



**ASIC**

Australian Securities & Investments Commission

## **"No Dave, you can't do that": the regulatory challenges of e-commerce, and an update on financial services legislation**

*A presentation by ASIC's Executive Director Financial Services Regulation, Ian Johnston, to the National Insurance Brokers Association conference on 7 October 2001.*

I propose to cover with you this morning, three topics:

- The impact of recent world events
- In keeping with the futuristic theme of the conference, e-commerce regulatory challenges and initiatives, and an example or two of our enforcement heroics in this area, and
- The latest with the Financial Services Reform legislation

### **The impact of world events**

The tragic and almost surreal events of September 11 have shocked the world into a state of disbelief. In the aftermath: trying to come to terms with the senselessness of the terrorist acts, the loss of lives of so many everyday people and the loss of security we felt in our world: we are now appreciating the impact these events have had on the business world.

As would be expected, the US events have impacted on our markets and on Australian corporations, and we have been in touch with international regulators regarding the global effects.

We believe overall that the financial services sector responded responsibly to the events in the US – we supported the decision by a number of unlisted fund managers to suspend applications and redemptions following the temporary closure of a number of international equity markets. The decision to suspend resulted from the difficulty of striking accurate prices, particularly in respect of investments in markets that have been closed. Suspension of applications and redemptions enables unit prices to be struck that are fair to all unitholders. Having said that, we were also keen to see funds re-open as quickly as possible when it became possible to strike a price.

Prior to and alongside the events in the US, we have been experiencing corporate turmoil in our own backyard. Over the past twelve months we have seen a number of high profile collapses, which has re-ignited the debate on corporate responsibility. I have a few comments to make on these collapses.

Each year we experience almost 7000 corporate collapses in Australia - the difference (arguably) with this year is that a number of the collapses have been high profile companies and the collapses have directly affected many Mums and Dads – air travel, communication mediums and insurance products are all utilised by the average household.

We do not believe these corporate failures indicate a systemic collapse of good governance in Australia. Nor does it signify a return to the '80s: we do not have the endemic governance issues which confronted us a decade ago; although there are some signs of increased credit risk, we do not have the grossly inflated balance sheet asset values which then prevailed; we do not have the structural manipulation which profiled so highly in that decade; and we do not have a climate of high inflation and excessive commercial property values which contributed to the magnitude of the '80s collapses.

Indeed, since the '80s our corporate conduct standards have improved significantly and are respected as benchmarks by many of our peer countries. We cannot however afford complacency in the market environment. Businesses fail and will continue to do so; especially as the economic climate toughens – the best governed of companies can still

succumb to competitive and economic forces. Good governance does not ensure corporate success, and equally corporate failure does not necessarily imply poor standards of governance. Notwithstanding, there is little doubt that the corporate failures of the like of Ansett, HIH, One-tel, failed new economy floats over the past twelve months and the financial difficulties of Harris Scarfe have caused the community to refocus on questions of corporate governance. I'd also like to reiterate that while we don't believe we've seen a return to the 1980s – we may well see more collapses if the economic environment becomes progressively worse.

Likewise, recent events are reflected in ASIC's priorities as a Commission. These priorities include:

- being more visible in enforcing the Corporations Law; to be more strategic in its enforcement activity; and to meet the public expectation that we should be a vigilant and effective corporate watchdog. This is not an attempt to move to regulation by “fear”.
- Greater visibility regarding our policy and guidance (eg the Financial Services Reform policy process). We expect that on the regulatory front we will discharge our role to facilitate business and that our dealings with industry will be constructive and professional. There has been a very high level of consultation and collaboration with the financial services sector as we work together to implement the Government's blueprint for product and services delivery under the FSR legislation.
- the further promotion of access by financial consumers and investors to honest, competent and non-conflicted advice.
- Insolvent trading – Waterwheel in Victoria, Farmer Furniture and of course the high profile matters like HIH, One.tel, Ansett and Harris Scarfe; and
- Compliance with continuous disclosure obligations

In arriving at these priorities, we look at the volume of complaints we receive, we analyse industry and market trends and have regard to our dialogue with Industry Bodies and participants. We call it our RISK BASED APPROACH to regulation.

In digesting the thoughts expressed above, it should be remembered that government and regulators alike are well aware that responsible and entrepreneurial risk taking promotes efficient and competitive markets and are consequently not looking to stifle activity of this type.

I'd like to share with you now something a little unusual: an insight into the thinking of the regulator, before touching on the e-commerce and e-enforcement issues we face.

What you see on the screen is the regulatory pyramid. This shows how we categorise people who we regulate. This is not just appropriate to ASIC: it is generic and can be used by any regulatory body – police force, customs etc.

