B. Ethical Funds Management

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Australian Law Reform Commission
By online submission

Dear Madam/Sir

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Submission on Financial Services Legislation Interim Report A

We refer to the Financial Services Legislation Interim Report A (the **Report**) released on 30 November 2021.

We acknowledge and commend the significant amount of work undertaken by the Australian Law Reform Commission (**ALRC**) during this inquiry and in preparation of the Report. Simplification in this area of law is both necessary and welcome and we look forward to future recommendations and reports made by the ALRC.

We are performance driven investment managers who aim to optimise long-term returns in a socially responsible and ethical manner. In this submission, we have made a number of comments and raised some ideas in our role as financial product issuers and distributors. However, we also make a some more general comments in response to the Report and the inquiry.

We note that these comments are made “off the cuff” and based on a cursory review of the Report. Unfortunately, competing priorities have precluded a more considered submission. We therefore apologise in advance if any of our comments are already addressed by the ALRC or by changes in law.

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Question A11: Managing complexity through the use of rules

In question A11 of the Report, the ALRC has asked whether the *Corporations Act 2001* (Cth) be amended to insert a power to make thematically consolidated legislative instruments in the form of ‘rules’.

We think thematic rules are a good idea which will reduce complexity in the law. However, we suggest that the scope of the proposed rules should be expanded to cover no action positions taken by ASIC (Australian Securities and Investments Commission) with a focus on addressing the issues identified in relation to no action letters below. Otherwise, we suggest that the issues identified below should be dealt with elsewhere in the inquiry to reduce complexity in the law.

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We see two issues related to no action positions, they create:

1. regulatory certainty, but legal uncertainty; and
2. a body of “dark law”.

Regulatory certainty, legal uncertainty

No action positions are an efficient way for ASIC to provide stakeholders with regulatory certainty that ASIC will not take enforcement action in relation to certain conduct. However, they can leave a licensee in a conundrum – while ASIC may not take enforcement action against the licensee, a technical breach of the law will usually still occur. This may require the licensee to accept the risk of any underlying breach including legal action by another interested party (e.g. a consumer).

This issue can be illustrated in two no action positions:

- volume-based conflicted remuneration provisions for product issuers (responsible entities, superannuation trustees and platform providers); and
- retail/wholesale client distinction for self-managed super fund trustees.

Volume-based conflicted remuneration

Volume-based benefits are presumed to be prohibited conflicted remuneration. However, ASIC has taken a no-action position in relation to product issuers (such as responsible entities, superannuation trustees and platform providers) when providing general advice and accepting management or administration fees for those products (ASIC RG 246.126 to 130).

Nearly all responsible entities and superannuation trustees in the industry charge volume-based management fees and are technically in breach of the prohibition on conflicted remuneration. However, as the legislation does not accommodate for this common fee structure, these product issuers are left to rely on ASIC’s no action position, but accept the risk of potential legal action from other stakeholders due to the persisting underlying breach of law.

SMSF retail/wholesale client distinction

Generally, the law requires a superannuation trustee to have more than $10 million of net assets to be treated as a wholesale client. However, in ASIC media release 14-191, ASIC states that it will take no action if a licensee adopts the general test of a wholesale client (the trustee has net assets of at least $2.5 million certified by an accountant).

Therefore, a licensee may rely on ASIC’s no action position and treat a client as a wholesale client. However, if a licensee chooses to do so, this will not preclude an SMSF trustee claiming that the licensee should have treated it as a retail client based on the underlying breach of law.

In ASIC’s media release notes the conundrum faced by licensees:

> *“Although ASIC will not take action … this will not affect any private rights of action that may be available to third parties. Persons providing financial services to trustees of SMSFs need to make their own commercial decisions after considering the legal risks.”*

ASIC notes that it exercises its no action discretion where there is “an unintended contravention of the legislation as a result of conduct that is not inconsistent with the spirit and policy of the legislation” (RG 108). This leads to the question – if ASIC has determined

to not enforce the relevant law, should it be a law at all? To remedy this issue, we suggest consideration should be paid as to whether no-action positions should be part of the proposed rule book as a type of "law" or alternatively, whether no-action positions should trigger a review process to assess whether changes to the law have merit.

