FINANCIAL SYSTEM INQUIRY

FACILITATIVE REGULATION

26 AUGUST 2014

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Mr David Murray
Chair, Financial System Inquiry
Electronic Submission

Dear Mr Murray

Herbert Smith Freehills submits the Inquiry should support a new phase of regulation in financial services.

That phase can be characterised as a phase of 'facilitative regulation' (**Facilitative Regulation**).

The financial services industry has been subject to a succession of waves of regulation in recent decades. Much of this has been focused on increasing conduct and prudential requirements. Responding to these changes has contributed enormously to the compliance and cost frameworks for financial institutions.

The purpose of this submission is not to criticise this regulation. Rather, it is to recommend that future regulation be directed, at least in part, to enhancing efficiency in the distribution and structuring of financial products. This is the focus of Facilitative Regulation.

We have identified three areas on which Facilitative Regulation could initially focus.

1 Product Rationalisation

This is a prime area for Facilitative Regulation. The Interim Report produced by the Inquiry reports estimates of the efficiency drag caused by the inability of the industry to rationalise legacy products. We believe these estimates may in fact under-estimate the extent of the problem because the drag on the system arises not just from the actual costs incurred in sustaining obsolete and inefficient technologies and systems but also from the way that dealing with legacy issues consumes management time and acts as a break on innovation within organisations. These effects are more difficult to measure concretely but they are very real.

What could be done? We believe that it is important to recognise the need to strike the right balance between industry efficacy and protection of consumers' rights. Consumer confidence, in particular, is an essential pre-condition of an efficiently functioning market. We note in that regard that there is at least a perception that the previous government's 2009 Product Rationalisation initiative did not progress because of concerns as to whether, and how, a model which allowed product rationalisation and restructuring without client consent, should be supported.

1.1 Insurance and superannuation merger models can be applied

Various possible models of product rationalisation were canvassed in 2009. We believe that a combination of the approach currently operating in the insurance sector in respect of insurance company mergers and in the superannuation sector in relation to successor fund transfers could be applied to product rationalisation across the financial services sector.

There are two paths available for authorising mergers in the insurance sector:

a) APRA has the power to approve mergers of insurance companies in certain prescribed circumstances under the Financial Sector (Business Transfer and Group Restructure) Act; and

b) the Court has the same power in wider circumstances under the Insurance Act and the Life Insurance Act.

There will undoubtedly be advocates of both paths and critics of both paths. Notably, APRA has used its power judiciously. One of the issues is a perceived lack of clarity. This said, we submit that if the circumstances in which the power can be exercised by the regulator are articulated in terms which are well understood, any potential clarity issue can be addressed. On the other hand, the Court route is well tried and provides for evidence to be presented that clients will not be prejudiced. It also requires affected clients to be notified of the merger and allows clients who believe they would still be disadvantaged to appear before the

Court. If a regulatory route were also adopted, similar disclosure requirements could be implemented although, at least in the first instance, the regulator could be the adjudicator of whether clients' interests were protected. It is noteworthy that Parliament saw fit to adopt this same relationship in relation to certain superannuation fund mergers which can be approved by APRA (see section 144 of the Superannuation Industry (Supervision) Act).

In conjunction with these two mechanisms we propose that a rationalisation mechanism based on a test of the rationalisation preserving equivalency of rights of clients (based on the superannuation successor fund transfer mechanism) be part of the solution. In this way a three tiered system would operate based on both the type of financial products being rationalised and the impact on clients. The lowest level of rationalisation (level 3) would be possible without any third party approval based on the equivalency of rights test being satisfied and where an at least neutral impact on clients can be clearly demonstrated. It is envisaged that this would often be the case where the financial products are rationalised within the same legal entity (such as within a life insurance statutory fund context). The next level (level 2) would involve the need for regulator approval where the financial products are more complex and/or the impact on clients is not as straightforward. The highest level (level 1) would require court approval where clients are being migrated from one product to another where either more complex issues arise (such as the transfer of a product from life insurer to a general insurer) or as an alternative to a level 2 (or level 1) transfer.

2 Electronic Disclosure

This is the second area where Facilitative Regulation could significantly ease the existing regulatory burden and enhance consumer understanding and confidence in the system. The Interim Report notes that the current disclosure regime produces complex and lengthy documents. These disclosure requirements, as pointed out by the Inquiry, may have not been effective in enhancing consumers' understanding of financial products and services. In addition, compliance with disclosure requirements has been costly for the industry. We believe that enhancing the use of technology and electronic delivery are essential in improving the effectiveness of the current disclosure regime. Specifically, greater use of electronic disclosure will benefit both the consumers and the industry.

2.1 Current use of electronic disclosure requires consent

Currently, the Corporations Act requires retail disclosure documents be sent to the retail client. In most cases this necessitates the despatch of information in paper form. Generally, it is only where client consent is obtained that another form of disclosure, such as electronic disclosure, can be utilised. Whilst the legislation envisages that a permissible mode of delivery is electronic, ASIC has in our view correctly interpreted this as requiring the consent of the retail client (see ASIC Regulatory Guide 221 Facilitating online financial services disclosures).

