

## Financial Services Reform Act – The Regulator's Experience So Far

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#### Introduction

The theme of this conference Financial Services: A New Era is very appropriate when we consider the pace of statutory and regulatory development in consumer protection over the last decade. Compliance management has been part of this change and I hope to be able to demonstrate to legal practitioners here today the likely demand for your expertise in Financial Services Reform (FSR) implementation and the licence application process. I also hope to demonstrate that without a high level of co-operation across the different disciplines and functional lines within a conglomerate, implementation will open up the corporate entity to challenges from the regulator.

For a conglomerate like Westpac the implementation task is daunting, the licence process is demanding, and the allocation of staff and management resources is substantial. It is not an exercise to be taken lightly and it is quite likely that even a minimalist approach to implementation will be beyond the internal capability and expertise of many financial service providers, especially if they have not already commenced the business impact assessment process.

If you analyse the impact of the new law and its regulations across the value chain of a financial provider of products and services the impact is very substantial. Every part of the retail and wholesale businesses are touched and as a consequence the need for outstanding execution and co-ordination is essential if costly mistakes are to be avoided. (Attachment A. Value Chain Impact)

In our approach Westpac's legal counsel and advisors have played a pivotal role by ensuring consistency in application with only one interpretation of the requirements applied across the Group.

#### Background

To understand the significance of FSR compliance requirements we need to consider the last decade of development in corporate governance, for here lays the foundation stones on which the legislation and regulation are based.

The development of compliance as a separate field of activity has been driven by the courts and regulators establishing new mechanisms to encourage corporate entities to be more accountable and more pro-active in managing their responsibilities. They have done so by creating benefits or relief from penalties if an effective compliance program is in place. The emergence of this new style of

compliance regulation was in response to the recognition that the imposition of standards backed by civil or criminal sanctions are limited in their effectiveness.<sup>1</sup>

### 1. US Sentencing Guidelines

The US Organizational Sentencing Guidelines established a decade ago provides incentives for far reaching compliance programs and have produced a new occupation that advises organisations on how to build effective programs that promote ethical behaviour.<sup>2</sup> The Guidelines provide a method for determining the appropriate range of imprisonment in proportion to the offence and, more importantly for this discussion, the guidelines are geared toward deterrence and provide sentencing benefits for organizations that have an effective program to prevent and detect violations of the law. The minimum criteria for an effective compliance program include the establishment of compliance standards and procedures which are communicated to relevant staff, monitoring and reporting systems and the engagement of high level management in oversight.

### 2. The Courts

In 1995 the Federal Court made it clear that a most important factor in mitigation was whether the company has a corporate culture conducive to compliance with the Act, as evidenced by educational programs and disciplinary or other corrective measures in response to an acknowledged contravention.<sup>3</sup> The Trade Practices Act and its application by the TPC and subsequently ACCC as well as the Courts have also established through a series of decisions that the defendant must show the effectiveness of the compliance program to prevent further breaches occurring.<sup>4</sup>

### 3. Criminal Code

Our Criminal Code is now much more in line with US situation, since the Code makes compliance systems a relevant factor for courts to consider in assessing civil and criminal liability under Commonwealth statutes. One of the most effective ways in which legislators have required management to take responsibility for implementing compliance systems is through making individual directors or bodies corporate liable unless they can prove the application of a due diligence defence.<sup>5</sup> For example, failure to pay a customer’s money into a trust account, which complies with specified requirements, is an offence whatever the circumstances. Under the Commonwealth Criminal Code if an offence is committed by a company, a director may be subject to prosecution as well if, for

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<sup>1</sup> “...they can produce unnecessarily complex and inflexible rules leading to over-regulation, legalism, delay and strangling of enterprise. They can produce the wrong outcomes when enterprises comply with rules that are too narrow or broad. They can encourage evasion and creative compliance rather than substance and goals of regulation. They can fail if regulatory agencies are ‘captured’ by regulated entities. They also fail when strong monitoring and enforcement are lacking”. R. Baldwin. Regulation after ‘command and control’ in K. Hawkings (ed). The Human Face of Law (Clarendon Press, Oxford. 1997. pp 65-84

<sup>2</sup> D.E.Murphy. The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics, 2002, Iowa Law Review p.697

<sup>3</sup> TPC v TNT Australia Pty Ltd.

