CHAPTER FOUR

ISSUES ARISING FROM THE DRAFT BILL

Introduction

4.1 The Committee isolated six main issues arising from the submissions and hearings in relation to the draft Bill. As noted in the previous Chapter, these issues are not a definitive survey of all matters raised during the inquiry. Instead they are intended to highlight the more significant aspects of the practical implementation of the draft Bill and some broader questions relating to financial regulation. Again, as noted previously, the Committee decided to report as early as possible, to enable the Government to include its response to the report in the final Bill as presented to Parliament.

Adverse effects of the draft Bill on the delivery of financial services in rural and regional areas

4.2 The Committee identified adverse effects on the delivery of financial services in rural and regional areas as the most important issue arising from the draft Bill. The Committee received overwhelming evidence from regional banks, building societies and credit unions as well as the major banks that, as presently drafted, the draft Bill places an onerous and inappropriate regulatory burden on the industry, which if implemented would seriously affect the range of services currently being provided in regional areas. The Committee also accepts the evidence put before it that the inclusion of basic banking products in the definition of financial product and the flow on effects this has on the industry, in terms of both training for counter staff and the cost of complying with the disclosure regime that accompanies advice concerning financial products, is the element of the draft Bill which jeopardises the financial industry's ability to continue to maintain its present level of service in regional areas. The Committee believes that any reduction in service to regional areas would be a most unfortunate and unacceptable development.

4.3 The Australian Bankers' Association (ABA) told the Committee that it was concerned that the draft Bill did not take sufficient account of functional differences between certain financial products. The most important of these was the difference between traditional banking products issued by authorised deposit taking institutions and other investment or market linked financial products. These banking products are issued by prudentially regulated bodies, are capital assured and are not speculative or related to a market. They are generally repayable on demand and are well understood in the community. The draft Bill, however, equated these products with investment products where there was a potential risk of loss of both income and capital. There are two key areas where this is inappropriate: the giving of advice by counter staff and the agency distribution of these simple banking products. For instance, the draft Bill imposes onerous conditions in relation to banks and their agents, who are often rural

businesses such as newsagencies or pharmacies. These conditions would apply not only to the proprietors of those agencies, but also to every employee who provided financial products to retail clients.

4.4 The ABA advised that there are particular difficulties with rural and regional services in relation to the divide in the draft Bill between the provision of factual information and the provision of financial advice. Banks and agencies may have to commit to rigorous staff training programs even where the risk profile of a product is negligible. Also, there are very few consumer complaints about basic transaction banking products, because they are repayable on demand. It would be difficult to see disputes arising in those situations.

4.5 While giving evidence to the Committee the ABA noted that the Financial System Inquiry report—the Wallis report—at page 263 recognised the differing functional characteristics of financial products when proposing regulatory oversight of disclosure requirements. The ABA, quoting directly from the Wallis report, outlined for the Committee the inquiry's conclusion that the different level of risk profile in simple banking products compared with those of an investment nature needs to be recognised. The ABA further noted that whilst this recognition of difference had been reflected to a degree in the draft Bill in respect of product disclosure, the approach did not flow through the draft Bill's provisions relating to other requirements, particularly advice and third party relationships.

4.6 The Commonwealth Bank told the Committee that the inclusion of deposits within the draft Bill was a major concern. The present level of prudential regulation had allowed banks to offer simple, flexible, low cost deposit taking facilities. These products should be removed from the ambit of the draft Bill. Under the proposed provisions even these simple products explained by counter staff would be subject to the full advice process. At present, the Commonwealth Bank has about 17,500 staff in its branch network, of whom 1,200 are authorised to give advice. Under the draft Bill, however, some 13,000 would need to be trained to the level of giving advice.

4.7 The Commonwealth Bank advised that these provisions of the draft Bill would make it almost impossible to continue offering the same level of banking services for rural and regional customers. About 40% of the 110,000 Commonwealth Bank access points were in these areas, many of which are provided through agencies. Many of these continue to operate viably only because they provide banking services.

