

FINANCIAL SYSTEM INQUIRY

CHAPTER THREE

REGULATORY ARCHITECTURE

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This chapter considers Australia's financial system regulatory architecture.

INTRODUCTION

Previous inquiries into the financial system have led to substantial change in the financial services industry and the Australian economy.

From the Campbell inquiry came the floating of the Australian dollar, bank deregulation and removal of foreign exchange control. The Wallis Inquiry ushered in the current twin peaks regulatory model of APRA and ASIC.

These inquiries were fundamental in establishing a strong Australian economy and financial services industry.

This chapter considers the following issues

- ❖ Regulation making, regulatory structure and review processes
- ❖ Dispute resolution schemes
- ❖ Data
- ❖ Privacy legislation
- ❖ Advice regulation
- ❖ Removal of redundant / inefficient regulation

THE CURRENT REGULATORY SYSTEM

The regulatory framework considered by the Wallis Inquiry is dramatically different to the framework before this Inquiry.

Many reforms imposed after the Wallis Inquiry were adopted such as the twin peaks regulatory model. In certain cases, matters recommended by the Wallis Inquiry have been replaced and/or eroded as subsequent reforms sought to address specific objectives.

Before considering specific elements of the regulatory system, we should consider the ability of self regulation to drive behaviour and outcomes.

Self regulation

The FSC believes that effective self-regulation through Standards and Guidance Notes allows markets to find efficient solutions through principles-based requirements while protecting consumer interests.

Compliance with the FSC Standards is compulsory for all full FSC members. By adhering to FSC's Standards, member companies have undertaken to develop processes and products that provide investors with a quality assurance that goes beyond the base-line legislative and regulatory framework.

On a day to day basis, FSC's Standards are overseen by the relevant Board Committee under which the Standard sits. Moreover, the FSC's full members are required to adopt a Board resolution each year stating they are satisfied that:

- ❖ The company has complied with mandatory FSC Standards for the year just completed; or
- ❖ Where the company has not complied, the exemptions which have been granted to them by FSC in this regard; or
- ❖ The Standards which are not applicable to the company's business.

GUIDING PRINCIPLES

In developing our recommendations we propose a number of guiding principles for the Inquiry to consider, namely:

Confident consumers

Consumers need to have confidence in the financial system. Confident consumers will save more and will be more likely to use the services offered by the financial services industry.

Consumer behaviour will be impacted by legislation underpinning investment services, including the taxation system and its impact on investment in funds.

Informed buyer responsibility

The consumer should have access to regulated and unregulated products with a consistently applied disclosure. Disclosure needs to highlight the implications to the consumer of agreeing to the product features. It is recognised that disclosure alone is not sufficient to protect the consumer. The consumer needs access to affordable and unbiased transparent professional advice.

To this end, the Inquiry should also consider whether the distinction between sophisticated and unsophisticated investment choices is clear enough. By setting the minimum standard too high and not allowing for innovation or risk, the regulatory framework runs the framework could prevent maximum efficiency in financial markets.

Ultimate responsibility can and should remain with the investor. However, the ability for investors to be placed in 'default' options that are simpler and backed by industry and public assurances (where relevant) will always be important to Australian consumers.

Consistent and efficient regulation

Regulation needs to be consistent across the financial services system. Regulation should be principles-based and encourage innovation and competition to enable a sustainable industry. It should not cause unnecessary costs to consumers, or cause disincentive to innovate. Financial services businesses need to have the flexibility to develop, produce and sell products efficiently. The customer should not be confronted with a variety of inconsistent and complicated regulatory

frameworks when buying financial products.

Transparency

There needs to be transparency around product fees, the ownership structure of providers, potential other sources of bias and remuneration systems.

However, transparency need not come in the form of additional work for regulators. Market discipline via disclosure is an effective way for market participants to actively set themselves apart from their competitors by demonstrating the advancement in their own internal risk management and governance processes.

Requiring disclosure board audit committee structure, meeting frequency and qualifications; equivalent board risk committee information; risk management system descriptions; and governance systems in place, amongst other things, would help to form a useful framework for investors to draw information from. Minimum disclosure requirements should reflect the expectations of the market.

REGULATION MAKING, REGULATORY STRUCTURE AND REVIEW PROCESSES

Process

Any review of the financial system must also be focussed on Australia's international competitiveness and include a cost/benefit analysis of the proposed regulation. In particular, we recommend the following be included in the Best Practice Regulation Handbook:

- ❖ Consultation should be public and provide stakeholders with a reasonable time to review and assess impacts for submission. We recommend that 90 days consultation as articulated in the Best Practice Regulations Handbook remains a suitable and reasonable timeframe;
- ❖ We strongly encourage post implementation reviews be conducted;
- ❖ Regulators should be set red tape reduction targets – regulators should be obligated to consult on alternative measures to achieve desired outcomes; and
- ❖ Regulatory Impact Statements (RIS) are critical for the determination of the cost/benefit of proposed regulation on consumers and the industry.

Regulatory governance and accountability

The FSC believes that the current regulatory governance model is inadequate. Senate Estimates and Parliamentary oversight hearings provide a mechanism for political oversight of regulators but are unable to properly review the operation and performance of regulators.

A wider and deeper accountability process is required.

RECOMMENDATION

There is a need to structurally enhance the level of oversight and accountability through consideration of a range of measures through:

- Publishing a Risk Appetite Statement (RAS) setting out its enforcement and surveillance priorities and that this should be closely linked to an overarching RAS - developed either by Government or Council of Financial Regulators (COFR);
- The RAS should be the basis for the establishment of key performance indicators and other measures against which regulators' performance can be assessed; and
- Better reporting of performance against the RAS.

Consideration should be given to a formalised role for Council of Financial Regulators (COFR) in ensuring policy objectives are being reflected in regulator activities as well as ensuring proper coordination across regulators.

