

## CHAPTER TWO

### BACKGROUND TO THE DRAFT BILL

2.1 The draft Financial Services Reform Bill is the culmination of an extensive reform program of the regulatory requirements applying to the financial services industry. It is the sixth stage of the Corporate Law Economic Reform Program announced by the Treasurer in March 1997 as a fundamental review of key areas of regulation which affect business and investment activity.

2.2 Developments in the global and Australian business environment have made imperative the reform and streamlining of Australia's corporate law. Developing a regulatory framework which responds to the demands of contemporary business is a major contribution to achieving Australia's economic goals.

2.3 The reform program has been developed with the benefit of consultation with the business community and the Business Regulation Advisory Group. The objective of the program has been to promote business and market activity leading to important economic outcomes including increased employment by enhancing market efficiency and integrity and investor confidence.

2.4 The reform agenda has been based on the key principles of market freedom, investor protection, information transparency, cost effectiveness, regulatory neutrality and flexibility, and business ethics and compliance.

2.5 The draft Bill is the legislative outcome of a number of recommendations of the Financial System Inquiry (FSI). The FSI proposed that there be a single licensing regime for financial sales, advice and dealings in relation to financial products; consistent and comparable financial product disclosure; and a single authorisation procedure for financial exchanges and clearing and settlement facilities.

2.6 The aim of the regime is to achieve a competitively neutral regulatory framework which provides more uniform regulation, thus reducing compliance and administrative costs and removing unnecessary distinction between products. Further, consumers will enjoy a more consistent system of consumer protection.

2.7 The position paper – *Financial Markets and Investment Products* – released in December 1977 was followed by a consultation paper, titled *Financial Products, Service Providers and Markets – An Integrated Framework* in March 1999. An extensive consultation process provided valuable feedback on the reform proposals which resulted in the release in February 2000 of the draft *Financial Services Reform Bill* together with the Commentary on the draft provisions.

2.8 The draft Bill proposes a regulatory framework for the financial services industry that facilitates innovation and promotes business, while at the same time ensuring adequate levels of consumer protection and market integrity.

2.9 The draft Bill covers a wide range of financial products including securities, derivatives, general and life insurance, superannuation, deposit accounts and non-cash payments. The regime will apply to the activities of existing financial intermediaries such as insurance agents and brokers, securities advisers and dealers, and futures brokers, as well as any other person carrying on a financial services business.

2.10 The flexible and adaptable framework proposed will encourage innovation and competition in markets and clearing and settlement facilities.

2.11 The reforms will play a significant role in the Government's push to make Australia a global financial centre.

## **OUTLINE OF THE BILL**

### **Objects of Chapter 7 of the Corporations Law**

2.12 The draft Bill proposes to replace Chapters 7 and 8 of the Corporations Law with a new Chapter 7. The objects of the new Chapter are given as promoting:

- confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services;
- fairness, honesty and professionalism by those who provide financial services;
- fair, orderly and transparent markets for financial products; and
- the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities.

2.13 These objects are to be attained by the draft Bill's key proposals:

- providing comparable regulation of all financial products, including securities, derivatives, superannuation, life and general insurance and bank-deposit products;
- licensing financial markets and providing consistent and comparable regulation for similar financial products;
- licensing all financial advisers and dealers and imposing statutory obligations on these intermediaries which are designed to protect retail investors, and
- ensuring that 'promoters' or issuers of financial products provide comprehensible disclosure documents that assist investors to compare different investment products and to make informed decisions.

2.14 The draft Bill seeks to harmonise the existing diverse regulatory arrangements for financial markets and investment products. Difficulties with the current regulatory framework include the lack of consistent regulation of similar services and products

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and overlapping regulatory regimes which impose unnecessary administrative costs on regulators and compliance costs on participants.

2.15 Throughout the draft Bill criteria to be satisfied (for example, to obtain a licence) are broadly stated and flexible to accommodate different market structures, investment products and financial intermediary services.

### **Key definitions**

2.16 Part 7.1 contains the key definitions applicable to proposed new Chapter 7 of the Corporations Law. They will replace some of the existing definitions in the Corporations Law and are drafted so that they are capable of application to the full range of financial products that are to come within the Chapter. For example, the concept of ‘able to be traded’ will replace the term ‘admitted to quotation’ in relation to Chapter 7 to reflect the fact that the provisions will apply to all financial products markets and not just those in relation to securities. Similarly, the concepts of ‘acquire’ and ‘dispose’ have been defined broadly to capture the wide range of products that are subject to the Chapter.

2.17 The draft Bill draws a distinction between retail clients and wholesale clients. Retail clients benefit from additional protection in the form of:

- the Financial Services Guide;
- the Statement of Advice;
- product disclosure documents; and
- compensation and complaint handling arrangements.

2.18 The definition seeks to accommodate the range of products and services that come within the regime. The draft Bill distinguishes between general insurance products and other kinds of financial products. The test for ‘retail client’ is different for these two categories of financial products.

### **Definition of Financial Product**

2.19 The draft Bill begins with a broad general definition of financial product which focuses on the key functions performed by financial products. This general definition is then clarified or added to by a list of specific inclusions and a regulation-making power to include further products. The scope of both the general definition and the specific inclusions is then narrowed by a list of specific exclusions, a regulation-making power to exclude products and an ASIC exemption power.