4.8 The Bendigo Bank Group told the Committee that there was a major difficulty in distinguishing between product information on the one hand and financial product advice on the other. There were particular concerns with the effect of this on local agencies such as pharmacies, newsagents and stock and station agents, in rural and regional areas.

4.9 The ANZ Bank advised that there was a lack of clarity in the definitions of general and personal advice, flowing from the failure of the draft Bill to take account of the differences between low risk basic banking products and higher risk investment

products. The onerous obligations under the draft Bill would threaten the expansion of services to small communities in country locations.

4.10 Westpac Bank advised that the inclusion of basic banking products (such as those used to meet everyday transactions and not used primarily to obtain significant return on funds) and the flow on effects in terms of training and disclosure requirements that follow this inclusion, would adversely affect rural and regional customers. They advised that the viability of in-stores would be threatened and the willingness of small business people in country towns to act as agents would, in all probability, decrease. Westpac noted this could constrain access for basic banking products for rural communities.

4.11 Westpac also advised the Committee that the inclusion of basic banking products in the draft Bill could not be in response to customer concerns as complaints data and market research supported the proposition that customers are currently being provided the most appropriate deposit account for their needs in the vast majority of instances. Westpac, like the ABA, also shared the view that the inclusion of basic banking products within the ambit of the draft Bill did not align with the recommendations of the Wallis Inquiry which recognised the need for consumer protection measures to differentiate between the different risk profiles of different products.

4.12 The Australian Association of Permanent Building Societies (AAPBS) advised that about 750 of their 1,120 outlets were agencies which, like their branches, offer simple deposit and transaction accounts. In this respect the definition of financial product advice in the draft Bill was too broad and indiscriminate, which would impact adversely upon the distribution of their services through agencies.

4.13 The AAPBS advised that the draft Bill had obvious problems for building society agencies, which are usually businesses in a country town. If counter staff had to be trained to give full personal advice then the costs were such that building societies may decide that it is not worthwhile to continue to operate agencies. The AAPBS quoted Mr Mark Scanlon from the Bass and Equitable Building Society, the only building society in Tasmania, as saying that under the provisions of the draft Bill there was no point in continuing agencies. Mr Scanlon later provided the Committee with a summary of agency business for the Bass and Equitable Building Society.

Location	Business Type	No. of Accounts	No. of Transactions in June 2000
Devonport	Jewellery store	143	751
East Devonport	Newsagency	810	1611
Shorewell	Newsagency	31	613
St Helen's	Photography processor	669	593
Latrobe	Home Hardware/ Festival Supermarket	231	683
Penguin	Travel Agency	377	522
Smithton	Pharmacy	916	632
Sheffield	Pharmacy	324	416
Deloraine	Pharmacy	385	483
Somerset	Newsagency	56	372
Stanley	General Store	260	298
Riverside	Pharmacy	222	587
Kingsmeadows	Pharmacy	75	838
Shearwater	Newsagency	356	805
TOTAL		**4855**	**9204**

4.14 The Credit Union Services Corporation (Australia) Ltd (CUSCAL) told the Committee that the draft Bill imposed onerous disclosure and conduct requirements, which were appropriate only for risky investment products, on simple core banking products. Credit union products were simple, safe and widely understood. The result of the new requirements would be to increase costs for staff training and business systems. In particular, the draft Bill would have a negative effect on rural services through agents and the rural transaction centres. The increased burden may result in these services becoming uneconomic.

The information economy and e-commerce

4.15 The Telstra evidence included much comment on the information economy, convergence and the on-line delivery of financial services. The Committee regards these as of central importance in the reform of financial services. The Telstra evidence raised many questions in relation to these matters which, like Australia's international competitive position, will be a core element in future economic performance.

4.16 Telstra representatives advised the Committee that it supported the draft Bill, but had some concerns about the operational implementation of the reforms and the compliance issues which flow from implementation. These concerns are that certain transactions may be inadvertently brought within the legislation. The main area of concern relates to trade credit. Telstra is the largest credit provider in Australia in respect of non-interest charging credit and provided a range of choices for consumers

as to how they pay their phone bill. Product choice and selection includes paying by means of the emerging opportunities through the Internet and on-line or through other bill payment mechanisms. Telstra understood that the draft Bill was not intended to include trade credit but that this was not expressly clear in the present drafting.

