

Financial Products, Service Providers and Markets — An Integrated Framework

A consultation paper, Financial Products, Service Providers and Markets — An Integrated Framework¹ (known as CLERP 6), was released on 3 March 1999 by the Minister for Financial Services and Regulation, the Hon Joe Hockey MP. The consultation paper builds on the reforms proposed by the Government in the position paper of December 1997 entitled Financial Markets and Investment Products.

The aims of CLERP 6, in general terms, are to build a more flexible and responsive regulatory framework for financial services and to facilitate the financial services industry's adaptation to the changing domestic and international environment.

This article outlines the proposals contained in the consultation paper, their origins and rationale, and plans for their implementation.

OVERVIEW OF THE CORPORATE LAW ECONOMIC REFORM PROGRAM

In March 1997, the Treasurer announced the Corporate Law Economic Reform Program (CLERP) involving a fundamental review of key areas of regulation which affect business and financial activity. The broad objective of the Program is to ensure that business regulation is consistent with promoting a strong and vibrant economy and provides a framework which assists business in adapting to change.

It involves a stronger focus on the effect of regulation on financial markets and the economy as a whole in order to establish a more favourable climate for both investors and business.

The key principles guiding the Program are:

- market freedom;
- investor protection;
- information transparency;

¹ The consultation paper is available on the Treasury Website and from AusInfo Bookshops.

- cost effectiveness;
- regulatory neutrality and flexibility; and
- appropriate corporate behaviour and swift enforcement.

Substantial progress has been made under the Program with the introduction into the Parliament of the Corporate Law Economic Reform Program Bill in December 1998. That Bill proposes wide-ranging changes to the Corporations Law in relation to fundraising, takeovers, corporate governance and accounting standards.

CLERP proposals on electronic commerce have also been implemented by:

- the *Payment Systems and Netting Act 1998*, which recognises market netting practices; and
- the *Company Law Review Act 1998* and the Corporate Law Economic Reform Program Bill, which address the remaining electronic commerce reforms relating to the Corporations Law.

CLERP also proposed a more efficient and flexible regime for financial markets and products through the development of an integrated regulatory framework for all financial products. These reforms form the basis of CLERP 6.

A consultation paper on a further area of reform, to reduce the paper compliance burden of Australian companies and enable the Australian Securities and Investments Commission (ASIC) to make greater use of communications technology, is expected to be issued by the end of June 1999.²

THE CLERP 6 PROPOSALS

Origins

The origins of CLERP 6 are various, but contain a common theme of harmonisation.

In October 1996, a paper on the interchangeability of financial instruments was released by the Treasury. That paper focussed on the blurring of distinctions between securities and derivatives and recommended similar treatment for both under the Corporations Law.³

In March 1997 the Financial System Inquiry (the Wallis Committee) came to a similar, but more broadly based conclusion. It recommended, in relation to all financial products, that there should be a single licensing regime in relation to

² CLERP 7.

³ Treasury, Paper on Regulation of Securities and Derivatives, October 1996.

all financial sales, advice and dealing, and a consistent comparable financial product disclosure regime.⁴

The Companies and Securities Advisory Committee has also done extensive work in relation to derivatives. It concluded, in its June 1997 Final Report, that the regulation of securities and derivatives should be harmonised.⁵

The Insurance and Superannuation Commissioner and ASIC have also worked to harmonise the conduct and disclosure obligations of securities dealers and investment advisers under the Corporations Law with life insurance intermediaries under the Life Insurance Code of Practice. The achievements of the regulators were limited by the differing legislative frameworks in which each operated.

The consultation paper

An initial CLERP 6 position paper on Financial Markets and Investment Products was released for public comment on 19 December 1997.

The proposals in that paper have now been fleshed out, taking account of the comments received, in the latest consultation paper, *Financial Products, Service Providers and Markets — An Integrated Framework*. Public comments have been sought on the consultation paper.

Broadly, it contains proposals for the uniform regulation of all financial products (including securities, derivatives, superannuation, life and general insurance, bank deposit products and foreign exchange), a harmonised regime for the licensing of financial markets, clearing and settlement facilities and financial service providers, and uniform disclosure requirements.