Regulator mandates need to explicitly incorporate additional requirement to balance consumer protection and other objectives against Australia's competitiveness and attractiveness as a financial centre.

We believe the membership of COFR should be extended to include all financial sector regulators and agencies. COFR should also be tasked with promoting the efficiency of financial sector supervision and minimising overlaps in activity.

RECOMMENDATION

A formalised role for COFR should be established to ensure government policy objectives are being reflected in regulator activities as well as ensuring proper coordination across regulators.

Regulators - structure and mandate

The Wallis Inquiry recommended two key regulators, namely the market conduct regulator and the prudential regulator. ASIC was formed to “provide Commonwealth regulation of corporations, financial market integrity and consumer protection”.¹ APRA was established to prudentially regulate Approved Deposit taking Institutions (ADIs), General Insurers (GIs), Life Insurers (LIs) and superannuation funds.

The objective of establishing the prudential regulator distinctly from the market conduct regulator was to ensure that each regulator was able to focus on their respective responsibilities. We note that the UK has also recently moved to a twin peaks regulatory model because of a view that the single regulator, the Financial Services Authority was ultimately ineffective (for a number of reasons) in avoiding the impact of the financial crisis on the UK, and preventing the numerous miss-selling scandals.

The UK now has a prudential regulator, the PRA (which is housed within the Bank of England) and a market conduct regulator, the FCA. The PRA has primary responsibility for the prudential regulation of the major financial services institutions that may have a systemic impact if they were to fail. In addition to being responsible for market conduct, the FCA also has responsibility for prudentially managing those organisations that would have a second order effect if they were to fail.

Whilst the FSC supports the current twin peaks approach to regulation we have a number of concerns that the responsibilities of the regulators have tended to blur, duplicate and at times conflict - for example the expectations on the structure of risk and compliance functions within regulated entities.

The FSC submits that this Inquiry is ideally suited to consider the objective of the regulators by comparing their current operations to the original intent (as stipulated in the Wallis Inquiry) and determine if their mandates remain valid and whether amendments are needed.

Parliament has delegated too much power to ASIC and APRA to create policy, standards and rules. The power is delegated to them by the Parliament. We believe that the Parliament has devolved too much authority to the regulators and that these powers should be reviewed by the Inquiry.

It is the FSC’s view that amendments to policy outside APRA and ASIC’s clear remit should be a matter for Parliament and not the regulator to address potential/perceived gaps.

RECOMMENDATION

Twin peaks has been a largely effective regulatory model. The Inquiry should review and articulate a revised mandate for each major regulator. Policy should be established by Parliament, not by regulators.

¹ Wallis Inquiry Recommendations page 31

APRA

APRA's purpose as a prudential regulator is first and foremost to protect the financial promises held out to deposit-holders of ADIs, policy-holders in general and life insurance companies and members of superannuation funds in Australia.

In that capacity, APRA has carried out its role by implementing principles-based prudential standards (as opposed to the rules-based regulatory regimes that have been unsuccessful in the United States, amongst other jurisdictions), coupled with sufficiently regular and intrusive prudential reviews at regulated institutions.

APRA's supervision includes the ability to formulate and give effect to prudential standards that are mandatory on APRA regulated entities. To ensure a consistent prudential framework amongst regulated entities, APRA has sought to develop a framework where standards may be consolidated across the various industries it regulates. In a media release dated 12 September 2011, APRA noted:

"APRA has long sought to apply a consistent, harmonised approach to the setting of prudential requirements for regulated institutions, where appropriate. Harmonisation simplifies compliance, particularly for groups that operate across regulated industries."

Further, APRA's Corporate Brochure 2012 states:

"APRA recognises the complexity and diversity which exists among institutions and avoids a 'one-size-fits-all' approach. APRA's supervision allows institutions to use a variety of approaches to comply with high-level principles, rather than APRA seeking to direct an institution through detailed prescription."

Based on the above, APRA has been very clear that the nature of prudential standards were to be "principles based". In addition, the application of the standards would depend on the nature, size and complexity of the business. Further, that a risk based approach could be taken to adopting the "principles".

Whilst the FSC supports the prudential framework and APRA, the current framework consists of a number of prescriptive requirements which we feel distracts from the above stated objectives of a principles based regime. See the following for specific examples.

RECOMMENDATION

APRA should be responsible for prudential regulation first and foremost to protect the financial promises held out to deposit-holders of ADIs, policy-holders in general and life insurance companies and members of superannuation funds in Australia.

APRA should not be responsible for:

- Policy;
- Approving product design effectively providing government endorsement; and
- Data publication.

To date, APRA has drafted an effective and complete suite of Prudential Standards (utilising the prefix “SPS”) for the superannuation industry, in a bid to replicate the success in regulating Authorised Deposit-taking Institutions (ADIs) and Insurers. There remain a number of challenges to the regulatory framework in effectively supervising the superannuation industry in the same way in order to drive positive outcomes ultimately for Australian superannuation funds, but most importantly, their members.

To the extent that it is sensible for standards to clearly outline the role(s) of those audit functions, this should also be investigated by APRA on a spot-check basis in order to ensure that the expectations around the standards of work performed is commensurate with commercial and industry practice.²

RECOMMENDATION

APRA should work with ASIC to understand the nature and timing of their reviews and/or visits to determine whether a co-ordinated approach could be adopted or findings leveraged for the purposes of both regulators.

² For example, deficient funds are likely to seek the “lowest common denominator” in the provision of assurance services and this is an early warning indicator that the regulator should utilise in deciding whether to intensify supervision and/or regulatory action.

In order to perform sufficiently regular and intrusive visits, APRA should similarly employ a risk-based approach to determining what it wishes to investigate across the many funds it supervises. As such, it should focus on tasks that directly represent the interests of members and policyholders of the institutions it regulates rather than on product endorsements.

