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Performance Audit

ASIC's Implementation of Financial Services Licences

Australian National Audit Office

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Canberra ACT
24 January 2006

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Securities and Investment Commission in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *ASIC's Implementation of Financial Services Licences*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name.

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations/Glossary

ABS	Australian Bureau of Statistics
ADI	Authorised Deposit-taking Institution
ADJR Act	<i>Administrative Decisions (Judicial Review) Act 1977</i>
AFSL	Australian Financial Services Licence
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
Banking Act	<i>Banking Act 1959</i>
Corporations Act	<i>Corporations Act 2000</i>
Finance	Department of Finance & Administration
FSL	Financial Services Licence System
FSR	Financial Services Reform
FSR Act	<i>Financial Services Reform Act 2001</i>
FSR Bill	Financial Services Reform Bill 2001
FSRA Act	<i>Financial Services Reform Amendment Act 2001</i>
FSRCP Act	<i>Financial Services Reform Consequential Provisions Act 2001</i>
IAB Act	<i>Insurance (Agents and Brokers) Act 1984</i>
IPC	Information Processing Centre
LARA	Licence Analyst's Roadmap to AFSL
LAW	Licence Assessment Worksheet
MI Act	<i>Managed Investments Act 1997</i>
NFA	No Further Action
OPR	Output Pricing Review
PHIAC	Private Health Insurance Administration Council
RASS	Risk Assessment and Scoring System

RPG	Regulatory Policy Group
SeRF Groups	Sector Risk Focus Groups
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
STIRS	Surveillance Targeting Intelligence Reporting System
Treasury	Department of the Treasury

Summary and Recommendations

Summary

Introduction

1. The Australian financial sector is responsible for managing assets of almost \$2 trillion. It is regulated primarily by the Australian Securities and Investments Commission (ASIC). ASIC is responsible for regulating company and financial services laws to protect consumers, investors and creditors. From 11 March 2002, its responsibilities include the licensing of entities engaged in the business of providing financial services, broadly defined.

2. This responsibility was conferred by the *Financial Services Reform Act 2001* (the FSR Act). It amended the *Corporations Act 2000* (the Corporations Act) to replace a number of existing financial sector licences with a single licence. Potentially, the new licence extended to a range of financial activities not covered by earlier Corporations Act licences, particularly in the superannuation, insurance, deposit-taking, payment service and foreign exchange sectors.

3. The primary objectives of the reforms were to benefit the industry through more uniform regulation and to give consumers a more consistent framework of consumer protection in which to make their financial decisions. To achieve these, ASIC received Budget funding of \$63 million over the years 2001–02 to 2005–06. This included funds for licensing and for granting relief from licensing, for surveillance and enforcement, and for the development of industry guidance.

Audit approach

4. The audit objective was to examine the effectiveness and efficiency of ASIC's implementation of Australian financial services licences. In particular, the audit examined ASIC's planning for the introduction of financial services licences; the roles of the Department of the Treasury (Treasury) and ASIC in defining the effective scope of licensing; ASIC's assessment and processing of licence applications; and ASIC's supervision of licensees.

Overall audit conclusions

5. A single licence regime is now in place for the financial services sector. By the transition deadline of 10 March 2004, ASIC had issued 3 738 financial services licences. By 30 June 2004, this had risen to 3 853 financial services licences. The number of licences had risen to 4 135 by 30 June 2005.

6. The broad definitions underpinning the Corporations Act licence regime could bring many entities offering financial services within its regulatory scope, either as licensees or authorised representatives.¹ However, statutory exemptions have served to limit the scope of the licensing regime, as have ASIC's statutory powers to grant relief from financial services licensing requirements. Together, these have reduced the need for licences.

7. Two-thirds of all the licences granted during the two year transition period were granted during the last six months. ASIC successfully dealt with the late influx, and the generally poor standard of applications, by reallocating resources from other activities, such as the surveillance of licensees (so that surveillance staff could be available to achieve licensing targets), and by curtailing analysts' scrutiny of applications (to reduce processing time). ASIC's licence systems did not properly record critical elements of its licence decisions, such as ASIC's assessment of the applicant's character or its assessment of the applicant's evidence that they could meet their licence obligations. Overall, important regulatory risks were not systematically addressed until after the end of the transition period.

8. The end of the transition period has seen ASIC re-structure its licensing activities. From March 2005, licensing operations are carried out within ASIC's Regulation Directorate and licensee surveillance activity within its Compliance Directorate. This better reflects the complexity of ASIC's enforcement and regulatory tasks and the need to have a strong enforcement and regulatory presence in all the areas of the financial services industry. To this end, ASIC is making greater use of risk analysis.

Recommendations and entity responses

9. ANAO has made seven recommendations, six to ASIC alone. Of these, three are aimed at improving the documentation of ASIC's licence processing, the useability of its public licensee database and the reporting of ASIC's compliance performance. The remainder focus on improving ASIC's processes for identifying and managing regulatory risks.

10. Treasury and ASIC are the joint respondents to the remaining recommendation, that they consider the benefits of making licence applicants' certifications more enforceable than at present.

¹ At May 2004, 1 083 financial services licensees (or 28 per cent) had appointed 36 367 authorised representatives to provide financial services on their behalf.

11. ASIC and Treasury agreed with the relevant recommendations. In addition, ASIC provided the following summary comment on the report:

ASIC welcomes the recognition by the ANAO of the substantial and important work done by the organisation to implement the new financial services regime. The transition to that regime represented a very significant change in regulation, and a major challenge, for numerous sectors of the financial services industry.

We agree with the recommendations made by the ANAO, and confirm that those recommendations that relate to ASIC have been or are being implemented.

As the ANAO notes, ASIC has now re-structured its activities. We believe these changes and the resultant changes in the allocation of our resources has positioned us well to deal with the regulatory landscape as the FSR regime matures.

Key Findings

ASIC Resources and Budget Funding

12. The 2002–03 Budget included \$90.7 million for implementing financial services reform, including \$59.9 million for financial services licensing. ASIC spent more on financial services reform-related activity than was budgeted. In addition, to address the peak licensing workload and the generally poor quality of the majority of the license applications, resources in other units were reallocated to the licensing area. This meant that less resources than were originally budgeted were spent on activities such as surveillance.

Licensing

13. The *Financial Services Reform Consequential Provisions Act 2001* (the FSRCP Act) set out how ASIC was to go about licensing existing industry participants. For two years up until 11 March 2004, those who met basic legislative criteria could directly replace their old licence with a new licence, a process called *streamlining*. Unlike streamlined applicants, new applicants were subject to the full licensing processes set out in the amended Corporations Act. Over the transition period, ASIC granted 953 licences after a full assessment process, granted another 909 licences under a limited licence assessment process, and streamlined 1 875 old licences into new licences.

14. ASIC succeeded despite a late rush of applications. To do so, ASIC took administrative action to reduce processing times, accelerated the processes for checking applicants' *bona fides*, and reallocated resources from other activities (including the surveillance of licensees).

15. In September 2005, ASIC advised ANAO that considerable additional workload was generated by the generally poor quality of the majority of the licence applications. As a result, the ANAO found that ASIC applied almost twice the resources anticipated on processing licence applications. This was funded, in part, by reallocating resources from ASIC's non-licensing activities.

Applications for relief

16. ASIC has statutory powers to grant relief from financial services licensing requirements. Between October 2003 and April 2005, ASIC granted 2 532 relief applications, half relating to the licensing provisions. ANAO examined ASIC's records of its significant relief applications and confirmed that the applications received a high level of scrutiny.

17. ANAO estimates that ASIC's processing of relief applications consumed four times the resources initially anticipated. In this context, ASIC advised ANAO in September 2005 that, while it significantly over-estimated the number of relief applications, it also significantly under-estimated the complexity of the applications for relief that were sought.

Licence coverage

18. Initially, the licensed population under the new financial services regime was less than that of the pre-FSR Corporations Act regime it replaced. Legislative provisions exempt significant proportions of the financial services sector from the requirement to hold a licence. ASIC and Treasury are also of the view that, in light of the rigorous licence assessment process, a significant proportion of former financial service providers who were previously expected to apply for a licence instead chose to act as the authorised representative of another licensee.

19. ASIC is aware of lower than expected coverage among financial advisers and in the superannuation sector. However, in this respect ASIC advised ANAO, in September 2005, that it was difficult to provide useful estimates of the potential population which might fall within the financial services licensing regime, and therefore of the current rates of coverage.

Licence processes

20. ASIC's decision to grant a licence depends on its assessment of the adequacy of the facts of the licence application and ASIC's judgment as to whether the applicant complies with the statutory criteria. The main licence assessment record is an electronic Licence Assessment Worksheet (LAW). Developed as a tool to manage licensing work flows, each LAW follows a standard format. It summarises the licence assessment undertaken by ASIC staff and records any comments or concerns they may have raised.

21. ANAO examined a random sample of 50 LAWs and found that, while effective as a means of managing workflow, they were less effective as a record of licensing decisions. In particular, ANAO found that the LAWs did not always record ASIC's assessment of the merits of the application and its consideration of all relevant matters. Consequently, the critical elements of ASIC's licence decision were not always clearly identified, in accordance with the key principles of administrative law.

22. In applying for a licence, applicants are required to make certain certifications. ANAO found that there is merit in Treasury and ASIC considering the benefits of making these certifications more readily enforceable.

Consumer information

23. ASIC's on-line databases are intended to support consumers to make informed financial decisions, through a public register of licensees and their authorised representatives. ANAO detected some deficiencies in the operation of ASIC's internet interface to the databases, which ASIC has since rectified. ANAO has also recommended further improvements to the database to assist members of the public searching on-line for licensee information.

Managing regulatory risk

24. ASIC aims to prevent, deter and detect non-compliance and, where it finds non-compliance, to rectify it. ASIC's deterrence strategies include the public announcement of surveillance activities and campaigns and their results, including enforcement outcomes.

25. ASIC's plans for implementing the new licences focused particularly on the risk that many market participants might apply too late to obtain a licence during the transition period. This was borne out by the late rush of applications.

26. ASIC did not undertake a broad risk assessment of regulatory risks posed by the licensing changes until March 2004. At that time, it gave its highest rating to the risk of unlicensed trading, allocating it a probability of between 70 to 90 per cent and a critical impact. In this respect, ASIC stated in its *Annual Report 2003–04* that it viewed the coming years as an opportunity to increase resources devoted to compliance and to lift standards of compliance across the industry.

27. ASIC advised ANAO in September 2005 that it now has in place an integrated risk assessment model that considers both regulatory risk and impact. In this regard, ANAO has recommended that ASIC now undertake a systematic assessment of the regulatory risks posed by financial services licensing.

Monitoring and early warning systems

28. ANAO found that ASIC has in place a basic suite of regulatory compliance monitoring and early warning systems. These include systems to risk-rate financial sector entities, to record consumer complaints, to monitor the late lodgement of annual financial statements, and record reported breaches of the Corporations Act.

29. In respect of late lodgement of annual returns, ASIC has experienced a rising rate of default. However, it advised ANAO that it has taken action to reduce the rate of non-lodgement from over 15 per cent to four per cent at September 2005.

30. Over the period 2002–03 to 2004–05, ASIC received 806 statutory notifications of Corporations Act breaches from licensees or their auditors. In most cases, ASIC confirmed that the licensee had rectified the breach and the great majority of breach notifications (95.5 per cent) concluded with no further action. However, a small proportion required more serious attention and enforcement action. While licensees are required to report only significant breaches, this term is not defined in the Corporations Act and licensees may be erring on the side of caution.

31. ANAO has recommended that ASIC integrate the existing elements of its monitoring and early warning systems to assist in better targeting its surveillance activities.

Surveillance activities

32. Surveillance is ASIC's key activity for detecting non-compliance. Surveillance helps to ensure that industry participants are meeting their obligations under the Corporations Act and that accurate information has been provided in licence applications. ASIC sought additional Budget funding to conduct surveillance of licensees and to investigate an increasing number of suspected breaches of the law. An additional \$25.908 million in surveillance funding was approved for the years 2002–03 to 2005–06, sufficient to conduct almost 4 000 inspections over that period.

33. ASIC has been unable to reach its surveillance targets due, in part, to the low initial take-up of financial services licences. ASIC's records show 1 596 surveillances of financial services licensees since mid-2002 (when the first licences were issued) until June 2005, representing 54 per cent of its target to that date. The late transition of existing licensees significantly curtailed surveillance, reducing the population subject to surveillance and diverting

surveillance resources to licence processing. In December 2005, ASIC advised ANAO that it expects to undertake approximately 1 200 surveillance activities in relation to financial services licensees in the 2005–06 financial year.

Surveillance outcomes

34. ANAO examined ASIC's electronic surveillance records and found that half of all surveillances resulted in a categorisation of 'No Further Action' (NFA). However, this categorisation does not adequately reflect the results of the surveillance activities. In particular, surveillance action *did* occur in some instances categorised as NFA. In July 2005, ASIC advised ANAO it was considering reviewing its recording of surveillance outcomes to determine those which do not properly reflect the surveillance undertaken and to determine more appropriate outcome codes for licence surveillances.

35. In terms of surveillance results up to June 2005, ANAO found that:

- ASIC's program of Verification Visits to streamlined licence holders resulted in a significant number of enforcement referrals or requirements for corrective action by licensees. Some 352 licensees were visited to ensure that their documented processes matched those required by their licence applications. More than 7 per cent of those visited were referred for possible enforcement action. Almost half needed to rectify their systems;
- ASIC's examination of businesses' Product Disclosure Statements results in significant changes in almost a third of the cases; and
- a quarter of all surveillances prompted by consumer complaints result in businesses making significant changes to their practices. In addition, these complaint-driven surveillance actions resulted in ASIC considering enforcement action in 13 per cent of cases.

36. In addition, ASIC also undertakes targeted or campaign surveillance actions. These may focus on particular industry sectors, activities or risks. Of these, 7 per cent resulted in the consideration of enforcement actions and 14 per cent achieved a rectification of the licensee's procedures. However, some 65 percent are categorised NFA and recent ASIC campaigns have resulted in lower than expected enforcement outcomes. In light of this, ANAO has recommended that ASIC review its targeting methodology.

Reporting surveillance performance

37. ANAO also examined ASIC's public reporting of its surveillance outcomes. ASIC has previously expressed its intent to measure its effectiveness against its statutory mandate and its published strategic plan. In this context, ANAO notes that, in some years, ASIC's Annual Reports have included summary outcomes for particular surveillance activities. However, ASIC's reporting has yet to provide a consistent picture of its surveillance activities and outcomes across its licensed population. ANAO found that there is still progress to be made to relate ASIC's surveillance results to its specified outcomes and objectives, as well as the resources allocated to those outcomes and objectives.

Recommendations

Set out below are ANAO's recommendations and agencies' abbreviated responses. More detailed responses are shown in the body of the report immediately after each recommendation.

**Recommendation
No.1
Para 3.41**

ANAO recommends that ASIC and Treasury consider the merits of seeking legislative amendments to provide for enforceable declarations and certifications as part of a financial services licence application.

Agreed: ASIC, Treasury.

**Recommendation
No.2
Para 3.69**

ANAO recommends that ASIC improve its licence application process and assessment recording systems such that ASIC's licence assessments and decisions are adequately documented and properly authorised.

Agreed: ASIC.

**Recommendation
No.3
Para 3.89**

ANAO recommends that ASIC improve the useability of the public licensee database in order that consumers are able to access relevant and reliable information about licensees and authorised representatives.

Agreed: ASIC.

**Recommendation
No.4
Para 4.18**

ANAO recommends that ASIC undertake a systematic assessment of the regulatory risks posed by financial services licensing, so as to better inform judgements about the appropriate balance between managing operational and regulatory risks.

Agreed: ASIC.

**Recommendation
No.5
Para 4.41**

ANAO recommends that ASIC integrate its existing monitoring and early warning systems to assist it to target, plan and conduct its surveillance of financial services licensees.

Agreed: ASIC.

**Recommendation
No.6
Para 4.59**

ANAO recommends that ASIC review its methodology for targeting and conducting its surveillance activities to maximise value for money for the resources allocated to these activities.

Agreed: ASIC.

**Recommendation
No.7
Para 4.72**

ANAO recommends that ASIC develop and implement performance measures for its financial services licences compliance activities.

Agreed: ASIC.

Audit Findings and Conclusions

1. Introduction

This chapter briefly describes the Australian financial services sector, the role of ASIC and the essential legislative features of the licensing regime, including who needs a licence and the general licence obligations placed on licensees.

The Australian financial services sector

1.1 The Australian financial sector is regulated primarily by ASIC. It is responsible for regulating company and financial services laws to protect consumers, investors and creditors. The Australian Prudential Regulation Authority (APRA) is responsible for overseeing the stability and efficiency of the financial system.

1.2 In 2003–04, Australia's national accounts recorded that the finance and insurance sector contributed 7.7 per cent to Gross Domestic Product.² As at 30 June 2004, the consolidated total financial assets of financial institutions was \$1 946 billion. Banks (other than the Reserve Bank of Australia) accounted for \$1 116 billion and superannuation funds \$572 billion.³ In addition life insurance corporations held \$193 billion in assets and insurance corporations \$90 billion.⁴

1.3 In recent years, the sector has experienced strong growth, particularly in the superannuation and funds management industries. As Treasury observed during its public consultations on the findings of the Financial System Inquiry (the Wallis Inquiry):

The importance of financial markets to the Australian economy is demonstrated by the steady increase of investment in financial assets. In 1997 the total market turnover for these financial markets was approximately \$33 trillion. ... Compulsory superannuation has resulted in a large increase of investment in superannuation products relative to other investment products. These assets are channelled into the funds management industry which means that an increasing proportion of household sector investment is in market linked investment. The increasing exposure of household investment to

² ABS, *National Income, Expenditure and Product*, Australian National Accounts, March 2005, p. 59.

³ ABS, *2005 Year Book Australia*, table 26.2.

⁴ Figures do not add due to the \$1 946 billion figure being a consolidation of sectors.

market risk underscores the importance of effective regulation of Australian financial markets.⁵

1.4 The health and stability of the finance and insurance sector is important both to the immediate need of the economy for investment in economic production, and for supporting retirement incomes over the longer term. It comprises a relatively small number of very large market participants with many billions of dollars of assets, and a significant number of smaller entities. This is especially so in the general insurance sector and, to some extent, in the superannuation industry. In both sectors, there are potentially significant numbers of smaller entities that might provide financial services, advice or products falling within the broad definitions contained in the Corporations Act and that may need a financial services licence.

Financial services regulation

1.5 The Wallis Inquiry noted in its 1997 report that the stability, integrity and efficiency of the Australian financial system were critical to the performance of the entire economy. It concluded that:

Financial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgements. Regulations for these objectives are necessary across the entire economy.⁶

1.6 Examining the regulation of financial markets, the Wallis Inquiry found complex and overlapping regulation of different activities within financial markets, such that participants could be subject to more than one regime, sometimes with contradictory rules.⁷ In response, the Government adopted the Wallis Inquiry's recommendation of a single licensing regime⁸ and proposed licensing laws to apply to all persons providing a financial service, whether as principals or as authorised representatives.⁹

⁵ Treasury, *Financial Markets and Investment Products: Promoting competition, financial innovation and investment*, Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 6 ('CLERP 6'), December 1997, pp. 13 and 17. The paper may be found at: <<http://www.treasury.gov.au/documents/286/PDF/full.pdf>>.

⁶ Financial System Inquiry, *Final Report*, AGPS, Canberra, March 1997, pp. 1 and 16.

⁷ *ibid.*, p. 271.

⁸ *ibid.*, p. 36.

⁹ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 11.

