DEVELOPMENTS IN THE FINANCIAL SERVICES INDUSTRY:

Investor Protection in the New Economy and CLERP 6

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Investing in the time of the New Economy

Sydney recently hosted the 25th annual conference of the International Organisation of Securities Commissions (IOSCO). Delegates from regulatory bodies from around the world attended and discussed issues of global economic significance. One of those issues was the "New Economy" and how it can be most effectively regulated.

IOSCO's Statement of Objectives and Principles of Securities Regulation sets forth the following three objectives:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- The reduction of systemic risk.

These objectives and the principles that support them represent a commitment by IOSCO members to serve the interests of public investors through adoption and implementation of sound regulatory standards that may be applied effectively under varying economic conditions, in both buoyant and depressed markets. Underlying this regulatory framework is the fundamental truth that a well-informed investor is a better-protected investor. Developments in today's fast-changing, technology-fuelled New Economy suggest that it is important for regulators and market professionals not to lose sight of this truth or the need to serve the interests of the public investor. Accordingly, the IOSCO Technical Committee issued a Bulletin regarding Investor Protection in the New Economy.

The Bulletin sought to remind investors, market professionals, and regulators that in the robust but volatile conditions that the New Economy has brought to many countries' securities markets, it is important not to lose perspective. Markets are cyclical creatures. The need to identify market and investment risks, and to disclose these risks to investors so that they understand them, and the need for market professionals to discharge their responsibilities properly, are as great, if not greater, at the upper part of a market cycle as they are at the bottom. These are not new issues, but are of heightened importance in the New Economy. As the Treasurer said in opening the conference:

> Everybody loses interest in corporate regulation when a market booms. It's only when it fails they look to allocate liability. But it's when it's booming, when the activity is going on, that people need to be at their most vigilant.

The New Economy has empowered the individual investor with online, fast and efficient access to market and financial information that, as recently as a few years ago, was only available to a select few institutions and individuals who could afford to pay for it. Technology also is revamping the structure of securities markets and reducing trading costs in ways that could not have been foreseen. The combination of easy access to new technology, reduced costs and the prospects of profits from investment in new technology companies has caused many investors to enter the securities markets for the first time, and others to intensify their investment activity.

The positive benefits of the New Economy are accompanied by new investor expectations and behaviour, and changing conduct of market professionals, presenting challenging investor protection issues for securities regulators.

- While technology has given the individual investor access to more investment information than ever before, it has not necessarily improved the quality of this information, or the ability of many investors to use it. Some investors have eschewed long-term investment strategies based upon company-specific information for short-term trading based upon market indicators, momentum and volatility.

- While technology and online brokerage services have lowered securities commissions, investors' use of margin to purchase securities has reached all time highs in many markets, placing investors at greater risk of loss during market downturns. ASIC has issued investor alerts drawing attention to the risks of margin borrowing in particular; as I have said before, an activity to be engaged in only by consenting adults, with money they can afford to lose.

- And while market professionals (including brokers, dealers, investment advisers, underwriters, and market listing committees) normally perform valuable gate-keeping and advisory functions for the benefit of investors, the euphoria associated with new technology investments may have caused some of these market professionals to lose their perspective and to compromise the judgments that they normally provide to the market place and investors.

The New Economy is also a global economy. Trends that once were limited to individual markets are now reflected instantaneously in markets around the world. Never before has there been a greater need for an international consensus on the issues that affect investors in these markets. Never before has there been a greater need for global cooperation among regulators in addressing these issues.

The IOSCO Technical Committee identified the following four areas of concern:

- The initial public offering process;

- The valuation of high tech companies, including accounting and financial reporting issues;

- The effects of short-term trading strategies on investors' risks and expectations; and

- Preserving investor confidence.

1. The Initial Public Offering (IPO) Process

- Investors should investigate companies fully and know how to gauge a company's value before they invest.

- Investors should be aware that when a company goes public, the number of shares offered to the public often represents only a small percentage of the company's total shares outstanding. While limited supply and aggressive demand may mean that the share price will go up in the secondary market, the price may well fall back subsequently.

