My dear Mr Chairman and Senators,

This submission is from a Chartered Financial Adviser, who has been a practitioner for 25 years.

My submission is focussed on why there have been product failures particularly MIS as a financial product.

Re: Proposed changes to the Corporations Act to protect consumers of financial services products – Requirement for preview product Audits by ASIC.

The Corporations Act in its present form, came about by the actions many years ago of a Tasmanian Senator – the Hon Peter Rae, who had a vision for proper regulation and linked consumer protection.

He pretty much single handed, created the changes. We owe Senator Peter Rae a debt of gratitude.

The result is the present Corporations Act which is a national Act where all States and Territories enact exactly the same legislation in each jurisdiction with a referral of powers to the regulating authorities.

The Trade Practices Act is included in the Corporations Act so as to empower it for financial services.

Rae created two regulators that are ASIC – the Australian Securities and Investments Commission which manages the markets and the participants, and APRA – The Australian Prudential Regulation Authority, which manages the banks and other deposit taking bodies plus the life insurance companies.

They have a formally constituted Joint Parliamentary committee (The JPC) on Superannuation and Financial Services, which is the oversight committee for both regulators.

It is the only committee of the Parliament that has its own enabling legislation.

APRA works very well and has a vice like grip on its operations and is admired by all.

ASIC however is quite the contrary.

Unfortunately most of the ASIC staff of lawyers do not seem to understand the market driven nature of the financial services industry. They apply a socialist view of the market to the legislation.

They operate on a “regulate to death approach” which seems to be the norm.

Every time the government regulates something, someone in the economy has to pay. However the ASIC lawyers ignore this and thus the consumer pays. Fees and charges are an issue raised with you.

Hence ASIC has had a focus on regulating advice, but ***this is not the reason for failures in the market.***

ASIC takes the view wrongly that WestPoint and similar failures were advice failures, whereas **the reality is that they were product failures.**

In essence ASIC produced the product failures.

It as a regulator allowed the product onto the market and it is the regulator of the market product.

The financial services advisers just sit there and shake their heads at the overall lack of judgement by ASIC, in relation to what they should be doing with product.

We have been seeking for six years now, a process by where ASIC ramps up its audit and provision review and thus subsequently of APIR codes for new product. No ASIC approval and you cannot place the product into the market.

We suggested a structural change to the way the regulator does this.

The regulator who does not understand product or the reality of the market has simply ignored us.

Presently the regulator does not essentially review the product, merely that the product provider or the new product has to meet basic requirements of the prospectus, and as long as it fits then it's an administrative function, the regulator gives it its authorisation code, and a way it goes into the market.

There is no detailed understanding by the regulator of what the product is, whether it will deliver what its prospectus says it will; how well it will deliver this; who will deliver this outcome for investors; and what is their background experience and capacity to make such statements in the prospectus.

They will try and convince you that they do, but the reality is that they do not.

We say that the regulator should engage a panel of external auditors, develop a new product approval matrix, that deals with the basis of the product, the legal structures involved, the bankers involved, the management team involved, their experience over time, the administrative arrangements, and the fund management specialisation and internal skill bases, that will allow the product provider to actually deliver on the prospectus.

This is the key to making sure the product and its sponsors are going to deliver to investors.

Our view is that the regulator should give this requirement to one of the panel of the auditors, being a different auditor from a different panel each time, and that that auditor will require the proponent to pay for all of the provision of data, testing of the actual capacity of the fund management proponent, and an internal examination of all documents.

Once this is done in a more detailed level than presently is the case, the auditor provides to the proponent a certificate, which the regulator would then receive, review and then determine whether the product is allowed onto the market.

The assessment is therefore done at arm's length to the regulator and the regulator does not need to staff a level of expertise for this assessment.

The product proponent also have to pay for another audit to be done 18 months after the first time the product is released to the market for sale, and that review is provided to ASIC in order for the product to continue to be on the market.

Senators this is nothing over dramatic, except that it puts the onus on the Financial Services industry to lift their game in respect of PDSs and new financial services products coming on stream.

It means that the regulator is not involved in the auditing process, and the auditing process is a lottery amongst the panel of auditors controlled by ASIC.

Costs of the audit are borne by the proponent, who has to pay ASIC for the audit, and ASIC then pays the auditor.

That way there can be no suborning of the audit process.