The FSC supports the Cooper Review recommendations on MySuper, but we do not believe it is appropriate for the prudential regulator to effectively endorse products. We fundamentally question the extent to which regulators should be endorsing any product. If it is deemed that MySuper be a special case,

As a general observation we are concerned that product endorsements may be a source of moral hazard from the regulatory perspective because of the expectations potentially created by consumers if a particular MySuper product were not to deliver to expectations. We are aware that some product providers are currently promoting the fact that APRA has endorsed their product.

RECOMMENDATION

APRA should not be required to approve specific products. In particular, we believe that it is not appropriate that APRA be required to approve MySuper products.

APRA prudential framework

APRA's prudential framework covers Australia's banks, building societies and credit unions (authorised deposit-taking institutions), life and general insurance and reinsurance companies, friendly societies and superannuation funds (excluding self-managed funds). APRA's framework is designed to ensure the protection of interests of depositors with deposit-taking institutions, policy holders of insurance contracts or members of superannuation funds. APRA supervises relevant entities charged with managing client's funds and interests ensuring the prudent execution of APRA Regulated Entities (**AREs**) responsibilities.

The prudential standards across all AREs are overly prescriptive. The use of terminology like “must”, “should” and “will” throughout the standards, supports the rules based nature of the prudential standards.

Detailed below are examples of the level of prescription which we consider requires re-consideration, The Financial Services Inquiry should not however limit its investigation to the below areas.

RISK MANAGEMENT - CPS 220

CPS 220 is a new standard and the level of prescription is extensive. There are detailed requirements contained in the RMS, detailed contents for risk management policies and procedures, and details regarding the risk management function and the role of the Chief Risk Officer. Where a Board, or the Board Risk Committee, is required to set and approve the RMS the above level of prescription will only distract the Board and/or Board Risk Committee from attending to its broader risk governance responsibilities and engage in unnecessary review of documentation.

Further the prescriptive role of the Board in CPS 220 and the Board Risk Committee, per CPS 510, has created duplication in oversight and therefore inefficiencies. Again this will only burden meetings with additional compliance in procedural matters which may distract from the principles of good risk governance. When considering the membership of the Board Risk Committee we feel the duplication can be overcome through sound principles that enable the Board and Risk Committee to determine their agendas.

OUTSOURCING - CPS 231

Assessment of outsourcing options: In assessing the options for outsourcing, there are a list of 7 items that that an entity must take into consideration. Each of those factors may not be relevant, for example, if the service provider is an existing service provider that can provide additional services sought. In this instance, it may not be relevant to undertake a tender process or a review of service providers. The wording in our view needs to be less prescriptive and include phrases like “where relevant” consider the factors listed.

FIT AND PROPER - CPS 520

CPS 520 is extensive with detailed requirements and the rules based nature of CPS 520 means that it is overly prescriptive. CPS 520 has over the years, had significant additional detail added. Consequently, AREs policies and underlying standards have become more detailed and overly prescriptive.

In addition, there are other provisions in CPS 520 that are overly prescriptive including “the process for assessment of fitness and propriety” is overly prescriptive extending to 10 paragraphs.

RECOMMENDATION

Regulation should be principles-based.

ASIC

ASIC should return to its focus on the consumer as envisaged in the Wallis Inquiry, that is, ASIC should “seek to establish a consistent and comprehensive disclosure regime for the whole financial system, (and) also have responsibility for the regulation of advice and sales of retail financial products, including the licensing of financial advisers under a single regime. It should oversee industry based schemes for complaints handling and dispute resolution and establish a common means of access for consumers”.³

RECOMMENDATION

RECOMMENDATION

ASIC should be responsible for:

- Financial sector consumer protection regulation;
- Financial market integrity; and
- Regulation of corporations, including incorporation, governance, insolvency and liquidation and takeovers.

ASIC should not be responsible for:

- Policy;
- Company registrations; and
- Setting advice provider competency minimum standards.

The Wallis Inquiry recommendation no. 15 proposed that ASIC would be responsible for setting a single set of requirements for:

- ❖ Minimum standards of competency and ethical behaviour;
- ❖ Requirement for the disclosure of fees and adviser's capacity;
- ❖ Rules on handling client property and money;
- ❖ Financial resources or insurance available in cases of fraud or incompetence; and
- ❖ Responsibility for agents and employees.

There has been significant reform since the Wallis Inquiry including the imposition of a new regulator across all providers in the Financial Services sector in the form of the Tax Practitioners Board (TPB) who now also carries responsibility ostensibly over the same conduct as ASIC.

The FSC queries the role of a regulator in setting minimum competency and education requirements of an evolving profession. We note that ASIC is currently proposing enhancements to education and experience required by individual investors, advisers and other professionals involved in the financial services industry. These requirements are in isolation with those requirements the TPB is setting for the same providers.

RECOMMENDATION

A single regulator should set minimum standards of conduct behaviours of advice providers.

We support the role of ASIC as the non-prudential regulator of financial entities. We query recent practices by ASIC in pushing merit-style regulation of non-APRA regulated financial entities onto the industry in essence outsourcing its regulator duties onto financial services participants.

ASIC now has some prudential powers for example setting the capital adequacy of fund managers (Responsible Entities). Whilst the FSC agrees that minimum net tangible asset requirements are appropriate for responsible entities to hold, the manner in which they are calculated and who is required to hold the capital can have significant impacts beyond simple financial resources to enable orderly wind-ups.

This is an example of regulators making public policy which has been inappropriately delegated by Parliament.

