MUTUAL RECOGNITION OF FINANCIAL SERVICES REGULATION: OPPORTUNITIES AND CHALLENGES FOR AUSTRALIA

ADDRESS TO THE ASIC SUMMER SCHOOL

OUR FINANCIAL MARKETS: THE BIG ISSUES

18-20 FEBRUARY 2008

THE SOFITEL

MELBOURNE

20 FEBRUARY 2008

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Thank you for extending to me an opportunity to talk to the ASIC Summer School here in Melbourne, today.

The Summer School provides, among other things, a valuable opportunity for an exchange of views on major policy matters. That's why I'm here. Specifically, I want to take the opportunity to outline the Treasury's perspective on the important policy issues associated with the mutual recognition of securities regulation generally and, specifically, with the United States.

International global capital flows

Since the early 1980s, financial markets have become increasingly integrated, and at an increasingly rapid rate. International financial integration has been supported by developments in information and communications technology (ICT) and by financial innovation; and it has been driven by investor appetite for access to foreign markets, risk diversification and the hedging of foreign exchange and other risks.

The generally positive story hasn't been free of disturbing episodes; the fall-out from the sub-prime crisis in the United

States serves as a painful reminder that even very deep and liquid markets populated by sophisticated players can get into positions that prove difficult to understand or explain.

This recent financial market turmoil follows other episodes that are still fresh in our memories: the Asian financial crisis of the late 1990s, the Russian and Latin American debt crises and the pronounced stock market crash of the early part of this decade that was prompted by the collapse of ICT stocks. Common to all of these episodes is a mispricing of risk. In the most recent of these crises there is the added dimension of a lack of information concerning counterparty credit risk. That information is gradually being discovered, of course; and as that happens, all sorts of people are re-learning old lessons about risk management.

To be fair, higher levels of financial integration do mean greater exposure to counterparty credit risk; and, as even the publican who runs a 'slate' for his regular customers knows, there is only so much you can do to manage that risk. But you can do some things. This is a point I'll come back to a little later.

These lessons we are re-learning about risk management are not of purely financial interest. International capital market volatility is not a zero sum game, with the winning players merely extracting wealth from well-heeled losers. Financial volatility affects prices

and sometimes – as in the most recent episode – liquidity. Through both price and liquidity channels, it affects real macroeconomic performance, and the income and employment opportunities of all sorts of people, all over the globe. International capital market volatility matters, therefore, to any government that is properly focussed on the living standards of its citizens.

Inevitably, in the wake of every episode of instability there will be some governments wondering whether they haven't allowed too much integration with global players; Malaysia's response to the Asian financial crisis illustrates the point. While, for obvious reasons, it didn't have quite the same international dimension, the Sarbanes-Oxley response to the stock market volatility referred to earlier provides another illustration of the sensitivity of policy makers to financial market volatility.

Yet, despite the occasional serious disruption caused by international financial volatility, the policy advice going from Treasuries to their political masters has generally remained stubbornly supportive of liberalisation; and for good reason.

Australia's capital market liberalisation began in earnest at the end of 1983, with the floating of the Australian dollar and the abolition of exchange controls. That was followed by an extensive program

of liberalising foreign investment restrictions. And, still in the 1980s, the banking system was opened up to foreign banks.

Similar regulatory change occurred at similar times in many other countries.

The growth in cross-border financial flows facilitated by these regulatory reforms has been quite extraordinary.

In 1980, less than 6 per cent of world gross domestic product (GDP) was mobile across international borders. By 2005 around 16 per cent of world GDP was flowing through the international financial system each year.[1]

Addressing the challenges from international capital flows

If you asked the publican how he manages the counterparty credit risk on his slate (you might want to use different words!) he would probably emphasise the importance of knowing something about the background of the customer: "Where does he live? Has he ever got into trouble with the police? What's his family like?"

ASIC doesn't have responsibility for managing counterparty credit risk, of course. Rather, an important part of its job is to improve the chances of those risks, and others, being managed well by market participants. And it does that by ensuring that all market

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[1] Reserve Bank of Australia, *Reserve Bank Bulletin* – July 2006

participants have a better idea of just who it is that they are dealing with.

