

Senate Inquiry into the Performance of ASIC

ISA SUBMISSION

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Industry
Super
Australia 

Table of Contents

SUMMARY	2
1. ASIC'S LEGISLATIVE RESPONSIBILITY AND OBLIGATIONS	3
1.1 The critical role of ASIC in the Australian financial system	3
1.2 The financial advice sector and FOFA	3
The financial advice landscape prior to FOFA	4
The Commonwealth Financial Planning Limited (CFPL) Scandal	5
The importance of FOFA reforms	6
Current FOFA legislation	6
Proposed Government Amendments to FOFA and their potential impacts	6
ISA does not support dilutions or winding back of FOFA reforms	9
Comments on ASIC's approach to regulation	10
1.3 ASIC's activities in market supervision and surveillance	10
2. ASIC'S RELATIONSHIP WITH THE INDUSTRY	100
3. AREAS FOR IMPROVEMENT	11
3.1 ASIC's broad responsibilities	11
3.2 Funding model for ASIC	11
Current ASIC funding arrangement	11
Alternative funding options	13
3.3 Secondment with different industry entities	133
3.4 Explicit regulatory function	14
4. CONCLUSION	14
APPENDIX 1 – HOW THE FCA CHARGES THEIR FEES?	15

About Industry Super Australia

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

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The opinions within are those of the author in their capacity as spokesperson for Industry Super Australia (ISA). ISA, the authors and all other persons involved in the preparation of this information are thereby not giving legal, financial or professional advice for individual persons or organisations. Consider your own objectives, financial situation and needs before making a decision about superannuation because they are not taken into account in this information. You should consider the Product Disclosure Statement available from individual funds before making an investment decision.

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| SUMMARY

The Senate Economics References Committee is conducting an inquiry into the performance of the Australian Securities and Investments Commission (ASIC). The terms of reference for the Inquiry are broad and Industry Super Australia (ISA) does not intend to address all matters raised but will focus on ASIC's role in respect of its supervision and enforcement of financial advice laws and make some high level observations in relation to ASIC's operations.

ISA submits that ASIC has a broad remit and has been successful in ensuring our financial markets operate in a fair and transparent manner in order to maintain good investor confidence. While there have unfortunately been some very prominent and damaging financial collapses over the past five or six years, in general terms throughout the period of the global financial crisis, our financial markets did not experience some of the systemic failure seen in other jurisdictions. With other regulators, ASIC can take some of the credit for Australia emerging comparatively well through the 2008-2010 period.

The inquiry has been in part triggered by regulatory action taken against Commonwealth Financial Planning Limited (CFPL) in which thousands of CFPL clients were given financial advice which failed to meet legal requirements. ISA notes that the CFPL scandal occurred before the introduction of the Future of Financial Advice (FOFA) reforms. As the Committee will be aware, ISA has been a strong advocate for reform of the regulation of the financial advice industry. Following a number of financial collapses and devastating consumer losses, the Financial Services Regulation (FSR) regime which was premised on disclosure of conflicts of interest, was found to be inadequate and had not prevented product providers improperly influencing financial advice recommendations through the payment of financial incentives such as commissions, volume rebates, and other financial and non-financial incentives. Unfortunately as indicated by many of the consumers who have provided evidence to the committee in this Inquiry, the failures of the FSR framework will continue to be felt for many years. While ASIC has identified improvements to their processes in dealing with enforcement issues in recent years, it must also be recognised that the pre-FOFA regulatory framework was primarily to blame for permitting conflicted remuneration structures and inadequate protection of consumers.

In an environment in which we are still dealing with the fallout from the systemic conflicts which existed prior to the FOFA reforms, it is incomprehensible that any financial institutions would be simultaneously advocating for significant dilutions and carve-outs from the new requirements. ISA believes that the FOFA legislation should not be watered down and that any dilution of the best interests duty or conflicted remuneration provisions will seriously compromise consumer protections put in place to prevent further instances such as that which triggered this inquiry. We submit that to the extent that a further review of the regulation of advice or of ASIC's regulatory role is required, it should take place as part of the Government's proposed Financial System Inquiry.

ISA's submission also notes that ASIC's capacity to be an effective regulator is impacted by its resourcing. To the extent that the Committee considers it appropriate to review ASIC's funding base this should also be considered as part of the Government's proposed Financial System Inquiry.

ISA recommends the following areas for improvements for ASIC:

- ASIC should also commence a formal secondment process with the industry, to enhance their industry knowledge and responsiveness.
- That ASIC is given a specific mandate for regulatory policy advice and development and greater independence to express public views on the effectiveness of the regulatory framework without fear or favour from Government.

1. ASIC's legislative responsibility and obligations

1.1 The critical role of ASIC in the Australian financial system

ASIC plays an essential role in regulating the Australian financial industry. Being a corporate, markets and financial services regulator, ASIC's responsibilities are broad, covering a number of important and complicated areas. These include financial advice and services, market, credit and financial reporting of companies, among others.

ASIC's mission is to ensure that the markets are "fair and transparent, supported by confident and informed investors and consumers."¹ In an environment in which financial services and financial transactions are increasingly complex and international in nature, the regulatory task becomes more difficult and challenging.