<sup>4</sup> TPC v CC (NSW) Pty Ltd, 1995, TPC v CSR Ltd 1991 ACCC v Australian Safeway Stores 1997

<sup>5</sup> C.Parker. The Emergence of the Australian Compliance Industry: Trends and Accomplishments. Australian Business Law Review Volume 27 June 1999.

example, the director ‘aids, abets or procures’ the commission of the offence. In this example if the directors were informed the account did not comply with FSR and took no steps to deal with the matter, the directors may also be personally liable for the breach because of their ultimate responsibility for these processes. Directors have a defence to breaches of these provisions if they can show a positive culture of compliance within the organisation and adequate compliance systems and processes.

#### 4. New Statutory Requirements and Enforceable Undertakings

Over time we have seen statutory provisions strengthen and specifically referenced compliance requirements. For example, in the Eighties the law required the implementation of a compliance program or systems and reporting to a statutory body.<sup>6</sup> Recently we have seen more detailed compliance requirements. For example in the Managed Investment Act 1998 there is now a need to have in place compliance plans, a compliance committee and reporting mechanism through to the Board.

Regulators have also used their enforcement instruments to achieve further compliance concessions. In response to investigatory findings against a particular financial services company and its management Enforceable Undertakings have been used to introduce the concept of best practice in complaint handling and compliance management. EU’s are enforceable in a court and provide the administrative solution for many statutory contraventions.<sup>7</sup> ASIC’s reliance on this form of enforcement has been based on the belief that through example other market participants will move to address these issues and lift their performance in compliance management. While EU’s are very effective and certainly much quicker than the Courts they still are too slow in impacting on a very competitive and growing market.

#### **Financial Services Law Reform**

CLERP 6 was justified by the Government on the basis of the need to reduce multiplicity of licensing and regulatory regimes, to provide a regulatory regime that copes with new entrants into the market, to introduce cost efficiencies and to increase disclosure to the consumer about financial products and services. By the time that FSR law came into being the objectives had shifted and no longer reflected the original justification for reform.

The objectives of the new law now include: to promote confident informed decision making while facilitating efficiency, flexibility and innovation in products and services, fairness, honesty and

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<sup>6</sup> The Affirmative Action (Equal Employment Opportunity for Women) Act 1986 requires qualifying companies to implement a policy for reducing and preventing discriminatory practices by requiring them to report annually. The Privacy Act 1988 requires the implementation of systems meeting certain standards to ensure the privacy of tax file numbers collected by businesses and other organisations.

<sup>7</sup> Enforceable Undertakings are “...more versatile than any of those remedies, and may be used to achieve outcomes which might not be available by those means, and which are more focused (eg adoption of a compliance regime, restriction of a person’s securities business or practice as an auditor).” PS. 69.5

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professionalism by those who provide financial services, fair, orderly and transparent markets and reduction in systemic risk and provision of effective services by clearing and settlement facilities.

The first two objectives are key policy changes. The extension of 'know your customer' approach across the entire retail and wholesale financial services sector, together with training and accreditation requirements have also been accompanied with a higher level of accountability for compliance. The Australian Standard on Compliance Management AS 3806 is now formally recognised as the benchmark against which licensees will be assessed and a substantial body of policy information is now available.

ASIC has certainly provided transparency in its views on compliance, however we now have such a large body of law, regulations and policy pointing us in the right direction, that it is highly unlikely that most licensees will be able to absorb the implications this material has for them and the licence process. Legal Counsel can play an important role in determining how the licensee complies in a consistent way with these requirements while taking advantage of the limited concessions provided by ASIC.

