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I N F O R M A T I O N A N D R E S E A R C H S E R V I C E S

Bills Digest
No. 26 2001-02

Financial Services Reform Bill 2001

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Law and Bills Digest Group
21 August 2001

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Financial Services Reform Bill 2001

Date Introduced: 5 April 2001

House: House of Representatives

Portfolio: Treasury

Commencement: The main provisions of the Bill commence on Proclamation. The Government has stated its intention that this Bill should commence on 1 October 2001.

Purpose

The Bill aims to harmonise the regulatory regime for the financial services industry. The Bill establishes a single licensing regime for the provision of financial services. The regime will capture entities that deal in a financial product, provide financial product advice or make a market for a financial product. Consistent disclosure obligations will apply to retail financial products. In addition, financial markets and clearing and settlement facilities will be subject to a consistent authorisation procedure.

Background

The Financial System Inquiry

The origins of this Bill lay in the recommendations of the Financial System Inquiry (FSI).¹ The FSI found that regulation of the financial system was institutionally based. For example, in the case of licensing, life and general insurers are registered under the *Insurance (Agents and Brokers) Act 1984*. In contrast, securities dealers, futures brokers and superannuation intermediaries are licensed under the *Corporations Act 2001*. The FSI found that the requirements for a license under the various regulatory frameworks were not consistent. While insurers need only be licensed to deal in insurance products, the Corporations Act requires that a person obtain a licence if they wish to provide advice in relation to shares, managed investments or futures.

Product disclosure was also found to be institutionally based and inconsistent. For instance, the *Insurance Contracts Act 1984*, the life insurance code and the general insurance brokers' code of practice regulate disclosure in the insurance industry.

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Disclosure for superannuation products is controlled by the *Superannuation Industry (Supervision) Act 1993*. In the banking industry the Banking Code of Practice applies however managed investments are governed by the *Corporations Act 2001*.

The FSI concluded that the lack of consistent regulation for similar services and products increased the compliance costs for providers of financial services particularly for conglomerates consisting of number of separate institutions. Furthermore, inconsistent regulation caused confusion for consumers limiting their ability to compare different products.

In addition, the FSI reported that the law draws an artificial distinction between ‘securities’ and ‘futures contracts’ which limits the degree of innovation in financial products and restricts competition between the Australian Stock Exchange and the Sydney Futures Exchange.

To address these issues, in March 1997 the FSI made recommendations which included that:

- a single licensing regime should be introduced for financial sales, advice and dealing. There should be separate categories of licence for investment advice and product sales, general insurance brokers, financial market dealers, and financial market participants (recommendation 13)
- disclosure requirements for retail financial products (deposit accounts, payments instruments, securities, collective investments, superannuation and insurance products) should be consistent and comparable (recommendation 8)
- a single set of requirements should be introduced for financial sales and advice including:
 - minimum standards of competency and ethical behaviour
 - requirements for the disclosure of fees and adviser’s capacity
 - rules on handling client property and money
 - financial resources or insurance available in cases of fraud or in competence; and
 - responsibilities for agents and employees (recommendation 15).
- the existing Corporations Law regulation of securities and futures contracts in Chapters 7 and 8 should be replaced by a broader framework encompassing ‘financial products’ (recommendation 19).

Within the framework set by the FSI, the proposals have been subject to a lengthy period of consultation and development. The proposals were examined by the Corporate Law

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Economic Reform Program (CLERP) in December 1997.² A consultation paper on the proposals was published in March 1999.³

A draft of the Bill was released for public comment in February 2000. The Parliamentary Joint Statutory Committee on Corporations and Securities examined the draft Bill and reported in August 2000.⁴ The Government then delayed introducing the Bill due to concerns about the constitutional basis of the Corporations Law following the High Court's decision in *R v Hughes*⁵. These concerns have now been addressed by a referral of powers by the States that has enabled the Commonwealth to enact the *Corporations Act 2001*.

Main Provisions

Item 1 repeals Chapters 7(securities) and 8 (the futures industry) of the *Corporations Act 2001* and inserts a new Chapter 7 entitled 'financial services and markets'.

Licensing of Financial Markets

Chapters 7 and 8 of the Corporations Law currently separately regulate securities and futures exchanges such as the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE). The law creates a distinction between securities⁶and futures contracts.⁷ Futures contracts can only be traded on a futures exchange while securities are traded on the stock exchange. In recent years there has been a growth in derivative products, that is contracts or instruments whose price depends on the value of an underlying asset such as a share or a commodity. Different types of derivatives may be classified as either a security or a futures contact and this classification will determine which exchange they can be traded on. Lately, developments in products for financial investment have seen the creation of hybrids which have made the process of classification more difficult.⁸

The FSI and CLERP argued that the legal distinction between securities and futures restricts competition between securities and futures exchanges and inhibits the development of innovative financial products.⁹ The new regime in **proposed Part 7.2** is intended to implement a flexible regulatory framework for financial markets.

Proposed section 791A provides that a person may not operate a *financial market* unless they have an Australian market licence (AML) or the Minister has exempted the market from the operation of Part 7.2. A contravention of this section will be an offence giving rise to a penalty of up to \$55 000 (\$275 000 for corporations) and/or 5 years imprisonment.¹⁰

The term *financial market* is broadly defined by **proposed section 767A** and includes a facility through which offers to acquire or dispose of financial products are regularly made or accepted. The definition encompasses markets such as the ASX and the SFE.

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Significantly, it generally excludes the so called over the counter (OTC) markets. These markets essentially involve institutions and professional dealers. There is no facility which matches buyers and sellers as participants deal with each other bilaterally. The major OTC markets are in currency options, forward rate agreements (FRAs), interest rate swaps and interest rate options.¹¹

How is a licence obtained?