1.7 The Government's licensing proposals were part of the Financial Services Reform Bill (the FSR Bill) introduced in April 2001. The main purposes of the Bill were to:

- (a) harmonise the regulation of all financial products, including: (i) securities, futures and derivatives, foreign exchange; (ii) managed investment schemes, superannuation, general and life insurance; (iii) deposit accounts; and (iv) means of payment services such as smart cards and e-cash;
- (b) provide a single licensing framework for financial product providers and a flexible scheme for the authorisation of market operators and clearing and settlement facilities; and
- (c) provide for a single uniform product disclosure standards regime (with the exception of securities, otherwise dealt with under Corporations Law).¹⁰

1.8 From 11 March 2002, the licensing provisions of the FSR Act came into effect, replacing existing types of licences with a single licence.¹¹ As well as replacing existing licences, the FSR Act drew financial services, broadly defined,¹² within the scope of licensing. This potentially extended the scope of licensing to a range of activities not previously covered. The extended coverage encompassed financial advice and services in respect of superannuation and retirement savings accounts, general and life insurance policies and investments, deposit accounts, other means of payment services (such as smart cards and e-cash) and foreign exchange transactions other than pure money changing.¹³

1.9 The objective was to: put in place a competitively neutral regulatory system to benefit participants in the industry by providing more uniform regulation, reducing administrative and compliance costs, removing

¹⁰ ASIC, *Building the FSRB Administrative Framework – Policy to implement the Financial Services Reform Bill 2001*, April 2001, p. 35.

¹¹ Prior to the FSR Act, various provisions of the Corporations Act separately licensed securities dealers, investment advisers, futures brokers and futures advisers, and their proper authority holders. In addition, the *Insurance (Agents and Brokers) Act 1984* (the IAB Act) licensed general insurance and life insurance brokers and insurance agents, while foreign exchange dealers were regulated under the *Banking (Foreign Exchange) Regulations of the Banking Act 1959* (the Banking Act).

¹² See section 766A, in Division 4 of Part 7.1 of the Corporations Act. Division 4 also includes definitions of other activities, such as advising on and dealing in financial products, which also constitute the provision of financial services. The scope of Division 4 depends also on Division 3, which provides the definition of financial product, along with the power (at section 765A(2)) for ASIC to declare that 'a specified facility, interest or other thing is not a financial product'.

¹³ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 21.

unnecessary distinctions between products; and to give consumers a more consistent framework of consumer protection in which to make their financial decisions.¹⁴

ASIC's role

1.10 ASIC was established by the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). ASIC and its predecessor (the Australian Securities Commission) have regulated financial markets, securities, futures and corporations since January 1991.

1.11 The objects of the ASIC Act are set out at section 1(2) and are usually called ASIC's Charter. In plain terms, ASIC is required to:

- uphold the law uniformly;
- effectively and quickly, promote confident and informed participation by investors and consumers in the financial system;
- make information about companies and other bodies available to the public; and
- improve the performance of the financial system and the entities within it.¹⁵

1.12 The FSR Bill gave a new role to ASIC as the administrator and regulator of financial services reform. The culmination of extensive consultation by Treasury on the findings of the Wallis Inquiry, the FSR Bill developed the broad framework of the Wallis reforms, with the accompanying regulations (prepared by Treasury) and interpretative guidelines (prepared by ASIC) giving shape to the regime. Under FSR, ASIC was to provide guidance to industry to interpret the legislation, provide advice about the licensing and disclosure requirements and monitor industry's compliance with these.¹⁶

1.13 ASIC's initial priority was to develop administrative policy and processes to effectively implement the FSR Bill.¹⁷ In particular, ASIC was to manage the transition of existing licences into financial services licences. The

¹⁴ Explanatory Memorandum to the Financial Services Reform Bill 2001, p. 1.

¹⁵ As described by ASIC at www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+at+a+glance?opendocument.

¹⁶ Parliamentary Joint Committee on Corporations and Securities, *Report on the Financial Services Reform Bill 2001*, August 2001, p. 26.

¹⁷ Op. cit., *Building the FSRB Administrative Framework – Policy to implement the Financial Services Reform Bill 2001*, p. 6.

transitional arrangements were introduced to Parliament on 7 June 2001 in the Financial Services Reform Consequential Provisions Bill. It dealt with when the financial services reform regime began to apply to different entities, and how they should move from their existing regulatory regime into the FSR regime over the two year transition period.

1.14 The FSR and FSRCP Acts amended the Corporations Act and the ASIC Act to provide ASIC with the statutory framework to grant licences for authorised purposes, to set conditions on those licences, to conduct surveillance and to maintain regulatory oversight of its licensed population. The powers to carry out these actions derive from the ASIC Act and, in particular, section 11(1) which allows ASIC to exercise any powers and functions conferred on it by corporations legislation.¹⁸

1.15 In implementing the new licence regime and requiring applicants to meet certain minimum standards of competency and integrity, 'the licensing process provided ASIC with the means to weed out those that did not meet the standards'.¹⁹ Applications were assessed against the standards developed and promulgated by ASIC in the lead-up to licensing and during the transition period. ASIC continues to update its policy and licensing guidance to potential applicants, publishing material on its website.²⁰

Who needs a financial services licence or authorisation?

1.16 The FSR Act amended the Corporations Act so that, from 11 March 2004, it became illegal for any entity to conduct a financial services business without a financial services licence. A financial services licence is a permit granted by ASIC under Part 7.6 of the Corporations Act. It authorises a person or a body corporate to carry on a financial services business, an act that would otherwise be unlawful.²¹

1.17 The licensing provisions of the Corporations Act describe when a licence is required, how it should be applied for and how ASIC should assess

¹⁸ The ASIC Act, at section 5(1), defines corporations legislation to include the Corporations Act and Regulations and the ASIC Act. Section 12A extends ASIC's powers to certain other financial services Acts and to Division 2 of Part 2 of the ASIC Act, governing ASIC's role in regulating unconscionable conduct and consumer protection in relation to financial services.

¹⁹ Hon Chris Pearce MP, Parliamentary Secretary to the Treasurer, *Address to the ASIC Summer School*, 9 February 2005, p. 4.

²⁰ ASIC's financial services homepage is at: <www.asic.gov.au/asic/asic_polprac.nsf/byheadline/Financial+Services+home+page?openDocument>.

²¹ *Black's Law Dictionary* (eighth edition) defines a licence as a 'permission, usually revocable, to commit some act that would otherwise be unlawful' (2005, Thomson-West, p. 938).

that application. Specifically, section 911A(1) of the Corporations Act requires that a person carrying on a 'financial services business in this jurisdiction must hold an Australian financial services licence covering the provision of the financial services'. The Corporations Act and its Regulations exempt a wide range of entities from the requirement to hold a financial services licence. ASIC has also exercised its powers under the Corporations Act to grant applicants relief from some or all financial services licence requirements.

1.18 ASIC may grant a licence only if the applicant has provided the information and documents that ASIC requires, and if ASIC has no reason to believe that applicant is not of *good fame and character*²² or would not comply with their licence obligations.²³ In turn, a licensee may, by written notice, authorise a person (an *authorised representative*) to provide a specified financial service or financial services on behalf of the licensee.²⁴

1.19 ASIC's approach to the licensing process has been to give prospective applicants early warning of their statutory obligations and the minimum standards expected of them in order to comply with many of their key obligations. ASIC advised ANAO in September 2005 that licensing was not a passive process, that it actively examined applicants' claims so as to ensure that ASIC had no reason to believe that the applicant was not of good fame and character and no reason to believe that the applicant would not comply with their licence obligations.

²² *Butterworths Australian Legal Dictionary* defines good fame and character as, 'A person's disposition, reputation, integrity and moral standing. In determining whether a person fits this description, consideration is given to the regard in which that person is held by his or her acquaintances. The terms "fame" and "character" are distinct. Fame relates to an individual's popularity in the wider community while good character is an objective standard and not necessarily a reflection of what the general public actually thinks ... Good fame and character is often used as an indicator of a person's 'ethical fitness' to become accepted or registered in a particular organisation or profession', 1997, page 527. When ASIC forms its view on an applicant's good fame and character for licensing purposes, section 913B(4) of the Corporations Act requires that ASIC have regard to, '(a) any conviction of the person, within 10 years before the application was made, for serious fraud; and (b) whether the person has held an Australian financial services licence that was suspended or cancelled; and (c) whether a banning order or disqualification order under Division 8 has previously been made against the person; and (d) any other matter ASIC considers relevant'.

²³ Section 913B sets out the licence requirements and section 912A sets out licensees' obligations. ASIC advised ANAO on 8 September 2005 that its licensing processes involved checking applicants' *bona fides* and assessing their capacity to comply with their licence obligations.

²⁴ As per section 916A of the Corporations Act, which also provides that the financial services specified may be some or all of the financial services covered by the licensee's licence. Authorisations are void to the extent that they purport to authorise a person to provide a financial service that is not covered by the licensee's licence or that is contrary to a banning order or disqualification order under Division 8 of the Corporations Act licensing provisions. It is an offence for a licensee to issue a void authorisation and an authorisation may be revoked at any time by the licensee giving written notice to the authorised representative.

Financial Service

1.20 A person²⁵ carries on a financial services business if they are in the business of providing *financial services* in respect of *financial products*. A person provides a financial service if they provide financial product advice, deal in a financial product,²⁶ make a market for a financial product, operate a registered investment scheme, or provide a custodial or depository service.²⁷ There are some important exemptions from the very broad range of activities covered by this definition, namely:

- work ordinarily done by clerks and cashiers;
- advice given by a lawyer in the ordinary course of their activities;
- advice given by a registered tax agent in the ordinary course of their activities;
- financial services provided by recognised accountants which are an integral part of (and not merely incidental to) their accounting activities;²⁸
- public information services providing general advice only; and
- an authorised representative of a financial services licensee.²⁹

1.21 In addition, section 911A(2) of the Corporations Act also provides other exemptions covering, for example, the activities of administrators and

²⁵ For the purposes of this Report, unless the text specifically states otherwise, the term *person* includes corporations formed under Corporations Law, partnerships, trustees and natural persons, as the circumstances demand.

²⁶ 'Dealing' includes the issuing a superannuation interest by the trustee of a public offer superannuation fund. However, the trustees of standard employer sponsored funds (usually industry and corporate funds) are exempt by virtue of Regulation 7.6.01(1). This exemption does not extend to giving financial advice to members or prospective members.

²⁷ As per section 766A of the Corporations Act. Other sections of the Corporations Act define each of these activities more closely, namely section 766B in respect of financial product advice, section 766C in respect of dealing, section 766D in respect of making a market, and section 766E in respect of custodial and depository services. Other definitions and exemptions are at Division 3 of part 7.1 of the Corporations Act Regulations.

²⁸ Regulations set out the nature of exempt advice in respect of financial reports (r 7.1.29(3)), taxation issues (r. 7.1.29(4)) and superannuation funds (r 7.1.29(5)) that may be given by recognised accountants. On 13 May 2002, ASIC declared (in Class Order CO 02/551, issued under section 926A of the Corporations Act) certain types of members of CPA Australia, the Institute of Chartered Accountants in Australia and the National Institute of Accountants to be recognised accountants

²⁹ The Corporations Act requires licensees to adequately train and supervise their authorised representatives and to report any changes of personnel to ASIC within prescribed times.

liquidators, the executors of deceased estates, and of APRA regulated entities providing advice only to wholesale clients.³⁰

1.22 ASIC may also declare individuals or classes of people exempt from part or all of the licence requirements by virtue of its powers at sections 911A(2)(l), 926A and 926B of the Corporations Act. During the licence transition period, for instance, ASIC reported that it considered over 1 000 applications for relief from part or all of the licensing and related provisions and that it had issued approximately 80 FSR-related class orders, exempting classes of applicants from some or all of the Corporations Act provisions.³¹

Financial product

1.23 A financial service is delivered in respect of a *financial product*, which is broadly defined as means by which a person makes a financial investment, manages financial risk or makes a non-cash payment.³² It includes such things as securities, interests in managed investment schemes, derivatives, most life insurance policies, superannuation interests (including retirement savings accounts), debentures, stocks and bonds issued by governments, any deposit-taking facility of an Authorised Deposit-taking Institution (ADI), and most foreign exchange contracts.

1.24 There are also important exemptions from this broad definition, including:

- products purely incidental to another product;³³
- health insurance;³⁴

³⁰ Wholesale clients are defined as large businesses (see section 761G) that are taken to be sufficiently financially competent not to require the Corporations Act protection offered to retail clients by the licensing and disclosure regimes.

³¹ ASIC Information Release IR04/088, *Overview of ASIC's implementation of the Financial Services Reform Act*, 29 March 2004.

³² As per section 763A of the Corporations Act. Other sections define classes of products more closely, namely section 763B in respect of financial investment, section 763C in respect of managing financial risk, and section 766D in respect of making a non-cash payment. Other definitions and exemptions are at Division 1 of part 7.1 of the Corporations Act Regulations.

³³ The 'incidental product' exemption in section 763E of the Corporations Act only applies to things that are financial products by virtue of the general definitions in section 763A. It does not apply to something that is specifically included as a financial product under section 764A.

³⁴ The mission statement of the Private Health Insurance Administration Council (PHIAC) includes the objective of protecting the interests of consumers of private health insurance products. PHIAC was established in 1989 by Part VIAA of the *National Health Act 1953*.

- insurance provided by the Commonwealth, State or Northern Territory governments;
- reinsurance;
- credit facilities and certain other non-cash payment facilities;
- interests in exempt public sector superannuation schemes; and
- money orders and electronic funds transfers.³⁵

1.25 ASIC may also, from time to time, decide whether certain facilities or products fall within this definition and may exclude them by virtue of its powers at sections 765A(2) of the Corporations Act. In doing so, ASIC has stated that it seeks to strike a balance between licensing those entities where 'there is a regulatory benefit in doing so while ensuring that the numbers of licensees is kept to a level that enables sufficient scrutiny, otherwise the regulatory benefit of licensing this population will be undermined significantly'.

Licence obligations and conditions

1.26 Financial services licensees may be individuals, companies, partnerships or trustees. Their licence can authorise them to provide different types of financial services and products and may be subject to conditions set by ASIC. Specifically, section 913B allows ASIC to grant a licence *only* if:

- the applicant has provided the information and documents that ASIC requires; and
- ASIC has no reason to believe that the applicant is not of good fame and character or would not willingly comply with *all* the obligations placed on licensees by section 912A of the Corporations Act (summarised in Table 1.1). Failure to comply with any or all of these obligations is not, in itself, an offence under the Corporations Act. However, non-compliance would be a suitable basis on which ASIC could apply a banning order or suspend or cancel a licence, after offering a hearing.³⁶

³⁵ Other exemptions are detailed at section 765A of the Corporations Act and in Division 1 of Part 7.1 of the Regulations.

³⁶ Under sections 920A and 915C of the Corporations Act, respectively.

1.27 Upon receipt and consideration of a proper application, ASIC may grant a licence, setting out any conditions to apply.³⁷ Foremost among these conditions is ASIC's express authorisation to provide specified types of financial services in relation to specified types of financial products. These particular conditions are referred to as *licence authorisations*.³⁸

1.28 ASIC also sets other licence conditions governing such matters as licensees' minimum financial requirements, the training of their authorised representatives and the development of their compliance plans. Correctly establishing the licence conditions is important to the licensee, who must clearly understand their obligations. It is also important to ASIC, as it enables ASIC to take prompt enforcement action in the case of a significant breach.³⁹

³⁷ By virtue of section 914A of the Corporations Act.

³⁸ A licensee can be authorised to use certain restricted terms in the conduct of their business, namely stockbroker or sharebroker, futures broker, insurance broker or insurance broking, general insurance broker and life insurance broker.

³⁹ For example, in ASIC's view, 'A breach of a licence condition [*to comply with ASIC's policy for training and supervising representatives*] is **much easier to establish** than a breach of the legal requirement to properly train and supervise staff [*at section 912A(1)(f)*]. ... Without the licence condition, we would have to prove that complying with [*section 912A(1)(f)*] means complying with [*ASIC's policy for training and supervising representatives*] and then prove that there has been a breach. In other words, a two step process'.

Table 1.1**General obligations of financial services licensees**

Focus of obligations	General obligations under section 912A(1) ¹
Primary responsibility of licensees	(a) Do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly
Compliance	(b) Comply with the conditions on the licence (c) Comply with the financial services laws
Corporate governance	(aa) Have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative (d) Unless the licensee is a body regulated by APRA—have available adequate resources (including financial, technological and human resources) to provide the financial services covered by the licence and to carry out supervisory arrangements (e) Maintain the competence to provide those financial services (h) Unless the licensee is a body regulated by APRA—have adequate risk management systems
Management of representatives	(ca) Take reasonable steps to ensure that its representatives comply with the financial services laws (f) Ensure that its representatives are adequately trained, and are competent, to provide those financial services
Consumer redress	(g) If those financial services are provided to persons as retail clients—have a dispute resolution system complying with subsection 912A(2) ²
Notes: 1: Section 912A(1)(j) permits regulations to be made to specify additional obligations. To date, only one regulation has been made. Regulation 7.6.03B(2) obliges foreign entities with a financial services licence to have an agent resident in Australia at all times. 2: Licensees dealing exclusively with wholesale clients are not required to meet this obligation.	

Source: ANAO analysis of ASIC information and the Corporations Act.

1.29 After a financial services licence is granted, ASIC may, after offering the licensee a hearing, alter the licence conditions. In a similar fashion, ASIC may suspend or cancel a financial services licence in particular circumstances, such as when a licensee does not comply with its statutory obligations. In this case

too, ASIC must give the licensee the opportunity of a hearing before exercising this power.⁴⁰

1.30 In addition to requiring licensees to meet *all* the relevant general obligations and the licence conditions imposed by ASIC, the Corporations Act imposes other obligations on licensees. For instance, section 912B requires licensees to put in place arrangements to compensate retail clients for losses or damages resulting from the licensee breaching its statutory obligations⁴¹ and part 7.8 obliges licensees to handle clients' money separately from that of the licensee and to report on it accordingly in their financial statements.

Audit Approach

1.31 This performance audit examined the effectiveness and efficiency of ASIC's implementation of Australian financial services licences. In particular, it examined:

- ASIC's planning for the introduction of financial services licences;
- the roles of Treasury and ASIC in defining the effective scope of licensing;
- ASIC's assessment and processing of licence applications; and
- ASIC's supervision of licensees.

1.32 ANAO met with ASIC in December 2004 to discuss the scope of the audit. This audit does not examine ASIC's performance in enforcing licensees' compliance with the Corporations Act. Audit fieldwork commenced in January 2005 and concluded in June 2005.

1.33 In August 2005, ANAO provided a Discussion Paper, or relevant extracts thereof, to ASIC, Department of Finance (Finance) and Treasury. In November 2005, a proposed report was issued to relevant agencies under section 19 of the *Auditor-General Act 1997*.

1.34 The audit was conducted in accordance with ANAO auditing standards at an estimated cost of \$520 000.

⁴⁰ The Corporations Act provides special procedures for suspending or cancelling the financial services licence of an APRA-regulated licensee, including the requirement to consult with APRA and, in the case of an ADI under the Banking Act, the power to suspend or cancel lies with the Minister rather than ASIC.

⁴¹ See also Regulation 7.6.02AA.

2. ASIC Resources and Budget Funding

This chapter examines the appropriation arrangements used to fund the Government's new policy proposals for licensing and related matters. It also outlines the Budget resources allocated to ASIC for licensing, granting relief from licensing and for the surveillance of licensees and, where possible, compares these allocations to ASIC's actual expenditure.

ASIC's Output Pricing Review

2.1 A program of Output Pricing Reviews (OPRs) was initiated by Finance in 1999–2000 as part of the accrual budgeting framework's focus on output prices rather than input costs. The aim was to help the Government and its agencies to understand and agree on the optimal choice of the quality, quantity and price of outputs for the agency's contribution to Government outcomes. Primary responsibility for conducting an OPR lay with the agency. Finance's role was as a specialist adviser and facilitator, providing strategic oversight for the process.⁴²

2.2 In June 1999, the then Chairman of ASIC noted in ASIC's Annual Report that, 'Achieving timely enforcement has put unacceptable pressure on our staff, to which they have responded very well. But we may now have too few staff on the ground to achieve the outcomes we and the government want.'⁴³

2.3 In May 2000, ASIC flagged its intention to cease its regional small business program as a result of budget pressures.⁴⁴ In response to concerns that ASIC's funding was insufficient, an OPR of ASIC's operations, originally intended for consideration in 2002–03, was brought forward to start in February 2001.

