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27 March 2015

Senior Adviser
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Dear Madam/Sir,

Financial System Inquiry Final Report

Submission by Australian Shareholders' Association

Background

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. ASA is an independent not-for-profit organisation funded by, and operating in, the interests of its members, primarily individual and retail investors, self-managed superannuation trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members, but follow the ASA through various means, as our relevance extends to the broader investment community.

ASA made two comprehensive submissions in the first two stages of the Financial System Inquiry (FSI): those submissions still stand. We set out below our submission on the FSI Final Report, to respond to new themes and to restate important principles. Although we have otherwise limited our comments to the matters of greater relevance to ASA members, there is little in the Final Report's 44 Recommendations that ASA would disagree with. We congratulate the Inquiry on its work.

We make some general comments before we discuss those Recommendations which have particular impact on our members, and retail investors generally.

ASA applauds the emphasis on fair treatment throughout the Final Report- in particular the statements on pp 6 and 11. We urge Government to take heed of these. Of the three crucial themes of resilience, efficiency and fairness, we consider that fairness is the area that needs the most work. That is clearly interdependent with efficiency, and ultimately resilience, of the financial system. As p 6 states, consumers and investors should not be entirely shielded from the consequences of their decisions, but they must have a reasonable prospect of understanding what they might invest in. The system must be realistic about the extent of '*behavioural biases and information imbalances'.*

The Executive summary of Chapters 4 and 5, pp xx and xxi, says little regarding equity markets, whether on the raising or trading of capital, or the governance of these markets and companies in general. The reference in the first paragraph of p 14 states '… *the framework for the issuance and trading of debt and equity in Australia is operating reasonably well. Australia has a well-functioning equity market …'*, but it doesn't quote evidence or discuss this further. The funding chapters focus mainly on wholesale (debt) funding, especially of the banking system, and to a minor extent on retail corporate bonds- but not equity capital, except for CSEF under Recommendation (R) 18 (and thus by implication for SMEs) and venture capital.

Chapter 4 examines 'consumer outcomes' extensively, but through a conceptual framework of financial products and services. That is, it considers the position of the public as *consumers* of financial products and services that have been manufactured and distributed to them. Whilst this is necessary and important, it is by no means sufficient. To some extent this may be a matter of terminology, but the over-simplification is unfortunate. The five categories of system participants described on p 6 do not mention investors; by default they must be understood to be included in 'consumers'. We note that the Final Report defines its own use of 'consumers' to be 'retail clients' as defined in the Corporations Act, but the Final Report also refers in places to 'retail consumers'. In Chapter 3 'retail investor' is used, but this seems to be only with respect to CSEF. 'Investor' is used with respect to CFDs, which are anything but a mainstream form of investment. Retail equity investors, whether directly in public companies and trusts, or indirectly through superannuation and managed funds, are mostly accorded only a shadowy presence in the Final Report, despite the very large source of capital that they represent.

The provision of equity finance is crucial to an open, advanced economy. The providers of equity — both professional and retail — should be considered as distinct from, and more sophisticated than, mere consumers of products and services. Strong, efficient and fair mechanisms for raising and trading equity capital are essential. This assessment also requires comparison of Australian equity's attractiveness to investors, relative to other domestic and international investment classes. That subject is much broader than the admittedly important debate on real or purported tax distortions.

Australia enjoys a financial system that is generally efficient, resilient and well regulated. However, the financial sector itself has not adequately advanced the goals of providing good value, variety, transparency, fairness and competition benefits to individuals. Improvements in consumer outcomes have often taken years to bring about, with resistance from the finance sector. This is partly because lobbying by industry is plausible and well-funded, whereas consumer sector advocacy is fragmented and weakly resourced. Government and regulators are well meaning, but frequently slow in considering and then implementing change. To counter this asymmetry and expedite reform, it would be desirable to have greater resources devoted to independent academic research in finance, especially as it concerns consumers and retail investors. Good work is being done, but it seems to have had only a marginal impact on the advancement of policy, and should be broadened. Timely, objective and rigorous analysis should be available (or supplied to Government sector inquiries) to provide balance to the selective arguments of the finance industry and its professional advisers. ASA supports the statement on p 193 of the Final Report that '*reviews and proposed changes to the financial services framework should [always] involve consumer organisations in policy development, alongside industry, regulators and other stakeholders*'.