- Investors need clear disclosure of new and increasingly interdependent business relationships emerging in IPO markets.
- Investors should understand that factors such as high offering price and dilution of shares may limit investor returns.

2. Valuation of High Tech Companies, Including Accounting and Financial Reporting Issues

- Investors should understand the difference between trading and investing.
- Investors should understand that the time value of money will impact valuation models, which are based upon expectations of future economic gains.
- Investors and market professionals should understand that in some cases, they may need to go beyond reported financial results to determine whether a company has ongoing sources of earnings and cash flow to survive. It was, of course, in response to that, that the ASX introduced the extra disclosure rules for the stocks in the New Economy category.
- Accounting guidance is needed to ensure that companies use consistent methods to account for certain transactions, common in Internet companies, such as advertising and other barter transactions. ASIC has been active on this issue and will continue to be active.

3. The Effects of Short-term Trading Strategies on Investors' Risks and Expectations

- Investors who trade online should understand that the ability to enter an order quickly does not assure that the order will be executed more quickly than an order given to a broker by traditional means. Delays in order processing may occur, resulting in uncertainty about the price at which execution occurs.
- Investors should be clear about the risks and costs associated with investing on margin.
- Online brokerages have changed investors' relationships with their brokers; however, brokers continue to have the obligation to act in the best interests of their customers

4. Preserving Investor Confidence

- Investors should gauge the objectivity and bias of investment advice they are receiving about IPOs and issues trading in the secondary market.
- Market professionals who provide advice and recommendations should be mindful of their investor suitability obligations, and disclose clearly to investors any potential conflicts of interest they may have with respect to the securities they are recommending
- To preserve investor confidence in the IPO process and secondary trading, it is important for securities regulators to question any departures from the legal and professional standards, such as departures from market place listing standards or variations of lock-up periods.

Not all of these issues are novel or unique to New Economy companies or to investing online through the Internet. For example, many of the issues regarding IPOs have arisen during prior "hot issue" markets, and many of the online investing issues are basic questions regarding how market professionals discharge well-established traditional obligations of fair dealing with customers. The issues identified in the Bulletin are, however, particularly relevant in the New Economy environment.

Clearly it is not the role of securities regulators to recommend purchase or sale of securities by individual investors, nor particular strategies to guide their investment decisions. Securities regulators should, however, endeavour to see that investors have access to all material information, including information about the risks associated with investing. The ability of investors to protect themselves requires that they become adequately informed, both through their own efforts and through receipt of fair and honest advice from market professionals.

CLERP 6

Empowerment of the investor, product disclosure and a homogenous licensing regime for industry professionals are not new concepts for the Australian market place. This is in many ways the very substance of the Wallis reforms, embodied in the CLERP 6 proposals; the Financial Services Reform Bill.

The Financial Services Reform Bill is the final phase of a reform program which seeks to harmonise regulation of the financial services industry in Australia. The Bill is quite revolutionary in the changes it proposes, which include a single licensing framework for providers of financial services, minimum standards of conduct, uniform disclosure obligations and greater flexibility. As the Minister for Financial Services and Regulation, Mr Joe Hockey, has said, with the introduction of these reforms, the government plans to create an opportunity for Australia to become a global financial centre alongside London and New York.

The Bill has a proposed commencement date of 1 January 2000 and the government, by now, will have received many submissions commenting on the changes proposed including the Commission’s submissions on the Bill. ASIC has responded to the major implementation issues arising from the Bill and its accompanying commentary. Our submission to Treasury can be viewed on our website.

ASIC commented on matters relating to implementing the draft Bill. They are:

1. a modification and exemption power in relation to licensing;
2. the power to declare professional bodies;
3. the division of regulatory responsibility in markets regulation;
4. transitional issues for licensing;
5. regulation of back office commissions;
6. lodgement of disclosure documents;
7. approval of codes; and
8. regulation of pressure selling of financial products.

One matter to which ASIC has devoted much thought is the proposed transitional arrangements to a new licensing regime. ASIC has suggested to Treasury that it give further consideration to some form of deemed licensing (grandfathering) for existing market participants. ASIC believes that this may even be the best solution, if it is accompanied by a commitment to a surveillance program backed by strengthened administrative powers designed to deal with licensees who are not meeting the competency or conduct requirements. It will be less resource intensive for industry. And it will be less resource intensive for ASIC, although that is not the moving force behind the proposal. This proposal was designed to improve the package overall. If this approach is regarded as too broad, then we have suggested that such a solution should at least apply for some categories of market participants.

