SECURITIES & DERIVATIVES INDUSTRY ASSOCIATION

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31 July 2009

Dr Shona Batge
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of The Senate
Parliament House
CANBERRA ACT 2600

By email: corporations.joint@aph.gov.au

Dear Dr Batge

Inquiry into financial products and services

The Securities & Derivatives Industry Association, as the peak industry body representing wholesale and retail stockbrokers and investment banks in Australia, would like to make the following submission to the Committee in order to assist its Inquiry into financial products and services.

We are grateful for the opportunity to raise these issues with the Committee, and would be happy to discuss our submissions further at the Committee's Hearing on this Inquiry.

Yours sincerely,

David Horsfield MSDIA
Managing Director/CEO

ABOUT SDIA: The Securities & Derivatives Industry Association is the peak body representing the interests of wholesale and retail market participants in Australia. SDIA was formed in 1999 at the time of the demutualisation of the Australian Stock Exchange. Currently we have 66 member organisations, which account for some $4bn worth of trading daily on the ASX, which is approximately 98% of the market by value. In addition we have over 1300 individual members and are working to build the profession of stockbroking. Our member firms employ in excess of 25,000 people.

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Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into financial products and services

Submission

31 July 2009

Introduction

Events in financial services and the financial markets in 2008 were a stark demonstration of the local effects of the global financial crisis. SDIA is very supportive of the Committee's inquiry into some of the more dramatic and disastrous events which occurred in Australia. Whilst we are not in a position to make specific comments on the affairs of the companies mentioned in the Terms of Reference which are the subject of ongoing regulatory inquiries and/or action, we would like to comment in turn generally on the issues raised in the Terms of Reference, namely:

1. the role of **financial advisers**;
2. the **general regulatory environment** for these products and services;
3. the role played by **commission arrangements** relating to product sales and advice, including the potential for **conflicts of interest**, the need for appropriate **disclosure**, and **remuneration models** for financial advisers;
4. the role played by **marketing and advertising** campaigns;
5. the adequacy of **licensing arrangements** for those who sold the products and services;
6. the appropriateness of **information and advice** provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. **consumer education** and understanding of these financial products and services;
8. the adequacy of **professional indemnity insurance arrangements** for those who sold the products and services, and the impact on consumers;
9. the need for **any legislative or regulatory change**; and
10. the involvement of the banking and finance industry in providing **finance** for investors in and through *Storm Financial*, *Opes Prime* and other similar businesses, and the practices of banks and other financial institutions in relation to **margin lending** associated with those businesses (No.10 added 16/3/09).

1. The Role of Financial Advisers

Licensed financial advisers, including stockbrokers, are already subject to a raft of requirements particularly in relation to retail clients, including:

- training
- suitability of advice[1]
- disclosure of interests[2]
- complaints handling, and
- compensation.

These requirements are either made conditions on licences, or are provisions of the *Corporations Act*. The *Financial Services Reform* (**FSR**) program created a new offence from 2004 of giving **unsuitable advice** along with the offence - which already existed - of failing to **disclose interests** that could influence advice.

Firms are subject to capital adequacy requirements, and our Members who are ASX Participants are subject to further requirements under the ASX operating rules, including enhanced capital adequacy and dealing, manipulation and orderly market rules. From April 2008 the ASX enforcement regime has included maximum fines of $1,000,000 (plus GST).

A perceived gap has been the regulation of **margin lending**. However, this is now being addressed by reforms in the area of consumer credit[3], which will make margin lending a financial product under the *Corporations Act*, and subject to all the requirements which apply to any other financial product under the *Act.*

2. The General Regulatory Environment for these Products and Services

The *Campbell Committee* (1981) and the Financial System Inquiry (*Wallis Committee*) 1996 were the most recent comprehensive reviews of financial services and products regulation in Australia.

The *Wallis Committee* reported in 1997[4], and some of its key recommendations included:

- *Regulatory structure*: Corporations Law, market integrity and consumer protection should be combined in a single agency, which led to the establishment of ASIC in 1998
- *Product Disclosure:* requirements should be effective, consistent and comparable
- *Licensing:* a single licensing regime should be introduced for financial sales advice and dealing. A single set of requirements should be introduced for financial sales and advice which include:
    - Minimum standards of competency and ethical behaviour

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[1] Reasonable basis for Advice: S945A(1), S945B (Retail Clients only)
"Know your client/know your product rule", i.e.

