist in the detection of illegal activity which crosses international borders, the ASC has entered into numerous arrangements with international regulators, reflecting its cooperative approach to international enforcement of Australian corporate law.

5.11. The ASC has adopted a cooperative approach because in many cases the extraterritorial operation of the Law is unclear, leaving any unilateral assertion by Australia of extraterritorial jurisdiction open to legal challenge. This approach respects the sovereignty of other countries. It minimises breaches of foreign and international law and maximises the likelihood of foreign authorities both assisting the ASC in enforcing Australian laws and improves the regulation of their own jurisdictions.

5.12. The well-developed international cooperative arrangements which are in place with international regulators are a key component for the effective regulation of the Australian financial markets. The existing arrangements facilitate information-sharing among the world's market regulators and allow common regulatory standards to be developed. These arrangements are manifested in international agreements and informal, but well-developed, relationships between existing financial regulators. These arrangements are likely to assume greater importance in future with increased globalisation of financial market activity. It is vital that these relationships are not adversely affected in the course of re-shaping the financial system regulatory arrangements.

Arrangements with exchanges and industry bodies

5.13. The ASC currently has well developed working relationships with the ASX and SFE.

5.14. The enforcement relationship between the ASC and ASX involves the monitoring of trading by the ASX. Where a breach or potential breach is detected, the ASX prepares a report for the ASC setting out details of the relevant conduct.

5.15. Industry bodies can also play an important role. They possess several advantages in relation to enforcement:

- their real time access to market and industry information;
- their rules are generally more flexible and responsive; and

- their self-interest in retaining what are their core assets, namely the efficiency and integrity of their particular sectors of the financial system.

5.16. However, there are limits on the ability to effectively use industry bodies in enforcement activities:

- their inherent conflicts of interest;
- the limits on the investigative powers available to self-regulatory agencies; and
- the lack of access by self-regulatory agencies to real punitive or criminal sanctions.

5.17. The ASC considers that the best system is one where ultimate responsibility for enforcement rests with a statutory market regulator but with support from industry bodies. The ASC does not consider that it is appropriate for industry bodies to be given full regulatory powers and responsibilities such as have been granted to statutory regulators and other law enforcement bodies. The reasons for this view are:

- the powers granted to statutory regulators, such as the ASC, to gather information and conduct investigations are in themselves extraordinary. Their ambit is dictated by the need for effective regulation but they ought to be viewed as quite exceptional and not to be granted as a matter of course;
- compulsory process (ie used to gather information and evidence) is by its nature intrusive; and those agencies which are permitted to exercise that process are currently and should always be liable to appropriate review and monitoring of their activities and in particular their use of that process; and
- there should be no risk of compromising the use of compulsory processes or powers to conduct investigations or prosecutions. Compromise may occur because of commercial interests or other self-interest.

Recommendation

- The ASC recommends that the financial market regulator should have the ability to enter into effective cooperative relationships with other regulators, exchanges and industry bodies.

Full portfolio of enforcement responses

5.18. There are three basic types of enforcement action available to the financial market regulator responding to market misconduct:

- preservation
- recovery
- prosecution

5.19. Preservative remedies available to the ASC under the Corporations Law include injunctions, receivership and provisional liquidation which are designed to prevent damage or further damage occurring or which seek to preserve the *status quo*. These remedies are usually the easiest and quickest of the three categories of remedy to pursue.

5.20. Recovery includes those remedies that enable a person to recover by court order, either from the wrongdoer or a third party, property of the company or damages. For example, damages may be awarded under s1005 of the Law where a person suffers loss due to misleading or deceptive conduct arising from a dealing in securities.

5.21. Prosecution is the bringing of criminal proceedings which, in the case of allegations of serious corporate wrongdoing under the Law, are conducted by the Director of Public Prosecutions (DPP) after referral of the matter by the ASC. The DPP will determine whether and what charges should be laid and has the conduct of the prosecution, supported by the ASC.

5.22. In addition to these remedies, there are various other administrative remedies which may be pursued. Some of these remedies may be made by the ASC after natural justice hearings, such as stop orders on prospectuses, licence revocations or orders preventing a person from taking part in the management of any company for a specified period. Other remedies may be granted by other bodies such as the Corporations and Securities Panel (which may grant orders that unacceptable circumstances have occurred in relation to a takeover) or the Companies Auditors and Liquidators Disciplinary Board (which may suspend or revoke the right of individuals to practice as auditors or liquidators).

5.23. The ASC recommends that additional administrative remedies which could usefully complement those currently available should be give to the market regulator. In particular, the market regulator should have the same power to accept enforceable undertakings which is currently available to the ACCC. Details of this recommendation and other suggested law reform proposals to complement the enforcement capability of the market regulator are contained in paragraphs 5.28
to 5.52.

5.24. The ASC may decide to lend support to litigation or disciplinary action taken by third parties. This may be done, for example, through the release of records of examinations and related books under s25 of the ASC Law or the release of information pursuant to s127 of the ASC Law.

5.25. It may be seen that the ASC has a wide variety of enforcement options available to it. All are necessary to give the ASC the flexibility it needs to effectively address the broad range of complex financial market conduct which typically arise, and to ensure that regulatory responses are appropriately graded having regard to the seriousness of the conduct in question.

5.26. It is essential that the market regulator possess the capacity to utilise, in a timely manner, a full portfolio of enforcement responses. This enables the regulatory response to be tailored to the particular circumstances. It is essential that the regime for enforcement is not fragmented. A fragmented regime would lead to a reduced capacity for individual regulators to respond quickly and effectively to market misconduct.

5.27. Appendix 16 contains further details of the enforcement options available to the ASC.

Recommendation

- The ASC recommends that the financial market regulator should possess adequate enforcement powers, including a full portfolio of enforcement responses.

Law reform would enhance enforcement effectiveness

5.28. The ASC's experience in conducting investigations and enforcement action indicates that the law should be amended to facilitate appropriate and cost-effective responses to corporate wrongdoing.

Admissibility of written records of examination

5.29. The ASC recommends that the law be amended to expressly provide that written records of examinations conducted by the ASC are admissible in proceedings for alleged contravention of national scheme laws.

5.30. Part 3 Division 9 of the ASC Law sets out a code by which the signed records of examination may be admitted into evidence in proceedings (whether civil or criminal). However, the ASC has experienced difficulty in having written records of examination admitted into evidence in committal hearings in prosecutions because the procedures for the conduct of committals are prescribed by State evidence laws which apply because the prosecutions are conducted in State courts. State evidence laws typically provide for signed statements to be admitted as part of "paper" committals.

5.31. Although ASC examinations are conducted under oath and written records of the examination are signed by the examinee (Part 3 Division 2, ASC Law), because they do not answer the description of a "statement" in State evidence laws, they are not generally admissible in these proceedings. As a result, ASC investigators must reduce transcripts of examination evidence to statement form before they will be admissible in these proceedings. This is duplicative and costly, and is a significant factor in the time taken in investigations before charges can be laid. Having reduced the information to statement form, there is then no compulsion upon the examinee to sign the statement.

5.32. Because committal procedures are defined by State evidence laws, amendment to national scheme laws may not overcome this problem, and amendments may be required to all State evidence laws. An alternative may be for the adoption of Commonwealth evidence laws and procedures in relation to trials for alleged contraventions of national scheme laws.

Uniform evidence laws

5.33. The ASC recommends that the laws of evidence be made uniform throughout Australia.

5.34. The fact that corporate activity in Australia is by its nature complex and often not confined to one state was a primary factor in the decision to introduce the Corporations Law and to administer it under a single body, the ASC.

5.35. Even minor differences in evidence laws can result in long delays in investigations. For example, it is often not possible until the end of an investigation to know in what State jurisdiction a charge may be brought. Even if evidence has been obtained voluntarily in statement form, because the wording of the prescribed signing clause (called a jurat) for each jurisdiction is different, it may be necessary to have a statement signed a number of times with different jurats. Similarly, the lack of uniform laws relating to the admissibility of business records is a source of considerable difficulty for the ASC.

5.36. To the extent that the ASC continues to use voluntary statements, unless uniform evidence laws are adopted by the States, or Commonwealth evidence laws are adopted for trials relating to national scheme laws, these mere procedural requirements will continue to increase on the cost and length of investigations.

Release of records of examinations

5.37. The ASC recommends that it be given express power to provide, subject to conditions imposed by the ASC, a copy of a record of examination to an examinee's lawyer, and a copy of a tape of the examination to the examinee and to their lawyer.

5.38. The ASC considers that the administration of the law would be improved if these powers were to be made express in the ASC Law. The proposed amendments would better recognise the right of the examinee to be represented; and would make express the ASC's right to impose the same conditions on the use of tapes as those which it can impose in relation to the release of transcripts of an examination.

Subsequent use of inconsistent answers

5.39. The ASC recommends that the law be amended to allow for a compelled answer by an accused to be available for use when the person has contradicted it at his or her trial.

5.40. In the UK, s2(8) of the Criminal Justice Act (which applies to UK Serious Fraud Office investigations) provides that a suspect's answers to compulsory questioning can only be used in proceedings for false evidence, or where the individual makes a statement inconsistent with the compelled answer. (Except in those circumstances, the suspect's answers to compulsory questioning cannot be used against them in subsequent criminal proceedings.)

5.41. The ASC supports this approach. At present, a person who lies in an examination conducted under the ASC Law is liable to prosecution under s64 of the ASC Law. However, such actions are not effective in establishing the truth of matters before the court during the trial of the substantive offence.

Enforceable undertakings

5.42. The ASC recommends that the law be amended to allow the ASC to accept legally enforceable undertakings in relation to compliance with national scheme laws and matters over which the ASC has jurisdiction.

5.43. The Trade Practices Act confers upon the ACCC power to accept enforceable written undertakings in connection with matters where the ACCC has a function or power. These undertakings can be withdrawn or varied by consent of the ACCC. Where the ACCC considers that the undertaking has been breached, it can apply to the Court for orders for compliance with the breach, as well as compensatory orders for loss suffered as a result of the breach. This permits the ACCC to allow a graduated response to perceived contraventions of the law, particularly in those cases where there may be ambiguity or market uncertainty in relation to the nature of conduct which contravenes the law.

5.44. The ASC's regulatory and surveillance functions would be considerably enhanced if the ASC, like the ACCC, could accept enforceable undertakings, for example, where a licensed person has failed to provide appropriate advice to its clients (say, by inducing pensioners to enter into negative gearing investment schemes borrowing on the security of their homes). The ASC may think it appropriate in such a case to obtain an undertaking from the licence holder that it would train its staff and give affected investors an opportunity to vary their investments. If the licence holder failed to abide by the undertaking, not only would the ASC have an effective action in relation to revoking the licence of the person, it would also have an action available for the benefit of those who have been affected by the conduct.

5.45. Undertakings enforceable by the ASC were included in the package of legislative reforms that were announced following the Collective Investments Review. However, no law reform has yet eventuated as a result of those proposals.

Wider availability of management disqualification orders

5.46. The ASC recommends that the law be amended to allow for a management banning order to be sought once it has been established that a person has breached a civil penalty provision, whether or not subsequent criminal proceedings may be pursued.

5.47. Currently, if the ASC can establish to the Court that a civil penalty provision (such as breach of directors' duties or insolvent trading) has been contravened, the ASC can apply for the person to be disqualified from management. However, such management disqualification orders cannot be sought if a criminal prosecution arising out of the same conduct will be conducted or is being conducted against the relevant director.

5.48. A person alleged to have contravened a civil penalty provision with fraudulent or dishonest intent may therefore continue to manage corporations until a conviction is recorded and they are therefore banned from management. This may not occur for a considerable period until after the alleged offence was committed. Such a person will typically remain in management longer than a person who contravenes those provisions without such intent.

5.49. The ASC considers that the civil penalty provisions should be amended to allow for a management banning order to be sought once it is established that a person has breached a civil penalty provision, whether or not subsequent criminal proceedings may be pursued. This would satisfy the public policy consideration of ensuring that those unsuitable to manage corporations do not do so, and would recognise that this is a protective measure, rather than a penalty.

Protection for people giving voluntary assistance to the ASC

5.50. The ASC recommends that the law be amended to protect from liability those people who provide investigative assistance or information to the ASC on a voluntary basis.

5.51. Section 92 of the ASC Law currently provides that a person is neither liable to a proceeding, nor subject to a liability, merely because that person has complied, or proposes to comply, with a requirement made under Part 3 of the ASC Law, which is the Part that relates to investigations and information gathering by the ASC.

