HERBERT SMITH FREEHILLS

FINANCIAL SYSTEM INQUIRY

ASIC FUNDING

25 AUGUST 2014

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Mr David Murray
Chair, Financial System Inquiry
Electronic Submission

Dear Mr Murray

We make this submission to provide our views on the proposal in the Interim Report of the Financial System Inquiry (July 2014) (**Interim Report**) to move ASIC to a more autonomous funding process[1] and, in particular, the introduction of an industry levy to fund ASIC. While significant attention is being given to the *method* of funding, we are concerned that to date there has been insufficient focus on the *adequacy* of funding.

In considering reform to the model of ASIC's funding, the most important objective should be to ensure ASIC receives adequate, stable funding. We consider (for reasons briefly outlined below) that there are significant benefits to the private sector if the end result of reforms to ASIC's funding model is a capable, effective regulator.

In his book *Finance and the Good Society*, Professor Shiller (Yale Professor and Nobel Laureate in Economics) explains:[2]

> "[R]egulators … are fundamentally important to the financial system. It is they who make and interpret the all-important rules of the game. Just as in sports, people in business want referees who will enforce the rules. Everyone has an interest in the game being fair. The fact that players try to push the limits of the rules or argue with referees doesn't mean they don't want them. In the same way, businesspeople very much want regulators, for regulations imposed on all players do not generally work to their individual disadvantage – quite to the contrary, they typically work to the advantage of all."

Although views differ on whether ASIC's current funding is adequate, as the Interim Report notes, respected international bodies, such as the Financial Stability Board and the International Monetary Fund, have raised concerns about ASIC's lack of stable funding. Those concerns were expressed before the Government's recent announcement that a further $120 million will be withdrawn from ASIC's funding over the next five years.

Recent statements by ASIC Chairman Medcraft, and the Senate Inquiry into ASIC's performance, have highlighted the potential consequences. ASIC said in its main submission to the Senate inquiry:[3]

> "What we are able to achieve depends on our level of funding. Ensuring ASIC has adequate resources affects the strength and integrity of the financial system and the confidence of investors."

In short, ASIC is only able to achieve what it is resourced to do – a proposition with which we agree.

However, poor resourcing impacts not just what ASIC does, but also how well it does it.

Underfunding the regulator can lead to ineffective, inconsistent or incorrect application of the rules. Without an effective regulator, those participants who refuse to play fairly, but can get away with it, benefit. Corporates following the rules may still be penalised by a regulator, lacking in experience or resources, who applies the rules incorrectly or capriciously.

[1] Interim Report, 3-09. We acknowledge the contributions of Jeremy Birch, Senior Associate, and Claire Mather, Solicitor, in preparing this submission.

[2] Robert J. Shiller, 2012, *Finance and the Good Society*, Princeton University Press, 94.

[3] Main Submission by ASIC to the Senate inquiry into the performance of ASIC, October 2013, 11.

The direct and indirect costs of poorly targeted investigations and enforcement, or ill-informed supervision, can be significant for business. This is particularly so in an environment where the regulatory burden is already increasingly being shifted onto the regulated population.

Regulatory requests for information can be ill-considered and unnecessarily broad, diverting corporates' time and resources. Internal investigations carried out at the regulator's behest may be unwarranted and ultimately exonerate the target of any wrongdoing, but still impose significant costs and divert management attention.

At a practical level, underfunding the regulator gives rise to inefficiency in the conduct of its inquiries and investigations, particularly as a result of the inability to adequately staff these matters. For example, entities the subject of ASIC inquiries may be left in a situation of limbo as investigations are placed on hold for long periods. This uncertainty and inefficiency is not in anyone's interests – that of the public interest and ASIC, or the regulated population.

Beyond the costs of self-regulation, an under-resourced regulator can make poor enforcement decisions. Enforcement action through regulatory prosecutions inevitably imposes a large burden on targets and can cause lasting reputational harm, regardless of the outcome.

We do not necessarily endorse an industry levy as the solution. We do, however, submit that, whilst there are challenges in its implementation, it is worthy of consideration, at least as an element of a stable funding model, given the need to ensure that ASIC is adequately funded.

Obviously there are a number of difficulties in implementing any levy.

While it may be easy to identify from ASIC's budget the cost of regulating segments of the market, translating that into a model for levying specific amounts on individual regulated entities within those markets is much more difficult.

We also note Senator David Bushby's point in his dissenting report in the Senate Report on ASIC's performance, that an agency allowed to determine its own funding envelope can act on self-interest to expand its regulatory reach.[4] This necessitates a third party setting the level of funding. Who fills that role and the criteria used to decide upon overall funding levels are questions that will not be easy to resolve.

A danger of an industry levy, identified by UNSW Professor Dimity Kingsford Smith and UNSW students in their submission to the Senate Inquiry, which we consider should be taken into account by the FSI,[5] is that if the levy is ASIC's sole funding source this may create the potential for 'regulatory capture' or at least a perception of improper influence. Such a concern is particularly acute in a concentrated market such as Australia.

Both Senator Bushby's and Professor Kingsford Smith's concerns could be addressed through appropriate mechanisms in the implementation of any levy, including that an industry levy not constitute the sole source of funding.

We also note the views of Adjunct Professor of Economics at Monash University, Rodney Maddock, published in the Australian Financial Review on 5 August 2014.[6] Professor Maddock says that introducing an industry levy "reduces pressure on the regulator to perform". He says that having regulatory agencies "fight for their budget allocation" means they have to "demonstrate a real need for additional funding".

We agree that the level of funding should be set by reference to a considered analysis of the need for funding. However, we disagree that more stable funding will necessarily reduce the pressure on the regulator to perform. The threat of funding cuts is a very blunt tool to encourage regulatory effectiveness which also has potentially disastrous consequences for financial markets. If a regulator's "underperformance" leads to funding cuts, this is not a competitive market where a new entrant will step in to fill that regulatory role. Relying on funding cuts as the primary response to an underperforming regulator is more likely to simply exacerbate the negative impacts on financial markets.

The implementation issues and risks of an industry levy are real and deserve careful analysis, however in our view the debate concerning the levy should not lose sight of the more important issue which is that ASIC should be adequately funded going forward. While the levy may impose a cost on industry, underfunding ASIC will ultimately impose a heavier burden on corporate Australia while at the same time putting the integrity of the financial system at risk.

[4] Senate Economic References Committee, *Performance of the Australian Securities and Investments Commission*, June 2014 – Additional Comments (Dissenting Report) by Deputy Chair, Senator David Bushby, paragraph 1.19.

[5] Submission by Professor Dimity Kingsford Smith and Students of UNSW Law studying the advanced elective Securities and Financial Services Regulation Class of 2013, 21 October 2013.

[6] Rodney Maddock, Be careful how much independence we hand out, Australian Financial Review, 5 August 2014, 47.

We do not necessarily advocate for an industry levy. The pros and cons of a levy need to be worked through and debated. We submit that the critical issue is to ensure that ASIC receives sufficient and stable funding so that it can operate as a strong, capable regulator. Whatever funding model or combination of funding models is ultimately recommended, this should be its primary goal.

Yours sincerely

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