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Financial System Inquiry
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Dear Committee Members

Second round submission - the nature and quality of financial services regulation

We are writing in response to the Committee's invitation in the Interim Report to provide feedback on whether there are issues that are not addressed in the Interim Report which should be addressed in the Final Report.

The Interim Report addresses the 'regulatory burden' (at 3-91 to 3-97). As part of this, it deals with the 'volume of regulation' (at 3-96 to 3-97). However, the Interim Report does not address, directly, a very significant issue, being the nature and quality of financial services regulation. We submit that this is a priority issue which should be addressed in the Final Report. Any attempt to deal with the regulatory burden, without dealing with the sprawling nature and the poor quality of much of the regulation governing financial services, would be incomplete.

Our view that the nature and quality of financial services regulation demands attention and remedial action is not merely an expression of frustration by lawyers who have to work out what the regulations might mean. The Interim Report identifies 'a predictable rule of law' as a pre-requisite to a well-functioning financial system (at 1-1). The rule of law is undermined when regulation is unclear and inaccessible to those affected by it, as well as those who enforce it.

Two examples of what we would describe as bad quality law are:

- the rules governing financial product disclosure (see Part 7.9 of the Corporations Act); and
- the Future of Financial Advice provisions (see Part 7.7A of the Corporations Act).

We also:

- consider that directors of APRA-regulated institutions should not themselves be subject to duties which turn on the interests of 'APRA beneficiaries' (ie, depositors, policyholders and superannuation fund beneficiaries); and
- question the value of some of the guidance material prepared by the regulators.

Financial product disclosure

In our view, the rules that currently govern financial product disclosure should be repealed and replaced.

The Corporations Act, the Corporations Regulations and ASIC class orders contain literally hundreds of provisions which establish separate disclosure regimes for:

- superannuation products (other than a product that is solely a defined benefit product, solely a pension product or a risk-only superannuation product);
- simple managed investment schemes (other than 'quoted products', some 'stapled securities' and some investor-directed products);
- investor-directed portfolio services;
- investor-directed portfolio service-like schemes;
- other investment products, such as superannuation platforms, multi-funds and hedge funds, as well as risk products;
- margin loans;
- first home saver accounts; and
- short-form product disclosure statements.

The state of affairs represented by the disparate disclosure regimes identified above is both regrettable and unnecessary. We think the current system is irretrievably broken and that there is no real alternative to abolishing it and starting again. We provide support for our view later in this letter (see Section 1).

The Interim Report says 'it may be possible to remove some disclosure requirements where they have proven ineffective and adopt alternative approaches' (at 3-58). We agree. The Interim Report also says 'further attempts can be made to improve effective disclosure' (at 3–58). To the extent this implies that the disparate disclosure regimes identified above should be retained but modified further, we disagree profoundly. To a large degree the regimes identified above are the result of previous attempts made over many years to improve disclosure. There is no reason to think that further tinkering is likely to make a positive difference.

Future of Financial Advice

Turning to the Future of Financial Advice provisions, they are some of the poorest quality legislative provisions we have ever seen. In many respects they are very unclear. The limitations on the grandfathering of conflicted remuneration stand out as provisions which are very difficult to understand and apply and which produce outcomes that were clearly not intended. Again, we provide support for our view later in this letter (see Section 2).

We appreciate that there is unlikely to be any real appetite to revisit the FoFA provisions, at least in terms of the quality of the drafting, anytime soon. However, we do identify those provisions as an example of a problem – very poor quality law – which adds considerably to the regulatory burden for industry participants and regulators. The Senate Economic References Committee's report into the performance of ASIC recommended that ASIC be more willing to prosecute breaches of financial services regulation. This is very difficult when the law is so unclear.

Duties of directors of APRA-regulated institutions

In our view, for all APRA-regulated institutions (and for responsible entities of registered managed investment schemes) a director's primary duty should be to the institution itself. The duties owed by the institution to APRA beneficiaries (or scheme members) is a separate question. The point is that directors should not themselves have such duties. See Section 3 of this letter.