2.4 The OPR was completed and the findings presented to Finance and Treasury in February 2002. It was the basis of the proposals to supplement ASIC's funding that were put before the Government during the preparation of the 2002–03 Budget.

⁴² Finance, *Annual Report 2000-01*, p. 18.

⁴³ ASIC, *Annual Report 1998-99*, p. 9.

⁴⁴ ASIC, *ASIC News*, Issue 25, May 2000, p. 1.

2002–03 Budget funding

2.5 Prior to the commencement of the OPR for FSR implementation, ASIC received one-off funding of \$2.6 million in the 2001–02 Budget, and a further \$0.5 million in the 2001–02 Additional Estimates. This enabled ASIC to prepare for the implementation of a single, harmonised licensing and product disclosure framework while awaiting the outcome of a broader OPR.

2.6 Early in 2002, the Government considered ASIC’s overall funding bid. The bid was based on the 13 activities identified as requiring additional resources in ASIC’s OPR. The Government approved additional expenditure for 11 of the 13 activities. The 2002–03 Budget subsequently announced substantially increased on-going additional funding of \$90.745 million for the years 2002–03 to 2005–06.⁴⁵ Table 2.1 details the OPR activities funded, including a total of \$59.898 million to implement financial services licences.

Table 2.1

ASIC OPR Budget funding, 2002–03 to 2005–06

Year	Develop FSR policy and guidance (\$ million)	License financial services providers (\$ million)	Conduct surveillance of market participants (\$ million)	Assess and process applications for relief from the FSR provisions (\$ million)	Enforce the FSR provisions (\$ million)	Other non-FSR (\$ million)	Total annual Budget supplementation (\$ million)
<i>Column</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>	<i>F</i>	<i>G</i>
2002–03	0.474	3.276	3.274	3.484	1.13	7.729	19.367
2003–04	0.478	6.254	6.495	2.963	1.891	7.706	25.787
2004–05	0.464	2.261	7.685	1.604	2.604	7.706	22.324
2005–06	0.464	1.936	8.454	1.604	3.103	7.706	23.267
Totals	1.880	13.727	25.908	9.655	8.728	30.847	90.745

Source: ANAO analysis of ASIC and Finance data.

⁴⁵ The Treasurer, *Budget Measures 2002–03*, Budget Paper No.2, cites a total of \$90.8 million on p. 159. The discrepancy is due to accumulated rounding errors over the four years cited.

2.7 Column G of Table 2.1 shows, for each year, the total supplementation approved by Ministers in the 2002–03 Budget to cover the estimated costs of the components of ASIC’s OPR bid. Over the years 2002–03 to 2005–06, the supplementation comprised \$51.170 million for financial services licensing activities examined within this audit (in columns A through to D) as well as funding for other FSR activities which are not examined in detail in this audit, namely:

- \$8.728 million for licensing enforcement in Column E;
- \$29.600 million to restore ASIC’s capacity to enforce the laws for which it is responsible, included in the amounts in Column F; and
- \$1.247 million to license markets under the FSR regime, included in the amounts in Column F.

2.8 The 2002–03 Budget supplementation brought appropriations to ASIC to implement financial services licences to a total of \$62.998 million for the years 2001–02 to 2005–06.

2.9 The 2002–03 Budget supplementation was funded, in part, by increases in ASIC’s structure of fees and fines, also approved in the context of the 2002–03 Budget. The introduction, from 2004–05, of financial services licence fees for the annual lodgement of profit and loss statements, balance sheets and audit reports was aimed at achieving fuller cost recovery.⁴⁶ However, the financial services licence fees were projected to fall short of full cost recovery, while there was an estimated over-recovery of \$50 million a year from the national companies and securities fees scheme. ASIC advised ANAO in September 2005 that, to 30 June 2005, it had collected \$5.782 million in licence revenue, as shown in Table 2.2.

Table 2.2

ASIC’s collections of licensing fees, 2002–03 to 2004–05

	2002–03 (\$)	2003–04 (\$)	2004–05 (\$)
Prescribed Fee	312 790	1 850 029	2 558 543
Late Fee	30 155	381 390	649 280
Total	342 945	2 231 419	3 207 823

Source: ASIC advice to ANAO, 2 September 2005.

⁴⁶ At July 2005, the fees were \$135 for a natural person and \$330 in any other case: see www.asic.gov.au.

Appropriation Arrangements

2.10 Section 53 of the Constitution provides that the Senate may not amend proposed laws appropriating revenue or moneys for the ordinary annual services of the Government. In order to settle the question of which matters fit into the term 'ordinary annual services of the Government', the Senate and the then Government made an agreement, known as the Compact of 1965 (the Compact).⁴⁷ The Compact determines the allocation of items between the Annual Appropriation Acts.⁴⁸ The Compact requires that:

- annual Appropriation Acts No.2, No.4 and No.6 include, among other things, activities for which appropriations have not been made in the past, all non-operating appropriations, and grants to the States authorised by section 96 of the Constitution; and
- annual Appropriation Acts No.1, No.3 and No.5 include the costs and expenses of maintaining the Government's ordinary annual services.

2.11 The 2002–03 Budget included \$90.745 million for ASIC to implement new policy announced by the Government. The first year's funding of \$19.367 million for ASIC's departmental expenditure in 2002–03 was presented for Parliament's consideration in Appropriation Bill No.1 (ordinary annual services of government) and not in Appropriation Bill No.2.⁴⁹

2.12 The Clerk of the Senate and Finance do not have a shared view of the arrangements. The Clerk considers that proposed expenditure, both departmental and administered, for new policies should be in appropriation bills not for the ordinary annual services. Further, the Clerk indicated that if running costs associated with new policy proposals were included in Bill No.1, this was without the knowledge or approval of the Appropriations and Staffing Committee or the Senate. However, Finance advised ANAO that the allocation of amounts for departmental expenditure on new policy to Bill No.1 rather than Bill No.2 was a longstanding practice supported by exchanges of correspondence in 1999 between the then Finance Minister and the President of the Senate.

2.13 To assist with resolution of issues concerning the appropriate allocation of amounts between the Annual Appropriation Acts, which span beyond this

⁴⁷ The Compact is not legislation, and issues relating to it may only be conclusively determined by the Parliament.

⁴⁸ *Agency Resourcing 2004–05*, Budget Paper No. 4, p. 2.

⁴⁹ *Budget Paper No.4, 2002–03*, p. 287 and *Budget Paper No.2, 2002–03*, p. 159.

audit, the Clerk provided Finance in October 2005 with a written statement of the Senate's understanding of the 1999 modification to the Compact. However, Finance advised ANAO in December 2005 that it does not consider that there is any ambiguity regarding the appropriate allocation of amounts between the Annual Appropriation Acts.

2.14 The current approach to appropriating funds for new policy is longstanding. However, given the different perspectives outlined above on this issue, ANAO considers that the Department of the Senate and Finance should take steps to develop a shared understanding of the appropriate allocation between the Annual Appropriation Acts of departmental amounts for new policy.

ASIC's FSR expenditure

2.15 Under the Commonwealth's accrual budgeting framework, the annual appropriations to ASIC approved by Parliament in the 2002–03 Budget were appropriated as an aggregate annual amount for ASIC's Outcome 1: 'A fair and efficient market characterised by integrity and transparency and supporting confident and informed participation of investors and consumers'. Accordingly, ASIC was able to draw the aggregate Budget appropriation as needed to fund its existing activities and the additional OPR components, providing total annual expenditure remained within the limits of the annual total appropriated for Outcome 1.⁵⁰

2.16 ASIC advised ANAO in December 2005 that its actual expenditure to date on FSR-related activities, including licensing, was \$13.5 million higher than the additional \$44.3 million appropriated to Outcome 1 for FSR-related activities, as follows:

- 2002–03 actual expenditure of \$18.166 million compared to \$11.638 million appropriated for FSR-related activities;
- 2003–04 actual expenditure of \$21.888 million compared to \$18.081 million appropriated for FSR-related activities; and
- 2004–05 actual expenditure of \$17.795 million compared to \$14.618 million appropriated for FSR-related activities.

2.17 In this context, ASIC advised ANAO in September 2005 that:

⁵⁰ The ability to do so is shared by all Budget funded agencies under the accrual budget framework.

ASIC would agree with the statement that we spent more than we were appropriated for FSR related activity. ... ASIC would agree that, with hindsight, its estimates of licensing processing times were in error, however they were made on the best information available to ASIC at the time. ASIC would also agree that resources in other units were diverted to the licensing area in order to manage the workloads, however, we would not agree with the conclusion that this was due to any inefficiency in the licensing process. Rather this was driven by workload and by the generally poor quality of the majority of the licence applications.

Resources for licensing

2.18 ASIC's aim was to have the capacity to license or re-license all financial system participants and process a smaller continuing flow of new applicants. The funding identified for this purpose in the OPR was \$13.727 million over the four years 2002–03 to 2005–06. As shown in Column B of Table 2.1, peak resources were allocated to 2003–04, anticipating the likely burden of licence processing as the transition period drew to a close.

2.19 The estimates were based on ASIC's experience with implementing the *Managed Investments Act 1997* (the MI Act)⁵¹ and the assumption that ASIC would grant 6 600 licences during the two-year transition period. This included around 440 new applicants in 2004–05 and around 480 in 2005–06. By the end of the transition period, ASIC estimated that its regulated population would have grown by almost two-thirds, from 4 040 at June 2002⁵² to 6 600 at March 2004. However, by the end of the transition period ASIC reported that it had granted only 3 738 licences, less than 57 per cent of the number anticipated.

2.20 The OPR estimates also took into account ASIC's introduction of electronic systems to streamline procedures for applicants and reduce the workload for ASIC staff, and the need to manage key risks posed by the licensing process. In ASIC's view:

Deficiencies in application assessment work increase costs to business. They also increase government costs, in terms of greater need for law reform to modify the law and correct anomalies. Poor licensing procedures result in the

⁵¹ In response to Recommendation 89 of the Financial System Inquiry, the MI Act amended the Corporations Act, allowing a two-year transition period commencing 1 July 1998 during which ASIC licensed 376 entities responsible for managing 2 247 investment schemes.

⁵² ASIC *Annual Report 2001–02*, p. 78.

approval of applicants who do not have appropriate capacity and expertise at a risk to consumers and investors.

Fundamentally, the inadequate implementation and ongoing operation of the FSR Act due to poor licensing processes or inadequate surveillance will result in consumers, investors and industry losing confidence in the integrity of financial markets and service and product providers.⁵³

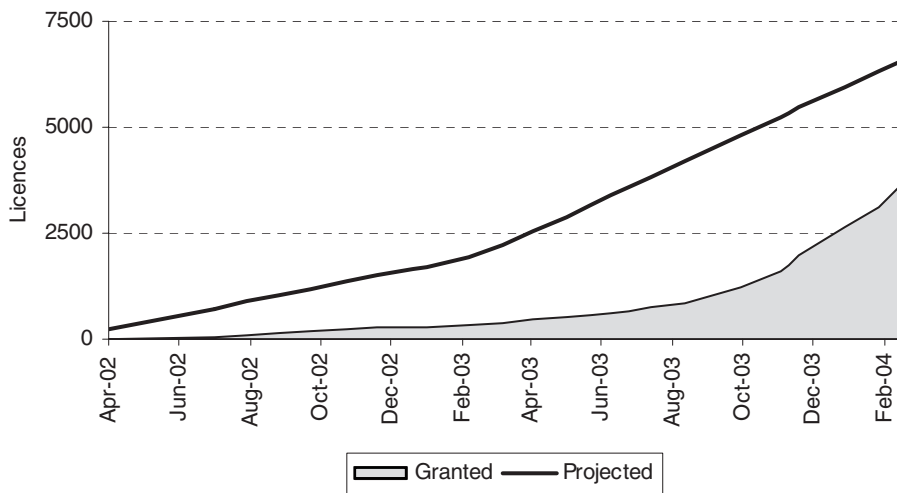
2.21 Without a robust licensing process, ASIC was concerned that the Government’s objectives of modernising the regulatory system and promoting a strong economy and growth through effective financial regulation would be at high risk.

Peak Period Licensing

2.22 By September 2002, it was clear to ASIC that the financial services industry was slow to transition. Licence applications were well behind the number anticipated, as shown in Figure 2.1. ASIC anticipated a late rush of as many as 5 500 applicants in the six months from September 2003 to March 2004, with possibly 5 000 applications in the last four months of transition. ASIC estimated a total of at least 6 000 applicants, and possibly as many as 8 000.

Figure 2.1

Actual and projected licence numbers, April 2002 to March 2004



Source: ANAO analysis of ASIC data.

⁵³ ASIC, *ASIC’s Pricing Review Report*, January 2002, pp. 19 and 20.

2.23 The late rush posed a significant risk to successful transition to the new regime. ASIC sought to address the likely pressure on its licensing resources through measures to reduce the likely population of applicants and by reducing the time it took to process licence applications. In its discussions with Treasury, ASIC advised that:

Based on our experience during the first six months of the FSR regime and assuming that the current legislative processes and exemptions remain, we anticipate that there is a significant risk to the successful transition to the new regime (including whether or not ASIC will be able to licence all of the industry participants who require a financial services licence by 11 March 2004). To facilitate transition and early licence applications (where relevant) we suggest the following needs to be considered:

- a) expanding the scope of the streamlining process;
- b) reducing the scope of the regulated population who will need a financial services licence (i.e. providing broader exemptions); and
- c) encouraging applications early in the transition period by providing incentives and minimising disincentives to applying early.

We note that over time the regulations have reflected some exemptions, however, we consider further ones warrant consideration.

2.24 Subsequently, the Regulations were amended so that, from March 2003, the number of applicants eligible for the minimal licence assessment under the streamlining arrangements was expanded to include entities regulated by APRA and certain insurance agents and brokers.⁵⁴

2.25 ASIC also made significant adjustments to its licensing operations, aimed at reducing the time taken to process applications. The changes were formalised as the *ASIC Peak Licensing Project*, which replaced ASIC's existing FSR implementation plans. The focus of the new plans was licensing operations for the period from March 2003 and, in particular, for the period September 2003 to April 2004. To reduce licence assessment times and marshal additional resources to assist in licensing operations, ASIC adopted three major strategies:

- transferring the processing of streamlined applications to its Information Processing Centre (IPC);

⁵⁴ The expansion of streamlining was achieved by amending Regulation 10.2.38 via Corporations Amendment Regulations 2003 (No.1) (Statutory Rules 2003 No.31).

- focusing almost exclusively on processing transitioning applicants and dropping work on applications to vary licences, and reducing staff training to primarily 'on-the-job' training; and
- drawing on compliance and enforcement staff to assist peak processing.

2.26 In July 2003, ASIC commenced training IPC staff, who usually dealt with routine queries and lodgements, so that they would be able to assess streamlined licence applications by September 2004.

2.27 As a result of its review of licence processing times, ASIC reduced the time taken to process Risk Assessment and Scoring System (RASS) reports used by licence analysts. A RASS report summarises existing ASIC data and lists the applicant's office holders, responsible officers and (if available) auditor, along with any associated entities. It also lists particular regulatory actions ASIC may have taken against individuals or associated entities (such as banning orders) and alerts analysts as to whether the applicant is subject to surveillance. ASIC had found that:

RASS reports generated for assessing financial services licence applications are sometimes bulky and reduce the efficiency of assessment. This issue has most impact for 'large end of town' entities, with many associated entities.

2.28 The reduction in RASS workload, constrained by the need to maintain the quality of assessments, assumed that the depth of the information in the report was more critical for smaller entities than for larger groups.

2.29 By these and other means, ASIC aimed to significantly reduce its total processing effort by some 60 per cent, compared to the original OPR estimates.⁵⁵ However, ASIC advised ANAO in September 2005 that, contrary to its expectations, it experienced substantially *greater* licensing effort rather than any reduction in average processing times. ASIC estimated that processing licence applications required 124 000 staff hours, almost 30 per cent more than the total of the 96 000 staff hours allowed for in the OPR. ASIC advised ANAO that:

Despite a large degree of industry education, [*online answers to Frequently Asked Questions*] and available assistance through [*ASIC's telephone*] infoline and [*financial services licensing*] project office, the quality of documents received [*from applicants*] remained poor throughout the transition period. Therefore

⁵⁵ ASIC aimed to reduce the time taken to process streamlined and composite applications from 9.9 hours each (as estimated in the OPR) to 2.0 hours and 7.5 hours respectively, during the peak licensing period. Similarly, ASIC aimed to reduce the time taken to process a full application from the OPR estimate of 16.5 hours to 15 hours.

any estimates of processing times made at the time of the OPR and throughout the transition period were subsequently proven to be optimistic and incorrect. There were numerous occasions when analysts had to ask applicants for the same information more than two or three times, the quality of documentation was poor and, in particular, it was found that applicants struggled in their documentation with regard to compliance, Responsible Officers and financial information, plus applicants made repeated calls to the analysts to 'check' where their licence application was up to. All of this was time consuming and made it impossible to meet the estimated process times.

Furthermore analysts at the ASIC 3 and ASIC 4 level undertook the majority of the assessment; therefore assessment time is longer than would have been for a higher grade of staff. In addition towards the end of transition there were over 70 applications where supporting documentation was not received and the analysts spent time chasing the applicants up by either email or phone call.

2.30 ASIC also applied licensing resources to the conduct of licensee surveillances (4 600 staff hours for Verification Visits to streamlined applicants) and to training staff (21 500 staff hours). Including these resources and accounting for the lower than estimated number of licences issued, ANAO has estimated that ASIC's OPR estimate of the effort required and the resources necessary for licensing was half that which was actually required.⁵⁶

Resources for granting relief

2.31 ASIC may grant relief from provisions of the Corporations Act in appropriate circumstances. ASIC has, since 11 October 2003, published a number of reports on the exercise of its relief powers. From that date up until 30 April 2005, ASIC received 3 006 applications for relief and granted 2 532 of those applications, as shown in Table 2.3.

Table 2.3

ASIC's disposition of relief applications, October 2003 to April 2005

Granted	Refused	Total	Anticipated	Actual compared to anticipated
2 532	474	3 006	13 172	22.8%

Source: ASIC advice, ANAO analysis of ASIC data in *ASIC's Pricing Review Report*, January 2002, and in *Overview of decisions on relief applications from financial service providers*, an ASIC report of December 2004, and its subsequent editions for May 2005 and July 2005.

⁵⁶ ASIC advised ANAO that it also applied licensing resources to acquit its ongoing responsibility for managed investment schemes (31 600 staff hours) and the registration of auditors and liquidators (3 700 hours). The ANAO estimates do not include these resources.

2.32 ASIC's OPR estimated that there would be over 13 000 applications for relief, in respect of which Budget funding provided almost \$7.8 million (out of a total of \$9.655 million over the period 2002–03 to 2005–06). ASIC advised ANAO in September 2005 that, while it significantly over-estimated the number of relief applications, it also significantly under-estimated the complexity of the applications for relief that were sought. On this basis, ANAO estimates that ASIC's processing of relief applications consumed four times the resources initially anticipated.

Resources for surveillance

2.33 As it had insufficient resources, the OPR stated that ASIC had not been able to investigate an increasing number of suspected breaches of the law, although they merited prompt and significant investigation.

2.34 Taking into account ASIC's expanding role in implementing financial services reforms, the OPR identified the resources necessary for ASIC to maintain an effective regulatory presence in key financial industry sectors, including deposit-taking, securities dealing, life and general insurance, superannuation and managed investment. ASIC bid for funding so it could inspect industry participants or schemes on a regular basis, and to visit riskier entities more frequently than those assessed as low risk. Without additional funding, ASIC thought it unlikely that it would ever be able to conduct surveillance on all its regulated entities.

2.35 Based on the findings of the OPR, in May 2002 the Government approved an additional \$25.908 million surveillance funding for the years 2002–03 to 2005–06. ASIC estimated that this would be sufficient to conduct almost 4 000 inspections over that period.

