

Chapter 2

Current regulation of financial products and services in Australia

2.1 This chapter provides a broad overview of the current regulatory arrangements for financial products and services in Australia. It also provides a brief snapshot of the Australian financial services sector at the time of writing.

Financial services regulation in Australia

2.2 The regulation of financial services providers has been designed to maximise market efficiency, with minimal regulatory intervention to protect investors. The Australian Securities and Investments Commission (ASIC) informed the committee:

The fundamental policy settings of the FSR regime were developed following the principles set out in the Financial System Inquiry Report 1997 (the Wallis Report). These principles are based on 'efficient markets theory', a belief that markets drive efficiency and that regulatory intervention should be kept to a minimum to allow markets to achieve maximum efficiency. The 'efficient markets theory' has shaped both the FSR regime and ASIC's role and powers.¹

2.3 Regulation to protect investors is limited to conduct and disclosure requirements imposed on Australian Financial Services Licence (AFSL) holders. The purpose of these is:

(a) conduct regulation – rules designed to ensure industry participants behave with honesty, fairness, integrity and competence, as well as rules relating to the settlement of disputes between market participants and investors; and

(b) disclosure regulation – rules designed to:

(i) overcome the information asymmetry between industry participants and investors by requiring disclosure of information required to facilitate informed decisions by investors; and

(ii) promote transparency in financial markets.²

2.4 ASIC described the system as designed to be 'largely self-executing', with ASIC's role being 'to oversee and enforce compliance'.³ The financial services licensing system and the associated conduct and disclosure requirements are outlined in more detail below.

1 ASIC, *Submission 378*, p. 4.

2 ASIC, *Submission 378*, pp. 4-5.

3 ASIC, *Submission 378*, p. 5.

2.5 ASIC's role in administering the licensing process, or monitoring and enforcing compliance with licensees' regulatory obligations, does not include ASIC vetting licensees' business models or preventing the availability of complex or high risk financial products to unsophisticated investors. ASIC noted:

Conduct and disclosure regulation does not involve any guarantee that regulated products and institutions will not fail and that promises made to retail investors will be met. Under a conduct and disclosure regime retail investors are still subject to risks.⁴

Licensing

2.6 Section 911A of the *Corporations Act 2001* (Corporations Act) stipulates that financial services businesses, including those who provide financial product advice, must hold an Australian Financial Services Licence (AFSL). As part of its responsibility for regulating the financial services industry, licences are issued and monitored by ASIC.

2.7 Section 766A of the Corporations Act states that the provision of a financial service includes the following:

- providing financial product advice;
- dealing in financial products;
- making a market for financial products;
- operating a registered scheme; or
- providing a custodial or depository service.

2.8 Section 763A of the Corporations Act defines a financial product as a facility where a person makes a financial investment, manages financial risk or makes non-cash payments.⁵

2.9 An AFSL imposes a number of obligations on licensees and their representatives, including the scope of the financial services the licensee is authorised to provide.⁶ All financial services providers hold a single category of licence, though the conditions attached to their AFSL may vary between licensees. In accordance with section 914A of the Corporations Act, ASIC has the discretion to alter the conditions attached to AFS licences. This includes exemptions to particular licence conditions in certain circumstances.

4 ASIC, *Submission 378*, p. 18.

5 Sections 763B, 763C and 763D of the Corporations Act define these terms.

6 ASIC, *Submission 378*, p. 126.

2.10 Section 911A provides that authorised representatives or employees of AFSL holders (licensees) are not required to hold a licence themselves. The licensee is responsible for the financial service or advice delivered by their representative. If a person is providing a financial service or advice without supervision, if their conduct is not covered by someone else's compensation arrangements, or if client assets and payments are held in their name or paid into their account and commissions are received directly, then they are likely to require an AFSL in their own right.