- Compliant – educate
- Opportunists – surveillance
- Crooks - enforce

## **E-commerce and our enforcement actions**

It should come as no surprise to you that ASIC maintains a keen interest in electronic commercial activity in the market. As the regulator of the securities and futures markets and consumer protection watchdog in the financial services sector, ASIC must ensure consumer confidence, commercial certainty, efficiency and market integrity irrespective of the medium employed.

The Internet presents us with the challenge that within the length of our lifetimes, *'the power of acquiring information and disseminating power will be doubled, and we may be justified in looking forward to the arrival of a time when the whole world will have become one great family, speaking one language, governed in unity by like laws'*.<sup>1</sup>

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<sup>1</sup> *Devil Take the Hindmost: A History of Financial Speculation*, Chancellor, Farrar, Straus & Girous, New York, 1999

But while the technology may be new the challenge is not. This particular quote was offered in response to the introduction of rail networks in 1842. But it nevertheless holds currency.

The point is reinforced that technology presents our existing values with new delivery channels and the challenge for all of us is to engage in e-commerce in a way that is conducive to delivering trust, confidence and certainty.

ASIC's approach to electronic commerce is driven by a desire to maintain a consistency of regulation within these new channels, and to look to the future as a real-time electronic regulator. ASIC believes that electronic commerce has the potential to provide benefits to business and consumers alike in terms of efficiency, costs and choice. It also has the potential to generate innovative new problems, which must be managed if business and consumers are to have confidence in electronic commerce systems.

ASIC's general approach to electronic commerce, and an essential part of the philosophical basis for developing its approach to regulatory and enforcement issues, is:

- The same types of regulatory mischief that occur in the electronic environment, also occur in the traditional markets;
- Technology is a positive development - a tool for changing and improving current market structures;
- ASIC is concerned with achieving regulatory objectives rather than developing technological solutions;
- ASIC will aim to be technology neutral in its policies;
- To the extent that it is consistent with good policy, ASIC will seek to ensure that regulatory requirements applying to electronic commerce are no more onerous than those applying to more traditional ways of doing business;
- ASIC will seek to ensure that consumers using electronic commerce have at least the same levels of protection as are provided by the laws and practices that apply to existing forms of commerce; and

- ASIC will pro-actively assess the impact of technological developments on efficiency, safety and equity of the financial system and will seek input from industry as appropriate.

Here are some of the **challenges** we face:

Distribution channels to consumers are increasingly faster, more sophisticated, and often delivered in a perceived "real-time" environment where the home-based midnight internet surfer is able to access a bewildering range of products and services from around the globe – without the introspection and consideration which a 10:00am meeting at his adviser's office in Collins Street might otherwise provide.

As a result, consumers do not necessarily have the expertise or the ability to understand the nature, or the suitability, of the financial products made available to them in financial markets, particularly those accessed through electronic means. This raises the real risk of consumers selecting unsuitable products, or financial commitments, with the attendant further risk of consumers becoming dissatisfied with products, services and their providers or their advisers, leading to inadequate and inefficient flow of investment funds to capital markets. Consumers' difficulties in choosing financial products and commitments that are suitable for their particular needs and financial circumstances are often exacerbated due to a number of reasons, which consumer protection regulation seeks to rectify.

In respect of the internet, the technology is obviously substantially more advanced but the challenges introduced by its adoption apply equally.

Specifically the internet poses challenges such as:

- It is borderless and global in nature, while regulators are constrained by the geographical confines of their authority;
- The affordability and accessibility of system access, makes it a ready tool for abusers at every end of the social spectrum;
- The anonymous or "faceless" nature of the technology;

- The use of cryptography as a further mask to ready identification;
- The immediacy with which transactions can be conducted; and
- The lack of collateral information (eg fingerprints or eye witness ID).

Broadly speaking, key regulatory and enforcement issues in e-commerce include:

## **1 Disclosure Documents**

We seek to ensure that investors have at least the same protections as they would in the physical world, when disclosure documents and information is delivered electronically. Our latest policy initiatives in the e-commerce area involve disclosure of information.

There has been a well-documented explosion in e-commerce capabilities to disclose information, both from a business to business (B2B) and business to customer (B2C) perspective. To some extent this has been spurred on by government initiatives.<sup>2</sup>

Not surprisingly, some product providers are considering the extent to which they can discharge their legal reporting obligations (which ASIC administers) via the internet.

ASIC is minded to be generally facilitative of the use of the internet to deliver information. It aims to be technology neutral within the constraints of existing regulatory requirements and principles. This is reflected by the case-by-case approach ASIC has to date taken in relation to applications for relief for the delivery of part electronic application forms in life insurance. In the superannuation area, product providers have also sought and obtained case-by-case relief to ensure that disclosure proposals are within the parameters of the law.

In examining the extent to which disclosure documents can be provided over the internet, ASIC will consider a number of policy perspectives, including:

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<sup>2</sup> The Government has allocated funds to a superannuation program (SuperECProgramme) which is designed to deliver cost and administrative efficiencies by the medium of new technologies.