Licensing Exemption and Modification Power

ASIC strongly supports the proposed single statutory regime for intermediary licensing which will protect consumers and facilitate efficient business conduct by imposing consistent regulatory standards across functionally-equivalent financial services. We recognise that the regime is intended to be as flexible as possible to allow its application across a wide range of persons and products.

The present era of rapid market and technological change will continue to produce innovation in the structure and modes of delivery of financial products and services. It is not realistic to expect that the Bill can be drafted in a way which will always be capable of incorporating this change. To a large extent, the change is unpredictable. In ASIC's experience, regulatory flexibility beyond the terms of the legislation will inevitably be needed to prevent unintended consequences and to promote the objectives of the new Law.

ASIC considers that regulatory flexibility can best be achieved in a timely and responsive manner by vesting a licensing exemption and modification power in the regulator. Without this, exemptions or modifications will need to be via legislation or regulation, a more time-consuming process than a regulator issuing exemptions or modifications. This is particularly true in the case of individual applications for relief which often need to be determined on an urgent basis.

While, to date, there has been no modification power in relation to licensing, ASIC is unaware of any fundamental policy reason why such a power should not be included. While we are aware that some (although by no means all[1]) industry bodies have expressed concerns about ASIC's modification power, our understanding is that this has been in the context of product disclosure rather than licensing. The criticisms also appear to be based on some misapprehensions about ASIC's accountability in using these powers.

While the absence of an exemption and modification power will not prevent ASIC adopting policies regarding its enforcement of the provisions (ie "no action" positions), these statements of enforcement intention do not change legal rights and duties and, therefore, do not affect the ability of private parties to enforce their rights. They do not provide a high level of certainty for market participants. The capacity to adopt no action positions is no substitute for a formal exemption and modification power.

[1] When ASIC conducted its Good Advice Licensing Review process, comments received from the securities industry on both the Issues Paper and Draft Report indicated a strong support for ASIC to have an exemption and modification power.

The Bill will apply a statutory licensing regime for the first time to new classes of intermediaries (eg life and general insurance companies). In the absence of an exemption and modification power, ASIC's regulatory flexibility in relation to these new classes of intermediaries will actually be reduced. For example, at present ASIC has the capacity to modify the requirements of the Life Code of Practice, as this is a regulator-issued Code[2]. Under the Bill, however, there is no capacity for ASIC to modify the conduct and disclosure requirements as they apply to life companies, life brokers and their agents. We suggest that it is not in anyone's interest at present, to reduce ASIC's regulatory flexibility.

An exemption and modification power would enable anomalies or inconvenience created for particular parts of the financial services industry to be overcome. An example is offshore providers of custody and investment advisory services to non-retail clients. Under the Bill a licence will be required and various other requirements will apply, particularly those in Part 7.7. It may be considered appropriate in some circumstances to provide relief from these provisions. For example, it may be argued that certain modifications to the financial statement requirements in Part 7.7 should be given on the basis that the licensee will comply with comparable requirements in its home jurisdiction. As the Bill is presently drafted, ASIC would not be able to provide this relief. This seems unduly restrictive, given that ASIC possesses the power to modify financial statement requirements as they apply to companies generally (Part 2M.6).

Similarly, while foreign companies registered in Australia are capable of obtaining an Australian dealers or an investments advisors licence, such entities face significant costs and inconvenience in having to prepare all of their accounts, including those relating to their foreign operations, under Australian Accounting Standards. In the absence of an exemption and modification power, ASIC is unable to relieve the regulatory burden on such parties, even though their accounts relating to foreign operations are prepared according to recognised alternative standards applicable in other jurisdictions.