Australian market licences may only be obtained by a body corporate who lodges an application with Australian Securities and Investments Commission (ASIC). While the decision about whether or not a licence should be granted belongs to the Minister, ASIC must advise the Minister about the application (**proposed section 795A**).

Under **proposed section 795B** the Minister may grant a licence if satisfied of a range of matters including:

- that the applicant will comply with its obligations (see below)
- the applicant has adequate operating rules and procedures to ensure that the markets will operate in way that promotes objectives of fairness, orderliness and transparency
- the applicant has adequate arrangements for supervising the market
- no disqualified individual is involved in the applicant¹²
- adequate arrangements are in place to compensate clients, where for example clients suffer pecuniary loss because of a misappropriation of money or other property by a contributing member of the exchange; and
- no person is likely to control more than 15 per cent (or a higher percentage if the regulations allow) of the body corporate.

The Minister may impose conditions on, vary or revoke an AML. The Minister has a responsibility to ensure that every licensee will be subject to conditions that specify:

- the particular market that the licensee is authorised to operate
- the classes of financial products that can be dealt with on the market; and
- where the Minister considers it appropriate, the type of clearing and settlement arrangements that apply (**proposed section 796A**).

Under **proposed section 797C**, where the Minister considers that a licensee has breached or is in breach of its obligations under proposed Chapter 7 of the Corporations Act, the Minister may give the licensee written notice to show cause at a hearing before a person nominated by the Minister why the license should not be suspended or cancelled. The Minister may not take action before considering the report and the recommendations of the

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person conducting the inquiry. A licence may be immediately suspended or cancelled by written notice in circumstances that include where the licensee goes into external administration (**proposed section 797B**).

Obligations of Licensee

The obligations of licensees are set out in **proposed Division 3** of Part 7.2. General obligations include:

- compliance with licence conditions
- having adequate arrangements for supervising the market including monitoring the conduct of participants in the market and enforcing compliance with the market's operating rules (**proposed section 792A**)¹³

A licensee also has specific obligations to notify ASIC if it:

- has breached or will be unable to meet its general obligations
- takes disciplinary action against a participant in the market
- the licensee suspects that a participant is breaching or will breach the market's operating rules or the Corporations Act (**proposed section 792B**).

Licensee's have a general obligation to assist ASIC (**proposed section 792D**).

As noted above, failure to comply with these obligations can lead to the suspension or cancellation of a licence by the Minister.

Clearing and Settlement Facilities

Proposed Part 7.3 inserts a new licensing regime for clearing and settlement facilities replacing elements of Chapters 7 and 8 of the Corporations Act which regulate the Sydney Futures Exchange Clearing House and the Securities Clearing House. Clearing and settlement facilities guarantee the fulfilment of transactions and provide protection against counterparty credit risk through novation clearing.¹⁴

In order to control systemic risk in the financial system, the FSI recommended that clearing and settlement facilities should be regulated.¹⁵ A person may only operate a clearing and settlement facility if they have an Australian CS facility licence or an exemption granted by the Minister (**proposed section 820A**). The Bill defines a *clearing and settlement facility* as a facility that provides a regular mechanism for the parties to transactions relating to financial products to meet obligations to each other that arise from entering into the transactions and are prescribed by regulation (**proposed section 768A**). The Minister may grant licences after an application to ASIC. Amongst other matters, the Minister must be satisfied that the applicant has adequate operating rules to ensure, as far

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as is reasonably practicable, that systemic risk is reduced and the facility is operated in a fair and effective way (**proposed section 824A and 824B**).

A series of amendments to Part 7.3 were made by the House of Representatives, during the Bill's passage through that House, to reflect the Reserve Bank's (RBA) responsibility to control risk in the financial system.¹⁶ As a result of these amendments regulatory oversight of clearing and settlement facilities will be shared between ASIC and the RBA. Under **proposed section 827D**, inserted by the House, the RBA is empowered to determine standards for ensuring that CS facility licensees conduct their affairs in a way which causes or promotes overall stability in the financial system. Licensee's must notify the RBA if they are or may be in breach of these standards (**proposed section 821BA**). The RBA is required to assess licensee's compliance with the standards at least once a year (**proposed section 823CA**).

ASIC will retain the ability to give directions to licensees if it considers it necessary to ensure that services are provided in a fair and effective way or to reduce systemic risk (**proposed section 823D and 823E**). In the latter case, ASIC must consult with the RBA.

Limits on Involvement

Raising the 5 per cent threshold

Currently Part 7.1A of the *Corporations Act 2001* prohibits a person from owning more than 5 per cent of the voting power of the Australian Stock Exchange. The Bill raises this threshold to 15 per cent or a higher amount if approved by the Minister. Importantly the shareholding restriction is extended to apply to other market licensees not just the ASX. **Proposed Part 7.4** imposes ownership limits on body corporates that hold an Australian Market Licence or an Australian Clearing and Settlement Facility Licence as well as holding companies of such body corporates.

Proposed section 850C prohibits a person (or two or more persons acting under an arrangement) from acquiring shares in a body corporate where the acquisition results in an 'unacceptable control situation'. This term is defined in **proposed section 850B** as where a person's voting power in a licensee or holding company of a licensee exceeds 15 per cent or a higher percentage if specified by the Minister. The Minister may only specify a higher percentage if satisfied that it is in the national interest to do so. A contravention of proposed section 850C is an offence and the remedial orders available to the court include an order to divest the shares.

On the application of the Minister, ASIC, the licensee (or its holding company); or a person who has any voting power in the body may apply to the Court for an order so that the unacceptable control situation no longer exists (**proposed section 850D**).