2.36 ASIC anticipated that it would visit industry participants, on average, once every eight years once the mature licensing regime was in place by 2004–05. This compares to more frequent visits in other jurisdictions as shown in Table 2.4 below.

Table 2.4

Comparative frequency of surveillance of financial market participants, Australia and selected jurisdictions

Jurisdiction	Regulator	Frequency of visits to regulated entities
Australia	Australian Securities and Investments Commission	8 years
United States of America	Securities Exchange Commission	5 years
Hong Kong Special Administrative Region of the People's Republic of China	Securities and Futures Commission	4 years
United Kingdom of Great Britain and Northern Ireland	Financial Services Authority	2.5 years

Source: ANAO analysis of ASIC data.

2.37 Although the OPR documented and contrasted the relative *efficiency* of ASIC's surveillance activities compared to regulators in other jurisdictions, it did not include measures of the *effectiveness* of other regulators apart from proposing the benchmark of visiting regulated entities once every eight years.

2.38 The OPR also did not include performance measures of ASIC's compliance activities or benchmarks against which ASIC's post-OPR regulatory efficiency and effectiveness might be measured. Although at 30 June 2001 (immediately prior to the OPR) ASIC was responsible for almost 4 000 entities licensed under the pre-FSR Corporations Act, the OPR did not include quantitative information on ASIC's surveillance activities or outcomes, nor measures of the efficiency and effectiveness of its relevant existing compliance activities. Neither did it propose measures by which ASIC's regulatory performance might be measured or reported.

2.39 In addition, the OPR did not discuss or explain ASIC's preference for a less frequent and intense regime of surveillance than that adopted by comparable regulators.⁵⁷ In September 2005, Treasury advised ANAO that ASIC's resource bid was summarised and incorporated without detailed

⁵⁷ As well as being less frequent, ASIC was also aware that its surveillance would be less intense than that of other comparable regulators. In developing the OPR proposals, ASIC allocated an average of 135 staff hours for visiting a licensed entity, compared to the 350 staff hours allocated by the Ontario Securities Commission, a comparable Canadian regulator. At July 2000, ASIC employed one surveillance staff member for every 109 licensed entities, a ratio which was anticipated to fall to one supervisory staff member for every 97 licensed entities with additional OPR funding. This compares to a ratio of one supervisory staff member for every 26 licensed entities in the case of the Financial Services Authority in the United Kingdom.

examination or analysis in Treasury's formal advice to Government in the 2002–03 Budget context:

As a result of the new financial services regulatory regime introduced by the Financial Services Reform Act 2001, the licensing obligations that were imposed on ASIC were expanded. Given that the financial services regime was a totally new regulatory arrangement, it was a practical challenge to estimate the required funding to administer licensing for financial service providers based on past experience. ... The OPR indicated that the number of [*licence*] applications that ASIC was expected to process during the two year transitional period was 6 600. This was a significantly larger population of regulated entities than ASIC previously licensed or registered. It was also considered by Treasury at the time to be a conservative estimate, given that ASIC estimated potentially as many as 8 000 applicants and based on the views of industry experts who were suggesting a much larger number of licence applications was likely.

Accordingly, it appeared reasonable to Treasury at the time to accept the estimate provided by ASIC.

2.40 In September 2005, ASIC advised ANAO that it did not generally base its surveillance selection around targets such as visiting all entities within a particular period. In the context of the OPR, the use of international comparisons was intended to highlight ASIC's approach and the associated risks to decision-makers in Treasury and Finance. However, although both Treasury and Finance prepared Budget material on the basis of the OPR, neither analysed the OPR observation that, 'The frequency of [ASIC's] planned visits is significantly less than comparable regulators overseas'.

2.41 Notwithstanding the less frequent and intense regime of surveillance funded in the 2002–03 Budget, ASIC has not reached its surveillance targets. By June 2005, ASIC had conducted less than 54 per cent of its planned surveillances as set out in 2001–02 (discussed in Chapter 4).⁵⁸

⁵⁸ The rate is calculated by comparison with the number of surveillances planned for in ASIC's February 2002 OPR bid.

3. Licensing

This chapter outlines the scaled licence assessment process implemented by ASIC and overall licence numbers and coverage, including an analysis of the effects of exemptions and ASIC's relief decisions. It includes the findings of the audit examination of a random sample of licence records and a further sample of post-transition licence variations.

Licence assessment

3.1 In May 2000 ASIC proposed to Treasury that the new financial services licensing regime be introduced over a two-year transitional period:

The transitional arrangements should seek to achieve the following aims: provide a sufficient period of time for market participants and ASIC to do efficiently and effectively all things which the law requires in relation to migration to the new regime; and provide sufficient flexibility in the administration of the new regulatory regime during the transitional phase so that unexpected difficulties can be overcome.

3.2 The FSRCP Act amended the Corporations Act to provide for a concessional transition phase. Until 11 March 2004, many existing licensees could qualify to exchange their current licence for a financial services licence with a minimal licence application. This was called a streamlined application. In addition, section 1435 of the Corporations Act and Regulation 10.2.37 effectively allowed a *composite* application, comprising a streamlined component (covering existing licensed activities) and a supplementary component (usually an extension of the existing licensed activities).⁵⁹

3.3 After the end of the transition period, neither of these methods of applying for a financial services licence would be available. All subsequent applications were to be accompanied by proof satisfying *all* licence requirements and were to be subject to ASIC's full assessment.

3.4 ASIC developed these statutory provisions into a scaled application assessment process, advising potential applicants that ASIC would focus more closely on applications seeking authorisation for new activities. ASIC also advised that, in making its decisions where an applicant had a satisfactory history of compliance:

⁵⁹ Regulation 10.2.37 allowed ASIC to consider the streamlined component as the main application and to simultaneously consider the extension to new activities as a licence variation, avoiding the need to separately consider each component and to charge two application fees.

[ASIC] will give weight to the fact that some of the financial services for which you seek authorisations are, when considered separately, covered by the legislative streamlining process. In such circumstances, we will focus on those products and services included in your application that are not covered by the legislative streamlining process.⁶⁰

3.5 ASIC's scales of licence assessment therefore comprised:

- streamlined assessment (Scale One);
- composite assessment against Scales Two, Three and Four (assessments of varying intensity in which ASIC gave weight to the applicant's previous experience); and
- full assessment (against Scale Five, the most intensive assessment) which applies to new applicants and to certain other applicants.

Streamlined applications—Scale One

3.6 Streamlining was authorised by section 1433 of the Corporations Act.⁶¹ This section requires ASIC to grant a financial services licence to qualified applicants. Applicants qualified if they were currently licensed to carry out, or were lawfully carrying out, an activity that would require a financial services licence *and* they wished only to be licensed for their existing activity. Table 3.1 sets out the classes of qualified applicants.

3.7 Initially, holders of a dealers licence, investment advisors licence, futures brokers licence and futures advisors licence, and registered insurance brokers qualified for streamlining. From 11 March 2003 streamlining was extended by regulations to Australian Authorised Deposit-taking Institutions, life companies, general insurers and approved trustees of superannuation funds.⁶² Streamlined applications could be submitted up until the end of the transition period on 10 March 2004.⁶³

3.8 Streamlined applicants were exempt from proving to ASIC that they had the capacity to meet all their licence obligations. The chief component of their application was their declaration to the effect that they would, if granted a licence, comply with their obligations as a financial services licensee. ASIC

⁶⁰ ASIC, *How do you get an Australia financial services licence? Process guideline*, October 2001, p. 20.

⁶¹ Inserted by the FSRCP Act, effective from 27 September 2001.

⁶² This was achieved by amendments to sub-regulation 10.2.38(2) to the Act.

⁶³ As per sections 1433 and 1430 of the Corporations Act and Regulation 10.2.38.

would then be compelled to grant the applicant a licence that permitted them to provide services that equated as closely as possible to the activities previously regulated:

Applications for 'streamlined licences' must include a statement by the licensee in which they state that they will comply with their obligations as a financial services licensee ... The purpose of this requirement is to ensure that those applying for streamlined licences appreciate that although they are entitled to such a licence, it will entail a change in the obligations to which they are subject.

In issuing a streamlined licence ASIC does not have any discretion and must grant the licence if it is made in accordance with [*the Corporations Act*]. ASIC must impose a condition on the licence specifying the financial services that the licensee can provide and these must be as close a possible to regulated activities of the applicant. ASIC can, however, at the time of issue, or at a subsequent time, impose additional conditions on the licence in the normal manner.⁶⁴

⁶⁴ Paragraphs 4.43 and 4.44 of *Financial Services Reform (Consequential Provisions) Bill 2001*, Revised Explanatory Memorandum, p. 14.

Table 3.1**Entities qualifying for streamlined application for a financial services licence**

Applicant	The financial services being applied for:	Disqualifications ¹
Pre-FSR Corporations Act licensee: <ul style="list-style-type: none"> ● securities dealer ● investment advisor ● futures broker ● futures adviser Pre-FSR IAB Act registration as: <ul style="list-style-type: none"> ● general insurance broker ● life insurance broker ● life insurance agent Pre-FSR Banking Act registration as: <ul style="list-style-type: none"> ● foreign exchange dealer 	The same financial services and products that the applicant was authorised to provide under their pre-FSR licence or insurance broker registration	A person who is or was insolvent under administration (for five years after the start of administration) or a responsible officer of such a person; A body corporate that has been externally administered (for five years after the start of the administration) or a subsidiary of such a body; A person who was convicted of fraud (for 10 years after the conviction); A person who is subject to court proceedings for criminal fraud; A person found liable by a court in proceedings brought by a regulator for conduct contravening financial services laws (for 10 years after the conduct occurred); A person who is subject to court proceedings brought by a regulator for conduct contravening financial services laws;
Certain APRA regulated bodies: ² <ul style="list-style-type: none"> ● ADI³ ● Life insurer⁴ ● Approved Trustee of superannuation funds under the <i>Superannuation Industry (Supervision) Act 1993</i> (the SIS Act)⁵ ● General insurer⁶ 	The same financial services and products that the applicant lawfully provided immediately before FSR commencement	A person who has had an authorisation, registration or licence to engage in financial services cancelled, suspended or revoked by a regulator (for five years after the cancellation, suspension or revocation); A person associated with certain of those persons; A person <i>deemed</i> a registered insurance broker under section 24(2) of the IAB Act.
Notes: <ol style="list-style-type: none"> 1: Schedule 10D of the Regulations specifies persons who are not covered by the streamlining provisions in section 1433 of the Corporations Act. 2: From 11 March 2003, by amendments to the Regulations. 3: Authorised Deposit-taking Institutions are licensed by APRA under section 9 of the Banking Act. 4: Life insurers are licensed by APRA under section 21 of the <i>Life Insurance Act 1995</i>. 5: Approved Trustees are licensed by APRA under Part 2 of the SIS Act. 6: General insurers are licensed by APRA under section 12 of the <i>Insurance Act 1973</i>. 		

Source: ANAO analysis of the Corporations Act and Regulations and of ASIC information.

Composite applications and full applications—Scales Two to Five

3.9 Composite assessments were generally available to applicants who were eligible for streamlining for all of their existing services *and* who wished to widen their licensed activities to include new products. Under the composite process, the applicant's experience as a provider of financial services was taken into account. For most applicants the assessment was minor and they were required to provide only one or two supporting proof documents,⁶⁵ mainly in respect of the services they wished to provide in respect of new products. In general, composite applications applied to:

- applicants for a streamlined licence in respect of formerly regulated activities who sought permission to widen their activities; and
- applicants seeking authorisation to provide a service or product that they did not provide immediately before FSR commencement, even though lawfully able to do so.

3.10 In comparison to streamlined and composite applications, a full (or Scale Five) application process under section 913B of the Act requires ASIC to form a view of the applicant's ability to comply with their licence obligations. This view is to be formed on the basis of the applicant's application, fame and character, previous compliance with the Corporations Act, and criminal or any other matter ASIC considered relevant.

3.11 Insurance agents, applicants varying their financial services (and possibly also their products) and applicants who were new to the industry were subject to the full licence assessment process. Under a Scale Five assessment, the licence analyst was required to check that the applicant had made all the required declarations, had supplied all the necessary proofs, and had satisfactorily answered any additional queries from ASIC.

Licensing outcomes

3.12 Statutory exemptions have served to limit the scope of the licensing regime, as have ASIC's statutory powers to grant relief from financial services licensing requirements. Together, these have reduced the need for licences.

3.13 By the transition deadline of 10 March 2004, ASIC had issued 3 738 financial services licences, comprising:

- 953 applications under the full assessment process;

⁶⁵ Summarised from "Step 3: Are you eligible for streamlining" in the ASIC guide *How to apply for a financial services licence*, January 2003, pp. 19 and 20.

- one qualified licence;
- 1 875 streamlined applications; and
- 909 composite applications.⁶⁶

3.14 Table 3.2 shows the distribution of licences within each industry sector at 30 June 2004, including all the licences issued during the transition period. By 30 June 2004, ASIC had issued 3 853 financial services licences, rising to 4 135 by 30 June 2005.

Table 3.2

Financial services licence distribution by industry sector, 30 June 2004

Financial industry sector	Licensees
Financial adviser	809
Deposit taker	154
Conglomerate	116
Superannuation	270
Market dealer	539
Managed fund	578
Life insurance	462
General insurance	925
Total	3 853

Source: ANAO analysis of ASIC data.

3.15 Initially, the licensed population under the new financial services regime was less than that of the pre-FSR Corporations Act regime it replaced.⁶⁷ In this regard, ASIC advised ANAO in June 2005 that:

Due to the lack of comparable data [*from the pre-FSR Corporations Act licence regime*], it has not been possible to determine whether the apparent shortfall in financial services licences could be explained by an increase in the population of authorised representatives.⁶⁸

3.16 Nonetheless, ASIC is of the view that the lower than expected number of licences might be due to the number and scope of eventual exemptions from

⁶⁶ ASIC Information Release 04/88, 29 March 2004.

⁶⁷ Page 78 of ASIC's *Annual Report 2001–02* cites a total of 4 005 pre-FSR licences and 35 financial services licences current at 30 June 2002.

⁶⁸ ASIC, *A preliminary Risk Assessment of Authorised Representatives of financial services Licence Holders*, 30 June 2004, p. 1.

the regime, or because many persons who might have been expected to have sought a licence decided to operate as authorised representatives instead, or because some persons who held a pre-FSR licence chose not to apply for a financial services licence (including some who may have elected to vacate the industry in light of the obligations imposed under the new licensing arrangements). In this respect, in September 2005 Treasury advised ANAO that:

As at 1 September 2005, the number of financial services licences issued by ASIC was 4 404, which is less than the number of licensees that were estimated to apply for an AFSL prior to the introduction of the new financial services regulatory regime. However, the new regime introduced rigorous assessment requirements for obtaining an AFSL and also introduced new conduct and disclosure requirements, which modified the behaviour of financial service providers.

As such, a significant proportion of those financial service providers that were previously expected to apply for an AFSL instead applied to act as authorised representatives under another's AFSL. This is evidenced by the number of authorised representatives that have been registered with ASIC, which at 1 September 2005 was 41 759.

Coverage

3.17 As discussed in Chapter 1, the broad definitions underpinning the Corporations Act licence regime could bring many of those offering financial services within its regulatory scope, either as licensees or authorised representatives. However, statutory exemptions have served to limit this scope. For instance, exempting the majority of accountants, lawyers and tax agents in respect of certain professional advice excludes some 200 000 people from the need to hold a financial services licence or to become the authorised representative of a licensee.⁶⁹

3.18 Under the pre-FSR Corporations Act licensing regime, employees providing financial services and working for a licensee at a licensee's office had to be registered as *proper authority holders*. Continuing the arrangements under the pre-FSR Corporations Act, the greater portion of the 345 000 employees of banks, other financial institutions and insurance companies and

⁶⁹ The exemptions are set out in paragraph 1.20 of Chapter 1. The ANAO estimates were compiled from the annual reports of State Law Societies and professional accounting organisations.

related service companies⁷⁰ are exempt from the need to be authorised representatives of a financial services licensee.⁷¹

3.19 To date, ASIC has not developed reliable estimates of the number of people who may need to be authorised representatives of financial services licensees. More broadly, in September 2005, ASIC advised ANAO that it was extremely difficult to provide useful estimates of the potential population which might fall within the financial services licensing regime, and therefore of the current rates of coverage. ASIC further advised ANAO that:

While contraventions of the obligation to hold a licence are regularly detected and dealt with, ASIC's compliance and enforcement activities do not reveal evidence of systematic under-licensing of the population.

3.20 Allowing for the number and scope of exemptions,⁷² on the basis of ASIC estimates at May 2004, ANAO estimated that the *minimum* potential population requiring a financial services licence or authorisation was 107 119, compared to 3 798 licensees and 36 367 authorised representatives at that time (see Table 3.3).

⁷⁰ As at June 2002, Finance Sector Union website, accessed 26 April 2005.

⁷¹ Under the new arrangements, section 766A(3) specifically excludes clerks and cashiers, and Regulation 7.6.04A exempts employees of the providers of general insurance and basic deposit products and providers of non-cash payment facilities related to basic deposit products. However, lawyers, tax agents and accountants do need a financial services licence where their advice extends beyond that purely integral to the ordinary services.

⁷² ASIC also has the power to exempt particular persons or classes of persons from the requirement to hold a financial services licence and other related requirements. For example, by virtue of interim relief granted by ASIC under section 926A of the Corporations Act, Class Order 03/1096 exempted actuaries from the licensing requirements until 1 July 2005. Class Order 05/680 extended this exemption until 1 January 2006 and, on 7 December 2005, Class Order 05/1194 further extended the relief until 1 July 2006. A similar power enables ASIC to exclude specific activities or products from the definition of advice or product and to effectively narrow the scope of operation of the licensing requirements.

Table 3.3**Financial services licence coverage by industry, May 2004**

Financial services industry sector	Expected number of financial services licencees	Actual number at May 2004	Percentage Coverage
Authorised Deposit-taking Institutions	243 ¹	159	65.4%
Conglomerate	200	110	55.0%
Financial Adviser	2 500 ²	799	32.0%
General Insurance	1 400 ²	889	63.5%
Life Insurance	200 ²	467	233.5%
Managed Fund	500 ²	566	113.2%
Market Dealer	500 ²	541	108.2%
Small general insurers, brokers and agents	100 000 ³	16	0.0%
Superannuation funds	1 576 ⁴	251	15.9%

Notes:

- 1: From APRA *Annual Report 2003–04*, page 29.
- 2: Many of these were formerly licensed under the pre-FSR Corporations Act provisions.
- 3: ASIC's 27 November 2000 estimate of the number of small entities and businesses, such as car dealers, travel agents and boat brokers, who may advise on or offer insurance products in the course of their business dealings.
- 4: Comprises approved trustees and standard employer sponsored superannuation funds, from APRA *Annual Report 2003–04*, page 29.

Source: ANAO analysis of data from ASIC's 10 May 2004 *An Overview of the Financial Services Industry from FSRA Licence Application Data*, and other data from ASIC and APRA Annual Reports.

3.21 ASIC observed in May 2004 that the lower than expected coverage in the financial adviser and superannuation industries⁷³ was in need of further investigation. Among the possible explanations canvassed by ASIC were:

There are many inactive holders of old licences, who may have decided not to apply for [a financial services licence] with higher compliance obligations. Many may have chosen to become authorised representatives of [financial services licence] holders for legal or economic reasons.

⁷³ Any superannuation trustee offering financial advice to members or prospective members is very likely to require a licence (though dealing by the trustees of standard employer sponsored funds (usually industry and corporate funds) is exempt). Superannuation trustees may not need a licence if, for instance, they have an arrangement with another licensee to provide advice to members or prospective members.

Some may have decided the new regulatory regime is too onerous for the scale of their operations and have become unlicensed under the new law. It is therefore important to investigate and quantify these and other possible explanations.⁷⁴

3.22 The appointment and supervision of authorised representatives is, under the Corporations Act, essentially a matter for licensees. Licensees must notify ASIC when they appoint an authorised representative or revoke an appointment. The population potentially requiring the authorisation of a financial services licensee, and thus coming under ASIC's regulatory oversight, is potentially significant.