In particular, unlike other jurisdictions, the Australian market did not suffer systemic failure during the Global Financial Crisis (GFC). Together with APRA and the RBA, ASIC has contributed in keeping our financial system stable and well-functioning compared with international peers.

ISA's engagement with ASIC has primarily been in two areas, financial advice and services, and markets. As such, we will focus our discussion on ASIC's performance in these matters.

1.2 The financial advice sector and FOFA

Industry super funds have argued for a ban on the payment of sales commissions and other conflicted remuneration by product manufacturers such as bank owned super funds for over two decades. Our position is based on the detrimental effect conflicted remuneration has had on merit based financial product selection and the erosion of individual and aggregate retirement savings.

Over recent years, the ill-effects of conflicted remuneration structures have been devastatingly illustrated by a number of high profile collapses including Storm, Westpoint, Timbercorp and Trio Capital among others.

These scandals occurred from 2005 to around 2010, which pre-dated the introduction of FOFA. This period was marked by a number of failures in the regulatory environment to protect consumers. While ASIC in its submission dated August 2013 has acknowledged a number of areas which it has addressed to improve its enforcement activities, as has been recognised in a number of parliamentary inquiries, ASIC was operating in a flawed regulatory framework which failed to adequately protect consumer interests.

The FOFA reforms have and will continue to positively transform the financial advice industry, including ASIC's roles and activities. To fairly assess ASIC's performance, it is important to understand the changing environment in which it has operated.

In this section of the report, ISA will focus on:

- The landscape of the financial advice sector prior to FOFA
- The CFPL scandal
- FOFA reforms
- Proposed amendments to FOFA

¹ ASIC website <http://www.asic.gov.au/asic/asic.nsf/byheadline/Our+role?openDocument>

The financial advice landscape prior to FOFA

The Parliamentary Joint Committee on Corporations and Financial Services in its Inquiry into Financial Products and Services in 2009, emphasised that the regulatory regime (i.e. pre-FOFA) was “failing to protect consumers from poor financial advice and its consequences.”²

The report pointed out serious problems, including conflicts of interests, commission-based remuneration and the limited regulatory power of ASIC.

It can be said the financial advice industry was used as a distribution and marketing channel for financial products to retail customers. There were limited regulatory requirements or assurances of advice quality. The framework at the time was premised on disclosure of conflicts of interests, which has been proved as inadequate to protect consumers. The financial incentives provided by product providers led to biased and poor quality advice.

The following table summarises the major financial collapses in Australia over the past years and the key features and impacts.

Table 1 – Financial collapses in Australia between 2006-2010

Company	Year of Collapse/ Scandal broke	Scheme	Commissions and Fees	Clients Affected	Total Losses
Storm Financial	2009	Margin lending/ Financial Planning	6-7% upfront commission with two trail commissions of between 0.22 – 0.385% and 0.33% pa. ¹ Volume based rebates also paid.	14,000 ²	\$830 million ³
Timbercorp / Great Southern	2009	Managed Investment Schemes (MIS)	10% up front commission, ongoing fixed based fee, and 27.5% performance fee ⁴	18,000 ⁵ (Timbercorp) 47,000 (GS) ⁶	\$3 billion+ ⁷
Opes Prime	2008	Non-standard margin loan, or 'equity finance scheme'	trail commissions of up to 0.75% to referring brokers ⁸	1,200 retail customers ⁹	up to \$1 billion ¹⁰
Bridgecorp	2007	Property Investment	Unknown	14,500 ¹¹	\$459 million ¹²
Westpoint	2006	Margin Lending	10% up front commission ¹³	3,524 ¹⁴	\$388 million ¹⁵
Fincorp	2007	Property Investment	\$3 million in fees ¹⁶	8,102 ¹⁷	\$201 million ¹⁸
Trio/Astarra	2009	Corporate and Retail Super	4% up front commission ¹⁹ and 1.1% trail commission ²⁰ Additional volume rebates also paid to advisers ²¹	6,000 approx. ²²	\$176 million ²³
Commonwealth Financial Planning Limited	2009-2010	Financial Planning	Unknown. But there was report of trailing commissions of 0.44% - 0.83% ²⁴	1,127 clients receiving compensation ²⁵	\$50 million in compensation. Actual losses unknown.

Source: All data are taken from publicly available sources which are provided in the end notes.

² Parliament Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services in Australia, November 2009

It is also worth noting that ASIC did express its concerns about the poor quality of the financial planning sector through surveys done in 2003³ and 2006.⁴

The Commonwealth Financial Planning Limited (CFPL) Scandal

One of the triggers for this inquiry is ASIC's enforcement activities in relation to financial advice provided by CFPL. Like the other collapses over recent years, the CFPL scandal clearly demonstrates the failures of the financial advice regulatory framework pre-FOFA. Media reports on the CFPL scandal have identified problems which have been central to all the above mentioned financial collapses:⁵

- Poor and inappropriate advice: Finance adviser Don Nguyen was reported to invest money from senior clients into high-risk and high-fee generating products instead of moderate-risk investments as instructed. Independent consultants found cases of clients receiving unsuitable advice.⁶
- Remuneration based on the volume of product sold, not on quality of advice: CFPL put up a league-style ladder around the office which praised high performers, i.e. those who sold the most products.⁷
- Inadequate auditing: Discrepancy existed between the bank and customers' documentation. Lack of documentation was also a problem.
- External compliance was replaced with an internal compliance team in 2004, and compliance was known as the "business prevention unit".⁸ ASIC also raised concerns about CFPL compliance practice in its investigation.⁹

ASIC has since banned seven CFPL advisers (including charges for fraud).

ASIC has made a submission to this Inquiry on the CFPL case, which provides assessments of the case and the lessons ASIC has taken from it.

Table 2 – ASIC's internal lessons from the CFPL case and pre-FOFA period

Issues	Policy and Actions
Lack of transparency and disclosure to the public about ASIC's investigation	ASIC has committed to greater transparency in its policy and practice. This includes publishing public enforcement policy, biannual enforcement reports and greater publicity about results of regulatory actions.
Inadequate communication with the whistleblowers. Lengthy process.	Review of whistleblower policy is in progress.
Too much reliance on CFPL's ability to identify and rectify its internal problems.	A forward-looking approach to regulation of the financial services industry is in place. This focuses on addressing concerning trends as they emerge instead of being passive.

Source: ASIC's submission to Senate Inquiry about its role and performance – the CFPL case

³ ASIC Media Release 03-037 Financial planner survey results released <http://www.asic.gov.au/asic/asic.nsf/byheadline/03-037+Financial+planner+survey+results+released?openDocument>

⁴ ASIC Media Release 06-104 Survey finds quality of advice on super still needs improvement <http://www.asic.gov.au/asic/asic.nsf/byheadline/06-104+Survey+finds+quality+of+advice+on+super+still+needs+improvement?openDocument>

⁵ Ferguson & Vedelago (2013) Profit above all else: how CBA lost savings and hid its tracks. The Sydney Morning Herald. Accessed October 7, 2013. <http://www.smh.com.au/business/profit-above-all-else-how-cba-lost-savings-and-hid-its-tracks-20130531-2nhde.html#ixzz2hC9EBaDe>

⁶ Ibid. 5

⁷ Ibid. 5

⁸ Ferguson, Adele (2013) Pressure on ASIC over CBA fraud. The Sydney Morning Herald. Accessed October 7, 2013. <http://www.smh.com.au/business/pressure-on-asic-over-cba-fraud-20130617-2oegh.html>

⁹ ASIC (2011) Enforceable undertaking [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/026213940.pdf/\\$file/026213940.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/026213940.pdf/$file/026213940.pdf)

The importance of FOFA reforms

The sales driven culture of the financial advice industry pre-FOFA, which resulted in a number of financial scandals, called for swift reforms. Following the Inquiry by the Joint Parliamentary Committee, the Government consulted on the reforms and then introduced the FOFA legislation.¹⁰

The FOFA legislation contains a number of interdependent components to improve the quality and availability of financial advice. ISA has always advocated strongly for the FOFA reforms, including the best interests duty, the ban on conflicted remuneration and the opt-in and transparent disclosure of ongoing fees. ASIC's regulatory power was also extended in relation to refusing, cancelling or suspending a licence or banning an individual in circumstances in which they are likely to contravene their obligations. Importantly, the imposition of personal advice obligations on the individual provider of advice facilitates ASIC's power to administratively ban individuals.

The FOFA reforms will help to transform the financial planning industry in Australia. According to research commissioned by ISA from Rice Warner Actuaries, the FOFA reforms will have an unambiguously positive impact on the affordability and provision of financial advice and a very positive impact on the future level of superannuation and other savings.¹¹

ISA notes that over the past year many financial planning businesses have demonstrated a strong commitment to improving standards, ensuring that conflicted forms of remuneration are phased out, and to building the professional basis of financial planning. The FOFA reforms have supported these efforts and ensure that minimum conduct requirements for providers of financial advice are significantly raised. It will undermine, if not jeopardise, the professional ambition of financial planners if product providers are able to recommence the practice of providing volume based payments to incentivise the sales of their products.

Current FOFA legislation

A number of significant compromises were made to the FOFA legislation in order to have the Bills passed through a hung parliament. While the reforms represented a significant improvement in terms of minimum obligations for providers of financial product advice, there were nonetheless a number of concessions made to all aspects of the draft legislation based on industry submissions. ISA submits that if there are further instances of misconduct or financial collapse, it may be necessary to reconsider areas in which the FOFA Bills were diluted, or even whether it is feasible to allow product providers to be the major employers of financial advisers within a vertically integrated financial services industry.

Proposed Government Amendments to FOFA and their potential impacts

At the time of writing this submission, the Government is considering how to implement its pre-election policies in relation to the FOFA reforms. ISA welcomes statements from the Government that it will work carefully and methodically through the proposals. This is essential since many of the proposals were formulated prior to the finalisation of legislation and regulations, let alone industry experience since its formal commencement in July 2013.

If enacted as originally announced ISA has grave concerns that the amendments could create an even weaker regulatory environment than that which existed prior to FOFA. Any actions to undermine FOFA are highly undesirable. The table below summarises major policy proposals and their potential impacts.

¹⁰ Parliament inquiries from 2009 to 2011 include the PJC Inquiry into Financial Products and Services (2009), Inquiry into the collapse of Trio Capital (2011) and Inquiry into the Future of Financial Advice Reforms (2011)

¹¹ Rice Warner Actuaries, March 2010, Transformation of the Financial Advice Industry <http://www.industrysupernetwork.com/wp-content/uploads/2013/07/Rpt-The-financial-advice-industry-post-FoFA-2013.pdf>

Table 3 – Government Policy to Reform Financial Advice and potential impacts¹²

Major Government Policy to Reform Financial Advice	Impacts
Removal of the opt in requirement	<ul style="list-style-type: none"> ▪ While much opposition was mounted by the industry to this measure, the opt-in requirement is a compromise to prevent asset-based fees from replicating all the problems caused by commissions, including conflicted advice and consumers paying for advice that they do not receive. ISA estimates that 2.8 million Australians are paying commissions and on-going fees for advice they do not receive.¹³ Advice paid for by ongoing fees or commissions is estimated to cost up to 17 times more than advice paid for on a fee-for-service basis.¹⁴ ▪ Repealing opt-in would also be in conflict with recommendation 1.12, 1.13 and 1.25 of the Cooper Review which recommended all ongoing advice arrangements relating to superannuation be subject to renewal requirements.
That the annual fee disclosure statements contained in the Corporations Amendment (Future of Financial Advice) Bill 2011 be prospective only as per the government’s long standing commitment and that they should not apply retrospectively to existing clients.	<ul style="list-style-type: none"> ▪ Without the fee disclosure statement (FDS) there is no consolidated disclosure to the client in relation to the cost of ongoing charges for financial advice. ▪ The FDS is also an important trigger for the consumer to consider the value of any advice with which they have been provided. ▪ FDS requirements could be streamlined to convey only essential information and ensure there is consistent treatment of pre and post reform adviser income.
That section 961B(2)(g) be removed from the proposed Best Interests Duty. [Section 961B(2)(g) requires the adviser to ‘take any other step that at the time the advice is provided would reasonably be regarded as being in the best interests of the client, given the client’s relevant circumstances.’]	<ul style="list-style-type: none"> ▪ The ‘any other step’ requirement avoids the best interest test being a tick-a-box checklist. The industry asked for prescribed legislative steps in the best interests duty, then sought to minimise those steps. ▪ ASIC has made it clear that the obligations triggered by 961B(2)(g) are to ensure that any product recommendation is justified by a strategy, that the limits of advice recommended are explained, and that reviews of the strategy are prompted. These are all reasonable requirements which do not impede the delivery of scaled advice. ▪ This section is workable and practical. Industry super funds deliver tens of thousands of pieces of scaled financial advice and are not impeded by subclause (g).

¹² Recommendations 1, 2, and 5 have already been implemented. We only list major proposals in this table.

¹³ ISA estimates based upon Roy Morgan research.

¹⁴ Rice Warner Actuaries, Value of IFFP Advice, May 2011.

Major Government Policy to Reform Financial Advice	Impacts
<p>That the best interests duty in the proposed legislation be amended to explicitly permit clients and advisers to agree to limit the subject matter of advice provided in order to facilitate the provision of 'scalable advice'.</p>	<ul style="list-style-type: none"> ▪ This proposal would allow contracting out the best interest duty and diminish consumer protections provided by the best interests duty. ▪ Given the asymmetry which exists between planners and clients, this proposal could lead to planners limiting the scope of advice in a way which serves their interests rather than their client's. ▪ Major institutions in the past have sought to use 'client consent' to limit their liability in a manner detrimental to clients' interests, resulting in regulatory action.
<p>That no changes to existing remuneration structures be made where risk insurance is purchased by an individual consumer who has received specific advice on such insurance, whether such risk insurance is purchased inside or outside superannuation or whether such risk insurance is purchased through an individual policy or through access to a wholesale group policy.</p> <p>That any ban of commissions on risk insurance in superannuation be limited to automatic insurance cover within superannuation funds where individuals have not accessed any specific advice, namely in default superannuation arrangements.</p>	<ul style="list-style-type: none"> ▪ This proposal would allow commissions on group insurance products within Choice and potential MySuper products. ▪ Commissions on insurance typically amount to 1/3 of premiums paid and can add hundreds of dollars a year to premiums with their impact on retirement savings equivalent to a 0.5% trail commission on the total super balance. ▪ If implemented, insurance will become a conduit for commissions within superannuation and could improperly influence super product recommendations. ▪ Implementing such a recommendation would be in conflict with recommendations 1.14 and 1.26 of the Cooper Review, which recommended against commissions on risk insurance being allowed inside either MySuper or Choice super products.