The restriction on share ownership in the ASX was inserted in 1997 following the decision of the members of the exchange to demutualise.¹⁷ The Government stated at that time that

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because of the critical role played by the ASX in the national economy it would not be in the public interest for any one party to gain control of the ASX. It was also stated that the 5 per cent limitation would encourage a diverse ownership.¹⁸ Similarly in relation to the current Bill the Government has noted that the integrity of the market may be threatened by the real or perceived danger that the operation of the market may be compromised to suit the interests of large shareholders.¹⁹

The Explanatory Memorandum provides essentially four reasons to justify the increase in the shareholding threshold:

- the 5 per cent limit unduly restricts the ability of licensees to raise capital
- the higher limit may facilitate alliances between markets
- low shareholding limits insulate management from the pressure to perform that comes with a free market for corporate ownership and control
- the ownership limits are in keeping with those applying to financial institutions under the *Financial Sector (Shareholding) Act 1998*.

It should be noted however that the new threshold is significantly higher than that applying in other demutualised exchanges around the world.²⁰

Exchange	Ownership Limit
Hong Kong	5 per cent
Toronto	5 per cent *
Singapore	5 per cent*
Stockholm	10 per cent
London	4.9 per cent

*A higher threshold may be approved by the regulator

Fit and Proper Tests

Proposed Division 2 of Part 7.4 specifies a number of classes of person who are disqualified. The definition of disqualified person is important because under **proposed paragraphs 792A(i) and 821A(h)** market licensees and CS facility licensees must take all reasonable steps to ensure that no disqualified person becomes, or remains involved in the licensee. Furthermore **proposed paragraphs 795B(h) and 824B(2)(f)** state that the

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Minister may only grant a licence if satisfied that no disqualified individual is involved in the applicant.

A person will be held to be involved in a licensee or applicant if the individual is: a director, secretary executive officer of the licensee or applicant or its holding company; or has more than 15 per cent of its voting power (**proposed section 853B**).

Disqualified persons include bankrupts, persons convicted of an offence involving dishonesty such as fraud²¹ and persons ordered by a court not to manage a company²². Persons may also be disqualified by ASIC after considering the person's fame, character and integrity (**proposed section 853C**).

Licensing Providers of Financial Services

The key section in Part 7.6 is **proposed section 911A**. In general terms it provides that a person who carries on a financial services business must hold an Australian financial services licence (AFSL) covering the provision of financial services. Failure to comply with proposed section 911A is an offence punishable by a fine for individuals of up to \$220 000 and/or 2 years imprisonment.

In order to appreciate the scope of the licensing requirement it is necessary to examine some of the defined terms.

What is a financial service?

Proposed section 766A states that a person will provide a financial service if they provide:

- financial product advice
- deal in financial products
- make a market for a financial product
- operate a registered managed investment scheme, or
- provide a custodial or depository service or other conduct specified in the regulations.

What is a financial product?

A financial product is a facility which allows a person to make a financial investment; manage financial risk or make non-cash payments (**proposed section 763A**).

Obligation of licensees

Under **proposed section 912A** the obligations of licensees include:

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- to the extent that it is reasonably practical, doing all things necessary to ensure that financial services are provided efficiently, honestly and fairly²³
- complying with the conditions on the licence
- taking reasonable steps to ensure that its representatives comply with the financial services laws
- maintaining the competence to provide the financial services
- ensuring that its representatives are adequately trained
- having internal and external dispute resolution procedures that are approved by ASIC.

Additional obligations may be imposed by the regulations.

If a licensee provides services to retail clients, then the licensee must have arrangements for compensating persons for loss or damage suffered because of breaches of the relevant obligations under Chapter 7. Such arrangements must either comply with regulations or be approved in writing by ASIC (**proposed section 912B**).

Proposed section 912F states that licensees must provide their licence number whenever they identify themselves in a document in connection with providing financial services.

ASIC Role

Applications for financial services licences must be made to ASIC. In contrast to market and CS facility licences, financial services licences are granted by ASIC rather than the Minister (**proposed section 913A and 913B**).

ASIC has the power to add conditions, vary suspend or cancel a licence (**proposed subdivisions B and C of Division 4**). The power to suspend or cancel may be invoked in specified circumstances including where a licensee is insolvent or engaged in serious fraud (**proposed clause 915B**).

Where the Australian Prudential Regulation Authority (APRA) regulates the licensee²⁴ there are procedures for consultation (**proposed section 914A and 915I**²⁵). The procedure differs depending upon whether the APRA supervised entity is an authorised deposit-taking institution (ADI)²⁶ or non-ADI²⁷.

If the entity is not an ADI, ASIC cannot impose, vary or revoke, suspend or cancel a condition if in ASIC's view it would significantly limit the ability of the entity to carry on its activities without first consulting APRA.

In the case where ASIC is of the view that its action would significantly affect an ADI, then the powers of ASIC are transferred to the Minister. The Minister is required to consider the advice of ASIC after it consults with APRA.

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ASIC is empowered to make a banning order under **proposed section 920A**. Such orders may be made in a range of circumstances which include where:

- the person's licence has been suspended or cancelled
- ASIC believes that the person has not complied with their obligations under **proposed section 912A** (see below)
- the person is insolvent under administration, or
- the person has been convicted of fraud²⁸

A banning order prohibits a person from providing any financial services. The penalty for breaching a banning order for an individual is a fine of up to \$2750, six months imprisonment or both (**proposed section 920C**).

Proposed section 922A provides that ASIC must establish a register or registers containing information on licensees, authorised representatives of licensees, persons who are banned or disqualified and declared professional bodies. The registers must be open to inspection by the public.

