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Financial Sector Reforms

Financial sector reforms catch lawyers and accountants napping

There is a significant amount of confusion amongst lawyers and law-makers as to exactly who is caught by the new Financial Sector Reform laws. However, it is clear that as the law is currently drafted most tax professionals who carry on a financial services business will require an Australian Financial Services Licence (AFS Licence) from 11 March 2004 when the two year transition period expires.

A financial services business includes any business that provides advice regarding, or deals in, financial products such as shelf companies, family trusts, superannuation funds or even a simple cheque account.

Any business that provides a recommendation or a statement of opinion about a financial product is giving financial product advice if the opinion could reasonably be regarded as being intended to influence another person's decision. A tax professional who arranges for a person to acquire, vary or dispose of a financial product (either as principal or as agent of a client) will probably be dealing in the financial product. The Australian Securities and Investments Commission (ASIC) are responsible for policing the new laws and they have interpreted the term arranging to include a situation where the transaction would probably not have taken place without the advisor's involvement.

This means that businesses which give advice regarding the following products, or arranges for these products to be issued, will probably require an AFS Licence:

- Establishing companies, trusts or superannuation funds
- Acquiring forward purchase agreements in regard to foreign currency, interest rates and raw materials such as plastic resins, chemicals or seed where the purpose of the agreement is to eliminate the risk of price increases;
- Commodity hedging contracts and insurance policies;
- Deposit or cheque accounts with a bank, building society or credit union.

This said, lawyers and tax agents only need a licence if they give advice outside the scope of their usual activities as a lawyer or tax agent or engage in dealing activities. This is because lawyers and tax agents are exempt from parts of the new law. However this exemption does not extend to accountants who are not registered tax agents. Failure to comply with the new law is an offence punishable by a fine of up to $20,000 or up to six months in jail.

Throughout this paper reference will be made to "new law" and "old law". When referring to the new law I mean the *Financial Services Reform Act 2001* ("the Act") and the regulations that have been made to support the Act. When I refer to old law I mean the law contained in chapters 7 & 8 of the Corporations Act up until introduction of the new regime on 11 March 2002.

SCOPE OF THE NEW REGIME

From 11 March 2004 s 911A(1) of the Act will require most taxation professionals who carry on a financial services business to hold an Australian Financial Services Licence. The term financial services business is defined in s. 766A, which refers to five activities, each of which amounts to conducting a financial service business. It is important to note that only people who conduct a business of providing financial services are caught by this new regime. This means a one off activity, or a regulated activity undertaken outside a business context, is unlikely to require a licence.

This paper will focus on the two activities of relevance to taxation professionals: providing financial product advice and dealing in a financial product. To fully understand the scope of the new law it is necessary to understand the following key terms:

- Financial Product
- Financial Product Advice
- Dealing in a financial product

WHAT IS A FINANCIAL PRODUCT?

The scope of the mischief identified in this paper is partially brought

about by the very broad general definition of the term financial product[1]. Examples of financial products include:

Facilities through which a person makes a financial investment:

- shares, debentures, bonds and other securities issued by a family company,
- units in a unit trust or equitable interests in a discretionary trust[2],
- self managed superannuation funds or retirement savings accounts,
- bank deposit accounts (eg: savings accounts, term deposits).

Facilities through which a person manages financial risk:

- insurance policies (eg: life, general, travel but not health),
- commodity hedging contracts (in regard to products such as gold, wheat, wool, cotton and milk),
- forward interest and exchange rate agreements.

Facilities through which a person makes non-cash payments:

- Bpay, credit card merchant and direct debit facilities,cheque accounts, but not an overdraft facility,
- debit cards, but not credit cards or charge cards.

By contrast, the old law only regulated securities and this term was defined to mean debentures, stocks or bonds, shares, interests in a managed investment scheme, or units of such shares, or an option contract over shares etc, but not a futures contracts[3].