4.17 Telstra also advised that it was very concerned about the potential for overlap between the draft Bill, which will be black letter law, and a new EFT code of conduct being developed by the industry association, which is a self-regulatory model. There is also a plethora of codes of practice being developed under the Australian Communications Industry Forum for customer relationships in credit management. These codes include billing, complaint handling, compensation, privacy and similar issues. Telstra advised that it was worried about dual compliance obligations at the operational level. In particular, there was the issue of compliance of "front of house" staff who give advice to consumers which would be either personal advice, general advice or investment advice, which would be caught by the draft Bill. It is important that any overlap between the draft Bill and the EFT code be resolved before either commences and that they operate in a logical sequence.

4.18 The costs and timeframe of compliance were also of concern to Telstra. The putative commencement date of 1 January 2001 could impose quite significant costs, particularly with the systemic issues resulting from compliance check lists and staff training. There could be a serious risk of operational dysfunction and non-compliance. If staff have to be trained to give personal advice as a result of the final legislation and regulations, the systems and process changes are potentially horrific.

4.19 Telstra advised that another important point was the potential of convergence and on-line delivery of financial services, which would be quite different from the previous off-line delivery. There are issues of how the requirements apply to a consumer who is clicking through options on-line. Telstra is at the forefront of convergence in the e-commerce environment and intends to be more involved in the financial services sector, particularly in on-line applications. Telstra advised that new delivery mechanisms for financial services, such as the so-called smart card market, are not yet mature and that there is some concern at the degree of regulation necessary at this time. Black letter law could discourage innovation in the technology area, which would be disadvantageous to e-commerce. The e-commerce framework should have high-level regulation but not detailed prescription, particularly in the area of business to consumer. There is concern that if the draft Bill and the self-regulatory codes do not dove-tail, then there may be operational dislocation and failure to achieve the best out of the so-called new economy in cyber space.

4.20 The Telstra representatives gave further details of instances of its front of house staff providing advice to consumers with inadvertent consequences. Such advice included payment options for a telecommunications service, a mobile phone plan, or a smart card scheme. Telstra advised that some definitions in the draft Bill were so vague and general that these day to day transactions could be seen as providing a financial service and giving financial advice, for instance in the case of a consumer in difficulties who is unable to pay their bill.

4.21 Telstra further advised the Committee that a concern arose because front of house staff were expected to cross sell other Telstra products. For instance, a telephony product associated with a mobile phone plan may have a payment choice with a commission from a partner that delivers on-line insurance or banking services. This is a grey area, especially because Telstra's main portal provides basically all consumer on-line products, including e-commerce products as well as the traditional telephony products.

Australia as an international financial centre

4.22 The Committee decided to highlight the comments and concerns of the Australian Stock Exchange Limited (ASX) because they relate closely to the crucial issues of Australia's international competitive position and to its role as an international financial centre. Both the Financial System Inquiry and the discussion papers for CLERP6 indicated that any reform should address these issues. The ASX evidence also raised interesting conceptual issues about the nature and purpose of regulation of the financial sector.

4.23 The ASX representatives placed before the Committee a number of issues which they advised are vital to the positioning of Australia as a global financial services centre. By way of preliminary comment the ASX advised that the Australian stockmarket capitalisation was now about $655 billion, four times its size of a decade ago. Trading volumes have grown just as rapidly over this period, which in turn has led to growth in liquidity, one of the most competitive features of a market. The number of retail investors has also increased, although shares are still a relatively new form of investment for many retail clients. The Australian stockmarket, however, although the twelfth largest national market in the world by market capitalisation, is only about 1.12% of the world total, compared with the 50% for the United States and 33% for Europe.