The need for reform and objectives of CLERP 6

For the most part, the CLERP 6 proposals do not involve regulating areas that are not already subject to some form of regulation, whether legislative, by administrative statement or through an industry code. However, the proposals harmonise that existing regulation into a single framework and extend it to a limited range of related products which were previously not subject to specific issuer and product disclosure requirements.

The drivers for these wide-ranging reforms are:

- the significant changes in the financial services industry — an explosion of financial products, driven in part by consumer demand but also by

4 Final Report of the Financial System Inquiry, March 1997.

5 Companies and Securities Advisory Committee, Final Report, Regulation of On-exchange and OTC Derivatives Markets, June 1997.

technological developments and globalisation, as well as the increasing competitiveness of the financial services industry and the blurring of boundaries between institutions; and

- the piecemeal and varied regulation applying to different products and intermediaries, with securities dealers licensed under one set of provisions and futures brokers, insurance brokers and foreign exchange dealers under others. The requirements under each regime vary, leading to regulatory arbitrage and increased compliance costs and limiting opportunities for competition.

It is clear that the law has not kept pace with the changes that have occurred in the types of financial products which are available and their distribution, and does not contain mechanisms which would allow it to remain relevant as future developments occur.

The objectives of CLERP 6 are thus:

- to remove unnecessary distinctions between financial products;
- to increase competition through having a competitively neutral regulatory regime;
- to facilitate product innovation;
- to reduce compliance costs; and
- to ensure consistent consumer protection.

By pulling together the existing body of regulation, it is envisaged that:

- consumers will benefit by receiving consistent, comparable disclosure in relation to all financial products and by knowing that all financial service providers will be required to meet the same basic standards of competence, dispute resolution and disclosure; and
- financial service providers will benefit in that they will only need one licence to undertake a range of financial service activities and will be subject to a single set of conduct and disclosure obligations. Thus, if a person wishes to deal in a range of financial products only one licence, not multiple licences, will be required.

Key areas of reform

The key areas of reform are:

- the disclosure which will be required to be made in relation to financial products;
- a single licensing, conduct and disclosure regime for financial service providers; and

- bringing all financial product markets and clearing and settlement facilities within a single licensing regime.

The definition of financial product

At the crux of the proposals is the definition of ‘financial product’. This needs to be flexible enough to cover future developments in the financial services industry and, for this reason, the proposal includes a broad functional definition which encompasses:

- making a financial investment;
- managing a financial risk;
- obtaining credit; and
- obtaining or receiving a means of payment.

The implementing legislation will also include lists of:

- specific inclusions, such as securities and derivatives, general and life insurance, superannuation and retirement savings accounts, deposit accounts, credit outside the Uniform Consumer Credit Code, foreign exchange and electronic cash; and
- specific exclusions, such as contracts of insurance entered into by a registered health benefits organisation in respect of a business regulated under the *National Health Act 1953*, interests in retirement village schemes and credit contracts to which the Uniform Consumer Credit Code applies.

There will also be scope to take products out of the definition of ‘financial product’ (and hence out of this regime) through regulations or through the use of an ASIC exemption power.

Product disclosure

The consultation paper proposes a uniform regime for disclosure in relation to all financial products incorporating:

- point of sale disclosure;
- periodic reporting requirements; and
- ongoing disclosure of material matters.

The aims of the disclosure regime are:

- to ensure that consumers receive better targeted information — disclosure documents have been criticised for being too long and providing a mass of confusing data;
- to promote comparability between different financial products; and

- to provide a set of requirements which are adaptable and apply across a range of products; while
- not placing undue burdens on the financial services industry.

Point of sale requirements

There is considerable debate about what information consumers need to make informed decisions about financial products. At one end of the spectrum is a requirement for all the information a consumer and their professional adviser would reasonably require to make an informed assessment — such an approach requires the issuer to undertake a due diligence exercise. At the other end is a focussed disclosure approach under which the product issuer is required to disclose information about specific matters.

Given this debate, the consultation paper outlines, and seeks comments on, two alternative approaches:

- Alternative A would impose a focussed approach in relation to the issue of all financial products other than securities (which would remain subject to the prospectus provisions of the Corporations Law).
- Alternative B would subject superannuation and the investment component of life insurance to the prospectus provisions of the Corporations Law, just as managed investments currently are, while other financial products would be subject to the specific items requirement referred to in Alternative A.
 - Alternative B seeks to address concerns that superannuation and the investment component of life insurance products are so closely related to managed investments and are used interchangeably by consumers that they should be subject to the same disclosure regime.
 - Those products which are less directly competitive with managed investments, superannuation and the investment component of life insurance, would be subject to the focussed approach of Alternative A.