FINANCIAL PRODUCT ADVICE

Old Law

Most people who conducted an investment advice business were required by s. 781 of the old law to hold an investment adviser's licence. Money market dealers and exempt public authorities were completely carved out of the old regime. Solicitors and accountants in public practice did not need a license to give investment advice that was "merely incidental to the practice of their profession"[4].

As the old law will continue to apply during the two year FSRA transition period it is important to understand what is meant by the merely incidental exemption and when the old law would otherwise require lawyers and accountants to obtain a security dealer's licence. The scope of the merely incidental exemption has never been tested in the Courts. However, in Policy Statement 119 ASIC said that a lawyer or accountant can only rely on the merely incidental exemption when all of the following requirements are satisfied:

- investment advice that they give forms an integral and merely incidental part of their overall services; and,
- they do not charge a discrete fee for the advice given; and,
- they do not receive any commissions or other benefits from product issuers.

Example

Les is a qualified accountant and includes reference to the fact that he provides business consulting and investment advice on his business cards, letterheads and other promotional material. Last week Les's largest client asked him to meet with his daughter, Davina, in order to assist Davina set up a savings plan and establish a small share portfolio.

Using marketing material that states that Les provides investment advice is probably sufficient to require him to obtain a licence[5]. In any event, if the only advice Les gives to Davina is to answer the questions raised by Davina's father there can be no doubt that the advice given is not merely incidental to accounting services as he has not provided any accounting services to Davina. This said advice in regard to establishing a savings account (or any other deposit account) did not require a license because the old law only prohibited unlicensed advice in regard to securities. However, Les required a licence before he could give more than broad asset allocation advice in regard to establishing a share portfolio[6].

New Law

Section 911A(1) of the Act requires a person who carries on a financial services business to hold an AFS license. Section 766A in the new law refers to five activities, each of which amounts to conducting a financial service business. The first of these is providing financial product advice. This term is defined as giving a recommendation or a statement of opinion that:

(a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial product. . .; or

(b) could reasonably be regarded as being intended to have such an influence[7].

However, s. 766B(5) provides that lawyers and registered tax agents can give advice that is reasonably regarded as necessary to their activities as a lawyer or tax agent without needing an AFS licence. While this exemption is very similar to (and perhaps broader than) the merely incidental exemption found in the old law it must be noted that this is not a blanket exemption that applies in regard to every situation.

Regulation 7.1.29 appears to give a broad exemption from the new law to accountants generally. This regulation provides that, as long as the accountant does not make a recommendation or provide an opinion[8], advice given by recognised accountants on certain matters is not financial product advice. These matters include:

- Financing the acquisition of assets that are not financial products;
- Processes for establishing, structuring and operating a superannuation fund;
- Management of risk associated with conducting a business (eg: hedging strategies);
- Business planning including establishment, structuring and administration.

However, in my opinion this regulation is ineffective. I say this because the definition of the term financial product advice found in the Act does not extend to advice given in circumstances where the adviser does not 'make a recommendation or provide an opinion'. Therefore, the regulation does no more than repeat the law set out in s. 766B(1) of the Act.

The following examples describe common situations were small business clients typically rely on their accountant (who may or may not be a registered tax agent) for financial advice, recommendations and opinions.

Make a financial investment

What is the most appropriate business structure through which to acquire business assets, minimise the negative financial consequences of business failure, maximise tax planning opportunities and allow for succession?

What is the best way to capitalise a business structure (eg: by issuing ordinary shares, redeemable preference shares, convertible notes, debentures, units in a trust or a combination of the above) so as to minimise tax problems, satisfy a Bank's requirement to see an appropriate level of risk capital in the business, provide investors with varying levels of security and simplify the process of returning surplus capital?

Should a person who has recently been made redundant establish a self-managed superannuation fund and roll over eligible termination payments into this fund to preserve the taxation concessions associated with superannuation.