Regulator guidance

Finally, we do not agree with the unqualified statement in the Interim Report that 'guidance material produced by Regulators ... helps the regulated population comply with regulation' (at 3-96).

Not infrequently regulators have no sound basis in the law for their views. In some cases regulators, particularly ASIC, is asked to try to remedy problems in regulation through guidance and class orders. We are aware of many recent examples where ASIC has been asked by Treasury and Government to modify

legislation (that has only recently been enacted) by class order, and in other cases to attempt to do so by regulatory guidance. While class orders may provide welcome or needed relief, they add to the difficulty in applying the law and sometimes in even knowing what the law is. This difficulty is added to when regulatory guidance reflects what the regulator thinks the law should say, not what it does say. We provide support for our view in Section 4 of this letter.

This is not intended to be a criticism of all regulatory guidance. FAQs issued by both ASIC and APRA are a very effective means of allowing the regulators to provide practical assistance to industry. Not only can they be timely and to the point, but they can readily be changed or updated if, on further reflection or with the benefit of industry feedback, the regulator changes its mind about the correct response.

We now deal with each of these matters in more detail.

1 Financial product disclosure

1.1 To illustrate our view that the rules governing financial product disclosure are unclear and inaccessible, assume you would like to find out how to disclose fees and costs in a product disclosure statement for a MySuper product.

1.2 Going by the table of contents in the Corporations Act, you would start with the traditional PDS regime in Subdivision C ('Preparation and content of Product Disclosure Statements') of Division 2 of Part 7.9 of the Act. Unless you knew any better you would stop there - and be under the erroneous impression that you had found the right set of rules. However, assume you do know better and are aware of the provisions of Subdivision 4.2B ('Content of Product Disclosure Statement for superannuation product') of Division 4 of Part 7.9 of the Corporations Regulations. You would then know that, by virtue of regulation 7.9.11N ('Modification of Act--superannuation product'), Part 7.9 of the Act applies as set out in Part 5B ('Modifications for superannuation products to which Subdivision 4.2B of Division 4 of Part 7.9 applies') of Schedule 10A to the Corporations Regulations.

1.3 Turning to Part 5B of Schedule 10A, you would find that section 1013C(1) ('Product Disclosure Statement content requirements') of the Act applies (albeit in a modified form), that the rest of section 1013C applies (without modification), that sections 1013D ('Product Disclosure Statement content--main requirements') and 1013E ('General obligation to include other information that might influence a decision to acquire') are omitted but that section 1013F ('General limitations on extent to which information is required to be included') is not omitted (although whether anything turns on it not being omitted is another matter). In other words, you would work out that much of the traditional PDS regime does not apply but that some of it does (with or without modification).

1.4 Having established this and then having returned to Subdivision 4.2B of Division 4 of Part 7.9 of the Regulations, you would find out that the form and content requirements in Schedule 10D ('Form and content of Product Disclosure Statement--superannuation product to which Subdivision 4.2B of Division 4 of Part 7.9 applies') to the Corporations Regulations apply. Before turning to Schedule 10D, you would ponder a rather obscure regime for incorporating material into a PDS, contained in regulation 7.9.11P ('Requirements for references to incorporated information for superannuation product'). You would need to do that because some information about fees and costs must, indeed, be incorporated by reference.

1.5 Working through Schedule 10D you would find that you need to include in the PDS a section entitled 'Fees and costs', that you must include a prescribed fees and costs template and that you must fill in the template in accordance with Division 3 ('How to fill in the template') of Part 1 of Schedule 10 ('Disclosure of fees and other costs') to the Corporations Regulations, subject to modifications to the Schedule 10 rules set out in Schedule 10D. A worked example of fees and costs of the MySuper product must also be included in accordance with Divisions 5 and 6 of Schedule 10 (this time, thankfully, there are no modifications to the rules governing completion of the worked example).

