NARROW ROAD CAPITAL

Time for ASIC to Fix its Longstanding Problems

In April 2016 I published an article on the myriad of problems in Australian financial services that ASIC had failed to address. The article was written shortly after the announcement that ASIC's then head, Greg Medcraft, was being given an eighteen month extension to his initial five year term. At that time, it was clear that ASIC had forgotten what its role was. It was unwilling to take meaningful action against clear criminal behaviour by large financial service providers. As a result, calls for a Royal Commission into banking were building. In light of this month's final report of the Financial Services Royal Commission, I've gone over my 2016 recommendations to see where ASIC needs to act.

ASIC's Culture

Here's what I wrote about ASIC's culture in April 2016:

At the heart of the problem is that the senior management of ASIC has forgotten why it exists. The role of a financial regulator is to actively prevent and discourage misconduct by providers of financial products and services, and participants in financial markets. This role is fulfilled through law enforcement, education and ensuring equitable access to information.

ASIC is not responsible for protecting investors from their own stupidity, but it is in charge of punishing those who defraud and mislead them. The ability to provide financial products and services, particularly to retail customers, is a privilege, not a right. The right to fair and honest treatment overrides any perceived rights of negligent licensees to continue to operate.

It has been said that regulators should always carry a baseball bat, and occasionally swing it with lethal intent. ASIC needs to change how it is perceived from that of a "watchpuppy" to one of a feared regulator. In most instances regulators will negotiate outcomes for correcting unintentional errors and injustices. However, in cases where licensees have wilfully committed criminal activity, the punishment must be swift and punitive, that is swinging with lethal intent.

These high profile cases should involve imprisonment for key individuals, termination of employment for those who knew or should have known, substantial financial penalties and cancellation of licences. For large financial institutions, penalties should be large enough that shareholders are materially impacted. This will encourage shareholders to hold company directors accountable for corporate culture, with directors, in turn, holding management accountable. As much as is possible, the potential rewards for financial crime should be substantially outweighed by the potential punishment.

The Royal Commission's final report was particularly scathing of ASIC for its failure to enforce the law. The report included the sentence "Financial services entities are not ASIC's 'clients'" likely as a reminder to ASIC of what its role as a regulator is. Enforceable undertakings were used when criminal charges were more appropriate, and the failure to act on breaches of enforceable undertakings demonstrated how weak ASIC has been. The imposition of an oversight body for ASIC and APRA, as well as noting that ASIC's enforcement powers may need to be given to another body has been seen as a public humiliation of ASIC. There's no doubt that ASIC needs to change and it's relatively new Chair, James Shipton, is indicating he will lead that process. Here's some thoughts on what he needs to do.

Pursuing Actions Against Large Financial Services Providers

It has long been known that ASIC is tougher on small financial services providers than their larger peers. The Royal Commission confirmed this and made many recommendations for ASIC to lift its game. For those wanting to know whether large firms are truly sorry about their misconduct consider the following questions:

- Has the institution identified and compensated all clients that it wrongfully treated?
- Has the institution identified and compensated all whistleblowers?

Until large financial institutions can clearly demonstrate a "yes" to both questions enforcement actions should continue. The recently imposed restrictions on Colonial (stop charging existing clients and stop taking on new clients) are a good start. Large financial penalties and licence cancellations should follow.

Fiduciary Duty and Independence of Advice

This was one of the overarching themes of the Royal Commission's final report. Advisers in the financial services industry (and arguably many other professions) should be required to act in the best interests of clients. Commissions should be clearly disclosed and signed off by clients. The distinction between conflicted and independent advice should be clear. The final report recommended that conflicted advice be disclosed with a simple statement. This could be:

"I am a salesperson, not a financial advisor which means that I may earn commissions by selling products and services to you. The products and services I am selling may not be in your best interests, and you may want to seek independent financial advice before agreeing to purchase."

One or Two Page Summaries for IPOs, Investments, and Insurance

Some financial products and services remain excessively complicated with disclosure documents becoming ever longer as governments pass more legislation. If ASIC mandated summaries at the beginning of long documents, which it provided a template for or pre-approved, the average citizen would have a better chance of understanding the risks of what they are purchasing. If the risks of a financial product can't be summarised in one or two pages, it is probably too complicated for retail investors to buy and financial planners to recommend.

Whistleblower Protections and Rewards

ASIC and the current Coalition Government both struggle to understand the price that whistleblowers commonly pay. Sackings, demotions, pay reductions and public shaming are all common outcomes for whistleblowers. Without whistleblowers making public the misconduct that was occurring, it is unlikely that the Royal Commission would have taken place. Labor's plan to incentivise whistleblowers and to create fear that misconduct will be reported is a very positive step. My submission to the 2017 Whistleblowing Review contains detailed recommendations.

Enforce Insolvent Trading Laws

There's been some improvement in prosecuting phoenixing with a few cases making their way through the courts. However, there's a long way to go before this criminal behaviour gets the attention it should. ASIC's default position should be that if a liquidator believes phoenixing has occurred then charges should be strongly considered and directors should be banned.

Clarify and Enforce Responsible Lending Obligations

ASIC's commencement of legal action against Westpac for failing to follow responsible lending legislation is the right step. As the Commission's report noted, the law is somewhat unclear and there needs to be a process of clarifying it. If ASIC were to lose the case, the next Federal Government should fix the legislation.

ASIC Funding

The new ASIC funding regime should never have been necessary. If ASIC was issuing the sort of regulatory penalties that are common in the US and Europe, ASIC's regulatory costs would be more than covered. **Why should those doing the right thing have to pay for the costs created by those committing crimes and misconduct?** ASIC needs to start issuing penalties large enough that shareholders see their dividends cut and thus demand accountability from directors and senior management.

Written by Jonathan Rochford for Narrow Road Capital on February 8, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure