ASIC
Australian Securities & Investments Commission

FSRA seven months on

An address by Ian Johnston, Executive Director, Financial Services Reform, ASIC, to the NIBA Conference, Sunday 20 October 2002, Adelaide.

Good afternoon. It is with great delight that I return to speak to you at this year's conference. Although I note that this year I have only 30 minutes so I have had to be ruthless in selecting my jokes…

"FSRA seven months on" is my topic for discussion. A lot can happen in seven months: Reflections on Last Year: Post Sept 11 Environment and now it is only one week after events in Bali. Both events impact directly on this industry, but are heartbreakingly wider.

Since 11 March 2002 this year there has been over 148 000 new Australians born; the Federal Government has injected over $3 million into it's National Crime Prevention Program; the Brack's government in Victoria has collected around $140 million in speed-camera fines; and most importantly Financial Services Reform has become a very real part of our lives. Speeding fines and FSRA share a quirky similarity – both have potentially adverse cost implications in the short-term and both have the effect of causing changes in behaviour. Some would also say they share the same level of popularity - but with FSRA we think you should be licensed to operate the bus but are happy for you to drive it as fast as you like.

FSRA is a journey that has been many years in the planning… Today I propose to revisit the journey thus far – I will start by reviewing how the FSRA objectives marry-up with the Financial Systems Inquiry recommendations, I will then fill you in on ASIC's experience to date and I will close by touching on a couple of hot issues for the industry.

Convergence to Consumer protection

You will be only too aware that the Financial Services Reform Act is a product of the Financial Sector Inquiry (known as Wallis). As stated in the FSI report overview, the inquiry was borne out of the era of accelerated change experienced since the early 80's: rapid technological innovation and an evolving business environment together with longer-term changes in customer needs and profiles. The report talked of a greater array of industry participants, products, distribution channels, competition emerging from new providers of financial services and increasing globalisation of financial markets.[1] This we have certainly seen.

The Inquiry was charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. Recommendations were to be made on the nature of the regulatory arrangements that would best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness."[2]

Industry input to the inquiry focused in large part on market convergence and product convergence. The piecemeal and varied system of financial regulation, determined according to the industry and product being provided, was seen as inefficient and led to confusion and unnecessary regulatory overlap.

The Wallis Committee recommendations that inspired FSRA included:

- Disclosure requirements should be consistent and comparable across all financial products.
- Profile statements should be introduced for more effective disclosure about retail financial products.
- A single licensing regime should be introduced for financial sales advice and dealing
- A single set of conduct requirements should be introduced for financial sales and advice to include:
    - Minimum standards of competency and ethical behaviour
    - Requirements for the disclosure of fees and adviser's capacity
    - Rules on handling client property and money, and
    - Financial resources or insurance available in cases of fraud or incompetence and that
- Regulation of collective investments and public offer superannuation should be harmonised

Those recommendations have formed the basis of the FSRA. But it is interesting to opine on whether the initial objectives of CLERP 6, are the same as the final objectives of FSRA. There are two schools of thought - some argue that there has been a change of focus while others believe that since its genesis in Wallis, the legislation has had consistent aims.

[1] FSI Report Overview, page 3
[2] FSI Report Overview, page vii

The initial CLERP 6 consultation paper focused on "a more efficient and flexible regime for financial markets and products achieved through an integrated regulatory framework for financial products. This to provide consistent regulation of functionally similar markets and products." The aim was to remove the piecemeal, varied and at times duplicative regulatory and licensing regimes in favour of a single regime, and to increase cost efficiencies and enhance disclosure to financial sector consumers.

And so the critical recommendation of Wallis was to move from sector-based regulation to what has been known as the Twin Peaks model. This resulted in the creation of two regulatory bodies – APRA to regulate prudential matters and ASIC to regulate conduct and market integrity.

FSRA

The main objectives of the FSRA that commenced on 11 March 2002 are to promote confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services. It is also intended to promote fairness, honesty and professionalism by those who provide financial services and create a fair, orderly and transparent market for financial products.

Whilst there is a consistency of theme from Wallis to FSRA, the initial Wallis drivers of converging markets, greater competitive neutrality and increased confidence in the integrity and safety of the system arguably lost ground to an increased consumer protection focus.

With the Financial Services Advisory Committee (FSAC) yet to report on whether the Wallis recommendations are achieving what they set out to achieve; the Parliamentary Joint Committee on Corporations and Financial Services shortly to report on the regulations and ASIC policy statements made under FSRA, and a disallowance motion brought by the opposition, we await with interest the "official" views on how FSI and FSRA marry up. It will be interesting also to keep abreast of industry's judgment of whether FSRA delivers the key benefits promised.