1.6 You may think your task is at an end but, regrettably, it is not. You spot in Schedule 10D a requirement to 'apply, adopt or incorporate the definitions in relation to fees mentioned in section 29V of the SIS Act'. So, at this point you turn away from your work on the PDS to start your work on the incorporated material. In doing so you would count your blessings that the PDS does not also cover other investment options available in the superannuation fund because, if it did, you would have to incorporate by reference information about the fees and costs of those options and, in doing so, you would not use the template in Schedule 10D, you would use the alternative template in Schedule 10.

1.7 If you stopped there, you would, possibly inadvertently, be doing the right thing. However, if you knew more, you would turn to section 29QC ('Obligation to give consistent information') of the Superannuation Industry (Supervision) Act 1993, which requires fee and cost information in the PDS to be calculated in the same way as the same or equivalent fee and cost information given to APRA.[1] You would then try to overlay that requirement onto all of the work you had done so far - unless you were also aware that ASIC had deferred the commencement of the section until 1 July 2015 by class order.

1.8 Given all this it seems a little unfair to criticise product issuers for complex and long documents, while leaving the legislation untouched.

2 Future of Financial Advice

2.1 In this section we expand on the difficulties with the limitations on the grandfathering of benefits that are conflicted remuneration and how they produce outcomes which were clearly not intended. We do so to illustrate our point about the very real problems resulting from bad quality financial services regulation.

2.2 The grandfathering limitations operate by reference to 1 July 2014.

Two alternative limitations

2.3 There are two alternative limitations. To work out which one is potentially relevant in any given situation, you have to ask whether the benefit in question is given by someone 'in the capacity as a platform operator'.

2.4 To answer this, the first step is to work out whether the benefit-giver is a 'platform operator'. Doing so can be difficult. The answer turns on whether they provide 'custodial arrangements' under section 1012IA ('Treatment of arrangements under which a person can instruct another person to acquire a financial product') of the Corporations Act. Section 1012IA is not a simple section.

2.5 If the benefit-giver is a platform operator, there is a further question: are they giving the benefit in their capacity as such? Again, answering this question can be difficult.

2.6 It is possible for a platform operator to give one benefit in their capacity as such and another benefit not in that capacity. This can be so, even though both benefits relate to the same 'product' or 'service' and even though the same parties are paying and receiving each benefit.

2.7 This can lead to benefit A being grandfathered but benefit B being banned. We provide three examples to illustrate the point.

Example 1: IDPS

2.8 A company is the operator of an investor-directed portfolio service. Under a pre-1 July 2013 distribution agreement, the operator pays a dealer group a share of the management fee charged to the investor, being a flat percentage of the value of each investment held under the service for the

[1] Assuming you could find section 29QC – the Thomson Reuters version of the legislation does not include the section but includes, instead, an editorial note saying the 'attempted insertion of s 29QC ... was misdescribed and could not be made'.

investor. It also pays the dealer group a share of the transaction fee charged whenever investments are bought or sold at the investor's direction. The investor joined the IDPS before 1 July 2014.

2.9 In this example, the share of the transaction fee is likely to be given by the platform operator in its capacity as such. If that is so, the first of the two limitations is potentially relevant. Under that limitation, the transaction fee can probably continue to be grandfathered - even if the transaction involves the acquisition of an investment post-1 July 2014.

2.10 By contrast, the share of the management fee may not be given by the platform operator in its capacity as such. If that is so, the second of the two limitations is potentially relevant. Under that limitation, to the extent the management fee relates to investments acquired before 1 July 2014, it may well continue to be grandfathered. However, to the extent it relates to investments acquired after that date, it may well not.