2.20 The general definition focuses on three key functions that financial products provide:

- making a financial investment;
- managing a financial risk; and

- making non-cash payments.

### **Licensing of financial products markets**

2.21 The purpose of Part 7.2 of the draft Bill is to create a single licensing scheme for securities and futures exchanges in a more flexible regulatory framework than the current seven fold licensing arrangements.

2.22 The draft Bill covers the different responsibilities allocated to the Minister, ASIC and market licensees in carrying out their respective functions in monitoring and promoting market integrity and consumer protection.

### **Licensing of clearing and settlement facilities**

2.23 Clearing and settlement facilities are the subject of Part 7.3 of the draft Bill. The purpose of Part 7.3 is to provide a more flexible and comprehensive regime for the regulation of clearing and settlement facilities. Instead of the two routes to authorisation provided in the current Corporations Law, there will be one.

2.24 The draft Bill permits access to the relevant transfer provisions by a wider range of facilities. The proposed provisions will permit (but not require) more than one clearing and settlement facility to handle the clearing and settlement of transactions executed on the one financial product market.

2.25 The draft Bill does not increase the regulatory burden on those clearing and settlement facilities currently regulated under the Corporations Law. Rather than imposing additional obligations, some of the new provisions reflect aspects of the new, more complete framework (for example, suspension of a licence) which are not addressed in the current Law.

### **Compensation arrangements**

2.26 The National Guarantee Fund (NGF) and its administration are addressed in Part 7.4. In addition, requirements are prescribed for compensation arrangements to cover a retail client for specified losses of property entrusted to a participant in a financial products market or clearing and settlement facility, where the NGF does not apply.

### **Licensing of providers of financial services**

2.27 Part 7.5 sets out when an Australian Financial Services License is required, who may apply for a licence and when a financial service is provided. It provides that:

- persons seeking to carry on a financial services business will need to obtain an Australian Financial Services Licence;
- financial services are providing advice, dealing in, or making a market in financial products; operating a managed investment scheme; or providing a custodial or depository service;

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- a licence will be required where services are provided to either wholesale or retail clients. Additional obligations will be placed on licensees who offer services to retail clients;
  - licences may cover all financial services in relation to all financial products or a subset of services and products;
  - transitional licensing arrangements will apply to persons who are currently registered or licensed under banking, insurance, superannuation or Corporations Law regimes;
  - licensees may authorise natural persons or corporate representatives to act on their behalf;
  - authorised representatives will be able to act for more than one licensee with the written consent of each licensee (cross endorsement).

### **Disclosure and other conduct requirements for licensees**

2.28 Parts 7.6 and 7.7 prescribe the disclosure regime for financial services licensees and regulate the way they deal with their clients' moneys.

2.29 The disclosure regime encompasses a number of elements.

- Disclosure obligations will apply to financial service providers who provide services to retail clients.
- Financial service providers must give their retail clients a Financial Services Guide.
- Where personal advice is provided to a retail client that advice must have a reasonable basis. The provider must investigate the subject matter of the advice having regard to the client's objectives, financial situation and needs, and must base the advice on that investigation.
- The provider must give the client a Statement of Advice including the basis on which the advice was given and information about any conflicts of interest (including commissions, fee, or benefits) that the provider may have in giving the advice.
- The level of analysis undertaken and the issues that should be considered by the provider will vary depending on the complexity of the advice sought.
- Additional information must be included where the advice is to replace an existing financial product. This information must address the potential loss of any benefits and the costs associated with replacing the financial product.
- The client must be warned if the advice is based on information that is incomplete or inaccurate.
- Warnings must be provided to retail clients where general advice is provided.

2.30 Part 7.7 provides that licensees will be required:

- to establish and maintain a separate account in which to hold client (both retail and wholesale) funds;
- where they hold funds or assets on behalf of clients, to provide periodic statements to clients;
- to keep financial records that correctly record and explain the transactions and the financial position of the financial services business carried on by the licensee;
- to prepare profit and loss statements and balance sheets and lodge them together with an auditor's report with ASIC;
- to give priority to clients' orders; and
- to disclose and obtain client consent when they will be acting on their own behalf in a transaction with a non-licensee.

### **Financial product disclosure**

2.31 Financial product disclosure requirements and other requirements relating to the issue and sale of financial products form the subject matter of Part 7.8. This disclosure regime will replace a range of existing disclosure regimes for financial products, some legislative and some self-regulatory. The draft Bill provides for:

- point of sale disclosure through the giving of a Product Disclosure Statement (PDS);
- other disclosure obligations in relation to financial products encompassing:
  - ongoing disclosures; and
  - periodic reporting requirements;
- other obligations for transactions in relation to financial products covering:
  - handling money from applicants for financial products;
  - confirmation of transactions in relation to financial products; and
  - alternative dispute resolution mechanisms for product issuers;
- obligations with respect to advertising in relation to financial product;
- cooling-off periods for certain financial products.

2.32 Part 7.8 will not replace the disclosure requirements for shares and debentures under the Corporations Law. However, some amendments will be necessary to the Corporations Law to take account of the new disclosure regime.

**Title to securities and other matters**

2.33 Parts 7.9 and 7.10 conclude the draft Bill, dealing with matters relating to title to, and transfer of, certain securities and other financial products. Qualified privilege, the role of codes of conduct and the Minister's power to delegate are also covered.