For example:

1. **(APRA - RSE Licensees)** An APRA RSE Licensee is generally “expected” to have an operational risk reserve of 0.25% of FUM.
2. **(ASIC - responsible entities)** An ASIC regulated Responsible Entity is generally required to have NTA of the greater of \$5 million or 10% of average revenue uncapped. This is the general rule - in very limited situations, the \$5 million might be a lower figure (see ASIC RG 166) however even in that limited case the NTA required is still the greater of that lower figure and 10% of average revenue uncapped. There are technical rules about what is treated as revenue - expenses paid out of the fund are treated as revenue for example. There are also technical rules and adjustments in RG 166 about how NTA is determined. See ASIC RG 166 for more detail.
3. **(ASIC - custodial and depository services)** Under ASIC’s RG 166, in relation to financial requirements for “custodial and depository services”, if the entity provides custodial and depository services (other than incidental custody), the NTA is the greater of \$10m or 10% of revenue uncapped. (There are different requirements for incidental custodians.) An RE operating as an RE is not treated as providing a custodial service.
4. Under **(APS 210)** SMSF deposit investments are categorised as ‘retail’ money for the purpose of calculating the liquidity ratio while deposit investments by other super funds are categorized as ‘wholesale’. This will increase the amount of liquid assets required to be held against deposits. We are concerned this creates an uneven playing field and disadvantages deposit investments by large super funds (compared with SMSFs). We believe APRA’s standard should be revisited to ensure like-for-like treatment of member directed deposits between different types of super funds

For ASIC purposes, if the same legal (AFSL licensed) entity is subject to multiple ASIC financial resource requirements, aggregation of the separate ASIC requirements does not occur, rather the highest result out of all the ASIC requirements would apply to that entity.

If different ASIC AFSL activities are operated from different legal entities (i.e. with a different AFSL), each legal entity will be subject to its own ASIC financial resource requirements.

Due to the removal of the exemption for certain dual APRA/ASIC regulated entities (under the Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013, from 1 July 2015, the APRA Figures (1) and ASIC figures (2 and/or 3) are separate amounts. i.e. ASIC capital does not count for APRA capital, and both the ASIC and APRA amounts are required to be held.

Figure 1.

BUSINESS ACTIVITY	REQUIREMENT
Superannuation	.25%
Managed investments	\$5m or 10% of revenue
Custody and depository services	\$10m or 10% of revenue

RECOMMENDATION

Parliament should set capital requirements. The regulator's mandate regarding capital requirements be clarified so the markets can continue to operate efficiently and maximise returns to consumers. Arbitrage must be eliminated.

ATO

The FSC agrees with the findings of the Cooper Review that the SMSF sector is "largely successful and well-functioning".⁴

An argument has been mounted that the SMSF market should be regulated by APRA and ASIC consistent with other superannuation funds. The FSC's view is that requiring APRA to regulate SMSFs would be a distraction to APRA. To enable APRA to focus on the systemically important large organisations, SMSFs should sit with the ATO.

Rather than regulating all SMSFs, APRA will need to assure themselves that they can perform analysis on the SMSF sector and gain a clear

⁴ Super System Review- Final Report Part 1 Consolidated Page 1

understanding of the systemic risk it presents by its overall profile.

Without basic data to do this, however, that task will be impossible. As discussed below, the FSC believe that the ABS should produce and publish financial services industry data.

The ABS can work with APRA to decide on the appropriate data required by APRA to ensure that APRA are aware of the systemic risks involved in the SMSF sector. We note that the new prudential regulator in the UK only regulates those financial institutions that are systemically important, the balance of the financial institutions are regulated by the market conduct regulator.

RECOMMENDATION

SMSFs should continue to be regulated by the ATO.

DISPUTE RESOLUTION SCHEMES

There are currently a number of dispute resolution schemes in the financial services industry that resolve complaints of consumers.

- ❖ The Superannuation Complaints Tribunal (SCT) manages all complaints that emerge of superannuation funds. The SCT is funded through the APRA superannuation fund levy but is actually provided with resources through ASIC.
- ❖ The Financial Ombudsman Service (FOS) is an industry scheme funded as a levy through its members. FOS resolves disputes between consumers and its financial services members. The FOS board is made up of representatives from the financial services industry and consumer groups.
- ❖ The Credit Ombudsman Service (COSL) is also an industry funded compliant resolution body that resolves disputes between consumers and its financial services members. COSL's board is also representative of industry and consumer advocates.
- ❖ The Taxation Practitioners Board will resolve advice provided by tax (financial) advisers.

Whilst complaints originating from superannuation funds are managed through the SCT, it is not uncommon for complaints to be shared between the various complaints resolution bodies. Financial services

organisations make their own decision on which complaints body they belong to. There is therefore no single set of standards that apply across all the complaint groups which creates unnecessary confusion and duplication.

RECOMMENDATION

There should be a rationalisation of complaints groups.

We propose that the following principles provide the basis for complaints resolution in Australia:

- ❖ There should be one avenue for complaint for all consumers in the financial services and superannuation industry.
- ❖ Complaints should be made at no cost to the consumer.
- ❖ All financial services institutions and superannuation funds must be a member of the complaints body.
- ❖ The complaints body should be funded by a combination of a membership and per complaint fee.
- ❖ The complaints body should be accountable to its funders, the government and the consumer via a representative board.
- ❖ The complaints body should be set up under Statute where there is access to the high court for appeals on error of law only.

Regular audits of financial services regulation

We consider it appropriate for a stocktake of financial services laws (including legislative instruments such as ASIC Class Orders) to be undertaken at periodic intervals by the Productivity Commission (PC) with the aim of identifying redundant regulation and/or ways of making existing regulation more efficient (for example whether regulation could be streamlined by transferring provisions in delegated legislation to legislation).

RECOMMENDATION

Financial services law (including legislative instruments such as ASIC Class Orders) be audited by the Productivity Commission no less than every 4 years to eliminate duplication and remove unnecessary regulation.

Interaction with regulators

The FSC submits that the means by which the industry deals with the regulator need to be consistent and modernised.

RECOMMENDATION

The Inquiry should recommend:

- Prescribed electronic format for dealing with regulators; and
- Rationalisation of data collection to avoid repetition and subtle variance across regulators.