2.11 Prospective licensees are required to undertake a number of steps in order to demonstrate to ASIC that they are going to be able to meet the conditions applying to licence holders. These include (but are not limited to) the requirements for licensees to provide the following information or documentation:

- details of the financial services business, including the nature of the services to be provided and to whom they will be offered, and an organisational chart;
- information on the prospective licensee's responsible managers to enable ASIC to assess organisational competence, including criminal and bankruptcy checks, references and qualifications against their role; and
- demonstrations that the prospective licensee has the necessary financial resources to carry on the proposed business, including financial statements and cash flow projections.

2.12 ASIC noted that it has limited grounds on which to deny an application for a licence:

ASIC must grant an AFS licence if:

- (a) the application is made properly;
- (b) ASIC is satisfied that the applicant or the applicant's responsible managers are of good character;
- (c) ASIC has no reason to believe that the applicant will not comply with licensee obligations; and
- (d) the applicant has provided ASIC with any additional information requested for the purposes of assessing the application.

ASIC cannot refuse an application for an AFS licence for reasons beyond the above-specified criteria (e.g. ASIC cannot refuse to grant a licence on the basis of the licensee's proposed business model). ASIC cannot refuse to grant a licence without giving the applicant an opportunity to be heard and a refusal to grant a licence can be appealed to the Administrative Appeals Tribunal (AAT).⁷

⁷ ASIC, *Submission 378*, pp 125-126.

2.13 The Corporations Act sets out a number of conditions or obligations applying to AFSL holders and their representatives. These include the following general obligations under section 912A:

- providing relevant financial services efficiently, honestly and fairly;
- arrangements to manage conflicts of interest;
- complying with licence conditions and relevant financial services laws, including taking reasonable measures to ensure that authorised representatives do this;
- having adequate resources;
- maintaining competence to provide the financial service, including training representatives to maintain their competence;
- adequate risk management systems; and
- a dispute resolution system and compensation arrangements for retail clients.⁸

2.14 Licensees must also meet other legislative obligations including:

- notifying ASIC of any likely breach of their licensee obligations (section 912D);
- disclosure requirements under the Corporations Act, including the requirement to provide clients with information on remuneration, commissions and other benefits derived from the advice being provided (sections 941-943 and 946-947);
- a requirement for personal advice to have a reasonable basis and be appropriate for the client (s945A);
- market conduct provisions in the Corporations Act; and
- consumer protection provisions of the ASIC Act.⁹

2.15 The conduct and disclosure requirements most relevant to this inquiry are explained in more detail below.

8 The compensation arrangements are to meet claims from the licensee's failure to meet their obligations under the Corporations Act, rather than for investment failure.

9 See Part 2, Division 2, Subdivision D of the ASIC Act.

Conduct obligations

2.16 Licensees authorised to provide advice about financial products are required to meet certain minimum legislative standards when advising clients.

2.17 The Corporations Act outlines the circumstances that constitute the provision of financial product advice, split into two categories: personal advice and general advice. Under section 766B(1) of the Corporations Act, financial product advice is defined as:

...a recommendation or a statement of opinion, or a report of either of those things, that:

- (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
- (b) could reasonably be regarded as being intended to have such an influence.

2.18 Section 766B(3) of the Act defines personal advice as:

...financial product advice that is given or directed to a person (including by electronic means) in circumstances where:

- (a) the provider of the advice has considered one or more of the person's objectives, financial situation and needs...; or
- (b) a reasonable person might have expected the provider to consider one or more of those matters.

2.19 Section 766B(4) defines general advice as: '...financial product advice that is not personal advice.'

2.20 Advisers providing personal financial advice must ensure that there is a reasonable basis for that advice, often referred to as the 'suitability rule'.¹⁰ Section 945A of the Corporations Act stipulates that:

- (1) The providing entity must only provide the advice to the client if:
 - (a) the providing entity:
 - (i) determines the relevant personal circumstances in relation to giving the advice; and
 - (ii) makes reasonable inquiries in relation to those personal circumstances; and
 - (b) having regard to information obtained from the client in relation to those personal circumstances, the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and

¹⁰ ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, p. 33.