Dark law

The other problem with no-action positions is that they create a body of "dark law" – that is rules that you cannot necessarily know about through the statute book.

This is illustrated in the example of the SMSF retail/wholesale client distinction above. A person would not know that the no action position existed without knowledge of the 2014 media release (we note that this no action position is also not considered in the ALRC's retail client flowchart). As the position was communicated in a media release, it is also difficult to determine whether or not such a position remains current.

Another example is ASIC's 2004 no-action letter related to financial advisers operating limited managed discretionary accounts (now repealed). This no action letter had application to all financial advisers in relation to operating managed discretionary accounts. However, if you did not know the letter existed, you would not know about the no action position. In addition, as the letter was issued to an industry association, the letter was not made publicly available online and you needed to request the copy of the letter from that association (who could theoretically decide to only provide it to members).

We think publishing no-action positions in the proposed thematic rule book will reduce the occurrence of this "dark law".

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Proposal A4(d): Removing the incidental product exclusion

In Proposal A4 item (d) of the Report, the ALRC has proposed to remove the incidental product exclusion by repealing section 763E of the *Corporations Act 2001* (Cth).

While this proposal will simplify the law, we question whether it would result in reduced certainty for product providers that offer a product where a financial service is only an incidental part. To provide this class of stakeholder with certainty, we think there is value in retaining the incidental product exclusion with minimal detriment to the complexity of the financial product definition.

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Some other thoughts on reducing complexity

Another way complexity can be reduced is by simplifying certain disclosure and conduct regimes where there is unnecessary complexity. Two areas which may benefit from this are target market determinations and fee disclosure statements. We note that both of these areas of law were implemented in an environment of relative haste and we suggest they may benefit from a review with the benefit of time and hindsight.

Target market determinations

The target market determination (**TMD**) regime imposes disclosure and conduct requirements in Part 7.8A of the *Corporations Act*. However, requirements are scattered across different sections of the Act, regulations and ASIC instruments without theme or

hierarchy resulting in it being unnecessarily difficult to understand. For example, section 994 attempts to be a catch all provision dealing:

- firstly, with the requirement to make a TMD (subsection (1));
- then, the timing of the requirement (subsection (2));
- then, exceptions to the requirement of making a TMD (subsection (3) and (4));
- then, content requirements for a TMD (subsection (5));
- but, imbedded in the content requirements are reporting and review triggers which affect both distributors and issuers which are further elaborated on in subsection (6) and (7); and
- then, addressing the key concept of how to determine a target market only appears towards the end of the section, in subsection (8).

In addition to being structurally complex, the legislative regime also shows the common problems identified by the ALRC of complex use of definitions and difficulty in navigating the definitions. We suggest there may be easy gains in reducing complexity by adopting a more logical flow and legislative hierarchy to this regime. Further, consideration could be paid to how TMDs interact with product disclosure statements and how disclosure in these documents can be made with reduced duplication resulting in better consumer experiences and outcomes.

Fee disclosure statements

The concept of fee disclosure statements was simple – where you have an ongoing fee arrangement give the client:

- a fee disclosure statement – disclosing services rendered and service to be rendered in the future; and
- a renewal notice – to ask the client to renew the arrangement.

However, the execution of this concept was overly technical and complex with a focus on timing and deadlines which culminated in a 22-page regulatory guide (RG 245, now repealed). The prescription of detail in the provisions related to timing ironically resulted an increase in unintended consequences and ASIC found it necessary to take no-action positions in its regulatory guidance related to timing.

This can be contrasted with the timing requirement for annual reports which is succinctly stated (section 319(3) and 232D of the Corporations Act) and did not require any regulatory guidance for explanation.

We suggest that simplification of this regime could achieve another easy gain to reducing complexity.

Thank you for considering our submission and we look forward to future recommendations and reports by the ALRC.

Yours sincerely,

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