DATA

APRA has responsibility for the collection, analysis and publication of financial sector data.

We believe that APRA, as the prudential regulator, should not be producing data which are potentially and may influence consumer on where to invest their savings.

RECOMMENDATION

Whilst APRA has a role in analysing statistics on the institutions that they regulate, APRA should not be publishing data which may influence a consumer on where to invest their savings.

We believe that the Australian Bureau of Statistics (ABS) is better suited for producing and publishing industry statistics. The FSC supports the idea that there is official statistical data produced and made publicly available.

The ABS has experience in collecting, organising, publishing and commenting on data. We are comfortable that the ABS, with industry feedback, could develop a set of meaningful data that can be used to inform the market, and in particular, the regulators and financial commentators.

APRA would be an important stakeholder in determining what data they need to properly carry out their prudential regulatory functions. Clearly some specific data required by APRA or others may need to be kept commercially in confidence and not passed onto the ABS for the purposes of reporting product dashboard data (such as MySuper performance and fees).

RECOMMENDATION

APRA retain the role of collection and analysis of data to meet its prudential regulatory responsibilities. Production and publication of data in the financial sector should be conducted by the ABS.

Under this framework:

- ❖ APRA would collect, analyse and pass on the appropriate data to the ABS;
- ❖ The ATO would collect and pass on SMSF data to APRA for analysis and to the ABS for data reporting; and
- ❖ The ABS would undertake data reporting on the entire superannuation industry.

For the purposes of producing basis statistics, the FSC submits that the data should be produced and published by the ABS.

Systemic issues should be considered by APRA given the risk this large and evolving pool of savings could have on retirement savings if this sector were to suffer a systemic failure.

RECOMMENDATION

SMSF data should be collected by the ATO and analysed by APRA for systemic assessment. The ABS should produce statistical reports on the entire superannuation sector.

PRIVACY LEGISLATION

As of the 12th of March this year, the Privacy Commissioner will have wider reaching powers and an increased scope for enforcement regarding breaches of privacy. Whilst we strongly support the regulators focus on privacy, and the need for more prescriptive requirements the financial services industry has specific needs that may require (and justify) a dedicated privacy regulator, or for this to be covered under the remit of the existing financial services regulators. There are also concerns that in its current state, the Privacy Commission will not have sufficient in capacity to regulate the new obligations given the sheer scale of client data associated with the financial services industry.

RECOMMENDATION

A dedicated privacy regulator be established for financial services or that the Privacy Commission's mandate be tailored for financial services.

Regardless of which approach is taken the regulators need to streamline any Privacy obligations to ensure that they can operate within the context of the risk and compliance frameworks requisite to ASIC and APRA's expectations and that the scope and powers of the Commission are clearly defined and operated to.

ADVICE REGULATION

Dual regulators (ASIC and Tax Practitioners Board)

The Wallis Inquiry recommended a single licensing regime should be introduced for financial sales, advice and dealing. However, recent reforms have resulted in significant amendments not only to the legal framework encompassing licensing, conduct and payments within financial services, but financial services is now under an additional regulator and quasi licensing regime.

18 years into the redesign of the tax agent framework, financial services was caught within the Tax Agent Services Act (TASA) regime effectively imposing an additional layer of conduct, competency and licensing obligations. The inclusion of financial services (not limited to

advice providers because of the nature of the ASIC licensing regime) is that services which are not tax agent services are now inadvertently caught. Further, the accountant based regime does not accord with the ASIC/FSR structured regime financial services operates within.

The implication is that financial advisers now operate now operates under two conduct/competency regulators ASIC and the Tax Practitioners Board.

RECOMMENDATION

The Inquiry reassess the need for two conduct / competency and licensing regulators on financial services providers.

ADVICE LAW

The government is reviewing and proposing to remove inefficient and redundant legislation from the recently enacted Future of Financial Advice regime (FoFA).

FoFA enacted reforms which capture market activity and remuneration practices not intended to be caught because the law has levied responsibilities using definitions/structures created by the Financial Services Reform Act (2001) rather than imposing the obligations on those it sought to reform – namely financial advisers/planners.

As such, the drafting to exempt practices makes

- ❖ Servicing consumers cumbersome and expensive needs to balance advice with protection;
- ❖ Thwarts innovation;
- ❖ Creates legislative hurdles for online advice; and
- ❖ Does not reduce the paperwork for consumers.

Future reform should consider amendments to the Corporations Act to truly regulate the provision of advice as opposed to information or services by product providers. We submit that “advice” should be limited to the existing definition of personal advice.

That is, advice is provided by a person who is competent by education and experience to provide advice. Otherwise the service is not advice

but information provided by a non-advice provider. This structure has been adopted by TASA – where the service is or is not a tax agent service and the consumer recipient of the service can not be confused by jargon/fancy language like “general advice” into believing they are receiving tax advice when they are receiving tax information.

Simplification of ‘advice’ in the law will aid consumers understanding and reduce complexity and cost of services for consumers.

RECOMMENDATION

“Advice” should be limited to the existing definition of personal advice.

REMOVAL OF REDUNDANT / INEFFICIENT REGULATION

Financial services regulation must balance the benefits it can create and protect on the one hand such as safeguarding retirement savings and protecting consumers without impeding efficient and competitive markets on the other hand.

Reforms commented in this chapter can be enhanced by removal of regulations noted in this section. This section sets out some areas where we consider changes or a review of existing legislation/regulation is required to assist in the efficiency and effectiveness of the financial services industry to reduce unnecessary regulation. Our comments cover:

- ❖ Digestibility of the financial services laws – rationalisation is required as it is unwieldy and unduly complicated;
- ❖ Difficult provisions to be rectified – superannuation funds and the wholesale/retail client test;
- ❖ PDS regime and other disclosure documents;
- ❖ Fees and other costs disclosure – product disclosure statements for listed trusts;
- ❖ Technology: Provision of disclosure documents; and
- ❖ APRA Prudential Framework – examples of prescription in its application at times.