Manage financial risk

When would it be appropriate to purchase a key man insurance policy to allow one family to buy out another family's interest in a partnership upon the death of one of the partners?

What insurance policies should a new business consider purchasing (eg: workers compensation, public liability, product liability, directors and officers and professional indemnity, fire and general, contractors all risk etc)?

What level of budgeted production can be prudently sold forward using various commodity hedging products? This is of particular concern to the primary production industries such as mining, wheat farming, wool and cotton growing and the production of milk.

When, and at what levels, should a debt funded importing or exporting business purchase forward foreign exchange or interest rate contracts?

What volume of raw material should be purchased forward, to lock in the price of these raw materials, given the volume of orders a primary producer or manufacturer may have (eg: farming business forward purchasing fertiliser and seed, or a plastic manufacturer purchasing resin and other chemicals)?

Make non-cash payments

What financial products are available to make non cash payments or speed up a business's cash collection cycle (eg: Bpay, credit card merchant or direct debit facilities)?

Most of these products are not securities; therefore practitioners did not need to be licensed under the old law before giving advice on these matters. And, despite the relatively restrictive wording of Policy Statement 119, even where the products are securities advice given in these circumstances would usually be covered by the incidental exemption if an accountant or lawyer gave the advice in the ordinary course of the conduct of their profession.

It appears to be incongruous that (as currently drafted) the new law requires an experienced accountant to hold an AFS licence before she can give an opinion or recommendation in regard to any of these financial products, however a relatively inexperienced first year lawyer or tax agent might not be caught by the new regime.

REGISTERED TAX AGENTS

I am aware that is becoming increasingly common for tax practitioners to obtain their registration as a tax agent via a corporate entity. In my opinion, because of the wording of the exemption that tax agents have in regard to giving financial product advice[9] the exemption only applies to the person/entity that holds the registration as a tax agent.

While the Act specifically provides that an employee or director of an AFS licensee can provide a financial service[10] (and similar but restricted provisions can apply to employees of some representatives) neither the Act nor the regulations provide that an employee or director of a registered tax agent can rely on the tax agent exemption.

A suitably worded regulation is required to confirm that appropriately qualified, experienced and supervised employees and directors of tax agents can rely on the exemption.

DEALING IN A FINANCIAL PRODUCT

Engaging in dealing activities requires a person to obtain a licence under both the old law and the new law, no matter what industry or occupation the person pursues.

There is no merely incidental exemption for dealing activities under the old law therefore the starting position is that under the old law both accountants and lawyers required a dealer's license before engaging in dealing activities[11]. However, this did not become an issue under the old law because dealing was not so expansively defined and the old law regulated a relatively small number of financial products. Another important argument is that an accountant or lawyer who might have otherwise been caught by the old prohibition against dealing would usually be doing no more than completing the transaction as agent of their client or merely facilitating (or arranging) the transaction on their client's behalf.

In contrast, s. 766C(1) in the new law provides that the following conduct (whether engaged in as principal or agent) constitutes dealing in a financial product:

- applying for or acquiring a financial product;
- issuing a financial product;
- underwriting securities or managed investment interests;
- varying a financial product;
- disposing of a financial product[12].

Arranging for another person to engage in the above conduct is also dealing in a financial product unless the actions concerned amount to providing financial product advice[13].

I do not understand how a dealing activity can also amount to giving financial product advice. Financial advice means giving a recommendation or opinion etc, whereas dealing requires the professional to actually do something more tangible.

The term arranging is not defined in the Act, however ASIC has said in LIC 60[14] that arranging refers to the process by which a person negotiates for, or brings into effect, a dealing in a financial product. ASIC goes on to say that the following conduct may constitute arranging:

- where involvement in the chain of events leading to the relevant dealing is of

sufficient importance that, without that involvement, the transaction would probably not take place (for example: where an individual is the main or only person consumers deal directly with in a particular transaction);

- where an individual's involvement significantly "adds value" for a second person;
- where benefits are received depending on the decisions made by a second person.
- where a service provider takes steps to bring into effect an acquisition or disposal of a financial product albeit another intermediary is also involved in the process and executes the customer's order (for example: where a lawyer refers a client to a licensee in circumstances where the licensee is no more than an order taker).