Accountability

Those who express concern about vesting modification and exemption powers in ASIC may not be taking full account of the many types of scrutiny and review to which ASIC is subject. ASIC only uses such powers to adapt provisions of the Law to better fit specific cases where anomalies exist or illogical results would be produced. Modifications and exemptions have always been made within the policy of the Corporations Law, not to extend the Law. Generally, modifications promote flexibility for market participants when complying with the Law, while ensuring consumer protection and market integrity are not compromised.

Modifications and exemptions are currently subject to a large degree of transparency. Specific exemptions are made after consultation with persons who may be directly adversely affected. Class order modifications are only made after there is consultation with relevant parts of the industry. Where class orders are made in conjunction with new or substantially modified ASIC policy, regulatory impact statements are prepared and submitted for approval by the Office of Regulation Review (part of the Productivity Commission). The regulatory

[2] Issued by the ISC.

impact statements address a number of criteria[3]. Class order modification instruments are published in the ASIC Digest and all modifications and exemptions are Gazetted. Exemptions and modifications of any type can be subject to administrative or judicial review by the Administrative Appeals Tribunal or the Federal Court respectively, on application by a person who is affected by them. These reviews are public, and in the case of the AAT, in a 'no-cost' jurisdiction.

Scope of the power

If the view is taken that industry concerns about ASIC's ability to modify the licensing regime are not addressed by the material above, the breadth of the power could be narrowed, or some additional reporting obligations imposed to allow more scrutiny. The latter could involve the introduction of a provision requiring ASIC to report regularly on its use of the power, for example in its annual report. This would allow scrutiny of ASIC's use of the power by the Minister, the Parliamentary Joint Committee on Corporations and Securities, and the public.

If it is not considered appropriate for ASIC to have the power to provide relief from the obligation to hold a licence, we consider that, as a minimum, ASIC should have the power to provide exemptions and modifications in relation to the conduct and disclosure requirements applying to licensees (ie Parts 7.6 and 7.7) on both an individual and class basis.

Professional Body Declarations

A new exemption has been proposed from the requirement to hold a financial services licence, if the service is provided by someone "as a member of a declared professional body and [the service] is the provision of financial product advice that is covered by the declaration" - proposed section 881A (2) (d). These declarations are to be made by ASIC under s.882A, and have two purposes. Firstly, they replace the current incidental advice exemption for solicitors and accountants (s77(5)), because it is considered that provision is not adequate. I hardly need to tell this audience that the issue of incidental advice a long running sore, which ASIC addressed at length in its Good Advice report in November 1995. Secondly, they are intended to allow for some degree of self-regulation by professional persons who are providing financial product advice.

Incidental advice

In ASIC's view, the current proposal may not finally resolve the problem of incidental advice, for a number of reasons. At first blush they appear to be directed at something else - the ability for professional bodies to engage in self-regulation in relation to licensing. It is not clear that the professional bodies are to put in place rules to deal with the issue of incidental advice at all. The professional bodies as self-regulatory organisations may principally be addressing conduct in relation to the provision of financial product advice in the course of carrying on a financial services business.

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[3] These are: the problem being addressed, the objectives of the action, the options, an impact analysis of each option, who was consulted, the conclusion and recommended option and the implementation proposed.

If the concern is that the current exemption (which largely codifies the case law position in this area) is being abused in some cases, then this issue can be dealt with more directly. This may be done by strictly defining the scope of what would be considered incidental.

In formulating a definition of incidental advice, the definition in ASIC's Good Advice Guide (PS119) will be useful[4]. The definition was included after industry consultation, and reflects the case law on the concept of carrying on of a business in this area. As this approach is also in keeping with the direction in which the market is already moving it would be a more efficient mechanism to achieve the desired regulatory outcome.

If there is concern about continuing a specific exemption for incidental advice in the Law, an alternative would be to refer to the Explanatory Memorandum discussion of when a licence would be required and the relevant test for the 'carrying on of a business'. Persons involved in financial services activities outside these narrow confines should be required to become licensed. We consider that such an approach would limit the use of an exemption and not result in a significant gap in coverage of the regime from a consumer perspective.

Professional bodies as SROs

The introduction of statutory recognition for self-regulatory bodies in financial services would be a significant development in Australian financial services regulation. ASIC is concerned that it may not reflect international trends and may be at odds with the theme of the recommendations in the Final Report of the Financial System Inquiry. The major jurisdiction that has tried this approach of declaring professional bodies(the UK) is now moving away from it [5].