Chapter 5 focuses on the roles and strength of the regulatory system. We strongly endorse the objective on p xxi of the Executive summary that '[ALL OF] *Australia's regulators have the funding, skills and regulatory tools to deliver their mandates effectively'*. This must include the Australian Taxation Office and the Australian Bureau of Statistics, the latter of which, even though not a 'regulator', undertakes a vital role in providing timely and reliable data on the economy.

It is understandable but disappointing that the Final Report has focused so much on the banking system. That is a paradox, as it is the part of the Australian finance system that is generally working very well. It has an excellent regulator in APRA, as well as strong discipline imposed by Basel and international agencies. In contrast, consumer interests, general and life insurance, and the investment sector, have not been subject to the same disciplines. They suffer from overpricing and inefficiency, and insufficient fairness and transparency; the FSI does acknowledge this, but we feel that the Final Report could be more forceful on these themes. We welcome the Report's statement on p xviii of the Executive summary that '*the superannuation system is not operationally efficient due to a lack of strong price- based competition'*. We agree: the same problem pervades the non-superannuation managed funds sector where, despite a very large number of participants, and obvious opportunities to reap the rewards of scale, there has been limited innovation or pricing benefit for investors.

Charts 9 and 10 in Appendix 4 show the frequency of topics raised in submissions, and by whom. Subjects of particular interest to ASA (eg, financial product disclosure, financial advice and its failures, public superannuation fund governance and corporate bonds) were raised in only a small number of submission, although they were in the 'top 3' themes for some groups of respondents. Unfortunately, no tax topics were included in these charts. We must assume that they were deliberately excluded by the FSI, along with its decision to place all the tax matters in Appendix 2, to be considered in the tax White Paper. The Government's directive to exclude taxation from the terms of reference of the FSI has been unhelpful. Dividend imputation — which is of fundamental importance to retail shareholders —is mentioned only on p 17 and in Appendix 2. We comment further on that in the final paragraph of this submission.

The Final Report makes about a dozen references to 'financial literacy', but they are scattered and do not appear to give rise to a specific recommendation. We agree with submissions by others that have stated that good disclosure is a necessary but not sufficient condition for consumer protection. Much stronger and wider financial literacy must be a paramount and long-term objective for Australia, starting in schools. This will help to mitigate the behavioural biases and informational imbalances that the Final Report notes. Financial advice and planning must of course continue to be made more professional, and be thoroughly monitored. However, the best protection against flawed products and distribution, or poor disclosure and advice, is a well-informed public. That should also act as a spur to better product development and price competition. Australia has a serious need for well-resourced counselling and consumer financial advisory services; these bodies must be confident of receiving sustained Government funding to maintain their valuable services and operate in parallel with ASIC's work. It is in no one's interests if the inefficiencies, misbehaviour and investor losses of the last decade are perpetuated.

Our more detailed comments on the Final Report and its Recommendations follow.

Chapter 1: We endorse the eight recommendations. However, for R 6, ASA believes that ex-ante funding of the FCS would be preferable, or at least a split where some of the funding is raised before distress occurs.

Chapter 2: ASA supports all the five recommendations. We suggest that R 9 include an express statement that fairness be an objective, and reported on, regarding (1) the distribution of tax concessions within superannuation, and (2) fairness of means testing for pensions etc. to ensure consistency with policy on tax concessions for superannuation.

Recommendation 13 on governance and reporting by public offer superannuation funds is very important, and is closely linked to ASA's mandate, albeit at one remove. We referred to this in Part 3.5 of our first submission and p 10 of our second submission. Industry Super Funds have, in general, been a very successful development and performed well for their members— which in many cases have included the public in recent years. Although it is true that many such funds have outperformed their sector peers, it is doubtful that this is attributable (beyond a small extent, if any) to their board composition, as some have asserted. That is much more likely to occur from a focus on costs and their non-profit status. The Final Report notes that some submissions to FSI were concerned that a requirement for independent directors would lead to expanded boards and greater costs. It is hard to accept this; even if true, the costs would be very small relative to the asset bases of most public offer super funds. We note that some public offer funds, which were originally aligned with a particular union or industry, still spend money on commercial sponsorships that relate to that industry, or otherwise advertise to increase membership. Such practices appear to be at odds with SIS Act obligations, once the funds decide to open up to public membership.

