CHAPTER 3

OUTLINE OF THE BILL

3.1 The Department of the Treasury advised the Committee that the modifications made to the exposure draft Bill to produce the current Financial Services Reform Bill were 'significant' in number. These modifications, according to Treasury, affected all aspects of the Bill and were mostly, but not entirely, of a 'minor or technical' nature.

3.2 The provisions of the Bill, noting 'significant' changes from the exposure draft Bill, are discussed below.

Objects of Part 7

3.3 The current Bill proposes that Chapters 7 and 8 of the Corporations Law[1] be replaced by a new Chapter 7 which is set out in schedule 1 of the current Bill. The key changes that this will bring about in the Corporations Law, and the key changes between the exposure draft Bill and the current Bill are discussed below. At the end of this discussion another section deals with the recent amendments to the current Bill.

Key definitions

3.4 Part 7.1 contains the key definitions applicable to proposed new Chapter 7 of the Corporations Law. These definitions will replace some of the existing definitions in the Corporations Law and they are drafted so that they are capable of application to the full range of financial products that are to come within the purview of Chapter 7. 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, not just securities. Similarly, the concepts of 'acquire' and 'dispose' have been defined broadly to capture the wide range of products subject to Chapter 7.

3.5 The 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.

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1 When the current Bill was drafted it referred to the Corporations Law. On 28 June 2001, however, the Corporations Bill 2001 received Royal assent. References to the Corporations Law should therefore now be deemed to be references to the new Corporations Act.

3.6 This definition seeks to accommodate the range of products and services that come within the financial services regime. The 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.

3.7 An important change between the exposure draft Bill and the current Bill is the addition of the new subclause 761(G)(6) the effect of which is to define persons receiving superannuation products, or retirement savings account products, as retail clients—'regardless' of the circumstances of the provision of the product, or the circumstances of the provider or client. The additional protection afforded to a retail client therefore will apply to clients seeking superannuation and retirement savings account products.

Definition of financial product

3.8 The 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.

3.9 The general definition focuses on three key functions that financial products perform:

- making a financial investment;
- managing a financial risk; and
- making non-cash payments.

3.10 An important difference between the exposure draft and the current Bill is the inclusion of paragraph 764A(1)(k). This addition to the current Bill deems spot foreign currency transactions to be financial products for the purpose of being regulated by the Bill.

3.11 Paragraph 764A(1)(l) also is an addition to the exposure draft. This addition subjects certain managed investment schemes, equitable rights in such schemes, and options to acquire equitable rights in such schemes, to be deemed financial products subject to the operation of the Bill.

3.12 Paragraph 765A(1)(x) is also new. It exempts the equipment and infrastructure used to provide financial products from the operation of the Bill. Without this addition the providers of rooms, for example, in which insurance agents concluded contracts with clients, may have been subject to the provisions of the Bill.

Definition of financial service

3.13 Clause 766A of the current Bill deals with the defining marks that indicate that a person has provided a financial service. This clause has been altered from that in

the exposure draft so that '[t]o avoid doubt' it is now expressly stated that a person does not provide a financial service, and is thus not subject to the regulations relating to the provision of financial services, where that person merely performs 'work of a kind ordinarily done by clerks or cashiers'.

3.14 The current clause 766C similarly has been expanded from its counterpart in the exposure draft to make it clear the mere administrative activity is not 'dealing in a financial product' for the purposes of the current Bill.

Licensing of financial markets

3.15 The purpose of Part 7.2 set out in the Bill, is to create a single licensing scheme for securities and futures exchanges in a more flexible regulatory framework than the current multiplicity of licensing arrangements.

3.16 The 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.

3.17 The current Part 7.2 exhibits many changes from its counterpart in the exposure draft Bill. Most of these changes are of a technical nature.

