FINANCIAL SERVICES REFORM - AN END OF TRANSITION PROGRESS REPORT

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It has now been almost six months since the end of the Financial Services Reform ("**FSR**") transition period. While the FSR regime commenced on 11 March 2002, most participants in the financial services industry took close to full advantage of the two year transitional period. This means that for many people, the majority of the FSR regime is little more than 6 months old. This makes it an appropriate time to reflect on the FSR regime. However, it is important to be careful about the sort of assessment that can be made this early in the FSR regime. As is to be expected with regulatory change of this type, following the start of the regime and the transitional arrangements, there is a period where participants in the relevant industry become accustomed to the new regime. Due to recent end of the transition period, we are still in the middle of this phase of the implementation of the FSR regime.

This timing has an understandable effect on people's attitude to the regime. Put simply, at this stage in the process the vast majority of the costs have been incurred but there has been little, if any, opportunity to realise any of the benefits which the new regime may bring. The reason for this is that the majority of the costs will be incurred in adapting to the new regime (for example, in updating training and compliance) but the benefits of a uniform regime will only become apparent over an extended period of time (for example, reduced costs for conglomerates that only have to comply with one regulatory regime instead of several). The Investment and Financial Service Association ("**IFSA**") has estimated that the implementation of FSR cost well over $100 million[1]. As IFSA stated, "[y]ou don't re-arrange your operations to comply with over 1000 pages of new legislation, regulations, ASIC policies and industry guidelines, without spending large sums of money". IFSA also commented, "Whilst there has been considerable pain in implementing the new regime, the overall community gain will pay huge dividends in terms of consumer confidence and understanding of the financial services industry"[2].

At the moment we could only expect to have an indication of the benefits to come. A more comprehensive assessment of the FSR regime would involve comparing the costs incurred

[1] IFSA Media Release, "Financial Services Reform Act Big Boost to Consumer Protection", 10 March 2004, pa 5.

[2] Ibid, per R Gilbert, IFSA CEO, pa 9.

with the benefits which it has provided. Clearly, it is too early to determine what those benefits are, so that analysis will have to wait for some time. Therefore, for the moment we will instead focus on a comparison of the regime with its original objectives and an examination of some of those aspects of the regime which have proved problematic during the two year transitional period.

Of course, while the FSR regime encompasses not the just the regulation of conduct of financial service providers but also other areas such as the regulation of financial markets and clearing and settlement facilities, this discussion is limited to the regulation of holders of Australian financial services licences **("licensees")** as this is the aspect of the FSR regime which has by far the most impact on the financial services industry generally.

The Objectives of FSR

Before going further it is useful to reflect on what the FSR regime was intended to look like. It originated in 1997 with the recommendations of what is commonly referred to as the Wallis report[3]. At the time, there was a perception that financial products which served a similar functional purpose (for example, managed funds and some life investment policies) were regulated under different regimes and had, for example, different disclosure requirements, even though from a consumer's perspective those products fulfilled the same role. The Wallis report found that regulation of conduct and disclosure in the financial services industry was inconsistent and that a uniform regime should be introduced to cover a wide range of financial products. The introduction of a uniform regime was intended to benefit both industry participants and consumers by creating a single consistent regime that would both reduce compliance costs and would assist consumers.

More specifically, in relation to conduct requirements, the report recommended the development of a single set of requirements for investment sales and advice including:

- minimum standards of competency and ethical behaviour;
- requirements for the disclosure of fees and adviser's capacity;
- rules on handling client property and money;

[3] Financial System Inquiry, Commonwealth Treasury *Financial System Inquiry Final Report*, (Canberra: AGPS, 1997), p278-290. Hereafter "Wallis report".

- financial resources or insurance available in the cases of fraud or incompetence; and
- responsibilities for agents and employees.

THE DEVELOPMENT OF THE FSR REGIME

The FSR regime has had a difficult development. This is reflected by the number of times the Act and regulations have been amended. Chapter 7 of the Corporations Act which contains the FSR regime has been amended several times. In addition, the associated regulations have been amended 23 times. In response to the legislation, ASIC has released approximately 15 Policy Statements, 20 Guidance Papers and 145 Frequently Answered Questions.