While ASIC's interpretation of the meaning of the term arranging may be incorrect, I find it difficult to concede that s. 766C(2) is not intended to widen the ambit of the meaning of dealing to capture activities done by professional advisers that might have otherwise been exempt because of the type of arguments raised above in regard to the old law.

The following examples describe common situations that may require a lawyer or accountant to obtain an AFS licence because their conduct amounts to dealing in a financial product (even if only as an arranger):

Applying for, acquiring or issuing a financial product:

- some of the steps taken to incorporate a shelf company and/or transfer ownership of a shelf company to a client;
- materially assisting a client arrange insurance cover for a new business;
- opening a bank account for a client.

Varying a financial product:

- negotiating on a client's behalf changes to the terms on which insurance policies are written;
- providing material assistance in rolling over a forward foreign exchange contract because goods that are being imported (and have to be paid for in a foreign currency) have been delayed in transit;
- materially assisting a client change the terms on which a debenture is issued, perhaps by leading the negotiations on the terms of the debenture with the debenture holders' trustee.

Disposing of a financial product:

- assisting a client negotiate the sale of a family business and then attending to the formalities required to transfer shares in a family company, or trustee company, or units in a unit trust to the purchaser of the client's business;
- complying with Court orders, or an out of Court settlement agreement, by transferring financial products between:
  - spouses, de factos and other parties to a family court settlement, or
  - litigants in a commercial dispute;
- arranging to release an insurer from its obligations under a contract of insurance as part of a negotiated settlement agreement;
- arranging for a client to grant a common law mortgage over shares (which will dispose of the legal estate) to secure contractual obligations being entered into by a client.

At the very least, para 2.3 in LIC 60 must be reviewed however the better solution would be to define the term arranging in the Act (or by regulation) such that these everyday activities would not require an accountant or lawyer to obtain an AFS licence.

REFERRALS

Some tax professionals have arrangements in place with product issuers or licensees to receive fees, commissions or other benefits for referring their clients. My interpretation of the old Policy Statement 120 (PS 120)[15] and regulations 7.6.01(1)(e) and 7.6.01(1)(ea) suggests that the act of referring a client will sometimes require an AFS license.

While I have already made the point that ASIC's Policy Statements are not law, ASIC has said in PS 120 that in its opinion under the old law a 'mere referral' did not require a licence. However, PS 120 provides that if a person making a referral gives any direct or indirect securities advice, as a part of introducing the client, then this is not a mere referral. For example, if a person discusses, either in general or in particular, the merits of investing in securities they are not making a mere referral[xvi]. ASIC considers that a mere referral is made when a person:

- does nothing more than merely introduce a potential investor to a licensee; and
- does this merely as an incidental part of their other business[17].

Similarly, where there is an arrangement in place that provides for more than a payment of a simple referral fee (eg: a trailing commission is paid rather than a one off fixed fee), or the practitioner actively seeks out leads from their client data base, then the referring party must hold a proper authority from the licensee[18]. This is because the old law assumes that in this event the referral is a discrete business activity, not an incidental part of the referrer's other business.

Regulation 7.6.01(1)(e) and 7.6.01(1)(ea) relevantly provides that a financial service provided by a person (person 1) where the service consists only of:

- informing a person (person 2) that a financial services licensee, or a representative of the financial services licensee, is able to provide a particular financial service, or a class of financial services; and
- giving person 2 information about how person 2 may contact the financial services licensee or representative;

is covered by an exemption from the requirement to hold an Australian financial services licence.

