



ASIC

Australian Securities & Investments Commission

**Submission by the Australian
Securities and Investments
Commission on the Corporations
Amendment (Future of Financial
Advice) Bill 2011**

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A Executive summary

- 1 The Australian Securities and Investments Commission (ASIC) makes this submission to assist with the Inquiries into the *Corporations Amendment (Future of Financial Advice) Bill 2011* (FoFA Bill).
- 2 ASIC has not made comments about the proposed best interest duty and ban on conflicted remuneration in this submission. However, ASIC supports these measures (which it discussed in its submission to the Parliamentary Joint Committee's *Inquiry into financial products and services in Australia*). We would also support effective anti-avoidance measures that would ensure that the spirit of the proposed reforms around remuneration are not avoided through industry restructuring e.g. via vertical integration.
- 3 ASIC is considering a further submission in relation to these aspects following the recent introduction of the *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*.

ASIC submissions to past inquiries

- 4 As noted above, ASIC has previously provided a submission to the Parliamentary Joint Committee as part of its *Inquiry into financial products and services in Australia* (FPS Inquiry). We have also provided a submission in relation to the PJC's *Inquiry into the collapse of Trio Capital and any other related matters* (Trio Inquiry). These two submissions:
 - (a) examined policy underpinnings of the Australian financial services regulatory (FSR) regime;
 - (b) set out the key issues raised by the relevant inquiry's terms of reference, including adequacy of licensing arrangements;
 - (c) set out ASIC's forward program to improve performance of its oversight role; and
 - (d) included an outline of areas for possible reform to address the issues raised by the relevant inquiry.
- 5 In our submission to the FPS Inquiry, we suggested that the Government should consider the following modifications to ASIC's licensing and banning powers:
 - (a) changes to the licensing threshold so that ASIC can refuse or cancel a licence where a licensee may breach or is likely to breach its obligations (rather than will breach its obligations);

- (b) clarification that ASIC can ban individuals who are involved in a breach of obligations by another person; and
- (c) ‘negative licensing’ of individuals so that ASIC can ban individuals who are not fit and proper and may not comply with the law.

6 The PJC in its report on its FPS Inquiry recommended that:

- (a) section 920A of the *Corporations Act 2001* (Corporations Act) be amended to provide extended powers for ASIC to ban individuals from the financial services industry (recommendation 6); and
- (b) that sections 913B and 915C of the Corporations Act be amended to allow ASIC to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee ‘may not comply’ with their obligations under the licence (recommendation 8).

7 The amendments proposed to ASIC’s licensing and banning powers in the FoFA Bill reflect the Government’s implementation of these recommendations.

8 While reforms to improve client engagement with financial advice were not considered as part of the FPS Inquiry or Trio Inquiry or ASIC’s submissions to these inquiries, there is data to suggest that many retail clients are not fully engaged with the financial advice they receive.¹ Reforms that support client engagement such as those contained in the FoFA bills will improve this.

9 Without an opt-in requirement, ongoing asset based fees can operate in a similar way to commissions in that they can generate a conflict of interest. They could also be charged to clients without any ongoing service being provided. An opt-in requirement helps ensure that ongoing asset based fees do not become a substitute or replacement for trailing commissions.

This submission

10 This submission focuses on the factors driving the need for the regulatory reform proposed in the FoFA Bill. These have been highlighted in the collapses of Storm Financial Limited and Trio Capital Limited, which were the subject of past PJC inquiries, and other corporate collapses of financial services businesses (e.g. the Westpoint Group). Shadow shopping surveys undertaken by ASIC have also identified the need for change, in particular highlighting concerns about the effect on advice of

¹ See paragraph 25.

conflicts of interest over remuneration (e.g. commissions): see REP 69 *Shadow shopping survey on superannuation advice*.

- 11 ASIC also previously reviewed the exposure draft Bills relating to the FOFA reforms. Our review of the exposure draft legislation focused on ensuring that obligations arising from the reforms are enforceable in a practical sense.

B Entry into and removal from the financial services licensing regime

Key issues

- 1 This section discusses the adequacy of the current licensing regime given concerns raised during the FPS Inquiry and Trio Inquiry.
- 2 Similar concerns have also recently been raised in the media in relation to other financial services businesses.²
- 3 As we have stated in our previous submissions to past PJC inquiries, the key issues in relation to the licensing regime are:
 - (a) whether the licensing regime, which sets the threshold for obtaining an AFS licence relatively low and the threshold for cancelling an AFS licence relatively high, currently establishes appropriate entry criteria for AFS licensees;
 - (b) as well as the focus on AFS licensees there should be more focus on the directors, employees, agents or other representatives of that entity. At the moment ASIC generally:
 - (i) cannot prevent persons from entering the financial services industry; and
 - (ii) can have difficulty removing individuals.