3.18 One change that was not of a technical nature was the removal of clause 799A in the exposure draft Bill. This clause had stated that 'an unacceptable ownership situation' would arise if any one person's voting power in the Australian Stock Exchange exceeded 5 per cent. Part 7.4, discussed below, replaces clause 799A.

Licensing of clearing and settlement facilities

3.19 Clearing and settlement facilities are the subject of Part 7.3. 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.

3.20 The 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 market.

3.21 The 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 not addressed in the current Law, for example, suspension of a licence.

Limits on involvement with licensees

3.22 Part 7.4 as set out in the current Bill appears to be an addition to what was set out in the exposure draft Bill. It is, however, a replacement for clause 799A in the exposure draft.

3.23 Clause 799A was to limit to 5 per cent the shareholding of any one entity in the Australian Stock Exchange. This 5 per cent limitation was deemed to unnecessarily restrict the ability of the Exchange to play a part in the global marketplace.

3.24 In place of this limitation, Part 7.4 of the current Bill applies a shareholding limitation of 15 per cent to financial markets and clearing and settlement facilities that are prescribed as being of national significance. However, it will be possible for the Minister to approve a larger shareholding in relation to a market or facility where this is in the public interest. The Explanatory Memorandum to the Bill contains guidelines for assessing whether a market or clearing and settlement facility is of national significance.

3.25 This Part also provides a new 'fit and proper person' test, in line with international developments in the regulation of exchanges and clearing and settlement facilities.

Compensation arrangements

3.26 The National Guarantee Fund and its administration are addressed in Part 7.5. 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, where the National Guarantee Fund does not apply.

Licensing of providers of financial services

3.27 Part 7.6 sets out when an Australian Financial Services License is required and who may apply for a licence. It provides that:

- persons seeking to carry on a financial services business will need to obtain an Australian Financial Services Licence;
- 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;
- licensees may authorise natural persons or corporate representatives to act on their behalf; and
- authorised representatives will be able to act for more than one licensee with the written consent of each licensee (cross endorsement).

3.28 Clause 911A in the current Bill corresponds to clause 881A in the exposure draft Bill. The new clause has a considerably expanded number of exemption categories that allow employees of representatives and corporate groups providing services in relation to basic deposit products, to be exempt from authorisation.

3.29 This change simplifies the operation of the Bill considerably and is justified on the grounds that employees acting as mere instruments are merely carrying out the directives of others, and it is those others, and only those others, logically, who should have to be authorised.

3.30 In Part 7.6, clause 916B in the current Bill specifically prohibits an authorised representative of a financial services licensee from authorising another to represent them.

Disclosure and other conduct requirements for licensees

3.31 Part 7.7 prescribes the disclosure regime for financial services licensees and authorised representatives.

3.32 This 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.

3.33 Clause 941C in the current Bill corresponds to clause 911C in the exposure draft Bill. Clause 941C, however, has several extra parts which in effect obviate the

need to provide people with a Financial Services Guide where the financial service provided was simply general advice given in a public forum.

3.34 Without the new clause 941C it is possible that the practicality of print, radio and television journalists commenting on financial matters may have become unworkable because it is conceivable that the Bill could have been interpreted to mean that readers and listeners should be provided with Financial Services Guides.

Other provisions relating to conduct

3.35 Part 7.8, which was Part 7.7 in the exposure draft Bill, provides that licensees will be required:

- to establish and maintain a separate account in which to hold client funds (both retail and wholesale);
- to provide periodic statements to clients, where they hold funds or assets on behalf of 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

3.36 Financial product disclosure requirements and other requirements relating to the issue and sale of financial products form the subject matter of Part 7.9. This was Part 7.8 in the exposure draft Bill and, with a few technical variations, the approach adopted in the exposure draft has been retained.

3.37 This disclosure regime will replace a range of existing disclosure regimes for financial products, some legislative and some self-regulatory. The 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 products; and
- cooling-off periods for certain financial products.

3.38 Part 7.9 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.

Market misconduct and other prohibited conduct

3.39 The Bill provides in Part 7.10 for the prohibition of market misconduct. This is a new section which was not included in the exposure draft Bill.

3.40 The provisions of Part 7.10 generally retain the form of the current provisions of the Corporations Law in respect of these matters but their scope has been extended, as appropriate, to apply to all financial products and markets.

3.41 A number of market misconduct provisions will become civil penalty provisions. This means that contraventions will be subject to both civil penalties and criminal consequences.

Title to securities and other matters

3.42 Parts 7.11 and 7.12 are technical sections 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.

Telephone monitoring during takeover bids

3.43 Among the other miscellaneous amendments which conclude the Bill is one that will insert a new section, clause 648J, into the *Corporations Act 2001*. It will require bidders and targets to record all telephone conversations with target shareholders during the bid period. Privacy safeguards to protect the information are also to be required.

3.44 The rationale for this is that it will provide greater protection for target shareholders, and enhance ASIC's capacity to investigate and take enforcement action in these situations.

Amendments

3.45 In a letter of 25 June 2001, the Minister for Financial Services and Regulation advised the Committee that he expected some amendments to be made to the Financial Services Reform Bill 2001 when it was debated in the House. Some amendments were made on 28 June 2001. The Department of the Treasury advised the

Committee that these amendments were the result of representations that both the Minister and Treasury had received. The substantive amendments are discussed below.

3.46 The amendments, among other things, provided an 'explicit role' for the Reserve Bank of Australia in relation to systemic risk issues associated with clearing and settlement facilities.

3.47 The exposure draft Bill had recognised the importance of systemic risk in relation to clearing and settlement facilities. It included as a general obligation the requirement to do all things reasonable to reduce systemic risk. The exposure draft Bill also anticipated a parallel licensing regime of clearing and settlement facilities of significance to the payment system. That regime would have been under the Payment Systems (Regulation) Act. However, the proposal for parallel licensing raised questions about the ultimate comparability of the two regimes.

3.48 According to advice from the Department of the Treasury, industry developments in Australia in the interval between the exposure draft Bill's release and the introduction of the current Bill into the Parliament raised questions about the separability of the relevant clearing houses. It was thus deemed necessary to recognise the Reserve Bank's role in relation to systemic risk in the payment systems generally.

3.49 Another of the recent amendments dealt with the power, under the original Bill, to make a regulation to exempt people from the financial service provider licensing provisions. This particular power 'was just a straight exemption power to be made by regulations'.

3.50 As a result of representations the Government received, particularly from the media organisations, it was recognised that in certain circumstances it might be necessary to exempt people from the financial service provider licensing provisions, but subject to conditions. Thus people could be excluded from the licensing provisions, but could still be subject to a range of conditions. The original Bill was therefore amended so that it now contains a provision that enables any exemption from those licensing provisions to be subject to conditions.

3.51 Another amendment dealt with the licensing of natural person trustees, particularly in the context of superannuation funds. Representations were made to the Minister that the Bill was unclear as to whether each individual trustee had to be licensed or whether the group of trustees could be licensed. The view was also expressed that for some employer superannuation funds and the like it would be difficult for the trustees as individuals to satisfy the licence criteria.

3.52 The relevant amendment in effect creates a notional entity, namely the group of individual trustees, and allows the licensing of that notional entity, rather than requiring the licensing of each individual trustee.

3.53 The recent amendments also saw the licence obligation to act 'competently and honestly' in the original Bill replaced with an obligation to act 'efficiently,

honestly and fairly'. This was in effect no more than a return to the current position in the Corporations Law.

3.54 Another amendment related to the respective roles of APRA and ASIC in relation to the licensing of APRA regulated bodies. In the original Bill there are provisions requiring ASIC to consult with APRA when it is making licence conditions, or varying, suspending or revoking the licence of an APRA regulated body. Concerns were raised about these provisions, in particular it was suggested that the requirements for compulsory consultation with APRA were a little broad.

