

CHAPTER 2

Overview of the Act, regulations and ASIC policy statements

The Financial System Inquiry

2.1 The *Financial Services Reform Act 2001* (FSR Act) was the main piece of legislation in a package of four statutes introduced to reform financial sector regulation.¹

2.2 It represented the sixth stage of the Corporate Law Economic Reform Program developed in response to the recommendations of the Financial System Inquiry (Wallis Inquiry) released in March 1997.

2.3 The Wallis Inquiry had been established in May 1996 to examine the consequences of financial deregulation in the 1980s and the drivers of further change with a view to formulating regulatory arrangements that would deliver an efficient and cost-effective service for users and encourage innovation and competition.

2.4 In its report, the Wallis Inquiry observed that regulation of the financial services industry was fragmented and complex. There were inconsistencies in licensing requirements for financial service providers in different industry sectors with instances of overlapping and contradictory regulation. There were also inconsistencies in product disclosure requirements and a lack of comparability of product information. Regulation of financial markets under the then Corporations Law was incomplete and inflexible.

2.5 These factors had created inefficiencies for operators, confusion for consumers, and greater costs.

2.6 The Wallis Inquiry proposed a functional approach to regulation and recommended that responsibility for corporations, market integrity and consumer protection be vested in one regulator. These recommendations set processes in train that saw ASIC's establishment in 1998 and the passage of the FSR Act and related legislation in the second half of 2001.

1 Other Acts in the package were the *Financial Services Reform (Consequential Provisions) Act 2001* which set out the transitional arrangements for the new regulatory regime, the *Corporations (Fees) Amendment Act 2001* and the *Corporations (National Guarantee Fund Levies) Amendment Act 2001*.

The Financial Services Reform Act 2001

2.7 Upon the introduction of the Financial Services Reform Bill 2001 into the Parliament, the then Minister for Financial Services and Regulation, the Hon. Joe Hockey MP, explained that the legislation was designed to:

- provide a harmonised licensing, disclosure and conduct framework for all financial service providers;
- establish a consistent and comparable financial product disclosure regime; and
- create a streamlined regulatory regime for financial markets and clearing and settlement facilities.²

2.8 The Explanatory Memorandum to the Bill said that these reforms:

...will put in place a competitively neutral regulatory system which benefits participants in the industry by providing more uniform regulation, reducing administrative and compliance costs, and removing unnecessary distinctions between products. In addition, it will give consumers a more consistent framework of consumer protection in which to make their financial decisions. The Bill will therefore facilitate innovation and promote business, while at the same time ensuring adequate level of consumer protection and market integrity.³

2.9 These features reflected the principles embedded in many of the Wallis Inquiry's recommendations which proposed consistency, flexibility and responsiveness in regulatory arrangements to encourage competition and innovation and also to accommodate future change in the financial system. These goals were to be achieved without unduly compromising consumer protection and market integrity.

2.10 The legislation also contained provisions relating to market misconduct and telephone monitoring during takeover bids, and raised the voting power limit from 5 to 15 per cent for a body corporate (or the holding company of such a body) holding an Australian market licence or an Australian clearing and settlement facility licence.

2.11 The FSR Act represented the culmination of policy formulation and drafting processes involving significant public and industry consultation. The Committee contributed to this process with two inquiries, the first conducted after the Department of the Treasury's release of an exposure draft of the Bill in February 2000 and the second following the Bill's introduction into the Parliament on 5 April 2001.⁴ On

2 Second Reading Speech, 5 April 2001, *House Hansard*, pp. 26 and 521.

3 Financial Services Reform Bill 2001, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p 1.

4 *Report on the Draft Financial Services Reform Bill, August 2000* and *Report on the Financial Services Reform Bill 2001, August 2001*.

both occasions, the Committee's recommendations were influential in the Bill's development.

2.12 In its second report, the Committee noted that the Bill had been well received by the financial services industry and that, generally, the consultation process had been 'appropriate and effective'.⁵ Although some aspects of the Bill were regarded as problematic, this was not considered sufficient to affect its overall acceptance. The Committee recommended that the Bill be passed.

2.13 A number of the Committee's recommendations involved issues that have been raised in the current inquiry. These include concerns about the treatment of certain deposit products offered by ADIs, commission disclosure, the legislation's impact on small business and certain issues relating to Australia as an international financial centre. These and other issues covered by the inquiry will be discussed more fully in the following chapters.

Key elements of the regulatory framework

2.14 The FSR Act replaced Chapters 7 and 8 of the Corporations Act 2001, repealed the Insurance (Agents and Brokers) Act 1984, parts of the Superannuation Industry (Supervision) Act 1998, the Retirement Savings Account Act 1997, the Insurance Act 1973 and the Banking (Foreign Exchange) Regulations. It reformed and consolidated the disparate elements of several regimes into a single, wider-ranging regulatory framework.

2.15 Three interrelated features underpin this regulatory framework. These are briefly described here as they give an insight into the fundamental role played by the regulations and ASIC policy in the overall regulatory scheme.