2.11 The policy rationale for this potential difference in outcome is absent.

Example 2: IDPS-like scheme

2.12 If the IDPS operator in example 1 is swapped with the responsible entity of an IDPS-like scheme, the same grandfathering outcome applies in relation to the transaction fee. However, in this case the share of the management fee can continue to be grandfathered - even to the extent that it relates to investments acquired after 1 July (provided the investor joined the IDPS-like scheme before 1 July 2014). Again, the policy rationale for this difference in outcome is absent.

Example 3: Not a platform operator

2.13 To compound the absurdity, if the IDPS operator and responsible entity in the above two examples are swapped for someone who is not a platform operator, the transaction fee probably would not be grandfathered where the transaction involves the acquisition of an investment after 1 July 2014 (even if the investor joined the relevant service or product before 1 July 2014). Again, the policy rationale for this difference in outcome is absent.

Benefit identification and classification

2.14 The difficulties identified above are heightened by the fact that reasonable minds can reach different conclusions in carrying out the task of benefit identification. The term 'benefit' is not defined in the law. In a given circumstance, it can be difficult to say whether there is one over-arching benefit or multiple subsidiary benefits. For example, a fee calculated as a flat percentage can be consistent with a multiple benefit analysis being correct while a fee calculated as a tiered percentage can be consistent with a single benefit analysis being correct.

2.15 Finally, if the benefit in question is, unlike the management fee and transaction fee discussed above, not a client-specific benefit, the grandfathering outcome is likely to be different yet again. It is very difficult to see how the limitations can apply where the benefit in question does not relate to a particular client.

2.16 The provisions discussed above have created a veritable quagmire for the regulated population.

3 Duties of directors of APRA-regulated institutions

3.1 The Interim Report asks whether it is appropriate for directors in different parts of the financial system to have different duties (at 3-48).

3.2 The Inquiry is referring to the differences between the duties of directors of banks, insurers and superannuation trustees. For some of these institutions, but not others, the directors are subject to duties which focus on the interests of 'APRA beneficiaries', these being depositors (in relation to a bank), policyholders (in relation to a general or life insurer) and fund beneficiaries (in relation to an APRA-regulated superannuation fund).

3.3 At one end of the spectrum, a bank director has no specific duty to prefer the interests of depositors over the interests of the bank. At the other end, a superannuation trustee director must perform their duties and exercise their powers in the best interests of the fund beneficiaries. Where there is a conflict, they must give priority to the beneficiaries and ensure that their interests are not adversely affected by the conflict. In between these extremes, life insurer directors are subject to a duty of priority while general insurer directors are not.

3.4 The differences came about in part because the provisions for each kind of regulated institution were drafted at different times in different policy contexts – 1959 (for banks), 1973 (for general insurers), 1995 (for life insurers), 1993 and 2012 (for superannuation trustees) and 1998 (for responsible entities). The nature of the legal relationship between the regulated institution and the APRA beneficiary (or scheme member) has also been relevant – for example, superannuation funds and registered schemes are invariably trusts, where the concept of the best interests of the beneficiaries has been central, while life policies are contracts and so the duty of priority was developed.

3.5 The Inquiry asks whether these differences are justified. We suggest this is the wrong question. It implies that banks should have duties to act in the best interests of depositors and give them priority and that the same duties should apply to their directors. We suggest the right question is whether imposing these sorts of duties on directors makes a difference which justifies the difficulties that doing so causes.

3.6 Going by the reported court cases, these duties have made little, if any, difference to the people they are intended to benefit. There have been no cases which have turned on the duties of priority imposed on life companies and their directors notwithstanding that the duties have formed part of the law for nearly 20 years. There has only been one case which has featured any real consideration of the best interests and priority duties imposed on responsible entity directors – the 'Prime Trust' case (*Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342) – and it is telling that, while the court found the directors had contravened those duties, it also found that they had contravened other duties.

3.7 These duties create tensions and conflicts for individual directors which they are not in a position to resolve. On the one hand, the director is meant to act in the interests of the regulated institution while, on the other, the director has a duty which turns on the interests of someone who stands in a fiduciary or creditor relationship with that institution.