Major Government Policy to Reform Financial Advice	Impacts
<p>In relation to monetary conflicted remuneration:</p> <p>(i) 'General advice' should be exempted from the definition of 'conflicted remuneration'</p> <p>(ii) The sale of financial planning business between a licensee and its authorised representatives should not be considered conflicted remuneration</p> <p>(iii) That section 963B(1)(c) be amended to link the payment for advice provided to a specific advice provider (rather than to any representative of a licensee) and to apply only where there is a causal link between past advice and current advice.</p>	<ul style="list-style-type: none"> ▪ Given that within the vertically integrated banking sector, financial planners and teller staff work side by side, the integrity of the reforms rely on a uniform application of the conflicted remuneration provisions. ISA is concerned that allowing conflicted remuneration on general advice would significantly undermine the ban and could enable gaming of the reforms. In addition, allowing commissions or volume based payments to be paid on general advice would shift financial planners away from personal advice in order to earn volume based sales commissions and would be likely to make financial advice less available. ▪ In effect, this proposal would be likely to promote a new stream of sales advisers incentivised by sales commissions. ▪ Point (ii) was implemented through grandfathering regulations. ▪ Point (iii) again could allow a licensee to arbitrage conflicted remuneration provisions. This provision was carefully drafted to prevent gaming of the conflicted remuneration provisions where a customer receives advice and execution services from the same licensee and conflicted remuneration can be generated on the execution services.
<p>In relation to volume based fees that Division 5 has the following major amendments:</p> <p>(i) Section 964A should be amended to expressly exempt general and risk insurance from the application of Division 5.</p> <p>(ii) Flat dollar shelf space fees would be expressly carved out of Division 5.</p> <p>(iii) Section 964A(3)(b) be amended to delete the words "does not exceed an amount that may reasonably be attributed to efficiencies gained by the funds manager because of the number or value of financial products obtained by a fund manager". This permits rebates from fund managers to product providers/platforms without the need to prove that efficiency exists.</p>	<ul style="list-style-type: none"> ▪ The proposed changes effectively reverse the restrictions on the payment of conflicted volume payments/rebates. ▪ Volume rebates are basically wholesale commissions, and give rise to all the problems caused by retail commissions but are more problematic because there is no disclosure of the amounts paid or amounts received. Volume rebates or volume based benefits paid by platforms will simply replace commissions as a way for product providers to create incentives for financial planners to prefer their products. ▪ ISA commissioned research estimates that up to \$3 billion in volume rebates are paid annually to financial advisers. ▪ Tolerance of any volume based payments will continue to misalign the interests of advisers/dealer groups and their clients, and will result in bias in the advice process.

ISA does not support dilutions or winding back of FOFA reforms

ISA believes that the proposed amendments to the FOFA legislation represent very significant weakening of the regulatory framework. Banks have sought to characterise changes as "dealing with unintended consequences" or "reducing red tape". However, the reforms could result in a weaker regulatory environment than that which existed prior to the FOFA reforms, in circumstances in which consumers have

been led to believe that commissions have been abolished and that advice must be provided in their best interests.

Any dilution of the best interests duty or conflicted remuneration provisions will seriously compromise consumer protections put in place to prevent further instances such as that which triggered this inquiry. We submit that to the extent that a further review of the regulation of advice or of ASIC's regulatory role is required, it should take place as part of the Government's proposed Financial System Inquiry.

Comments on ASIC's approach to regulation

ASIC has adopted a more proactive risk-based approach to its surveillance activities. In our view, this is the most appropriate approach since it allows ASIC to identify and address key systematic risks in an increasingly complex industry in a timely manner, thereby minimising the risks of systemic or market failures. ASIC's risk-based approach is in step with the approach adopted internationally in terms of financial regulation.

ISA also welcomes the changes ASIC has made over the past few years, especially in increasing its transparency and adopting a more forward-looking approach to regulation. ASIC's current efforts to improve its policies on whistleblowers and increasing public awareness of its activities are steps in the right direction.

1.3 ASIC's activities in market supervision and surveillance

Since taking over the market supervision role from the Australian Stock Exchange (ASX) on 1 August 2010, ASIC has been actively engaged in market developments domestically and overseas.

ISA has participated in public consultation and discussion with ASIC on a number of issues in this area, especially High Frequency Trading (HFT). ISA made a number of submissions to ASIC in relation to HFT activities, which we believe are damaging to long-term investors such as superannuation funds.¹⁵ ASIC undertook a thorough consultation process on High Frequency Trading and Dark Pools¹⁶, which ultimately resulted in some improvements in the transparency requirements and monitoring of HFT, albeit not going as far as the recommendations proposed by ISA. ISA will continue to strongly advocate for further tightening of the regulation of HFT and consideration on market structure issues so that a holistic approach can be taken with the view to creating fairer and more efficient capital markets.¹⁷

2. ASIC's relationship with the industry

ISA submits that ASIC has a proactive engagement with the finance industry. ASIC consults and discusses with relevant stakeholders on proposed regulatory measures. In the implementation of FOFA and Stronger Super reforms, ASIC has undertaken broad industry consultation and in our experience, all viewpoints presented during the consultation process are considered. ASIC has also presented a balanced view in their final reports and decisions with reasons being clearly articulated and communicated.