When it comes to cross-border transactions, ASIC plays this role through a set of consultation and cooperation arrangements with international organisations and through significant bilateral arrangements with foreign regulators.

In terms of multilateral arrangements, ASIC is an active member of the International Organisation of Securities Commissions (IOSCO).

IOSCO is the international standards leader for securities regulation and has 120 members in 109 jurisdictions.[2] More than 90 percent of the world's securities markets are regulated by IOSCO members.[3]

The Chairman of ASIC, Mr Tony D'Aloisio, is a member of the IOSCO Executive Committee, the President's Committee[4] and he is also a member of the IOSCO Technical Committee.[5]

The IOSCO *Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of information* is

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2 http://www.seccom.govt.nz/speeches/2007/jds151007.shtml (accessed 18 December 2007)
3 http://www.seccom.govt.nz/speeches/2007/jds151007.shtml (accessed 18 December 2007)
4 http://www.iosco.org/lists/display_committees.cfm?cmtid=1 ((accessed on 3 January 2008)
5 http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (accessed on 3 January 2008)

a keystone document underpinning information sharing to support enforcement by regulators around the globe.

In addition to multilateral mechanisms, ASIC has also sought to leverage regulator-to-regulator relationships to combat international market misconduct.

To date, ASIC has signed 35 Memoranda of Understanding (MOU) with regulators in 29 countries.[6] This includes MOUs with the United States Commodities Futures Trading Commission and the United States Securities and Exchange Commission (SEC).

These 35 MOU define the relationship between the signing parties with regard to mutual assistance and the exchange of information for the purpose of enforcing and securing compliance with relevant domestic financial services legislation.

The number of international issues requiring ASIC's attention has risen from 210 in the year 2000 to 549 in 2005-06. During the same period, ASIC increased its calls for assistance from foreign regulators from 84 to 146 requests.[7]

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6 http://www.asic.gov.au/asic/asic.nsf/byheadline/OIR+-+Memorandum+of+Understandings?openDocument (accessed on 15 February 2008). In some instances, MOU are in place with more than one regulator per country. This reflects regulatory arrangements in other countries.

7 Australian Securities and Investments Commission, ASIC, *Annual Reports – various additions 2000-01 to 2005-06*.

US developments in cross border recognition of securities regulation

Internationally, there are tentative moves to go beyond co-operating on enforcement and information sharing, to embracing genuine mutual recognition. This would entail the formal recognition of both foreign regulation and foreign regulators.

There are moves by the United States and the European Union to improve cross border regulation of international capital flows through a recognition or harmonisation framework.

In Australia's case, the most important steps to strengthen bilateral cross border regulation, in the form of mutual recognition, are those tentatively being taken by the United States.

In 2007, the SEC took some first steps in a new direction that would allow foreign exchanges and broker dealers to operate in the United States under their home regulation in return for mutual recognition by foreign regulators.

The tentative steps being taken by the United States provide an impetus for other nations – including Australia – to consider the opportunities that mutual recognition provides to enhance and strengthen securities regulation while avoiding an unnecessary additional compliance burden.

The importance of global finance markets to Australia

As a small economy with relatively large endowments of under-developed resources, Australia has much to gain from continued enhancement of its access to global capital flows.

Moreover, as a general principle, the larger the pools of capital that investors can access, the more liquid the market and the more competitively priced and efficiently allocated will that capital be.

Thus, accessing competitively priced capital helps with the economic development of Australia. But it also helps Australian businesses to compete globally. And Australian investors benefit, too, from being able better to match their risk appetites to investment opportunities.

The regulatory framework therefore has significant implications for the growth of the national economy and the welfare of its citizens. Its contribution will be greatest where the gains from cross border financial flows can be harnessed and, to return to my earlier theme, the costs from doing so are minimised.

Australia's approach to the regulation of cross border securities regulation

The cornerstone of Australia's corporations and financial services regulatory framework is the *Corporations Act 2001*.