3.23 At May 2004, ASIC's records showed that 1 083 financial services licensees (or 28 per cent) had appointed 36 367 authorised representatives to provide financial services on their behalf. These representatives were appointed mainly by financial conglomerates (21 per cent) or by licensees in the insurance sector (62 per cent).⁷⁵ The remaining 17 per cent (or 6 200) authorised representatives may include a number of the 100 000 entities who offer financial services as part of conducting other non-financial business. To address this, in October 2005, ASIC announced relief for licensees from the authorisation requirements for distributors of general insurance products.⁷⁶

3.24 ASIC advised ANAO in December 2005 that:

It should be acknowledged that ASIC's estimates were made in 2000, before the legislation was in its final form, and thus were necessarily very preliminary. They also relied heavily on industry estimates, and included entire categories of person and entity that were subsequently either excluded by the law, or did not require licences due to commercial decisions made by their controllers.

3.25 At that time, ASIC also advised that its Compliance Directorate is undertaking a project in the 2005–06 year to identify and remedy any unlicensed activity.

⁷⁴ ASIC, *An Overview of the Financial Services Industry from FSRA Licence Application Data*, 10 May 2004, p. 21.

⁷⁵ ASIC, *A Preliminary Risk Assessment of Authorised Representatives of financial services Licence Holders*, 30 June 2004, p. 1.

⁷⁶ ASIC Class Order [CO 05/1070] *General insurance distributors*, issued on 26 October 2005 under paragraph 926A(2)(c) of the Corporations Act. The relief granted was as contemplated in the Government's 2005 *FSR Refinements Paper*.

Relief from licensing requirements

3.26 ASIC has statutory powers to grant relief from financial services licensing requirements. The FSR Act and the *Financial Services Reform Amendment Act 2003* (FSRA Act) gave ASIC the power to exempt applicants from the Corporations Act licensing provisions or to modify the action of the licensing provisions. ASIC's published guidance to applicants is that it will consider giving relief under the Corporations Act to address atypical or unforeseen circumstances and unintended consequences of the licensing provisions of the Act. ASIC may also give relief on its own initiative or on application.⁷⁷

3.27 The power to administratively alter the action of an Act of Parliament is referred to as a *Henry VIII provision*. Bills proposing Parliament's delegation of its legislative powers are sometimes subject to separate scrutiny by Parliamentary Committees, though not in the case of the Corporations Act licensing exemption powers. In recognition of its delegated powers, and in the absence of specific guidance from Parliament, ASIC has formulated and published policy guidance, including the general position that:

[ASIC will] grant relief only in a way that is consistent with Parliamentary intention. The Corporations Act is intended to harmonise and raise standards of conduct. ASIC will give weight to the value of promoting international harmonisation where relevant.

3.28 Factors ASIC states it may consider when deciding whether to exercise its relief powers include whether:

- (a) strict compliance with the FSR regime would be impossible or disproportionately burdensome;
- (b) persons to whom financial services are provided would still have the protection intended by Parliament;
- (c) those to whom the relief applies (eg the applicant) will receive any benefits;
- (d) a reasonable person would think that the predominant purpose of the product to which the service relates is not a financial product purpose;

⁷⁷ ASIC policy statement [PS 167] *Licensing: Discretionary powers*. In granting relief ASIC keeps in mind the regulatory goals of: (a) promoting consumer confidence in using financial services (including informed decision-making); (b) promoting the provision of efficient, honest and fair financial services by all licensees and their representatives; and (c) supporting confident use of financial markets by consumers and market participants.

- (e) the service is subject to adequate alternative regulation;
- (f) the likelihood and extent of potential consumer detriment resulting from the proposed relief is minimal; and
- (g) the service is only provided to wholesale clients (or in some cases only to professional investors as defined in section 9 of the Corporations Act).

3.29 As discussed in Chapter 2, up until 30 April 2005, ASIC had received 3 006 applications for relief and granted 2 532 of those applications (as shown in Table 2.3). A large portion of ASIC's relief applications occurred during the two-year financial services licensing transition period. Over this time, ASIC reported that it considered over 1 000 FSR-related applications for relief and issued approximately 80 FSR-related class orders to enable:

the new regime to apply appropriately, having regard to the breadth and diversity of financial services and financial products captured by the new regime. Some of this relief is interim to allow the long-term application of the new regime to be assessed.⁷⁸

3.30 In September 2005, ASIC advised ANAO that half of the applicants sought relief from the licensing provisions, the remainder seeking relief from the Corporations Act's conduct and disclosure provisions.

3.31 ASIC categorises applications for relief as *standard* or *minor and technical* (in which case ASIC can often rely on existing practice to determine the application) or *novel* (raising entirely new or significantly different policy considerations). In this latter case, the application for relief is likely to be considered by ASIC's high-level Regulatory Policy Group (RPG). ASIC may also attach conditions to the relief it grants.

3.32 ASIC's RPG considers applications for novel relief and the bulk of class orders developed by ASIC. This is consistent with ASIC's view that class orders which modify the action of the Corporations Act are significant matters. ANAO examined ASIC's records of its RPG deliberations and confirmed that proposals for novel relief and class orders receive a high level of scrutiny. RPG records show that ASIC strives to achieve the consistent application of the Corporations Act regulatory regime across the variety of industry participants.

⁷⁸ ASIC Information Release IR04/88.

However, ASIC's consideration of class orders does not usually estimate their impact on the size of ASIC's regulated population, or changes to the coverage of, for instance, the licensing regime versus the disclosure regime. In this regard, ASIC advised ANAO in September 2005 that:

ASIC class order exemptions are often conceptually based and make calculation of the number of persons who can take the benefit of the class order difficult (for example, a class order exemption for a defined type of non-cash payment facility).

Recording licence assessments and decisions

3.33 ASIC's decision to grant a licence depends on its assessment of the adequacy of the facts of the licence application and its judgment as to whether the applicant complies with the statutory criteria. Matters of fact include, for instance, whether prescribed documents have been supplied. Matters of judgement include, for instance, ASIC's consideration of the good fame and character of the applicant and whether they have any grounds to believe the applicant would not comply with their licence conditions.

3.34 ASIC's licence decision includes both objective and subjective elements, each of which must be substantiated and properly recorded. ASIC's judgement may later be relied upon when it pursues regulatory action against licensees which it believes have contravened the Corporations Act. It may also be called into question if, for instance, an applicant wishes to have a licence decision reviewed.

3.35 For streamlined applications, ASIC's decision-making was reduced to ensuring that the applicant was properly qualified to streamline and then confirming that the applicant had declared their intention to meet their licence obligations. A greater level of decision-making was called for in the case of composite applications. This was also the case for full applications.

The licence application form

3.36 ASIC commenced planning the implementation of the FSR legislation in 2000 and had outlined its plans for licensing by the end of that year.⁷⁹ Early in 2001, while designing and building the computer systems to support licensing (and before the FSR Act had been passed by Parliament), ASIC

⁷⁹ ASIC had also considered some aspects of a single licensing regime late in 1999.

released its first set of guidance to potential applicants.⁸⁰ This included ASIC's first published guide to the licensing process, subsequently replaced in March 2002 by ASIC's first version of the licence application.⁸¹

3.37 ASIC commenced developing its licence application forms and supporting systems in 2001. Financial services licence application forms were authorised by ASIC in February 2002. They became effective on 11 March 2002.⁸² As the form was available on-line, provision was also made for electronic signature and lodgement.

3.38 Applicants were advised that it was an offence under the Corporations Act to provide false or misleading information (including any material omission) to ASIC and that to do so might be grounds to revoke any licence based on the application. The advice alerts the applicant to section 1308(8) of the Corporations Act,⁸³ the contravention of which is an offence by section 1311(1). However, ASIC's internal legal advice of July 2002 was that ASIC would be unlikely to proceed with a prosecution on a false or misleading statement in a licence application due to deficiencies in the construction of the application:

It would be difficult to prosecute because [*the*] application form certifications were drafted, not with potential prosecution in mind, but as educational tools to remind applicants of their obligations under the Act. As they refer in part to future conduct, it would be difficult to prove beyond reasonable doubt that the applicant knew that a statement as to future conduct was false.

⁸⁰ ASIC, *Implementing the Financial Services Reform Bill 2001 – First set of Policy Proposal Papers and documents*, April 2001.

⁸¹ The most recent version of the licence application form was issued by ASIC on 30 September 2004.

⁸² To complete the application, applicants must supply:

- their details;
- the types of financial services they wish to provide;
- the details of any current licences they hold and whether they considered themselves eligible for a streamlined application;
- their statements against the licence obligations and requirements;
- documents in support of their statements against the licence obligations and requirements (called proofs); and
- their certification and declaration of the veracity of the information they have supplied.

⁸³ Which provides that an application for a financial services licence must not include a statement that is false or misleading in a material particular or omit something that makes the application misleading in a material respect.

[The] certifications only re-state general obligations dealt with in other statements in the application form. The form is not clear whether certifications are made by the applicant or the individual signatories, which raises issues as to who is the appropriate offender.

Certifications by “high-risk streamlined offenders” are about future conduct and the applicant’s belief that responsible officers are of good fame and character; thus it would not be straightforward to prove beyond reasonable doubt [*that the applicant knew*] that such statements were false.⁸⁴

3.39 ANAO notes that ASIC has not subsequently revised the relevant certifications on the financial services licence application form. In this regard, ASIC advised ANAO in September 2005 as follows:

Certifications typically relate to a combination of current factual matters and promises about future matters. The parts relating to factual matters will very likely be subject to section 1308. To the extent that certifications relate to future matters, it is far more difficult to bring enforcement action under section 1308.

However, this difficulty relates to the current drafting of section 1308, rather than the form of ASIC’s certifications. It follows that legislative amendment may be required in order to ensure the enforceability of licence certifications.

3.40 ANAO concludes that certifications on the financial services licence application form remain largely unenforceable. This may undermine or defeat the primary licence objective of convenient and effective control of licensees.

Recommendation No.1

3.41 ANAO recommends that ASIC and Treasury consider the merits of seeking legislative amendments to provide for enforceable declarations and certifications as part of a financial services licence application.

Agency Responses

3.42 ASIC agreed and advised ANAO that it is implementing the recommendation in that it will consider, with Treasury, the merits of the proposal. Treasury also agreed with the recommendation and commented as follows:

Treasury notes that ASIC is quoted in the report to the effect that the unenforceability of certifications is due to a number of factors, including the difficulty for ASIC to proceed with a prosecution on a false or misleading

⁸⁴ ASIC internal memorandum, *AFSL Certification issues*, 12 July 2002. The advice also noted that ‘[ASIC’s] enforcement directorate is unlikely to prosecute for such offences because the penalty for an offence under section 1311(1) is five penalty units (or a fine of 25 penalty units for a body corporate)’. These fines amount to \$550 and \$2750 respectively.

statement in a licence application, given that the forms are drafted as an educational tool to remind applicants of their obligations under the law. The certification requirements refer to future conduct, for which it would be difficult to prove that the applicant knew that the statement relating to future conduct was false.

While the view of ASIC is noted, Treasury considers that the licensing regime contains effective mechanisms to deter persons from deliberately misleading ASIC. ASIC determines licence conditions on the basis of applications provided to it and imposes conditions on a licence relating to certifications of factual matters or future events.

Under subsection 1308(8) of the Corporations Act 2001, a licence applicant must not provide false or misleading information (including any material omission) to ASIC in making an application for a financial services licence. Section 1311(1) provides that it is an offence to do so and that to do so might be grounds to revoke any licence.

Therefore criminal penalties can apply if a licence applicant knowingly makes a false or misleading statement or omission on a licence application relating to a factual matter.

With respect to future events, ASIC is able to attach conditions to a licence based on the information provided in a licence application, including information relating to the financial services that the applicant proposes to provide. Corporations Regulation 7.6.03 outlines the information that is required to be provided in a licence application and, in particular, Regulation 7.6.03(f) provides that a licence application must contain a description of the financial services that the person proposes to provide. If a licence is granted by ASIC and the applicant subsequently does not provide financial services in accordance with its licence conditions, such that the information provided in its licence application about future events is false or misleading, ASIC would have scope to take action by revoking the licence or amending its conditions.

Against this background, it appears that there are effective sanctions in relation to false or misleading information provided in licence applications both in relation to factual matters and future events. Nevertheless, given the concerns raised in this report, Treasury will give policy consideration to the matter raised by Recommendation 1, in consultation with ASIC.

Treasury would also note that the recommendation to seek legislative amendment to provide for enforceable declarations and certifications in financial services licence applications may create issues of consistency with Commonwealth criminal law policy enunciated by the Attorney General's Department. Section 1308, as currently drafted, is in accordance with criminal law policy and the suggested change raised in this report would need to be considered within this context.

ASIC's licence assessment records

3.43 In general, good decision-making in government accords with key principles of administrative law. In the case of deciding licence applications, for instance, it is important that the record of assessment clearly shows that the merits of the application were identified, that all relevant matters were considered, that the decision was based on the facts, and that the critical elements of the decision were clearly identified for the consideration of the decision-maker.⁸⁵

3.44 ASIC's exercise of judgment in granting a licence must be balanced by considerations of natural justice. In particular, section 913B(5) of the Corporations Act provides that ASIC may refuse to grant a licence *only* after granting the applicant a hearing and receiving any submission they may wish to make. Applicants may also appeal to the Administrative Appeals Tribunal if they are dissatisfied with ASIC's treatment of their application. Applicants may also ask the Federal Court or Federal Magistrates Court, under section 5 of the *Administrative Decisions (Judicial Review) Act 1977* (the ADJR Act), to review ASIC's decision.⁸⁶

3.45 In the case of ASIC, as for other government agencies created by legislation, officers cannot rely upon executive power to make decisions. Rather, it is important that special care is taken to ensure that decision-makers are officers who have been properly delegated the authority under legislation.⁸⁷ In this case, the proper authority to grant a financial services licence is a delegation under section 102 of the ASIC Act.

Record-keeping

3.46 The proper documentation of the licence decision is important for regulatory, operational and legal reasons. Accordingly, ANAO considers that each of ASIC's financial services licence assessment records should clearly demonstrate that ASIC's decision accorded with the Corporations Act and was based on the facts of the application, including any inquiries made by ASIC. It should set out the reasons for ASIC's decision, along with the material facts

⁸⁵ From Clayton Utz, *Good decision-making for government—A legal perspective*, 2003.

⁸⁶ Section 1337B(3) of the Corporations Act also confers on Supreme Courts in the States and Territories the jurisdiction to review ASIC's decisions.

⁸⁷ Clayton Utz, *Good decision-making for government – Authorised decision-making*, 2003, p. 3.

and any relevant evidence or other material.⁸⁸ The material facts include, for instance, records of ASIC's testing of an applicant's claims against the relevant provisions of the Corporations Act, any reasons for applying particular conditions to a licence, and ASIC's attestation that it has no reason to refuse a licence.

3.47 In 2000, the Australian Government adopted the International Standard for Records Management (AS/ISO 15489). Section 7.2 of the Standard states that 'A record should correctly reflect what was communicated or decided or what action was taken' and 'A reliable record is one whose contents can be trusted as a full and accurate representation of the transactions, activities or facts to which they attest'. The National Archives of Australia, the Government agency responsible for the administration of the Standard, advised ANAO that:

Full and accurate records must be:

- compliant—complying with the record-keeping requirements arising from the regulatory and accountability environment in which the organisation operates;
- adequate—for the purposes for which they are kept;
- complete—containing not only the content, but also the structural and contextual information necessary to document a transaction;
- meaningful—containing information and/or linkages that ensure the business context in which the record was created and used is apparent;
- comprehensive—documenting the complete range of the organisation's business for which evidence is required;
- accurate—reflecting accurately the transactions that they document;
- authentic—enabling proof that they are what they purport to be and that their purported creators did indeed create them; and
- inviolate—securely maintained to prevent unauthorised access, alteration or removal.⁸⁹

⁸⁸ These are the items required in a statement of 'reasons for decision', as set out at section 13(1) of the ADJR Act.

⁸⁹ The term is defined in the National Archives of Australia on-line glossary at: <<http://www.naa.gov.au/recordkeeping/dirks/dirksman/glossary.html>>.

The Licence Assessment Worksheet (LAW)

3.48 ASIC's primary record of the licence assessment process is an electronic LAW generated and recorded in the Financial Services Licence System (FSLs). In ASIC's view:

The [LAW] is an integral part of [FSLs]. The worksheet was developed to enable concerns to be captured and searched and to allow automatic feeding of concerns into requisition and requirements letters. The analyst submits it electronically to the team leader for consideration of the recommended action.

The worksheet identifies those areas of law and policy that ASIC must consider in the granting of an AFSL. The separate areas in the worksheet explore [statutory licence] requirements. [ASIC Policy Statements] provide further details on how ASIC interprets legislation and how those requirements can be met to satisfy licensing requirements.⁹⁰

3.49 When licence applications are received, more senior staff members (often team leaders) allocate them to licence analysts. At the first stage of assessment, the *pre-lodgement* stage, the analyst checks to ensure that the application has been submitted in a suitable form and that it is accompanied by the required documents. Applications that pass the pre-lodgement stage proceed to be checked by the licence analyst, following the checklist of actions required in the LAW, guided by ASIC's *Licence Analyst's Roadmap to AFSL* (LARA). LARA identifies the steps in processing a licence application. Its aim is to encourage consistent licence decision-making of a high standard throughout ASIC:

It is recognised throughout this document that a flexible approach will need to be taken by licensing analysts under-plied by common sense. This approach must always be applied on a risk basis in order that the quality of the assessment is not lowered. Higher risk entities and products need closer scrutiny and higher standards applied than others. It is important that you take into account all factors when deciding on your assessment approach. Our intelligence in our approach to assessment is the first part of the regulatory cycle in which surveillance and enforcement follow. We are the gate keeper and therefore the quality and transparency of the process needs to be maintained while achieving the greatest efficiency.⁹¹

⁹⁰ ASIC, *Licensing Analyst's Roadmap to AFSL (LARA)*, p. 141.

⁹¹ *ibid*, p. 10.

3.50 The LAW follows a standard format. It allows the analyst to comment in respect of concerns they may have about the application under each of the major licence obligations, and to indicate any further information they require from the applicant (*requirements*). When assessment is complete, the analyst finishes the LAW and drafts correspondence (usually a *requirements letter*) to the applicant. The finished LAW and draft correspondence are forwarded to the analyst's team leader for consideration, usually drafted to the effect that the licence should be granted, though less frequently drafted so as to refuse the application or to inform the team leader that the applicant has withdrawn their application.

3.51 In most cases examined by ANAO, the requirements letter informs the applicant that ASIC has considered their application and is minded to grant a licence, in some cases with a request for more information or documentation. Attached to the letter are the proposed licence conditions and a request that the applicant sign a consent indicating whether they wish to proceed with the application. If the applicant wishes to proceed, the licence takes effect from a specified date.

Examination of licence assessment records

3.52 To test the robustness of ASIC's licensing process, ANAO selected a random sample of 50 licensing records from ASIC's FSLs database. ANAO found that most of the LAWs in the ANAO sample recorded minimal comment on, or analysis of, the application. Only a few LAWs recorded detailed comments about concerns raised by the analysts or evidence of consideration of additional information provided by applicants. In most cases, the information recorded on the LAWS appeared perfunctory, in that definitive assessments were unclear or unstated. The findings summarised below in Table 3.4 relate to the 43 records examined.⁹²

3.53 LAWs were the primary record subject to ANAO's audit examination of ASIC's licence assessments. They were supplemented with related documents recording surveillance concerns and ASIC's correspondence with applicants. ANAO also compared LAWs with records on ASIC's publicly available on-line database of licensees.

⁹² ANAO randomly selected 50 records from the FSLs database. Six were removed from the sample as they were applications which had either been withdrawn before any assessment had been recorded or had failed ASIC's pre-lodgement assessment. Another was removed as it concerned an applicant awaiting ASIC's assessment.