- (c) the advice is appropriate to the client, having regard to that consideration and investigation.

2.21 In other words, the adviser must know their client, know the product and/or strategy they are recommending, and ensure that the product and/or strategy is appropriate to the clients' particular needs. This standard does not require that personal advice needs to be 'ideal, perfect or best'.¹¹ A more detailed explanation of the requirement to provide advice of a standard that complies with section 945A is included in ASIC's Regulatory Guide 175.

2.22 Section 949A of the Corporations Act requires that licensees providing general advice to clients warn them that the advice does not take into account their personal objectives, financial situation or needs.

Disclosure obligations

2.23 Part 7.7 of the Corporations Act requires licensees and their authorised representatives to provide certain disclosure material to retail clients.

2.24 All retail clients of financial services providers must be given a Financial Services Guide (FSG):

The FSG provisions are designed to ensure that the client is given sufficient information to enable them to decide whether to obtain the financial services from the providing entity. An FSG must also include information about:

- (a) the kinds of financial services the providing entity is authorised to provide under its AFS licence;
- (b) who the providing entity acts for when providing the authorised services;
- (c) remuneration (including commission) or other benefits connected to providing the authorised services;
- (d) other interests, associations or relationships that might be expected to be or have been capable of influencing the providing entity in providing the authorised services; and
- (e) dispute resolution systems.¹²

2.25 Where a licensee provides personal financial advice to a retail client, a Statement of Advice (SOA) must also be provided:

11 ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, p. 34.

12 ASIC, Submission 378, p. 129. See section 942B of the Corporations Act. Further information is available at ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, pp 18-32.

An SOA must set out the advice and the basis on which it was given. It must also contain:

- (a) the name and contact details of the provider of the advice;
- (b) information about remuneration (including commissions) or other benefits that the provider and related or associated persons or entities may receive (these amounts must be disclosed in dollars unless otherwise permitted by ASIC relief); and
- (c) information about other interests, associations or relationships that might be expected to be or have been capable of influencing the advice.¹³

2.26 These obligations require licensees and authorised representatives to disclose any potential conflicts of interest when providing financial advice, either because of their particular ownership or remunerative arrangements. Section 947B(6) of the Corporations Act states that the information provided in the SOA 'must be worded in a clear, concise and effective manner'.

Competency and training requirements

2.27 A general obligation for licensees under section 912A of the Corporations Act is to ensure that authorised representatives are adequately trained and competent to provide the relevant financial services. The level of training required of financial advisers is commensurate with the complexity of the products they advise on and whether the advice is of a general or personal nature.¹⁴ Products are divided into Tier 1 and Tier 2 categories, with the latter being comprised of more straightforward products such as general insurance products and basic deposit products.¹⁵ ASIC's Regulatory Guide 146 sets out in detail the various minimum training standards for advisers and how these can be met. The most arduous minimum training requirements, applying to financial advisers providing personal advice on more complex financial products, are equivalent to diploma level qualifications.¹⁶

Professional indemnity (PI) insurance

2.28 Section 912B of the Corporations Act requires that licensees have compensation arrangements for loss or damage caused by breaches of their legislative obligations under Chapter 7 of the Act:

13 ASIC, Submission 378, p. 132. See section 947B of the Corporations Act. Further information is available at ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, pp 43-56.

14 ASIC, *Regulatory Guide 146*, 'Licensing: Training of financial product advisers', August 2008, p. 16.

15 ASIC, *Regulatory Guide 146*, 'Licensing: Training of financial product advisers', August 2008, p. 17.

16 ASIC, *Regulatory Guide 146*, 'Licensing: Training of financial product advisers', August 2008, p. 5.

Under these arrangements, licensees must obtain PI insurance that is adequate having regard to the nature of the licensee's business and its potential liability for compensation claims, or be approved by ASIC as alternative arrangements. In determining what is adequate insurance, ASIC will take into account what is available in the market.¹⁷

2.29 ASIC has established a transition period for the implementation of compulsory PI insurance:

To achieve this objective, we will take a staged approach to administering these requirements:

(a) For an implementation period of two years after the requirements commenced on 1 January 2008, we consider it to be adequate for licensees to have PI insurance based on what is available in the market, provided it meets some minimum standards.