Who is exempt from the requirement to be licensed?

Authorised Representatives

A range of exemptions from the requirement to be licensed are listed in **proposed subsection 911A(2)**.²⁹ Perhaps the most significant is where a person is a representative of another person who holds a licence in relation to the particular service.

Proposed section 916A provides that the holder of a licence may by written notice authorise a person to provide a financial service or services on their behalf. Representatives are not permitted to sub-authorise. In the event where a body corporate is a representative, its employees may only provide financial services if specifically authorised by the licensee.

Where a representative has been authorised by only one licensee, that licensee is responsible to the client regardless of whether or not the representative's actions were within their authority (**proposed section 917B**). **Proposed section 917C** provides for joint and several liability where a person is representative of two or more licensees. The only exception to these liability rules is where a representative discloses to the client in a transparent manner that particular conduct is not within their authority (**proposed section 917D**).

The Australian Consumer's Association has opposed this exemption expressing scepticism about the ability of representatives to adequately disclose to consumers that they are acting outside their authority.³⁰

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Members of Declared Professional Bodies

Proposed paragraph 911A(2)(e) exempts a person who provides financial product advice as a member of ‘declared professional body’ from the requirement to be licensed. This provision is designed to capture advice given by professionals such as lawyers and accountants.

Such persons do not require a licence when giving financial advice under existing subsection 77(5) of the Corporations Act if it is ‘merely incidental’ to the practice of their profession.³¹ Over the years there has been some confusion about what advice falls into this category. ASIC policy statements have said that advice is incidental if it is not integral to the service and if no charge or commission is received for the advice.³²

The Bill removes this exception and instead seeks to involve professional bodies in a co-regulatory regime that imposes standards on professional bodies who are then responsible for supervising the activities of their members. **Division 7 of Part 7.6** provides that professional bodies may seek a declaration from ASIC.

ASIC must specify what kind of financial product advice members of a declared professional body (DPB) may provide (**proposed section 918B**). Declarations may be varied or revoked and are subject to conditions imposed by ASIC (**proposed sections 918C and 918D**).

The general obligations of declared professional bodies are set out in **proposed section 919A**. They include that the body:

- must make reasonable attempts to ensure that its members comply with the law in relation to financial product advice
- have adequate resources to supervise the provision of financial product advice by its members
- ensure that its members are adequately trained to provide that advice
- have adequate powers to remove or discipline members.

Other obligations on the DPBs may be imposed by the regulations.

DPBs must notify ASIC within 3 days if the DPB takes disciplinary action against a member or if the DPB believes that one of its members has committed or is about to breach proposed Chapter 7 (**proposed section 919C**).

ASIC is empowered to perform surveillance checks on DPBs and their members (**proposed section 919D**).

It is important to note the exemption in relation members of declared professional bodies only applies where the financial service that is provided is advice (**proposed paragraph**

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911A(2)). If a lawyer or accountant, for example, is dealing in financial products a licence will be required.

The DPB regime has generally not received a favourable response from the legal profession. For example, the Law Institute of Victoria has stated that ‘given that the obligations on declared professional bodies are potentially onerous, it is likely that the various law societies will not seek to become declared professional bodies’.³³ Large commercial law firms have called for the continuation of the exemption which exists under subsection 77(5).³⁴ The law firms argue that the regulation of ASIC is unnecessary given that activities are already subject to the scrutiny of the law institutes and societies.

The Bill does exempt ‘legal advice’ from the definition of financial product advice (**proposed subsection 766B(5)**). However major law firms argue that the exemption is too narrow. In its recent Policy Proposal Paper No.1, ASIC stated that the exemption does not capture any express or implied opinion or recommendation which is not legal in character and that accounting or taxation advice given by a lawyer may in some circumstances amount to financial product advice.³⁵ In response law firms have argued that :

‘It is impossible for lawyers who are documenting or advising clients about commercial transactions to avoid giving financial advice and it would be very bad public policy if the regulatory burden imposed by the [Financial Services Reform Bill] discourages lawyers from doing that.’³⁶

The definition of legal advice would be of less significance if all law societies/institutes became a DPBs however as stated above there is no guarantee that they will take on that role.

Organisations seeking a carve out from the licensing regime

Not for Profit Superannuation

The Corporate Superannuation Association and the law firm Freehills have argued that not-for-profit superannuation, that is corporate and industry superannuation funds, should be excluded from the licensing requirements of the Bill. They have argued that the industry is already well regulated by the *Superannuation Industry (Supervision) Act 1993*.

Such funds have voluntary trustees and they exist principally to receive mandatory employer contributions. Unlike public offer funds which are operated for profit they do not compete for customers. The not-for-profit sector is concerned that its trustees may be unable to meet the requirements of the Bill under proposed section 912A such as maintaining the competence to provide financial services, capital adequacy and ensuring that its representatives are adequately trained. The Freehills submission argues that this criteria does not ‘readily translate to the administration of superannuation funds by elected

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trustee representatives, who rely heavily on outsourcing specific functions to qualified service-providers in order to meet their responsibilities.’³⁷

The Minister for Financial Services and Regulation has opposed the suggestion that the industry should receive a general exemption from the Bill stating that the ‘Government’s fundamental position is that people looking after the money of others should be competent and capable of doing so.’³⁸ It should be noted that the Bill does make some concessions to the benefit of the not-for profit funds. Firstly, capital adequacy requirements would not be imposed on such entities by the licensing regime because they are supervised by APRA and therefore exempted by **proposed paragraph 912A(d)**. Secondly, the satisfaction of competency requirements was made easier by the insertion of **proposed section 761FA** by the House of Representatives which will allow the competencies trustees of a superannuation fund to be assessed collectively rather than individually.