Practically speaking, the standards which the draft Bill would require to be met before ASIC could exercise this power are such that ASIC does not believe that at this stage any existing professional bodies will be able to fulfil the requirements. To this extent, the provision may not change the regulation of licensees. It is clear that some professional bodies, such as accountants, have put in place educational requirements so that (some of) their members can over time meet the criteria for obtaining a licence. This does not, however, extend to these bodies putting in place any regime to regulate licensees.

From a practical perspective, the introduction of clause 882A may create a number of problems or gaps in regulatory coverage:

a) clause 882A(3) suggests that, provided ASIC is satisfied with their adequacy, members of a declared professional body can be subject to alternative conduct standards in providing financial product advice. This would appear to lead to alternative regulatory structures, rather than consistent regulation of financial product advice;

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[4] The three factors indicative of whether advice is incidental are that:

a) the investment advice the lawyer or accountant give forms an integral and merely incidental part of their overall services;
b) they charge no discrete fee for the advice; and
c) they do not receive any commissions or other benefits from product issuers.

[5] see the Financial Services Authority CP 30, issued in October 1999.

b) there are no provisions enabling ASIC to obtain timely and relevant information about how the declared professional bodies are administering their licensing arrangements. Consideration should be given to making a specific audit power be available to ASIC;

c) ASIC's powers to deal with a professional body's failure to maintain proper standards of administration are inadequate. Where there has been inadequate monitoring of members ASIC may only vary a declaration by varying the kind of advice that may be provided by members - not an appropriate response to what is in fact the professional body's need to change the way to administers its responsibilities. The circumstances in which a declaration can be revoked do not address the situation where proper procedures are in place but they are not being administered effectively by the professional body. Clause 882C(2)(e) refers only to ASIC no longer being satisfied that the declaration criteria exist, whereas the revocation power should be exercisable where the criteria exist but are not being applied or adequately applied[6];

d) it is not clear that ASIC will have the ability to take action in respect of specific members' conduct where the professional body fails to do so, as there is no express statement that ASIC's administrative powers apply to members of declared professional bodies; and

e) the fundamental ability of a professional body to operate as a SRO should be considered as part of the declaration process. For example:

  i) corporate governance structures;
  ii) fit and proper purpose tests for the members of such a body; and
  iii) requirements for annual regulatory plans and reporting obligations of such a body to ASIC about the performance of its regulatory functions and a range of other matters.

Recent experience both in Australia and overseas indicates that unless these issues are addressed then there is the real possibility of regulatory gaps and inadequacies emerging.

The proposal for declared professional bodies is likely to be resource intensive both for ASIC and the participants involved, and, we anticipate, may not be likely to result in many declarations for purposes other than incidental advice. Whether the approval power is intended to deal narrowly with the incidental advice issue or be a more general power to create a self-regulatory structure, it will involve ASIC in additional resource-intensive activity.

Finally, the codes approval power in clause 1041A already provides ample scope for professional and industry bodies to assume a significant role without having been declared as professional bodies under clause 882A. Approved codes can promote detailed standards to be met by members, whether in relation to financial product advice or otherwise, as well as

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[6] For example, the criteria include a requirement that there are adequate powers to discipline members. Provided these exist, ASIC will have no ground for taking any action in respect of a professional body which does not use those powers, and in fact carries out no monitoring or surveillance of its members' activities.

any additional standards that go beyond such legal requirements. To a significant extent, ASIC will rely on the SRO role played by the professional or industry body that administers an ASIC-approved code when enforcing the legal requirements applicable to the members of that body and the code. This would mean that compliance with the standards in the approved code will generally be taken by ASIC to be indicative of compliance with the relevant legal obligations of the member of the code.

To allow members of professional bodies appropriate time to organise their affairs, the transitional provisions should provide that the current limited exemption in the Corporations Law for incidental investment advice operates during the transitional period.