Periodic disclosure and ongoing disclosure of material matters

Having purchased a financial product, a consumer needs further information to assess whether to keep the product, add to it or renew it.

The paper proposes that this information be delivered in two ways:

- periodic disclosure — in relation to investment products (not risk products), product issuers will be required to provide clients with information about returns on those investments, at least annually;

- in the case of banks, building societies and credit unions, it is envisaged that this obligation would be satisfied by the periodic statements currently issued; and
- ongoing disclosure — there will be an obligation on the product issuer to disclose significant events or material matters relevant to information contained in the financial product information statement.

Licensing of financial service providers

Any person (whether a natural person or a body corporate) who carries on a financial services business will need to obtain a financial service provider's licence. The licence may cover all financial services in relation to all financial products, or a subset of services and products.

This licence will replace the licensing and registration requirements currently applying to securities dealers, investment advisers, futures advisers and brokers, general and life insurance brokers and foreign exchange dealers. For service providers offering a range of products, a single licence will replace the current requirement for multiple licences. The proposals should, therefore, reduce regulatory arbitrage, encourage competition and reduce compliance costs.

The regime will be modelled on the Corporations Law, with principals rather than agents being licensed. Such an approach ensures that government resources available for regulating service providers are most effectively targeted and that principals appropriately bear the cost of training, supervising and controlling their agents and employees.

A person provides financial services when they:

- provide advice;
- deal in a financial product;
 - this includes a product issuer selling its own products or an intermediary entering into, acquiring, disposing, underwriting, applying or issuing a product on behalf of another person;
- make a market for a financial product;
- operate a registered managed investment scheme; or
- provide a custodial or depository service.

However, only those who carry on a financial services business will be required to be licensed. Carrying on of a financial services business involves elements of system, repetition and continuity. It will therefore not encompass one-off transactions.

Licence criteria and obligations

Under the new regime, ASIC will grant a financial service provider's licence where an applicant satisfies a prescribed set of criteria. The criteria will be flexible to take account of the activities the applicant wishes to engage in. For example, the application of criteria such as adequate financial resources should take account of the activities the licensee proposes to undertake. A more stringent standard would apply to a licensee who holds client funds or accepts counter-party risk than a licensee who only provides advice on insurance products.

ASIC will need to be satisfied that the applicant:

- has appropriate financial resources and internal controls;
- has relevant competence, skill and experience;
- will discharge the obligations of a licensee in an efficient, honest and fair manner;
- has adequate systems in place for the training and supervision of its representatives; and
- can demonstrate ongoing compliance with the law.

These criteria will apply to all potential licensees — whether they intend to deal with retail or wholesale clients.

Where a financial service provider offers its services to retail clients, it will also be required to:

- have adequate arrangements for compensating clients for losses suffered;
 - this could take the form of professional indemnity insurance, membership of an approved fidelity fund or any other arrangement approved by ASIC;
- have adequate internal dispute resolution procedures and be party to an external dispute resolution mechanism; and
- actively monitor and supervise its authorised representatives to ensure their compliance with conduct and disclosure requirements.

Authorised representatives

Any person (whether a natural person or a body corporate) who acts for a licensee in carrying on a financial services business will need to be authorised. This includes both agents and employees where they do such things as provide advice, deal in products and arrange contracts.

Persons who solely perform administrative functions, such as answering routine administrative queries and collecting money, will not need to be authorised as representatives.

The proposals seek to facilitate a range of business structures, while ensuring adequate consumer protection, by allowing:

- corporate representatives, subject to controls to enable supervision; and
- representatives to act for more than one principal with the consent of other principals.

Financial service provider conduct and disclosure

Financial service providers (whether a licensee or an authorised representative) who provide services to retail clients will be required to meet minimum conduct and disclosure standards.

The Financial Services Guide

The first obligation will be for a service provider to give a retail client a Financial Services Guide (FSG).