These factors limit ASIC's ability to protect investors by restricting or removing from the industry participants who might cause or contribute to investor loss; and
 - (c) whether the licensing regime results in a gap between investor expectations and the requirements of the licensing regime.

Licensing threshold

- 4 Currently, ASIC must grant an AFS licence if:
 - (a) the application is made properly;
 - (b) ASIC has no reason to believe that the applicant will not comply with the licensee obligations;

² See Adele Ferguson, 'Romad's woes highlight flaws in financial services licensing', *Sydney Morning Herald*, 2 November 2011, <<http://www.smh.com.au/business/romads-woes-highlight-flaws-in-financial-services-licensing-20111101-1mtwl.html>> and Adele Ferguson, 'Sonray founder's exposure dramatises how advisers can operate through back door', *Sydney Morning Herald*, 15 August 2011, <<http://www.smh.com.au/business/sonray-founders-exposure-dramatises-how-advisers-can-operate-through-back-door-20110814-1iszg.html>>.

- (c) ASIC is satisfied that there is no reason to believe that the applicant or the applicant's responsible officers are not of good fame or character; and
- (d) the applicant has provided ASIC with any additional information requested for the purposes of assessing the application.

5 ASIC cannot refuse an application for an AFS licence for reasons beyond the relevant criteria (e.g. ASIC cannot refuse to grant a licence on the basis of the licensee's proposed business model). At most, the licensing process seeks to ensure that an entity is confined to providing financial services that it is competent to provide and has adequate resources to provide at the time of application. It does not involve an endorsement of business models adopted by the applicant.

6 After a licence is granted, ASIC only has the power to suspend or cancel a licence in limited circumstances.

7 ASIC can only immediately suspend or cancel a licence on application by the licensee or where the licensee is insolvent, ceases to carry on the business, is convicted of serious fraud, or is incapacitated.

8 ASIC can suspend or cancel a licence after a hearing when:

- (a) the licensee has not complied with its obligations;
- (b) ASIC has reason to believe the licensee will not comply with its obligations in the future;
- (c) ASIC is no longer satisfied that the licensee is of good fame or character;
- (d) a banning order is made against the licensee or a key representative of the licensee; or
- (e) the application was materially false or misleading or omitted a material matter.

9 ASIC's decision to suspend or cancel a licence can be appealed to the Administrative Appeals Tribunal (AAT). In practice, ASIC has found it very difficult to establish before the AAT that a licensee will not comply with obligations in the future. This makes it difficult to remove licensees who may potentially cause investor losses in advance of an actual breach. We are happy to provide examples if needed.

Focus on the entity

10 Under the Corporations Act, a person or entity that carries on a financial services business in Australia must obtain an AFS licence from ASIC covering the provision of the relevant financial services, unless an exemption applies. A key exemption is for those who provide services as

a representative of a licensee. Essentially, representatives are employees, directors, authorised representatives (including corporate authorised representatives) of the licensee. ASIC does not approve representatives.

- 11 This means that the AFS licensing regime generally focuses on the AFS licensee, rather than the directors, employees or other representatives of that entity. However, officers involved in the decision making of a licensee are subject to tests of good fame and character (e.g. police checks) when a licence is granted. Also on grant of a licence, and at other times in surveillance, there is assessment of key persons nominated by the licensee for the relevant financial service business.
- 12 In addition, conduct and disclosure obligations of the FSR regime are largely imposed on the AFS licensee (i.e. the entity), not the representatives who work for that entity.³
- 13 This focus on the entity limits ASIC's ability to restrict individual participants in the financial services industry where, for example, they might have worked for another entity that, in turn, is suspected of engaging in questionable conduct.⁴
- 14 While authorised representatives must be registered with ASIC, ASIC has little information about employee representatives. On the whole, ASIC must rely on licensees to ensure the competence and integrity of their representatives in the financial services industry.
- 15 ASIC can experience difficulties in locating (and taking action against) so-called 'bad apples' in the financial services industry. For example, there is no register that records representatives in the financial services industry, which might assist in identifying individuals of concern.
- 16 In analogous jurisdictions such as the USA and UK, regulators maintain publicly searchable registers of individuals authorised to provide certain regulated services to consumers and investors. Registers enable searches by name or registration number and include information such as current and previous employment information, for example.
- 17 Moreover, ASIC's ability to ban individuals from the industry is also limited. Generally, ASIC may only ban individuals, after a hearing, on the following grounds:
- (a) ASIC suspends or cancels an AFS licence held by the person;
 - (b) the person has not complied with their obligations as an AFS licensee under s912A;

³ There are some specific conduct and disclosure obligations that are imposed directly on authorised representatives, as well as AFS licensees.