4.24 In this environment, the ASX advised, the Australian market needs to be able to respond quickly to change, domestic and international, in order to continue to grow and to remain relevant. The regulatory framework is a key element in Australia's ability to compete effectively. The ASX is therefore concerned that the draft Bill increases the regulation of the financial services sector and that this may affect adversely the level of domestic innovation in the marketplace. Australia's relatively small size in the global marketplace means that we can not afford inefficiencies in the regulatory framework of financial market products and services. The level of financial markets regulation should be that which best promotes market confidence, best facilitates the choice of Australia as a centre for financial markets operations and best equips our financial market participants to compete internationally.

4.25 The ASX representatives told the Committee that the draft Bill is far stronger on its regulatory and retail investor protection elements than on wealth creation, encouraging entrepreneurship and innovative business development. There are a number of areas where regulation has been quite significantly increased with no particularly cogent reasons for the increase. The different levels of regulation add

levels of cost and levels of inefficiency and could put Australia at a disadvantage internationally.

4.26 In this context the ASX noted that the draft Bill regulates Australian market and clearing settlement facilities more heavily than foreign-based markets which may operate in Australia. The ASX suggested that this may be partly a drafting problem, but that if it is not and is in fact a policy issue, then there is a risk that the draft Bill will hamper on-shore facilities and not properly protect Australians with access to off-shore facilities. Australian incorporated entities will be regulated under the draft Bill regardless of whether they operate in Australia, which will be an incentive for off-shore incorporation and operations.

4.27 The ASX representatives also raised the question of cost effectiveness, which the draft Bill was intended to enhance. The benefits of the draft Bill were intended to outweigh its costs. The ASX advised, however, that the draft Bill in fact increases the level of regulation. The ASX concluded that some of this additional regulation may be warranted, but there does not appear to have been a reduction in the other areas where regulation could have been reduced. For instance, the ASX suggested that the draft Bill framework for compensation for retail investors was unnecessarily complex, which would confuse investors about avenues of redress and raise issues of market costs and efficiencies. The ASX submitted that it was possible to streamline these procedures.

4.28 The ASX further advised that there were areas where it was unclear how much regulation there would be, because the level was being left to ASIC or the regulations. In this regard the ASX noted that the model for stock market regulation in Australia has been co-regulation, which is a combination of statutory and self-regulation. This model achieves a productive collaboration between the government regulator and the self-regulator, in this case the ASX. The Minister has assured the ASX that the draft Bill would not change the relationship between ASIC and the ASX or increase the regulation of markets. It is fundamental to the co-regulatory framework that the Minister remains directly involved, because of the economic and policy focus which the Minister and the Department can bring to bear on regulatory issues. For instance, under the draft Bill the Minister could take action which would bring aspects of the operation of the national guarantee fund into line with international practice and enhance Australia's international competitive position. Conversely, the Minister had wide powers of delegation to the statutory regulator which would need to be exercised appropriately.

4.29 The ASX representatives also raised the issue of the present 5% limit on individual shareholdings in ASX as a demutualised entity. The ASX submitted that the limit, if retained, should be increased to 15%, in line with the banking sector, with the possibility of a larger proportion, subject to a fit and proper person test. In the near term the funds of millions of Australians would be invested across a number of markets operated by different commercial companies with a range of ownership structures. There will not be an even-handed competitive environment if structural restrictions are placed on one type of market operator, or just one operator, instead of

being evenly applied. Restrictions on ownership should be justified in relation to regulatory outcomes and the efficient operation of the economy.

4.30 Finally, the ASX described the transitional arrangements under the draft Bill as being of critical importance. Many details were still not known. The ASX advised that there must be consultation with industry on these details and sufficient time for industry to prepare; this was necessary for a smooth and cost-effective transition period. The role of ASIC during this period would be critical and the ASX would support wide powers for ASIC to modify the application of the new provisions and to exempt or extend the time for compliance.

The impact on small business

4.31 The Committee considers that it is important that the draft Bill does not impact adversely upon small business. In this context the Committee noted the evidence of the Life Agents Action Group (LAAG) and the Association of Financial Advisers (AFA), both of whom expressly represented small business. Their evidence was particularly valuable, not only for the views expressed, but also as a contrast to submissions received from larger organisations.