The Policy Statements also indicate that much of their contents has been heavily influenced by ASIC's experience with Managed Investments Act, even though the complexity of investment products and services covered by the new law varies from the simple day to day transaction account to investment linked products and the sophisticated services provided by the wholesale market. An example of this influence is the reworked PS 146, Licensing: Training of financial product advisers which sets out minimum training standards for people who provide financial product advice to retail customers. The policy continues to reflect a two tier approach to the educational standards necessary to cover the whole advisory workforce who may provide general and personal advice on a very wide range of products and services.

In summary, FSR Act, its regulations and ASIC's policy statements have demonstrated that prescriptive requirements with some degree of flexibility continue to be part of the regulatory approach adopted by Parliament and regulators. For others FSR signals the next stage of evolution in corporate governance with the new law seen to place on an organisation and in particular its directors a responsibility for the creation and maintenance of an ethical environment.<sup>8</sup>

### **Implementation Approach**

Implementation of FSR requirements requires many strategic decisions to be taken by an aspiring licensee. For Westpac our strategic approach was very clear and had commitment from CEO and the Board. We embarked on a focussed program which would act as a catalyst and change agent to help us differentiate our service from our competitors. Three key strategic themes drove implementation: for the customer we want to be the Trusted Advisor, for staff we want to demonstrate that we are a

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<sup>8</sup> S. Cohen. Compliance, Corporate Governance, and Ethics: The New Regime. Unpublished 2002

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Learning Organisation and for management our compliance approach needs to protect our reputation.

This focus established an effective framework and momentum necessary to deliver a comprehensive, organisation wide program. We started from a frank and honest review of our existing strengths and weaknesses and ensured that these were addressed. Attachment B outlines the key issues and deliverables which were agreed upon. That review of our capacity to deliver and subsequent implementation could not have been achieved without the full co-operation of our legal team.

For Westpac the FSR touches 286 products and their respective terms and conditions (Product Disclosure Statements), requires 18,000 staff to be trained at 1000 locations for an average 20 hours. The compliance plan has in excess of 500 business requirements including new infrastructure to track staff accreditation and ongoing training requirements and new monitoring techniques centred on the interaction between customer and staff member during the advice giving process. The cost of implementing the new law is \$29 million.

Successful execution of the 'Know Your Customer' approach involves front line staff establishing the needs of the customer and making the best fit recommendation across a large product range and ensuring that all the relevant information has been disclosed to the customer at the right time<sup>9</sup>.

How successful we are at implementing this program will be dependent on many things, but most importantly what is needed is the recognition that behavioural change for management, sales and service staff is a fundamental to successful execution.

Here lies the key issue for compliance practitioners and their legal counsel. For many of the large financial corporations the retail banking market strategy has focused on their bankassurance and wealth creation which targets sales of value add products to their customer base. The profile of front line staff shows that they are often not staff well conversed in giving 'needs based' advice. Nor is management of the service network familiar with mandatory role accreditation and monitoring the customer/staff interface with its associated disciplinary issues.

Only in the area of insurance, superannuation and investment products have specialist staff been trained to the required top level: Tier One as prescribed in Policy Statement 146. For the vast majority of front line staff FSR implementation will require them to undertake initial and ongoing training, be accredited to sell a certain range of products and services and be monitored for compliance on a regular basis. For management they will need to review performance objectives, KPI's, commission and other sales incentives to ensure that they compliment customer needs based selling.

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<sup>9</sup> Financial Services Guide. Statement of Advice and Product Disclosure documents must be provided to the customer at key points during the advice seeking and sales process. The different contact points the customer uses further complicate this process: telephone, Internet, branch network, mail.

For those who are familiar with financial planners and advisors you will be aware that for compliance purposes we can automate ‘needs analysis’ through a structured decision making process. However ensuring that advisors deliver to the investor all the relevant information in a way they understand and at the right time is a continuing challenge, especially with an industry that operates on a fee/commission basis. Now all retail banking network staff that provide general or personal advice will be held accountable in a similar way.

In planning implementation the following questions need to be addressed:

1. How do you go about introducing a role accreditation framework across the workforce and manage the industrial issues?
2. How does management know that staff have a good understanding of their requirements?
3. How does management ensure customer’s needs are being met?
4. How does management establish that PDS and other disclosure material are handed out and explained at the right time?
5. How is the licensee going to monitor the customer/staff interface across all relevant channels of contact?
6. How is the compliance plan going to be developed and maintained and who is going to audit the effectiveness of the control mechanisms?

### **Preparation for licence**

The licence application process is not an end in itself. It is just one step in a long journey with the transition period extending implementation capacity over two years. For conglomerates most will need this time period to deal with all of the issues.

An applicant for a licence will need to demonstrate not only to ASIC but to senior management as part of the licence due diligence exercise that it can meet its obligations. In practical terms this means that an implementation plan needs to be developed to meet each of the requirements including:

- Be able to meet all the obligations as required;
- Have adequate operating rules and procedures to ensure that the market will operate in a way that promotes the objectives of fairness, orderliness and transparency;
- Have adequate arrangements for supervising markets which includes having arrangements to handling conflicts between its own commercial interest and its role as a market supervisor, monitoring the conduct of participants in relation to the market and enforcing compliance with market’s operating rules;
- Ensure that there would be unacceptable control situation arising if a licence was granted; and
- Ensure that no disqualified individuals appear to be involved with the applicant.<sup>10</sup>

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<sup>10</sup> S 795 B (1) (a) to (h)

ASIC’s Policy Statements, licensing kit and other material provide a wealth of guidance on the issues. The most important compliance related Policy Statements are PS 164 Licensing: Organisational Capacity and PS 146 Licensing: Training of financial product advisers. Among other things PS 164 makes it clear that the licensee responsibilities are to determine on an ongoing basis what measures, process, procedures it needs to fulfil its stated obligations.

The benchmark against which ASIC will determine the appropriateness of the compliance approach taken by the licensee is AS 3806 however the policy statement has recognised that all licensees do not have the same capability to deliver.<sup>11</sup>

A licensee would be well advised to assess their approach to compliance and the new compliance requirements as part of the implementation exercise if they wish to maintain an exemplary record with the regulator. For example, very few companies having direct reporting lines to the Board for the chief compliance officer and with compliance now being firmly on the agenda for directors we can expect changes in reporting lines as a result of FSR implementation.

The FSR compliance program must cover all of the licensee’s obligations, not just those to be considered as most important by management. This is not to say that all obligations should be given the same risk status and all require monitoring at the same level of intensity as others. But it does mean that how you define the compliance plan and address the monitoring of compliance risk that may affect consumers is critical to getting it right.<sup>12</sup>

From the consumer and management’s point of view the biggest risk is the risk of biased or negligent advice. Hence the importance of training and accreditation, reviewing performance goals and sales and referral incentives and upgrading staff disciplinary policy.

It is important to note that PS 164 refers to compliance manual, compliance system and compliance plan. They are all different and describe individual measures that make up the program which covers not just FSR but all statutory and regulatory compliance activities. The important issue to focus on is ensuring that the compliance approach and program put in place is comprehensive and effective in identifying problems and tracking remedial action.

Both Managed Investment and Superannuation compliance plan activity provides a solid basis for development of the FSR plan. In defining the business requirements which stem from the statutory requirements there is a need for close co-operation between legal, compliance and the business unit to ensure that the business requirement can be executed, be monitored and is consistent with the

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<sup>11</sup> PS 164.67.

<sup>12</sup> Policy Statement 164.47

statutory intention. ASIC’s Financial Services Policy Handbook provides you with a checklist of compliance issues.<sup>13</sup>

Unfortunately this is not the end of the task since there is a requirement for compliance measures to cover Corporations Act obligations. It is also important to carefully review what are the existing systems and gaps in relation to corporate governance responsibilities and ensure that areas not covered are included in the implementation program.

In fact commentary on this section of the Act has already suggested a potential for ‘double jeopardy’ situation to occur for financial services licensees since breaches of other financial services law cannot only lead to penalties under those laws, but to a licensee’s licence being suspended or cancelled pursuant to the Corporations Act provisions.<sup>14</sup>

### **Licence Due Diligence**

A useful licence plan has been developed and is commended for your consideration. Called The Seven Stages of FSR Licensing it deals in a systematic way with many of the issues which we grappled with as part of our implementation exercise which commenced in May 2001, when the new law and licence requirements were not in place<sup>15</sup>.

A four stage licence application due diligence process is now being undertaken within the Westpac Group to ensure that we are ready to apply for licences and will fulfil all legislative and policy requirements.

- Development of compliance plans and supporting processes by each business, reviewed by internal compliance officers and PriceWaterhouseCoopers, to ensure that all FSR obligations have been addressed by the required date.
- Readiness Review of each business co-ordinated by the FSR Project Office. Issues such as training rollout and monitoring approaches to be locked in with appropriate budget resourcing assigned.
- Conglomerate Review of all licence questions to ensure consistency and complete coverage.
- A final management assurance of FSR readiness by each business in conjunction with the Chief Compliance Officer, Chief Legal Counsel and relevant business heads.

Legal practitioners whether in house or external should play a significant role in each one of these steps since:

- Compliance plan’s business requirements need to be defined with legal counsel assistance to ensure consistency and fulfilment of the obligation.

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<sup>13</sup> p. 6244 ASIC Financial service Policy Handbook December 2001

<sup>14</sup> s. 912 A. The Essential Guide to FSR p.545

<sup>15</sup> Karen Del Toll of Clayton Utz, Australian Corporate News. Issue No. 6 p. 69



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- Through their implementation activity legal counsel will be aware of attempts by business to minimise business requirements and therefore expose the licensee to compliance risk. The licence application due diligence process gives legal counsel the opportunity to escalate such issues.
  - Corporations Law requirements and their application to the FSR licence process are unlikely to be considered by anyone else.
  - Senior and executive management are unlikely to give licence readiness assurances if they are aware that legal counsel has not been playing an integral role in guiding business units and FSR project team deliberations to ensure a consistent, accuracy and comprehensive approach to legal obligations.

From my experience the following issues may be of relevance to you in your licence due diligence process:

- Conduct due diligence education for staff and managers giving the assurance which the process requires. With the exception of corporate centre, managed fund and superannuation area it may well be that business unit managers are unlikely to have been part of a due diligence exercise. What the process entails them to do so they can give management the assurances they will need will need to be spelt out.
- Anticipate a loss of corporate memory. Financial service and product providers all experience high staff turnover rates. A central document depository is necessary to ensure that any ASIC inquiry on licence undertakings can fully addressed in the knowledge of what management relied on to make the assurances.
- Conduct in-depth interviews with key senior managers to ascertain their awareness of the commitments which their business managers have made on their behalf, their level of commitment inc resourcing and understanding of their obligations. This is particularly the case with designated Responsible Officers.
- Ensure that compliance plan has effective control/monitoring mechanisms for all key requirements to show a culture of compliance exists.
- Consider all licence applications together for consistency and complete coverage although it may be advantageous to lodge separately
- Consider carefully the timing of the licence application/s given other live ASIC issues, your stage of implementation and level of comfort that you have that the program is on track, the competitive issues given that there are some negative customer experiences and finally and ASIC’s stated intentions to vigorously enforce licence obligations.

### **Post Licence Compliance Issues**

Post licence commencement and adherence to the new FRS regime is also very important since implementation completion and benefit realisation will be ongoing after the licence has been granted and you now become a possible target for early enforcement action by ASIC.

At Westpac the Group Compliance Committee made up of executive and senior business and corporate heads monitors the Group’s progress with the FSR project team continuing to ensure execution on time at the business unit level. Going forward our FSR obligations will be embedded in normal operating processes and are already supported with enhanced monitoring capability. Our compliance reporting rolls up into in the quarterly Business Unit Risk Performance Review process and implementation and compliance risk commentary will be covered in my report to the Board. Finally the compliance plan will be internally audited as part of the normal business unit audit cycle.

### **The next steps in evolution**

The next step in the evolution of consumer protection regulatory environment is unlikely to occur in the next 3-5 years, nevertheless we should anticipate governments responding to emerging issues driven by offshore activity and regulators responding to industry and consumer group demands. For me the two key issues which are likely to receive attention are ethical behaviour of corporate entities and needs based credit advice.

It is questionable whether a compliance program can be truly effective if it does not have an ethics component since much of what compliance activity is about affecting in a positive way the culture: the behaviour of management and staff. The way in which a company’s management fosters staff accountability for reporting compliance issues and how it goes about protecting reporting mechanisms and rewarding ethical conduct are issues which have already been raised in the United States and are likely to find their way onto the regulatory agenda especially if corporate governance and social accountability continues to gather momentum.

Once FSR is integrated into the way in which financial providers operate and has demonstrated consumer benefits, the debate is likely to return to credit. While Consumer Credit Code provisions focus on disclosure requirements, the lenders obligations do not extend to ensuring that the best product is recommended to meet the customer’s needs. It will be hard to mount a sustainable argument against why the established approach in FSR of ‘knowing your customer’ and undertaking a needs analysis for all credit products should not be introduced.

## Value Chain Impact

Retail Distribution	Retail Products	Retail Delivery Mechanisms	Wholesale	Corporate
Know your customer	More products regulated	Timing of documentation	Differentiating wholesale customers	Lending to employees for share purchases
Needs analysis	New documentation	Storage & retrieval of documentation	Financial advice to retail customers	Compliance including monitoring
Competency Assessment	New marketing controls	Intranet competency assessment	Coverage of activities	Licensing
Accreditation	Ongoing disclosure	Registering & training staff accreditation	Confirmation of transactions	Corporate governance
Third party channels	Third party products			Directors' Liability
Cooling off process	Clearing & payment streams			

FSR STRATEGY

## Attachment B

**Financial Services Reform Implementation: Issues and Deliverables.**

<b>Issue</b>	<b>Deliverable</b>
Role Accreditation	An accreditation framework for all customer contact sales and service staff
Training Infrastructure	Common foundation for planning, delivering, assessing and visibility of all training and accreditation
Training Plans	For each role and individual training plans to be put in place
Career Mapping	Career Map and options clear for all roles and all staff.
Training Course Inventory	Well understood inventory, in active use, integrated into performance planning
Time to Learn	Built into manpower planning and focussed on business requirements
Sales Process	Best practice national sales process, supported by integrated tools and training
Sales support Tools	Effective needs based selling tools and help optimise sales and cross sales opportunities
Product Terms and conditions	Consumer friendly, plain English and best practice disclosure
Product reference Material	Easily accessible, current and comprehensive product information available at all customer touch points
Product development and management process	Optimum due diligence and release process, fully integrated with front line training and support tools.
Compliance responsibility	Responsibility is clearly embedded in defined roles within each business
Compliance Plan	Plan is in place and integrated into broader compliance approach for the business
Compliance Culture	Each business is knowledgeable of its compliance responsibilities takes them seriously, and makes risk weighted business decisions
Regulator Relations	Develop an excellent working relationship with ASIC. Licences granted with only standard conditions applied.