The Final Report states that governance should be strengthened because members do not have the power to remove directors who breach their duties. Members of public offer funds *should* be allowed both to appoint and remove directors (perhaps subject to APRA and ASIC approval). Super funds' governance requirements ought to be harmonised as far as possible with the ASX Principles. A transition period is desirable to avoid disturbance, but it should be no longer than three years. We support aligning civil and criminal penalties for life insurance company directors with those applying to MIS directors, as proposed on p 136.

Treasury conducted a major enquiry on super fund governance ['Better *regulation and governance, enhanced transparency and improved competition in superannuation' Discussion Paper 28 November 2013*] and received 90 submissions. We note that that Paper also addressed important topics in transparency and disclosure. It is disappointing that Treasury has not announced the findings of its own inquiry (now over a year old), and surprising that FSI makes no reference to that enquiry. We urge Treasury to publish the findings immediately, and Government to enact recommendations that are long overdue, to reform the governance and transparency of this very major pool of savings. Although R13 refers only to governance, the transparency and reporting proposals in the Treasury Paper should also be acted upon forthwith.

Chapter 3: ASA commented on R 18 (on CSEF) in Part 3.1 of our first submission. We are surprised that Treasury is conducting a further inquiry into CSEF, for which submissions closed on 5 February 2015, and that doesn't refer to the FSI's work. This follows the year-long and very comprehensive CAMAC investigation into CSEF, which reported to Treasury in June 2014. ASA believes that after such extensive consultation, and many stakeholder submissions, it's time to for Australia to implement its CSEF regime.

Chapter 4: ASA endorses all these recommendations. Please also see our introductory comments, especially on the paramount principles of fairness, suitability and accountability that must pervade the entire financial system when consumers are involved. We emphasise, again, the importance of financial literacy and counselling to ameliorate the imbalances of knowledge that exist between providers and advisers on the one hand, and consumers on the other. We welcome ASIC's increasing focus on behavioural biases that undermine the legislation, which (naively) assumes economically rational financial consumers and investors.

Recommendation 21: ASIC has done useful work on regulating and monitoring Complex Products [eg, REP 384 and REP 400], retailed structured finance products and hedge funds; but a tougher and more comprehensive regime is needed. Of the three options considered on p 201, we agree that the first option is the best.

Recommendation 22: We strongly support ASIC being given a product intervention power. ASA is a member of the Consumer Advisory Panel, and we endorse the joint submission by the Panel of an independent research paper on this subject. Given the depth and substance of that paper, we make only a few additional comments here. MISs in forestry and agribusiness have caused enormous investor losses, as have various types of listed hybrids in previous years, and high yielding loans to finance companies. Page 207 refers to Banksia Securities and similar 'debenture' cases. We are aware that ASIC consulted on this through its CP199, and so did APRA: we understand that the two regulators made recommendations to Treasury a year ago, but that Treasury has not yet proposed action. Aside from supporting the broad theme under R 22, we urge Government to implement reforms quickly to reduce the risk that similar cases can recur because of investor misunderstanding about non-bank products.

Of the three options considered on p 210, we agree that option 1 is the best, because it is broadest and can therefore be best targeted at specific abuses rather than crudely at a whole class of products or services. However, we do think that there is merit in option 3 '*Prohibit distribution of certain classes of non-mainstream products to retail consumers'.* We note that the Final Report says the intervention power is not intended to address problems of pricing of retail financial products; yet we are concerned that large volumes of hybrids have been marketed to retail investors by listed companies, especially banks, and that investors do not understand their risks, or cannot make a realistic assessment of the returns against the risks. Even if option 3 is not implemented now, Government and ASIC should be alert to the need to take the UK's more severe step of banning distribution of such products, at least to retail investors who do not qualify as 'sophisticated investors'. Page 209 refers to CFDs: these high risk products (with embedded gearing of 100 or more times) do merit the application of R 21 and R 22 now.