- Accessibility of a member or policyholder (including potential customers) to the internet. In one application for relief ASIC received, we required the provider first to obtain a member's consent before distribution of information to that member by email;
- The extent to which technology can ensure that information and application forms which must be delivered together, are in fact delivered together;
- The extent to which the electronic version of information should replicate the paper version; and
- The extent to which the purpose or effect of signature requirements (in the case of point of sale materials) can be achieved by some other means.

### **Removing regulatory barriers to electronic distribution**

Regulators face an unenviable task of balancing the legitimate business needs and expectations of industry – for efficient, quick and competitive methods of communication, with the requirements of protective legislation designed to ensure that customers are not disadvantaged by technological developments. This tension is best exemplified in areas where legislation has imposed an obligation on product providers to disclose information to consumers, but where technological changes mean that consumers need to make contact with the product provider to obtain the information they need, and to which they are entitled.

In essence, the potential antiquity of posted mail (whereby the information is delivered by the product provider to the consumer's address) and its replacement by email portals or website searches (through which the consumer goes to the product provider's electronic address to obtain information) signifies a subtle, but fundamental shift in onus in the delivery of financial information.

In February 2000, ASIC took the proactive step of encouraging the development of a fully electronic system for offering securities. Under PS150, issuers of securities will be able to make effective use of electronic technology when designing their electronic application



processes, provided potential investors have electronic access to the same prospectus material and other information as paper-based applicants do.

ASIC has also taken a similar approach to other financial products. In interim policy announced via an Information Release dated 31 May 2001 (IR 01/08), ASIC has facilitated trustees of superannuation funds and life companies using electronic disclosure documents and electronic application forms provided certain conditions are met including in particular the following:

1. Consumers must be given access to the application form at the same time and using the same means (including specifically the same electronic means) as the relevant disclosure document
2. The application form must contain the specific warnings and acknowledgements required under G.I.1, the Life code and the SIS determination
3. Trustee and life companies must be reasonably satisfied about conditions 1 and 2 above before issuing a life insurance or superannuation product pursuant to an application.

This relief is designed to achieve a consistent approach to regulation of electronic commerce across the financial services sector.

There are however some significant differences in the superannuation and life insurance world: for example, when applying for life products, the applicant may be required to make certain statements that are critical to the actual product and its costs; such as whether or not the applicant smokes. These statements are not relevant for securities applicants.

Whilst our relief has taken into account industry consultations, we have flagged the need (in IR 01/08) for a more comprehensive review of electronic communications in light of FSR reforms.

## **2 Unlicensed investment advice**

We continue to take action against advice given by persons without an appropriate licence or with no consideration of the needs of investors receiving the advice – who are often self-proclaimed internet “financial gurus”.

The Chimes Case: In February 1999, ASIC obtained an injunction against the operator of a chatroom, the *Chimes Index*. The operator posted a number of articles that advised in respect of particular securities, however he was neither licensed as an investment adviser or a securities dealer. Breaches of the order led to a suspended jail term and permanent restraint from dealing in securities.

### **3 Computer software advice**

There are escalating numbers of trading analysis software systems that generate buy and sell signals or provide interpretive information recommending or promoting the trading of securities (with no securities dealer's licence). The sale of these systems is often accompanied by compulsory attendance at expensive (\$10,000 or more) training seminars.

#### ***Sharetrading Software***

In June this year we warned consumers to be wary of computer sharetrading software promising quick and easy returns. The warning follows the conclusion of a national campaign against the false and misleading marketing of computer sharetrading software.

ASIC launched a surveillance and enforcement campaign in September last year, after receiving a significant number of complaints about computer sharetrading software. As part of the campaign we wrote to 60 vendors marketing trading software through newspaper or radio advertisements, internet web pages or training seminars, warning them to ensure their claims were not false or misleading.

We took enforcement action against a number of companies following these warnings and there are also a number of actions presently before the court restraining companies from marketing, selling or distributing share-trading computer software programs. Breaches of the Corporations Act include providing investment advice without an appropriate licence to

do so and engaging in misleading or deceptive conduct in the marketing and sale of these computer software programs.

#### **4 Disclosure (particularly continuous disclosure)**

##### **Dot-com disclosure**

Over the three months from May this year, ASIC had examined 18 new economy companies over their compliance with continuous disclosure provisions. ASIC identified the 18 companies from an analysis of quarterly cash flow statements to the ASX and other intelligence.

ASIC and ASX have agreed that the quarterly cash flow reporting requirements imposed by ASX should be continued until a company has demonstrated a positive cash flow for four quarters, given the continuing lack of compliance by many high tech companies with the continuous disclosure requirements.

