



Law Council
OF AUSTRALIA

Business Law Section

Mr David Crawford
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: fsi@treasury.gov.au

14 April 2015

Dear Mr Crawford,

Final Report of the Financial System Inquiry

The Corporations Committee of the Business Law Section of the Law Council of Australia (“**BLS**”) makes this submission on certain aspects of the Final Report of the Financial System Inquiry (November 2014) (“**Final Report**”).

Chapter 4: Consumer Outcomes – Product design and intervention

The Final Report recommends what it describes as a targeted and principles based product design and distribution obligation (Recommendation 21) and a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment (Recommendation 22). The BLS believes such an obligation and power would operate very differently to the description used in the Final Report.

The BLS continues to oppose the introduction of a product intervention power even if it is limited to circumstances where there is risk of significant detriment to a class of consumer and with regulator accountability. See our submission dated 26 August 2014. We consider that ASIC does not have the cultural and skills mix to exercise this power, the power risks constraining innovation and the threat of the power may increase costs. We consider that the introduction of the power could be extremely intrusive to the financial markets in the way in which it is exercised and have far reaching consequences for Australian regulation. We also consider that the power is incompatible with other Australian policies such as reducing red tape and building Australia as a competitive international financial centre.

The product design obligation is expressed to be a fuzzy and benign obligation that should impose minimal costs on firms with good practices. However, even simple financial products may not be suitable for all investors, depending on their risk profile.

We do not consider that the FSI has adequately tested and evaluated its recommendations in this area. The benefits of the proposal are described in the Final Report to be substantial but we do not consider that the Final Report adequately substantiates that.

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If despite our views it is proposed to introduce a product design obligation and a product innovation power in the Corporations Act we strongly submit that caution should be exercised in the development of the legislation, with the benefit of a proper review and analysis of past regulatory failures and detailed ongoing consultation with all stakeholders. Having regard to the profound policy shift that these changes would represent and their potential impact on the Australian regulatory regime the BLS submits any regulatory change should be implemented with the utmost care. The proposed reforms set out in the Final Report are some of the most dramatic and significant proposals for reforming the financial services sector for some time.

The BLS is concerned that there has not yet been enough research and evaluation of a proposed product design initiative and outcome as suggested in Chapter 4 of the Final Report. The fact that a similar system is operating in the United Kingdom, whilst interesting, and clearly something to be considered, should be just one of a number of matters that should be assessed.

Reference is made in the Final Report that the availability of these provisions at the time may have assisted in mitigating the consumer detriment caused by the failure of agribusiness schemes and financial collapses such as Storm Financial and Opes Prime. We strongly encourage government to undertake a careful review of those case studies to assess how behavioural biases may have influenced investors and regulators at the time, how the obligations and powers that are proposed may have mitigated loss and to assess what features that these recommended obligations and powers should consequently have. Having regard to its remit the FSI could not undertake work of this nature.

In addition, we note that enforcement and damage recovery proceedings have not concluded in relation to all of these collapses. We believe it would be useful to defer final design of any legislation until there is a fuller resolution of these proceedings (including the action commenced against ASIC arising from the Storm Financial collapse).

The Final Report makes a number of observations concerning safeguards that are not fleshed out in any detail (judicial review mechanism, consultation with other regulators, engagement with affected parties, post implementation reviews, formal review after 5 years, etc). It would be very important that the safeguards are fully developed with appropriate consultation so as to ensure that the power has the limited role that is suggested.

One area where we believe that it would be desirable for further debate is the question of what body should exercise such a power. Giving the power to ASIC to act as investigator, prosecutor, judge and jury is problematic as a matter of policy, as has proven to be the case in other contexts (e.g takeovers and the development of an independent Takeovers Panel). We submit that serious consideration be given to the establishment of an independent body if this proposal is pursued.

As always, the BLS would be keen to assist and work with government on these issues if it chooses to proceed with regulatory reform in these areas.

Chapter 5: Regulatory tools – ASIC sanctions

The Final Report comments on the scope of ASIC enforcement powers and the quantum of maximum penalties (Recommendation 29).

As noted in the Final Report we supported ASIC's submission seeking an increase in maximum penalties.