Digestibility of the financial services laws

The Financial Services Reform Act 2001 achieved the commendable aim of bringing together, and rationalising, a large part of the regulation of the financial services industry. Regrettably, that achievement has been progressively undermined over time due to the increasing stock of regulation and legislative instruments.

We are now faced with a highly complex set of financial services laws that are supplemented by, modified, replaced and rewritten, through regulations and Class Orders. This substantially increases the risk of mistakes in applying the law. Further, compliance costs are significantly increased.

Apart from the inaccessibility of the law, the manner in which it has developed has also created doubt about its validity in certain cases. Legislative instruments (such as ASIC Class Orders) have been utilised to create entirely new regulatory regimes for certain categories of financial products or to regulate certain types of financial services, impose entirely new obligations and liabilities on financial service providers, and in some instances seek to achieve a result which may not be contemplated by the primary legislation (such as the Corporations Act).

While the FSC acknowledges that the law needs to be sufficiently flexible to be adapted to new industry developments, it is submitted that it is time to consolidate and rationalise financial services laws.

Particular areas of concern are as follows:

- ❖ The Product Disclosure Statement (“PDS”) regime is now extremely complex. Part 7.9 of the Corporations Act is subject to extensive regulations that appear in various (sometimes unexpected) places, including Schedules of the Corporations Regulations. Added to this is a myriad of ASIC Class Orders and ASIC Regulatory Guides impacting on Part 7.9 of the Corporations Act.
- ❖ There are a number of examples of Corporations Regulations appearing out-of-order. For example, regulations dealing with financial services guides appear in Division 3 of Part 7.7 of the Corporations Regulations. Division 3 deals with statements of advice, not financial services guides.
- ❖ Until relatively recently, the financial requirements applicable to the holder of Australian financial services licence (“AFSL”) could be easily located in the conditions of the AFSL issued by ASIC.

This approach has now been abandoned for some important categories of AFSL - responsible entities, wrap account operators and custodians. These licensees are incentivised (by virtue of complex drafting principles in the relevant ASIC Class Orders) to comply with certain financial requirements set out in the Class Order rather than those which appear in their existing AFS licence conditions. These Class Orders have the effect of varying existing AFSL conditions. Yet, section 914A of the Corporations Act requires that ASIC may only vary AFSL conditions of an existing AFS licence after the AFSLs has been provided by ASIC with an opportunity for a hearing. The Class Orders do not constitute a right to be heard (and general consultation on the Class Orders does not satisfy the hearing opportunity required to be provided to existing AFSLs under section 914A).

In summary, we have concerns with legislative instruments (for example, ASIC Class Orders) being used as a mechanism to vary licence conditions (without a hearing) on existing AFSLs (or at least have that effect or strong incentive).

- ✦ Recently an extensive new regime regulating custodians, responsible entities and other asset holders was created through ASIC Class Orders. The Class Orders impose entirely new obligations on asset holders, some of which are based on obligations imposed on responsible entities but go far beyond these entities. Many of the new requirements would more appropriately be included by way of an amending Act to the Corporations Act.

Class orders

There are a number of ASIC Class Orders made under Chapter 7 which would be more appropriately incorporated into Chapter 7 itself. This is because these Class Orders provide the regulatory framework for certain products and services that are not specifically regulated under Chapter 7, although it is arguable they should be. Two examples of these Class Orders are ASIC Class Order 04/194 regulating Managed Discretionary Accounts and ASIC Class Order 13/1410 which notionally inserts sections 912AAC, 912AAD and 912AAE imposing minimum standards for custodians. There are also a number of Class Orders whereby ASIC provides relief from the requirements of Chapter 7 (for example licensing and disclosure relief) which could be incorporated into the body of Chapter 7.

Legislative framework of Chapter 7: Regulations

The current legislative framework of Chapter 7 of the Corporations Act is excessively (and unnecessarily) complex. This is in part because of the vast number of Corporations Regulations which have been made under Chapter 7, many of which either contradict or provide essential further detail on the primary legislative position as set out in Chapter 7. This means that the legislative framework is unwieldy and piecemeal and can be very difficult to work through. For example (and this is of course not an exhaustive list):

- ❖ Regulation 7.1.04(2): the extended definition of “derivative” which is set out in this Regulation (and the corresponding exceptions to the definition), which really should be set out in section 761D, along with the primary definition of “derivative”;
- ❖ The various definitions specified in Regulations made under Part 7.1, for example Regulation 7.1.04CA, which identifies specific kinds of financial products and Regulation 7.1.04G, which identifies who is the issuer for an FX contract: these could be incorporated into the relevant primary provisions of Chapter 7; and
- ❖ Regulation 7.6.01: which sets out further exemptions from the requirement to hold an AFS licence, could be incorporated into section 911A(2).

There are many Regulations that could readily be incorporated into the body of Chapter 7 itself, which would assist in simplifying the legislative framework for the financial services regulatory regime. It would be a worthwhile exercise to undertake a comprehensive review of the Corporations Regulations made under Chapter 7 to identify which of these could be sensibly incorporated into Chapter 7 itself.

Difficult provisions to be rectified – superannuation funds and the wholesale/retail client test

There is considerable uncertainty in the financial services industry concerning the circumstances in which superannuation fund clients may be treated as “wholesale clients” under Chapter 7 of the Corporations Act. The retail/wholesale distinction is fundamental to many important provisions of the Corporations Act.

The uncertainty arises because of the uncertain meaning of a critical provision in the Corporations Act – section 761G(6). If a financial service, other than the provision of a financial product, “relates to a

financial product”, then the client must be acting as the trustee of a large superannuation fund (with net assets of at least \$10 million) in order to qualify as a wholesale client. None of the other wholesale client categories are available in such circumstances.