ASIC's actions led to nine companies releasing additional information to the ASX and another company appointing an administrator.

Of the nine companies that released additional information, seven did so after discussions with ASIC. Examples of additional disclosure obtained include the extent of one company's asset write-downs and losses following the liquidation of a recently acquired subsidiary; fuller disclosure of year end position; securing short-term funding to cover a delay in repayment of monies lent and the prospects of recovering the remaining loan moneys

Some listed companies are continuing to ignore the basics of good company disclosure and new economy companies need to remember that the requirement to lodge quarterly cash flow statements to the ASX does not in itself satisfy their continuous disclosure obligations.

All listed companies should have procedures in place to ensure that they comply with their continuous disclosure requirements, and ASIC will continue to undertake surveillance activity of listed companies where it considers such activity is necessary.

## **5 Shutdown of internet scams**

History tells us that criminals and other market wrongdoers are early adopters of technology, with law enforcement frequently following behind. Given the spectrum of internet-based regulatory risk, the challenges for ASIC and other law enforcement agencies are obviously substantial. Here is a taste of the top internet rips-offs out there:

***Market manipulation or the "pump and dump"***

Cheap shares are purchased in a company and false or misleading statements are sent out about that company to boost share prices. When investors are taken in, and the share price has significantly increased, the party responsible sells its shares for a neat profit. The shares tend to deflate to their regular value when the hype passes and the investor wears the loss. A real life example of this is the Rentech case, which you may recall from last years conference:

Rentech was a US company that traded on the small cap market of NASDAQ. On 8 and 9 May 1999, messages relating to the stock of Rentech were posted on internet bulletin boards in the United States including bulletin boards operated by Yahoo! and Raging Bull.

The messages contained a statement that the price of Rentech stock would increase to US\$3.00 or more, from the then price of around US\$0.33, once pending patents were released by the company.

On or around 8 and 9 May 1999, up to four million spam emails were received by addressees in the United States, Australia and in other parts of the world.

The contents of the spam e-mail similarly asserted that the price of Rentech stock would increase by up to nine hundred percent (900%) in the next few months. The messages also made a number of other representations about Rentech stock.

The first NASDAQ trading day after the transmission of the spam e-mails and the web board postings, the price of Rentech stock doubled and the trading volume was more than 10 times the previous months average trading volume. Shares recently purchased by those responsible were quickly sold for a significant profit.

The US SEC received complaints about the spam and consulted Rentech. Rentech denied the content of the messages and asserted that they had not originated at Rentech. The

SEC's original investigations determined that the source of the Yahoo! And Raging Bull posting was from accounts held with Australian based ISPs.

The SEC contacted ASIC and a joint investigation was started. We served notices on Australian ISPs and suspects were identified in Queensland and Victoria. Simultaneous search warrants yielded a large volume of documentary and computer data. Action has been taken against those responsible.

This case highlighted the fact that the transmission of messages over the Internet is not completely anonymous and that regulators can trace authorship and prosecute. This is a particularly good example of the borderless nature of cyberspace and the need for co-operation across jurisdictions.

***Free stock offers and share hawking:***

There is a growing trend towards website promotion through the offer of "free stock" in companies yet to be formed. These are frequently promoted as a means of encouraging web users to register with the site, thereby gaining access to email addresses. The promotional activity is likely to be illegal, offering securities in a proposed corporation and often involve consumer protection breaches such as "referral selling", with more "free stock" offered if friends and acquaintances are referred.

***High yield trading schemes:***

We are concerned about aggressive scheme promotions characterised by the offer of high returns in offshore investments. These "too good to be true" offers are often promoted by word of mouth emails and websites with information delivered to potential investors at "confidential" seminars – "high yield" and "risk free" are not the Ken and Barbie combination you're led to believe!!

You may recall ASIC's April Fools Day Millennium Bug Insurance cyber-scam, which was designed to educate consumers about the risks of investing on the internet. On 1 April 1999, ASIC set up a scam website offering a fake investment scheme in an effort to

highlight the willingness of people to invest in companies about which they know nothing. Exposed a month later, ASIC's April Fools Day Joke had succeeded in convincing more than 1400 people to seek out further investment information from the "site" and 233 people pledged over \$4 million to our scheme. These people did not search our registers, or they would have found that no such company existed and that the directors were bogus.

***“Exotic” scams:***

The transition of exotic investment, pyramid and "ponzi"-type schemes from the physical environment to the internet, is a natural but unwelcome development.

**The dominion of Melchizedik** – you may know this better as the Balos Case. George Balos organised an investment scheme using the names British Marine Bank and Commodities International, which he offered to investors. He gave the appearance that he was operating an investment business. He arranged loan accounts for investors in the above fictitious companies and paid a high rate of interest. Balos arrived at the name BMB by using numerology.