¹⁵ ISN's letter to ASIC on High Frequency Trading, September 2012, <http://www.industrysuperaustralia.com/wp-content/uploads/2012/09/140912-ISON-submission-to-ASIC-re-draft-market-integrity-rules-and-guidance-on-automated-trading.pdf>

¹⁶ ASIC website, Market supervision and surveillance page <http://www.asic.gov.au/asic/asic.nsf/byheadline/Markets+homepage?openDocument>

¹⁷ ISN's letter to ASIC on Consultation Paper 202 on Dark Liquidity and High-frequency trading proposals, May 2013
[https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp202-submission-ISON.pdf/\\$file/cp202-submission-ISON.pdf](https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp202-submission-ISON.pdf/$file/cp202-submission-ISON.pdf)

3. Areas for improvement

In this section, ISA would like to briefly discuss our view of how ASIC's performance can be enhanced. Areas of discussion are:

- ASIC's increasing responsibilities,
- ASIC's funding structure,
- Further engagement with the industry.

3.1 ASIC's broad responsibilities

In recent years, ASIC has taken more responsibilities, becoming a "regulatory conglomerate that also covers insurance, superannuation, credit markets, margin lending, business names and share market disclosure".¹⁸

There has been some public debate about the scope of ASIC's current activities and whether it would be appropriate for some of its current activities to be divested to other single-purpose entities.¹⁹ A report from the International Monetary Fund (IMF), on the other hand, suggests that "the adequacy and stability of ASIC's funding is crucial for it to carry out proactive supervision".²⁰ ISA is of the opinion that it is first crucial to address ASIC's funding, and whether it is adequate to support the regulator's responsibilities.

3.2 Funding model for ASIC

Current ASIC funding arrangement

Since its inception, ASIC has been funded entirely by the Government: "Funding for ASIC comes from allocations within the annual budget of Parliament".²¹ On the other hand, the majority of RBA's income comes from its "portfolio of financial assets" while Australian Prudential Regulation Authority (APRA)'s funding is "largely financed by fees imposed on the financial sector entities it supervises as determined and collected by the Australian Government—as a levy on supervised entities."²²

As part of its operations, ASIC also collects fees and charges on behalf of the Commonwealth Government under the Corporations Act, fees and charges under the National Credit Act from 1 July 2010, and also new fees collected by ASIC since 1 August 2010 from market operators. The following chart summarises ASIC's operating expenses and fees and charges collected on the behalf of the Government for the past five years.

It is clear that ASIC collects more revenue than its expenditure. However, it does not keep the revenue stream.

¹⁸ Maiden, Malcolm (2013) Funding the key to ASIC overhaul. Sydney Morning Herald. <http://www.smh.com.au/business/funding-the-key-to-asic-overhaul-20131010-2vbf.html>

¹⁹ Ibid.

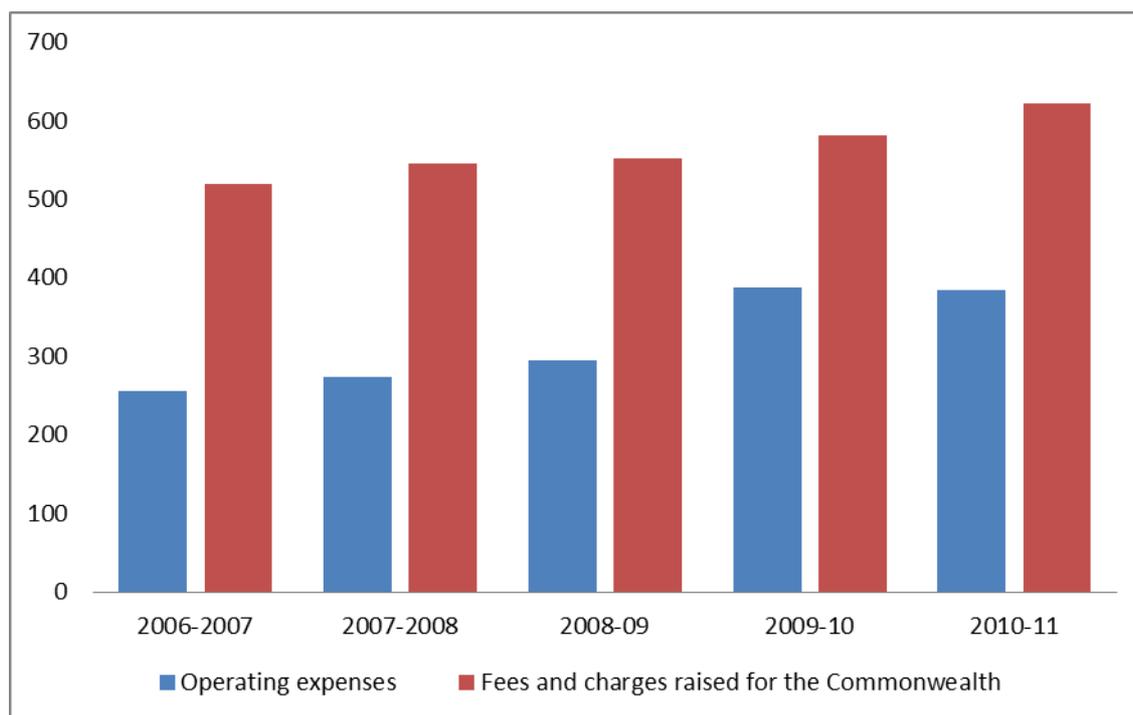
²⁰ IMF (2012) Australia: Financial System Stability Assessment.

