



ASIC

Australian Securities & Investments Commission

The impact of FSR on the regulatory culture of ASIC

A speech by the Deputy Chair of ASIC, Jeffrey Lucy, to the 7th Annual Conference of the Australian Compliance Institute, Sydney, 5 September 2003

Thank you for this opportunity to share with you our views on the culture of regulation and how we see our internal behaviour changing as a result of Financial Services reform.

I'd like firstly to touch on the current regulatory approach and offer general views on compliance. I will then look at how we see our approach and behaviour changing to meet the demands of FSR reforms, going forward.

Regulation generally

On mention of financial services reform, we tend to focus on the Financial Service Reform Act because it is affecting us now, but financial services regulatory form has been with us for many years. Significantly so since the introduction of the Wallis recommendations, which saw the establishment of both new and expanded regulators.

From ASIC's perspective, we have been regulating financial services since 1998 (and some since 1999). Industries such as insurance, superannuation, deposit taking, financial planning and funds management, from this time, fell within our regulatory jurisdiction.

ASIC's statutory mandate was upgraded accordingly: we regulate and enforce laws that promote honesty and fairness in financial markets, products and services and in Australian companies. The ASIC Act provides that we must strive to:

"maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; promote the confident and informed participation of investors and consumers in the financial system; and administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements...."

As you would be aware, ASIC regulates the financial sector under governance by Commonwealth Treasury. For those of you that have been in the industry for some time, it may be apparent that the regulatory emphasis has moved away from black letter enforcement to setting high industry standards and leaving it to industry to comply with the legislative requirements.

Take for example the current regulatory framework for financial services: it is effectively three tiered. At the top sits the legislation (the Financial Services Reform Act or FSRA) passed by Parliament. The legislation as drafted is Principles based. I mentioned that the government has moved away from black letter law. The second tier is ASIC Policy and Guidance, which is also principles based, notwithstanding that we are more prescriptive in some areas. The policy expands on the legislative principles and leaves the detail to be determined by industry.

The final tier is standards. Industry buy-in at this level is necessary to ensure appropriate codes of practice are developed and a best practice

framework is set. We encourage industry participation in developing prescriptive templates eg for Product Disclosure Statements and Financial Services Guide; in developing codes of conduct or practice and ensuring these are adhered to by the Industry.

The risk, if industry does not develop good standards and indeed comply with those standards, is that the Government will see fit to address this gap with more prescriptive legislation. This means industry loses the flexibility that the current principles based regulation affords. The legislation is designed to enable you, as financial services providers, to keep pace with international and domestic developments in the Financial Services Sector and offer a level playing field between you and your competitors. Such a significant regulatory change would necessarily result in a corresponding significant cultural change.

It goes without saying that we need a well-resourced regulator to be able to approach the job in a way that focuses on industry self-compliance. In particular, we ascribe to the theory that good regulation requires well-resourced enforcement otherwise if things go increasingly wrong we will be required to pull away from principle based regulation and the Government will return to black letter law.

Benefits of compliance

We support the flexibility offered by the current regulatory arrangement and encourage your compliance as it benefits all parties: it helps us as the regulator achieve our statutory objectives of improving the performance of the financial system and the entities within it; it promotes confident and informed participation by investors and consumers in the financial system and benefits the industry and you individually because you have upgraded compliance systems in place and an honest, efficient and knowledgeable

staff. This builds firm credibility and sustainability in a competitive environment, attracts business and importantly increases your bottom line.

FSRA improves the already high level of compliance in Australian financial services by setting high standards across the sector whereas up until now different standards have applied to various operators. FSRA will no doubt bring about changes in the industry - while there is no reason to assume growth won't continue to be strong in the Financial Services Sector, we are seeing and most likely will continue to see rationalisation or mergers across some industries to lower administration costs. Likewise the overall impact of FSRA will vary across industries - some industries have participants already trained to the necessary competency standards and have in place adequate compliance systems. Others will need to take additional steps in order to comply.