4.32 The Life Agents Action Group (LAAG) raised the issue of commission disclosure on risk business; that is, insurance products which do not have any investment or savings content. The LAAG submitted that commission disclosure on risk business serves no benefit, with no evidence of genuine consumer concern. In any event, commission content of a risk sale has no impact on claim payment or policy benefits. Also, agent preference for a particular company or product is related not to commission, but rather to service and relationships. Agents who are mainly commission driven will go broke. The draft Bill is particularly unjust in that it requires commissioned agents to disclose earnings, while salaried officers are exempt. Moreover, salaried officers are usually placed on quotas and receive bonuses. Consumers at present have a right under other Commonwealth legislation to request information about commissions; this is acceptable but few ever do ask.

4.33 The Association of Financial Advisers (AFA) raised similar concerns. The AFA agreed with commission disclosure on investment and superannuation products where the results are affected by the amount of commission paid. However, for pure risk products the commission does not affect the price of the product or its outcome; disclosure will not help a consumer to make an informed decision on insurance cover. Disclosure, if necessary, should be total distribution costs and not just commission. Big companies employ salaried officers who do not have to disclose remuneration, whereas small self-employed businesses must do so. In many cases it is even the same product which is being sold. This is not a level playing field. Also, some insurance companies have a high expense base but pay virtually no commission; this is because their marketing costs are very high. The AFA submitted that commissions are only one cost, which did not necessarily reflect the quality of the product.

Co-regulation and the position of professional bodies

4.34 As with the position of rural and regional deposit taking agencies, the Committee believes that the draft Bill should not affect anyone whose involvement in financial services is incidental to their main activity. In addition, the draft Bill should apply in the clearest possible fashion. The Committee believes that both the accounting and legal professions provided significant input in this area and that the co-regulation model has potential to be expanded into other areas of the financial services sector.

4.35 The Law Institute of Victoria (LIV) submitted that the draft Bill had significant implications for the way in which legal practices are conducted, with the potential to increase the cost of legal services for consumers due to the dual overlapping regulatory requirements which would apply to the legal profession.

4.36 The LIV submitted that the draft Bill could include within its coverage the majority of lawyers, who as part of and incidental to their day to day legal practice, either provide financial product advice, deal in a financial product, or provide a custodial or depository service. Providing any of these services (apart from as an authorised representative of a licensee) will require a lawyer to hold an Australian Financial Services Licence and comply with the disclosure and other provisions of the draft Bill.

4.37 The LIV suggested that the definition in the draft Bill of financial product advice is wide and could cover a number of unintended situations. For instance, it could include a lawyer who advises on the scope of cover of a general insurance policy; or who advises a client not to purchase a business by way of shares, because the lawyer has discovered contingent liabilities in relation to them; or who advises about legal aspects of superannuation or other investment products being considered by the client. In these cases, a general insurance policy, shares and superannuation are all financial products.

4.38 The LIV submitted that where such advice to a client is part of, or incidental to, a legal practice, such advice should be either expressly excluded from the draft Bill, or prescribed by the regulations to be outside the definition. This would be consistent with the existing exemption applying to lawyers where advice is given in those circumstances, under the Corporations Law and the relevant ASIC Policy Statement. This approach, the LIV submitted, would continue the present position and maintain the policy underlying the present exemption. If, however, a lawyer provides financial advice as a financial planner or adviser, then he or she should be licensed under the provisions of the draft Bill. In these cases retail clients should be entitled to all of the protection of the proposed legislation. It is essential to maintain the present exemption of incidental activities, even though the draft Bill provides for ASIC to make declarations in relation to professional bodies. Nevertheless, the draft Bill should retain the declaration procedure, which should be available to members of professional bodies who hold themselves out as financial advisers as well as legal

practitioners. Such a declaration is, however, subject to the relevant professional body being willing and able to convince ASIC that it has met the required criteria.