Division of responsibility for market regulation

Parts 7.2 and 7.3 of the draft Bill articulate the division of responsibility between the Minister, ASIC and the licensee in regard to financial products markets and clearing and settlement facilities (CS facilities). The Bill gives statutory recognition to ASIC's role in advising the Minister on business rule changes and market and clearing and settlement applications[7] and in advising the Minister in general[8], and also gives the Minister power to delegate any of his powers under proposed Chapter 7, to ASIC[9]. ASIC believes that it is desirable to supplement these provisions with a further exposition of ASIC's role in relation to Markets and Clearing Settlement Facilities.

A very extensive role for the Minister is defined and articulated in the draft. ASIC's supervisory role over markets and self-regulatory organisation appears limited by the provisions which is not in line with recognised international best practice. IOSCO has stressed the need for a strong, credible, independent regulator with expansive powers as a bulwark against market failure. The existence of a regulator with those attributes is an important feature of Australia's international reputation as a stable and orderly marketplace. In the legislation implementing CLERP 6 the role and powers of ASIC in relation to markets should not only be broad, they should be explicit.

We suggest that emerging international best practice requires statutory recognition of ASIC's ability to conduct regulatory oversight activities of increasingly diverse, 'for-profit' exchanges, incorporated directly into the legislation. ASIC's role as the independent primary regulator of market and CS facility operators should be clearly articulated in the legislation. If Australia is to fulfil its potential as a regional financial centre, legislative proposals in this area need to be consistent with best practice in other jurisdictions and the relevant IOSCO principles.

This would be achieved by the legislation stating that ASIC, as the statutory regulator, will:

a) have first responsibility for assessing licence applications and amendments to operating rules and form an opinion as to an applicant's having satisfied the legislative criteria; and

[7] Subsections 798A(2)(h), 827A(2)(h)
[8] Sections798B and 827B
[9] Section 1041D

b) do all such things as required to exercise independent supervisory oversight of the activities of the market or facility.

ASIC considers that compared to our counterparts overseas our express regulatory powers in relation to the activities of regulated markets do not appear sufficient to enable us to meet the mandate of promoting market integrity in relation to the Australian financial system[10].

The rapid demutualisation and commercialisation of exchanges has implications for all the parties in the co-regulatory structure. It is now possible that a conflict of interest may arise between a commercial market operator's need to maximise its profitability and the proper fulfilment of its supervisory and regulatory functions. The growing potential for conflicts of interest makes it even more important that ASIC has specific power conferred on it by the Corporations Law to enable it to effectively discharge its statutory responsibility to oversee market and CS facility licensees to ensure that they comply with their ongoing obligations.

Licensing Transitional Arrangements

ASIC's preferred position for the transition to the new licensing regime, as raised previously, involves deemed licensing (grandfathering) for existing market participants. The comments below are made with respect to the provisions of the draft Bill as they currently stand.

Specific transitional provisions needed

The transitional arrangements should seek to achieve the following aims:

a) provide a sufficient period of time for market participants and ASIC to do efficiently and effectively all things which the Law requires in relation to migration to the new regime;

b) provide sufficient flexibility in the administration of the new regulatory regime during the transitional phase so that unexpected difficulties can be overcome; and

c) if the liability provisions of IABA are to continue to apply to insurance intermediaries during the transitional period they should be capable of establishing the liability of brokers for the conduct of their representatives. Currently IABA does not provide for this, and reliance has to be placed on common law liability provisions.

Managing the transitional period

Also critically important to an effective transition, regardless of the transitional arrangements adopted, is an ASIC exemption and modification power applying specifically (and only) to management of transition issues.

[10] ASIC Act 1989 s12A(2)

Our experience in managing the transition to the managed investment scheme regime was that there were a number of instances where modification powers in relation to the transition period were invaluable.

In making those modifications, ASIC did not delay the implementation of the scheme. It merely exercised its power to ensure that the transition was smoothly effected and did not impose unnecessary regulatory burdens. This would be ASIC's aim in administering any modification power in relation to the licensing transition period.

Examples of the circumstances where the power could apply are:

a) where the transition arrangements impose an unreasonable burden on the person or entity required to transfer to the new regime within a 2 year period,

b) where it is inappropriate in the circumstances of the person's or entity's business to require the person or entity to transfer to the new regime within the 2 year period.