In that regard:

- We agree with the comment in the Final Report that Australia should not introduce the extremely high penalties for financial firms recently seen in some overseas jurisdictions.
- We agree with the observation in the Final Report that stronger enforcement of the current framework can reduce demands for more rules and regulations. In that regard we agree with many of the observations of the 2014 Senate Economics Reference Committee Report concerning reforms that ASIC should introduce into its operations to improve its enforcement record.

Again we submit that government should exercise care in developing any new legislation in this area, including undertaking a proper study of the background and features of the financial collapses of recent years and assessment of the lessons learned from the final result of the proceedings that have commenced following those collapses. Any increase in sanctions, and other initiatives linked to the recommendation on penalties needs to be carefully assessed.

Appendix 1: Significant matters – Simple bonds

The Final Report recommends (recommendation 33) reduced disclosure requirements for large listed corporates issuing simple bonds and the development of standard terms for simple bonds.

The BLS strongly supports this recommendation. Legislative action to make retail issuance competitive with wholesale issuance for ASX 150 companies would increase investor choice and improve market efficiency.

Appendix 1: Significant Matters – MIS regulation

The Final Report picks up on the work done by the Corporations and Markets Advisory Committee (**CAMAC**) on the regulation of managed investment schemes (**MIS**) in 2012 and 2014. In Recommendation 42, the FSI supports the Government's review of the CAMAC recommendations on MIS, giving priority to matters relating to:

- Consumer detriment, including illiquid schemes and freezing of funds; and
- Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.

The BLS strongly encourages the Government to continue to progress the work done by CAMAC in the area of MIS regulation. It is particularly important that this remains a priority if the proposed legislation to abolish CAMAC is passed by the Senate.

While some of CAMAC's recommendations are far-reaching and raise complex tax considerations, there are several reforms that could practicably be implemented within the existing framework, to strengthen the sector and reduce the risk of consumer detriment arising from the legal design (as distinct from the investment performance) of MIS. Also, reform could better integrate the Australian managed investment sector with global CIS markets, improving export prospects and increasing competition for funds management services here in Australia.

These include:

- Limiting the circumstances in which ASIC must register an MIS under Chapter 5C, so that MIS can no longer be used as vehicles for entrepreneurial activities rather than as passive investment vehicles. This would involve legislation to prohibit the creation of new 'common enterprise' schemes (see CAMAC, July 2012, 11). Post-GFC experience in the agribusiness sector demonstrated that the legal structure of a registered MIS is not adequate to resolve the respective rights and entitlements of investors and financiers in situations where the scheme involves trading activities as distinct from passive investment in financial instruments or real property. Trading enterprises should be carried on by companies;
- Tightening the rules relating to redemptions, so that only MIS whose investments are truly liquid can offer redemption facilities on an ongoing basis. The problem with 'frozen funds' was that MIS with underlying investments that were illiquid (for example, loans made to property developers) were permitted by the legislation to offer investors the opportunity to redeem their investments at short notice (see CAMAC, March 2014, 132-3); and
- Allowing for MIS that are structured to conform to the regulatory requirements of appropriate transnational 'passport' regimes, such as UCITS, to register under Chapter 5C without having to change their structure to meet our jurisdiction-specific requirements. An additional alternative form of investment structure may enhance access by the Australian funds industry to foreign markets and offer more product choice for Australian investors. A structure that is modelled on an established and globally recognised structure (such as UCITS funds with their specific investor protection features) may attract investors that prefer highly regulated investments and enhance the ability of industry to compete for fund-related business from foreign investors (see CAMAC, March 2014, 210-211).

The Final Report also includes Recommendation 43 to 'introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors'.

The BLS strongly supports this recommendation. This would involve the Government finalising and implementing the work done with industry between 2007 and 2010 on a mechanism to facilitate the rationalisation of genuine legacy products (that is, not simply those that are performing poorly), subject to a 'no disadvantage test' for relevant consumers. The mechanism included providing tax relief to ensure consumers were not disadvantaged as a result of triggering an early capital gains tax event. Like the FSI, the BLS sees significant benefit in adopting such a mechanism to improve efficiency and consumer outcomes.

If you have any questions regarding the submission, in the first instance please contact the Chair of the Corporations Committee, Bruce Cowley, on 07-3119 623 or via email: bruce.cowley@minterellison.com.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'John Keeves' in a stylized, cursive script. The signature is written on a white background.

John Keeves, Chairman
Business Law Section