Nevertheless the Minister has stated that the application of the Bill to the not-for profit sector would not commence until the passage of the Government’s choice of superannuation fund legislation.³⁹ Given the defeat of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 1998 in the Senate in August 2001, regulations exempting the not-for-profit sector from this Bill may be expected.

Media Advisers

Under the existing Corporations Act, ‘media advisers’, that is persons who give investment advice on securities in newspapers or periodicals or in radio or on television, have the benefit of an exemption from the definition of ‘investment advice business’ in subsection 77(6) and are therefore not required to be licensed.⁴⁰

The Bill removes this exemption. ASIC policy proposals suggest that under the regime imposed by the Bill, a close analysis of the conduct of financial commentators in newspapers and on radio and television is required to determine whether conduct amounts to financial product advice. ASIC has stated that the test is whether the opinions or recommendations are intended to influence, or could reasonably be regarded as intended to influence, a person’s decision in relation to financial products.⁴¹

Media organisations such as SBS, News Corporation, the Federation of Australian Commercial Television Stations, and the Press Council have lobbied for the continuation of the explicit exemption in the Corporations Act in order to provide certainty.

In evidence before the Joint Statutory Committee on Corporations and Securities, an officer of the Treasury stated that the Government would address the concerns of the media industry through the regulations. The officer stated that if a media organisation is giving general advice then the regulations would exempt them from the licensing regime.⁴²

The exemption would be subject to at least two conditions, namely: that the media adviser disclosed any conflicts of interest and that the sole purpose of the media activity is not to give advice.⁴³

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Such an exemption would seem to exclude columnists in newspapers for example from the licensing regime however specialist publications such as investment magazines may be within its ambit. It is arguable that the sole purpose of these magazines is to provide general advice.

Financial Services Disclosure

A new disclosure regime is introduced by **proposed Part 7.7**. It applies to financial services licensees as well as their authorised representatives. The regime is intended to address the recommendation of the Financial System Inquiry that disclosure requirements for retail financial products should be consistent and comparable. The Bill proposes three types of disclosure document: the Financial Services Guide, the Statement of Advice and the Product Disclosure Statement⁴⁴. These disclosure statements need only be given when the person provided with financial services advice is a retail client. The definition of retail client is therefore crucial to understanding the operation of the regime.

What is a Retail Client?

The meaning of the terms 'retail client' and 'wholesale client' are specified in **proposed section 761G**. Generally speaking under proposed Chapter 7 a financial product or service will be held to be provided to person as a retail client unless specified exclusions apply. Superannuation products and retirement savings accounts products will always be deemed to be supplied to retail clients. **Proposed subsection 761G(5)** excludes wholesale general insurance products. **Proposed Subsection 761G(7)** provides a more general list of exclusions. A person will be a wholesale client if one of four tests is satisfied:

- The product value test: The price of financial product, or the value of the financial product to which the financial service relates, equals or exceeds the amounts specified in regulations. According to the Explanatory Memorandum, the prescribed amount will be set at \$500 000. This is consistent with the 'sophisticated investor' test in the existing *Corporations Act 2001*⁴⁵
- The business test: the financial product or service is provided for use by a business that has more than 20 employees or more than 100 employees if the business is a manufacturer
- The individual wealth test: the financial product or service is provided to a person with net assets or gross income for the last two years which exceeds an amount specified in the regulations⁴⁶
- The professional investor test: **Item 261** in the consequential amendments (Part 2 of Schedule 1) inserts a definition of 'professional investor' into section 9 of the Corporations Act. It includes: financial services licensees, bodies regulated by APRA, trustees of superannuation funds with assets of more than \$10 million, and listed entities.

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The Financial Services Guide

Financial services licensees and authorised representatives must give retail clients a financial services guide (FSG) if they provide them with a financial service (**proposed section 941A and 941B**).

The content requirements of the FSG's for licensees and representatives (the providing entities) are set out in **proposed sections 942B and 942C** respectively. They include:

- the contact details for the financial services provider
- services that the providing entities is authorised to provide and the kinds of products to which those services relate.
- details of the remuneration including commission and other benefits that are received by the providing entity or its related parties.
- details of any associations and relationships which might influence the providing entity
- information about internal and external dispute resolution procedures.

There are some circumstances where the FSG does not need to be provided. These are listed in **proposed section 941C**. Two significant exemptions include general advice given in a public forum and where the financial service relates to basic deposit products. The exemption in relation to general advice in public forum is a limited one. The client must still be given information on the contact details of the providing entity, information about the provider's remuneration and details of any associations or relationships which might influence the providing entity.

Under **proposed subsection 941C(6)** the FSG does not need to be provided where the financial service relates to a basic deposit product or related facilities for making non-cash payments such as cheque accounts.⁴⁷ Clients must still be given the name and contact details of the provider and information about internal and external dispute resolution procedures.

Personal Advice- Retail Clients

Where a licensee or authorised representative provides personal advice to a retail client a written statement of advice (SoA) must be given. Personal advice is financial product advice given in circumstances where the provider of the advice has considered the objectives, financial situation and needs of the person or where a reasonable person might expect the provider to have considered those matters (**proposed subsection 766B(3)**).

The content of the statement of advice for licensees and representatives are listed in **proposed section 947C and 947D** respectively. The SoA must include:

- the advice and the basis for the advice

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- the name and contact details of the person providing the advice
- information about the provider's remuneration and details of any associations or relationships which might influence them, and
- any other information required by the Regulations.

An SoA must contain the level of detail a retail client would reasonably require for the purpose of making a decision about whether to act on the advice.