2.16 The core feature is the concept of the 'financial product'. As the FSR Act is all about regulating conduct in relation to financial products, the definition of this term sets the boundaries of regulation. The term has a functional definition and includes things such as a security, derivative, futures contract, insurance contract, an interest in a managed investment scheme, a bank deposit product and superannuation. There are some definite exclusions from the list and, among these, are health insurance, reinsurance, an interest in a superannuation fund as prescribed by the regulations and credit facilities as defined in the regulations.

2.17 The second feature involves what constitutes conduct in relation to a financial product or, more specifically, the provision of a 'financial service' in the context of carrying on a financial services business. The provision of a financial service can entail giving financial product advice, dealing in a financial product, making a market for a financial product, operating a registered scheme or providing a custodial or depository service. Engaging in any of these activities triggers a licensing

5 *Report on the Financial Services Reform Bill 2001*, p. 85 (para 6.1).

requirement which itself comes with a range of obligations designed to promote investor confidence and the integrity of the financial system.

2.18 The third feature underpinning the framework refines the boundaries of regulation further and is based on a distinction between ‘retail’ and ‘wholesale’ clients. The nature and extent of a licensee’s obligations will depend largely on whether the consumer of a financial service is a retail or wholesale client. The distinction is important because most of the consumer-protection and disclosure standards apply only to retail clients, the assumption being that wholesale investors, by virtue of their knowledge and experience, do not need the same level of protection as retail investors.

2.19 Generally, an investor is a retail client according to the value of the financial service provided. An investor is a wholesale client where the financial product or service is used in connection with a business or otherwise where the investor has net assets or a gross annual income meeting certain levels. The definition relies on regulations to prescribe values and calculation methods.

2.20 The definitions and sub-definitions of the three key features come with regulation-making powers and discretionary powers exercisable by ASIC which can extend or modify their application.

The regulations and ASIC policy statements

2.21 The regulations and ASIC’s discretionary powers are a central feature of the new regime. Besides making the legislation more flexible, they ‘flesh out’ the detail needed for implementation of the principles embodied in the FSR Act which is why they were timed to commence at the same time as the FSR Act.

2.22 The Explanatory Statement to the regulations leaves their importance to the regime’s efficacy in no doubt.⁶ It says that the regulations are intended to:

...provide detailed requirements—for example, the procedure for transferring securities, the matters which must be addressed in an application for a licence and the requirements for disclosure by the issuer of a superannuation product;

...provide for exemptions from the requirements of the Act (or for modified application) where the impact is inappropriate ...

...assist in the transition to the new regime; and

...make consequential and miscellaneous amendments.⁷

6 Corporations Amendment Regulations 2001 (No. 4) SR 2001 No. 319 made on 8 October 2001. These were followed by the Corporations Amendment Regulations 2002 (No. 2) SR 2002 No. 16, Corporations Amendment Regulations 2002 (No. 3) SR 2002 No. 41 and Corporations Amendment Regulations 2002 (No 4) SR 2002 No. 53. All had a commencement date of 11 March 2002.

2.23 Given these rather wide-ranging objectives, it is perhaps not surprising that the regulations are extensive and complex.

2.24 As with the regulation-making powers, the FSR Act provides considerable scope for ASIC's exercise of discretionary powers. These powers find expression, among other things, in ASIC's policy statements which give detailed guidance on how ASIC will administer the laws for which it is responsible. During the lead-up to the commencement of the new regime, ASIC released policy statements and guidance notes on a range of matters, most notably, those concerning licensing, disclosure and transitional matters.

2.25 At the Committee's hearing on 23 May 2002, Mr Ian Johnston, Executive Director, Financial Services Regulation at ASIC, commented that:

...a policy statement is guidance that ASIC issues. It gives an indication to the marketplace as to how ASIC will interpret the law and how we will apply the law—but it does not have the force of law.⁸

2.26 In its August 2001 report on the Financial Services Reform Bill, the Committee recognised the key role played by the regulations and ASIC's policy statements, and concluded that:

...certain reservations expressed about the Bill are justified because the full nature of its operation cannot be known until the Australian Securities and Investments Commission (ASIC) releases its policy papers and the Department of the Treasury has finished drafting the regulations.

...lack of detail in the Bill might place too great a degree of responsibility on ASIC to interpret the legislation, thus leading to reduced certainty about the Bill's operation.⁹

2.27 The consultation process for the regulations and ASIC policy statements was conducted within a relatively tight timeframe following the introduction of the FSR Act into Parliament.

2.28 As the implementation of the new regime depends largely on the regulations and ASIC's exercise of its discretionary powers, it is important that these mechanisms remain faithful to the objects of, and the principles embodied in, the legislation.

2.29 The main principles upon which the new regime is founded—outlined previously—complement the main object of the FSR Act which is to promote:

7 Corporations Amendment Regulations 2001 (No 4) SR 2001 No. 319, Explanatory Statement, issued by the authority of the Minister for Financial Services and Regulation, p. 1.

8 *Committee Hansard*, 23 May 2002, p. 66.

9 *Report on the Financial Services Reform Bill*, p. 85.

- a) 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;
- b) fairness, honesty and professionalism by those who provide financial services;
- c) fair, orderly and transparent markets for financial products; and
- d) the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities.¹⁰

2.30 The current inquiry seeks to examine the regulations and ASIC policy statements to determine whether or not they are consistent with the legislation's objects and principles. The remainder of this report will discuss the inquiry's findings.

10 Section 760A.