Submission to the Senate Economics References Committees on

Inquiry into Wealth Management Companies

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Introduction

Wealth management companies play a crucial role in growing the personal wealth of investors and helping them with their retirement planning. Accordingly, the failure of these institutions represents a betrayal not only to their shareholders but to the investors who trusted these companies with their personal funds and retirement plans. Consequently, in view of the damage that wealth management companies may cause, it is important for these organisations to be monitored closely. Therefore, this submission focuses solely on the role that the Australian Securities and Investments Commission (ASIC) plays in this sphere.

If any part of this submission requires or invites further explanations, please contact Associate Professor Marina Nehme at the University of New South Wales, Sydney, The Faculty of Law and Justice at [redacted]

General Observation

The observations made in this submission can be summarised in the following manner:

- ASIC has a range of tools at its disposal to be able to regulate the wealth management industry properly;
- Consideration should be made regarding whether product design and distribution obligations should also apply to personal advice provided to retail client or high net worth individuals. High net does not mean that those individuals have the necessary expertise to understand the advice provided;
- ASIC has to be more proactive regarding its approach to the industry. It has the capacity to do that as it has the necessary arsenal to protect investors; and
- In case of failure of a wealth management fund, ASIC should step up to protect vulnerable investors by relying on s 50 of the *Australian Securities and Investments Commission Act 2001* (Cth) (*ASIC Act*) to take action against the relevant offenders in the name of the company and/or the investors.

ASIC's Power

Over the last few decades, ASIC's purview has expanded drastically, and this has been accompanied by an expansion in the regulatory tools at the disposal of this regulator to monitor and regulate corporations and to ensure consumers' protection. As will be highlighted in this submission, these tools allow for both proactive and reactive measures to be implemented to deal with misconduct.

The Theoretical Framework Relied on in this Submission

The regulatory tools allow ASIC to apply a responsive regulatory approach to regulation where the regulator can use a mix of enforcement strategies and sanctions. This is really beneficial as a regulatory body that has only one sanction, which cannot politically or legally be used in some situations, will not be able to deliver a 'punishment payoff', since it is easy for the rational offending firm to calculate the cost-benefit of breaking the law. On the other hand, when a regulator has a number of weapons available for any particular offence, the information costs of calculating these probabilities will be discouragingly high, even for a large company with a legal team at its disposal.[1] The information costs referred to above mean that a regulator with an 'enforcement pyramid' may have superior resources with which it can bargain with the entities it regulates. According to Braithwaite and Ayres, compliance is most likely when an agency displays an explicit enforcement pyramid which is represented in the below diagram.[2]

[1] Ayres and Braithwaite, Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992), 36.
[2] Ibid, 35–6.