The question of how commissions should be disclosed is a matter to be dealt with in the regulations. The Opposition has expressed a preference for disclosure in dollar terms rather than as a percentage arguing that it will be more easily understood by consumers.⁴⁸

In contrast, Government members of the committee have supported the views expressed by industry groups such as the Life Agents Action Group and the Association of Financial Advisors that there should be no disclosure of quantum on risk products (insurance products with no investment or savings component) because the amount of commission does not affect return and is therefore not relevant to the consumer.⁴⁹ The Government has previously rejected this view arguing that:

‘the purpose of disclosure at this stage is to help the consumer identify any potential influences on the advice given or any potential conflicts of interest which the adviser may have in recommending the product. It is not to indicate the extent to which any return the consumer may receive is reduced by such commissions.’⁵⁰

Under **proposed section 945A** providers of advice to retail clients must have a reasonable basis for their advice. Providers must make reasonable inquiries of the client in relation to objectives, financial situation and needs of the person. They must also warn clients if the advice is based on inaccurate or incomplete information. Similar requirements apply to personal advice given by members declared professional bodies (**proposed Division 5 of Part 7.7**). Failure to comply with these requirements constitutes an offence with individuals liable for penalties of up to \$22 000 and/or 5 years imprisonment.

There are some circumstances where the SoA does not need to be provided. These are listed in **proposed section 946B**. The first exemption relates to execution-related telephone advice, for example, advice given by broker in relation to the purchase or sale of shares. An SoA does not need to be provided in relation to this type of advice where the client agrees not to receive the SoA, the provider has a statement in its FSG informing clients that they may request a record of any advice given to them and the provider keeps a record of the advice. A SoA is also not required for advice concerning basic deposit products. The Government has accepted the argument that the nature of these products is generally understood by the community. In both cases however the provider is still required to give information about the provider's remuneration and details of any associations or relationships which might influence them

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Where in contrast to situations discussed above, the financial advice is of a general nature, the provider must warn to clients that their individual circumstances have not been taken into account in providing the advice (**proposed section 949A**).

Product Disclosure

The new regime for product disclosure is contained in **proposed Part 7.9**. A product disclosure statement must be given to retail clients where personal financial advice is provided recommending a particular product or where a provider offers to issue or sell a financial product to a retail client (**proposed sections 1012A-1012C**). The part does not apply to securities nor to debenture stocks or bonds issued by Governments (**proposed section 1010A**). Other exemptions from the requirement to give a PDS are set out in **proposed sections 1012D and 1012E**. These include situations where a client makes additional contributions to an existing financial product⁵¹ (for example a further payment on life insurance investment product) and personal offers of managed investment products to less than 20 people in a 12 month period which raise less than \$2 million.⁵²

What must the PDS include?

The main requirements of the product disclosure statement are set out in **proposed section 1013D**. They include information on:

- the name and contact details of the issuer of the financial product
- the benefits and risks of holding the product
- costs associated with holding the product including fees, charges and expenses
- commissions that may or will impact on returns to the product
- significant characteristics or features of the product, and
- significant taxation implications of the product.

The PDS must contain any other information that might reasonably be expected to have a material influence on a reasonable retail client's decision to acquire the product.

Schedule 2 Continuous Disclosure

The Bill relocates the continuous disclosure provisions to **proposed Chapter 6CA**.

Currently companies listed⁵³ on the ASX have an obligation under Part 7.11 of the Corporations Act to notify the exchange if they have information which:

- is not generally available

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- but is of kind that a reasonable person would expect to have a material effect on the price of the company's securities.

At present a contravention of these provisions is a criminal offence meaning that it must be proved beyond reasonable doubt, however consistent with the recommendations of the Companies and Securities Advisory Committee, the Bill also applies a civil penalty regime. The civil standard of proof is the balance of probabilities.

The introduction of the civil penalty regime would seem to be justified given the fact that there has not been a single criminal prosecution for a contravention of the continuous disclosure provisions since they were introduced in 1994.⁵⁴

Indeed, according to ASIC Chairman David Knott the amendments do not go far enough in light of the poor disclosure record of Australian companies in recent times.⁵⁵ In a recent speech, Mr Knott stated that ASIC should be given the power to fine companies for inadequate disclosure. While welcoming the extension of the civil penalty regime to cover market offences including the continuous disclosure provisions, Mr Knott stated that:

‘The need to institute formal proceedings, even of a civil nature, is not necessarily the best means of regulating and improving disclosure conduct. Moreover, there are issues connected with the burden of proof and with the Courts' approach to evidentiary and procedural requirements in civil penalty matters that may tend to limit their practical use to ASIC.’⁵⁶

The Chairman noted that the power to impose fines for market misconduct has recent been granted to ASIC's counterpart in the UK – the Financial Services Authority. The Companies and Securities Advisory Committee considered this issue in 1996 and recommended that the Commission should have the power to impose small administrative penalties for minor contraventions of the continuous disclosure provisions.⁵⁷

Schedule 3- Requirement to tape telephone calls during takeover bids

Item 29 inserts a new requirement into Chapter 6 of the *Corporations Act 2001* which deals with takeover bids. **Proposed section 648J** will require the bidder or the target to make a clear sound recording of calls it makes to persons holding relevant securities for the purpose of discussing the takeover bid. Contravention of this requirement is an offence. Penalties up \$55 000 and/or 6 months imprisonment may be imposed on individuals.

The holder of the securities must be notified at the beginning of the call that it is being recorded. Recordings must be kept for 12 months after the end of the bid period or such longer period as is determined by ASIC in writing (**proposed section 648P**).