The purpose of the FSG is to ensure that retail clients receive key information about the type of services being offered by a financial service provider. The FSG should enable the client to identify:

- who is offering the service (both the natural person with whom the client is engaging and, where relevant, the licensee who is responsible for that person's conduct);
- any associations the licensee and/or authorised representative may have with a product issuer;
- the nature of the service being offered;
- fees and charges applying to the service; and
- avenues for redress that the client may pursue if the services provided are not satisfactory.

Suitability requirements

Where a financial service provider gives a client advice, they will be subject to a suitability or 'know your client' rule. This will require that the service provider have a reasonable basis for making a recommendation and ensure that advice provided to a client is appropriate to the client's needs.

To satisfy the suitability requirement, a financial service provider who provides personal advice to a retail client will have to:

- conduct a needs analysis and make reasonable inquiries of the client to ascertain the client's financial needs and objectives, and financial circumstances.
 - The level of inquiry and analysis will vary from situation to situation. For example, if a client is only interested in obtaining

motor vehicle insurance a less detailed analysis would need to be conducted compared with a client who is seeking a full financial plan.

- identify a product or products which would potentially satisfy the client's needs;
- assess the suitability of the identified products against information obtained as part of the needs analysis; and
- provide a record of the advice including a recommendation based on that assessment.

Wholesale/retail clients and opting up

The consultation paper incorporates a distinction between a retail client and a wholesale client.⁶

The purpose of the distinction is to ensure that the consumer protection components of the regime are appropriately targeted and that wholesale markets are not unduly burdened.

However, a retail client can opt to be treated as a wholesale client thereby potentially losing the benefit of a number of consumer protection requirements. The reason for including this mechanism is to provide some flexibility in the regime, to allow retail clients to access wholesale markets that they might not otherwise be able to access, and to allow sophisticated and regular participants in the financial system the flexibility to determine the level and type of disclosure and reporting that meets their needs.

Transitional arrangements

To ensure a smooth transition with minimal disruption to existing businesses, the consultation paper proposes that existing licensees and registrants will have a two year transition period to obtain a licence under the new regime.

Industry Codes of Conduct

The Government is committed to supporting and fostering industry-based codes of conduct developed between industry and consumer groups and designed to guarantee the delivery of quality services to consumers.

Under the new regime, existing codes of conduct will have a continuing role in the new regulatory framework and industry sectors will be encouraged to modify their codes in the light of the new framework and to develop new codes.

6 'Retail client' is defined in the Dictionary of the consultation paper (at page 147); other clients are 'wholesale clients'.

The role of codes of conduct will be to establish best practice standards for meeting the requirements of the Law. In addition, codes that establish best practice in areas not covered by the Law may be developed. However, it will not be mandatory for an industry participant to be party to a code.

ASIC will have power to approve a code as being consistent with the Law and should be consulted in the development or modification of codes of conduct. In exercising its powers, ASIC will be required to take account of the benefit of having codes of conduct harmonised to the greatest extent possible to reflect the regulation of the financial services industry.

At the same time, however, where codes govern activities not covered by the regulatory framework, or where codes provide detail about how to meet regulatory requirements, the different characteristics of particular financial products or activities should be recognised.

While ASIC will be empowered to approve codes, they should largely be administered by the industry.

The objective of the Government's approach to codes is to provide flexibility to industry participants and foster an environment whereby industry works co-operatively with the regulator and consumer associations to establish best practice.

Financial product markets

In general terms, the proposal involves:

- reducing the seven categories of markets which the Corporations Law currently provides to a single classification of 'financial product markets'; and
- applying the provisions to markets in all financial products.

This means that there will no longer be a distinction between securities exchanges and futures exchanges in the Law.

Existing approved exchanges will not need to seek a new licence, but will have to comply with the new obligations.

What is a financial product market?

The starting point of the definition of financial product market is the definition of 'stock market' in section 9 of the Corporations Law. In brief, a licence will be required to operate a facility where offers to buy, sell or exchange financial products are regularly made or accepted. The proposal requires multiple buyers and sellers and an operator before it is regulated as a market.

The definition will, in addition, encompass information services in limited circumstances.

At this stage, it is likely that the provisions will only affect markets in securities and derivatives. However, the provisions will be drafted so that they can apply to a market in any other financial product, when they develop.