It may be that the maximum period for which ASIC can extend any transitional arrangements should be fixed at either 12 or 18 months.

Regulation of back-office commissions

On page 115 the Commentary indicates that back-office commissions will not need to be disclosed in Statements of Advice given by financial services licensees unless they might reasonably be expected to be capable of influencing the service provider in providing the advice. The Commentary anticipates that regulation of the exception in relation to back-office commission will be by use of the 'false and misleading provisions' and ASIC's investigatory powers.

ASIC takes no issue with the policy decision on treatment of back-office commissions. However, the statement in the Commentary that ASIC will be able to regulate their payment by the use of those provisions, is problematic. The influence that their payment may create may be as subtle as a service provider preferring to recommend a product in relation to which support services are provided as opposed to one where they are not provided, although they are provided at market rates, because the former may carry a higher potential for earning for the service provider.

Lodgement of disclosure documents

Subdivision E, Div 2, Part 7.8 requires Product Disclosure Statements for managed investment products, superannuation products or investment life insurance products to be lodged with ASIC. The Commentary (paragraphs 8.104 and 8.105) proposes that while ASIC will not pre-vet these documents, it will have an opportunity to consider the PDSs before the products are issued.

ASIC is concerned that a lodgment requirement will create an expectation that ASIC will to some extent conduct an assessment of PDSs as they are lodged. This may lead to an unrealistic view by the marketplace and consumers that ASIC is monitoring the issue of the products. In fact, without a substantial increase in resources ASIC will not be able to assess the documents as they are lodged.

In many cases, ASIC can see little regulatory benefit in requiring the documents to be lodged. Lodgment should be required for listed managed investment schemes and some of the non-mining primary producer managed investment schemes, where ASIC does conduct some vetting. Other than for these cases, the lodgment requirement could be removed, provided the issuer keeps the PDSs for a fixed period, say 7 years. This would allow them to be preserved for any future surveillance, statistical analysis or enforcement action ASIC may be involved in.

If the requirement to lodge all documents currently listed in s 985B is maintained, ASIC suggests that an express statement that ASIC will not monitor the lodgment of the documents, or their contents, be included in the Explanatory Memorandum.

Approval of codes

Paragraph 10.13 of the Commentary describes the effect of codes of conduct as establishing best practice standards. ASIC will be able to approve codes under clause 1041A if they represent best practice in the matters they cover and are consistent with the Corporations Law.

It is not clear how ASIC will be able to determine what constitutes 'best practice' in any particular industry, and if it does, how this will have any practical effect. As codes do not have legal standing, compliance with them will have limited relevance to any actions for breach of the Law. It may be that breach of a code will not in fact constitute a breach of the Law[11].

Real issues will arise for ASIC where a code is complied with but there are questions of breaches of the Law. It may be that the interpretation of the Law on which ASIC based its approval of the code was incorrect. In these circumstances, it may be difficult for ASIC to succeed in an action for any breach of the Law that had occurred, and ASIC itself may suffer a loss of regulatory reputation if action is taken by third parties against the entity which complied with the code but may be found to have breached the Law.

There are currently no provisions in the Bill which deal with whether an ASIC decision in relation to an application for approval of a code would be reviewable. Given that codes are intended to be voluntary and it is likely that nothing will flow from a failure to comply with them, it seems anomalous that an ASIC decision not to approve a code will be subject to AAT and Federal Court review. ASIC suggests that clause 1041A is specifically exempted from the administrative review regime in the Corporations Law.

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[11] It is likely that 'best practice' in some cases requires something more than mere compliance with the Law.

Pressure Selling

ASIC is concerned that the provisions in the Bill will not effectively regulate pressure selling of financial products. Pressure selling may lead to disastrous consequences for consumers, especially where there is a long time lag between the purchase of the financial product and the consumer's realisation that the product is inappropriate.

The Commentary envisages that a combination of unconscionable conduct provisions and "cooling off" provisions will provide adequate protection against pressure selling practices. While ASIC regards these provisions as important for the consumer protection regime, they alone may not be sufficient.