Balos held papers reporting that the British Marine Bank was a corporation registered in the **Dominion of Melchizedek** (Mal-khay-tzed-ek). The Dominion of Melchizedek is a phantom country. While its name is derived from the Old Testament the Dominion itself exists only on the Internet ([www.melchizedek.com](http://www.melchizedek.com)). If this wasn't so sad, it would be funny.

Balos of course used the money paid by depositors to pay interest. He also lived at Crown Casino, purchased at least \$3M in gambling chips and bought 2 Rolls, a Bentley and a Mercedes Benz.

Balos was sentenced to 11 years gaol on 46 fraud charges brought by ASIC. In all Balos was involved in a \$10m fraud.

There is quite a spectrum of innovative internet-based scams in existence – which encourages the fairly aggressive position on education that ASIC continues to take, to drive home the message that consumers should not be tripped up by their own gullibility.

### **Consumer Education**

Allied with our millennium bug insurance hoax, in May 1999, ASIC launched the 'Gull Awards' which is located on the ASIC website. The Gull Awards feature precautionary tales of money and deceit and continue to alert consumers to investment scams and how to avoid them.

"How does paying off \$200,000 worth of debts with just \$2,200 sound? How about too good to be true?!". This is the offer our latest Gull award winner received by email. 'We'll pay your debts and you don't have to pay us back....EVER' the email says.

This story is an example of how people use junk e-mail, or 'spam', to promote dodgy scams, a quick and easy way to reach thousands of potential victims.

Our Gull winner was contacted by 'Debts Processing Agency' via a Hotmail account, which promised all he had to do to repay up to \$200,000 worth of debts was send a cheque or money order to a Coffs Harbour post office box in the amount of \$2,200. Once the money was sent, all the debts would instantly disappear.

What the email didn't say is that applicants would have to enlist other people to the scam in order to get their money back – something that's commonly known as a 'pyramid scheme'.

Typically, a potential member pays to join the scheme (in this case, the payment was disguised as a fee for eliminating debt). The only way to advance is to recruit others who also pay to join. In Australia, it is illegal to promote or participate in a pyramid selling operation.



After our Gull winner alerted ASIC, our Electronic Enforcement Unit immediately began a joint investigation with the NSW Fair Trading Department, which took only two weeks to complete. The NSW Supreme Court issued orders against the company and its directors, to cease operating immediately.

Although this operation was shut down very quickly, pyramid schemes and other scams like it can potentially cause consumers to lose large amounts of money.

The ASIC website includes 'Internet Safety Checks' that highlight basic checks which should be made by consumers before investing in internet-based schemes. These tips include checks to ascertain whether a company exists, whether or not it has issued a prospectus, whether the people involved hold an investment adviser's or dealer's licence or a proper authority from a licensed dealer.

ASIC has also drafted a series of 'Consumer Alerts' which have been placed on ASIC's FIDO site ("Financial Information Delivered On-Line"). The Consumer Alerts relate to the risks associated with on-line trading, spam-scams and warnings in respect of investment advice from bulletin boards, chat rooms / internet discussion sites and on-line investment newsletters. Many of these alerts are unfortunately born out of real-life experiences. Our Electronic Enforcement Unit, which was established to respond to the challenge presented by the Internet and to continue to develop our e-enforcement capabilities, is responsible for much of the action taken in relation to the e-scams discussed.

## **Financial Services Reform Legislation**

I mentioned the Financial Services Reform legislation. I'm well aware of the keen interest of this audience in that topic. In fact, I recall being in this auditorium two years ago when the Minister for Financial Services Regulation, Joe Hockey, addressed you on FSRB. Let's just say that the event was memorable and that the friction generated that day produced a lot of heat – and some light.

The commencement date for the legislation is 11<sup>th</sup> March 2002 and commencement will be followed by a two year transitional period.

Now that the legislation has been passed, ASIC's role is fourfold:

1. Applying or administering the law, as enacted, through development of policy and processes to help industry meet their legal requirements.
2. Facilitating transition on commencement
3. Conducting surveillance and enforcement post commencement; and
4. Educating consumers

Our key role initially is in applying the law after it commences. With major new legislation such as this, we believe we need to assist market participants and consumers in understanding how ASIC will do so. We do this through Policy Statements, and Guidelines including licensing kits.

Policy Statements give guidance, indicating how ASIC will administer specific areas of the law and how we will exercise discretions and powers given to us. While these statements do not have the force of law, industry participants have regard to our Policy Statements in conducting their affairs.

FSRB imposes a new licensing regime and for many, new standards of disclosure and conduct. Our task then is to licence participants and to apply the disclosure and conduct requirements.