3.8 The general law says that when a person would otherwise owe duties to act in the interests of two other people, and those duties conflict, the person must not act – and yet we have statutes that create a very similar kind of tension, if not conflict, and leave it to the director to try to serve two different masters relying on the uncertain concept of priority. In other words, the statutes force individuals to do what the general law, which embodies a lot of wisdom about the realities of human nature and relationships, accepts they cannot do and should not be asked to do.

4 Regulator guidance

<u>Example1: SMSFs and the retail/wholesale test</u>

4.1 One example of sub-optimal regulator guidance was illustrated very recently. On 8 August 2014, ASIC announced that it would take no action where a self-managed superannuation fund trustee is treated as a wholesale client, notwithstanding that the trustee does not meet the $10 million net asset threshold, even though the financial service in question may relate to a superannuation product. It did so despite its view to the contrary published in 2004 (in QFS 150).

4.2 In changing its mind on this issue, ASIC referred to the 'ongoing legal uncertainty about when a financial service relates to a superannuation product'. It said nothing of its own contribution to the uncertainty, made through QFS 150.

Example 2: Price to acquire an interest in a scheme

4.3 A further example is ASIC's approach to the requirement that the constitution of a registered managed investment scheme make '*adequate provision*' for the price to be paid to acquire an interest in the scheme (as required by section 601GA(1)(a) of the Corporations Act). 'Adequate provision' is not defined and has not been interpreted by the courts in this context, but ASIC issued guidance in 2000 (in the form of Superseded Regulatory Guide 134) that, in its view, 'adequate provision' meant that the price had to be 'independently verifiable' (ie, objectively determinable without reference to any discretion on the part of the responsible entity). This guidance had a long pedigree, having first emerged in ASIC's Superseded Policy Statement 55 in connection with the issue of units under the prescribed interests regime which predated the current managed investment scheme regime. This view, transplanted to the managed investments scheme regime, had significant implications because:

(a) a responsible entity of an unlisted scheme will almost invariably exercise discretion when calculating the net tangible asset value of the scheme; and

(b) listed schemes were generally restricted from issuing units at a discount (or at a premium) to their market price.

4.4 As a result ASIC published a number of class orders (CO 98/52, CO 05/26 (which replaced CO 98/52), and CO 13/655 and CO 13/657 (which have partially replaced CO 05/26)), giving rise to the curious situation of the Corporations Act being modified by ASIC to deal with the consequences of ASIC's independent interpretation of a term used in the Corporations Act. Since then, in February 2014, ASIC amended its guidance on this point, acknowledging (in Regulatory Guide 134 (Managed investments: Constitutions)) that:

> 'Because s601GA is principles-based, there are differing views on the exact content that is required for a constitution to make adequate provision for the consideration that is required to be paid to acquire an interest in a scheme...We believe that what constitutes 'adequate provision' will depend on the circumstances of the scheme.'

4.5 Although ASIC still encourages responsible entities to adopt an approach which controls the use by the responsible entity of its discretion, it acknowledges that other ways of making 'adequate provision' exist. Therefore ASIC guidance, applied for many years and resulting in complicated ASIC-initiated modifications to the Corporations Act, which remain in place notwithstanding, has now been changed, without any real explanation.

Concluding comment

4.6 These examples show how guidance material can often be more likely to hinder than to help the regulated population in achieving compliance. We suggest that the Final Report recommend that regulators be required to satisfy themselves that their guidance reflects the law as made (not as they would prefer it to be) and, whenever the position is unclear, to refrain from issuing guidance - particularly when their guidance suggests that the law is more burdensome than may, in fact, be the case.

If you have any questions about this letter, or would like to discuss any aspect of it, please contact Michelle Levy, Partner, on (02) 9230 5170.

Yours faithfully