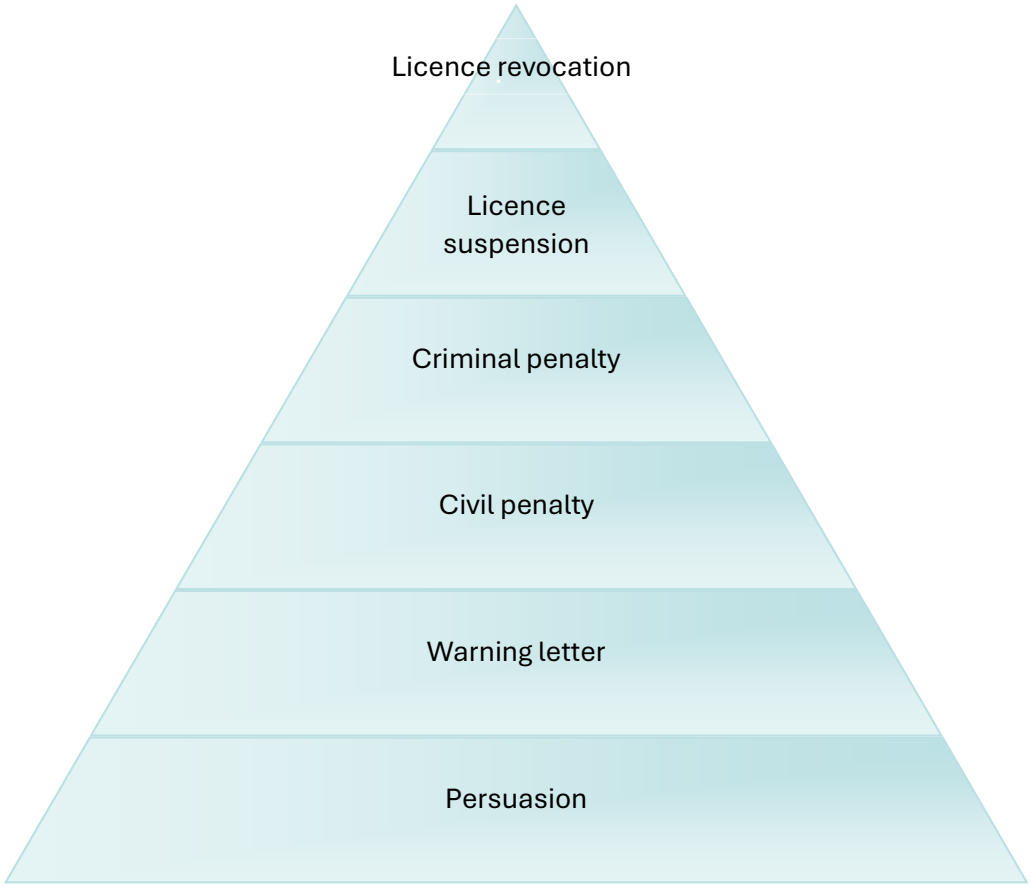

Diagram 1. Braithwaite's enforcement pyramid[3]

As depicted in Diagram 1, the base of the pyramid represents attempts to coax compliance by persuasion. The next stage of enforcement is a warning that action may be taken if the violation continues. If this fails to secure compliance, civil penalties will come into play, followed by criminal prosecution. If these methods do not work to secure compliance, the regulator might then temporarily suspend the offender's licence to operate. If all else fails, permanent revocation of the offender's licence is the last step taken by the agency. This escalation of sanctions is sketched in the form of a pyramid. The width of each layer represents the proportion of the total number of enforcement activities that occur at that level. The explanation for the varying size is simple. If the regulator can plausibly threaten to match any non-compliance by moving up successive levels of the pyramid, then most of the regulator's work will be done effectively at the bottom levels of the pyramid. The lighter sanctions may dissuade the regulated entity from continuing its illegal activities because it will not want the regulator to use its strong sanctions. Put another way, when there is an equilibrium between harsh and soft sanctions, the regulator attains the result it requires by speaking softly.[4]

[3] Braithwaite's enforcement pyramid as illustrated in Ayres and Braithwaite, above n 1, 35.
[4] Ibid, 35– 6; John Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (State University of New York Press, 1985), 63–4.

In summary, the basic idea of Braithwaite enforcement pyramid is that governments should respond to the conduct of those they seek to regulate in deciding whether a more or less interventionist approach is needed. It is better to begin with dialogue and then increase in severity. The reason behind this is that most organisations aim to act properly yet mistakes occur. While a move toward more aggressive and legalistic enforcement no doubt has its advantages, making regulation more effective in some respects, it can also be counter intuitive. For instance, tough regulation may be viewed as unreasonable by the regulated community. Stringent regulation is designed to cope with 'bad apples' and unusually hard cases which, in reality, constitute a minority of all the problems in the domain of regulatory supervision. Most firms, being 'good apples', are accordingly subjected to unreasonable regulation. If this population ('good apples') is large, such harsh regulation will appear even more unreasonable because it raises the costs of business, leading to lost opportunities for the progress of the 'good apples' businesses.[5]

Bardach and Kagan also observed that inspectors generally tend to look at the set of rules listed in the regulation and expect them to be followed. However, these authors argue that those rules might not be the most serious rules and the inspector's attention will thus be diverted to trivial matters. The rules may also be expensive to implement and not very relevant.[6] This could lead the inspector to fail to observe a source of potential harm that escapes the rule. This blindness could also afflict the regulated entity, whose management may concentrate on the set of rules listed in the regulation and in doing so fail to devote time and money to serious problems.[7] Greater communication between the regulators and the regulated entities is required, because such legalism can lead to resentment on the part of the regulated entities, ultimately tending to destroy their cooperation.

Such cooperation may prevent resentment and hostility from brewing within regulated entities as this is problematic and can cause the following vicious cycle:

[5] Eugene Bardach and Robert Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Temple University Press, 1982), 92–3.

[6] The rules in general cannot be detailed enough to cover all the different situations and dangers that may emerge from technological changes and human interaction.

[7] Bardach and Kagan, above n 5, 105.