My reading of these regulations is that a tax professional who makes a referral to a licensee can do no more than advise the client that the licensee is able to provide certain financial services and provide the licensee's contact details. If this interpretation is correct, then these two regulations have the effect of codifying the essential elements of PS 120. This means that a lawyer or accountant will require an AFS licence whenever they identify

the client's needs, then provide a recommendation and finish by referring the client to an appropriate licensee for a second opinion and to complete the transaction. Should the lawyer or accountant go on to consult with the licensee regarding the referral the efficacy of the referral exemption becomes even less certain.

The following examples demonstrate every day situations where this series of events could happen:

- a small business proprietor advises that he has taken on a full time assistant but has not acquired workers compensation insurance as required by law. The lawyer advises the client that he must immediately take out workers compensation insurance (step 1 – exempt advice when given by a lawyer) and refers the client to an insurance broker to arrange the cover (step 2 – referring a client but doing more than permitted by r. 7.6.01(e));

- a tax agent acts for the executors of a will. The estate has a large share portfolio and a significant capital gains tax liability. As part of the tax agent's taxation advice the executors are advised that they should consider crystallising the capital loss available on the estate's under performing shares to reduce the capital gains tax liability (step 1 – exempt advice if the tax agent is personally registered as such, not exempt if only an employee of a tax agent). The tax agent then refers the client to a stockbroker for a second opinion and to arrange the sale of the shares (step 2 – arranging a dealing). In some situations the tax agent may be required to call the stock broker after he has met with the client to ensure that the broker fully understands the client's circumstances and requirements

- the proprietor of a business is experiencing cash flow problems and seeks advice in regard to improving her debt collection procedures. The accountant recommends that she offer her clients Bpay and/or direct debit facilities (step 1 – requires a license to advise) and refers her to a bank manager to purchase these products (step 2 – requires a dealing license);

- a young couple seek advice in regard to the most appropriate business structure to adopt for their new venture. The tax agent recommends operating the business via a discretionary trust with a proprietary company as the trustee (step 1 – may be exempt if this advice is reasonably regarded as a necessary part of the activities of a tax agent) and refers the client to a law firm or para-legal business to acquire these two entities. At a later date the tax agent calls the financial service provider and give instructions on behalf of the client in regard to the identity etc of the shareholders and directors of the new company and the donor, appointor and beneficiaries of the trust (step 2 – arranging a dealing).

In my experience the scenarios painted above are a regular feature of the everyday practice of law or accountancy and because the conclusions that I have drawn in regard to the new regulations are consistent with ASIC's policy statement 120, I suspect that someone somewhere within ASIC or Treasury do intend that the new regime will prohibit referrals that are more than "mere referrals".

I am sure that Parliament did not intend that lawyers and accountants need a license to undertake these activities. However, the language of r 7.6.01(1)(e) and 7.6.01(1)(ea) does not achieve the Parliament's policy objective. If the policy intent is to allow lawyers and accountants to do more than give clients the name and address of an appropriate licensee then in my opinion the wording of r 7.6.01(1)(e) and 7.6.01(1)(ea) should be amended to reflect this intention.

PROVIDING CUSTODIAL OR DEPOSITORY SERVICES

Section 766E(1) of the Act provides that, a person provides a "custodial or depository service" to a client if a financial product, or a beneficial interest in a financial product, is held by the service provider in trust for, or on behalf of, the client or another person nominated by the client.

In my opinion, if the holding of the relevant financial product is in whole or in part a business carried on by a tax professional or a trustee, it is very hard to avoid concluding that the following activities will requires an AFS licence:

- holding documents such as share certificates, bank bills or life policies in safe custody for a client;

- a trustee of any trust holding any kind of financial product on trust for beneficiaries.

Various exemptions from this requirement are set out in s 766E(3) however none of these appear relevant to the provision of safe custody services by tax professionals or the trustee of a family trust acquiring financial products. If anything, the existence of the exemptions in s. 766E(3)(c) reinforce the concern that the definition in s. 766E(1) has as wide an impact as suggested above.