4.39 The LIV also submitted that perceived anomalies in relation to product disclosure statements, dealing in financial products and providing a custodial or depository service, should be addressed.

4.40 Finally, the LIV expressed concern about the proposed commencement date of 1 January 2001, which would not give its members sufficient time to implement systems and procedures to ensure proper compliance, apply to ASIC for licenses and declarations or comply with training and other requirements. In addition, much of the substance of the reform will be in regulations and ASIC policy decisions, which have not yet been made public. The LIV considers that 1 July 2001 would be a more realistic commencement for the draft Bill. There should also be a transition period of at least 6 months so that professional bodies can be confident that relevant obligations in relation to licensing, conduct and disclosure would not apply until all applications had been processed.

4.41 The Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia (the Accounting Bodies) submitted that one issue which required clarification was who the draft Bill required to be licensed. The Accounting Bodies advised that if specific financial product advice was being provided, then licensing is appropriate. However, under the present provisions of the draft Bill there is a risk that all 100,000 of their members must be licensed. This was because professionally qualified accountants give financial advice as a routine activity. The Accounting Bodies suggested that licensing in these circumstances was not the intention of the draft Bill and that this should be made explicit. The Accounting Bodies also supported the provision in the draft Bill under which ASIC could declare professional bodies, which met stringent criteria, to participate in the licensing regime. This provision is in accordance with an express recommendation of the Financial System Inquiry. In relation to declared professional bodies, the draft Bill continues a long history of co-regulation. Nevertheless, the standards which ASIC would apply must be developed in full consultation with the Accounting Bodies if they are to be realistic. These standards should be as precise as possible.

4.42 The Accounting Bodies submitted that the present exemption for incidental financial advice is uncertain and confusing. There is a real risk that the Corporations Law is being breached, with a consequent result that professional indemnity insurance is invalid. This would have a severe effect upon clients. In the practical world of the practising accountant the present legislation simply does not work. At this stage, it is not clear that the draft Bill will resolve these issues.

Proper recognition of corporate structures and the definition of retail/wholesale client.

4.43 A number of submissions suggested that the draft Bill included anomalies as a result of a failure to recognise the conglomerate as a typical corporate structure in the

financial sector. This deficiency is in spite of the Financial System Inquiry expressly commenting on the existence and operation of financial conglomerates. This omission from the draft Bill will have adverse consequences for conglomerates in relation to costs, disruption and capital gains tax.

4.44 The Commonwealth Bank submitted that the draft Bill failed to take into account the structure of financial service conglomerates; it would be necessary to modify certain licensing and disclosure provisions to provide suitable exemptions. At present, many areas of the draft Bill do not recognise current conglomerate structures, which will force those conglomerates either to undertake fundamental structural change or to adopt administratively complex procedures. Either of these would be costly and disruptive. Also, any structural change may have adverse capital gains tax implications. In most financial service conglomerates, staff are employed by a single corporate entity within the group, while other related entities within the group hold licences to provide financial products and services. These licensed entities usually do not employ staff of their own, but use the employees of the service or holding company. The Commonwealth Bank suggested a number of amendments to the draft Bill to ensure that licensing and disclosure provisions apply fairly to financial services conglomerates. On a related issue, the Commonwealth Bank advised that certain corporate entities such as licensed dealers, superannuation funds and responsible entities, which are logically wholesale clients, may not meet the relevant conditions of the draft Bill and would therefore be treated as retail clients. Here again the Commonwealth Bank suggested amendments to overcome these difficulties.

4.45 The Australian Bankers' Association (ABA) submitted that the draft Bill seemed to ignore the nature of the financial conglomerate, despite the Financial System Inquiry expressly noting that the Australian financial system already predominantly comprises financial conglomerates. The FSI also noted that conglomeration is assisted further in some cases by innovation in product design so that products which have been traditionally the preserve of one type of institution may be offered by entities of another type. The ABA suggested amendments to the draft Bill similar to those put forward by the Commonwealth Bank. A number of other submissions made similar points about the conglomerate structure and about the distinction between wholesale and retail clients.