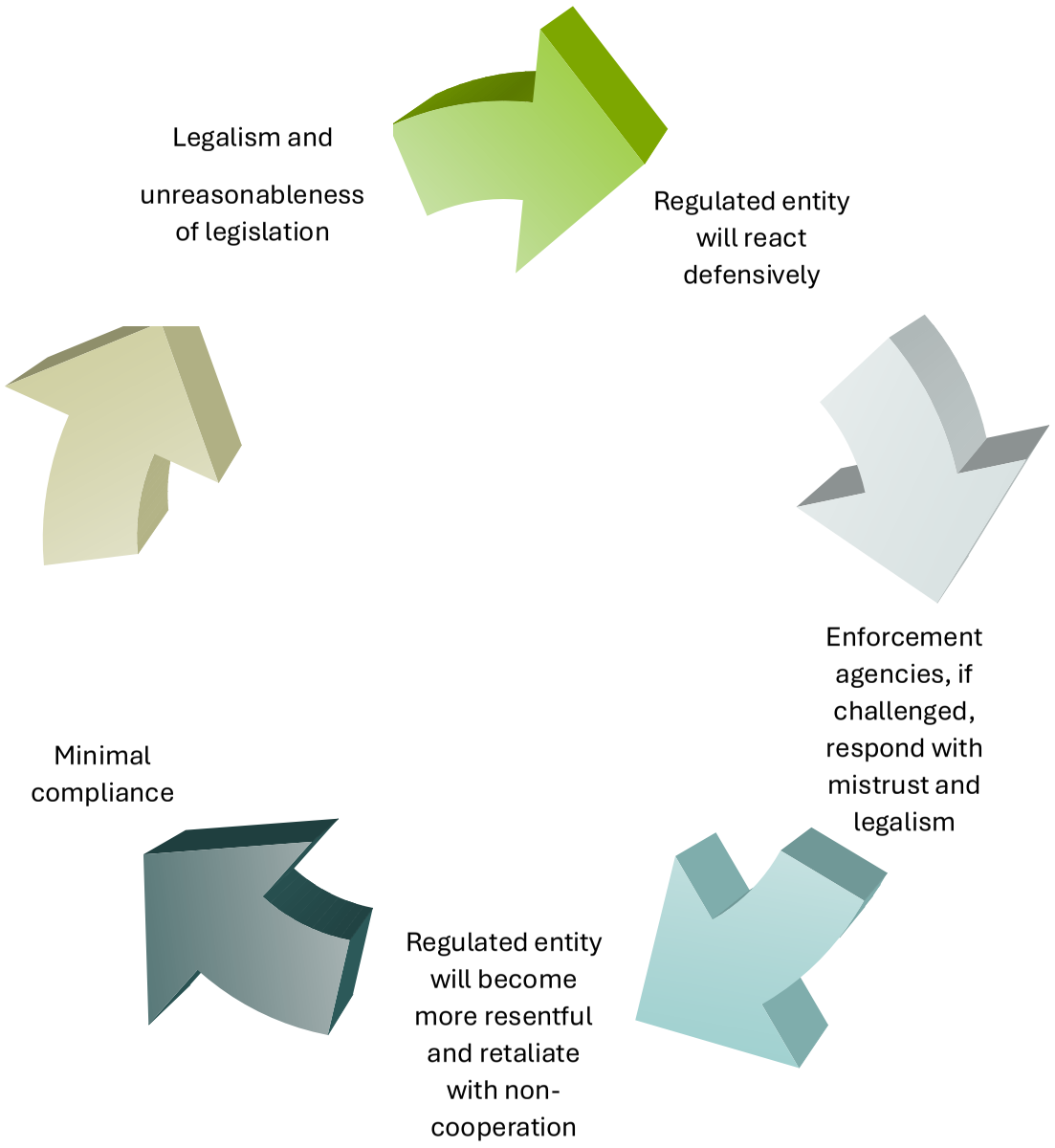

Diagram 2. Vicious cycle resulting from legalistic and unreasonable legislation.[8]

Resentment towards the regulator can blossom if a regulated entity believes that the rules imposed are unreasonable or excessively legalistic. For instance, if regulated entities have a fine imposed on them when they believe they have acted responsibly, the result may be counterproductive. Some business managers may respond by taking the position that they will act no more responsibly than the regulatory agency's rules require them to. This will lead to minimal compliance and more legalistic and unreasonable legislation.[9]

What would this framework allow ASIC to achieve?

The tools available to ASIC in the financial services arena have been incorporated in Braithwaite's pyramid in Diagram 3.

[8] This diagram is based on information given by Bardach and Kagan, above n 5, 105. The author took the information and formulated it in the form of Diagram 2.

[9] Bardach and Kagan, above n 5, 105.