The Act permits the unilateral recognition of a foreign market or foreign financial service provider where those entities are subject to home regulation that is 'sufficiently equivalent' to Australia's, in respect of investor protection and market integrity. I should emphasise that unilateral recognition – in practice, granted to markets by ministerial licence and to financial planners by ASIC – is extended only where Australia is quite satisfied on these points.

By definition, unilateral recognition does not demand reciprocity from foreign markets, regulators or governments.

Under existing law, there is also scope for mutual recognition through treaties. A relevant example is the *Australia – New Zealand Agreement on the Mutual Recognition of Securities Regulation*.

Foreign markets

To date, six overseas markets, including the Chicago Board of Trade and the Chicago Mercantile Exchange have been granted licences to operate in Australia. These markets have given Australian businesses ready access to international markets.

Foreign financial service providers

The Corporations Act also requires a person who carries on a financial services business in Australia to hold an Australian

Financial Services Licence. This licence is intended to assure investors that those offering and providing financial products are subject to appropriate regulation. ASIC is responsible for assessing applications for a financial services licence and determining if an exemption to hold an AFSL should be granted. An exemption may be provided if the foreign financial service provider is regulated by an overseas regulator and the financial services on offer are already prescribed as being suitable for an exemption.

As at May 2007, there were 289 foreign financial service providers, including 132 entities from the United States, with an exemption.

Australia – New Zealand mutual recognition of securities offerings

On 22 February 2006 the Governments of Australia and New Zealand signed a treaty on the *Mutual Recognition of Securities Offerings*.

This regime is expected to come into effect early this year. It will allow an issuer to extend an offer that is being made lawfully in one of the countries to investors in the other, host, country without having to comply with most of the substantive requirements of the host jurisdiction's fundraising laws applying to domestic offers.

The practical effect is that the one prospectus may be used in both countries, reducing compliance costs and furthering the integration between the two markets.

Improving Australia's cross border regulation of securities

With the financial services industry being so dynamic, it is imperative that Australia's regulatory framework remains competitive, flexible and responsive to global commercial and regulatory developments.

As we improve Australia's cross-border regulatory framework, there will remain a place for unilateral recognition. No doubt, there is scope for some fine-tuning of the existing scheme. However, for selected countries, mutual recognition will offer greater benefits. Mutual recognition goes further than unilateral recognition in strengthening the ties between regulators.

It might be useful for us to begin thinking about a set of principles that might guide our approach to mutual recognition. If nothing else, such a set of principles would assist foreign regulators and markets determine the regulatory approach that suits them best when they consider closer regulatory and commercial integration with the Australian finance industry.

Opportunities from mutual recognition

Mutual recognition of securities regulation between Australia and other countries offers both opportunities and challenges.

Mutual recognition offers the opportunity to reduce the regulatory burden on business; specifically, by avoiding duplicative regulatory requirements and their associated costs. Other things equal, it should lower the cost of capital, underwriting faster capital-deepening and productivity growth.

But there are other, less tangible, benefits for Australia. In particular, if we can establish a strong mutual recognition framework there is a real opportunity to strengthen the position and influence of the Australian finance industry in the region and globally.

Challenges arising from mutual recognition

While there are opportunities from mutual recognition there are also challenges. Most of these relate to more intense competition. For reasons to which I have already referred, more intense competition is generally to be encouraged; but it is something that should be done ‘eyes open’.

Concluding comments and the way forward

We welcome the opportunity to work with ASIC in enhancing and strengthening Australia's position with respect to the mutual recognition of securities regulation. We welcome also the steps being taken by the SEC to develop a framework for mutual recognition. We are very appreciative of the work the SEC is doing in this area and stand ready to work constructively with them in any way that might be helpful.

The successful implementation of mutual recognition between the United States and Australia would make a very substantial contribution to the already deep and strong ties between our two countries.

Our ambitions are broader, of course. We see possibilities for facilitating greater cross-border capital flows through mutual recognition arrangements with other countries with regulatory frameworks of similar quality.

But, for the moment, there can be no doubting where our efforts should be directed.

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