5.52. Thus, protection is currently available only where assistance is provided pursuant to a formal request. In the ASC's view similar protection from proceedings or liability should be available to those people who provide assistance to the ASC on a voluntary basis. This would foster a more cooperative and less adversarial relationship between the ASC and the commercial community; and would ensure that the ASC is able to secure valuable investigative assistance without the need to resort to the use of its compulsory information gathering powers, which, even if sensitively employed, can be regarded as intrusive

Recommendation

- The ASC recommends amending the law to enhance its enforcement capabilities:
    - to expressly provide that written records of examinations conducted by the ASC are admissible in proceedings for alleged contravention of national scheme laws;
    - so that the laws of evidence are made uniform throughout Australia;
    - to be given express power to provide, subject to conditions imposed by the ASC, a copy of a record of examination to an examinee's lawyer, and a copy of a tape of the examination to the examinee and to their lawyer;
    - to allow for a compelled answer by an accused to be available for use when the person has contradicted it at his or her trial;
    - to allow the ASC to accept legally enforceable undertakings in relation to compliance with national scheme laws and matters over which the ASC has jurisdiction;
    - to allow for a management banning order to be sought once it has been established that a person has breached a civil penalty provision, whether or not subsequent criminal proceedings may be pursued; and

- to protect from liability those people who provide investigative assistance or information to the ASC on a voluntary basis.

CHAPTER SIX

COST-EFFECTIVE REGULATION

SUMMARY

This chapter examines the funding of the regime and discusses some issues relating to an assessment of cost-effectiveness of the current regime. The ASC's revenue structure tends to be derived from smaller entities while regulatory activity is distributed differently. The ASC supports changes to the funding arrangements of the current scheme to better align the source of funds and beneficiaries of regulatory activity.

The ASC also makes the point that current funding arrangements through the budget process result in changes to the ASC budget which are not the result of any regulatory policy changes. The ASC believes that a different funding approach which recognises a user-pay basis but which also insulates the ASC from general budget-driven funding variations should be adopted.

Recommendations

- The ASC recommends:
  - that the regulatory system needs to be adequately funded;
  - that a funding mechanism which insulates the regulator from funding variations unrelated to specific regulatory policy be adopted; and
  - that any new funding mechanism recognise the need to recast the burden of regulatory cost for smaller entities and that revenue sources be better aligned with activity.
- The ASC recommends that the emphasis on cost-effective regulation should be a key principle underlying the regulatory system and that all regulators should have in place appropriate mechanisms for compliance cost and performance assessment.

Focus on cost-effectiveness

6.1. One of the attributes of modern market regulation is the need it to be cost-effective. This means ensuring that the regulatory system is adequately funded to carry out the tasks required and that it has, as a key focus, cost-effectiveness in its standards and operations.

6.2. Regulation brings with it both benefits and costs for the users of financial markets and services. In relation to securities regulation, very little work has been undertaken on cost-benefit assessments in Australia and more work in this area by regulators and others is required. At the same time, care needs to be taken in accepting without question propositions that the cost of regulation is too high, or conclusions drawn from international comparisons in the absence of detailed work in this area. There continue to be methodological problems, difficulties in overseas comparisons because of the different regulatory structures and the importance of taking into account differences in how regulatory systems are funded.

6.3. The ASC considers that:

- appropriate regulation has some significant benefits but it is important to recognise that it also has costs;
- there should be an increased emphasis on cost-effectiveness and performance assessment of the regulatory system;
- the best way of achieving cost-effectiveness is to have cost-effectiveness as a core principle rather than as a mandatory and inflexible requirement. This is because of some of the methodological, cost implications and other difficulties involved; and
- caution needs to be exercised in drawing conclusions about the cost-effectiveness of the current regulatory system from overseas comparisons given the data and other limitations of comparative studies.

Direct costs and funding of regulation

6.4. As a starting point in an examination of cost-effectiveness, it is useful to examine: the current direct costs of the Corporations Law regime; the source of its revenue; and a number of options for how these costs could be funded differently so as to reduce the disproportionate burden on smaller and medium sized enterprises.

6.5. The Committee's Terms of Reference require it to examine and make recommendations which "will provide the best means for funding the direct costs of regulation". It is important that funding of regulation is adequate to undertake the functions the community expects of its regulators. A major problem in the 1980s was that the previous system was not adequately funded to undertake the role required.

6.6. The Corporations and Securities Law Scheme is fully funded by cost recovery from the revenue collected by the ASC. The following table shows the overall costs of the scheme including payments to the States and Territories and other portfolio costs.

CORPORATIONS SCHEME FINANCES

	1994/95	**1995/96**	**1996/97**
OUTLAYS			
ASC	136 538	126 947	127 891
AASB/AARF[1]	658	678	1 452
CALDB[2]	318	318	318
CSP[3]	136	136	136
TOTAL ASC (Bill 1 + Bill 2)	***137 650***	***128 079***	***129 797***
CASAC	754	819	818
Corporations Law Simplification Unit	2 061	2 047	1 557
Business Law Division(BLD)	2 828	2 856	3 473
Dept. (A-G/Treasury) Portfolio Costs	15 043	16 546	16 050
GROSS OUTLAYS	***158 336***	***150 347***	***151 695***
PAYMENTS TO STATES	**122 498**	**126 418**	**131 980**
TOTAL REVENUE COLLECTED BY ASC	**257 594**	**275 471**	**280 160**

6.7. While the present scheme achieves effective cost recovery for the Government, it does not allow the ASC to receive any benefit from this recovery. Moneys allocated to the ASC through the budget process take no direct account of the amount of revenue collected, rather the allocation is made in the general context of the Government's budgetary policy. The effect of this is that any general policy decision to reduce public sector funding has an immediate and direct impact on the ASC. Funding cuts already imposed by the former and present Governments have resulted in staff reductions of the magnitude of 200 people and are likely to require a further reduction in staffing of at least that same number. None of this flows from any policy decision of the Government that the general delivery of corporate regulation in Australia should be reduced.

[1]Australian Accounting Standards Board/Australian Accounting Research Foundation
[2]Companies Auditors and Liquidators Disciplinary Board
[3]Corporations and Securities Panel

6.8. Different jurisdictions fund the regulatory structure in different ways. In the UK the system is funded from fees from authorised intermediaries, while in the US the SEC is funded from a market transaction levy and filing fees. The latter are based on a percentage of the capital raised in the securities offering.

6.9. In contrast, the Corporations Law regulatory scheme is overwhelming funded by payment of an annual return fee by Australian companies. While some large companies pay significant fees because of the large number of subsidiary companies which are part of their corporate operations, the fee for each individual company means that there is a general and relatively even contribution to the cost of administering the Corporations Law regulatory scheme. While listed companies and commercial activity attract higher fees, these fees are by no means proportional to the actual costs of regulating and servicing that activity.

6.10. Numerically, the vast majority of Australian companies are either small businesses, passive investment vehicles or trustees of trusts for taxation purposes. These companies are minor users of business facilitation services, albeit in some individual instances they may involve intensive ASC activity. The following table illustrates the extent to which the ASC's costs are directed at the activities of larger enterprises.

ASC COSTS AND ACTIVITIES

Activity	Approx. Cost	Purpose/benefit	Suggested user-pays objective
Compensation to the states.	$125m	State revenue.	A community benefit provided through services provided by the states.
Information program plus Community response, Infoline, company deregistrations, Information Technology.	$50m	Liquidation, credit reference, small companies, general commerce.	Broad benefit to commerce - therefore distribute the contribution widely.
Executive and ASC corporate costs.	$20m	Liaise with business, markets, governments and international, provide accountability and reporting infrastructure of a public institution.	Community benefit - therefore distribute the contribution widely.
Enforcement activity.	$34m	Protection of community and integrity of the market.	Broad benefit to community through market integrity benefit.
Policy, commercial applications and commercial regulatory programs.	$26m	Financial sectors of business, professional intermediaries, large companies, markets.	Narrower benefit to larger entities and institutions of commerce - therefore aim to improve user-pays element of this segment of costs.

6.11. The propositions within this chart could be open to different interpretations. It serves, however, to illustrate the point that while the ASC's revenue structure is very focused on smaller entities, regulatory activity is distributed differently.

6.12. The clear advantage of a system of funding which identifies a source of revenue which is applied to regulation is to remove that regulator from the vagaries of public sector government policy spending reductions. The experience in Australia, both at Commonwealth and State level, has been that corporate regulatory budgets have been subject to the "swings and roundabouts" approach where funding is increased to take account of a crisis (usually a major company crash or other event requiring extensive investigative resources), and then reduced again when that crisis has passed. Long term planning, recruitment and retention of professional staff, and general morale of staff all suffer in this situation. The ASC accepts, of course, that its funding should be subject to a process of government approval but strongly believes that this would best be accomplished by a scheme where identified revenue collected on a user-pays basis was available to the regulator. It is only by such a funding mechanism that longer term planning for effective regulation can proceed. While the mechanics of such a scheme would require further investigation, the ASC strongly recommends that this form of funding be adopted in principle.

6.13. The ASC also considers that the introduction of forms of user-pay systems in areas such as complex applications for discretionary relief, filing fees based on capital raised and a range of other similar measures could be acceptable to business. There are a number of ASC activities where the principal beneficiaries can be identified, charging is feasible and users can influence, to some extent, their level of usage. It is in these areas that the ASC suggests further examination of user-pay principles.

Recommendation

- The ASC recommends:
  - that the regulatory system needs to be adequately funded;
  - that a funding mechanism which insulates the regulator from funding variations unrelated to specific regulatory policy be adopted; and
  - that any new funding mechanism recognise the need to recast the burden of regulatory cost for smaller entities and that revenue sources be better aligned with activity.

Cost-effectiveness

6.14. The discussion above only examines the direct costs of the corporations regulatory regime and some issues about the distribution of those costs. However, in assessing cost-effectiveness it is necessary to take a somewhat broader view and seek to assess both the direct and indirect costs and benefits of regulation over time.

6.15. The benefits of regulation are difficult to value with any precision so the little work that does exists tends to be directed at the cost side of the equation. Many of the outcomes of regulation are akin to intangible assets such as "brand name" or "reputation" where the benefits arise from:

- greater certainty in private arrangements;
- reduced monitoring and screening costs;
- international reputation of our markets and participants;
- importance of confidence in promoting greater involvement in the market; and
- benefits that flow from mutual recognition by overseas regimes of our standards and requirements for internationally active entities.

6.16. The cost-effectiveness of regulation will be determined by two key elements: first, the actual requirements and standards of regulation; second, how efficiently a given standard and intensity of regulation is actually delivered. Therefore the test is both that "a particular regulation is effective but also that it is effective in an efficient manner and at reasonable costs" (Llewellyn 1996a).

6.17. A comprehensive framework for assessing cost-effectiveness would need to address:

- the criteria for assessing whether the regulatory requirements achieve the outcomes desired;
- the efficiency with which these requirements are delivered and in so doing take into account not merely the direct costs but also the full range of indirect costs and benefits;
- an assessment of the costs and benefits over time rather than as a static exercise and taking into account those costs which would be incurred as part of good business practice in any event;
- in undertaking international comparisons or benchmarking there will be a need to take into account differences in size and structure of the different markets; and
- the actual costs to market users of undertaking cost benefit evaluations.

6.18. The benefits of regulation can be both static welfare gains and dynamic gains from improved competition. Cost can be categorised as institutional, compliance and structural. Institutional costs are the direct costs of the regulatory infrastructure, compliance costs are those imposed on industry and structural costs are the welfare losses due to distortions introduced into competition and innovation (Llewellyn 1996a, pp 23-24).

6.19. The benefits of regulation to the consumer have been summarised as:

> *"◆ the correction of market imperfections and market failure;*
>
> ◆ *the benefits of economies of scale in monitoring and supervision;*
>
> ◆ *the increased confidence in the industry associated with the establishment of minimum standards;*
>
> ◆ *the benefits of increased competition whether these are in the form of lower prices, increased efficiency, more choice, or in any other way competition benefits the consumer;*
>
> ◆ *the development of a culture of compliance within the industry;*
>
> ◆ *through increased competence by suppliers of financial services which can arise through training and competence requirements established by the regulator;*
>
> ◆ *the offering of redress or compensation in the event of regulatory failure; and*
>
> ◆ *through the reduced probability of a financial institution failing.*
>
> *Although these consumer benefits are real they are not easy to quantify. This in itself may distort cost-benefits comparisons because costs are often more easily quantified." (Llewellyn 1996a)*

6.20. Although it is generally accepted that compliance costs are much more significant than the direct costs of regulation, some care needs to be taken in assessing arguments about the compliance costs of regulation imposed upon market participants because:

- it is difficult to disentangle those costs to firms that are the result of regulation (incremental costs) rather than those which would be incurred by firms for good business practice in any event;

- there is a need to distinguish between start up costs (non-recurring) which are incurred once, and are often significant, and recurring costs; and

- the fact that uncertainty, lack of flexibility in regulatory requirements and change itself involves costs for market participants.

6.21. International benchmarking exercises can be useful in assisting judgements about the cost of regulation. The ASC has undertaken some preliminary work in this area which indicates caution needs to be exercised in drawing specific conclusions because:

- the assessment usually only focuses on the direct costs of regulation;

- the difference in coverage and structure of the regimes means that cost allocation between different activities is difficult. For example, the ASC covers functions that in many other jurisdictions are not part of the financial services regime;

- many jurisdictions, such as the US, have both Federal and State regulation in areas such as mutual funds and financial advice that need to be taken into account in any comparisons;

- in most jurisdictions professional bodies and self-regulatory bodies deliver some regulatory services that in other jurisdictions are provided by the statutory regulator; and

- there is a level of minimum fixed costs in establishing a regulatory regime irrespective of the size of the market and this needs to be taken into account in bench-marking against relative market indicators.