[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cr12308.pdf/\\$file/cr12308.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cr12308.pdf/$file/cr12308.pdf)

²¹ Group of 30 (2013) The Structure of Financial Supervision – Approaches and Challenges in a Global Marketplace

²² Ibid. 28

Figure 1 – ASIC’s operating expenses and fees and charges collected on the behalf of the Government



Source: ASIC Annual Reports

There have been concerns that the budget for ASIC is inadequate given their broad and complex regulatory focus and this might prevent ASIC from working effectively.²³ ASIC’s funding is divided into core and non-core funding. In recent years, non-core funding for specific projects has been a significant part of its budget. This, according to IMF, prevents ASIC from proactive regulation.²⁴ For example, in ASIC’s handling of the CFPL case, ASIC has cited resource limitation as a reason for the delay in solving the CFPL case, as the same team had to deal with problems from the Storm Financial collapse.²⁵

Tightness and inflexibility in budget can limit ASIC’s effectiveness, turning it into a “desktop regulator”. Due to resource constraints, ASIC relies more on “its initial risk-based assessments, self-reporting of breaches of regulatory requirements and third party notifications” rather than more frequent onsite reviews and proactive surveillance.²⁶

The finance world is increasingly complicated with emerging risks and challenges. It is essential that ASIC is adequately funded and resourced to carry out its duties. We would not support any proposals to cut ASIC’s funding.

²³ For example, in 2012 the IMF called for increase funding for ASIC. <http://www.smh.com.au/business/asic-needs-more-funding-says-imf-20121122-29suo.html>

²⁴ Ibid. 22

²⁵ Shanahan, Leo (2013) ASIC admits it was slow to assess Commonwealth Financial Planning advisers. The Australian. Accessed 10 October, 2013. <http://www.theaustralian.com.au/business/financial-services/asic-admits-it-was-slow-to-assess-commonwealth-financial-planning-advisers/story-fn91wd6x-1226690471208#sthash.NmD2Fr6.dpuf>

²⁶ Ibid. 22

Alternative funding options

Were there to be a review of ASIC's role or funding basis, ISA recommends that this occur as part of the financial system inquiry. Were the issue of ASIC's funding to be included in the review, in our submission, the main goal should be to ensure an adequate and reliable funding source so that ASIC can carry out its objectives independently.

There has been suggestion that ASIC can replace "government funding with the industry levy model that financially underpins its sister regulator APRA".²⁷ This idea, in principle, will give ASIC the ability to independently organise and plan its operation budget.

The idea is close to the self-funding agency model (or user-pay regulation), where the industry is levied to fund regulation activities. Essentially, the sectors that require the most supervision will be paying the most. The Financial Conduct Authority (FCA) in the UK has been following this practice.²⁸ There are also suggestions in the US of similar user-pay regulation model for the Securities and Exchange Commission and the Commodity Futures Trading Commission.²⁹

Some advantages of the self-funding agency model are:

- The agency can independently set its budget based on necessary activities without relying entirely on the Government. This means there is potentially no need to delay important actions, which can result in more effective regulation.
- Financial regulation is paid for by participating firms, not by tax payers. Moreover, the area which requires the most regulatory resources will be allocated more charges.

For this fee-paying model to work, it is necessary to have a process which clearly defines the types and amount of fees paid by firms and how fees are raised. More importantly, there needs to be a clear accountability framework for the regulator to operate in. This should detail the regulatory body's responsibilities, reporting duties and also outline criteria for a periodic auditing process.

The Financial Conduct Authority (FCA) in the UK can provide a good example of this model.³⁰ Instead of Government funding, the FCA charges fees to all authorised firms that carry out activities that it regulates, as well as other bodies such as recognised investment exchanges (See Appendix 1 for details).

In terms of accountability, Treasury can appoint independent auditors to examine the FCA's actions and process. However, the criteria for evaluation are still in the process of being developed.

3.3 Secondment with different industry entities

ISA also recommends that ASIC organise a formal secondment procedure with the industry. Through this process, ASIC staff can work in different firms in the industry to ensure that the regulator's staff have a deeper understanding of the industry which it regulates, including market developments and culture. In addition to helping ASIC deepen its industry knowledge, it may also assist the industry to better understand the approach taken and the challenges and opportunities facing the regulator. Ideally the secondment program would explicitly seek to connect ASIC with graduate and/or leadership programs held by major institutions.

²⁷ Ibid. 22

²⁸ Durie (2013) ASIC eyes radical funding rethink on UK lines <http://www.theaustralian.com.au//business/opinion/asic-eyes-radical-funding-rethink-on-uk-lines/story-e6frg9io-1226683984845>

²⁹ Born and Donaldson (2013) Self-funding of regulators would help fiscal mess <http://www.politico.com/story/2013/03/self-funding-of-regulators-would-help-fiscal-mess-88666.html>

³⁰ The Financial Services Authority was split into two separate regulatory authorities, both operating under the Bank of England from 1 April, 2013. The FCA is in charge of market supervisory and consumer protection while the Prudential Regulatory Authority focuses on banks and insurance firms.