In order that everyone understands how we will do this, we have set a framework for developing policy proposal papers, a process document for how we will issue licences and a guide to how our existing policies would be applied, amended or replaced. The initial framework document was released with the first set of PPP's in April this year, and a supplementary framework was issued on 11 September, in response to the deferred commencement date of 11 March next year. These framework documents together explain

the interaction between the proposed policies, policy statements and guidance documents, and are available on ASIC's website ([www.asic.gov.au](http://www.asic.gov.au)).

There are four new stages to our publication timetable, and our releases are prioritised having regard to industry needs. In essence, we aim to have issued by 1 December 2001 those policy publications that are most important to implementing the FSR legislation:

**1. Before 1 October:**

- Licensing – Financial requirements PPP
- Adapting PS146 to the Financial Services Regime
- Interim Policy on Approval of Codes

**2. Before 1 November:**

- Licensing and Disclosure: Transitional provisions guide and PPP (dependant on final FSR regulations)
- Licensing process guideline on how to get a licence
- Market operators PPP

**3. Before 1 December:**

a. Licensing

- i. Organisational Capacities Policy Statement
- ii. PS146 (training of financial product advisers)
- iii. Internal and external dispute resolution PS
- iv. Discretionary powers PS
- v. Financial requirements policy
- vi. Advice and deal PS (subject to regulations)

b. Disclosure:

- i. Product disclosure policy
- ii. Discretionary powers PS

c. Licensing and Disclosure – transitional provisions policy (subject to regs)

#### **4. Early 2002 (before FSR Commencement)**

- Discretionary powers related instruments for both Licensing and Disclosure
- Market operations PS
- Licensing kits and electronic applications (February)

Because of the importance and scope of the legislation, and the fact that many participants would be regulated by ASIC in a manner unfamiliar to them, you will appreciate that significant policy development and guidance is required. We intend for our policies and processes to provide upfront guidance, so you can be prepared for commencement; and to set clear and objective minimum standards where possible.

We consulted extensively with industry and consumer groups to determine issues they would need earliest guidance on - not surprisingly, the answers were: how do we become licensed, how will ASIC determine what is financial product advice, and our views on disclosure documents required under the legislation.

Taking on board the results of this consultation process, we issued a first tranche of Policy Proposal Papers in April this year. We are working now to develop Policy Statements from the initial PPP's – some of which will be markedly different in content, partly as a result of comments received and consultation undertaken. In giving you an idea of where we are heading on these Policy Statements, I will focus on the policies that I believe are core areas of interest for you:

- Advice and Deal
- Organisational Capacities
- PS 146
- Disclosure (PDS), and
- Financial requirements

I will also touch on the process for obtaining a Financial Services Licence and assistance we will provide in this regard.

Lets start with **Advice and Deal** – this policy is subject to the issue of final FSR regulations. For those of you who have had the opportunity to review the Policy Proposals issued in April this year, you may recall that the Advice and Deal PPP addressed the scope of the licensing regime and provided guidance to assist persons to answer the fundamental question of whether someone is providing advice or is dealing. This guidance was offered through general principals that may help a person understand whether they are providing advice or dealing eg to look to the character and context of communication to determine if you are providing advice, whether you are simply passing on factual information or are simply making a mere referral to someone who is licensed; and examples to illustrate the use of the proposed principles in typically problematic situations eg call centres, bank tellers and internet portals)

We received extensive comment on the content of this PPP and the related Principles and representatives PPP. In general, most comments reflected a desire for ASIC to provide guidance about when someone is providing advice or dealing, but others reflected concerns that we were overstepping the requirements of the FSR legislation in providing too greater detail in the guidance.

We have carefully considered the comments provided and raised with Treasury possible amendments to the FSR legislation (before it was passed), or regulations to clarify certain aspects of the provisions. Some of the concerns have been clarified through these processes. For example, the draft regulations address the issue of providing quotes, and in what circumstances this is not the provision of advice. When the final FSR regulations are issued, we will review what, if any, policy guidance ASIC needs to issue on this subject, taking into account that:

- It is for the service provider to ultimately determine their obligations under the FSR legislation and regulations, and

- We need to strike a balance on the level of guidance we provide while ensuring we accurately reflect the legislative intent.

We expect finalisation of the FSR regulations shortly and will be in a position to assess where we stand at this time.

### **Organisational Capacities**

This policy statement will outline the minimum standards ASIC expects licensees to meet in order to comply with their key obligations and will continue to recognise that the FSR regime is designed to work in a flexible way. It will confirm that licensees are responsible for complying with the obligations the legislation places on them as licensees, including deciding which way is the best for them to do so.

These obligations include having adequate compliance measures, sufficient financial and non-financial resources; organisational expertise and skills; adequate risk management systems and adequate ongoing internal assessment and monitoring arrangements. What is required of a licensee to comply with the law will vary according to the nature, scale and complexity of the business the licensee carries on. In many cases there may be a number of ways for licensees to comply with what the law requires. In the way we administer the legislation consistent with this policy, we will seek as far as possible to retain this flexibility.