- must assess client's personal circumstances
- must properly research financial products the subject of advice &
- must ensure the advice is suitable for the client

Must warn client if advice is based on incomplete information from the client.
Penalties: Failure to have reasonable basis for advice: $22,000 fine/5yrs or both. Failure to warn client if advice based on incomplete personal circumstances: $22,000 fine/5yrs or both

[2] Disclosure of Interests: s946B(6), s947B(2)(d)&(e), 947C(2)(d)&(e)
Advice (& Statements of Advice) must include information about:

> (i) any other **interests**, whether pecuniary or not and whether direct or indirect, of the broker or of any associate; and
> (ii) any **associations or relationships** between the broker or any associate and the issuers of any financial products;

that might reasonably be expected to be or have been capable of influencing the adviser in providing the advice.
Penalties: Failure to disclose interests: $550 fine. Failure to warn client if advice is general advice: $11,000 fine/2yrs or both

[3] *National Consumer Credit Protection Bill* 2009

[4] *Financial System Inquiry - Final Report* Commonwealth of Australia March 1997

- 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;

The Financial System Inquiry was a thorough review of financial products and services and resulted in the *Financial Services Reform Act* which made significant reforms to the *Corporations Act*. The FSR changes came into effect in March 2004. Since then, there has followed a period of significant refinements and amendments, in areas such as product disclosure and advice. These changes lead to changes in the way licensees do business, and often result in costly technology, training and process upgrades.

FSR made important structural reforms to financial services, giving far more rights and protection to consumers and more power to ASIC. Its implementation has been costly and burdensome for financial services providers.

If the Government were now to consider wholesale changes to financial services, bearing in mind the long and expensive implementation of FSR, it is important that such changes are made for the right reasons, and that their consequences are fully thought-out. The right reasons do not necessarily include responding to a relatively small group of investors who have suffered loss, when the proper legal and regulatory responses are already in train. They also do not include adopting changes implemented overseas[5].

Accordingly, SDIA does not see the need for further structural or other significant reform in this area. All the significant issues have been addressed in FSR. Any further reform on this scale would risk overregulation and would inevitably lead to unforeseen consequences which would then need to be further addressed.

3. The Role played by Commission arrangements relating to Product Sales and Advice, including the potential for Conflicts of Interest, the need for appropriate Disclosure, and Remuneration models for financial advisers

Without commenting on the part played by financial planners, stockbroking is conducted normally in a fully-disclosed environment, with brokerage or other fees earned directly from the client, not built into arrangements with issuers.

It is important to distinguish between commissions paid by the client to the adviser directly, and those arrangements where commissions are paid by product issuers to the adviser. Where the latter arrangements with issuers do exist, and could reasonably influence advice to clients as a result, then the law already requires them to be disclosed to the client at the time that the advice is given[6].

Offshore Developments

Recently, regulators in the UK and US have announced changes designed to remove the influence of commissions paid by product issuers on advice that is given to retail investors.

As a result of its *Retail Distribution Review*, the UK Financial Services Authority has announced a range of measures, including the prohibition of commission paid by product issuers to advisers from 2012[7].

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[5] See also, No.3 below

[6] *Corporations Act* s946B(6), s947B(2)(d)&(e), 947C(2)(d)&(e), discussed at No.1 above

[7] *Financial Services Authority details enhanced standards people can expect from all investment advisers* FSA Release 082/2009 25 June 2009

The US Government has also announced measures which could lead to the abolition of commissions by product issuers. Under the measures, the Securities and Exchange Commission will be given the power to ban remuneration practices that it deems "inappropriate".

The Parliamentary Joint Committee will no doubt pay careful attention to these offshore developments. However, it is worth noting that Australia already addressed this issue by requiring disclosure. Coupled with the disclosure requirements in the *Act* noted above, is the requirement of licensees to manage conflicts of interest[8]. ASIC has provided guidance on how the requirement can be met by proper disclosure[9], and has significant powers to take licensing or criminal action where misconduct is detected.

Many will no doubt advocate to the Committee the adoption of a prohibition approach in this area, such as being adopted overseas. However, before throwing-out the existing Australian regime - which is in many ways more advanced than those offshore - there needs to be shown that there would be demonstrable benefits for the investing public in general as a result, not just to the small number of investors who have suffered recent loss. The worst thing that could happen would be a knee-jerk reaction to the collapse of these two companies, which ignores the thousands of other licensees whose conduct is not in question.

4. The Role played by Marketing and Advertising Campaigns

We may have seen the marketing of products more appropriate to the wholesale market. The new regulation of margin and scrip lending will considerably address any deficiencies here.

5. The Adequacy of Licensing Arrangements for those who sold the Products and Services

Provisions in the *Act* and in the *ASIC Act* already prohibit misleading, deceptive, dishonest and/or unconscionable conduct by financial services licensees and their representatives.

Where breaches or misconduct is detected, ASIC can under existing law ban individuals, suspend or revoke licences, or launch (with the DPP) criminal prosecutions.