3.4 Explicit regulatory function

Furthermore, we understand that there has been some debate regarding the appropriateness of ASIC's involvement in policy development. ISA submits that ASIC should be explicitly charged with the public advice to government in relation to emerging or existing market practices with which they hold concerns, in addition to input into appropriate regulatory responses. When considering the financial advice reforms, the ASIC submission into the inquiry into Storm Financial and others explicitly identified conflicted remuneration as a key cause of the collapse. Subsequent submissions have identified ongoing asset based fees and other forms of remuneration as creating further risks of the creation of conflicted remuneration structures. These views, whilst not necessarily being determinant of government policy, should be considered above the views of industry. Their regulatory role enables them to provide a unique and informed perspective or evidence critical to the development of policy.

While ISA (and industry super funds individually) might have occasion to engage in robust debate with the regulator, we retain the view that just as self-regulation carries with it limitations, so should industry advocacy of the weaknesses of their regulator be treated with caution, if not downright scepticism.

A well-resourced, apolitical regulator will best serve the needs of Australian consumers and citizens as well as the industries and markets it is charged to regulate.

4. Conclusion

ISA welcomes the opportunity to be involved in the Senate Inquiry into the performance of ASIC. Generally, we support ASIC's roles and mission and believe that it has been broadly successful in maintaining fair and efficient finance markets. While ASIC has identified improvements in its regulatory approach which are welcomed, in ISA's submission the primary cause for the numerous scandals and collapses rests with the inadequate regulatory framework which existed prior to the FOFA reforms.

ISA also submits a number of suggestions to improve ASIC's performance, including:

- ASIC's current funding regime should be reviewed to ensure that the regulator is adequately funded to carry out its duties.
- A formal secondment process between ASIC and the industry should be established. This will enhance ASIC's industry knowledge.
- Given ASIC's knowledge of the industry, it should have specific mandate for regulatory policy development and public advice to Government and Treasury. (For example where ASIC has a contrary view to government policy, it is not inappropriate that this be in the public domain).

Appendix 1 – How does the FCA charge their fees?

The FCA charges three types of fees:

- annual (periodic fees), which provide most of the funding needed to carry out the FCA’s statutory functions;
- application fees, which recover some of the costs incurred in processing certain applications; and
- special project fees, to recover exceptional supervisory costs where a firm undertakes certain restructuring transactions.

Authorised firms are divided into fee-blocks. Each fee-block generally represents a broad category of firms in finance sector. A firm can be part of more than one fee-block.³¹

Table 3 –Fee-blocks definitions

Fee-block	Summary of fee-payers	Commonly referred to as
A: this group is further divided into 16 sub-group This group represents around 92% of cost recovery paid to the FCA.	This group includes banks, building societies, insurers, fund/asset managers, trustees of collective investment schemes, retail investment intermediaries, mortgage intermediaries and general insurance intermediaries	Firms
B	Investment exchanges, auction platforms, multilateral trading facilities, service company and firms that are designated as the operator of a prescribed market for the market abuse regime	Market Infrastructure Providers
C	Collective investment schemes	CIS products
D	Designated professional bodies	DPBs
E	Issuers of listed and non-listed securities or their sponsors	Issuers of securities
F	Unauthorised persons subject to the FCA’s registration function	Mutuals/registrant-only
G	Firms registered under the Money Laundering Regulations 2007, covered by the Regulated Covered Bonds Regulations 2008, the Payment Services Regulations 2009, or the Electronic Money Regulation 2011.	MLRs/RCBs/PSRs/EMRs

The annual fees are calculated for the upcoming periodic fee year (from 1 April to 31 March). The FCA’s Business Plan is used to work out the annual funding requirements, which consist of two costs: ongoing regulatory activity costs & changes in scope costs.

³¹ FCA, How do we raise our fees <http://www.fca.org.uk/static/documents/how-we-raise-our-fees.pdf>

The cost allocation process is as follow:

- Direct costs are allocated directly to a fee-block (for examples: people costs and associated overheads);
- Indirect costs are allocated to individual fee-blocks in proportion to the direct costs allocated.

Although the fees set are forward-looking, once the fees are determined, they are final. This gives greater certainty to the FCA operation.³²

³² There are further rules to determine the amount an individual firm would pay. For more information, please refer to the document titled "How we raise our fees" by the FCA here <http://www.fca.org.uk/your-fca/documents/how-we-raise-our-fees>

End Notes for Table 1.

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⁶ Great Southern Limited, 'Financial Statements 30 September 2008' (Great Southern Limited, 2008), p 7.

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¹³ Kohler, Alan, 'Westpoint Wreck Shows How Deep Commissions Can Cut', *The Age*, 4 February 2006, section Business <<http://www.theage.com.au/news/business/westpoint-wreck-shows-how-deep-commissions-can-cut/2006/02/03/1138958906665.html>> [accessed 15 August 2011].

¹⁴ Ibid.

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