The prohibition against unconscionable conduct, while an important tool against some bad sales practices, is not a cost-efficient regulatory mechanism for pressure selling. The remedy it provides is 'after the event' and in many cases this offers little material compensation to consumers who have suffered loss. The consumer will usually have to suffer from a clear disability for conduct towards him or her to be found to be unconscionable. Each case turns on its unique circumstances, and therefore there is a lack of certainty for business, consumers and the regulator in relation to its application more generally to sales issues.

A "cooling off" provision may also fail to provide adequate protection in all cases. Cooling off is a useful "cure" for some pressure selling problems, but not all consumers will use it and, more importantly, not all consumers will turn their minds to whether they need to take advantage of this provision until it is too late (some will not understand the provision). There may be technical difficulties with cooling off where it is likely to be most needed - in relation to compulsory superannuation.

Some existing provisions that help regulate pressure selling will no longer apply, including the anti-hawking prohibition for managed investment schemes, and the same day sales prohibition for investment-linked life insurance sales in paragraph 11 of the Life Code.

Greater flexibility is envisaged for licensees in relation to the timing of delivery of the FSG in "time critical" cases. While ASIC supports appropriate flexibility in this area, we note that the capacity for important written disclosures to be provided *after* a sale may increase the vulnerability of some consumers to pressure selling.

Consideration could be given to the following:

a) a ban on so-called 'door to door' sales;
b) specific regulatory requirements for other cold calling activities (consistent with ASIC's approach to this issue to date);
c) a requirement that the confirmation of transaction information also refers to the cooling off period; and
d) a requirement for an additional disclosure warning in certain circumstances.

A "door to door sale" would be an offer of a financial product resulting from any unsolicited personal contact, that would not include:

(a) telephone contact;

(b) contact with a consumer after prior arrangement (eg by telephone); and
(c) contact at a work place where an employer has consented or arranged for such contact.

Where the procedures in relation to cold calling are not followed, the client should be given a right of return and refund, exercisable within 1 month after the expiry of the relevant cooling-off period.

Conclusion

The Financial Services Reform Bill can produce the type of effective revolution of the finance services industry which the Minister expects, if industry reacts positively to it. Let me return to the IOSCO Statement on the New Economy and rely on it for my conclusion - without any shame, since I helped write it, and it was designed to be used for speeches by chairmen! It is clear that investors do need to become better informed, both through their own efforts and through receipt of fair and honest advice from market professionals in order to survive in the New Economy.

Competitive pressures, always present but perhaps intensified in the New Economy environment, can lead market professionals to loosen practices in both the initial and secondary markets. In order to preserve investor confidence in the IPO process and secondary trading, ASIC has to monitor these trends and to question any departures from the legal and professional standards expected of issuers and market professionals. Areas of concern will include departures from established standards of disclosure and financial reporting, departures from market place listing standards, applications to waive or vary the escrow periods, and failure of market professionals to fulfil their duties and comply with applicable standards of market conduct. Australian investors have a reasonable expectation that they may place confidence in markets and market professionals, and be treated fairly and honestly.

With all of the financial information now available to investors in the New Economy, investors must be aware that not all of it comes without strings attached. In dealing with investment services firms, investors should gauge the objectivity and bias of investment advice they are receiving about IPOs and issues trading in the secondary market. Many "sell side" investment analysts recommending companies' securities work for firms that have business relationships with the companies these analysts cover. And some of these analysts' paycheques are typically tied to the performance of their employers. It is incumbent on securities regulators to see that investment services providers who provide advice and recommendations are mindful of their investor suitability obligations, and that they disclose clearly to investors any potential conflicts of interest they may have with respect to the securities they are recommending.

In many respects, today's euphoria about the New Economy and technology investing is nothing new. History shows that heightened speculation has always accompanied innovative and dynamic times. But also that many new companies rushing to market today will not be around for the long-term, perhaps not even a few months or years from now. Successful investors, through good times and bad, must focus a vigilant eye on managing risk. ASIC has worked hard to attempt to raise investors' awareness, so that whether they enter today's markets to trade or to invest, they will enter with a better understanding of their own tolerance for risk and with realistic expectations. ASIC's mission is not to guarantee that investors will avoid losses, but to see that investors are armed with useful information to guide their investment decisions.