3.54 Assessed against the record-keeping standards set out at paragraph 3.47 above, ANAO considers ASIC's licensing processes to be deficient in important respects. In making these observations, ANAO distinguishes between the information that analysts were *required* to record during their assessment of an application and that which ANAO considers *should* have been recorded.

Table 3.4

ANAO analysis of ASIC's licence assessment records

		Type of application:		
		Streamlined	Composite	Full
	Number in sample	18	10	15
Records of evidence in the LAW that:	the analyst had tested the applicant's eligibility for scaled assessment	0	0	1
	the analyst considered the good fame and character of the applicant	0	0	1
	the analyst had considered the applicant's proofs against the licence obligations	0	0	1
Other records of evidence that:	the analyst had considered the applicant's proofs against the licence obligations	2 ¹	6 ¹	12 ¹
	the Risk Assessment and Scoring System (RASS) report had been inspected	1	0	0
Note:				
1: In each of these cases, ANAO's examination of ASIC's correspondence showed that the licence analyst had requested further information from the applicant, notwithstanding the fact that the LAW recorded little or no other information in relation to each relevant statutory licence obligation.				

Source: ANAO analysis of a random sample of ASIC records.

Qualification for transitional concessions

3.55 In the first instance, the LAW made no provision to specifically record the analyst's assessment of an applicant's eligibility for a streamlined or composite assessment (assessment against Scales One through Four, at paragraph 3.5). While the application form allowed the applicant to *nominate* their application as streamlined, applicants may also have indicated that they

wished to provide services or products not covered by their original licences, or may have been a person disqualified from streamlining.⁹³

3.56 Although streamlined assessment offered applicants the convenience of obtaining a licence by sole virtue of their statement of intent to comply with their licence obligations, the LAW did not require the analyst to record that they had sighted the necessary declaration. That declaration was crucial to a streamlined application since, without it, ASIC was not required to grant the licence.

Clear and conclusive assessments

3.57 The LAW does not require the analyst to record their assessment or their advice to the decision-maker that there was no reason to believe that the applicant was not of good fame and character. In forming this view, ASIC must have regard to any conviction of the person for serious fraud in the previous 10 years; and whether the person has had a financial services licence suspended or cancelled or was subject to a banning order or disqualification under the financial services provisions of the Corporations Act.

3.58 To assist analysts to assess applicants' good fame and character, a RASS assessment was *automatically* generated for each licence application. The RASS allows analysts the opportunity to check ASIC's recorded information for prior convictions, banning orders, surveillances and other regulatory actions which might involve the applicant or their associates. However, the LAW did not require the analyst to specifically record whether they had inspected the RASS.

3.59 ANAO identified a lack of recorded evidence that ASIC had satisfied itself as to the applicant's capacity to meet its licence obligations or of their good fame, leaving some doubt as to ASIC's basis for granting a licence. Specifically, the ANAO sample included only one instance where the LAW recorded that the analyst had actively inquired into the good fame and character of the applicant.

3.60 ANAO also examined ASIC's correspondence with the applicants, including requests for further information. For 20 of the 43 applications examined, correspondence indicated that analysts had considered the evidence offered by applicants in support of their licence applications. However, the available records did not demonstrate that ASIC was *satisfied* by the

⁹³ ANAO's examination of the streamlined licence assessments in its sample found only one instance where the LAW recorded the analyst's consideration of the applicant's eligibility for streamlined assessment. In that instance, the applicant was disqualified as a person specified in Schedule 10D of the Regulations (as per Table 3.4).

information offered by the applicant. In this respect, there is no formal sign-off in the LAW recording the analyst's assessment that they have no reason to believe that the applicant would not meet their statutory obligations.

Unequivocal recommendations

3.61 ANAO notes that, in most instances, ASIC's FSLs database automatically translated a licence application for particular financial services and products into a set of licence conditions to be printed on the licence offer. However, the LAW did not require the analyst to review the conditions generated to ensure that they knew of no reason the applicant would not comply with the proposed licence conditions.

3.62 In the audit sample, ANAO could not find records of:

- positive assurances from analysts to team leaders on the state of the application and the advisability of granting a licence; or
- advice as to the action the analyst was recommending to the team leader; or
- consideration of the applicant's response to ASIC's initial letter offering a licence and detailing the conditions under which it might be granted.

Delegations

3.63 Delegations and authorisations play a key role in the Westminster system of public administration. They are the mechanism by which, in certain circumstances, officials may be provided with the authority to exercise a statutory power that the Parliament has vested in another individual or office-holder.⁹⁴

3.64 The relevant delegation for granting financial services licences is at section 102 of the ASIC Act. It allows ASIC to delegate the powers conferred on it under the Corporations Act. These include the power to grant financial services licences.

3.65 ASIC advised ANAO in September 2005 that all licence analysts and their managers have the requisite delegation to grant a licence on behalf of ASIC. However, the LAW does not record the delegations of analysts, decision makers and signatories to correspondence.

⁹⁴ Legal Briefing Number 74, *Delegations, authorisations and the Carltona principle*, Australian Government Solicitor, 14 December 2004, p.1.

ASIC's internal compliance reviews

3.66 To help maintain the quality of assessments, ASIC planned reviews of the quality and consistency of licence assessments during the peak period. This evolved into an internal compliance program, operating across ASIC's then FSR Directorate.⁹⁵ Among its main aims were the promotion of an effective compliance culture within the FSR Directorate and the establishment of appropriate avenues for staff to report (escalate) actual and potential compliance concerns.⁹⁶ Among its tasks were periodic reviews of LARA and the LAW.

3.67 ASIC's internal compliance reviews sought to mitigate the high risk of incorrect or inconsistent application of the Act to licence applications, resulting in incorrect licences. The reviews also sought to address the medium level risk that staff did not have requisite skills to accurately and efficiently assess applications or did not have the requisite knowledge to consistently assess applications. ASIC's internal compliance reviews reported issues including:

- a lack of file notes causing reduced transparency of reasons for decisions;
- inconsistencies and lack of transparency of reasons in file notes and LAW;
- no record of reasons for decisions; and
- failure to follow correct procedures for the RASS assessment.

3.68 ANAO notes that the issues identified in ASIC's internal compliance reviews are consistent with those identified in the course of ANAO's audit examination of ASIC's licence records.

Recommendation No.2

3.69 ANAO recommends that ASIC improve its licence application process and assessment recording systems such that ASIC's licence assessments and decisions are adequately documented and properly authorised.

⁹⁵ Until it was re-structured in May 2005, the Directorate was responsible for licensing and, through its Regulatory Operations arm, for planning and conducting surveillance of licensees.

⁹⁶ ASIC, *FSR Compliance Communication Plan*, Version 2 – February 2004.

ASIC Response

3.70 ASIC agreed and advised ANAO it is implementing the recommendation. ASIC commented that it is refining its assessment and decision recording processes, and is planning further enhancements early in 2006.

Unlicensed entities at end of transition period

3.71 ASIC advised ANAO that there were 25 streamlined and four composite applications that had not been decided, and for which licences had not been granted, at 11 March 2004. ASIC had anticipated this eventuality. Internal legal advice of January 2004 was that such applicants were unlicensed, although their applications were valid, and that the streamlined applications could be assessed as though the transition period was continuing.

3.72 ASIC's records showed that the streamlined applicants were unlicensed for periods ranging from 1 day to 97 days, with an average period of more than 20 days unlicensed. Similarly, the four composite applications were unlicensed for an average of 56 days, with one applicant unlicensed for 170 days. In respect of these applicants, ASIC advised ANAO in September 2005 that, in its view:

It should be made clear that of these 29 applications, five were lodged on Wednesday 10 March 2004, the day of transition, and eight were lodged on the Tuesday 9 March 2004, the day before transition, and that 25 of these applications were received between the 1st and 10th of March 2004.

3.73 However, while ASIC's licensing records would have readily identified those applicants unlicensed from 11 March 2004, ANAO found no evidence that ASIC promptly commenced surveillance of these unlicensed applicants, or advised them against providing any financial services until they were licensed.

3.74 ANAO examined ASIC's surveillance records for each of the 29 unlicensed applicants. In three instances, surveillance activities were recorded, one of which noted that the applicant was unlicensed. One surveillance was finalised on the date the applicant was granted their licence, the other two were finalised well after the applicants had been granted their licences. None of the surveillances resulted in enforcement action by ASIC.

Post-transition licence variations

3.75 As part of its post-transition ‘tidy-up’ of licensing, on 25 March 2004 ASIC issued a public statement that it was aware that some financial services licensees might be in technical breach of their licence because they did not have all of the licence authorisations they needed to carry on their financial services business. ASIC advised that, where licensees acted quickly to remedy technical breaches, ASIC would not take action against them. In addition:

Where a licensee has made a simple omission at the time a licence application was made and no further assessment would have been required at the time, ASIC will not carry out any further assessment in relation to the technical variation.⁹⁷

3.76 Section 914A of the Corporations Act gives ASIC the power to vary the conditions of a licence, either of its own initiative or on application by the licensee.⁹⁸ ANAO examined records of 94 post-transition variations, sampled from 256 provided by ASIC. As in the case of the licence application processing described for the random sample above, ASIC’s analysts used a LAW to record the processing of the post-transition application, including any concerns they may have identified, and to make a recommendation on the variation application. ANAO examined the LAW in the same way as for the random sample described above, including a comparison between the variation shown in the LAW and that recorded in the licence authorisation shown in ASIC’s on-line public register of licensees.

3.77 The sampled records covered the period 11 March to 21 April 2004, immediately after the end of the transition period. For all 94 examined, ANAO found that ASIC had recorded only minimal assessment when processing the application, regardless of whether the application was a variation to rectify a technical breach or to provide for an entirely new authorisation, as shown in Table 3.5.

⁹⁷ ASIC Information Release IR04/11 *ASIC’s approach to regulation of financial services: breach notification and disclosure*, 25 March 2004.

⁹⁸ ASIC may impose conditions, add conditions or vary a licence only after giving the licensee the opportunity of a hearing and to make submissions on the matter. Other arrangements apply to such variations in respect of APRA-regulated entities and ADIs.

Table 3.5

ANAO analysis of ASIC’s disposition of post-transition applications

		As recorded in the Licensing Analyst’s Worksheet (LAW)			
		New authorisation	Unclear	Technical variation	Total
As shown in ASIC’s on-line Register	New authorisation	43	19	5	67
	Unclear	2	4	0	6
	Technical variation	0	2	19	21
	Total	45	25	24	94

Source: ANAO analysis of ASIC licensing data.

3.78 ANAO found that ASIC’s on-line register of licensees showed that for 67 out of 94 approvals, applicants were granted significant changes to their original licence conditions. In each case, the assessment recorded by ASIC on the LAW was minimal. None of the 94 LAWs examined showed any significant depth of scrutiny. In a number of instances, analysts noted that the assessment was in accord with ASIC’s public guidance.

3.79 In 20 instances, ASIC’s on-line register of licensees showed significant changes to licence conditions.⁹⁹ However, analysts’ records in the corresponding LAWs showed that the variation was approved on the basis that it would have been available to the applicant *if it had been included in their streamlined or composite application*. In this regard, ANAO notes that eligibility for streamlined and composite applications ceased on 11 March 2004.

3.80 The legal basis by which ASIC effectively extended the financial services transition period is not clear. In ANAO’s view, ASIC’s power to vary licence conditions is not independent of ASIC’s other duties to properly consider all applications. In particular, the power to vary conditions does not

⁹⁹ ANAOs examination of this sample also showed 43 instances in which the LAW showed an application for a significant change to licence conditions, resulting in a corresponding change in ASIC’s on-line register of licensees. The LAW and on-line register agreed in the case of nineteen approvals of applications which were clearly technical variations of a kind described in ASIC’s information release. However, the LAW and the on-line register could not be readily reconciled in the remaining 32 cases.

appear to obviate ASIC's duty to assure itself it has no reason not to believe that the applicant will not comply with its licence obligations, *including* any variations to licence conditions.

3.81 Subjecting all applications for variations to the same level of proper scrutiny, regardless of the applicant's status during the transition period or any prior period, would remove any doubt that each had been adequately considered on its merits. However, the lack of clear and consistent records of assessments means that ANAO was unable to examine ASIC's reasons for granting the variations.¹⁰⁰

Rectifying technical breaches

3.82 During the post-transition tidy-up of licensing, ASIC was aware that applicants may have overlooked applying for all the authorisations necessary to cover their business. In its public information release of 25 March 2004, ASIC indicated that applicants who promptly notified ASIC of breaches and moved to rectify them would be unlikely to be subject to further regulatory action. To guide applicants for post-transition variations, ASIC included in its public announcement four examples of technical breaches, as follows:

- licensees acting under a binder¹⁰¹ who did not apply for the 'issue' authorisation for general insurance products;
- licensees advising or dealing in consumer credit insurance but who did not apply for that authorisation;
- licensees who applied early in the transition period and were not able to select the authorisation to advise in managed investment schemes, including Investor Directed Portfolio Services; and
- licensees providing services in relation to products that fell strictly outside the normal product class definitions. In this case, certain

¹⁰⁰ ANAO also found that ASIC's standard letter approving a variation states that they are 'minded to grant the application for variation of the licence conditions in the terms of the attached draft licence conditions' and attaches a consent notice asking the applicant to sign a consent to the draft licence conditions enclosed, referring to ASIC's dated letter. That date referred to should be the same as the *actual* date of the ASIC letter but in 18 cases in the sample the dates differed. A consent signed by the applicant in such cases may be nugatory since it purports to consent to conditions in a non-existent letter.

¹⁰¹ Until its repeal in 2001 by the FSRCP Act, the IAB Act defined 'binder' as, 'An authority given by an insurer to an insurance intermediary to deal with and settle, as agent for the insurer, claims against the insurer'. The term, which applies at section 916E of the Corporations Act in relation to licensees acting on behalf of other licensees, means that (for instance) an insurer is responsible for the conduct of another party (in this case another licensee) acting under binder, who is then regarded as the agent of the insurer rather than the insured.

'miscellaneous' authorisations may be required, eg. for managed investment warrants.¹⁰²

3.83 ANAO's examination of the 94 records selected from ASIC's licensing database showed ASIC analysts' records indicating that as many as 21 applicants may have been in technical breach.¹⁰³ In this context, ASIC exercises discretion as to whether it pursues regulatory action against breaches of the Corporations Law. Whether ASIC does so depends on the seriousness of the breach and its circumstances.¹⁰⁴

Consumer access

3.84 The licensing reforms aimed to support consumers to make informed financial decisions, with the assistance of services provided by regulated advisors and product providers. To assist consumers, the FSR Act provided for the consolidation of information about licensees and authorised representatives into public registers to be maintained by ASIC. The intention was to 'streamline access for people who seek information about these classes of people'.¹⁰⁵

3.85 In accordance with section 1274 of the Corporations Act, ASIC maintains website registers of financial services licensees, authorised representatives of licensees and people banned from holding licences. These assist consumers to check that they are dealing with bona fide licensed financial market participants. The Corporations Act also provides that consumers may inspect the registers and make copies of them or take extracts (sections 922A and 922B) and Regulations 7.6.05 and 7.6.06 spell out details of the information to be held on the registers.

3.86 The website registers are derived from information held on ASIC's databases. In the course of the audit, ANAO examined and compared entries on ASIC's database with the on-line register of licensees. When this register was searched by the *name* of the licensee, it displayed only current licence holders. If, however, a member of the public attempted to verify a licence *number*, ANAO found that the public database may show:

¹⁰² ASIC Information Release IR04/11.

¹⁰³ Of the 94 records examined by ANAO, six post-transition applicants had notified ASIC of a breach.

¹⁰⁴ ASIC, QFS 113, *What are the likely sanctions for breach of licence conditions?*, 19 April 2004, at www.asic.gov.au.

¹⁰⁵ Financial Services Reform Bill 2001 Explanatory Memorandum, paragraphs 11.49 to 11.51, p. 107.

- an indecipherable status for some licences; or
- a status of *pending*; or
- a status of *ceased*.

3.87 In September 2005, ASIC advised ANAO that the indecipherable search results had been remedied. ASIC also advised ANAO that the *ceased* and *pending* results were valid but that ASIC was not aware why the public facility to search the database had been structured so as to give different results when searching by licence number rather than by name.

3.88 ASIC further advised ANAO that, while electronic access by the public is limited to searching either by name or by licence number, part or whole copies of the register can be obtained by the licensee or a member of the public by applying to ASIC for a register extract and paying the required fee. Notwithstanding this, ANAO considers it important that searches of ASIC's databases should return results which can be easily understood by members of the public. This includes cases where a licence application is awaiting ASIC's decision or if a licence has ceased.

Recommendation No.3

3.89 ANAO recommends that ASIC improve the useability of the public licensee database in order that consumers are able to access relevant and reliable information about licensees and authorised representatives.

ASIC Response

3.90 ASIC agreed and advised ANAO it is implementing the recommendation, so that changes to ASIC's public registers relating to current, ceased, pending and suspended licences would be implemented by the end of the 2005 calendar year.

4. Surveillance and Regulatory Compliance

This chapter examines ASIC's planning to manage regulatory risks posed by licensing and analyses its monitoring and early warning systems as well as its major surveillance activities.

ASIC's regulatory compliance framework

4.1 The FSR Act allocated ASIC responsibility for consumer protection and conduct and disclosure laws throughout the financial services system. This included responsibility for monitoring and promoting financial services licensees' compliance with their obligations under the Corporations Act, as well as monitoring licensees' disclosure of adequate information to users of their services and purchasers of their products. ASIC's compliance actions are aimed at preventing, deterring and detecting non-compliance. Where ASIC finds non-compliance, it can act to rectify it, often in concert with other regulators, law enforcement agencies and the courts.¹⁰⁶

4.2 In the context of licensing, providing information and policy guidance for existing Corporation Act licensees and prospective licensees was ASIC's main preventive strategy.¹⁰⁷ As well as publishing extensive policy guidance, by June 2003, ASIC reported that it had devoted significant resources to guide and encourage the financial services industry:

We met more than 100 times with industry associations, gave 170 presentations to industry conferences and conducted a national seminar series attended by 1 732 people.¹⁰⁸

4.3 ASIC's aim was for applicants to make themselves aware of their likely obligations, of the responsibilities these obligations placed on them and on managers, owners and employees of the business, of the typical financial and human resources required to acquit those obligations, and of the controls and systems necessary to effectively manage compliance with licence obligations.

¹⁰⁶ ASIC's enforcement activities are outside the scope of this audit.

¹⁰⁷ For instance, in April 2001 ASIC published its first set of policy proposal papers and process documents, covering the likely scope of the licensing regime, the organisational capacities required of licensees, the training and qualification of staff, the content of product disclosure statements, ASIC's powers to consider relief from certain provisions of the Corporations Act and an outline of the licensing process. Through its website and other means, ASIC subsequently updated its existing advice as well as issuing new guidance, such as that on licensees' financial requirements issued in December 2001.

¹⁰⁸ ASIC, *Annual Report 2002–03*, p. 33.

4.4 ASIC's deterrent strategies include the public announcement of surveillance activities and campaigns and their results, including enforcement outcomes. By highlighting the likelihood of detection and the consequences of non-compliance, ASIC aimed to dissuade other licensees or prospective licensees from overlooking, encouraging, commissioning or undertaking actions in contravention of licence obligations.