We have observed a focus by some participants on what they see as more onerous compliance and Consumer Protection requirements, forgetting the more rational and consistent regime within which those requirements sit.

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 law to setting regulatory principles, which leaves ASIC policy and importantly, industry standards, to fill in the gaps.

Take for example the current regulatory framework: it is effectively three tiered. At the top sits the legislation, passed by Parliament, which has four general objectives:

1. Licencing: providing a barrier to entry
2. Disclosure

3. Competency
4. Know your client

The legislation as drafted is Principles based – as mentioned, the government have moved away from black letter law. Black letter law tells you what the law is and how you have to abide by it. Principles based tells you what the law is and leaves it to industry to find the way to comply.

The second tier of regulation is ASIC Policy and Guidance, which is also principles based though with prescription in some areas.

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 are seeing this currently with the PDS regime: when drafting the PDS Policy Statement, ASIC initially proposed a prescriptive policy, but pulled away from this so that the policy statement sets overall principles with detail to be determined by industry. IFSA have taken up this challenge and are working to develop industry guidelines for disclosure.

Protecting principle based regulation

The risk, if industry does not develop standards and best practice measures, 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.

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 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 principles based regulation and the Government will return to black letter law.

We support the flexibility offered by the current regulatory arrangement and therefore naturally encourage you to comply for the sake of both your industry and the future of your individual businesses. In this regard, compliance includes minimum compliance with the law and development of, and adherance to, industry best practice: otherwise, as well as additional layers of regulation, there will be additional costs of regulation, which will be borne by industry.

From a global perspective, Australia is leading edge in implementing a twin-peaks regulatory regime – prudential and conduct regulation split between two regulators - and many countries are watching with interest to see whether this regime delivers what is expected of it. Likewise, FSRA is a first in implementing a single licensing and disclosure regime, and many of our fellow regulators

abroad are viewing this process and legislation as a favourable precedent. This places a responsibility on ASIC to be a leader in regulation across all sectors.

Most of our regulated population, 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 you 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.

Consumers are more actively participating in the financial services marketplace. Retail participation in investment markets remains high although lacking depth and diversification. Consumers 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.

What all this is really saying is that, in order to regulate effectively, ASIC needs to keep across industry issues and be in a position to appreciate and respond to industry concerns. In recognition of this ingredient for good regulation, we adopted a consultative approach to implement FSRA. We consulted heavily with various financial services industries as to the practicality of the policy proposals.

Our regulatory approach is sometimes criticised by industry as being too tough, or too impractical. The example that comes to mind is our Policy Statement 146. Wallis said that we needed competency requirements; FSRA enacts these but it is up to ASIC to set the standards. We then were faced with three options: we could implement no standards, wherein we would have had an industry rife with rogue operators, probably unfairly bringing disrepute to industries that have worked hard to build credibility and professionalism. We could have required Authorised Representatives to sit exams every two years, imposing burdensome obstacles on industry: or we could craft the training requirements around the existing requirements. We chose the last option as the most pragmatic and reasonable option to maintain a standard of competency and ensure consumers were offered a level of protection.

I am pleased to acknowledge the good work of Industry and training bodies such as NIBA.

Having said all of that, we do, as a regulator, try to act in a consistent manner in our policies, in our approach to industry supervision and in enforcing the law.

FSRA Experience to date

Let me turn now to our experience under FSRA this far – 7 months into the 2 year transition period.

Before 11 March 2004 we expect to licence or re-licence anywhere between 7000 and 10,500 applicants. The number will depend on how industry organises itself. Our research and experience to date indicates that the vast majority of applicants intend lodging in the last nine months of the transition period. While one can understand industry delaying – some wish to see what the experience is before applying, while others simply are not ready, it will come as no surprise to you that ASIC would find it difficult to cope with a late deluge of applications and that the risk would be run of some participants being out of the market.

Almost seven months after commencement, applications received have been from a mix of Advisers, Securities Dealers, Financial Planners, Responsible Entities and Derivatives Dealers. Of these applications, the majority have been new applications, requiring full assessment. We attributed the high rejection rate and low numbers in the early months to two key factors: one being a lack of understanding on the part of applicants, and the other factor being our own assessment procedures. Our priority over the past months has been to reduce the length of time it takes to issue a licence. We have worked hard to address this by improvements to the AFS licensing application and have also worked to further educate the financial services sector on the licensing process and correct common misunderstandings by issuing clearer and more specific guidance.