In some instances, such as the provision of a product disclosure statement, the statutory test is more rigorous. It requires not just for the client to agree on a mode of delivery other than it being given to the client but that the issuer be reasonably satisfied that the client will receive the information (see Corporations Regulation 7.9.02A). Specifically, the issuer can make the product disclosure statement available in a manner agreed to by the client but the issuer must be able to be reasonably satisfied that the client has received the statement.

2.2 Electronic disclosure should be the default position

It is submitted that this regime is costly, unnecessary and antiquated for both issuers and consumers, particularly where the proportion of the public whose preferred method of communication is electronic is increasing. It is also burdensome for the clients to undergo administrative processes before given access to the relevant information. We submit that electronic disclosure by making available the required information should be the default position. If clients are desirous of obtaining the information in paper form, then they should be able to obtain it in such form.

In this context, a useful starting point for the formulation of the new disclosure model would be to employ a modified version of disclosure permissible under the Corporations Act in relation to confirmation of transactions. This would be harnessed to provide for a Disclosure Facility to be used. The Disclosure Facility would include a website, with or without a hyperlink.

Section 1017F(5A) of the Corporations Act uses this model in the context of confirmation of transactions. It provides for the circumstances in which a confirmation may be provided by means of a facility.

2.3 Better use of technology

In addition to submitting that electronic disclosure should be the default position, we also submit that technology should be better utilised. Current technology such as “read receipts” and acknowledgement pop-ups can be used to ensure that the clients are aware of the content of the disclosure documents.

For example, the issuer can add an acknowledgement pop-up or a hyperlink at the end of an electronic disclosure document. The issuer can require the client to click on the “read receipt” button in the form of a relevant pop-up or hyperlink. This “read receipt” will then serve as an instant communication from the client to the issuer that the client has read the relevant disclosure document. Such technology is readily available and inexpensive for the industry to implement. Further, consumers will benefit from easy access to electronic disclosure documents.

3 Other Disclosure Issues

As noted above, the Inquiry has observed that many disclosure documents are too complex and lengthy. We agree with that observation. Specifically, the relevant industry sentiment is that statements of advice are too lengthy. In part, this arises because many statutory requirements are cumbersome and repetitive.

3.1 Duplication

Much information is required to be duplicated between the Product Disclosure Statement (**PDS**), Financial Services Guide (**FSG**) and Statement of Advice (**SOA**). Such duplication is not conducive in helping consumers understand the information contained in these disclosure documents. Instead, duplication may add confusion for the consumers and costs for the industry. For example, information about the dispute resolution system is required in both the FSG under section 942B(2)(h) and the PDS under section 1013D(1)(g) of the Corporations Act. Different information about remuneration such as commission or other benefits that a relevant person has received or will receive is required to be disclosed in the SOA under section 947C(2)(e), the FSG under section 942B(2)(e) and the PDS under section 1013D(1)(e) of the Corporations Act. In circumstances where a SOA is not required, remuneration information is still required to be provided.

Additionally, the ability to incorporate information by reference is limited. Section 3.2 below sets out the circumstances where incorporation by reference can and cannot be used in the PDS, SOA and FSG.

3.2 Incorporation by reference

(a) PDS

Corporations Regulation 7.9.15DA provides that a PDS is permitted to incorporate certain information by reference. The relevant information must be information in writing and be contained in a publicly available document other than the PDS. Further, the PDS must refer to the statement and provide sufficient details to uniquely identify and locate the document and decide whether to read or obtain the document. However, Corporations Regulation 7.9.15DA(4) and ASIC Regulatory Guide 168.114 provide that certain information such as a summary description of the key features and risks of the product and information on the dispute resolution system, fees and costs, adviser remuneration cannot be incorporated by reference. Further, incorporation by reference is again limiting as it cannot be applied to certain products under Corporations Regulation 7.9.15DA(1A).

(b) SOA

An issuer can also incorporate information normally contained in the SOA under Corporations Regulation 7.7.09B. In order to incorporate information by reference, the SOA must also provide sufficient details so to enable the client to uniquely identify the document or part of the document that contains the statement or information and to decide whether they should read or obtain the statement or information. However, information required under sections 947D and 961H of the Corporations Act cannot be incorporated by reference.

(c) FSG

Another example of incorporation by reference is evident in the cross-references between a combined PDS and FSG document. A PDS and a FSG can be combined in prescribed circumstances under section 942DA of the Corporations Act. Where a PDS and a FSG are combined, Corporations Regulation 7.7.08A allows for

cross-references between the parts of the combined document. The cross-references must be clear, concise and effective, and not misleading or deceptive.

As illustrated above, the circumstances where incorporation by reference are permitted are useful in reducing the duplication of information provided to the consumers. Greater use also reduces compliance cost for the industry. It is submitted that a thorough review of these statutory requirements be conducted to ensure that:

a) duplication is removed; and

b) the ability to incorporate by reference from another disclosure document or an electronic medium (including a Disclosure Facility) is permitted more liberally.

Concluding, we would like to thank the Inquiry for its efforts to date in ensuring that the experiences and perspectives of industry practitioners and professionals are considered in the policy process. The issues are in many cases complex and technical and not capable of easy resolution. we would welcome any opportunities to discuss the recommendations contained in this submission in more detail with you further.

Yours sincerely

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