(b) At the end of the two-year implementation period, we will expect licensees to have PI insurance that reliably delivers on all aspects of the policy objective (for the avoidance of doubt, licensees are not required to obtain automatic run-off cover from 1 January 2010).¹⁸

2.30 Compulsory PI insurance is intended to reduce the risk that retail clients are left without compensation because the licensee does not have sufficient resources to meet claims. However, PI insurance is limited in its ability to protect consumers, being designed to protect the insured (the licensee) against losses from providing non-compliant financial advice. It does not cover losses incurred where a licensee becomes insolvent and their policy consequently ceases to exist. Protection is also limited by the circumstances insurers are willing to include in the cover they offer licensees.

Margin lending

2.31 Margin lending refers to the practice of lending for the purpose of investing, usually in shares, with the loan secured against the value of the borrower's investment portfolio. When the value of the borrower's equity falls below an agreed proportion of the value of their portfolio (the loan to value ratio, or LVR), a margin call is made requiring the borrower to rectify this by either contributing additional equity or selling some of their shares.

2.32 Prior to October 2009 margin loan products were not regulated as a financial product under the Corporations Act. Margin lenders were not therefore subject to the conduct and disclosure requirements of AFSL holders.

17 ASIC, *Press release*, 'Updated compensation and insurance arrangements for licensees', 26 October 2009.

18 ASIC, *Regulatory Guide 126*, 'Compensation and insurance arrangements for AFS licensees', October 2009, p. 5.

2.33 On October 26 2009 the parliament passed a bill to amend the Corporations Act to ensure that margin loans are regulated as financial products under the Act, and anyone providing or advising on margin loans will be required to be licensed to do so, either by applying for an AFSL or varying their existing one. The bill also introduced a responsible lending requirement for margin lenders and clarified margin call arrangements.¹⁹

Enforcement

2.34 ASIC is responsible for ensuring compliance with AFS licence conditions, comprised of monitoring, surveillance and intervention measures. Enforcement action is tailored to 'encourage compliance with the law and raise business competence and conduct standards'.²⁰

2.35 Non-compliance issues are brought to ASIC's attention via a number of means. These include mandatory breach reporting by licensees, complaints from external sources, targeted surveillance activities and document reviews.

2.36 Enforcement action may include administrative, civil or criminal action to address breaches. Administrative action available to ASIC includes suspending or cancelling the licence, banning the licensee from providing financial services or varying the conditions of the licence. ASIC also uses enforceable undertakings as an alternative to pursuing other remedies. Finally, ASIC may take civil and criminal action in accordance with the provisions of the Corporations Act dealing with breaches of the Act.²¹

2.37 ASIC is unable to take action in anticipation of a licensee not complying with its obligations.

2.38 In the financial year 2006-07, there were five ASIC-initiated licence cancellations; 20 in 2007-08; and 21 in 2008-09. ASIC also reported that most licences are granted with modification (88 per cent in 2007-08) and a considerable number are withdrawn during the application process (6 per cent in 2007-08).²²

Financial services sector in Australia

2.39 The focus for this inquiry has been on retail investment in financial products (excluding superannuation) made on the basis of personal financial advice. This

19 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. Margin lending is subject to further discussion in Chapter Three in the context of Storm Financial. Chapter Six addresses the margin lending reforms covered briefly here in more detail. Securities lending, also covered under these reforms, is discussed in the context of Opes Prime in Chapter Four.