Those changes have been made despite the fact that there was extensive consultation on the original Financial Services Reform Bill prior to its introduction into Parliament. While it is not unexpected that any new regulatory regime (especially one as complicated as FSR) will require amendment and adjustment during the implementation phase, the number of changes that have been made to the FSR regime goes beyond the typical fine tuning of a new regulatory regime. While we will not consider the reasons for such a large number of changes in detail here, it seems that many of the difficulties in implementation were only identified by the industry during the transitional period, rather than during the earlier government consultation.

This highlights the fact that government often drafts legislation on the basis of broad policy and then relies on industry to identify anomalies, while industry assumes that regulatory change will take into account current industry practice. Another factor was the extremely broad reach of the FSR Regime, which was highly ambitious in attempting to bring such a wide range of financial products within the one regime. The result in the case of FSR was the need for extensive amendments to the regime after its original enactment.

The frequent amendments were perhaps one reason why many people delayed in transitioning to the FSR regime. Many people preferred to adopt a wait and see approach instead of incurring costs in adapting to rules that were likely to be amended. This was particularly likely because many amendments resulted in a relaxation of various requirements.

A good example of this is the requirement to place licence numbers on documents. Originally, the licence number had to be provided whenever a licensee identified itself in a document in connection with providing financial services under the licence[4]. This would have involved considerable costs in updating stationery and other documents prior to obtaining a licence. That requirement was subsequently relaxed to include only a small number of prescribed documents[5]. An organisation that obtained its licence early in transition period prior to this change and complied with this requirement could have incurred significant expenditure which would have later proved unnecessary. However, as stated by IFSA, "[t]hese reforms have been so ambitious in their scope that, given the extent of the new legislative umbrella now covering the industry, it is inevitable that anomalies will crop up from time to time as industry beds down the changes over the next two or three years"[6]

Uniform Regulation of all Financial Products

As stated above, the major objective of the FSR regime was to establish a uniform regime for all financial products. However, in practice it is arguable whether instead of applying the same regulatory regime to all financial products, the objective should have been simply to remove those inconsistencies which were inappropriate. For example, the fact that regulation of the conduct of insurance agents was significantly different to the regulation of proper authority holders is difficult to justify. By contrast, the fact that consumers are given more detailed disclosure before becoming members of superannuation funds than before becoming a holder of a deposit product can be more clearly explained.

While an original objective of the FSR regime was to provide flexibility, the application of the same general rules and particularly the more specific regulations in relation to disclosure does create a tension between the desire for uniformity and the need to take into account the differences between financial products and their impact on consumers. Of course, the FSR regime does recognise these differences to some extent through the many exemptions for simple deposit products and more rigorous disclosure requirements for superannuation.

[4] Section 912F of Schedule 1 of the *Financial Services Reform Bill 2001*

[5] Section 912F and regulation 7.6.01C.

[6] Ibid fn 1, pa 8.

However, in contrast the requirements for providing advice on general insurance products are no different to those that apply to managed funds.

In this respect, while the FSR regime does diverge from the objective of uniformity, the question is not so much whether that divergence is justified as whether there should have been greater divergence originally. If the need to treat some products differently in certain circumstances had been recognised earlier, this might have reduced the need for significant ad hoc exemptions later, such as the regulation which provides an exemption from giving a Financial Services Guide for activities associated with car rentals[7].

Specifically, the question is whether products that are lower risk from the point of view of a client, like bank deposits and general insurance products for exiting require a significantly lower disclosure regime than higher risk products? These products contrast with product such as managed funds and superannuation, which obviously require a more expansive disclosure regime. This raises an interesting point, instead of having ad hoc exemptions for different products, should FSR have distinguished more clearly between simpler and more complex products from the beginning?

DISCLOSURE DOCUMENTS

We do now have, in accordance with the Wallis report recommendations, a regime where all financial products and services are subject to the same disclosure regime. This principally involves three different types of documents:

- Financial Services Guide **("FSG")** – which discloses information about providers of financial services including how they are remunerated;
- Statements of Advice **("SOA")** – which must be provided where personal advice is given and contain the advice as well as specific information about remuneration such as commissions and other potential sources of conflict of interest; and
- Product Disclosure Statements **("PDS")** – which contain information about a particular financial product, such as its significant risks and benefits and information about the cost of the product.

[7] Regulation 7.7.02(3)

These documents are all subject to a requirement that they be "clear, concise and effective"[8]. However, in practice, many of these documents produced so far are lengthy and complex. The length and complexity of these documents is probably the area of greatest criticism at the moment. Over the last six months many people have expressed dissatisfaction over these documents which in many cases are not the simple, straightforward documents they were originally intended to be.

There are, broadly, three reasons for this. The first is that FSR regime, principally through the regulations, has become more detailed and prescriptive. This is particularly the case in relation to disclosure of the remuneration which financial service providers receive[9]. While these changes were no doubt intended to ensure that all such remuneration was adequately disclosed, the requirements that now apply can often require detailed and lengthy disclosure. These requirements are currently in the process of changing again, with the introduction of a new regime intended to further strengthen the disclosure of remuneration in specific dollar amounts except in certain limited circumstances[10].

This leads to the second reason, which is the complexity of the financial services industry itself. In many cases the information which has to be disclosed is of a complex nature. The way in which a typical financial planner is remunerated is often far from straightforward. It is common for them to receive a percentage of a commission paid to a company which employs them or of which they are a principal, which is, in turn, a percentage of the commission received by the licence holder from the issuers of the products which the financial planners recommend. Detailed disclosure of these arrangements, particularly where the amount a given individual receives is not a set percentage but varies on a number of factors, is difficult to express succinctly. Similar examples apply to disclosure in relation to financial products, many of which are inherently complex.

The third reason goes back to the fact that the FSR regime is new and that the transitional period has now ended. Many people are still in the process of adapting to the new regime. For example, many people are currently revisiting their existing disclosure documents to identify ways in which they can be improved and simplified. This is both to improve

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[8] For example, section 1013C(3).

[9] For example, see regulation 7.7.04.

[10] Corporations Amendment Regulations (No. 6) 2004

compliance with regulatory requirements and to improve the documents from a commercial perspective.

Another relevant consideration is that disclosure documents for specific financial products and services will not generally serve as a substitute for an overall understanding of financial services within the community. There is some recognition of this within the FSR regime. For example, the content of a Product Disclosure Statement can take into account the extent to which the product is well understood by the kinds of person who commonly acquire products of that kind as retails clients[11].

Therefore, while it is likely that we will see improvements in disclosure documents over the next 12 months, the specific requirements in the FSR regime intended to ensure proper disclosure of remuneration, coupled with the complexity of the financial services industry, will continue to present a challenge. In addition, concerns that a relaxation of disclosure requirements could result in relevant information being omitted from disclosure documents means that it is unlikely that there will be a relaxation of disclosure requirements, particularly in the context of disclosure of remuneration.

MARKETING MATERIAL

One of the areas where there has been significant change to the FSR regime is in relation to the requirements for marketing of financial products. Under the FSR regime, the definition of "financial product advice" is extremely broad. As a result many advertisements and other marketing material are regulated under the FSR regime. Very broadly, there are three requirements that are likely to apply:

- providing a FSG;
- giving a warning to the effect that the advice does not take into account a person's individual circumstances;
- informing a person that he or she should refer to the relevant PDS.

In particular, the requirement to provide a FSG is clearly impractical in many situations such as posters, and radio and television advertisements. An FSG simply cannot be given in

[11] Section 1013F(2)(b)

situations like this. The original FSR regime contain some exceptions from these requirements. However, there have been an additional 7 separate exceptions from the requirement to give an FSG have been included in the regulations. These exemptions themselves often contain additional requirements to include disclosures about remuneration. The application of these exemptions varies, for example, depending on whether the advice is given by the issuer of the relevant financial product or other related people.