Standards of regulation

6.22. The actual standards applicable to the financial markets contained in the Corporations Law are broadly comparable to those that exist in other major jurisdictions (Appendices 13 and 15). In a number of instances Australian standards are less prescriptive than the equivalent requirements overseas. For example, prospectus disclosure in the US and the detailed rule books and reporting requirements for intermediaries in the UK.

6.23. International standards are increasingly important. For example, following the Barings collapse a range of regulatory and industry bodies, such as the Futures Industry Taskforce, promulgated best practice standards for derivatives market regulation. The ASC and exchanges were active contributors to this process and our legislative framework and procedures implemented by the exchanges were well placed to meet these key international regulatory standards. The increasing international nature of our financial market activity means that it is important that Australia's regulation be broadly comparable to generally accepted international standards.

6.24. What little evidence there is on the impact of regulation on the cost of capital or cost of financial services does not support the proposition that the cost of Corporations Law regulation is excessive. The cost of regulation is more likely to be influenced by the tax regime, small size of the market and limited competition in some areas of financial market activity. However, further work needs to be done and there are some aspects of the current regime that could be reviewed.

Cost-effectiveness in delivering these standards of regulation

6.25. The ASC approach is that assessing cost-effectiveness should be a key principle of the regulatory system and that more needs to be done in this area, including by the ASC itself. The ASC is currently examining how best to implement a capacity for such a self-assessment process to complement its other performance review measures noted below. These considerations have two elements. The first is its commitment announced in its 1996/97 Strategic Plan to place greater emphasis on economic input into its policy process. The second, is the creation of a committee drawing on market practitioners and users to assist ongoing assessment of the ASC's regulatory effectiveness of its regulatory programs.

6.26. The ASC has also been examining recent initiatives, such as the establishment of a cost-effectiveness function within the UK FSA regulator, the Securities and Investment Board, and the existence of an Office of Economic Analysis in the SEC in the US. The ASC is looking at what economic and cost-benefit capabilities it needs to complement its other policy and performance review measures.

6.27. The SIB in the UK has established a cost benefit unit and routinely carries out compliance cost reviews for all new proposals and is in the process of conducting a number of "value for money" reviews of regulation. Under the Financial Services Act the SIB is required to:

> *"have satisfactory arrangements for taking account, in framing any provisions which it proposes to make in the exercise of its legislative functions, of the costs to those to whom the provisions would apply in complying with those provisions and in other controls to which they are subject." (Schedule 7, paragraph 2)*

6.28. The other regulatory bodies in the UK have to meet similar requirements in their rule making functions. At a broader government level in the UK a Compliance Cost Assessment is now mandatory for all new policy proposals. A Compliance Cost Assessment is a structured and quantified appraisal of the cost to business of complying with legislative proposals and is designed not as a rigid decision rule but as an aid to judgement as part of the overall information in a decision making process. There are similar developments in other OECD countries and in Australia.

6.29. There have been important developments in regulatory assessment in Australia over the last few years under the auspices of the Council of Australian Governments (COAG) including the development of "Principles and Guidelines for National Standards Setting and Regulatory Action" (Industry Commission 1995).

6.30. The ASC does have some reservations about imposing further specific requirements, for mandatory cost-benefit assessment in the financial services area. The ASC is concerned that such a requirement will result in a more inflexible, time consuming regulatory policy development processes. There will also be issues about what regulatory requirements should be covered, including whether any such obligation would apply to ASX and SFE rule making activities (for example, the ASX listing rules are a major source of the regulation of listed companies) or to the activities of other professional bodies in the financial markets. While apparently attractive in principle, an additional requirement for a mandatory cost-benefit assessment for any new regulatory initiative would have considerable disadvantages:

- there remain considerable outstanding and difficult methodological issues in conducting a cost-benefit of financial regulation, especially in relation to the ability to value the benefits;

- experience in other jurisdictions indicates that this requirement can end up as a mere procedural step in the policy process rather than making a real contribution to regulatory assessment; and

- such activity is in itself costly and time consuming and those costs would be borne by market participants in a number of ways including: speed at which regulation can be introduced to respond to market developments; diversion of resources from other activities including business facilitation and enforcement; and direct costs of responding to survey and other work. The last is somewhat ironic in that the methodologies of assessing compliance costs will be a cost to market participants.

6.31. The ASC does recommend that the emphasis on cost-effective regulation should be a key principle underlying the regulatory system and that all regulators should have in place appropriate mechanisms for compliance cost and performance assessment. In the case of the ASC, we propose to complement our current efforts of performance assessment by adding an economic analysis capability in our policy work and to develop market practitioner and user input into the systematic review of the regulatory effectiveness of our major regulatory programs.

Recommendation

- The ASC recommends that the emphasis on cost-effective regulation should be a key principle underlying the regulatory system and that all regulators should have in place appropriate mechanisms for compliance cost and performance assessment.

ASC approach to performance assessment

6.32. The ASC's current monitoring of its own performance and effectiveness has three elements:

- a resource model based on activity levels;
- efficiency measures for key program activities; and
- a detailed benchmarking survey of major ASC stakeholders.

Resourcing model

6.33. Over the last two years the ASC has implemented a resourcing model to assist allocation of resources on a regional and activity basis. The model was developed arising from a detailed strategic review of ASC activities which identified that the ASC needed to improve:

- the alignment between resourcing decisions and the business planning process;
- the flexibility of deployment of resources; and
- the consistency of application of resources.

6.34. The ASC's initial resource distribution was inherited from the previous cooperative scheme and reflected the differences of local workload, community standards and state government priorities emerging out of that scheme. Since that time, market activity in different centres has continued to evolve and the workload has changed because of the removal under, a national ASC, of the requirement to lodge documents in the jurisdiction in which a company was incorporated.

6.35. A resource model was constructed to assist a more rational process for allocating resources across programs and geographical locations throughout Australia. The process of resource review is intended to improve delivery of ASC services to the community through more consistent outcomes, greater flexibility and more rapid responses to changes in the market.

6.36. The resource model was constructed by initially comparing actual resourcing levels for each program across regions. This was used to develop notional resourcing levels for 1995/96 for each program and region based on workload and regional population figures used as activity proxies for each program. The resource model is subject to continual updating and review. It is intended to be a key tool for consistently allocating resources so that national programs and services can be efficiently delivered throughout Australia.

Efficiency measures

6.37. The ASC uses a range of measures to assess whether key activities are meeting efficiency performance targets. In the major regulatory programs these key efficiency indicators are reported against on a monthly basis (Appendix 3).

6.38. The ASC has identified in its current business planning process that these efficiency measures need to be complemented by better performance outcome measures for its key programs. These measures would assess the impact of the programs on regulatory outcomes in the market place. One way in which the ASC has sought to assess its overall performance has been through an extensive benchmarking survey of its stakeholders about its major activities.

ASC stakeholder survey

6.39. The ASC conducted market research in 1994 and 1996 to track customer satisfaction with the performance of the ASC as a regulator. The research provides information about stakeholder satisfaction with:

- ASC processes in the development of policy and handling of applications; and
- ASC's role in enforcing appropriate disclosure to the market and in improving market and corporate behaviour.

6.40. The benchmarking survey in 1996 involved in-depth interviews with 22 professionals from a variety of professions which interact with the ASC in its various programs. There was also a quantitative component involving a sample of 571 professionals from all states and territories using a telephone administered questionnaire. The tracking survey enables the ASC to assess the views of key market participants on issues such as the priorities for its programs and perceptions of how well these are being delivered. The 1996 survey, for example, highlighted the importance placed on the enforcement side of ASC activities and perceptions that the ASC needed to continue to devote significant effort to this activity.

6.41. The market research findings provide the basis for the ASC's key performance targets contained in its 1997 Strategic Plan (Appendix 1). The 1996 research findings are summarised at Appendix 4 while ASC efficiency indicators for 1996/97 are contained in Appendix 3.

CHAPTER SEVEN

PRODUCT DISCLOSURE

SUMMARY

The current point-of-sale disclosure obligations differ significantly according to the nature of the investment product. This confuses investors and imposes unnecessary costs on issuers who issue products under more than one disclosure regime.

It is vital that retail investors be supplied with clear, comprehensible disclosure in a form which enables retail investors to assess and compare different investments. This is particularly important in an era likely to:

- herald an increase in direct marketing of investment products;
- lead to more product blurring; and
- lead to greater involvement by retail investors in investment markets.

To promote this objective, the ASC recommends that a consistent, mandatory disclosure obligation designed to provide information specifically for retail investors should apply in relation to all investment products.

Recommendations

- The ASC recommends that a consistent, mandatory disclosure obligation should apply to all investment products offered to retail investors.
- A disclosure regime should be introduced which focuses on the desired outcomes of disclosure and on the effectiveness of disclosure documents in communicating the desired information, not merely on prescribing the technical matters to be contained in product selling documents.

Overview of the current regulation of product disclosure

The regulation of the product disclosure differs significantly according to the nature of the investment product

7.1. The current regulation of product disclosure varies according to whether the investment product is:

- a security regulated by the ASC under the Corporations Law - this includes shares, debentures and prescribed interests such as public unit trusts (note that the definition of "debenture" excludes bank deposits or other debentures issued in the ordinary course of banking business. Other bank deposit liabilities are also effectively excluded from Corporations Law regulation by ASC action - refer to ASC Policy Statement 68);
- superannuation or life insurance products, regulated by the ISC; and
- bank deposits, regulated by the Australian Bankers' Association's Banking Code of Practice.

7.2. Appendix 11 provides a detailed picture of how product disclosure are currently regulated. The following table provides a brief overview of point of sale disclosure requirements:

	Securities - ASC	Life Insurance	Superannuation	Bank Deposits
Regulator of product	ASC	ISC	ISC	RBA
Source of disclosure obligation	Section 1022 of the Corporations Law for new issues.	Life Circular G11.	ISC Determination under s153(4) of the *Superannuation Industry (Supervision) Act 1993*.	ABA Code of Practice.
Content of disclosure obligation	The prospectus must contain all the information investors and their advisers would reasonably expect to find in the prospectus about: ◆ the financial position and prospectus of the issuer; and ◆ the rights attaching to the securities.	A key features statement must be prepared which is no more than six pages in length and contains prescribed information.	A key features statement must be prepared which is no more than six pages in length and contains prescribed information.	Specified matters must be disclosed including: ◆ fees and charges; ◆ method by which interest is calculated and the frequency of payment.

7.3. It can be seen from this table that for securities (including unit trusts) there is a prescribed outcomes approach to initial point-of-sale disclosure with the primary onus falling on the issuer to determine and satisfy the informational needs of investors. For life insurance products and superannuation there is greater emphasis on a prescribed content approach to disclosure. These point-of-sale disclosure requirements apply to new issues of securities only - for sales of existing listed securities the disclosures provided to the ASX which are then reflected in the market price act as a substitute for point-of-sale disclosure.

7.4. It is important to bear in mind that the broad disclosure obligation has been part of Australian securities law only since 1991. Before that time, the previous regulator - the National Companies and Securities Commission (NCSC) - administered a regime under which a prescribed content approach applied. Under that earlier regime, the NCSC was required to check that a prospectus complied with the law before it could be issued. The NCSC spent considerable time checking whether prospectuses complied with the checklists contained in the relevant legislation. This pre-vetting process often caused delay for issuers wishing to raise funds from the public. Under the current regime, however, the primary onus falls on issuers to assess the informational needs of investors. The ASC is not required to undertake detailed checks before a prospectus may be issued, but it does have more flexibility to post-vet prospectuses and to take appropriate action (such as requiring a supplementary prospectus to be issued) where the information in the prospectus is deficient.

Problems with the current regulation of product disclosure

Retail investors should be supplied with clear and comprehensible information to enable product comparisons to be made

7.5. There are several problems which arise from the present inconsistency in regulation of product disclosure:

- ***Investor confusion*** - the differences between the requirements under the various disclosure regimes may lead to investor confusion: in an era likely to herald an increase in direct marketing of investment products, more product blurring and greater assumption of investment risk by retail investors, it is vital that investors be supplied with clear and comprehensible information in a form which enables retail investors to assess the respective merits of different investments. Investors may find it difficult to compare the relative merits of like investment products if they are not subject to a consistent regulatory regime. The ability of investors and advisers to compare investment products is important in order to facilitate fair competition.

- ***Unnecessary costs*** - the differences between the requirements under the various disclosure regimes impose unnecessary costs on issuers who issue products under more than one disclosure regime. Where one of two or more sets of regulations potentially applies to a given financial product, there is a legal cost in determining which set of regulations actually applies. Further, where a market participant wishes to offer two products which are subject to different regulatory regimes, the participant must establish two regulatory compliance systems. The complexity involved in having two or more potential regulatory systems for products which compete against each other for funds can also affect the ability of companies to respond quickly and efficiently to market developments.