4.5 ASIC's general powers for monitoring, surveillance and investigation in respect of corporations legislation are conferred by Part 3 of the ASIC Act.¹⁰⁹ ASIC's specific surveillance powers in respect of holders of financial services licences are conferred by section 912C of the Corporations Act (licensees must respond to ASIC's notice and provide a written statement of information about the financial services they provide and the financial services business they carry on) and by section 912E, which requires that:

A financial services licensee and its representatives must give such assistance to ASIC, or a person authorised by ASIC, as ASIC or the authorised person reasonably requests in relation to whether the licensee and its representatives are complying with the financial services laws, and in relation to the performance of ASIC's other functions. ... Such assistance may include showing ASIC the licensee's books or giving ASIC other information.¹¹⁰

4.6 To ensure ASIC can maintain oversight of its licensed population, Division 6 of Part 7.8 of the Corporations Act requires licensees to maintain proper records, to prepare annual financial statements and to lodge these, along with an auditor's report, with ASIC within three months of the end of the financial year.¹¹¹ In addition, the Corporations Act also requires licensees to notify ASIC of particular significant events, as follows:

¹⁰⁹ Division 1 of Part 3 of the ASIC Act confers general powers of investigation where ASIC has reason to suspect a contravention of the corporations legislation. Division 2 confers the power to examine persons. Division 3 confers the power to inspect books for the purposes of the performance or exercise of any of ASIC's functions and powers under the corporations legislation, or for the purposes of ensuring compliance with the corporations legislation. Section 32A explicitly extends this power to books about financial services.

¹¹⁰ Section 601FF of the Corporations Act places a similar obligation to assist ASIC on the entity responsible for a managed investment scheme. In addition to these powers, section 915 empowers ASIC to revoke a licence in certain circumstances and section 920A empowers ASIC to ban a person providing any financial services or specified financial services in specified circumstances or capacities.

¹¹¹ See sections 989B, 989C and 989D of the Corporations Act and Regulation 7.8.13. Bodies corporate must lodge their statements within three months of the end of the financial year and all other licensees within two months. Failure to do so is a strict liability offence.

- Regulation 7.6.04 requires licensees to report, within three business days, events which may make a material adverse change to their financial position.
- Section 912D requires licensees to notify ASIC, within five business days, of significant breaches of their licence obligations.¹¹²
- Section 916F requires licensees to notify ASIC within 15 business days of the appointment of an authorised representative and to notify within 10 business days of changes to the details of an authorised representative or if the licensee revokes a representative's authorisation.

4.7 The authorisations and conditions placed on a financial service licence by ASIC may also impose reporting requirements. For instance:

- Where a licensee is authorised to use a restricted term (namely stockbroker or sharebroker, futures broker, insurance broker or insurance broking, general insurance broker and life insurance broker) they must notify ASIC within 10 business days of ceasing to be eligible to do so (for instance, if a stockbroker ceases to participate in the stock market).
- Where a licensee is also regulated by APRA and subsequently ceases to be regulated by APRA, it must inform ASIC within five business days of the event and of the reasons for the change.¹¹³

Risk assessment

4.8 ANAO found that ASIC did not undertake a systematic assessment of the regulatory risks posed by the policy changes to be implemented under the FSR Act until March 2004. This was after the transition period had finished. While ASIC considered some risks and risk indicators when planning and implementing the FSR policy changes and financial services licences, these risks were not systematically incorporated into its planning and

¹¹² Breaches are broadly defined and include breaches of other relevant financial services laws (including other Commonwealth Acts specified in Regulation 7.6.02AA) as well as situations in which the licensee considers it *likely* that they will significantly breach their obligations. In October 2004, ASIC published *Breach Reporting by financial services licensees – an ASIC Guide* to provide guidance, including advice to licensees to maintain a register of breaches, as follows: 'Although the Corporations Act does not require you to maintain a breach register, ASIC considers that, in practice, you will need to use a documented breach register to ensure that you have adequate arrangements in place to comply with your obligation under the Act to identify and report all significant breaches and likely breaches'.

¹¹³ See conditions 10 and 11 of ASIC *Pro Forma 209 Australian Financial Services Licence Conditions* at <[www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/PF209.pdf/\\$file/PF209.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/PF209.pdf/$file/PF209.pdf)>.

implementation framework. ASIC's plans for implementing the FSR changes emphasised the management of operational risks rather than regulatory risks, focusing particularly on the risk that many market operators would act too late to obtain a licence during the transition period.

4.9 During the two-year transition period, ASIC largely subordinated the management and treatment of regulatory risk to the task of managing operational risk. ASIC curtailed analysts' scrutiny of applications to reduce processing time and wound back its surveillance activities so that surveillance staff could be available to achieve licensing targets. This meant that important regulatory risks were not addressed until after the end of the transition period. In September 2005, ASIC advised ANAO as follows:

ASIC made the decision to reduce the level and intensity of surveillance activity prior to, and immediately after, the end of the transition period and instead focus upon providing guidance and assistance to licensees in complying with these new obligations. The legislation required licensees and their representatives, some of whom had not previously been the subject of this level of regulation, to develop an understanding of it and how it applied to their own circumstances. They were also required to create systems and procedures—many for the first time—that would enable them to comply with those new obligations.

In addition, the legislation itself was continuously evolving and being amended during that time. In the circumstances weight needs to be given to the fact that many licensees may not have fully understood their legal obligations or how to properly comply with them. It is therefore the case that ASIC identified the provision of guidance and assistance as a more appropriate regulatory tool in some instances than conducting intensive surveillance activities. In our view, reliance on enforcement or other regulatory outcomes as our primary strategy at this stage of transition would have been inappropriate. We also reinforce the comment that the majority of the population was not licensed until after October 2003.

4.10 Notwithstanding its efforts to manage operational risk, as earlier mentioned, ASIC's licensing database showed 29 licence applicants with old Corporations Act licences at 11 March 2004. These applicants were without the necessary financial services licence with which to legally undertake at least part of their business operations (see Chapter 3, paragraph 3.79) and were unlicensed for, on average, more than 25 days. However, ANAO found no evidence that *any* were subject to immediate ASIC warnings or surveillance scrutiny to ensure they were not trading without a licence.

4.11 ASIC's inaugural regulatory risk report of March 2004 gave the highest rating to the risk of unlicensed trading, allocating it a probability of between 70 to 90 per cent and a critical impact. Out of the 41 risks identified in the risk report, four risks arising from the FSR and licensing changes were in its top fifteen regulatory risks, along with at least one other related risk (arising from superannuation choice). Overall, the regulatory risks posed by licensing and other FSR changes appear to remain high and to warrant continued attention.

4.12 In this context, ANAO notes that ASIC's *Annual Report 2003-04* viewed the next two years as an opportunity to increase resources devoted to compliance and lift standards of compliance across the industry through ASIC's input and guidance. Specifically ASIC planned to '... target areas of particular risk, including schemes promoting illegal early access to superannuation, small and medium managed investment schemes, and product disclosure statements'.¹¹⁴

4.13 In December 2005, ASIC advised ANAO that:

ASIC has increased its resources devoted to compliance in the 2005–2006 year. ASIC now has a dedicated Compliance Directorate which is conducting more intensive surveillance activity with a concentration on those areas we regard as having the highest potential risk and impact.

Initial planning and risk identification

4.14 In April 2000, ASIC concluded a one-month project to identify regulatory risks and key indicators of risk for four of the six major industries affected by the proposed FSR policy changes.¹¹⁵ The risks identified were mainly those of prospective licensees being unable to comply with the licence obligations for a range of reasons, such as:

- a history of principals and representatives providing services or products not covered by licence authorisations and/or conditions;
- compliance planning being a low priority in some industries;
- ASIC's experience that industry sector staff and/or authorised representatives were inadequately trained and/or supervised;

¹¹⁴ ASIC, *Annual Report 2003–04*, p. 23.

¹¹⁵ Namely superannuation, insurance, financial planning and securities broking. Time pressures precluded the study from considering the two other major financial sector participants affected by the FSR changes, specifically the deposit-taking and the managed investments sectors.

- evidence of poor complaints handling procedures; and
- prospective licensees with too few senior staff experienced or qualified to acquit important roles.

4.15 As different groups within ASIC developed components of the FSR implementation plan, they noted the need to identify, rate and prioritise risks and identified specific populations of potential applicants who might find it difficult to meet the obligations imposed on licensees.¹¹⁶ However, regulatory risk identification and management was not coordinated and directed towards ASIC's overall FSR project planning. The risk management components of the initial project plans, the essentials of which were unchanged during ASIC's implementation of the FSR regime, focused on operational risks, on communicating and consulting with stakeholders (including key industry groups) and on assessing the likely posture of key stakeholders, including those who might require additional attention if the implementation of the FSR reforms was to progress smoothly.

4.16 The lack of systematic consideration of all risks also meant that ASIC was not in a position to explicitly consider and evaluate the relative weighting to be given to regulatory and other risks, such as operational risks. For instance, to address the potential operational risk that not all eligible applicants would be granted licences by the end of the transition period, ASIC advised Treasury in May 2000 that, in ASIC's view, the lesser burden of 'grandfathering' existing market participants by streamlining them into financial services licences was probably the optimal regulatory solution:

if it is accompanied by a commitment to a surveillance program backed by strengthened administrative powers designed to deal with licensees who are not meeting the competency or conduct requirements.

4.17 In this case, an operational risk (that licence applications might not be processed in a timely fashion) was managed by transferring a regulatory risk (that the applicant might have difficulty meeting their licence obligations) until after the end of the transition period (where it was to be treated by subsequent surveillance). This proposal, adopted in ASIC's planning and incorporated into the streamlining provisions of the FSR Act, was based on a view that existing market participants posed a lesser immediate compliance risk than other

¹¹⁶ These were entities which, prior to the introduction of financial services licences, were licensed neither by ASIC nor by APRA or which were, for the first time, subject to ASIC's competency and training standards. They included certain insurance brokers and multi-agents, accountants and lawyers providing more than incidental advice, and standard employer-sponsored superannuation funds.

potential applicants, and that the risk posed by their potential inability to comply with licence conditions was less than the operational risk posed by delaying or failing to assess licence applications by the end of the transition period. However, ANAO found no evidence of ASIC's explicit consideration or comparative analysis of these risks, nor of a broader assessment of all risks (including regulatory and operational risks) which could have informed such a judgement.

Recommendation No.4

4.18 ANAO recommends that ASIC undertake a systematic assessment of the regulatory risks posed by financial services licensing, so as to better inform judgements about the appropriate balance between managing operational and regulatory risks.

Agency Response

4.19 ASIC agreed and advised ANAO it is implementing the recommendation.

Surveillance, targeting and early warning systems

4.20 ASIC's August 2000 planning for FSR implementation was mainly operational in nature. Existing data collection, targeting and surveillance activities for managing regulatory risk were not focused on ASIC's new licensing task and, beyond the creation of a database to track licence activity and to identify risks or trends, ASIC's planning included no concrete proposals to manage the specific regulatory risks of licensing.

4.21 At that time, ASIC's monitoring and surveillance systems included campaigns and surveillance targeting particular activities or entities, an activity database that recorded (among other things) surveillance activities, and a regime for assessing and dealing with complaints from the public. The new licensing provisions included the requirement that licensees lodge audited annual financial statements with ASIC and added the requirement that they notify ASIC of significant breaches of their obligations. In July 2002, four months after the financial services transition period had begun, ASIC approved an FSR surveillance project intended to provide:

... a structured process and related systems to manage and conduct FSR surveillance activities, a structured process to manage [*surveillance*] campaigns in a consistent manner, tools for ASIC staff on processes/procedures for FSR surveillance activities, and accurate reporting and recording system.

4.22 By mid 2002–03, the FSR Directorate Business Plan articulated a number of key regulatory risks arising from licensing. Among these were the risk that inconsistent licence assessments might license those who should not be licensed, and the risk that applicants might make misleading statements or inaccurate statements in support of their application. These risks were addressed primarily by measures to improve the consistency of licence assessment and by relying on surveillance measures, particularly verification surveillance measures. Both risks and their treatment also featured in the Directorate’s 2003–04 Business Plan.

Risk Scoring—the STIRS system

4.23 By mid-October 2002, ASIC aimed to have the systems and procedures in place to commence financial services licensee surveillances and campaigns. At the operational level, this was reflected in ASIC’s FSR Directorate plans to develop and implement administrative and computing systems to identify risks during the licensing process (which might prompt surveillance activity) and to conduct Verification Visits to streamlined (or ‘grandfathered’) applicants.¹¹⁷ In practice, this meant the commencement of the design and development of the Surveillance Targeting Intelligence Reporting System (STIRS) and the development of ASIC’s program of Verification Visits.

4.24 STIRS was to have two stages. The first was an addition to ASIC’s licensing database of risk scores, developed from ASIC’s earlier pilot under the MI Act. Stage Two was to enable licence analysts to commence the assessment and referral of an entity (or entities) for surveillance and possible enforcement activity, based on risk scores and other information collected by the analyst.

4.25 After some delays, mainly due to the demands placed on ASIC’s resources by the processing of licence applications, the first stage of STIRS became functional in November 2003. It drew information from existing ASIC databases and combined it with input from the ASIC analysts processing licence applications. The STIRS risk score thus generated and recorded on the licensing database was intended to help target pro-active surveillance activities:

[STIRS] was intended to develop a quick and basic surveillance targeting system to enable the capture of risk data during the peak transition period to

¹¹⁷ In 2002–03, the Directorate planned to conduct Verification Visits, to develop a risk scoring system and, in later years, sophisticated targeting procedures. The Directorate’s 2003–04 Business Plan was to make its risk-scoring and early warning systems operational and to step up Verification Visits, with surveillance targeted according to risk scores to become operational in 2005–06.

better enable the allocation of surveillance resources. The brief for stage 1 was initially limited to the superannuation and insurance industries however this was expanded during the project when it was determined that the whole industry could be included with minimal extra effort.¹¹⁸

4.26 The risk scores were first evaluated in October 2003, when licence numbers stood at a little over 1 000. On the basis of this sample, ASIC formulated risk ranks (low, medium, high and very high). At this time, ASIC also undertook an evaluation of the risk scores of major financial service providers. ASIC found higher risk rankings among major service providers, mainly due to the larger likelihood of public complaints arising from their larger volume of business. By February 2004, risk scores had been calculated for over 3 000 licensees. ASIC's analysis of this larger data set showed risk scores consistent with those from its October 2003 analysis.

4.27 At May 2005, the time of the audit sample, ANAO found, of the licence application records on ASIC's FSLs database, STIRS had allocated nearly 28 per cent a very high or high relative non-compliance risk ranking. However, 11 per cent of records did not have a risk score.¹¹⁹ Table 4.1 shows the incidence of recorded surveillances for each risk ranking, with a peak of 30 per cent in the case of records with a very high risk ranking.

Table 4.1

STIRS risk rankings of records on ASIC's licensing database, May 2005

STIRS Risk ranking	Number of records	Percentage of records with a recorded surveillance
Low	1 524 (26.3%)	14.8%
Medium	2 024 (34.9%)	18.9%
High	1 188 (20.5%)	26.3%
Very high	414 (7.1%)	30.0%
Unrated	648 (11.2%)	0.3%

Source: ANAO analysis of ASIC data.

¹¹⁸ ASIC, *FSR STIRS Project, End Stage 1 Report and Stage 2 Plan*, Version 0.01 – 5 January 2004.

¹¹⁹ The risk scores combine an assessment of the riskiness of the applicant's industry, a general assessment of the risk posed by the applicant themselves, a component largely dependent on the applicant's volume of activity and some allowance for the 'gut feel' of the licence analyst.

4.28 STIRS Stage Two was scheduled to commence on 15 February 2004 for release on 8 August 2005. However, ASIC did not proceed as planned to link its risk scoring system to its surveillance procedures. ASIC also did not conduct a planned post-implementation review of STIRS, on the basis that it was not being used by staff. In September 2005, ASIC advised ANAO that it did not regard the updating of STIRS as a priority for compliance purposes, though it now proposed using STIRS as part of its new licensing risk assessment approach:

The new risk-based approach will commence with a senior group of licensing staff (the Risk Assessment Panel or RAP) assessing the risk of an application using STIRS, ASIC's Probability & Impact Model [*described in Table 4.2 below*], information received from other areas of ASIC and professional regulatory judgement.

4.29 In this context, in December 2005, ASIC advised ANAO that:

For compliance purposes, STIRS provides relatively limited information on licensees. It is however one of the sources of information we draw upon in our new integrated risk assessment process.

Sector Risk Focus Groups

4.30 In March 2005, ASIC advised ANAO that in September 2004, seven months after the cessation of work on STIRS, it had commenced developing Sector Risk Focus Groups (SeRF groups). Their purpose was to establish a common framework for analysing early warning risk information across the regulated financial services sector to achieve:

- consistent and comparable risk analysis across industry sectors;
- consistent and meaningful regular reporting to senior management; and
- information for strategic planning and decision-making for surveillance campaign and business planning.¹²⁰

4.31 SeRF groups comprise ASIC managers and analysts with experience in particular sectors and across industry sectors. Drawing on ASIC's existing information sources, as well as industry intelligence and trends, SeRF groups consider the regulatory risks arising in their industry sector and the likely impact on ASIC's regulation of the financial services sector should those risks

¹²⁰ ASIC, *FSR Sector Risk Focus Groups, Procedures Manual*, p. 1.

be realised. The group considers the evidence before them and then rates risks according to the template at Table 4.2.

Table 4.2

Calculating the Risk Score

Probability	Impact
1 Low 10% or less	A Negligible – little impact on our strategic effectiveness
2 Possible 10% to 30%	B Moderate – some impact, but still able to be handled internally
3 Likely 30% to 70%	C Significant – reduced effectiveness noticeable outside of ASIC
4 Probable 70% to 90%	D Serious – issue seriously damages our ability to fulfil our objectives
5 Nearly Certain 90% or more	E Critical – issue results in a complete inability to fulfil our objectives

Source: ASIC, *FSR Sector Risk Focus Groups, Procedures Manual*, page 3.

4.32 ASIC’s March 2004 assessment of regulatory risk had also adopted this risk scoring system. For example, at that time ASIC assigned a rating of 4E to the risk of unlicensed advice, indicating a risk with a major impact on ASIC’s regulatory objectives that was quite likely to occur.

4.33 Having identified and rated risks, ASIC’s SeRF groups reports can be considered for future surveillance and business planning. SeRFs may also initiate further research, maintain a ‘watch’ on regulatory issues, consider the development of guidance to industry or refer issues for more immediate surveillance. In March 2005, ASIC advised ANAO that the outcomes from monthly SeRF group meetings were to be used as input to senior management in ASIC’s business planning process. Finalised in September 2005, the business plan identified certain activities of authorised representatives as a high risk, along with certain types of breaches of licence conditions. At that time, ASIC advised ANAO that:

Ultimately, the priority areas of focus were decided by the Executive Director Compliance, in consultation with the Executive Directors of Regulation, Consumer Protection and Enforcement and signed off by the Commission. Other risks that arise in relation to particular entities, transactions, or notifications throughout the year will be considered using our integrated assessment model. We also intend to update our overall work on industry risks on a quarterly basis at meetings of the Compliance Directorate.

Lodgement of annual accounts

4.34 In respect of annual accounts, ASIC advised ANAO on 1 March 2005 that the rate of default by licensees had risen from 0.7 per cent for the 2001–02 financial year, to 4.6 per cent for the 2002–03 financial year. The rate of default rose further to 15.3 per cent for the 2003–04 financial year.

4.35 Failure to lodge annual returns is an offence under the Corporations Act, although licensees can apply to ASIC to delay their lodgement. Failure to lodge annual accounts may also indicate that the licensee has operational difficulties. On 7 March 2005, ASIC advised licensees that:

There are currently 618 licensees with overdue annual accounts. This is a disturbingly high number, as it means that approximately 15 per cent of the total number of financial services licensees are currently in breach of their obligations. ... The lodgement of accounts is very important for consumer protection as it enables ASIC to check that licensees are complying with the financial obligations under their licence.¹²¹

4.36 By June 2005, ASIC advised that the non-lodgement rate for 2003–04 had fallen to 360 and by September 2005 to 166, of which most were nine months overdue.

Breach notifications

4.37 Over the three financial years 2002–03 to 2004–05, ASIC received 743 breach notifications from licensees and a further 63 from auditors.¹²² In most cases, ASIC conducted a desk-top review of the breach notification, followed by correspondence to confirm that the entity had taken action to rectify the breach and prevent its future occurrence.

4.38 A small proportion of breach notifications (1.7 per cent) resulted in ASIC referring the breach for enforcement action and, in a further 1.4 per cent of cases, ASIC's records show changes to the licensee's procedures. The great majority of breach notifications (95.5 per cent) concluded with no further action.