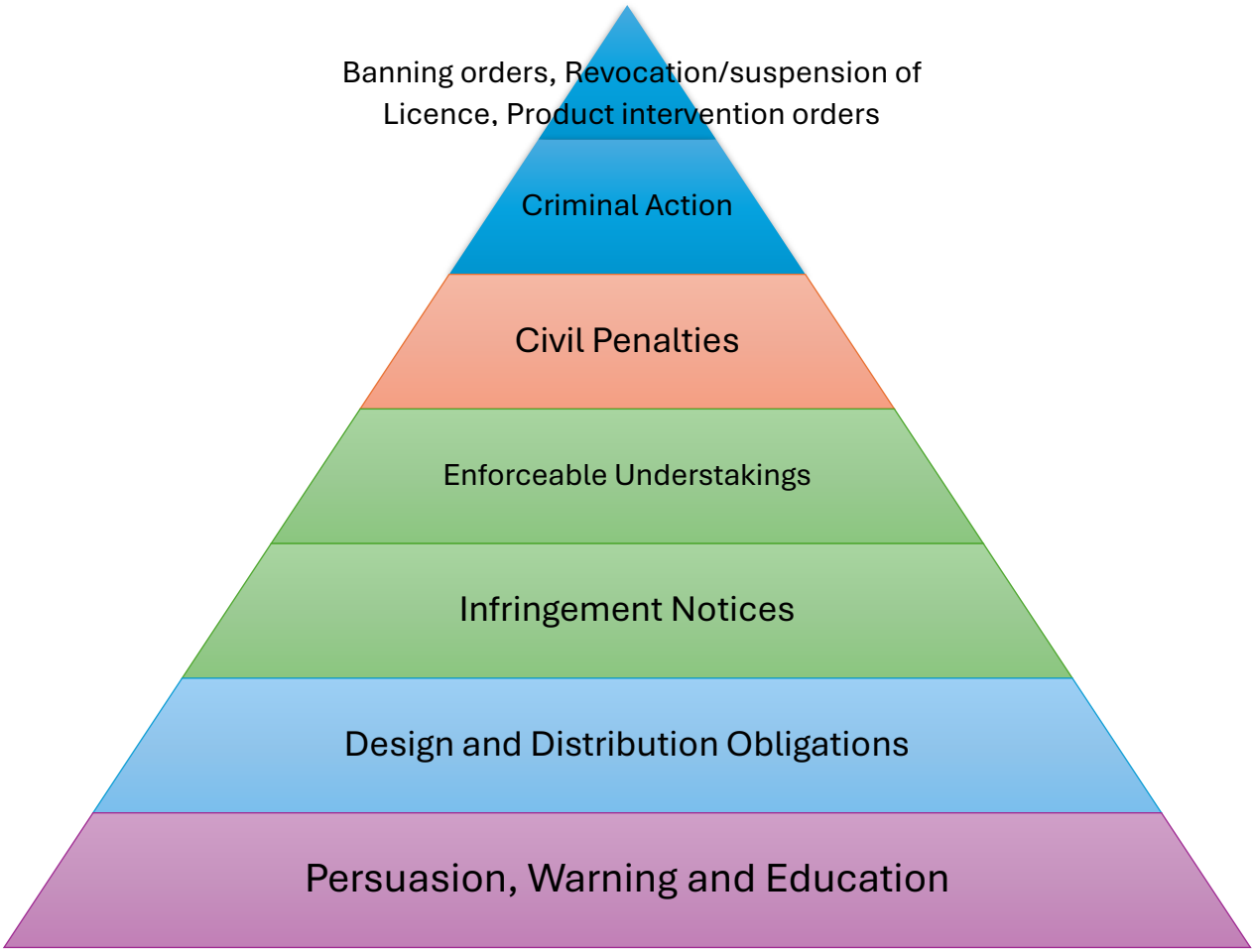

Diagram 3. Tools at ASIC's disposal

As ASIC has a range of tools at its disposal to deal with misconduct, ASIC is in the position to ensure investors protection while at the same time providing freedom for businesses to grow. However, due to the vulnerability of the people that may be negatively impacted by mismanagement in wealth management companies, ASIC should prioritise review of the practices in this industry by relying on preventative and proactive measures available to it in the pyramid.

Ability to Proactively Regulate the Industry

ASIC may rely on a range of tools available to it to protect consumers and investors. For example, education plays an important role in raising consumers' and investors' awareness of their rights and of the pitfalls that they may be facing when dealing with wealth management companies. Education campaign may focus on key factors investors should consider when dealing with wealth management companies, the red flags that they need to watch for and the questions that they could ask when seeking advice from these organisations. This is important even to clients who may be classified as wholesale investors due to their net worth. Just because their net worth is high does not automatically mean that they have the knowledge to understand the product being offered to them especially in instances where that net worth is reached due to the family home.