ASIC's role in compliance

Accordingly, we see our compliance role as having three key objectives: Firstly, to provide guidance on how we see the legislation applying, to assist with practical application of the provisions. As mentioned previously, we primarily issue our guidance through published Policy Statements and Practice Notes. Our policy statements are issued after a period of industry consultation. This is to ensure we have considered commercial and industry issues that may arise in relation to the area under discussion.

The FSRA legislation serves to structure compliance in a formal way, under s912A of the legislation (licensee obligations) and also under ASIC policy statements such as PS164, PS146, and PS175.

We have also shared with Industry our views on compliance. What we ideally like to see are organizations with a culture of compliance, not just interest in the bottom line. For example:

- Licensees who work with the regulator to lead the Industry by example
- Boards who instil a culture of “Compliance is a part of doing business”
- ACPA/ACI accreditation seen as a minimum qualification
- Honesty and timeliness in breach notifications
- Constructive criticism of legislation, regulation, policy and conditions
- Relief applications which recognise that which is exceptional

But failing ideal compliance, we will settle for good compliance:

- Take Compliance Seriously. Please do not see it merely as a window dressing for FSRA
- Implement meaningful Compliance structures
- Ensure adequate resources are employed on an ongoing basis
- Focus on Compliance within and throughout the business
- Separate your Compliance area from Legal/Risk Management

In addition to offering guidance, we see our compliance role as providing benchmarks for Industry and working with Industry to protect consumers and ensure an efficient market. These latter objectives we attend to in a number of ways:

Surveillances/ compliance visits

Financial Services is currently high on our list of priorities – not only from the perspective of the Financial Services Reform Act, which is the single largest reform ever experienced by this sector, but due a proliferation of new and wonderful ways to make money in the financial services sector. The nature of this regulatory field means that we pursue industry compliance through both complaint driven activities and campaign work. Our intensive surveillance program address issues in the financial services sector including breach-based or complaints driven surveillances, targeted or risk-based surveillances and pro-active surveillances.

Breach-based surveillance occurs where there is evidence, or ASIC has reasonable suspicion, of an entity's non-compliance with the Corporations Act. A breach may come to ASIC's attention via consumer complaints, external industry intelligence or internal ASIC activity. This type of surveillance is undertaken as the need arises and has a shorter planning timeframe and sharper focus than strategic surveillance.

A risk-based surveillance campaign is targeted to address ASIC's concerns about particular trends in the industry. ASIC uses information gleaned from analysis of compliance trends, industry analysis and international indicators. These surveillances usually focus on one or two issues.

We also conduct verification or compliance-based surveillance visits, both before and after licensing. These surveillances are used to ensure that applicants were providing accurate information in their applications, to educate industry and to deliver general compliance messages.

We have conducted 800 surveillance/compliance check activities in the past financial year. A number of referrals to our enforcement directorate result from these campaigns and are usually complaints of greater substance because they result from campaigns or advanced investigative activity. More of these complaints are resourced as they usually have a greater regulatory impact.

Applying our regulatory tools

In enforcing breaches of the Corporations Act we have access to a regulatory toolbox from which we are able to select the most appropriate tool in the circumstances. Selecting the right tool or remedy to achieve the desired result is often difficult as in some cases all regulatory remedies may apply. It is a matter of balancing the considerations and ensuring the remedy sought has an effective impact in addressing the mischief. The danger is

always that the best remedy may not be reasonably achievable and this means the easiest remedy may be sought, but is not necessarily the best.

We may seek both criminal and administrative remedies in one matter eg we may take criminal action against an advisor and administration action against the licensee. Or a criminal action may follow an administrative remedy.

The most frequently used regulatory tools in the last annual reporting period include criminal prosecutions, civil proceedings resulting in compensation orders and winding ups and banning, fines and disciplinary proceedings. In the financial services sector we also frequently make use of our stop order powers to correct misleading disclosure.