Initially, it appears that applicant misunderstandings arose most commonly in relation to specific transitioning issues. For example, many applicants have not fully understood the circumstances in which an applicant is entitled to streamline and the circumstances where a full application is required. Some applicants have selected *more or different* financial products than they were authorised to provide under their existing licence or registration, but have tried to use the streamlined process. This results in an unsuccessful application as the law only allows streamlining in respect of activities for which the applicant was already licenced or registered by ASIC. A new law always comes with new terms and new questions.

While we have provided some guidance in relation to the interpretation of certain terms, we are unable to provide legal advice to industry. We are however currently reviewing the guidance we give to industry and looking at ways to improve this while still staying within the bounds of our regulatory remit. Implementation of FSRA has already demanded, and will no doubt continue to demand, high levels of ASIC resources in order to see the transition through. We are committed to ensuring our staff are sufficiently trained and have the requisite knowledge and capabilities to deal with the ongoing fluctuation of licence applications and other issues.

One of the criticisms we have received regarding implementation is the lack of assistance we are providing to industry. This has not been deliberate – we have issued a significant amount of guidance and commentary to assist industry to prepare and transition as smoothly as possible. Obviously this has not been enough and part of the issue is attributable to the wide scope of differing industries and financial service providers that FSRA draws into our regulatory regime. To address the need for implementation assistance we have a project on foot that seeks to build on the initiatives we already have in place for industry assistance.
Specifically, this project seeks to improve ASIC's responsiveness and guidance to industry, increase the transition rate for the financial services industry and reduce the rate of streamlined applications that are rejected for lodgement.

We intend to achieve these objectives through identifying and implementing new initiatives, monitoring existing initiatives, implementing a communications plan and workshopping with both industry and ASIC business units. So we are making a concerted effort to do more.

Whilst the requirements of FSRA may seem onerous, compliance has benefits to both the regulatory and the regulated population – it ensures your business is manned by properly qualified and competent staff, using appropriate systems and offering an appropriate level of protection to consumers and it helps us, as the regulator, achieve our statutory objectives of improving the performance of the financial system and the entities within it and promoting confident and informed participation by investors and consumers in the financial system.

The specific benefits to industry and you individually are that 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 improves your bottom line.

In the converse, the potential consequences of not complying with legislation and not meeting best practice cannot be underestimated. For example, if ASIC conducts a surveillance that has a bad outcome, the negative effects to your business may be five-fold:

1. Interruption to your business
2. Financial and time costs of responding to ASIC enquiries and possibly defending a legal action
3. Reputational risk
4. Possible poor brand perception in the future – money flows to better regarded brands
5. Market impact

I would like to mention here that we also are pursuing a best practice outcome from a regulatory perspective: continuing to raise standards in financial services is a strategic priority for ASIC over

the next 12 months. In addition, the insurance broking industry has already benefited from specialised assistance with the issue of two Class Orders: Class Order 02/435, which ensures that the scope of an insurance broker's regulated activities includes dealing in, and advising on, insurance products of the kind in respect of which the person was registered under IABA, allowing streamlining under FSRA, and 02/734 which provides a timing concession regarding Insurance Broker Registration Renewals. ASIC has also been working on licensing assistance guides specific to insurance multi-agents and insurance brokers. Both of these guides will be released in the next couple of weeks.

By no means should you think that the news is mostly bad on the compliance front - Australia has a very good and overall a compliant financial services market. FSRA improves that by setting high standards across the sector whereas up until now different standards have applied to various operators. We do except though that there is a settling down period as industry participants, including brokers, adapt to changed circumstances.

Hot issues for the Industry

Mutual Aid and Discretionary Trust arrangements

With the current issues regarding availability and affordability of insurance, we have seen an increase in the popularity of mutual aid schemes or discretionary trust arrangements as an alternative insurance or risk management solution for businesses – particularly where professional indemnity and public liability, attracting high cost premiums, are concerned.

Due to the discretionary nature of claims payments these 'products' are not viewed as being insurance in nature and therefore have escaped prudential supervision to date. The collapse of UMP (United Medical Protection) and its catastrophic consequences for the medical fraternity has highlighted the need for these arrangements to be suitably regulated. I note that Treasury and APRA have met with MDOs (Medical Defence Organisations) to discuss reforms regarding medical indemnity arrangements to bring these into APRA's general insurance framework. There is some moral hazard here, for while these bodies are not legally considered to be providing insurance (and so are not presently APRA regulated) they are under FSRA managing a financial risk, and so need to be licensed. Under FSRA, the public of course would believe they are offering insurance and it's not difficult to appreciate the moral hazard of one of these, licensed by a Government agency, yet not prudentially regulated, collapsing. Our position is that they should be prudentially regulated.