Furthermore, ASIC has the tools to ensure that the financial products being offered are appropriate for the target audience through the design and distribution obligations (DDOs). The DDOs are designed to help consumers to receive appropriate financial products by 'requiring issuers and distributors to have a consumer-centric approach to the design and distribution of products.'[10] However, personal advice is excluded from the DDOs, and this is something that may need to be altered. The Revised Explanatory Memorandum justifies this exclusion by noting the following:

> While retail product distribution conduct includes providing financial product advice, the new regime excludes personal advice and associated conduct from most of the new distribution obligations. This reflects that such conduct already involves consideration of the client's individual circumstances and is subject to the best interest obligations under Pt 7.7A of the Corporations Act.[11]

While it is important not to make the regulation burdensome as noted previously in this submission, applying DDOs for personal advice in the context of wealth management, especially in instances when the wealth management companies are targeting retail clients, would not be unreasonable as the entity would have had to compile the information needed for DDOs to be able to fulfil its best interest obligations under the law. Therefore, the burden is minimal on the business, and it will provide ASIC with a tool to assess the appropriateness of product being offered to that target retail audience.

From a regulated entity perspective, ASIC may start shadow shopping campaigns in that area to assess the practices occurring within wealth management companies. This is something ASIC has done in the past with financial advisers for example on an ad hoc basis. ASIC could implement such practice on more regular basis to understand deficit within the industry and built proactive strategies to deal with them. Minor breaches may be dealt with quickly using infringement notices. However, if a minor breach has a range of underlying causes one way to tackle it is for an enforceable undertaking to be entered into as this sanction can achieve two important results:

- Tackle the core of the problem
- Provide quick remedy to consumers for any losses they may have suffered.

Enforceable undertaking provides the regulator with latitude to require that the regulated entity fulfils of a range of obligations that may improve the culture of the organisation.

More Egregious breaches and Failure of Institutions

When egregious breaches occur, ASIC has at its disposal a range of tools to tackle misconduct by Wealth Management companies, including civil penalties against financial providers and financial advisers.[12] One tool that ASIC has at its disposal but has used sporadically is s 50 of the *ASIC Act*. This provision allows ASIC to bring civil action in the name of the company, or a class action for shareholders/investors for the recovery of damages for corporate misconduct.

[10] ASIC, Regulatory Guide 274: Product Design and Distribution Obligations (September 2024) 4.
[11] Revised Explanatory Memorandum Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2019 (Cth) [1.84].
[12] For a list of civil penalties see s 1317E.

However there has been very little uptake of this power by the regulator over the years.[13] This is despite the wide purview of this power.[14] When the power has been used it has been very useful for investors as demonstrated in the Storm Financial collapse.[15]

Reliance on tools such as s 50 of the *ASIC Act* can allow the regulator to provide extra protection to investors. In instances where the company collapsed, ASIC may still take action on behalf of the company too against the directors if they were involved in the mismanagement of their powers. In doing so, the result of the action may be a range of remedies including compensation or account of profit depending on the breach and this may provide more funds for the liquidator to compensate creditors including investors for their losses. All this will not preclude the regulator from also taking action against the offender under the civil penalty regime. Criminal action may also be initiated depending on the breach that has occurred.

Conclusion

ASIC has a range of tools at its disposal that empower it to conduct its role. However, a close look at the industry is needed to understand the way it functions and the pitfalls or bad practices that are embedded within the wealth management industry. Discovering and taking action to rectify these issues requires financial resources and staff expertise which ASIC may not have. The reality is that implementing shadow shopping within that industry or starting litigation is costly. As such, ASIC resourcing needs to be revisited. Furthermore, extending the use of DDOs to personal advice may also be desirable to further protect retail client. Lastly, ASIC has the arsenal to protect investors however the regulator must be more proactive in this area.

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[13] Janet Austin, 'Does the Westpoint Litigation Signal a Revival of the ASIC s 50 Class Action?' (2008) 22 *Australian Journal of Corporate Law* 8, 8.
[14] See for example, ASIC, 'ASIC's Approach to Involvement in Private Court Proceedings' <https://asic.gov.au/about-asic/asic-investigations-and-enforcement/asic-s-approach-to-involvement-in-private-court-proceedings/ >.
[15] Michael Leff, 'A Comparison of Regulatory Enforcement, Class Action and Alternative Dispute Resolution in Compensating Financial Consumers' (2016) 28(3) *Sydney Law Review* 311.