- ***Competitive inequality*** - the costs associated with complying with different disclosure standards may be different, leading to competitive inequality.

7.6. Apart from the issue of regulatory inconsistency, the ASC is concerned that many prospectuses and other product selling documents are very long and complicated, and that retail investors have difficulty understanding them. There may be various reasons why this is the case - for example, the current prospectus requirements lead to the document being a communication document for both investors and advisers as well as a legal defence document, an educational document and a selling document. The ASC strongly believes that any proposed regime for product sales practices should address this issue.

A suggested model for the future regulation of product disclosure

7.7. There are four issues to consider in formulating a proposal about initial point of sale disclosure:

- What is the purpose of disclosure for retail investors?

- Is it necessary to impose a *mandatory* disclosure obligation upon product issuers in order to achieve this purpose?

- Is it necessary to impose a *consistent* disclosure obligation for retail investors in relation to all investment products? If not, how can comprehensible and comparable disclosure be provided to retail investors?

- If there should be a consistent, mandatory disclosure obligation, how should it be formulated?

The purpose of disclosure is to allow informed investment decisions to be made by retail investors

7.8. The ultimate purpose of point of sale disclosure obligation for retail investors is two-fold - to protect investors and to promote market efficiency. Disclosure protects retail investors by enabling them to make informed and rational investment decisions. Further, disclosure promotes market efficiency by promoting investor confidence and ensuring the efficient allocation of capital amongst fundraisers.

7.9. The ASC does not consider that the disclosure regime should be designed to eliminate investment risk - its sole concern should be to ensure that the investment risk is fully disclosed.

7.10. Reliance on disclosure as a means of investor protection also has a long history. In a comment on English legislation passed in 1844 William Gladstone said "... publicity is all that is necessary. Show up the roguery and it is harmless." Seventy years later in the US, this sentiment was echoed by Louis Brandeis, who said that "sunlight is said to be the best of disinfectants; electric light the most efficient policeman". The assumption is that frauds cannot stand sunlight and will not occur if full disclosure is required, but an offering that is not fraudulent ought to be permitted, even if it is highly speculative.

7.11. Although disclosure is a key regulatory tool, it must be borne in mind that there can be limits upon its usefulness. Retail investors may have difficulty understanding the information provided to them and may have difficulty comparing the information provided by one product issuer with the information provided by other issuers. In any event, the ASC would strongly maintain that disclosure of investment risk is not a substitute for adequate prudential or market regulation.

Mandatory disclosure is required because retail investors cannot demand the information they need

7.12. There is an issue as to whether mandatory disclosure is necessary or whether *caveat emptor* should apply to investment product purchases by retail investors. The ASC strongly believes that a mandatory disclosure obligation is essential where products are being offered to retail investors.

7.13. If the law did not impose a mandatory disclosure obligation, individual retail investors would need to separately conduct their own inquiries to determine the investment risks and suitability of various investment products unless all issuers voluntarily disclosed all the information required by investors. Retail investors are unlikely to have the knowledge or bargaining power to demand the information they need to make an informed investment decision. An informationally-asymmetric market would be likely to result under which sophisticated investors would be information-rich while retail investors would be information-poor. The need for mandatory disclosure is likely to become even more important in future with a likely increase in direct marketing of investment products and greater involvement of retail investors in investment markets.

7.14. The absence of a mandatory disclosure obligation for retail investors would be inconsistent with the approach taken in key overseas jurisdictions.

7.15. On the other hand, wholesale or sophisticated investors are able to demand the information they need to make investment decisions. Accordingly, a mandatory disclosure obligation should not apply in relation to offers made to wholesale or sophisticated investors.

A consistent disclosure obligation should apply to all investment product issuers

7.16. To enable investors to assess and compare the respective merits of a wide range of various investment products, the ASC considers that a consistent, mandatory disclosure obligation should apply to all investment products offered to retail investors, including bank deposits, finance company debentures, superannuation, life insurance and friendly society bonds, public unit trusts, investment company shares, various agricultural and tax-driven investment schemes, ordinary company shares and ordinary company debentures. The ASC is not suggesting that this disclosure regime would necessarily be appropriate for derivative products (such as warrants, futures or options) or pure risk-related products (such as death, disability, health or general insurance).

7.17. The ASC does not consider that a consistent disclosure obligation for investment products would necessarily need to be monitored by a single regulator. Rather, the consistent disclosure regime could be administered by whichever regulator was responsible for regulating the underlying investment product.

7.18. In any event, even if this recommendation is not adopted, the ASC considers that there are likely to be considerable benefits if a consistent, mandatory disclosure regime is applied in relation to all investment-linked managed fund products. This would be consistent with the approach of IMRO and PIA in relation to life products and collective investments.

7.19. The imposition of a consistent disclosure standard would be broadly consistent with the approach recently enacted in New Zealand whereby a consistent regulatory approach regarding point of sale disclosure and prospectus disclosure is to commence in 1997 for all investment products (although note that there are certain exemptions - some bank products such as term deposits and cheque accounts).

Recommendation

- The ASC recommends that a consistent, mandatory disclosure obligation should apply to all investment products offered to retail investors.

Consider whether it is practically feasible to formulate a general disclosure standard

7.20. It will be necessary to consider whether a general disclosure test applying to all investment products would be a practical mechanism for achieving the objective of providing useful and comparable information to retail investors.

7.21. A disclosure regime should be considered which focuses on the desired outcomes of disclosure and on the effectiveness of disclosure documents in communicating the desired information, not merely on prescribing the technical matters to be contained in product selling documents. Under this suggestion, the disclosure obligation would require the product issuer to provide clear, comprehensible and comparable information in a format which enables an informed investment decision to be made by retail investors. The disclosure obligation would specify key outcomes of disclosure.

Five outcomes of disclosure

7.22. The outcomes of disclosure would enable the investor to understand at least the following matters:

- the investment risks associated with the investment product;
- the rights attaching to the investment product;
- the consideration payable by investors, including fees and charges;
- the extent to which public or private insurance or guarantee arrangements are in place (in the case of capital-backed products); and
- the nature of the disclosure document. The document should enable investors to understand that it is a selling document, and does not involve a recommendation that the product is suitable for the investor's particular needs or objectives.

Outcome-orientated disclosure

7.23. The ASC considers that a focus on prescribing outcomes of disclosure is more appropriate than attempting to prescribe detailed content requirements for product selling documents. The reason for this is that it is very difficult for the legislature or regulator to prescribe in detail the information needs of investors in relation to particular financial products, particularly in an era of rapid product innovation and product blurring. Every product has different features or risks, and so it is not feasible to prescribe content requirements in detail. A general outcome-orientated approach permits new products to be marketed without the need for the legislature or regulator to first determine the detailed offer document content requirements for that product.

7.24. Under an outcome-orientated approach, the issuer must determine the information needs of consumers, both in terms of content and presentation (Sless 1996). Clearly they will not be the same in all cases. Thus, applying the suggested disclosure model to bank deposits, it is likely that very little would need to be disclosed about investment risk other than the nature of the insurance or guarantee arrangements. Information about rights and fees would also need to be disclosed, but these are already covered under the Code of Practice. For investment-linked products, however, far more disclosure would typically be required, particularly about investment risks. For small-scale fundraising ventures where the potential investors already possess some knowledge of the particular business venture, less disclosure would be required than for a large business venture seeking to attract investors with little or no knowledge of the business venture.

7.25. The precise information needs of an investor may also vary according to whether the investor is a new investor or a repeat investor (ie an investor adding to or changing his or her investment with a particular fund manager). In the case of repeat investors, it may be efficient and desirable for the information to be delivered otherwise than in the normal prospectus offer document format. At present the ASC is working on a project to seek to tailor the prospectus requirements to suit the information needs of repeat investors. This emphasises the importance of ensuring that the disclosure regulators retain sufficient flexibility to enable information delivery obligations to be tailored to particular circumstances.

7.26. The prescribed-outcomes approach emphasises the importance of effective communication of information. Given the development of alternative mechanisms for information dissemination, such as Internet, it will gradually become more important for document presentation to be tailored to the particular communication medium and the particular needs of the audience likely to be using that medium.

7.27. ***User-testing***: Issuers should be encouraged to conduct actual user-testing of point of sale disclosure documents to ensure that they actually satisfy consumer informational demands. The ASC considers that this is likely to be the most effective way of ensuring that disclosure documents meet the actual informational needs of investors. Thus, for example, assuming investors' needs include the ability to readily compare like investment products with each other, this will be reflected in the user-testing feedback. The ASC is currently discussing the possibility of a project with the IFA that may result in applying this approach to managed fund prospectuses. User-testing should result in the dissemination of disclosure documents which are tailored to the needs of investors, which is essential if investors are to make more complex investment decisions in the future.

Further analysis is required before implementing this proposal

7.28. The ASC is not recommending that a general disclosure test applying to all investment products should be implemented without further analysis of several issues, namely:

- whether it is feasible to formulate a general disclosure test to cover all investment products;
- whether there are better ways of achieving comprehensible and comparable product disclosure - in this regard, the solutions being pursued in overseas jurisdictions should be considered; and
- the costs and benefits of imposing a consistent disclosure obligation upon all investment product issuers.

7.29. The general disclosure test approach is not entirely consistent with the approach being taken in overseas jurisdictions. Thus, while New Zealand is about to review its prescriptive disclosure test for prospectuses, it is also about to allow investment decisions to be made on the basis of short, relatively-prescriptive documents. Prescriptive disclosure is also in force or being considered in the UK, USA and Canada. Prescriptive disclosure is being considered in these jurisdictions largely as a means of facilitating comparability between disclosure documents. The ASC considers that comparability is most likely to be efficiently and effectively achieved through the specification of relatively broad outcomes of disclosure (in paragraph 7.22 the ASC suggests that there are at least five such outcomes) coupled with user-testing of disclosure documents.

7.30. Finally, it should be noted that the above discussion relates solely to the informational needs of retail investors only. How the informational needs of advisers should be satisfied will need to be considered. It may be that the informational needs of advisers who provide advice about securities can continue to be satisfied via the Corporations Law prospectus obligation.

Recommendation

- A disclosure regime should be considered which focuses on the desired outcomes of disclosure and on the effectiveness of disclosure documents in communicating the desired information, not merely on prescribing the technical matters to be contained in product selling documents.

CHAPTER EIGHT

FINANCIAL ADVISORY SERVICES

SUMMARY

The present regulation of financial advisory services remains, in some areas, fragmented and inconsistent. A single regime which provides consistent regulation of financial advisory services would overcome these problems.

Accordingly, the ASC considers that there should be a single regime administered by a single regulator for all financial advisory services. This should be based on the Corporations Law and the recommendations contained in the ASC's Good Advice Report. While these proposals are currently being pursued as far as practicable through cooperative arrangements between the ASC and ISC, a single regime would allow the proposals to be implemented in a more efficient and cost-effective manner.

An efficient consumer complaints resolution system is an essential element of effectively regulating financial advisory services. The ASC considers that the regulator of financial advisory services should work closely with the current schemes, assessing opportunities for rationalisation, encouraging consistent coverage across all financial advisory services and promoting the development of a complaints clearing house service.

The ASC supports the continuation of an active role for industry and professional bodies (such as the ASX and the Financial Planning Association) in regulating financial advisory services. The ASC also supports the recognition in the law of the regulator's ability to delegate, under supervision, to such bodies. However, the ASC has reservations about making any further formal delegation of regulatory powers at this stage.

Recommendations

- The ASC recommends that there should be a single regime administered by a single regulator for all financial advisory services. The content of regulation should be based on the Corporations Law and the proposals in the ASC's Good Advice Report.

- The ASC recommends that there should be consistent coverage of consumer complaints against financial advisory services. The ASC recommends that the regulator should work closely with current schemes to identify opportunities for rationalisation, encourage consistent coverage across all financial advisory services and promote the development of a complaints clearing house service.

- The ASC recommends that the Law should recognise the capacity of the regulator to delegate functions to industry and professional bodies. This recognition should be combined with appropriate powers to establish performance standards for the delivery of these regulatory functions.

- The ASC recommends that the regulator should have the legal capacity to play an active role in developing, formulating, and monitoring compliance with codes of practice in a wide range of areas which are relevant to retail consumers of financial services.

Current market trends

8.1. Changes in investor needs and structural changes in the markets are having a major impact on providing financial services. Some significant aspects of these changes were identified in the process of developing the ASC's Good Advice proposals.

8.2. Investor needs and sentiments have changed because of:

- the increased number of persons seeking suitable investments for their savings/retrenchment packages;
- a higher awareness of the need to provide for one's own retirement income (following government policy direction to reduce government funding for retirement);
- well publicised large privatisations and mutualisations attracting retail investors to investment markets;
- the increased public perception that financial markets and products have become more complex and innovative due to competition; and
- the consumers' demand for "value for money" in products and services offered to them.