Education

I think it is important to note that all this enforcement action does more than target individuals who have breached the law. It has an education and market confidence impact.

It acts as a very visible reminder to directors and others in corporate management of their responsibilities and the liabilities that attach to failure to fulfill those responsibilities. It also instills confidence in consumers and who use financial services, to know that an independent regulator will take action against the wrongdoers.

The education profile we have built through our enforcement activities is complimented by ASIC consumer protection initiatives. Our FIDO website draws a remarkable number of hits from the public, providing information and guidance for consumers on protecting your wealth, avoiding scams and making informed financial decisions.

Law reform

ASIC also advocates, comments on and contributes to proposals to amend the provisions of the Act. This is an important but often less visible contribution.

Our monitoring of industry practices and our enforcement activities put us in a position to make a valuable contribution to law reform. We know how the market operates and what impact suggested reforms may have. We know which parts of Australian law are not working and what changes need to be made to achieve the desired outcomes.

The Government consults widely on its legislative proposals and ASIC takes seriously the unique and valuable contribution it can make to law reform.

MAJOR CHANGES BROUGHT ABOUT BY FSRA

Keeping in mind what we see as our key compliance objectives, I will now fill you in on what we see as some of the major changes to the way we go about our business, brought about by FSRA.

Responsibility of licensees

Arguably, the most substantive change we will experience with FSRA is the sheer magnitude of licensees we will regulate. We anticipate around 7,000 entities will need to be licensed to continue or commence operating in the financial services industry.

This engages us as a regulator more so than in the past. Some see us as the conduct police – like the police force we have continually been operating in the background, acting when offences have been committed. You and I both appreciate that this is the police forces role. We would be put out if the police assumed a right to come into or onto our property at any time, without any offence suspected, in the guise of doing their job.

However, when we licence entities to conduct financial services, we assume a responsibility that they will be doing 'the right thing' as stipulated by the law and licence conditions. Our consumer protection mandate dictates this. Accordingly, we must take a more intrusive role and conduct compliance checks on our regulated population on a larger scale than previously (because there will be more of you holding a licence than previously).

Changing the way we go about our business

This significant regulatory change necessitates changes in ancillary areas.

- **Increased reliance on electronic systems**

One of the other key changes we have seen resulting from FSRA is our increased reliance on electronic systems. For those of you who have applied for your Australian Financial Services Licence, or are in the process of doing so, you will be only too familiar with our online licensing application system. This system provides a "one size fits all" Australian financial services (AFS) licence application process. Since its initial implementation in February 2002, further electronic functionality has been introduced to provide online licence maintenance. The FSR system not only includes the current version of the AFS licence applications (modified having regard to staff and industry feedback, changes in legislation and policy and improved functionality), but also provides internal guidance to ASIC staff, such as integrated assessment guides, PS146 online search functions and end of transition planning. Many of our forms are now available in electronic form and our policy and guidance all appears online at www.asic.gov.au.

- **Smarter use of intelligence gathered**

While our reactive campaigns are targeted using complaints data, we source our pro-active campaigns and highlight potential problem areas from gathered intelligence. As a regulator we are naturally exposed to a lot of information and data; press reports, commissioned research, industry

liaison, internal databases, interviewing and desk reviews. Our intelligence process enables us to sift through this extensive information to target potential problem areas. This is often done at the strategic level, which allows us to be proactive in anticipating issues and consequently enables us to make a greater impact on that sector of our regulated population.

A Research and Analysis report is prepared quarterly, by a dedicated Research and Analysis Unit, to provide an indication of early warnings and risks that may require ASIC's attention, and to provide an overview of key trends in the market sectors regulated by ASIC.

The initial production stage of the report involves identifying issues and risks by sourcing information through internal interviews with senior staff and management, external interviews with selected experts, ongoing desk reviews of information from industry journals, media and other publications and finally, reviews of our internal databases.