The result is that the preparation of marketing material in strict compliance with these requirements is a complex and difficult matter. There are also currently inconsistencies in terms of practice within the industry, no doubt due to different interpretations of these requirements. While many licensees will by now have addressed these issues, issues surrounding the provision of FSGs and the preparation of marketing material is one area where the FSR regime unfortunately appears to have departed significantly from the original Wallis objectives. Although the regime is uniform in that the same rules largely apply to different products, those rules themselves are extremely complex.

ONLINE ADVICE

Another example of an area of the FSR regime which has led to recent controversy is the provision of personal advice online. The FSR regime contains strict restrictions on the provision of advice to a person that takes into account that person's personal circumstances. Broadly, prior to giving personal advice, the provider of that advice must make the necessary inquiries of the person's circumstances and then ensure that the advice which is provided is appropriate[12].

This envisages a process that works well in a typical financial planning scenario where ar adviser can talk directly to a client about his or her individual circumstances before considering these and then preparing a written financial plan. The disclosure documents i the FSR regime appear designed to fit into this framework, as an adviser initially provides a FSG and then the advice is provided in the form of a SOA which is accompanied by PDS describing the products which have been recommended.

In an online environment the application of these rules becomes complex. While there is provision for disclosure documents to be given electronically, there are difficulties whe

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[12] Section 945A

personal advice is provided online. An example is advice given through calculators on the internet. These range from calculators that allow people to determine the superannuation contributions which will be required to achieve a certain income in retirement through to websites designed to assist people in determining their risk profile. There is a general view in the industry that these sorts of calculators provide useful information to consumers at low cost and are particularly useful for those people who cannot afford or do not want to use a professional financial adviser.

However, often this advice will be characterised as personal advice as it takes into account the individual circumstances of the client (for example, the income they want in retirement). It is then difficult if not impossible to comply with the requirements to consider all of the client's relevant personal circumstances and to ensure that the advice is appropriate. This is an issue that is still being worked on. It is interesting in this context to note that the Wallis report criticised the pre-FSR regime for lacking the flexibility required to deal fully with the pace of innovation and rapid developments in the financial markets[13].

FOREIGN FINANCIAL SERVICE PROVIDERS

An area where there has been significant change in the FSR regime over the last two years is in the regulation of foreign providers of financial services. At the commencement of the regime on 11 March 2002, there was little allowance made for providers of financial services located outside Australia. Indeed, the test for when a person located outside of Australia was required to hold a licence was extended to include those whose conduct was intended or likely to induce people located in Australia to use financial services which they provide[14]. This presented significant difficulties in a range of common arrangements, for example, where an Australian superannuation fund wanted to appoint a US based investment manager.

This position has been the subject of extensive relief by ASIC. First, there is now class order relief so that the statutory "inducing" test referred to above only applies in relation to retail clients[15]. Secondly, ASIC has granted relief from the requirement for foreign financial service providers to hold licences where those providers are subject to "sufficiently equivalent

[13] Wallis report, pp278-290.

[14] Section 911D

[15] Class Order 03/824

regulation in a foreign jurisdiction and only provide financial services in Australia to wholesale clients[16]. This relief is subject to a number of other restrictions but generally provides a relatively straightforward way for foreign-based entities to enter the Australian wholesale market. It represents a significant change from the position under the FSR regime as originally enacted.

There is continuing work in this area, particularly where financial services are provided to retail clients. ASIC has already granted relief for limited activities that can occur where a person acquires a financial product outside of Australia and then the provider of that product or a related entity provides financial services to that person when they are in Australia[17]. However, difficulties can still arise where, for example, a client from a country such as New Zealand is temporally or permanently residing in Australia but still wishes to retain financial products acquired in New Zealand. An adviser in New Zealand could (provided the activities constituted a business) still be required to obtain an Australian licence in order to provide financial services to that person. The client may, however, have difficulty in finding an adviser in Australia who is suitably qualified to give them advice about financial products that are not generally available in Australia.