8.3. Intense competition following deregulation of financial markets has resulted in:

- changes in the distribution channels of investment products. In particular, a move away from a "trading oriented" sales agent role to a "relationship oriented" adviser role that enables advisers to have some ownership/ control of the client. There is also a move away from commission based to a fee based operation;
- emergence of alternative financial products, services and strategies which straddle traditional product/institutional boundaries. For example, products which have mixed characteristics of bank deposits and superannuation (RSAs); and
- emergence of financial conglomerates which provide different types of services and products under a single brand name.

Current regulation of financial advisory services

How are the financial advisory services currently regulated?

8.4. Under the current regulatory structure, different levels of regulation occur depending on the type of product involved and who provides the advice. The two key regulatory regimes that regulate provision of advisory services are:

- advice on company shares, debentures, prescribed interests (including superannuation interests) and futures contracts which are regulated by the ASC under the Corporations Law (Corporations Law regime); and

- advice on life insurance products (both risk and investment) which are regulated by the regulatory requirements administered by the ISC including the Life Code of Practice (ISC regime).

8.5. There is no comparable regulation of financial advisory services offered in relation to:

- non-financial assets (eg investments in real estate and business);

- deposits in banks and non-bank financial institutions regulated by RBA and AFIC (note the Banking Code of Conduct relates to product issuer disclosure rather than advisory requirements); and

- general insurance products.

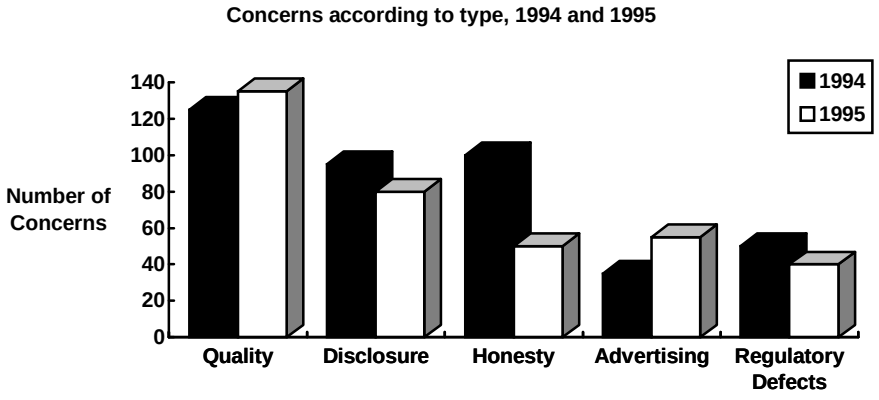
Current Regulation of Financial Advisory Services							
Regulatory Requirement	**Securities Advice**	**Super. Advice**	**Futures Advice**	**Life Ins. Advice**	**General Ins. Advice**	**Bank/ AFIC Product Advice**	**Negative Gearing Advice**
Licensing of principals based on educational qualifications/ experience/ integrity	✓ Dealers and Invest. advisers	✓	✓ Futures brokers and futures advisers	✓ Only life brokers	x	x	x
Suitability test (know-your-client and product research)	✓	✓	x	✓	x	x	x
Disclosure of conflicts of interest	✓	✓	x	✓	x	x	x
Risk disclosure	Proposed	Proposed	✓	x	x	x	x
Enforcement through administrative sanctions (banning)	✓	✓	✓	Partial	x	x	x
Civil and criminal sanctions	✓	✓	✓	✓	✓	x	x
Surveillance & investigations	✓ ASC	✓ ASC/ISC	✓ ASC	✓ ISC	✓ ISC	x	x
Reporting to the regulator	✓ ASC	✓ ASC/ISC	✓ ASC	✓ ISC	✓ ISC	x	x
Complaints resolution schemes	Limited	✓	Limited	✓	✓	ABO for banking services	x

8.6. There is further fragmentation of the regulation of financial advisory service providers depending on their membership of different professional or industry bodies such as the ASX, FPA, Sydney Futures Exchange (SFE) or accounting professional bodies such as the Institute of Chartered Accountants (ICA) and the Australian Society of Certified Practising Accountants (ASCPA). (Accountants and lawyers in public practice can provide investment advice on securities without a licence if such advice is incidental to the practice of their main profession.) However, currently only some of these professional bodies have requirements that directly focus on the activities of their members in the provision of financial advisory services.

Current developments

8.7. The ASC conducted a review of investment advice on securities in early 1994 because of concerns about poor sales practices and poor quality investment advisory services available in the market. In particular, the ASC had been receiving complaints from investors about inappropriate products recommended to them.

8.8. The ASC's latest review of its data clearly indicates that poor sales practices and poor quality investment advisory services (as evidenced by concerns relating to quality of advice and disclosure of conflicts of interests) continue to be a problem for investors.



Concerns are external complaints from investors and other industry participants

8.9. Poor sales practices in life insurance led to the Trade Practices Commission's review of the life insurance industry in 1992. Similar concerns about poor sales practices and quality of advice are evident in a number of other jurisdictions where extensive studies have been undertaken. For example, the UK's Pension Review (in 1992) arose out of concerns about the misselling of pension products and led to major changes in pension regulation. Similarly, the SEC's Joint Regulatory Sales Practice Sweep Report (1995) identified sales practice abuses by registered representatives and inadequate hiring, retention and supervisory practices of the principal firms that failed to prevent those abuses. These findings have led to more stringent compliance standards and enforcement measures by the SEC.

8.10. The ASC and ISC have recently embarked on a joint exercise which has led to significant harmonisation of current requirements. The changes proposed include consistency in the following areas:

- entry controls based on specified integrity and minimum competency standards when granting licences/registering life brokers;

- minimum advisory competencies for persons who provide advisory services relating to securities, superannuation and life insurance products in a representative/agent capacity (through obligations imposed on principals to comply with these standards); and

- advisory processes for persons who provide advisory services in relation to securities, superannuation and life insurance products (such as the disclosure of the identity of the principal, know-your-client and product research requirements).

8.11. However, there remains a number of differences between the two regimes which can be addressed only through law reform:

- persons providing financial advisory services relating to securities (including superannuation) and futures are regulated by the ASC through a statutory licensing regime. Persons providing financial advisory services relating to life insurance products are regulated by the ISC through a voluntary code (ie the Life Code of Practice). This results in differences in enforcement options under the two regimes;

- the ISC requirements (including those in the Life Code) do not include some key aspects of the Corporations Law regime. For example, the ISC does not currently require disclosure of conflicts of interests of the adviser; and

- a corporate entity can be a life agent but only a natural person can act as a representative of a Corporations Law licensee. Further, a life agent's duties are primarily to the life company but under the Corporations Law, a representative has direct obligations to the client (eg disclosure of conflicts of interests and know-your-client obligations under s849 and s851 of the Corporations Law).

Problems with the current regulation of financial advisory services

8.12. Several problems arise from the inconsistency of regulation of financial advisory services:

- ***Competitive inequality*** - Currently advisory regulation is confined to securities, futures and life insurance products. Financial advisory services offered in relation to a number of other products such as bank products and negative gearing advice relating to real estate and similar investments are not subject to regulation.

- ***Unnecessary costs*** - The inconsistencies between the ASC and ISC regimes and the presence of two regulators result in:

- unnecessary compliance costs to the industry participants (eg duplication of filing and other liaison costs);
- unnecessary administration costs to the regulators and therefore to the public (eg establishment costs and administration costs); and
- investor confusion.

Future regulation of financial advisory services

Why do financial advisory services to retail investors need regulation?

8.13. There are a number of reasons why financial advisory services need regulating:

- ***The lack of transparency of quality of service at the point of sale*** - The outcome of the financial transaction made on the basis of the advice only becomes evident after receiving the advice. Therefore, it is difficult for consumers to clearly ascertain the quality of the advisory service at the point of its purchase. The ASC's recent data indicate that there are significant concerns about poor quality advice.
- ***The difficulties in assessing quality of advice*** - It is not easy for retail consumers to obtain and assess information that determines the quality of the financial advisory service, such as the qualifications, experience and track record of advisers. Therefore, retail consumers often rely on proxies which may not always reflect a well researched position. The investor survey conducted by the ASC through Chant Link Association (June 1995) revealed that investors often relied only on recommendations from family friends in selecting financial advisers.
- ***Economies of scale*** - If each consumer investigated the competencies and integrity of advisers, it would involve a waste of resources.
- ***The lack of information in the markets about new products and services*** - The risks of new products and services may not become apparent to consumers because of their complexity and also the lack of information about such products.
- ***Competition leading to cost reductions that compromise the quality of advisory services*** - Market pressures can act as an incentive for service providers to cut costs in areas which are not readily observable by the consumer. For instance, expenditure on training staff and research resources can be reduced without the effects of such reductions being easily discernible by the markets and consumers for a significant time.

Single regime for regulating financial advisory services

8.14. A functional approach to regulating financial advisory services would achieve the following regulatory goals:

- ***regulating consistently*** across products or institutions in an environment where product and institutional boundaries are blurring;
- ***providing flexibility*** to accommodate differences which arise different types of service providers and consumers; and
- ***promoting commercial certainty*** to market participants and clarity to consumers about the boundaries of financial advice regulation.

8.15. Financial advisory services should be regulated where:

- the advisory service is offered or held out as enabling a user of such services to make a well informed decision on a financial transaction;
- it is difficult for the consumers to assess the quality of advice at the point of sale of the advisory service because of the long term nature of the contract involved or the absence of an immediate transfer of a tangible asset following the transaction; and
- the consumer is a retail investor and therefore does not have the necessary resources and expertise (as a sophisticated/wholesale investor does) to assess the quality of service before acting on reliance of the advice.

8.16. Therefore, the ASC recommends that financial advisory regulation should:

- encompass regulation of advice provided or held out as enabling a consumer to make a well informed decision about financial transactions involving securities, futures, superannuation, life insurance or deposits or deposit like bank/financial institution and other investment products;
- apply independently of any associated service. For example, advisory services offered by a fund manager should attract advisory regulation independent of its fund management activities;
- be sufficiently flexible to enable the regulator to:
  - modify and amend the application of the regulatory requirements to different classes of consumers such as sophisticated investors or different types of advisory services offered, such as general advice given in the media; and
  - bring within the regulatory regime new or different types of advisory services and products which need similar regulation.

8.17. Such a single regime for regulating financial advisory services can be administered more effectively by a single regulator than multiple regulators. A single regime maximises economies of scale in regulation and promotes a uniform approach to regulation which reduces unnecessary costs of compliance to industry participants.

Recommendation

- The ASC recommends that there should be a single regime administered by a single regulator for all financial advisory services. The content of regulation should be based on the Corporations Law and the proposals in the ASC's Good Advice Report.

Regulatory techniques

8.18. The following table identifies the appropriate techniques for regulating financial advisory services.

Risk	Appropriate Regulatory Tools
Incompetence and/or lack of integrity of adviser.	Entry controls based on minimum competency/fit and proper person tests and on-going monitoring.
Insufficient information.	Disclosure of information such as conflicts of interests, identity of the service provider, how fees are charged.
Inappropriate advice.	Conduct of business standards (ie know-your-client/suitability test) and monitoring.
Inadequate consumer redress.	Effective civil remedies and requirements for internal and external complaints resolution mechanisms.
Breaches of standards/fraud.	Monitoring and surveillance, swift enforcement action including criminal sanctions (Llewellyn 1996a).

8.19. The ASC considers that the Corporations Law provides the appropriate model for regulating financial advisory services. It has the following key elements:

- the licensing of *principals* based on their integrity and the ability to operate with adequate levels of competency and resources (eg computer and research facilities) when providing financial advisory services;
- the Conduct of Business Rules which apply to recommendations on securities. The obligations include the disclosure of conflicts of interests of the adviser and a requirement to have a reasonable basis for the securities recommendations (ie the know-your-client/suitability test); and
- the enforcement powers of the ASC to ensure appropriate compliance on a continuing basis.

8.20. There are, however, some inadequacies in the Corporations Law which should be addressed in the proposed regime. These include:

- the lack of an exemption and modification power in the provisions relating to investment advice which reduces the flexibility to tailor regulation to accommodate differences in consumer needs and changes in products and practices in the market;
- the absence of quick enforcement options, such as fining powers.

8.21. A regulatory regime for financial advisory services based on the Corporations Law model compares very favourably with the regulatory standards that apply to advisory services in major overseas jurisdictions (Appendix 13).

8.22. Further, there are significant administrative advantages in promoting a regulatory regime for financial advisory services based on the Corporations Law as a significant portion of the financial advisory market is already subject to the Corporations Law regime.

Advisers regulated under the Corporations Law	Advisers subject to the ISC regime
Principal securities licensees - 1750 Securities representatives - 25,000	Principals Life Companies - 52 Life Brokers - 103 Life Agents and Broker Representatives - 12,000

Complaints resolution mechanisms

8.23. A significant aspect of effective regulation of financial advisory services is an efficient consumer complaints resolution process. Currently, there are a range of investor complaints resolution schemes which are not exclusively for complaints relating to financial advisory services (Appendix 12). These include industry based schemes such as the FPA scheme, Life Insurance Complaints Services (LICS), Insurance Brokers Dispute Facility (IBDF) and Australian Banking Ombudsman (ABO) and the statutory Superannuation Complaints Tribunal.