4.39 Licensees are required to report only significant breaches, although this term is not defined in the Corporations Act. ASIC's current advice is that

¹²¹ ASIC Information Release IR 05-12 *ASIC warns financial services licensees to lodge overdue accounts*, Monday 7 March 2005, at www.asic.gov.au.

¹²² Licensees' auditors who detect breaches are also required to notify ASIC. Entity and auditor notifications are considered jointly here.

licensees should err on the side of caution¹²³ and it is therefore possible that many of the breaches reported are relatively minor in nature. However, in June 2005, ASIC observed that it had received no breach reports from particular industry sectors and very few from other major sectors of the financial services sector. In particular, notwithstanding other intelligence indicating potential breaches:

There has also been an absence of breach notifications received from particular large entities. [ASIC] will discuss proposals to investigate this potential area of non-compliance and provide recommendations as to possible regulatory options to check levels of compliance.

4.40 ANAO notes that ASIC advises licensees to keep a register of all breaches of the Corporations Act but is yet to undertake a systematic examination of licensees' breach registers. Such an examination could test the adequacy and completeness of licensee breach registers and provide a regulatory benchmark for the monitoring of breach notifications to ASIC.¹²⁴ In this context, ASIC advised ANAO in December 2005 that:

Reviews of breach registers (although not specifically required by the legislation) do regularly form a part of our surveillance reviews. For example, breach registers were examined in a number of our surveillance campaigns. There is a specific project in place in the 2005–2006 Compliance Business Plan to raise the level of compliance with breach notification requirements. That project has achieved a substantial increase in the number of reported breaches in the 2005–2006 year, compared with the same period in the previous year.

Recommendation No.5

4.41 ANAO recommends that ASIC integrate its existing monitoring and early warning systems to assist it to target, plan and conduct its surveillance of financial services licensees.

ASIC Response

4.42 ASIC agreed and advised ANAO it was implementing the recommendation. ASIC also commented that it considers that it is now well placed to improve its systematic assessment of risk and has implemented a

¹²³ The licensee has an obligation to rectify all breaches, even those that are not significant and need not therefore be reported to ASIC. ASIC advises, for instance, that 'Where there is a non-significant breach that requires compensation to clients or needs to be rectified in some other way, ASIC expects [the licensee] to take appropriate action even though the breach is not required to be reported.' ASIC, *Breach Reporting by financial services Licensees: An ASIC Guide*, October 2004, p. 9.

¹²⁴ It should also be noted however that the maintenance of a breach register is not a legal requirement.

new integrated process to undertake that assessment. ASIC also commented that a reliable risk assessment process was more difficult during the transition period, as much of the population was unknown until very late in the transition process.

Surveillance activity and outcomes

4.43 ASIC's records show 1 596 surveillances of financial services licensees since mid-2002 (when the first licences were issued) until June 2005.¹²⁵ Surveillance is ASIC's key activity for detecting non-compliance. ASIC uses surveillance to help achieve the regulatory objectives of ensuring that operators and industry participants are meeting their obligations under the Corporations Act and that accurate information has been provided in licence applications. It also gives ASIC early warning of entities that may need to be monitored for compliance breaches. In ASIC's view:

Surveillance work encourages compliance with the law, influences standards of behaviour, identifies non-compliance and improves the quality and impact of enforcement outcomes. Insufficient surveillance work undermines these objectives, but the impact takes several years to become apparent. The longer the delay in detecting serious breaches of the Corporations Act, particularly where there is significant loss to consumers or a threat to market integrity, the more resource intensive, and therefore costly, eventual enforcement becomes.

4.44 Financial services surveillances designed to test compliance with the law¹²⁶ fall into five main categories:

- Verification Visits, designed to verify the documentary evidence of streamlined licence applicants and certain composite licence applicants;
- proactive and campaign surveillances, undertaken on a planned basis at regular intervals, targeting identified compliance risks;
- reactive surveillances prompted by referrals or complaints;
- breach notification surveillances, generally desk-top reviews prompted by entities' statutory notifications of breaches of the Corporations Act provisions; and

¹²⁵ Financial services surveillances are recorded on ASIC's Financial Service Licensing System database, along with application and assessment information for each applicant. The surveillances of *all* financial market participants under ASIC's regulation (including pre-FSR licensees, financial services licensees, authorised representatives and other entities of interest) is recorded on ASIC's ASCTEC database. ANAO's audit examination encompassed both the ASCTEC and FSLs databases, covering the period July 2002 to June 2005.

¹²⁶ ASIC, *Financial Services Regulation Surveillance Guidelines*, p. 4 of Version 2, March 2003.

- product disclosure surveillances, which are generally desk-top reviews of disclosure documents.

4.45 In addition to its new surveillance activities in respect of financial services licensees, ASIC continued its existing surveillance program. ASIC continues to conduct some 240 surveillances each year of entities at the boundaries of the licensing regime, who may be operating without a financial services licence. While this activity has remained fairly constant since June 2002, ASIC's surveillance of pre-FSR Corporations Act licensees and other entities¹²⁷ has reduced (from 257 in 2002–03 to 253 in 2003–04 and 45 in 2004–05) as the number of pre-FSR licensees fell from approximately 4 000 when financial services licensing commenced down to nil after the transition period closed in March 2004.

4.46 The OPR included financial services licensee inspection targets. In this context, Table 4.3 demonstrates that ASIC fell short of the inspection targets for each year between 2002–03 to 2004–05. Overall, since June 2002 ASIC has managed to conduct 54 per cent of all the surveillances it planned.

Table 4.3

ASIC financial services licensee surveillance activity 2002–03 to 2004–05¹

	2002–03		2003–04		2004–05		Over three years	
Surveillance type	Actual	Percentage of target ²	Actual	Percentage of target ²	Actual	Percentage of target ²	Actual	Percentage of target ²
Verification visits	52	13.1%	282	61.0%	18	40.0%	352	39.0%
General financial services	243	57.4%	391	52.7%	610	67.4%	1 244	60.1%
Total surveillances	295	36.0%	673	55.9%	628	66.1%	1 596	53.7%
Notes:								
1: Figures exclude surveillances conducted as part of ASIC's continuing surveillance responsibilities.								
2: The annual targets used to calculate performance are the inspection targets from <i>ASIC's Pricing Review Report</i> , February 2002.								

Source: ANAO analysis of ASIC data.

4.47 ASIC has undertaken 60 per cent of its planned general financial services surveillance since June 2002 and only 39 per cent of the planned

¹²⁷ ASIC advised ANAO that, during the transition period in which old Corporations Act licences were gradually replaced by financial services licences, ASIC continued to conduct surveillances of existing Corporations Act licensees and their authorised representatives and of other entities which came to ASIC's attention.

number of Verification Visits were undertaken. In this regard, ASIC advised ANAO in March 2005 that this was due, in part, to the low initial take-up of financial services licences. As Verification Visits were targeted to streamlined licence applicants and certain composite licence applicants, the slow take-up restricted the number of surveillances that could be undertaken.

4.48 ASIC also advised ANAO that, while maintaining Verification Visits was seen as a priority during the peak licensing period, the rate of Verification Visits was reduced during ASIC's peak licensing period as licensing staff were focused on assessing the very large number of applications. ANAO found that for the last two and a half months of the transition period, during which time ASIC granted more than 1 000 licences, Verification Visits ceased entirely.

Licence surveillance outcomes

4.49 Table 4.4 provides a summary of the main outcomes of ASIC's 1 596 financial services surveillance activities. In almost 54 per cent of cases, the outcome was classified as 'No Further Action' (NFA).

Table 4.4

ASIC financial services licence surveillance outcomes 2002–03 to 2004–05

Surveillance outcome						
No further action required (NFA)	Rectification of target's procedures ²	Referred to ASIC enforcement or regulatory operations	Stop Order issued	Referred to another regulator or for other action within ASIC	Warning letter sent	Other action ¹
855	417	132	28	58	25	81
53.6%	26.1%	8.3%	1.8%	3.6%	1.6%	5.1%
Notes:						
1: Other action includes a range of outcomes, such as matters referred for the further development of ASIC's policies, and technical and policy issues which may be best addressed by amendments to the Regulations or the Corporations Act.						
2: This includes actions such as rectifying compliance plans and correcting or re-issuing public disclosure documents.						

Source: ANAO analysis of ASIC data.

4.50 In September 2005, ASIC advised ANAO that a record of 'No Further Action' covered a number of different outcomes, such as:

- ASIC assessing that there were no issues of concern (30.0 per cent of surveillances);
- ASIC sending a 'No Further Action' letter to a licensee at the end of surveillance (9.7 per cent of surveillances);
- ASIC assessing that the matters found were 'not sufficiently serious' (8.6 per cent); and
- no further action on the basis of lack of resources (1.1 per cent).

4.51 In July 2005, ASIC advised ANAO it was considering reviewing its recording of surveillance outcomes to determine those which do not properly reflect the surveillance undertaken and to determine more appropriate outcome codes for licence surveillances.

4.52 ANAO found that ASIC's computing systems showed 1 075 records coded as surveillances, although no associated evidence of surveillance action could be readily found. In this respect, in September 2005, ASIC advised ANAO that, due to limitations in its computing systems, all breach notifications had been recorded as surveillances, although most had not actually resulted in surveillance action. As a result, 757 breach notifications had erroneously been recorded as surveillance activities: these have been excluded from this analysis. At that time, ASIC also provided ANAO with additional analysis, advising of the surveillance activities that had been conducted in the case of the remaining 318 of the 1 075 records: these surveillance outcomes have been included in the audit analysis.

4.53 ANAO considers that improvements in ASIC's surveillance records would assist ASIC to readily satisfy an ordinary interpretation of its undertaking to inspect¹²⁸ licensees to encourage compliance with the Corporations Act. This undertaking was made by ASIC in its OPR, in the context of seeking \$25.908 million additional Budget funding for surveillance activities (as described in Chapter 2, Table 2.1).

¹²⁸ **Inspect – 1.** To look carefully into; to view closely and critically; to examine; now specifically, to investigate or oversee officially', Onions, C.T. (ed), *the Shorter Oxford English Dictionary*, Oxford University Press, 1973, p. 1083.

Targeted surveillances and campaigns

4.54 ‘No Further Action’ is the outcome in over 65 per cent of ASIC’s targeted surveillances, notwithstanding ASIC’s view that:

These should not be undertaken unless there is a reasonable prospect of a significant regulatory outcome such as some form of administrative, civil or criminal law action or there exists some strategic policy reason to carry out the activity, such as benchmarking industry standards.

4.55 Targeted surveillances usually commence as desk-top reviews of documentation, often in the context of a campaign focusing on particular industry sectors, activities or risks. ASIC advised ANAO in March 2005 that, in most cases, after an entity is selected for targeted or campaign surveillance, it is usually given notice of the surveillance and asked to provide particular documents for ASIC’s surveillance examination.¹²⁹ ASIC’s surveillance analysts then examine the documents and may then proceed to take further surveillance action, including visiting the entity. Some targeted campaigns, such as ASIC’s recent surveillance of financial service providers in regional Australia, have been designed to include a surveillance visit, though this is not the norm.

4.56 ASIC’s surveillance data shows that, of the targeted surveillances, 7.4 per cent result in a referral to enforcement and another 14.3 per cent achieve a rectification of the licensee’s procedures. For comparison, the rates of enforcement and rectification outcomes are shown for other surveillance activities in Table 4.5 below.

Table 4.5

Licence surveillance outcomes—enforcement and rectification

Type of surveillance	Referral to enforcement or compliance follow up	Rectification of procedures
Targeted and campaign surveillance	7.4%	14.3%
Product disclosure surveillance	0.3%	33.0% ¹
Reactive surveillance	13.2%	24.3%
Verification Visit	7.4%	45.2%
Note:		
1: Comprises stop orders (9.0 per cent) and rectifications to procedures (24.0 per cent).		

Source: ANAO analysis of ASIC data.

¹²⁹ Typically under section 31 or section 32A in Part 3 of the ASIC Act. Part 3 also provides other powers to give notice to produce books and to copy books.

4.57 ANAO found that it was not possible to readily examine the outcomes of ASIC's surveillance campaigns because:

- ASIC's planning documents were available for nine completed campaigns over the period July 2002 to June 2005 involving, potentially, several hundred entities. However, detailed results were not available for all campaigns.
- In September 2005, ASIC advised ANAO that its electronic records showed 196 campaign-related surveillances. This represents 42 per cent of the total of 460 pro-active surveillances identified by ANAO in its audit examination.

4.58 In comparison to enforcement and rectification outcomes, ASIC's targeted surveillance of financial services licensees is relatively less effective than its reviews of public disclosure documents, its reactive surveillances, and its program of Verification Visits. Recent ASIC campaigns have noted lower than expected enforcement outcomes. In particular, reactive surveillances have the highest rate of referral to enforcement at 13.2 per cent (these are generally conducted in response to a complaint from a member of the public).

Recommendation No.6

4.59 ANAO recommends that ASIC review its methodology for targeting and conducting its surveillance activities to maximise value for money for the resources allocated to these activities.

ASIC Response

4.60 ASIC agreed and advised ANAO it is implementing the recommendation. In agreeing with the recommendation, ASIC commented that it is moving to adopt a single harmonised system for the recording of all of its surveillance activities and outcomes. Some system changes are required and ASIC anticipated that new recording procedures will be in place by mid-2006.

Verification Visits and on-site surveillance

4.61 Verification Visits were undertaken to some licensees that had been granted a licence under the streamlined application process.¹³⁰ Under the

¹³⁰ Some licensees granted under Scale Two composite licensing assessment also received a Verification Visit.

Corporations Act, streamlined applicants were not required to provide proof of their ability to comply with their statutory licence obligations.¹³¹

4.62 The program of Verification Visits addressed the risk that, although streamlined applicants were, by definition, existing market participants who typically held a pre-FSR Corporations Act licence, they may not be able to adhere to their financial services licence obligations. The object of Verification Visits was:

... to verify statements made in financial services licence applications concerning an applicant's compliance arrangements and identify the type of compliance measures financial services licensees have in place in order to meet their ongoing licence obligations.

These visits do not involve a comprehensive assessment of the compliance arrangements of financial services licensees.¹³²

4.63 ASIC gave at least seven days notice of an impending Verification Visit, which typically lasted for 90 minutes. The focus of Verification Visits was to confirm that a sample of the systems, procedures and resources declared and certified by the applicant did, in fact, exist and were in use. Verification Visits were designed to focus primarily on the *form* of the licensing requirements, with substantive compliance testing explicitly excluded from their scope. Nonetheless, ASIC found that 53 per cent of the licensees visited failed this rudimentary level of testing, including:

- 66 instances of inadequate compliance measures;
- 44 instances where systems for monitoring and supervising representatives were inadequate;
- 65 instances in which mandatory calculations of cash flows were either not undertaken or were incorrect;
- 44 instances of inadequate risk management plans;
- 53 instances in which breach registers had not been established;
- 25 instances where professional indemnity cover was in doubt; and
- 19 instances of inadequate arrangements to resolve disputes.¹³³

¹³¹ ASIC granted 1 875 licences under the streamlining provisions.

¹³² ASIC, *Verification Visit Guide*, Version 3, June 2004, p. 3.

¹³³ ASIC, *ASIC verification visit program: Key findings*, September 2004, p. 7.

On-site surveillance

4.64 Almost all Verification Visits, which comprised 22 per cent of all licensee surveillances up until May 2005, were conducted on-site. However, ASIC was not able to advise ANAO how many of its other surveillances were conducted on-site and how many were conducted as desk-top reviews.

4.65 In this context, ANAO notes that ASIC's surveillances of breach notifications and product disclosure statements (which together comprise 57 per cent of surveillances) are almost exclusively desk-top reviews. The remaining 25 per cent of surveillances were either reactive (in response to a complaint) or targeted and campaign surveillances. Discounting those surveillances for which the electronic records do not show evidence of surveillance activities (see paragraph 4.52), ANAO estimates that:

- the proportion of on-site surveillances conducted by ASIC was at least 22 per cent and, at most, 63 per cent;
- for the period 2002–03 to 2005–06, this represents an annual average of at least 117 and, at most, 336 visits to licensees; and
- at this rate, ASIC will, at best, visit its licensees once every 12 years.

4.66 In general, on-site surveillance allows regulators to assess first-hand the quality of the internal controls and risk management systems being employed to manage the business being undertaken.¹³⁴ On the issue of on-site versus desk-based surveillance, ASIC commented as follows to ANAO in September 2005:

This is not a distinction we have generally recorded in our databases as we do not think it is the best way of reflecting the type of work undertaken. The vast majority of reviews have required licensees to produce extensive information to ASIC, utilising our formal information gathering powers. The only exception to this would be some of our [*Product Disclosure Document*] reviews, where the issues are often plain on the face of the document. Accordingly, we do not regard the majority of our surveillances as a "light touch" approach, or as not involving a true inspection.

¹³⁴ APRA, *Regulators – The Future*, speech to the Annual Conference of the Financial Sector Accountants Association, 24 May 2005, pp. 3 and 4.

Performance reporting

4.67 ANAO found that ASIC does not consistently report on its surveillance activities.¹³⁵ For instance, ASIC's *Annual Report 2001–02* cites a total of 525 inspections, which includes 10 Verification Visits and 74 referrals to enforcement. ASIC's *Annual Report 2002–03* cites 803 compliance checks. The *Annual Report 2003–04* cites 509 compliance checks which may also include 284 Verification Visits.

4.68 Overall, surveillance activities account for 28 per cent of ASIC's resources, of which the surveillance of licensees is a considerable part. In addition, ASIC does not provide measures relating surveillance activity to its specified outcomes and objectives, or to the resources allocated to those outcomes and objectives.

4.69 In June 2003, ASIC notified its intent to measure its effectiveness against its statutory mandate and its published strategic plan. With respect to licensed entities, ASIC's strategic plan included the objectives of fighting fraud and misconduct, raising standards in financial services and making a greater impact in the boardroom. More immediately, ASIC aimed to encourage a culture of compliance and disclosure among directors and others with financial reporting and audit obligations, to encourage improved compliance with the Corporations Act and to promote public awareness about scams and frauds.

4.70 ASIC regularly reports summary outcomes of certain of its enforcement and surveillance activities aimed toward these ends,¹³⁶ although fully measuring the effectiveness of these activities is a significant challenge:

Statistics or 'heads on sticks' portray activity levels, but do not fully reflect the effectiveness of that activity. For example, how do you prove that successful results against fraud and misconduct deterred other would-be offenders? [ASIC] will develop these measures in future [annual] reports.¹³⁷

¹³⁵ ASIC, *Annual Report 2001–02*, p. 34, *Annual Report 2002–03* p. 33, *Annual Report 2003–04* p. 21.

¹³⁶ For instance, page 7 of the ASIC *Annual Report 2002–03* and page 5 of the ASIC *Annual Report 2003–04* report enforcement outcomes including the number of criminals gaoled, of civil orders served against people or companies and the percentage of successful litigations. They also report the additional disclosures achieved by ASIC's actions, the amount of funds protected, frozen or recovered and the number of public complaints finalised, all of which may also be achieved through surveillance activities as well as enforcement.

¹³⁷ Chairman's Report, ASIC *Annual Report 2002–03*, p. 5.

4.71 In this regard, ANAO and Finance have previously identified the features of sound performance reporting frameworks and measures.¹³⁸ They include specifying the desired outcomes (including any intermediate outcomes), addressing any shared outcomes and providing information on the agency's contribution, identifying the contributing departmental outputs and administered items (usually programmes), and assessing their contribution to the outcome(s). However, ASIC has no measurable performance indicators for the effectiveness of its surveillance activities.

Recommendation No.7

4.72 ANAO recommends that ASIC develop and implement performance measures for its financial services licences compliance activities.

ASIC Response

4.73 ASIC agreed and advised ANAO it is implementing the recommendation.



Ian McPhee
Auditor-General

Canberra ACT
24 January 2006

¹³⁸ ANAO and the Department of Finance and Administration, *Better Practice Guide in Annual Performance Reporting*, 2004, p. 7.

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