Use of the term *stockbroker*

One area of weakness in licensing arrangements is the use of the term ***'stockbroker'***. The law already limits the use of the term to market participants or authorised representatives of market participants authorised by ASIC to do so[10]. However, we have seen a number of occasions in

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[8] *Corporations Act* s912A(1)(aa)

[9] ASIC Regulatory Guide 175 *Licensing: Financial product advisers — conduct and disclosure*; Regulatory Guide 181 *Licensing: Managing conflicts of interest*

[10] *Corporations Act* s923B

(1) A person contravenes this subsection if:

(a) the person carries on a financial services business or provides a financial service (whether or not on behalf of another person); and

(b) the person assumes or uses, in this jurisdiction, a restricted word or expression in relation to that business or service; and

(c) the person is not authorised, by the conditions on an Australian financial services licence held by the person, or by a person in relation to whom they are a representative, to assume or use that word or expression (see subsection (3)).

(2) If a person assumes or uses a word or expression in circumstances that give rise to the person committing an offence based on subsection (1), the person is guilty of such an offence…

(3) ASIC can only impose a condition on an Australian financial services licence authorising a person to assume or use a restricted word or expression in these circumstances:

(a) in the case of a word or expression covered by subparagraph (4)(a)(i)--if the person:

(i) can, under the licence, provide a financial service relating to securities (whether or not the person can provide other financial services under the licence as well); and

recent years where people call themselves *stockbrokers* who are not properly authorised to do so. *Stockbroker* is a professional term. Its misuse can lead to confusion in investors, who may be misled into thinking that they are dealing with someone of a certain standing. In order to call themselves stockbrokers, advisers should be properly qualified to do so. Accordingly, they should have to satisfy professional standards set by the appropriate body in excess of the minimum required by law.

6. The Appropriateness of Information and Advice provided to Consumers considering investing in those Products and Services, and how the Interests of Consumers can best be served

It is difficult to comment on the information or advice given to consumers by the companies mentioned in the Terms of Reference. However, generally it appears that there is and has always been a gap between the disclosure documents (particularly Product Disclosure Statements and Statements of Advice) prescribed by the *Act*, and the proper understanding of consumers. For example, decisions of the **Financial Ombudsman's Service** and its predecessors often note that while all the proper documentation was given to complainants, the documents do not amount to a rebuttal to a claim against the adviser that bad advice was given to a complainant.

7. Consumer Education and Understanding of these Financial Products and Services

Following-on from the comments made about consumer understanding in 6. above, perhaps financial services licensees could do more to ensure that clients understand the documents that they are given. However, licensees ought to be able to assume a basic understanding on the part of a consumer.

The authorities and educators could do more to increase consumers' financial understanding. ASIC has recently assumed the functions of the **Financial Literacy Foundation**, and it is hoped that it will continue the Foundation's good work, particularly in financial education at the secondary school level.

The SDIA also offers introductory courses for investors and market participants in securities and derivatives, as well as its flagship diploma level qualification, the *SDIA Professional Diploma in Securities and Derivatives*.

8. The Adequacy of Professional Indemnity Insurance Arrangements for those who sold the Products and Services, and the Impact on Consumers

In the absence of a Government-sponsored compensation fund, professional indemnity insurance is the best and most equitable method of ensuring consumers are adequately compensated for breaches of the financial services laws. If a Government fund were to be established (or even one financed by industry contributions), the danger of 'moral hazard' would inevitably arise, where those guilty of misconduct are able to escape the consequences.

(ii) is a participant in a licensed market whose licence covers dealings in securities;
…
(4) In this section:
(a) a reference to a restricted word or expression is a reference to:
(i) the expression stockbroker or sharebroker , or any other word or expression (whether or not in English) that is of like import to that expression; or …

9. The Need for any Legislative or Regulatory Change

We see no need for substantive legislative, structural or regulatory change. As mentioned above[11] Australia already has a rigorous regime in place for the regulation of financial products and services, backed-up by criminal sanctions in some areas, for example suitability of advice.

Much of the answer lies in the enforcement of the existing provisions, not in the enactment of new ones.

10. The Involvement of the Banking and Finance Industry in Providing Finance for Investors in and through *Storm Financial*, *Opes Prime* and Other Similar Businesses, and the Practices of Banks and Other Financial Institutions in Relation to Margin Lending associated with those Businesses (No.10 added 16/3/09).

It is difficult to comment on the provision of finance to consumers by the companies mentioned in the Terms of Reference, especially where investigations, regulatory and legal action are not concluded. However, it is noted that the new consumer credit legislation is specifically designed to cover margin lending and scrip lending arrangements such as were offered by the two companies mentioned.

Conclusion

It is difficult and perhaps premature to comment on the activities of the two companies mentioned in the Terms of Reference, especially where investigations and regulatory and legal action are ongoing. The new consumer credit legislation is specifically designed to cover margin lending and scrip lending arrangements such as were offered by the two companies mentioned.

We see no need for urgent or substantive reform to the regulation of financial services in this country.

Australia already has a strong regulatory regime applying to the provision of financial services and products, including the giving of financial advice to retail consumers. Much of the answer lies in the **enforcement of the existing provisions**, not in the enactment of new ones.

Securities & Derivatives Industry Association
31 July 2009

[11] See No.1&2