8.24. For consumers of financial advisory services, the current schemes provide a fragmented complaints resolution process. This is because they are mostly product or institutional based schemes (such as the ABO or LICS) and have different levels of coverage (including overlap of schemes) and different processes and limits of relief (Appendix 12).

8.25. There are gaps in complaints resolution relating to advisory services. This is because some of the regimes to which these schemes relate do not have specific conduct obligations, such as those for the know-your-client or disclosure of conflicts of interests obligations. The presence of multiple schemes also creates the risk of consumer confusion and unnecessary costs to industry participants.

8.26. In principle, the most effective way of overcoming these problems is to establish a single industry based complaints resolution scheme for all financial advisory services. Alternatively, the existing multiple schemes should be rationalised into three streams for advisory services provided by (i) employees and agents of banking and other financial institutions, (ii) securities and superannuation advisers and (iii) life insurance advisers. This would promote commercial certainty and cost efficiency for service providers because they would only need to join a single scheme.

8.27. However, as a step towards rationalising of current arrangements, the ASC supports the current initiatives of the schemes to harmonise their requirements. The ASC sees a role for the regulator to work closely with the schemes to seek opportunities for rationalising the current schemes, encouraging consistent coverage across all financial advisory services and to promoting the development of a complaints clearing house service to assist consumers.

Recommendation

- The ASC recommends that there should be consistent coverage of consumer complaints relating to financial advisory services. The ASC recommends that the regulator should work closely with current schemes to identify opportunities for rationalisation, encourage consistent coverage across all financial advisory services and promote the development of a complaints clearing house service.

Continuing role for industry and professional bodies

8.28. The ASC considers that the regulatory responsibility for administering advisory regulation should remain with the statutory regulator. At the same time, there is a key role that professional and industry bodies can play in delivering efficient, honest and fair advisory services to consumers (refer to the ASC's Good Advice Report). This participatory role which industry and professional bodies can play is based on the ASC's assessment of the advantages and disadvantages of self-regulation.

8.29. Industry and professional bodies in the financial advisory market can contribute to the regulatory process by involvement in the following areas:

- developing of personal competencies necessary for the provision of financial advisory services;
- developing of standards of conduct (such as Codes of Conduct for members) within the regulatory framework administered by the regulator;
- monitoring of members which will directly contribute to the regulator's monitoring role; and
- contributing to the regulator's policy making process both as initiators and commentators.

8.30. The ASC is of the view that this participatory role for industry and professional bodies helps promote the efficiency and integrity of the financial advisory markets:

- by providing practitioner participation in the administration of the financial advisory services regulation at an appropriate level;
- by avoiding the inherent risks of loss of investor confidence and anti-competitive effects that may result from a higher level of delegation of regulation to industry or professional bodies. This is occurring at a time when the financial advisory markets and the relevant industry and professional bodies are not yet sufficiently developed to accommodate such delegation.

8.31. The ASC supports the recognition in the law of the regulator's ability to delegate regulatory functions, under supervision, to industry and professional bodies. This should be accompanied by authority to establish appropriate performance standards for those regulatory functions, ability to monitor performance and capacity to take effective action where those standards were not being met. However, the ASC has reservations about any further formal delegation of regulatory powers at this stage.

8.32. The ASC also considers that the regulator of retail financial activity should have the legal capacity to play an active role in developing, formulating, and monitoring of compliance with codes of practices in a wide range of areas relevant to retail consumers of financial services. The ASC sees this as consistent with its approach of working with industry, professional bodies and consumers to encourage a culture of good practice and compliance.

Recommendations

- The ASC recommends recognition in the Law of the capacity of the regulator to be able to delegate functions to industry and professional bodies combined with appropriate powers to establish performance standards for the delivery of these regulatory functions.
- The ASC recommends that the regulator should have the legal capacity to play an active role in developing, formulating, and monitoring compliance with codes of practice in a wide range of areas which are relevant to retail consumers of financial services.

CHAPTER NINE

MANAGED FUNDS

SUMMARY

The current regulation of investment-linked managed funds is not consistent and coherent. Rather, it is split according to whether the product is a public unit trust or investment company - in which case it is regulated by the ASC - or an investment-linked life insurance or superannuation product - in which case it is regulated by the ISC. Different regulatory standards are applied to these different products, although the operational risks are broadly the same in all cases.

The ASC understands that this causes problems for industry as it leads to unnecessary costs being imposed on product issuers who wish to offer various investment-linked managed fund products, particularly unit trusts and superannuation. This is because more than one regulatory compliance system must be set up and administered. These costs are passed on to consumers. The differing regulatory standards also impede competition, which affects the international competitiveness of the Australian managed fund industry.

In this chapter the ASC considers options for a more coherent and cost-effective approach to the regulation of managed funds and a range of practical implementation issues involved.

Recommendations

- The current regulatory arrangements should be reviewed with a view to providing a more coherent and cost-effective regulatory regime for investment-linked managed funds.
- Market regulation is the appropriate form of regulation for investment-linked managed funds.
- There are several options for the future regulation of unit trusts and superannuation. Each option has advantages and disadvantages. Practical considerations and industry views should be taken into account in determining the most cost-effective option.
- The new regulatory regime for managed funds should build on existing structures as far as possible. In practical terms, this means utilising existing ASC and ISC administrative arrangements.

- The ASC considers that, subject to industry views about transitional and implementation issues, the preferable option is to build on existing national scheme laws and ASC infrastructure, including its enforcement capabilities.

The current regulation of managed funds

9.1. There are two types of managed fund product: capital-backed products and investment-linked products. For capital-backed products such as bank deposits, defined-benefit insurance products and finance company debentures, the basic risk for investors is that the issuing institution will not be able to pay the promised amount. Where there is a legitimate public expectation that this promise should be safeguarded, as in the case of bank deposits or defined-benefit superannuation (but not finance company debentures), prudential monitoring of the issuing institution is appropriate and currently in place.

9.2. For investment-linked managed fund products - such as unit trusts and investment-linked superannuation and life insurance bonds - investors face the risk that the value of the underlying assets of the fund may fall, thereby causing loss. While investors accept this risk, they demand that their funds are managed competently, that the manger avoids conflicts of interest, and that the risk of system failures and fraud are minimised. A consistent and coherent regime of market regulation should be implemented to regulate these operational risks, which are common to all investment-linked managed fund products. The ASC considers some of these key risks in paragraphs 9.41 to9. 47.

Managed funds are not coherently regulated at present

9.3. The current regulation of investment-linked managed funds is not consistent and coherent. The regulation of investment-linked managed funds is split according to whether the product is a public unit trust - in which case it is regulated by the ASC - or an investment-linked life insurance or superannuation product - in which case it is regulated by the ISC (Appendix 14).

9.4. Different regulatory standards are applied to these different products, although the operational risks are broadly the same in all cases.

9.5. The ASC understands that this causes problems for industry as it leads to unnecessary costs being imposed on product issuers who wish to offer various investment-linked managed fund products, particularly unit trusts and superannuation. This is because more than one regulatory compliance system must be set up and administered. These costs are passed on to consumers. The differing regulatory standards also impede competition, which affects the international competitiveness of the Australian managed fund industry.

9.6. The current split also gives rise to a number of enforcement issues where an entity is involved in offering both Corporations Law and SIS products. In many cases, the same internal management and systems will be involved for both types of product.

Recommendations

- The current regulatory arrangements should be reviewed with a view to providing a more coherent and cost-effective regulatory regime for investment-linked managed funds.
- Market regulation is the appropriate form of regulation for investment-linked managed funds.

Options for a more coherent and cost-effective regime

9.7. There are various options which may be considered for the regulation of managed funds. Each option has advantages and disadvantages. No option is free from difficulty. In determining the best option, it will be necessary to carefully consider the views of participants in the managed funds industry.

9.8. The ASC considers that any new regulatory regime designed to make the regulation of investment-linked managed funds more consistent and coherent should build on existing structures as far as possible. In practical terms, this means utilising existing ASC and ISC administrative arrangements.

9.9. It would be difficult to formulate an option which would involve having just one regulator for all aspects of managed fund regulation. Current arrangements involve a separation of the prudential monitoring of capital-backed promises (by the ISC and RBA) from market regulation of the operations of fund managers and of disclosure and sales practices (by the ASC and ISC). Even if all prudential and market regulation activities were merged (which the ASC would not recommend), there would still be potential additional regulation of managed funds from the ACCC (competition issues in the managed funds industry) and the ASX (in the case of listed trusts). Nevertheless, the ASC believes that there is scope for improving upon current arrangements.

9.10. Applying the principles of market regulation to unit trusts and superannuation, the ASC has identified four practical regulatory options which build upon current arrangements:

- the ASC as primary regulator;
- the ASC as disclosure and sales practices regulator;
- the ISC as primary regulator; and
- retain the status quo and encourage harmonisation.

Issues to consider

9.11. The following issues will need to be considered in determining which is the most cost-effective option for the regulation of unit trusts and superannuation:

- What are the current capabilities of the regulators?
- Which option can be implemented by the simplest legislative mechanism?
- Which option would lead to the most appropriate regulation of the whole area of superannuation?
- Which option would best avoid confusion among investors as to level of protection afforded by the regulatory regime?
- Which option is supported by other practical considerations, such as existing information systems and enforcement capabilities?
- Which option would facilitate the efficient and comprehensive integration of other managed fund products, such as open-ended investment companies and agricultural and tax-driven schemes, into the regulatory regime?

The ASC as primary regulator

9.12. Under this proposal the ASC would regulate disclosure and sales practices and would undertake fund manager approval and operational monitoring for all unit trusts and superannuation products. This would alter current arrangements by transferring the ISC's responsibilities for superannuation to the ASC. Prudential regulation of capital-backed superannuation promises by the ISC or RBA would continue.

9.13. This option has the advantage of utilising the ASC's expertise in market regulation, including fund manager approvals, operational monitoring and the regulation of disclosure and sales practices. It would be efficient from a practical viewpoint as it would build upon the ASC's existing national infrastructure, information and enforcement capabilities. It would avoid some of the possible limitations on the constitutional powers of the Commonwealth by maximising the use of the existing national scheme laws. It would also facilitate the efficient and comprehensive integration of other managed fund products into the regulatory regime, particularly open-ended investment companies - this could become an important issue should taxation law changes make this form of managed fund more attractive.

9.14. A practical issue which would need to be resolved in implementing this approach would be how to ensure coordination between the role of the market regulator and the prudential regulators. This does not, however, raise any new regulatory issue: the regulation of institutions making capital-backed superannuation promises would continue to be within the responsibility of the ISC (where the promises are made by a life office) or the RBA (where they are made by a bank, as in the case of RSAs)

9.15. An issue to consider is investor perception. A transfer of responsibility for the regulation of superannuation to a market regulator may cause investors to perceive superannuation as less secure. The ASC considers that market regulation gives scope for varying degrees of regulatory control depending on the level of protection legitimately demanded by the public for the particular investment product. Thus, for superannuation, relatively stringent regulatory standards would be appropriate. But these standards do not amount to public insurance or an implicit guarantee, and should not be perceived as such. In this light the transfer of superannuation to the ASC may be seen as giving appropriate messages to the investing public: superannuation is very well protected by a market regulator, but the superannuation regime as a whole is not publicly insured or guaranteed.

The ASC as disclosure and sales practices regulator

9.16. Under this proposal the ASC would regulate disclosure and sales practices for all unit trusts and superannuation products. Fund manager approval and operational monitoring would remain with the ASC (for unit trusts) and the ISC (for superannuation). The ISC regime would impose standards on superannuation fund managers reflecting the public policy arguments in favour of superannuation being a relatively low risk investment product. This would alter current arrangements by transferring the ISC's responsibilities for disclosure and sales practices for superannuation products to the ASC. Again, prudential regulation of superannuation promises by the ISC or RBA would continue.

9.17. This option would have the advantage of building on the ASC's expertise in the area of disclosure and sales practice regulation while involving no disruption to the existing fund manager approval and operational monitoring arrangements. A potential problem with this approach is that uncertainty may arise in relation to the market regulation of superannuation: in some cases it may be unclear whether a regulatory concern is a disclosure issue or an operational issue or both. Accordingly, if this option was adopted there would be a need for close and effective co-operative arrangements between the two regulators.

The ISC as primary regulator

9.18. Under this proposal the ISC would regulate disclosure and sales practices and would undertake fund manager approval and operational monitoring for all unit trusts and superannuation products. This would alter current arrangements by transferring the ASC's responsibilities for unit trusts to the ISC. Prudential regulation of capital-backed superannuation promises by the ISC or RBA would continue.

9.19. This option has the advantage of continuing to utilise the ISC's experience in the administration of superannuation. It also has the advantage of regulatory synergy between the market regulation of superannuation and the prudential regulation of capital-backed superannuation promises made by life offices. However, this advantage is likely to diminish over time if banks and other institutions become more significant players in the superannuation field through RSAs and other products.