There are different views on the meaning of “relates to a superannuation product”, and the ASIC guidance on the point is in our view neither sufficient nor satisfactory. For example, if a stockbroker provides trading services in relation to securities that are part of the assets of a superannuation fund, does that service “relate to a superannuation product”?

We submit that the applicable test should reflect the proximity of the service to the superannuation product held by the fund member. In particular, the general wholesale client categories should be available in relation to dealing services and general advice provided to trustees relating to fund assets.

It is submitted that further consultation, and ultimately amendments, are required to clarify when the trustee of a superannuation fund may be regarded as a wholesale client.

RECOMMENDATION

Trustees of a superannuation fund should be regarded as wholesale clients (unless they are SMSF trustees).

PDS regime and other disclosure documents

The Product Disclosure Statement (PDS) requirements have become fragmented over time and are in need of review. The two tier regime (shorter PDS for superannuation and simple managed investment schemes versus the full PDS regime for other products) is complex and unwieldy.

Generally, PDSs must contain such information which a person would reasonably require for the purpose of making a decision to acquire the product. Issuers will often include large volumes of information to ensure their obligations are met and/or which ASIC states is required in various ASIC Regulatory Guides, causing PDSs to regularly exceed 50 pages. Such documents may not be effective to enable retail clients to make informed decisions.

For certain products (such as superannuation products and “simple” managed investment schemes), the “shorter PDS” regime requires issuers to prepare a document of fixed length dealing with specific features of the product.

The bifurcated PDS regime has its difficulties, as time is spent ascertaining which of the PDS regimes apply.

For full PDSs or Shorter PDSs, some information which would otherwise need to be included in the PDS can be contained in a separate document and “incorporated by reference”. Many issuers use the Shorter PDS regime and prepare a separate document (for example a “product guide”) which contains much the same information that would have been included in a full PDS to ensure they meet their disclosure obligations.

The PDS content requirements in the Corporations Act are supplemented by a range of ASIC guidance materials, including “Benchmarks”, “Disclosure Principles”, “Good Disclosure Principles” and a number of specific Class Orders and Regulatory Guides. This increases the complexity for issuers when preparing disclosures.

Over recent years ASIC has determined in various ASIC Regulatory Guides, that further specific information around risk or particular features must be addressed in disclosure documents. The issuance of regulatory guides for unlisted property schemes and hedge funds are examples of this approach. These guides require particular types of products to include additional disclosure.

While there may be policy reasons for this additional disclosure, this disclosure results in inconsistency across managed investment schemes which limits comparability across products for retail consumers and adds complexity for issuers and to the length of disclosure documents which is not necessarily conducive to digestible or comprehensive disclosure.

While many disclosure documents are lengthier as a result of ASIC Regulatory Guides, the industry has now also completed the transition to the shorter PDS regime for some products. In brief, the philosophy behind shorter PDSs (Shorter PDS) is that simple products including certain superannuation funds and simple managed investment schemes can be described by an issuer in a standardised eight page disclosure document to assist an investor compare products.

Key information such as features, benefits, risks, investment options, fees and costs and taxation must be covered by the Shorter PDS whilst additional information may be incorporated by reference. The additional information is located separately, generally by way of an additional information booklet or via the issuer's website.

In addition, the requirement to retain documentation (including incorporation by reference material) for seven years is administrative and costly to maintain.

In summary, the current PDS disclosure regime is extremely complex and the volume of disclosure requirements are immense and has not had the effect of simplifying disclosure nor aiding comparability. We consider a holistic review of the disclosure regime is required and that there should be consumer testing by government or Treasury of proposals to increase disclosure, such as portfolio holdings disclosure and the extent to which the disclosure will be used by consumers.

RECOMMENDATION

There should be a reduction of regulatory complexity and improve disclosure to consumers by creating a single PDS regime for all financial products.

Further the FSC supports that disclosure provision be defaulted to electronic provision, with flexibility for the provider/trustee to consider additional or different means of provision or 'giving'.

Due diligence defence

The Wallis Inquiry recommendation No. 4 provided that a due diligence defence should apply to positive disclosure requirements. A due diligence defence was removed in 2002

RECOMMENDATION

Financial services law should provide due diligence defence.

Fees and other costs disclosure - product disclosure statements for listed trusts

The application of disclosure requirements designed for open ended unlisted managed funds to listed trusts is problematic and requires some adjustment.

Division 4C and Schedule 10 of the Corporations Regulations require prescriptive disclosure of fees and costs in a product disclosure statement ("PDS"). The responsible entity of an ASX-listed trust with property or infrastructure assets is required to include this information in a PDS for a capital raising or other unit offer (and also in takeover documents where scrip consideration is offered). In a number of respects the inflexible nature of the fee disclosure requirements means that issuers have two choices: to comply strictly and include material which is confusing to investors, or to vary the disclosure to make sense, and give precedence to the requirement to ensure disclosure is not misleading over the technical requirements of the Regulations. It is often impossible to comply strictly with both requirements.

Assuming the overriding policy consideration is to ensure that disclosure to investors is meaningful and readily understood, this principle should prevail over the previously stated driver for these strict requirements, namely that disclosure for all financial products should be comparable (a policy principle borne from Wallis Inquiry recommendation 8). This is difficult to achieve when the products themselves are not comparable.

We agree that it is helpful to consumers for responsible entities to be required to disclose the amount of management costs and expenses as a proportion of NET asset value of the relevant scheme in the fee table and worked example, as this reflects the true impact on consumers during the first year of their investment. However, the following issues have arisen in the application of Schedule 10 to listed trusts:

- ❖ The boxes in the fee table for establishment, contribution, exit and switching fees are never relevant for listed trusts, yet they must be included in the document.
- ❖ In the worked example, the inclusion of a statement about investing an additional \$5,000 during the year is confusing both to issuers and investors, as the capital raising or other transaction for listed trusts is almost invariably a single offer which closes, so no additional investment can be made.