Most law firms, and some accounting firms, provide clients with a safe custody service as an ordinary part of their practice and where the indicia of a business are satisfied[19] the trustee of a family trust will be carrying on a business of providing trustee services. Therefore, as currently drafted, s. 766E of the Act will potentially affect a very large number of enterprises carried on throughout Australia, particularly accountants, lawyers and small to medium sized family businesses.

CONCLUSION

The authors of the Wallis Report recommended that accountants and lawyers should not be licensed:

> ". . .where they provide financial advice...in the context of broader advisory services offered to clients extending beyond the financial sector, often where the adviser has a wide appreciation of the business and financial circumstances of a client." [20]

However, for the reasons given above, the new law has not yet achieved this objective and the real mischief is the implications for lawyers and accountants of the very wide definition of the term dealing.

CPA Australia, the Institute of Chartered Accountants in Australia and the National Institute of Accountants have each made a submission to the "Inquiry into the regulations and ASIC policy statements made under the *Financial Services Reform Act 2001*" that is currently being undertaken by the Parliamentary Joint Committee on Corporations and Financial Services. Their submissions address the issues identified above in regard to financial

product advice and include a draft regulation that should remedy the problem accountants have in regard to giving financial product advice. I am advised that the accounting bodies have also taken up the other issues addressed in this paper however, if this is so, the Joint Committee has not published a copy of their further submission.

The Taxation Institute of Australia has made a submission to the Joint Committee in regard to the uncertainty that exists in regard to advice generally and how the new law will impact on the administration and management of self-managed superannuation funds by accountants and tax agents. The Financial Planning Association has made a submission that focuses on the problem with referrals.

While individual law firms have made submissions to the enquiry none of the legal professional bodies have taken up any of these issues. However, I am reliably informed that some members of the Law Council are working behind the scenes on some issues and an early draft of this paper has been submitted to Treasury and members of the Joint Committee.

Copies of the various papers made to the Joint Committee can be obtained at the following website:
http://www.aph.gov.au/Senate/committee/corporations_ctte/FSRA_regs/papers/sublist.htm

While large city firms have the resources to adapt to the new regime, I expect that unless significant changes are made to the Act there will be a significant withdrawal of professional services in smaller city firms and most suburban, regional and country communities.

If the professional bodies are unable to win significant concessions on the issues raised here then tax professionals will have to either change the way they conduct their practice or start working towards obtaining an AFS licence in early 2003. I say this because the licensing process will take a significant amount of time for most of us to complete and ASIC have advised that applications received after November 2003 will not be processed in time to meet the 11 March 2004 deadline. ◆

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For more detail and an historical perspective on this topic, please refer to Keith Harvey's previous paper, Issue 36/5 November 2001

Keith will also be speaking on this topic on TaxTape August 2002

Reference Notes

1 *see s 763A*
2 *in my opinion discretionary trusts are caught by the very wide definition of the term facility which includes "an arrangement or term of arrangement". Section 761A says the term arrangement means a contract, agreement, understanding, scheme or other arrangement. It can be: formal, informal, written, oral, enforceable or not, based on either legal or equitable rights.*
3 *S. 92(1) of the old law. note: the definition has changed slightly in the new law.*
4 *old law s. 77 (5)*
5 *PS 119.9*
6 *PS 119.19*
7 *s. 766B(1)*
8 *see r. 7.1.29(2)*
9 *see s. 766B(5)(c)*
10 *S. 911(B)(1)*
11 *s 780 old Corporations Act.*
12 *s 766C(1)*
13 *s. 766C(2)*
14 *at para 2.3*
15 *refer also to PS 119.21*
16 *PS 120.16*
17 *PS 120.15*
18 *PS 120.18*
19 *Refer TR 97/11*
20 *At page 275*