Criteria for approval as a financial product market

As is currently the case in the Corporations Law, it will be the Commonwealth Minister who can approve an application for a licence as the operator of a particular financial product market.

The criteria will be broadly expressed and flexible. They centre on:

- adequate supervision;
- sufficient resources;
- adequate rules or procedures; and
- if retail investors participate, adequate protection (and this, in the paper, focuses on compensation arrangements).

An overseas financial product market which is subject to a comparable regime and satisfies certain other criteria (eg that adequate arrangements exist for co-operation between the regulator in the home jurisdiction and ASIC) can be approved to operate in Australia without separately meeting the Australian licence criteria.

Self-regulatory role

The role of the markets themselves as self-regulating organisations and front-line regulators will remain.

The Minister, however, is provided with certain powers in relation to market operations which are generally comparable to those included in the Law at present. He may, for example, require special reports by the market on the extent to which it is complying with the ongoing requirements. He can also require an audit of the effectiveness of the self-regulatory organisation's supervision arrangements, impose additional conditions on a licence or amend existing ones.

ASIC's role, also, will not change significantly. While it will have a power to prohibit trading in financial products, both the power and the safeguards are comparable to the provisions currently included in the Corporations Law.

Generally, it appears desirable to clarify in the legislation the roles of markets as front-line regulators, ASIC and the Minister. For this reason:

- the criteria for the disallowance of operating rules will be included in the Law;
- ASIC's charter is to be amended to require it to strive to facilitate efficiency, innovation and growth of financial markets while maintaining regulatory neutrality, market integrity and investor confidence; and

- ASIC will also be required to recognise the role of self-regulatory organisations in operating financial markets.

Licensing of clearing and settlement facilities.

Currently, there is no comprehensive definition of a clearing and settlement facility in the Corporations Law.

Definition

What the consultation paper proposes is to include in the definition facilities which:

- compare data with a view to confirming transactions; or
- transfer the title to financial products; or
- provide mechanisms for parties to a financial product transaction to meet their obligations.

The facilities will only be subject to regulation under the proposal if the service is provided:

- in conjunction with transactions entered into on a financial product market; or
- systematically in relation to off-market trades.

The consultation paper proposes a similar regulatory structure as is proposed in relation to financial product markets.

Facilitating competition

The provisions relating to clearing and settlement facilities will not assume one market — one clearing and settlement facility. They will be drafted with an open mind — the clearing and settlement facility may be independent and provide services to participants on several markets or may only clear and settle off-market transactions. Its participants will not necessarily be subject to the rules of a market operator or regulated as financial service providers.

The intention is that the new legislative structure will facilitate competition. To complement this, prescribed bodies, in addition to the Securities Clearing House, will be able to transfer the legal title to securities electronically.

However, it is desirable that the one clearing and settlement facility not be subject to regulation both under the Corporations Law and by the Payments System Board. Therefore, the Minister will be able to transfer regulatory responsibility to the Payments System Board of facilities of sufficient importance to the payments system.

In relation to clearing and settlement facilities, there will be a two year transitional period for facilities which are required to be licensed while existing approved facilities will not have to seek a new licence.

Harmonising offences and enforcement

The various provisions about misleading and deceptive conduct, market offences and enforcement powers will be harmonised.

The market offences in the Corporations Law and similar offences in the other relevant legislation will also be harmonised. These offences include insider trading, market manipulation and the prohibition on fictitious or artificial transactions.

The penalties for breach of the market misconduct provisions will also be revisited. The outcome is likely to be a range of options for enforcement:

- civil penalties;
- criminal sanctions for conduct with the requisite mental element;
- compensation orders;
- disqualification orders; and
- disgorgement of profit.

As a result of the first stage of the Financial Sector Reform legislation, ASIC received a number of new functions but the powers in relation to them were scattered through a number of Acts. The powers differed, creating problems for ASIC as the regulator.

These powers are to be harmonised, based on the powers the Commission currently has under the *Australian Securities and Investments Commission Act 1989*.

THE NEXT STEPS

After the submissions received during the public consultation period are taken into account, draft legislation to implement the CLERP 6 proposals will be prepared for release for a further period of public consultation.

The aim is to introduce the necessary amending legislation before the end of 1999, with a view to it commencing on 1 July 2000. However, any timetable is necessarily tentative.