The key issue with this change is that it removes the requirement from having specialisation inside ASIC, to having specialisation which exists in abundance, in the major auditing firms.

If the proponent ticks all the boxes and receives the certificate then they deserve it.

If the proponent is not tick all the boxes in the product does not get onto the market, and future problems go away. ASIC then starts an audit of that AFSL to determine their capacity to stay licensed.

I really cannot see what is hard about this process. It costs the Government and regulator nothing.

It would relieve ASIC of future failures of product to a large degree as it would maintain a harder more sustained and detailed look at new product, and then at 18 months review of how that new product was being managed into the market.

For example if ASIC knew at the start of some the managed investment schemes for timber, that the commission paid to Chartered Accountants of the original capital going into the scheme was 20% upfront, then that may have had an auditor ring an alarm bell on day one.

As well the mezzanine finance operations of Westpoint and two other funds would have rung bells with any auditor in relation to the capacity of the scheme or managed investment to actually deliver the outcome to investors, with the lending practices they had at the time.

There are numerous examples that would all have been cut off at the knees and been stillborn, and thus not a problem if this process of ASIC employing external auditors and new matrix structures on which to assess managed investment product prior to product meeting the market.

A lot of the discussion, and certainly a lot of the costs that the industry is bearing would not be happening.

This process would be welcomed by the Industry and seen by the Market as being sensible regulator preview audits.

You pass then great.

You don’t pass then tough.

It would sit well with the Government and the Senate to tighten up the product being presented to Australians, and Treasury view would be that this would make the industry more resilient.

Senators, I would think that the changes that I propose would have the support of Senator Mathias Cormann as Minister as it is an improvement.

I have appended the draft changes to Section 601EA of the Corporations Act and I am happy to draft the clause notes if you wish me to.

I cannot see any down side to this.

Yours sincerely,

Mervin C Reed FAICD FChFP AFPA ADFS(FP)AAIM JP
Financial Adviser and Planner
Fellow Chartered Financial Practitioner
Corporate Financial Planning Pty Ltd
Hobart, Tasmania
Authorised Representative 249446 and
Corporate Authorised Representative 250921
of Synchronised Business Services Pty Ltd AFS Licence No. 243313.
A Justice of the Peace - Tasmania
www.corpfinplan.com

Mervin C Reed is a Fellow Chartered Financial Practitioner
Mervin C Reed is a Fellow of the Australian Institute of Company Directors specialising in Corporate Governance.
Mervin C Reed is a non-aligned Financial Adviser
Mervin C Reed – Tasfarming.com is a strategic consultant to rural Tasmania specialising in Irrigation and Farm profitability improvement.

CORPORATIONS ACT 2001 - SECT 601EA

Applying for registration

(1) To register a managed investment scheme, a person must lodge an application with ASIC.

(2) The application must state:

(a) the name, and the address of the registered office, of the proposed responsible entity; and

(b) the name and address of a person who has consented to be the auditor of the compliance plan.

(c) That the applicant has received an external independent audit certificate required by ASIC from an auditor selected by ASIC, as to the management investment scheme's appropriateness for registration against the ASIC defined audit matrix of required criteria.

(3) Audit of Schemes:

(a) That a further ASIC independent audit certificate is required not later than 19 months after the managed investment scheme first enters the market, as to the appropriateness of the product to continue registration.

(b) ASIC shall select the appropriate Registered Audit firms by way of public tender for a period of 3 years, and applicants shall pay the prescribed audit fee to ASIC upon lodgement of application, and at re-audit of the scheme.

(c) That ASIC shall investigate any AFSL that lodges an application that fails to gain an Audit Certificate as to its competence to continue holding an AFSL.

(4) The applicant must have the consent referred to in paragraph (2)(b) when the application is lodged. After the scheme is registered, the applicant must give the consent to the responsible entity. The responsible entity must keep the consent.

(5) The following must be lodged with the application:

(a) a copy of the scheme's constitution;

(b) a copy of the scheme's compliance plan and the External Independent Audit Certificate

(c) a statement signed by the directors of the proposed responsible entity that:

(i) the scheme's constitution complies with sections 601GA and 601GB; and

(ii) the scheme's compliance plan complies with section 601HA.

Note: Section 601HC requires that the copy of the compliance plan be signed by the directors of the responsible entity.