In each process the key questions of "what is around the corner" and "how will it impact ASIC" are canvassed.

Issues identified from this process are then reviewed and some take a backseat on the basis that issues are being adequately addressed, are outside of our jurisdiction or do not pose a reasonable risk to us at this point. In the latter case, matters are kept on a living research watch list. The remainder of identified issues are prioritized and further researched, before being fed into the final report.

The final report is then considered at executive level, where matters are prioritized according to risk and where appropriate, allocated for action by a directorate.

- Identifying surveillance targets

Naturally we will have a very large licensed population come the end of the FSRA transition period. We have to work smarter in identifying targets for disclosure and conduct compliance checks amongst the regulated financial service population, and we have a system to enable us to do this. We will raise the public profile of ASIC's surveillance strategies by identifying targets where a regulatory outcome is more likely to be achieved; to make proper use of the intelligence gathered in the licensing process; to better allocate our resources and to meet ASIC's overall strategic goals.

- Industry consultation

We are working closer with Industry - both associations (including the ACI) and industry leaders - in implementing the FSRA reforms. We believe that adopting a high level of transparency in our dealings with the regulated population is essential to educate consumers and send messages to the industry.

On a broader level, we have found industry consultation a useful methodology to obtain compliance with the law. We often use a direct approach to a specific organisation to raise a concern about a product or an issue, which falls short of involving a clear breach of the law. This can act as an 'early warning' sign or highlight an issue of concern particular to that organisation. Both organisations then work together to come to a satisfactory outcome, which is documented but not necessarily publicised. This is an effective use of resources for both organisations.

This methodology has been used with success and has been welcomed by the organisations approached as they see some partnering in resolving issues of concern rather than escalating the issue resulting in court proceedings or media announced outcomes such as enforceable undertakings.

What must not be assumed going forward however is that industry can "drop" in to ASIC and talk about their licence and compliance regime. This naturally involves a resource intensive commitment on our end, which is just not feasible. At the end of the day, compliance is the licensee's obligation and it is the licensee that must put in place appropriate systems to meet their regulatory obligations.

- Substantial industry liaison

We have led and continue to participate in numerous industry liaison activities; meetings, ASIC speaks and speeches and presentations at industry conferences and seminars. These activities serve to lift awareness of compliance issues within ASIC. Our liaison with industry is practical and issues focused and helps ASIC better understand the "business" of the industry and better appreciate the commercial line.

- Specialised learning and development

Likewise, our internal learning and development initiatives have focused on financial services areas, particularly superannuation and insurance. We have involved industry speakers in our training wherever possible, to obtain a balanced perspective and assist our overall understanding.

Future developments

These are some of the key changes we have seen from FSRA to date. Going forward, we will continue to initiate pro-active work and respond to environmental factors.

Our strategic plan sets a number of future directions that are indicative of our compliance culture into the future. For example:

- Enforcement remains a high priority. ASIC has been more visible and more credible in this area in the past years and we know that we must

continue to produce results. We may also require more flexible enforcement remedies, which have been raised as part of the CLERP 9 discussions with the Government.

- Parliament has given us a massive task to implement its financial services reforms smoothly. As mentioned, we have become more active and more skilled in superannuation and insurance, where consumers are expected to make decisions despite poor understanding of the system and levels of accountability by trustees that are less than optimal. We must raise standards in particular sectors of the industry.
- We are working to close the gap between what the consumer needs for effective disclosure and what financial service providers, company boards and auditors have delivered.
- I mentioned previously that we are making smarter use of our intelligence. We will continue to build and enhance systems that capture and synthesise data, and upgrade our skills in managing and applying knowledge.
- Our increased workload and responsibilities means we must strengthen, retain and reward the human resources we have the organisation, in order to retain the considerable knowledge and skills base we have in a demanding and competitive market.