The licensing kits will also provide you with more detail on the types of documents that will assist you to show us that you meet and will continue to meet your licence requirements.

Accepting that anyone giving financial product advice needs to be licenced or authorised by a licensee, a licensee is responsible for ensuring that its representatives are properly trained and supervised – guidance on this general obligation will be set out in our organizational capacities policy statement also. The finally adapted PS 146, intended to be issued before

1 December will contain explicit training standards that must be met by representatives of licensee who provide retail advice.

### **IPS 146**

This has been a hot topic in industry discussions. Submissions received on the IPS146 proposals generally supported the proposed adapted application of IPS 146 to providers of financial product advice to retail clients, but also highlighted a high level of interest in a number of specific areas. In recognition of the concerns raised, we issued an Appendix to the Supplement framework document, which provides a summary of the tiers and further consideration of pre 1995 training.

Most general insurance products fall within Tier 2: motor vehicle, home and contents, travel and personal and domestic property insurance. We have restricted the lower Tier 2 level of training to people advising on these products because they are relatively straightforward, don't have an investment component, are subject to terms and conditions and are of limited life (often 12 months).

If you consider that the products you offer are more complex than this – you should ensure your advisers are trained at the higher educational levels.

You will note from this listing that there are some insurance products that are not considered Tier 2: insurance products covering consumer credit, sickness, accident or disability. This is because the choice made about these products has or may have an increased potential to significantly impact on a client's financial situation. Greater reliance is therefore placed on the adviser's competence for advice on these products. In addition, our regulatory experience has lead us to conclude that a higher standard of training is required to advise on these products.

### **Pre-1995 Training**

We continue to consider that training undertaken before 1 January 1995 would generally need to be supplemented but we do recognise that many industry people have undertaken further training post 1995.

We have now confirmed that an advisor with pre 1995 training will not have to undertake gap training where:

- The adviser has continued to work in the industry; and
- Either:
  - i. Is a member of a recognised professional association relevant to the financial services industry that has a formal requirement for Continuing Professional Development and the adviser has obtained the relevant points (NIBA of course meets that requirement)
  - ii. Where the above does not apply, undertook continuing training by regular attendance at workshops or courses relevant to their advisory activities and regulatory obligations.

Alternatively, an adviser with pre 1995 qualifications can demonstrate their current competence by undergoing individual assessment.

We will provide further clarification on the pre 1995 training issue before the end of the year.

### **Disclosure (PDS)**

There were varying industry views on whether ASIC should give guidance on compliance with the PDS provisions of the Bill. We decided to issue guidance to promote the objectives of the Bill and to share our experience in disclosure of important topics, such as risk, fees and benefits. The paper sets out:

- what we consider to be the key objectives of the PDS provisions
- what we consider to be good process in developing PDSs
- good disclosure principles that a product issuer should consider
- guidance of potential misleading and deceptive disclosure



- examples of good disclosure outcomes.

Our paper also suggests that the proposals may be adaptable to other disclosure obligations under the Bill eg FSG and SOA. Since the release of our PPP, Treasury has released draft regulations in this area proposing additional and more detailed product disclosure requirements for superannuation and RSA products. We will monitor the final FSR regulations on product disclosure.

Another interesting inclusion in the PDS is the subject of a legislative provision required by the Democrats, in order for the FSR Bill to pass through the Senate. The Democrats required a two-part amendment to the Bill, which requires disclosure in the product disclosure statement of "the extent to which labour standards or environment, social or ethical considerations are taken into account in the selection, retention or realisation of the investment". Arguably, if no consideration is given to these factors, disclosure of this fact must also be made.

Part two of the amendment says "ASIC may develop guidelines that must be complied with where a product disclosure statement makes any claim that labour standards or environment social, or ethical considerations are taken into account in the selection, retention or realisation of the investment". ASIC is giving consideration to guidelines in this regard.

In a nutshell, this amendment reflects that the environment, human rights and labour relations are issues that are important to investors – and it is suggested this will raise the benchmark of corporate behaviour on these issues. Captured companies will now be required to disclose where they stand on ethical, environmental and labour issues; indoctrinating the requirement for Boards to turn their minds to corporate social responsibility.

### **Financial requirements**

The financial requirements PPP was issued on the 21<sup>st</sup> September. This policy proposal paper canvasses proposed requirements that will apply to Australian financial service

licensees depending on the functions carried out by the licensees. These include a cash flow proposal for most licensees, and a net tangible asset proposal for custodians or depositories.

A licensee regulated by APRA is not subject to ASIC's financial requirements as those licensees must satisfy APRA's financial requirements instead.

The base level requirements on the licensee are:

- i. Positive net tangible assets (NTA) and solvent
- ii. Have sufficient cash resources to cover 3 months based on unfavourable assumptions
- iii. Audit compliance annually and when ASIC asks
- iv. Adequate risk management system including addressing financial risks.