This proposal was not part of the CLERP or FSI recommendations. During debate on the Bill in the House of Representatives, the Minister stated that he had received a large number of complaints from shareholders that had received phone calls during the proposed

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takeover of GIO by AMP. The Minister stated that both sides of that takeover battle were reported to have made misleading claims.⁵⁸ According to the explanatory memorandum this requirement will enable the holder of securities or ASIC to investigate whether statements made in such conversation complied with the Corporations Act especially the provisions relating to misleading or deceptive conduct. In the absence of such recordings, it would be difficult to prove that particular statements were made.⁵⁹

The provision has been opposed by key industry groups such as the Securities Institute of Australia, the Australian Institute of Company Directors and the International Banks and Securities Association of Australia. These groups have argued that the proposal is onerous, expensive and likely to retard takeover activity.⁶⁰ As presently drafted the provision would apply to all securities holders not just retail investors.

The Minister stated that the taping provisions were intended to capture wholesale activity and that the Bill would be amended in the Senate to address industry concerns.⁶¹ It is understood that the provisions will be narrowed so that they will only apply to telephone calls to retail clients.

Concluding Comments

Transitional provisions for the new regime introduced by the Bill are contained in the Financial Services Reform (Consequential Provisions) Bill. Generally speaking existing market participants will have two years to meet the new licensing requirements contained in the Bill.

Many key aspects of the new framework are contained in the regulations. Draft regulations are being released by the Treasury for comment in instalments over the next few weeks.

Endnotes

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- 1 The FSI is also known as the Wallis Inquiry after its Chairman. The report of the FSI is at [http://www.treasury.gov.au/default.asp?main=/publications/financialsysteminquiry\(wallisreport\)/](http://www.treasury.gov.au/default.asp?main=/publications/financialsysteminquiry(wallisreport)/)
 - 2 Corporate Law Economic Reform Program, 'Financial Markets and Investment Products', December 1997. As this was the sixth discussion paper issued in the CLERP process, the reforms are often referred to as CLERP 6. This paper is at <http://www.treasury.gov.au/default.asp?main=/publications/bills,actsandlegislation/corporatelaweconomicreformprogram/paper06/default.asp>
 - 3 *Financial Products, Service Providers and Markets- An Integrated Framework: Consultation Paper*, March 1999. This consultation paper can be found at

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<http://www.treasury.gov.au/default.asp?main=/publications/bills,actsandlegislation/corpoatelaweconomicreformprogram/clerp6/default.asp>

- 4 The Committee's Report is located at
http://www.aph.gov.au/senate/committee/corp_sec_ctte/clerp6/financial.pdf
- 5 (2000) 171 ALR 155
- 6 'Securities are defined in section 92 of the Corporations Act. The term includes shares, debentures, bonds, interests in a managed investment scheme and options over these instruments.
- 7 This term is defined in a very technical manner by section 72. Examples of contracts traded on the Sydney Futures Exchange include agreements to buy a certain quantity of a commodity eg wool or 90 day bank bills on a specific future date at an agreed price determined on exchange of contracts. Futures contracts also cover 'adjustment agreements' which include contacts made over movements in the share price index. In such cases, the obligation to pay or receive an amount of money depends on the state of the index.
- 8 In 1995 there was litigation between the ASX and the SFE over the classification of low exercise price options (LEPOS) *Sydney Futures Exchange Limited v Australian Stock Exchange Limited* (1995) 16 ACSR 148.
- 9 op cit n.2 pp. 34-36.
- 10 Existing section 1312 of the Corporations Act empowers the Court impose a fine of up to 5 times that which applies to a natural person if convicted on an offence.
- 11 op cit n.2 p. 16.
- 12 The fit and proper person requirements are set out in Division 2 of Proposed Part 7.4.
- 13 The market's operating rules may be enforced by ASIC, the licensee, the operator of a clearing and settlement facility or a person aggrieved by a person's failure to comply with the rules (**proposed section 793C**). A licensee's operating rules may be disallowed by the Minister.
- 14 The CLERP 6 discussion paper described novation clearing as where
 'the clearing house becomes a party to each registered contract and breaks the link between the original contracting parties. That is, the clearing house enters into substitute contracts with each of the original counterparties (the clearing house members rather than their clients), becoming the seller to the buyer and the buyer to the seller. Full counterparty credit risk is transferred to the clearing house and the obligations of each contract will be fulfilled notwithstanding the default by the original counterparty. This system permits parties to trade in an anonymous environment by removing the requirement to assess counterparty credit risk before transacting in the market.'
 Corporate Law Economic Reform Program, *Financial Markets and Investment Products*, 1997 p. 79.
- 15 Recommendation 57.
- 16 See section 10B of the *Reserve Bank Act 1959*.
- 17 For background on the decision to demutualise see Lee Jones, Bills Digest No.115 1997/1998.
<http://www.aph.gov.au/library/pubs/bd/1997-98/98bd115.htm>.