Chapter 5: R 28 and R 29 are vital. ASA reaffirms the statements made on these subjects in our second submission. The RBA and APRA appear to be well funded; but ABS and ATO are not, to the detriment of the economy. ASIC's funding needs to be considerably greater, and more reliable. The cuts to ASIC's funding in the last two years are deplorable and should be reversed. User-pays funding method is acceptable providing strong Chinese walls eliminate the potential for conflict of interest. ASIC needs more funding and expert staff to increase the surveillance of financial market sectors, eg, investment banks, hedge funds and complex products issuers are too thinly covered at present. Maximum penalties need to be greatly increased, as does the expectation of enforcement. Government's deregulatory agenda is naïve and one-sided. The cost-benefit analysis used by OBPR of removing regulation (absurdly) ignores the deleterious effects to consumers, which are likely to be many times larger than the savings to the business sector.

ASA supports the second recommendation in R 27; but the expectations and assessment of regulators must be apolitical, and consistent with resourcing determined in accordance with recommendations R 28 and R 29. We do not believe that the new Board suggested in R 27 is necessary or desirable: it would be more appropriate for the regulators to report directly to Parliament, rather than to the Government. There should be active liaison between regulators to ensure that matters do not 'fall between the cracks', and hence could be exploited by unscrupulous parties.

We made the following comment in our submission of 16 June 2014 regarding ASIC's REP 391 '*Cooperation between regulators: APRA and ASIC reporting standards.* Paragraphs 36-38: ASA welcomes this statement and in our submission to the Senate Inquiry into ASIC, we argued strongly for such cooperation. The boundaries between ASIC, APRA, ACCC and at times Treasury are not always clear, and ASA believes that where there is overlap there should be a "lead" regulator. Conversely, there are areas that seem to fall between the scope of regulators — at least in consumer law and finance — and unscrupulous operators design their business models to exploit those gaps.'

We disagree with the first part of R 31: the finance industry is very successful at asserting that regulatory improvements are 'onerous' and delay their introduction for years. Governments and regulators should be tougher and more sceptical about these claims, not offer additional latitude.

Appendix 1: ASA supports R 33, on the assumption that it is referring to A$ debt issues by listed entities incorporated in Australia. Is it intended to include listed trusts? We support R 35, and urge regulators and Government to complete the work started in ASIC's Consultation Paper 199 on debentures, and for Government to legislate these long overdue improvements with urgency. We also support R 37, R 40 and R 43, and the first limb of R 42. The second limb of R 42 doesn't appear to warrant priority. However, we are surprised that R 37 proposes the resumption of providing long term income or wealth projections; we understand that these were banned about 20 years ago following widespread abuse by life insurance salespeople, among others.

The text under R 44 comments on the ASX's role as a co-regulator. It appears to suggest that now that ASX's responsibility for market supervision has been transferred to ASIC, and proposals are under way to allow for stronger cross-border regulation, no conflicts of interest would remain and ownership restrictions can be loosened. We are not persuaded by this. ASX is still a quasi- regulator, as it mandates the Listing Rules for all listed entities, and it establishes the corporate governance principles, albeit they are not compulsory. ASX has a monopoly over the clearing and settlement system, and is seeking to extend this for up to a further five years. We do not support that, and we consider that the Listing Rules and market practices have favoured large shareholders over retail investors. Also, the governance principles and the Corporations Act have perpetuated the treatment of investors in listed (non-stapled) trusts as second class investors with respect to reporting, engagement and accountability. Irrespective of the question of ASX ownership, ASA would like to see the Listing Rules modernised — the provisions for investors in listed trusts be harmonised as far as possible with those for shareholders in listed companies, and ASX's monopoly on clearing and settlement opened to competition.

Box 3 on p 17 discusses some purported major tax distortions. We don't dispute the comments on the tax treatment of interest income and capital gains. However, we disagree with the direction of the comments on imputation. ASA strongly supports dividend imputation, as it has a direct bearing on all Australian share investors, and how they choose to invest. The Final Report does not indicate how many submissions were made that recommended the abolition of imputation, but we surmise that they were not from investors or investor bodies. We are concerned that the FSI may not have tested the veracity of assertions by some parties that the case for imputation is now weaker. It is not. If imputation were to be abolished, and double taxation of dividends reintroduced, it would necessitate radical changes to company dividend policy and probably cause substantial shifts away from Australian equity to other asset classes. It could be expected to encourage a major shift to international equities, which would counteract and perhaps exceed the inward capital flows that the final paragraph of p 17 considers to be desirable. It would inevitably harm Australian equity values and increase the cost of capital.

I recognise here the contributions made by my colleagues Richard Wilkins and John Campbell in preparing this submission.

Ian Curry
ASA Chairman