Overall in Financial Services, we seek to lift the standard of financial advice and conduct, partly through FSRA implementation, but also by means of our compliance focus on advice and disclosure. We will continue with extensive surveillance and compliance campaigns and sharpen their focus.

Adapting to the external environment

One key aspect of our future culture will be responding to the external environment. We are only too aware that the continuing state of change in the financial services sector means we must be capable of adapting our regulatory skills to any challenge we front.

We are already seeing increased globalisation and rationalisation in the industry, which will impact on what the industry does and how it distributes its products. It will also impact on how we regulate the industry. This is particularly so when we consider how far ahead of our international regulatory counterparts we choose to stay, noting that globalisation for industry means satisfying the regulatory requirements of multiple regulators around the globe.

Vertical integration of the industry has accelerated in the last five years. There are very few large adviser groups left which are not owned by banks, insurance companies or fund managers and this is the key reason why Banks have a responsibility to work towards the lifting of industry standards and to do it now. The industry simply can't afford another survey with similar poor results, in two years time.

The past decade has seen an almost constant state of change for the financial services sector. Drivers such as large scale regulatory reforms, economic and market forces and changing customer needs are resulting in significant consolidation activity in all industry sectors.

67% of the retail market by size is controlled by the 4 major banks and one major life insurer (AMP). Compare this to the year before when the top 5 managers constituted only 53% of the market. This would appear to be indicative of the trend towards even greater rationalisation.

Likewise, 80% of financial plans are now produced by people tied to an institution. Some people question whether this leads to enough independence for parties at various parts of the chain.

As at July 2002, 80 firms (measured by advisor numbers) owned nearly all distribution points for investment advice in Australia. The largest 8 dealer groups have two thirds of this population of advisers, and financial institutions own 6 of the 8. The regulatory risk attaching to the rapid expansion of distribution channels is that quality of advice may be sacrificed in the scramble to write business.

Industry specific dynamics are also working to necessitate change. For example, in the superannuation field – the fastest growing financial sector - the growth of retail funds, at the expense of corporate and public sector funds, continues its momentum. Almost 50% of superannuation members are now in retail funds. Superannuation has become a commercial product and increasingly this product is distributed through wealth management networks. Banks, financial institutions and other organisations have integrated roles as the originator/administrator of the product, the distributor of the product and the investment manager of the product.

All of these industry pressures, together with industry influence, will have an effect on ASIC. Our ability to respond to the reform and industry pressures while also focusing on areas where consumers need to be protected will be the determinant of our success. Particularly important will be managing the balance between facilitating industry and its development, particularly through the licensing and relief processes and ensuring we give effect to the central planks of FSRA - those of raising standards and protecting consumers.

Consequence of change

The trends towards vertical integration and consolidation raise obvious questions about conflicts of interest and the adequacy of disclosure – transparency of fees, charges and commissions - which are likely to become even more demanding for us. It is the sort of issue however that we should expect to confront in an ever-evolving economic climate where investment returns are under pressure.

Naturally, managing conflicts of interest and maintaining adequate levels of disclosure are key to ensuring a working independence of any party in the chain. We need to accept that consolidation is a reality in the financial services arena, which means managing the associated risks.

Consumers are more actively participating in the financial services marketplace. Funds are flowing very strongly into superannuation and other investments and retail participation in investment markets remains high although lacking depth and diversification. Consumers are less concerned with loyalty, are exercising their rights and expect high and possibly unrealistic standards of protection, especially in superannuation. In this regard, we are working to help consumers make more informed decisions.

As the financial industry changes, so too will the needs of consumers and the relationship between consumers and providers of financial services.

Most of the industry players we regulate, and the consumers we are working to protect, want effective, responsive and consultative regulation that maintains Australia's relevance in a global market and manages public expectations. We know that industry will be watching our performance on financial services reform closely, particularly as to how we deliver on our longstanding commitment to honest and competent advice and disclosure.