Treasury are also considering issues relating to the impact of the FSRA and the Insurance Contracts Act in this area.

Professional Indemnity

There are currently a number of insurance brokers who's professional indemnity insurance has not been lodged with ASIC, or has been provided on terms outside of the legislative requirements set out in IABA (Insurance Agents and Brokers Act). ASIC is planning to undertake a review of those

brokers whose PI details have not been lodged with us and you probably don't need to be reminded that no PI means no business!!

Treasury has issued it's draft Issues and Options paper on Compensation For Loss in the Financial Sector and have asked for comments by 8 November. This paper seeks to explore the need for compensation arrangements as well as what are appropriate compensation mechanisms for consumers moving forward. However, until the Compensation Arrangements Policy is finalised your existing IABA PI requirements remain unchanged.

Unauthorised Foreign Insurers

* Difference between IABA (mostly wholesale and captured) and FSRA (only retail)
* Weakens disclosure
* Acknowledge NIBA supports maintaining the IABA provisions

PS146

You will recall that policy statement 146 was issued in late November 2001 and sets out minimum training standards for people who provide financial product advice to retail clients. You will have noticed also that the final policy statement remains committed to the general approach of Interim Policy Statement 146. Financial products included in Tier 2 broadly include consumer credit insurance, basic deposit products, non-cash payment facilities, as well as general insurance products except for personal sickness and accident.

We have attempted to simplify compliance dates, by dividing the various compliance dates into three main groups depending on the type of financial products on which advice to retail clients is provided. You will need to refer to the Table of compliance dates in the Policy statement, but to give a broad idea: Advisers such as financial planners who advise on securities, MIS, public offer super etc were required to have met the training standards by the 30th June 2002 – no extension to this date was given.

Licensees who provide financial product advice must ensure that all natural persons who provide financial product advice on their behalf (including the licensee, if it is a natural person) meet the training standards, by the correct compliance date. These dates may be before or after the licensee has transitioned.

How does PS 146 apply to trainees/office staff/adviser assistants? We will not require that certain staff providing certain kinds of financial product advice meet the training requirements set out in PS 146. These representatives are customer service representatives and para-planners, where these representatives meet certain requirements. I will focus on customer service representatives, noting that para-planners aren't common in your industry.

Customer service representatives who are only providing financial product advice derived from a script do not have to meet the training standards. If advice is required outside the script – this must be referred to a party who meets the training standards. Naturally customer service operators must be monitored to ensure they are only operating within the scripted limits.

Pre-1995 training:

Advisers who have completed training that is listed on the ASIC Training Register (before 1 January 1995) will generally need to demonstrate that their knowledge and skills are complete and current, particularly in the areas of regulation, compliance and disclosure. This means producing evidence of relevant continuing training or undertaking approved supplementary or gap training.

A number of pre-1995 training courses were submitted by Industry this year for approval to be added to the ASIC Training Register. A number of these have been approved by NFITAB (National Finance Industry Training Advisory Body Ltd).

Non-compliance with training requirements

After the applicable compliance date, an adviser who does not meet the training standards must not provide advice to retail clients in any area or on any product. I've noted that this deadline was not extended – an Information Release to this effect was issued in June and also addressed queries we had received about particular circumstances as at the compliance date - such as what happens when you are awaiting exam results on the due date – in this case, a licensee will not be in breach if the advisor continues to operate under their Proper Authority.

It is the responsibility of the licensee to ensure advisors comply with the training requirements of PS146 and therefore provide sign-off to an adviser that they have met the requirements. ASIC does not confirm in any form that an adviser has complied with the training standards of PS146 – this responsibility rests with the licensee as part of its obligations under FSRA.

There is a new training register accessible through the ASIC website (www.asic.gov.au). The site is in the early stages of development. Maintenance of this website has been outsourced to NFITAB and any queries in relation to the site, such as training courses not listed, should be referred to NFITAB, not ASIC.

And a final note on PS146: Our experience with FSRA to date indicates that people are not reading the policy statement before making enquiries of ASIC about training type issues. If you are required to deal with 146 issues, I encourage you to read the Policy statement, refer to the Q and A's on our website (as your question may already have been asked and answered) and to generally avail yourselves of the guidance we have issued to make the transition to FSRA easier for yourselves.

No one ever promised that there would be no turbulence experienced with FSRA – but ASIC is making a great effort to assist you with implementation. It is however early days and in reality the full impact of FSRA is likely to be felt later in the transition period. Hopefully not too late though, which is why we will continually encourage you to transition early to avoid 11th hour issues preventing you from becoming licensed within the two-year time frame.