ASIC intends to consult separately on the appropriate additional financial requirements for licensees who have direct financial obligations to clients. This will typically apply to dealers who enter into financial product transactions with (rather than on behalf of) clients.

ASIC will also consult separately on financial requirements for licensees who hold more than \$100,000 of client money or assets.

Public comment on this paper is open for five weeks, with written submissions due by Monday 29 October 2001. We have already received one "draft" submission from the general broking industry. They strongly object to the 3 month cash flow requirement, arguing it is not appropriate for an intermediary, is costly and of no value. There is also confusion as to how it applies (ie doubling).

### **The Policy Consultation Process**

Throughout the consultation process we have received over 75 written submissions on our policy proposals for FSR. We have also conducted more than 30 meetings with various industry groups and companies to discuss the PPP's and take their views. Whilst the response was generally positive on our process, it was not surprising that there were

common themes among the issues highlighted by industry. Some commentators considered that the PPP's were too prescriptive in definitional areas whilst others considered in some areas the PPP's did not provide enough certainty to be of assistance to industry.

Clarification was required on a number of the policies, particularly Advice and Deal and 146. In some cases we were requested to provide specific examples. We have taken these comments into account, where appropriate, in moving forward to the policy statement phase.

### **Licensing**

We also issued in April a process-related publication: How do I get an AFSL?

This guideline will be updated by November 2001 and is intended to provide applicants with an insight into the licensing process and the categories of licence authorisations you may apply for. The intention is to provide you with as much information upfront as possible, to smooth the application process for a FSL and to ensure that the standard of applications is high: incomplete applications will be rejected.

The process guidelines will eventually be supported by Licensing Kits. These Kits will incorporate relevant contents of the process guidelines in order to take applicants through the application and detail the standard licence conditions. The Licensing Kits will be stand-alone publications and will be incorporated into the electronic applications for ease of use and access. We propose to produce Licensing Kits tailored for specific industries, after consultation with industry. This process has already commenced. (3<sup>rd</sup> October for NIBA).

In broad terms, a provider can apply for its FS license in one of three ways. A new licence application must be submitted by any party that wants to hold an AFS Licence, regardless of whether or not you currently hold an ASIC licence or registration. Generally, streamlining of the licensing process is available for those who have an ASIC licence or registration before commencement. In some cases ASIC may exercise its discretion and take into account an applicants behaviour and structure in determining whether an applicant may streamline.

Our licensing process has been developed to encourage electronic applications and electronic maintenance of licensee information. The e-licensing process guides you through the licence application, according to the type of licence or registration you hold now and the types of services you want your AFS licence to cover. Please take a moment to visit our e-licensing booth while you are here at the conference – we strongly encourage you to apply for an AFS Licence on line as this is faster and more efficient and we will be able to start assessing the application more quickly. Our system has been built specifically to cater for Financial Services licences under the FSR regime.

### **Impact of the FSRB on Industry**

One final note on FSR for you all to consider - This legislation represents significant change for a large and diverse regulated population across a variety of industry sectors - it harmonises licensing, disclosure and conduct regulatory frameworks for all financial products, markets and service providers. It will affect the life and general insurance, superannuation, deposit taking, intermediaries and managed investments industries. How FSRB impacts upon your business will depend on how you are currently regulated. It is up to you to determine the impact of FSRB on your business and business relationships: I recommend you refer to ASIC's policies and guidance on timing, licence applications and licensee obligations, IT impact, compliance and disclosure requirements for assistance and that you do this as early as possible after release of these ASIC publications.

### **Conclusion**

ASIC is working to provide certainty and trust within the emerging financial services environment. To achieve this we are focusing on building consumer confidence through educational activity, further developing our ties with industry and taking action against those who break the law. Our regulatory attack highlights our focus on the future and how we adapt to, not only the changes that are taking place today, but also those that are still beyond our line of sight. This has been a deliberate approach that ensures that within this context our regulatory framework remains apace of consumer expectations and industry's needs for certainty.

Indeed, it would be a monumental help if we had the benefit of time-traversing instruments to provide valuable insight into the future of regulation: to enlighten us as regulators as to where our strengths must lie and what we must prepare for going forward. Even without the benefit of foresight: I expect the last thing we have to worry about is Kling-ons on the starboard bow.

All we can know at this point is that the time ahead will be challenging, demanding and rewarding – that we must navigate ourselves through enforcement issues, legislative change, corporate governance matters and lightning progress in the world of e-commerce. We must adapt to the impact of uncertain world developments. For its part ASIC will continue to skill its staff to meet evolving corporate issues and educate consumers on our expectations and achievements.

In embracing this exciting new world Dave - may the Law be with you...