There is further work being done on these issues particularly as they apply in relation to New Zealand. The New Zealand and Australian Governments recently asked for comment on a joint discussion paper on the trans-Tasman mutual recognition of offers of securities and managed investment scheme interests. Under the proposal, provided certain conditions are met, regulated offers in New Zealand and Australia may be made in the other country in the same manner and with the same offer documents as permitted in the home country[18].

The trans-Tasman regulation of managed investment schemes is also affected by ASIC recent Class Order 04/526, "Foreign collective investment schemes". This exempts certain New Zealand schemes, amongst those of other countries, from the need to register Australia as a managed investment scheme. New Zealand schemes are also exempted from

[16] See ASIC Policy Statement 176, "Licensing: Discretionary powers - wholesale foreign financial services providers". Class Order relief has been given to UK FSA, US SEC, US Federal Reserve and OCC, Singapore MAS and Hong Kong SFC regulated entities, CO 03/1099, CO 03/1100, CO 03/1101, CO 03/1102 and CO 03/1103 respectively.

[17] Class Order 03/825

[18] Discussion paper, p 9. Note that the regime will not extend to other financial products such as life insurance or superannuation products.

the need to obtain an Australian financial services licence for the operation of the scheme in Australia. However, relief does not extend to disclosure documents nor to the promotion of the scheme in Australia. New Zealand currently provides relief for the promotion of Australian managed investment schemes subject to certain conditions[19].

It seems likely that the FSR regime, while not initially providing for the regulation of foreign financial service providers, will serve as a basis for continuing work to allow mutual recognition of sufficiently equivalent foreign based regulation.

WHOLESALE FINANCIAL SERVICE PROVIDERS

The application of the FSR regime to providers of financial services to wholesale clients has also proved problematic during the transition period. While most of the more detailed requirements of FSR including the requirement to give disclosure documents to clients apply only to retail clients, the obligation to obtain a licence applies to both to providing financial services to both retail and wholesale clients.

The scope of financial products covered under the FSR regime can lead to anomalous results. Providing a wholesale client with advice on credit (which is generally exempt from the FSR regime) does not require a licence whereas advice on a debenture or a cheque book does require a licence. In the retail context, of course, the Uniform Consumer Credit Code regulates credit, while for wholesale activities credit remains effectively unregulated.

The impact of FSR on securitisation is a good example of the complexity that can arise in applying the FSR regime to these types of activities. Despite interim ASIC class order relief[20], the issue of whether issuers and managers of securitisation programs require an AFSL is still unresolved.

In this context it is worth noting that the definition of a wholesale client is extremely broad For example, those just qualifying as a wholesale client, because they have net assets o $2.5 million or gross income of $250,000, are clearly different to institutional investors

[19] Securities Act (Australian Registered Managed Investment Schemes) Exemption Notice 2003

[20] Class Order 03/1098

Therefore, it is unlikely that despite the view that many wholesale clients do not need the protection of licensing, there is a real prospect of significant reduction in the regulation of providers of financial services to wholesale clients as wholesale clients are currently defined.

CONCLUDING REMARKS

The FSR regime has certainly had a difficult development during the transition period which has challenged the basis of uniform regulation. Despite a significant amount of legislative amendment as well as considerable work from ASIC, the regime is currently subject to criticism on a number of fronts, particularly in the area of the length and complexity of disclosure documents.

However, this period following the end of a transition period is always going to be one that leaves a new regulatory regime subject to criticism. Despite significant work and cost, there is a perception that there have been few benefits so far. As discussed above, this perception is not unexpected. While many of FSR's core objectives in terms of consistent regulation of conduct have been achieved, as we have seen there are still a number of areas where difficulties are likely to persist past the end of the transition period. As industry and consumers become increasingly used to the new regime, many of these problems will be addressed. The short time in which the regime has been in place makes any dramatic changes to the regime seem precipitous. Nevertheless, particularly in the area of disclosure, it seems likely that there will over time be some reassessment of the detailed rules in the FSR regime.