3.55 There was a concern about APRA licences, for example, a bank's licence to conduct its banking business. ASIC licenses it to distribute those products. If ASIC revoked its distribution licence then it could not do the activities that APRA had licensed it to do. In a situation relating to the revocation of the licence, the revocation power is actually given to the Minister rather than to ASIC. In relation to other APRA regulated bodies such as super funds, there is a requirement for ASIC to consult with APRA before it does anything that can impact upon the activities for which APRA regulates the body.

3.56 The original consultation provisions have therefore been refined by the amendment to limit the consultation to situations where what ASIC is doing could have a significant impact upon the activities of the body which APRA regulates.

3.57 Another amendment dealt with the insider trading provisions. In the original Bill, the mental elements in all the offences had been made consistent with the Commonwealth Criminal Code. In relation to the insider trading provisions, that meant replacing a mental element of 'ought reasonably to know' with a mental element of 'recklessness'—because that is what the Criminal Code would have required.

3.58 As a result, however, of representations made following the introduction of the original Bill, concern has been raised that it might have meant raising the threshold of proof for that offence, thus the recent amendment returned to the mental element of 'ought reasonably to know'.

3.59 A ' technical amendment' to the definition of 'associate' was also made.

Possible Future Amendments

3.60 An additional amendment, still under consideration, relates to the telephone monitoring amendment discussed above, and the concerns that have been raised about the breadth of the amendment. The Minister has indicated that he intends to narrow the provisions relating to monitoring telephone calls, so that they apply only to retail shareholders. Calls involving, for example, institutional investors who do not need the same amount of protection as retail shareholders therefore would not be captured by the monitoring requirements.

3.61 A further possible amendment relates to the definition of 'basic deposit product'. Representations have been made to the effect that the element of the current definition that requires funds to be able to be withdrawn immediately raises particular concerns for smaller credit unions who have discretion as to whether their customers can withdraw their term deposits at any time. This is something that is still being considered.

3.62 Another issue raised with both the Committee and with the Minister is the definition of what is retail and what is wholesale in relation to superannuation products. The current Bill defines all superannuation products as retail products. A number of industry participants have pointed out that pooled superannuation trusts, which act for other superannuation funds, should not be required to meet the disclosure provisions in the Bill designed for retail products. This matter is still under consideration.

Timing and Transitional Arrangements

3.63 On 7 June 2001 the Financial Services Reform (Consequential Provisions) Bill 2001 was introduced into the House of Representatives. The Bill passed the House on 28 June 2001. This Bill makes provision for the transition to the regulatory regime proposed by the Financial Services Reform Bill. It also makes a range of amendments to other legislation, which are necessary as a consequence of the Financial Services Reform Bill.

3.64 The transitional provisions in the (Consequential Provisions) Bill are of two types: those that deal with when the financial services reform regime begins to apply to different people, and those that deal with how a person moves from their existing regulatory regime into the financial services reform regime.

3.65 Generally, the (Consequential Provisions) Bill allows for the provisions in the Financial Services Reform Bill to be phased in over two years.

3.66 On 5 April 2001 the Minister indicated that, to allow sufficient time to consult on the regulations to be made under the Bill and to enable the Australian Securities and Investments Commission and industry to gear up for commencement, he now proposed to start the two year transition period from 1 October 2001.

3.67 The transitional arrangements for financial service providers and financial products, however, will ensure that this commencement date of 1 October 2001 will simply give those existing participants who are ready on that date the opportunity to comply if they so wish. Others who need more time to prepare will generally have up to 1 October 2003 to comply with the requirements of the Financial Services Reform Bill.

3.68 This will enable those financial service providers and product issuers who are ready by 1 October this year to take advantage of the efficiencies offered by the new regulatory regime at the earliest possible time, while not forcing an unrealistic commencement date on those who need more time.