⁴ See for example the articles written by Adele Ferguson listed at footnote 2.

- (c) ASIC has reason to believe that the person will not comply with their obligations as an AFS licensee under s912A;
- (d) the person has not complied with a financial service law; or
- (e) ASIC has reason to believe that the person will not comply with a financial services law.

18 ASIC's ability to ban individuals from the industry under the grounds in paragraph 17 are limited by two factors:

- (a) key obligations are imposed on the entity, not its representatives. Often individuals who have behaved inappropriately will not actually have breached the financial services law, because the key obligations are imposed on the authorising licensee; and
- (b) it is difficult to establish before the AAT that a person will not comply with its obligations in the future.

Gap between expectations, and requirements, of licensing regime

19 The FSR regime requires granting of an AFS licence where an application has been made properly and ASIC has no reason to believe the applicant will not comply with its licensee obligations and is satisfied that there is no reason to believe that the applicant and its responsible officer are not of good fame and character. Importantly, the 'no reason to believe' test requires actual evidence the applicant has been involved in illegal activity and not just mere suspicion.

20 The relatively low threshold for obtaining an AFS licence and the relatively high threshold for removing a licence is not well understood by retail investors. Licensing, therefore, may give retail investors a sense of security which is inconsistent with the settings of the regime. There is a perception amongst some consumers that an AFS licence means that the licensee has been approved by ASIC or that it signifies the high quality of the financial services provided by the licensee, which is not the case. For example, in submissions to the FPS Inquiry, some former Storm clients have stated that 'Storm was approved by ASIC'.

Changes to policy settings

21 The modifications proposed in the FoFA Bill to ASIC's licensing and banning powers will help address the limitations discussed above and enhance ASIC's ability to protect investors. They will do this by enhancing ASIC's ability to refuse or cancel a licence and to restrict or remove from the industry participants who might cause or contribute to investor loss.

- 22 We note that ASIC identified some other options to strengthen the licensing regime in its submission to the Trio Inquiry.
- 23 In relation to the licensing threshold, ASIC suggested that if it were considered desirable to give ASIC a greater discretion in the licensing process, the Government might consider amending the primary licensing provision in s913B to 'ASIC may grant a licence' (rather than 'ASIC must') if certain criteria are met. This would mean that, for the applicant, the award of a licence is more akin to a privilege rather than a right. We refer the committee to paragraphs 83-89 of that submission as also being relevant in the context of this current inquiry.
- 24 In relation to the focus on the entity, ASIC suggested that the Government might consider 'extending ASIC's current authorised representatives register to cover all individuals who offer financial advice (or, at the least, personal financial advice) on certain investment products'. This was on the basis that 'A more complete register of advisers providing personal advice to consumers and investors on Tier 1 financial products would enhance ASIC's regulatory efficiency in identifying and targeting poor advice, support licensees' efforts to conduct proper due diligence on prospective employees and facilitate investor checks on a prospective adviser'. Again, we refer the committee to paragraphs 90-94 of that submission as also being relevant in the context of the current enquiry.

C Improving consumer engagement with financial advice

25 There is some evidence of consumers' disengagement from the financial advice process and from regular contact with their adviser. ASIC's Report 251 *Review of financial advice industry practice* (September 2011) contained findings of a review of the top 20 licensees (the largest licensees ASIC regulates) and found that of the 4.6 million clients of the top 20 licensees, almost 1.5 million were identified by licensees as active (para 11). Therefore, more than 65% of the client group of the top 20 licensees were inactive.

Opt-in reforms

26 The renewal and disclosure requirements where ongoing advice is provided proposed in the FoFA Bill (opt-in), should help support client engagement with financial advice and also ensure that clients are not paying for advice they do not receive. The broader the scope of the opt-in reform the more effective it will be in achieving these outcomes.

27 Measures that ensure advisers and their clients stay in regular contact, and engage consumer inertia, may help improve the overall levels of active clients who benefit from regular advice. A further advantage of the opt-in requirement is that they may also help prevent asset based fees for financial advice acting like trailing commissions.

28 Without an opt-in requirement, ongoing asset based fees can operate in a very similar way to commissions. They can be charged to clients without any ongoing service being provided. An opt-in requirement helps ensure that ongoing asset based fees do not become a substitute or replacement for trailing commissions.

29 As noted above, potential benefits of the opt-in reforms include:

- (a) improved service and communication to clients;
- (b) helping to ensure clients are only paying for financial advice services they are receiving;
- (c) removing a source of potential conflict of interest because asset based fees can raise concerns about conflicted remuneration structures similar to trailing commissions.