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- 18 Explanatory Memorandum, Corporations Law Amendment (ASX) Bill 1997, p. 23.
- 19 Explanatory Memorandum, p. 85.
- 20 This information is drawn from a paper published by the International Organisation of Securities Commissions, Issue paper on Exchange Demutualisation, June 2001. The paper is at the following link:
http://www.iosco.org/docs-public-2000/2001-exchange_demutualization.html
- 21 See section 206B of the *Corporations Act 2001*.
- 22 Under 1274AA of the Corporations Act 2001, ASIC must keep a register of persons have been disqualified under Part 2D.6. This register will include people disqualified by the Court because they have been involved in 2 or more companies that have failed in the last 7 years (section 206D). It will also include persons disqualified for repeated contraventions of the *Corporations Act 2001* (section 206E).
- 23 This wording was inserted by an amendment made in the House of Representatives. Previously the section provided that services must be provided competently and honestly. For a discussion on the meaning of the requirement to perform services 'efficiently, honestly and fairly' see *Story v NCSC* (1988) 12 NSWLR 661 per Young J at 672.
- 24 APRA regulates a wide range of entities including banks, buildings societies, credit unions, insurance companies and superannuation funds.
- 25 The discussion that follows reflects the sections as amended by the House of Representatives.
- 26 That is, a bank, building society or credit union.
- 27 For example, an insurance company or superannuation fund.
- 28 This list reflects amendments made by the House of Representatives to section 920A on June 28 2001.
- 29 The regulations may be employed to add to this list. Paragraph 911A(2)(K) provides that the provision of a service may be exempted by regulation. ASIC also has the power to exempt a service under paragraph 911A(2)(I). Amendments made by the House of Representatives to the Bill will allow exemptions made under these paragraphs to be subject to conditions.
- 30 Australian Consumers' Association, Submission to the Parliamentary Joint Statutory Committee on Corporations and Securities, May 2001, pp 10-11.
http://www.aph.gov.au/senate/committee/corp_sec_ctte/fin_services/44%20Australian%20Consumers'%20Association.pdf
- 31 This exemption does not authorise the conduct of solicitor's mortgage schemes.
- 32 See ASIC Policy Statement 119, 'Investment advisory services: merely incidental investment advice by solicitors and accountants'
- 33 Law Institute of Victoria, Submission to the Parliamentary Joint Committee on Corporations and Securities, 7 May 2001. The submission is located at the following link:
http://www.aph.gov.au/senate/committee/corp_sec_ctte/fin_services/07A%20Law%20Institute%20Victoria.pdf

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- 34 Commercial Law Firms, Submission to the Parliamentary Joint Committee on Corporations and Securities, 18 June 2001. The submission is located at the following link:
http://www.aph.gov.au/senate/committee/corp_sec_ctte/fin_services/87%20Commercial%20Law%20Firms.pdf
- 35 See ASIC FSRB Policy Proposal Paper No.1 'Licensing: The scope of the licensing regime: Financial product advice and dealing', p. 15. The paper is located at:
<http://www.asic.gov.au/pdf/fsr1advdeal.pdf>
- 36 pp cit n.33 at page 2.
- 37 Freehills, Submission to the Joint Committee on Corporations and Securities, May 11 2001, p.4 . The submission may found at the following link:
http://www.aph.gov.au/senate/committee/corp_sec_ctte/fin_services/54%20Freehills.pdf.
Freehills has suggested that section 911A(2) should be amended to exempt "a person who provides financial services in the person's capacity as trustee of a standard employer-sponsored fund (within the meaning of SIS) that is not a public offer superannuation fund (with the meaning of SIS).
- 38 Hon. Joe Hockey MP, 'Backing Australia's ability with the Financial Services Reform Bill 2001', Speech to the Committee for the Economic Development of Australia, 3 July 2001.
- 39 *ibid.*
- 40 ASIC has clarified the operation of this section in its Policy Statement No.118: Investment advisory services: media, computer software and Internet advice, Updated January 2000.
- 41 See ASIC FSRB Policy Proposal Paper No.1 *Licensing: The scope of the licensing regime: Financial product advice and dealing*, pp 51-56. The paper may be found at:
<http://www.asic.gov.au/pdf/fsr1advdeal.pdf>
- 42 Ms Vroombout, Joint Statutory Committee on Corporations and Securities, *Hansard*, June 27 2001, pp269-270.
- 43 *ibid.*
- 44 Product disclosure is dealt with by proposed Part 7.9
- 45 p.31.
- 46 In its original form, the Bill provided wealth thresholds of \$2.5 million in net assets or income of at least \$250 000. The Bill was amended in the House of Representatives on June 28 to provide greater flexibility to update these thresholds by regulation.
- 47 Other products may be exempted by regulations.
- 48 Senator Conroy, Address to Clayton Utz Breakfast on the Financial Services Reform Bill, 10 May 2001.
- 49 Joint Statutory Committee on Corporations and Securities, *Report on the Draft Financial Services Reform Bill*, August 2000, p.22,29. The Report is located at the following link:
http://www.aph.gov.au/senate/committee/corp_sec_ctte/clerp6/financial.pdf

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- 50 Government Response to the Joint Statutory Committee on Corporations and Securities Report on the Draft Financial Services Reform Bill, 29 March 2001, p.4.
- 51 Proposed subsection 1012D(4).
- 52 Proposed subsection 1012E.
- 53 Disclosure obligations also apply to unlisted entities under Part 7.11.
- 54 Joe Longo, 'Market Misconduct and the Financial Services Reform Bill 2001', Paper presented to Centre for Corporate Law and Securities Regulation, July 2001.
- 55 ASIC has recently had cause to investigate the disclosure practices of companies such as Coles Myer, AMP, Brambles and Austrim.
- 56 Mr Knott's speech may be found at the following link:
http://www.asic.gov.au/pdf/AIRA_launch_speech.pdf
- 57 Companies and Securities Advisory Committee, *Report on Continuous Disclosure*, November 1996, pp 42-43.
- 58 The Hon. Joe Hockey, House of Representatives, *Hansard*, 28 June 2001, p. 28965.
- 59 p.184
- 60 John Breusch, 'Industry slams plan to tape takeover talks', *Australian Financial Review*, 18 June 2001.
- 61 The Hon. Joe Hockey MP, House of Representatives, *Hansard*, 28 June 2001, p27298.

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