- ❖ References to negotiation of fees are generally irrelevant for listed trusts, and in particular the change to the Consumer Advisory Warning that will apply to managed funds from 1 July 2014 which refers to “your employer may be able to negotiate to pay lower administration fees” seems to be an error in the drafting.
- ❖ Where the PDS relates to a transaction for a listed trust with significant costs such as for underwriting and adviser fees in a capital raising, issuers often use their common sense and vary from the Regulations to show how these costs affect investors in the first year from issue of the document (where the costs are significant) and in the second year, when costs drop to normal operational levels. Although we understand that ASIC generally accepts this approach, it is not formally permitted by the Regulations, and it should be, as it improves disclosure.
- ❖ For “internalised” listed stapled groups, where investors own shares in a listed company which owns the responsible entity, and the shares are stapled to one or two listed trusts (which is common), the responsible entity does not charge fees. It would be pointless to do so, as the fees would effectively be earned by the company which is owned by the same investors in the same proportion to their investment in the trust or trusts. Issuers often have challenges in calculating meaningful disclosure where the stapled group includes a company. While ASIC policy suggests that figures for the stapled company should be included if this helps to ensure the disclosure is not misleading, the concept of “management costs” is foreign to the company part of the structure and difficult to apply. The PDS for an offer of stapled securities in an internalised structure is required to include four or more pages of largely irrelevant information. The appropriate and relevant disclosure for investors is a statement in the financial section of the offer document regarding the expected expenses of the stapled group as a whole, which would be included in any case. The cost of preparing the fees and costs section of the PDS is sometimes significant, as issuers struggle with the application of rules which do not fit their circumstances - and this cost may ultimately be borne by investors.
- ❖ The drafting of the “minimum entry balance rule” in item 215 of Schedule 10 mandates the use in the example of fees and costs of an amount which is the “lowest multiple of \$50,000 that exceeds the minimum entry balance”. This means that if the minimum balance is \$100,000, the example must be calculated

on an investment of \$150,000 which is less useful to the investor than a simple example on the round figure of \$100,000. The distortion becomes worse where the minimum investment is say \$2 million, with the worked example then being on \$2,050,000 rather than a round figure. This problem applies to unlisted as well as listed trusts.

RECOMMENDATION

A single disclosure regime should be applicable to all financial product types akin to the current 'simple PDS' regime.

CHAPTER 3 RECOMMENDATIONS:

1. There is a need to structurally enhance the level of oversight and accountability through consideration of a range of measures through:
 - Publishing a Risk Appetite Statement (RAS) setting out its enforcement and surveillance priorities and that this should be closely linked to an overarching RAS – developed either by Government or Council of Financial Regulators (COFR);
 - The RAS should be the basis for the establishment of key performance indicators and other measures against which regulators' performance can be assessed; and
 - Better reporting of performance against the RAS.
2. A formalised role for COFR should be established to ensure government policy objectives are being reflected in regulator activities as well as ensuring proper coordination across regulators.
3. Twin peaks has been a largely effective regulatory model. The Inquiry should review and articulate a revised mandate for each major regulator. Policy should be established by Parliament, not by regulators.
4. APRA should be responsible for prudential regulation first and foremost to protect the financial promises held out to deposit-holders of ADIs, policy-holders in general and life insurance companies and members of superannuation funds in Australia.
5. APRA should not be responsible for:
 - Policy;
 - Approving product design effectively providing government endorsement; and
 - Data publication.
6. APRA should work with ASIC to understand the nature and timing of their reviews and/or visits to determine whether a co-ordinated approach could be adopted or findings leveraged for the purposes of both regulators.
7. APRA should not be required to approve specific products. In particular, we believe that it is not appropriate that APRA be required to approve MySuper products.

8. Regulation should be principles-based.
9. ASIC should be responsible for:
 - Financial sector consumer protection regulation;
 - Financial market integrity; and
 - Regulation of corporations, including incorporation, governance, insolvency and liquidation and takeovers.
10. ASIC should not be responsible for:
 - Policy;
 - Company registrations; and
 - Setting advice provider competency minimum standards.
11. A single regulator should set minimum standards of conduct behaviours of advice providers.
12. Parliament should set capital requirements. The regulator's mandate regarding capital requirements be clarified so the markets can continue to operate efficiently and maximise returns to consumers. Arbitrage must be eliminated.
13. SMSFs should continue to be regulated by the ATO.
14. There should be a rationalisation of compliants groups.
15. Financial services law (including legislative instruments such as ASIC Class Orders) be audited by the Productivity Commission no less than every 4 years to eliminate duplication and remove unnecessary regulation.
16. The Inquiry should recommend:
 - Prescribed electronic format for dealing with regulators; and
 - Rationalisation of data collection to avoid repetition and subtle variance across regulators.
17. Whilst APRA has a role in analysing statistics on the institutions that they regulate, APRA should not be publishing data which may influence a consumer on where to invest their savings.
18. APRA retain the role of collection and analysis of data to meet its prudential regulatory responsibilities. Production and publication of data in the financial sector should be conducted by the ABS.

19. SMSF data should be collected by the ATO and analysed by APRA for systemic assessment. The ABS should produce statistical reports on the entire superannuation sector.
20. A dedicated privacy regulator be established for financial services or that the Privacy Commission's mandate be tailored for financial services.
21. The Inquiry reassess the need for two conduct / competency and licensing regulators on financial services providers.
22. "Advice" should be limited to the existing definition of personal advice.
23. Trustees of a superannuation fund should be regarded as wholesale clients (unless they are SMSF trustees).
24. There should be a reduction of regulatory complexity and improve disclosure to consumers by creating a single PDS regime for all financial products.
25. Financial services law should provide due diligence defence.
26. A single disclosure regime should be applicable to all financial product types akin to the current 'simple PDS' regime.