9.20. Apart from concerns about investor perception discussed in paragraph 9.15 there are also some practical disadvantages with this option, including doubts about whether this option could be implemented by an efficient legislative mechanism and whether there would be coordination difficulties relating to the administration of listed unit trusts. Practical issues arising from the integration of other managed fund products such as agricultural and tax-driven schemes into the ISC regulatory regime would also need to be considered.

Retain the status quo and encourage harmonisation

9.21. Under this option, current arrangements would remain, with the legislature and regulators encouraged to harmonise regulatory requirements.

9.22. This option has the advantage of causing no disruption to existing regulatory arrangement and would build on existing regulatory expertise. On the other hand, there may be limits to the extent to which individual regulators could harmonise requirements in the absence of major legislative amendment.

Recommendations

- There are several options for the future regulation of unit trusts and superannuation. Each option has advantages and disadvantages. Practical considerations and industry views should be taken into account in determining the most cost-effective option.

- The new regulatory regime for managed funds should build on existing structures as far as possible. In practical terms, this means utilising existing ASC and ISC administrative arrangements.

- The ASC considers that, subject to industry views about transitional and implementation issues, the preferable option is to build on existing national scheme laws and ASC infrastructure, including its enforcement capabilities.

Market regulation of investment-linked managed funds

9.23. In this section the ASC considers in more detail the proposition that investment-linked managed funds require market regulation. The following paragraphs will address:

- the distinction between capital-backed and investment-linked managed fund products;
- the current regulation of managed funds; and
- the suggested model for the regulation of managed funds.

The distinction between capital-backed and investment-linked managed fund products

9.24. A managed fund may be described as an investment vehicle under which investors' contributions are pooled or used together by a financial market intermediary to purchase financial assets with a view to providing wealth-creation benefits for those investors. This description of managed funds covers a vast array of investment products, including bank deposits, finance company debentures, superannuation, life insurance and friendly society bonds, public unit trusts and investment company shares. It also covers various agricultural and tax-driven investment schemes.

9.25. There are many possible subdivisions or classifications of managed fund product. For example products could be classified according to the nature of the offering institution, according to the investor to whom the product is marketed (eg wholesale or retail) or according to certain features of the product itself (such as taxation features). Another classification divides managed fund products into two broad categories: capital-backed products and investment-linked products. Capital-backed products include bank deposits, defined-benefit insurance products and finance company debentures. Investment-linked products include public unit trusts, investment-linked life insurance and investment-linked superannuation products.

9.26. The ASC considers that this is a useful categorisation for regulatory purposes because the nature of the promise or agreement differs in the two cases, which affects the legitimate regulatory expectations of investors.

9.27. A capital-backed product involves a contract between a financial institution and an investor under which the institution promises to pay a specified amount (or an amount which can be calculated by reference to a formula) to the investor on a specified date or upon a specified event occurring. For example, life offices offer capital-guaranteed products where life offices reserves are used to ensure that the principal can be repaid.

9.28. On the other hand, the value or price of investment-linked products is marked to market to reflect the investment returns of the underlying assets such as equities, property or fixed interest securities.

9.29. While most managed fund products can readily be classified as capital-backed or investment-linked, clearly this will not always be the case - for example, some bank deposit products (such as indexed linked deposits) have mixed characteristics. With increased levels of product blurring, it is possible that further products with mixed characteristics may develop over time. The challenge is to develop a regulatory framework which is likely to be durable and relevant in light of future product blurring.

9.30. The following table illustrates basic aspects of key managed fund products.

Product	Description	Capital Backed or Investment-Linked	Administered By	Main Categories	Regulator
Unit Trust	Voluntary investment vehicle involving pooling of investors moneys into a segregated trust fund.	Investment-linked.	Licensed management companies.	Cash management trusts, equity trusts, property trusts, mortgage trusts, managed trusts.	ASC
Superannuation Fund	A fund administered to provide benefits for members of the fund upon retirement or upon attaining a particular age. Involves fund administration, the provision of defined benefits and/ or investment returns.	May be capital-backed (defined-benefit schemes) or investment-linked (accumulation schemes).	A superannuation trustee. A professional manager may be appointed. A variety of simplification mechanisms are available (eg fund of fund arrangements). Scheme funds may be invested in other superannuation products - PSTs.	Employer sponsored (compulsory) or publicly-offered (voluntary).	ISC
Life Insurance Bond	An insurance policy.	May be investment-linked or pure life insurance (ie capital backed). May be single premium or regular premium.	Life offices.	Investment-linked bonds include managed bonds, property bonds, equity bonds.	ISC
Bank Deposit	Promise to repay capital and interest on agreed terms.	Capital backed.	Banks.	At call; term deposits.	RBA

9.31. Banks are allowed to offer only capital-backed products on their own balance sheets - investment-linked products must be offered through a subsidiary. Although life offices offer both capital-backed and investment-linked products within the one company, they do so through segregation into different statutory funds.

9.32. Traditionally, banks and non-bank financial institutions have dominated the offering of capital-backed products. Bank subsidiaries, life offices and other fund managers dominate the investment-linked product market. Capital-backed products attract most of the community's savings, but the proportion of savings being attracted by investment-linked products is growing more rapidly, as shown by the following table prepared by the Financial Institutions Group of the RBA for COFS in June 1996.

PRODUCT TYPE BY ISSUER						
	Capital-Backed		**Investment-Linked**		**Total**	
	$b	%	$b	%	$b	%
June 1990						
Banks	253	51	0	0	253	43
NBFIs	142	29	0	0	142	24
Life Offices/Friendly Societies	61(b)	12	26	27	87	15
Non-Life Office Superannuation	40(c)	8	33	34	73	12
Public Unit Trusts	0	0	38	39	38	6
Total	*496*	*100*	*96*	*100*	*593(d)*	*100*
June 1995						
Banks	326	56	0	0	326	43
NBFIs	130	23	0	0	130	17
Life Offices/Friendly Societies	68(b)	12	56	30	124	16
Non-Life Office Superannuation	54(c)	9	81	43	134	18
Public Unit Trusts	0	0	49	27	49	6
Total	*577*	*100*	*186*	*100*	*763(d)*	*100*

The current regulation of managed funds

9.33. Public unit trusts and other collective investment schemes (such as agricultural and tax-driven schemes falling within the very broad definition of "prescribed interest") are regulated by the ASC under the Corporations Law. In addition to monitoring compliance with the approved deed and prospectus provisions by fund managers and trustees, the ASC plays a major role in facilitating the efficient operation of these markets by modifying the application of the Corporations Law. The broad coverage of the Corporations Law requires the ASC to be very responsive to market developments in order to ensure that new products are not precluded by virtue of not conforming to the existing funds management legal regime.

9.34. Life Insurance Companies are regulated by the ISC under the Life Insurance Act. Superannuation is regulated by the ISC pursuant to the Superannuation Industry (Supervision) Act 1993 (SIS). The ISC monitors the operation of superannuation funds and has the function of determining complying fund status for income tax purposes.

9.35. Complying fund status must be applied for by new superannuation funds in relation to their first year of income if they wish to claim the relevant taxation concessions. Complying fund status will be granted unless there is a culpable failure to comply with SIS. Established funds do not need to obtain a new certificate each year - once a complying fund certificate is granted, it is taken to be in force for all subsequent years unless a certificate of non-compliance is issued.

9.36. Banks and bank deposits are regulated by the Reserve Bank of Australia under the Banking Act. Non-bank financial institutions and their deposits such as building societies and friendly societies are regulated by AFIC.

9.37. Appendix 14 illustrates basic regulatory requirements for some key managed fund products. Appendix 14 shows that some common regulatory issues arise in the regulation of all managed funds products. Appendix 14 also shows that a broad distinction can be drawn between the regulation of capital-backed products and investment-linked products. In the case of on-balance-sheet capital backed products such as bank deposits the primary focus of regulation is on monitoring of solvency and liquidity requirements - the essence of prudential supervision. For investment-linked products such as unit trusts, however, greater relative importance is placed on market regulatory techniques such as segregation of investors funds and the imposition of "fit and proper person" and competency requirements on fund managers. For superannuation, the approach is mixed: it is commonly described as prudential regulation, although it may be noted from Appendix 14 that it has many of the features of market regulation.

9.38. Further, Appendix 14 shows that while in broad terms the regulatory requirements for investment-linked products seek to address the same basic regulatory objectives, the detailed regulatory requirements differ. For example, the financial entry requirements, liquidity, borrowings, related-party investments and segregation of investors' funds restrictions are different for public unit trusts and investment-linked superannuation products.

The suggested model for the regulation of managed funds

9.39. ***Capital-backed products***: For capital-backed products the basic risk facing investors is that the institution will not be able to repay the promised amount due to collapse or short-term liquidity problems. Where the promised payment is legitimately regarded by the public as effectively insured or guaranteed, the ASC recommends that the appropriate form of regulation is prudential monitoring of capital requirements. Thus, for example, prudential supervision is considered by the ASC to be appropriate in the case of capital-backed superannuation promises, such as capital-backed superannuation products issued by life offices or the proposed RSAs to be issued by banks. Such prudential regulation should be undertaken by the regulator of the institution which issues the capital-backed product.

9.40. On the other hand, it would be appropriate for capital-backed products such as finance company debentures to be subject to market regulation which is based on current Corporations Law requirements, including disclosure, obligations imposed on borrowing corporations and the collective monitoring function performed by debenture trustees.

9.41. ***Investment-linked products***: Investors in investment-linked managed funds face various operational risks, which market regulation is designed to address. These operational risks should be include management incompetence, conflicts of interest, system failures and fraud. The risk associated with market fluctuations cannot and should not be insured against by regulation. If the law sought to eliminate investment risk, many of the innovative financial products marketed to investors through managed fund vehicles would no longer be viable. Investors would not have the ability to accept greater risks for the opportunity of obtaining greater returns. However, investors legitimately expect that they are given all the information they need to understand fully, and to judge for themselves, the level of investment risk associated with any investment-linked product so that they can choose, with full knowledge, the product that best suits their investment needs and objectives.

9.42. Market regulation is designed to address only operational risks. Thus, investors in managed funds are concerned that the fund manager does not collapse - if it does, the investor loses his or her chosen manager and may lose the ability to pursue claims against that manager if it has breached the law. However, provided the investor's funds remain safely segregated in a trust fund, and therefore, protected from the risk of fraud, institutional collapse will not have the same consequences that it has for investors in on-balance-sheet capital-backed products. To ensure segregation, it is essential that the law requires adequate custodial arrangements to be in place.

9.43. Market regulation addresses the risk that managed fund will perform poorly due to poor management - this may be due to incompetence, conflicts of interest, system failures or various other causes. The ASC recommends that the appropriate form of regulation to address this regulatory risk involves the imposition of a "fit and proper person" test and clear on-going duties upon persons managing the fund's assets. The "fit and proper" person test should include tests of competence and integrity. The on-going duties should address particular risks of mismanagement which may affect investor returns, such as overpayment of fees to investment managers, investment decisions tainted by conflicts of interest and system failures. The risks of mismanagement can also be controlled by ensuring that the regulator has adequate powers to monitor managers and to tailor the precise regulatory requirements to the precise regulatory risks associated with various managed fund products. It is also vital to ensure that investors have the educative and factual information and complaints resolution processes available to them to monitor the performance of managers.

9.44. Another regulatory risk is fund liquidity. As was demonstrated in the case of property trusts in 1991, if there is a mismatch between the time it takes to liquidate an asset and the redemption period offered by the fund to exiting investors, the poor performance of a fund can result in a loss of investor confidence resulting in a run. The problem is exacerbated if investors consider that the prevailing redemption value of interests in the fund is likely to be higher than the value in the future. The proposed Collective Investment Legislation seeks to address this issue by allowing illiquid funds to offer a withdrawal facility in limited circumstances only.

9.45. Apart from concerns about fund liquidity, large-scale redemptions fuelled by loss of confidence in an individual fund manager may have adverse effects on a particular market if the fund manager is a substantial investor in that market. The downturn in that market will then exacerbate the perception of poor performance by that manager, as well as adversely affecting other managers and investors in the market. It may, therefore, be appropriate for the Inquiry to consider whether some form of "circuit-breaker", such as a freeze on redemptions, should be imposed in such circumstances.

9.46. An issue which arises is whether capital requirements should be imposed on fund managers. The ASC is opposed to the imposition of arbitrary capital requirements on fund managers. Arbitrary capital requirements do not ensure that the manager has the ability or capacity to perform its functions properly and are costly to maintain, thereby reducing the potential returns for investors. Arbitrary capital requirements also act as a barrier to entry which reduces competition amongst managers. At best, capital requirements provide a fund against which claims can be *partially* satisfied in the event if institutional collapse. However, market regulation does require that a manager be required to have the minimum level of resources necessary for it to operate competently. The amount of resources required needs to assessed by the regulator on a case-by-case basis as part of the point-of-entry approval process. The level of resources required will depend on many factors including the complexity and size of the fund.