20 ASIC, *Submission 378*, p. 148.

21 ASIC, *Submission 378*, pp 158-159.

22 ASIC, *Submission 378*, pp 146-147.

includes investment in shares, non-superannuation managed funds and debt securities (including debentures). The total value of household investment in these products is around \$350 billion, though this includes investment that was not made on the basis of advice.²³ ASIC indicated that around 34 per cent of retail investors who hold shares directly get advice from a financial adviser; debentures are infrequently sold via an adviser; while just over half the funds in managed fund products are placed through advisers.²⁴

2.40 The most common method for providing financial advisory services in Australia is through one of the approximately 160 dealer groups currently operating in Australia. There are just over 18,000 financial advisers in Australia working for 749 advisory groups operating over 8,000 practices. The largest 20 dealer groups hold approximately 50 per cent of market share.²⁵ Around 85 per cent of financial advisers are associated with a product manufacturer, either as financial advisers working within the group and using the dealer's support services or as directly employed authorised representatives under that corporate entity's AFSL.²⁶

2.41 ASIC explained the various business models used in the industry:

(a) Medium to large sized 'dealer groups' that often operate like a franchise where the licensee offers back office support. The advisers operate as authorised representatives who retain a right to take clients with them if they move to another licensee. The licensee is paid a proportion of the remuneration made by the authorised representative. Example: AMP Financial Planning.

(b) Institutional-owned financial adviser firms with employed advisers. Advisers in bank owned financial adviser firms are generally employed by the bank. Advisers are paid a proportion of the commissions earned or salaries or a combination of both. Example: Westpac Financial Planning.

(c) Smaller firms that have their own licence and might outsource compliance functions to specialist dealer services providers such as Paragem Partners or to large dealer groups who provide dealer to dealer compliance services. Example: Securitor.²⁷

2.42 Financial advisers are paid through a variety of remuneration models, including fee-for-service, commissions and bonuses. Fee-for-service charges are paid by clients to the adviser and may be an hourly rate or a proportion of funds under management (FUM). Commissions are paid by product manufacturers to advisers, usually as up-front payments as a proportion of the investment or as an ongoing

23 ASIC, *Submission 378*, p. 101.

24 ASIC, *Submission 378*, pp 106-107.

25 ASIC, *Submission 378*, pp 108-109.

26 IBIS World Industry Report, *Financial Planning and Investment Advice in Australia*, May 2009, p. 7.

27 ASIC, *Submission 378*, pp 109-110.

trailing commission. Bonuses are generally paid by manufacturers to providers for meeting certain volume targets. ASIC described commission-based remuneration as the most common industry practice:

Because an explicit fee for service would likely be perceived by retail investors as high in relation to the value of advisory services, most financial advisers tend to charge low or zero fees for service, in order to encourage business. They then get remuneration indirectly by receiving commissions from product manufacturers on the funds invested by retail investors. Product manufacturers recover the costs of commissions from the overall charges within the investment products.

Trailing commissions (usually 0.6% of account balances) are the main remuneration method for financial planners, with seven in ten planners citing them as a form of remuneration. Other forms of remuneration include initial commission on new investment/contribution (up to 4-5% of contributions), volume bonuses (i.e. additional commission of up to 0.25% of account balances), and fee for service charged to the client (up to 1% of account balance, or a flat fee, perhaps related to the hours involved). These amounts would not all be paid at the maximum level.²⁸

2.43 Only 16 per cent of total financial adviser revenue in 2008 came from fee-for-service charges. Independent advisers are more likely to earn a majority of their revenue from fee-for-service than aligned planners or bank planners, while affluent clients are more likely to pay fee-for-service than those in the low to mid-wealth range.²⁹

2.44 The effect of the industry's ownership and remuneration arrangements on the quality and cost of financial advice is explored in detail in Chapter 5 of this report.

28 ASIC, *Submission 378*, pp 110-111.

29 ASIC, *Submission 378*, p. 111.