9.47. This market regulation described by the ASC for investment-linked products is consistent with the regulatory approach currently applied by the ASC for unit trusts, as is shown by the table in Appendix 14. This table also shows that while the detailed regulatory requirements applying to superannuation are different to those applying to unit trusts, in broad terms they seek to address the same regulatory issues. Thus, applying market regulation to all investment-linked products would not involve major alterations to the broad approach to regulation currently being applied.

Conclusion

9.48. The ASC considers that market regulation is the appropriate form of regulation for investment-linked managed funds. Applying this principle to the regulation of unit trusts and superannuation, the ASC has identified four options for more coherent regulation which builds upon current arrangements. Three of these four options involve change to current arrangements. The other option does not involve changes to regulatory structures, but focuses on harmonisation instead. Each option has advantages and disadvantages. Practical considerations and industry views should be taken into account in determining the most cost-effective option.

9.49. The ASC considers that, subject to industry views about transitional and implementation issues, the preferable option is to build on existing national scheme laws and ASC infrastructure, including its enforcement capabilities.

9.50. The following tables show the current arrangements for unit trusts and superannuation, the ASC's preferred option for future regulation, and the two other options identified by the ASC which would involve change to the current regulatory arrangements.

CURRENT REGULATION			
Product	**Disclosure and Sales Practices**	**Fund Manager Approval and Operational Monitoring**	**Prudential Regulation**
Unit Trusts	ASC	ASC	None
Superannuation	ISC	ISC	ISC (Life Office Issuers) or RBA (RSAs)

OPTION A - THE ASC AS PRIMARY REGULATOR			
Product	**Disclosure and Sales Practices**	**Fund Manager Approval and Operational Monitoring**	**Prudential Regulation**
Unit Trusts	ASC	ASC	None
Superannuation	ASC	ASC	ISC (Life Office Issuers) or RBA (RSAs)

OPTION B - THE ASC AS DISCLOSURE AND SALES PRACTICES REGULATOR			
Product	**Disclosure and Sales Practices**	**Fund Manager Approval and Operational Monitoring**	**Prudential Regulation**
Unit Trusts	ASC	ASC	None
Superannuation	ASC	ISC	ISC (Life Office Issuers) or RBA (RSAs)

OPTION C - THE ISC AS PRIMARY REGULATOR			
Product	**Disclosure and Sales Practices**	**Fund Manager Approval and Operational Monitoring**	**Prudential Regulation**
Unit Trusts	ISC	ISC	None
Superannuation	ISC	ISC	ISC (Life Office Issuers) or RBA (RSAs)

CHAPTER TEN

CONSUMER AND COMPETITION REGULATION

SUMMARY

There are several areas where existing consumer and competition regulation overlaps with regulation under the Corporations Law. These overlaps should be removed. There is a need to recognise the principle that financial market regulation must balance the needs and interests of consumers and business. Accordingly, the ASC does not consider that it would be appropriate to rely on a generic consumer protection regime to regulate financial market activity.

Recommendations

- The ASC recommends that the overlap between s52 of the Trade Practices Act and ss995 and 996 of the Corporations Law be removed. At present, this regulatory overlap means that issuers preparing prospectuses or advertising an issue of securities must comply with two laws designed to achieve the one basic objective - to prevent misleading or deceptive conduct. In cases where the Corporations Law applies, s52 of the Trade Practices Act should not apply.

- There is a need for regulation in the financial markets which balances and reconciles the needs and interests of consumers and business. Accordingly, it would not be appropriate to rely on a generic consumer protection regime to regulate financial market activity.

- There is a need to for better coordination between the roles of the ACCC and the Treasurer on ASX and SFE rule amendments. One option for consideration would be for the ASC rather than the Treasurer to assume the role of approving rules and procedures of exchanges and clearing houses. The approval process would involve consulting with the ACCC.

Removing overlap on misleading or deceptive conduct

10.1. Currently there is an overlap between s52 of the Trade Practices Act (TPA) and ss995 and 996 of the Corporations Law in relation to fundraising, takeovers and other dealings in securities. Section 52 operates on the basis of strict liability for false or misleading statements. On the other hand, s996 reinforces a positive disclosure obligation and prevents false or misleading statements being made in prospectuses. Under the Corporations Law defences to actions for damages are available when issuers have conducted reasonable inquiries or have exercised due diligence. These defences are not expressly available if an action is brought under the Trade Practices Act.

10.2. The Corporations Law Simplification Taskforce has recently proposed that conduct in relation to fundraising, takeovers and other dealings in securities be dealt with solely under the Corporations Law and in the common law, and that s52 and associated provisions of the TPA should not apply. The effect is to ensure that the defences, particularly the due diligence or reasonable inquiries defences, can be raised against civil claims for actions relating to contraventions of the disclosure obligations under the Corporations Law.

10.3. The Simplification Taskforce argues that the:

- Corporations Law approach seeks to strike "an appropriate balance between the rights of investors and the obligations of business";
- TPA approach is inconsistent with international practice for the regulation of fundraising and takeovers; and
- current dual regulation provides an uncertain regulatory environment and this is likely to increase the cost of fundraising in Australia.

10.4. The Australian Competition and Consumer Commission (ACCC) in its submission opposed the Simplification Taskforce proposals on the basis that they will "significantly and unfairly reduce the scope of consumer protection by permitting the Corporations Law to regulate dealings in securities without allowing recourse to the broader protection primarily available for consumers under the relevant provisions of the TPA" (ACCC Submission 1996).

10.5. In contrast, the ASC supports the proposals from the Simplification Taskforce. In the ASC's view, financial market regulation involves achieving a careful balance between the interests of business in raising low cost capital and the appropriate protection of the interests of investors. It is achieving this balance that lies at the heart of a successful financial markets regulatory regime.

10.6. In the case of the ASC this balance is incorporated into both specific provisions of the Corporations Law and in its overall regulatory charter. The need to achieve a balance between market efficiency and investor protection is set out in s1(2) of the ASC Act:

> *"In performing its functions and exercising its powers the Commission must strive:*
>
> *(a) to maintain, facilitate, and improve, the performance of companies, and of the securities markets and futures markets, in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and*
>
> *(b) to maintain the confidence of investors in the securities markets and futures markets by ensuring adequate protection for such investors; and*
>
> *(c) ....."*

Recommendation

- The ASC recommends that the overlap between s52 of the Trade Practices Act and ss995 and 996 of the Corporations Law be removed. At present, this regulatory overlap means that issuers preparing prospectuses or advertising an issue of securities must comply with two laws designed to achieve the one basic objective - to prevent misleading or deceptive conduct. In cases where the Corporations Law applies, s52 of the Trade Practices Act should not apply.

Balancing the needs of consumers and business

10.7. One alternative to the Simplification Taskforce proposal would be to remove the separate financial market regulation for investor protection. This is on the basis that the general consumer protection provisions of the TPA are an adequate and comprehensive regulatory regime for conduct relating to securities, derivatives and other investment products.

10.8. The issue of a generic consumer protection regime also arises in proposals for a "consumer protection" regulator separate from the market and/or prudential regulator that has been canvassed in discussions of regulatory structures both in Australia and overseas.

10.9. There are a number of arguments for treating financial market regulation as part of a broader consumer protection regime. The main argument is that dealings or representations in securities and other investment contracts are no different from other forms of commercial conduct and should not receive special treatment or exemption from the general consumer protection regime. It could be argued that this is reinforced by two trends. First, there is a trend towards a blurring of boundaries between traditional financial service providers and non-traditional competitors. Another trend is that greater emphasis is being placed by financial service firms on the marketing and distribution of financial products using the same techniques developed for consumer products. One consequence of these trends is that it will be increasingly difficult to define the boundaries of the financial services sector.

10.10. While the ASC agrees with these propositions about the blurring of the boundaries of the financial services and the trends in marketing and distribution of financial products, it does not support the inclusion of financial market regulation within a single generic consumer protection regime.

10.11. The main reason for not supporting the proposition is the importance the ASC places on maintaining the careful balance between the interests of business and investors in the regulation of our capital markets. This inevitably involves some tension between competing interests, but this is important in achieving sensible regulatory outcomes. A regulatory structure that separates the responsibility for consumer protection from market efficiency and integrity runs a risk of undermining this important balance of interests, which is currently part of our regulatory structure.

10.12. There remain important differences between financial services and other types of consumer goods or services. For example, a security is neither a good nor a service. Rather it is a bundle of rights referred to in technical legal terminology as a "chose in action", although related activities such as providing advice do not involve providing services. It is the intangible nature of the returns from a financial claim based on the profits of enterprise that has provided the rationale for the specific approach and regulatory techniques and existence of a specialist regime for market regulation both in Australia and in all other major jurisdictions.

10.13. The regulatory techniques for promoting investor protection in a securities regime are also more specialised than in a generic consumer protection regulatory regime. They involve mechanisms such as "fit and proper" person tests, systematic surveillance activities, requirements relating to suitability and specific disclosure of conflict of interests and other obligations in response to the fiduciary type nature of the relationships often involved between the intermediary and customer in financial transactions. These techniques can be regarded as responses to information asymmetries because of the intangible and often ongoing nature of the financial claim. They provide efficiencies in monitoring and screening (Llewellyn 1996a) and are consistent with the approach adopted in most other major overseas regulatory regimes.

Recommendation

- There is a need for regulation in the financial markets which balances and reconciles the needs and interests of consumers and business. Accordingly, it would not be appropriate to rely on a generic consumer protection regime to regulate financial market activity.

Integrating competition policy and the market rule amendment process

10.14. There are a number of broad issues relating to merger and competition rules for the financial sector institutions that are beyond the scope of this submission. The ASC addresses in this submission the interaction of the Competition and Corporations Law regimes where approvals, authorisation or licensing is required under the Law. The ASC's experience to date has been limited to approvals relating to ASX and SFE business and listing rules for major market development projects such as implementing the SEATS trading system of CHESS for transfer and settlement of securities.

10.15. It is the ASC's observation that the current dual approval process by the ACCC under the TPA and Treasurer under the Corporations Law (on the basis of recommendations from the ASC) imposes significant additional costs on ASX and SFE market development projects and that better coordination mechanisms could reduce these.

10.16. Under s774 and s1136 of the Corporations Law the rules of the exchanges are subject to a formal disallowance process by the Treasurer. The process is based on a public interest test. Under the TPA many of the same rules are subject to review and authorisation by the ACCC on competition grounds. In a number of instances the differences in statutory responsibilities has meant that the exchanges face difficulties in meeting both sets of regulatory requirements.

10.17. The ASC does not suggest that the competition regime should not apply to the activities of the exchanges and other market participants. It is important that it continue to do so. However, it is also important to recognise the inevitable tension that can exist between the competing objectives of ensuring appropriate regulation to protect investors and the need to avoid unnecessary restraints on competition. As noted above, the ASC has to strive to achieve both investor protection and market efficiency.

10.18. The ASC suggests examining whether there is a better mechanism for reducing the costs to market participants involved in the dual review processes that currently operate under the competition and financial markets regulation regimes.

10.19. One option is that adopted in the UK and US to reconcile these objectives. While the procedural aspects of these regimes differ, both share the common approach of explicitly recognising the potential tension between the two policy objectives and incorporating the competition elements directly into the financial market regulation regime.

10.20. In the UK under the Financial Services Act of 1986 (FSA) the rules and other regulations in that system are subject to a special competition regime in which the need to balance investor protection with competition is explicitly recognised. This responsibility falls to the Treasurer and the FSA is exempted from the normal competition regime. The FSA requires that, in order to be authorised, the rules and regulations of the SROs and other regulated bodies must not act to "restrict, distort or prevent competition to a greater extent than is necessary to protect investors" (FSA ss119 (1), 120(1) and 121(1). Before taking action, the Treasurer must consult the Director General of Fair Trading who assesses the rules and advises the Treasurer on the competition issues.

10.21. In the US there is a similar substantive requirement in the Securities Exchange Act (ss6(b)(8), 15A(b)(9), and 23(a)(2)). These sections prohibit the SEC from adopting rules or approving SRO rules if the rules impose a burden on competition not necessary or appropriate in furtherance of the purpose of the Exchange Act. There is no requirement for referring the rules to any other agency for assessment of possible anti-competitive impact.

10.22. The ASC recommends further examination of the adoption of a similar approach. One option would be for the ASC instead of the Treasurer to assume the role of approving rule changes. The competition elements would need to be incorporated into the Corporations Law in relation to the rules and procedures of exchanges, clearing houses and other market participants that are subject to an approval, authorisation or licensing process under the Law. The approval process would involve the ASC consulting with the ACCC.

10.23. A more consistent approach to the application of competition elements in the financial markets regulatory regime would seem to be appropriate because both the ASC and ACCC are now within the Treasurer's portfolio.

Recommendation

- There is a need to for better coordination between the roles of the ACCC and the Treasurer on ASX and SFE rule amendments. One option for consideration would be for the ASC rather than the Treasurer to assume the role of approving rules and procedures of exchanges and clearing houses. The approval process would involve consulting with the ACCC.

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