Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Financial Products and Services in Australia

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Qualifications and bio of writer – Appendix I

Contents

Format of response

Prior to providing a view in relation to each of the areas being considered by the inquiry, I have provided some views of what underlying purpose and objectives of the inquiry I have attempted to address in this response.

This response does not attempt to address the macro issues that lead to the extreme volatility in financial markets and the failure of the banking system with its consequential impacts on various countries, businesses, investment capital/returns and individuals. This response focuses on what changes should be considered to improve the protection of the retail investor.

As is often the case, flaws in any system are only highlighted in times of stress. During prosperous times it is human nature to become less frugal and accepting. In favourable times it is often easier to push issues to one side in the false belief "no-body is getting hurt". However, inefficiencies, poor quality advice and lack of service for fees charged do hurt the long term productivity of the country and the wealth of all.

Lessons need to be learnt from the recent crisis and underlying issues addressed in order to prevent or at least minimise any future occurrence. Tough structural changes need to be made including critical self assessment by the regulator and industry bodies of their roles and their willingness to step-in and ensure protection for the unsophisticated "paying" client.

Any solutions or changes require industry and regulatory representatives of the retail investor to stand up and be accountable to make a difference.

It is clear from many of the individual submissions to this inquiry that there needs to be significant improvements in financial communication to the retail investor. The communication needs to be simplified and balanced in order to increase the protection of the retail client.

As a whole the current perception in the community is that the financial service industry lacks credibility, which is an unwarranted slur on the many highly professional financial advisors that do aim to ensure their client's long-term financial security objectives can be achieved. A distinction between financial product distributors and fully qualified financial planners and independent financial advice should be considered.

A more rigorous qualification assessment and maintenance process needs to be implemented by the industry in order to raise professional knowledge and ethical standards.

The industry and regulator must impose greater consequences to individuals breaching the trust placed in them by their clients. This is an

industry issue, not the sole responsibility of the regulators of the financial services industry.

This submission largely considers matters from the perspective of retail investors and offers some views on possible solutions or changes for the inquiry to consider. This submission is concerned with those retail clients who seek and pay for advice and who invest directly into an investment product/platform. This submission does not attempt to address the performance of wholesale funds / superannuation investments managed by professional investors.

It is important the community understands that accessing quality advice does cost, but equally they must be able to assess the value of this advice and be comfortable that the total cost of their investment and the remuneration paid to their advisor represents good value. Where this is not the case, a retail client must be able to seamlessly move to an alternative advisor or platform. This is currently not the case and a major impediment to returning some control back to the paying retail client and should be addressed as a priority.

General views on issues for the inquiry to address

While billions of dollars in wealth have been lost, impacting the lives of millions of people, the inquiry must distinguish between the impact of the systemic failures in the banking industry with its consequential impact and the impact on retail investors that could have been and should have been avoided, prevented, or minimised.

The inquiry should attempt to identify the underlying reasons for the factors that contributed to the inability of so many retail clients and their advisors to respond and protect their wealth and whether their financial advisors should have done more to protect them.

Genuine financial advice should encompass an entire client's financial position and objectives. It would appear from the submissions to this inquiry that retail clients are not receiving a balanced and comprehensive analysis of all aspects of their financial decisions or the material being presented is not comprehensible.

There is a skill and a cost associated with implementing protective investment strategies, whether all advisors who represent themselves as being a qualified financial advisor are capable of understanding, constructing and then communicating these strategies in a balanced analysis should also be addressed.

Did the retail client receive adequate professional support in their time of need in light of the advisory fees paid to their advisors? If the conclusion of the inquiry is that advisors should have done more for their retail clients, clear guidance to the industry on what type of "reaction", "monitoring", "balanced/protective strategies" should have been performed must also be provided in order for solutions to be implemented going forward.

There is a mountain of differing opinions and submissions to the inquiry as to whether financial advisors should receive trail commissions or only be able to charge a fee for service. While significant, this issue should not become all encompassing and override the inquiry.

Challenging other fundamental structural issues underlying the current financial delivery model must occur for the inquiry to be considered a success.

It is my view, while some fee aspects need to be addressed and in some instances banned , the method of receiving fees is not as critical as **ensuring the retail client receives clear advance knowledge of all fees and receives the appropriate level of service for fees paid (value for fees paid).** Advisors should be more accountable for monitoring (where fees are received for this service) their clients position

and demonstrating they are responding where necessary to changing circumstances.

It is also my strong view that the loss of wealth was due to a combination of greed, unrealistic expectations, a lack of financial literacy and a culture of taking advantage of a trusted position. To varying degrees each issue has played a part in the problems that are now upon the industry.

While everyone would like to be compensated for losses incurred, few are prepared to accept their role in contributing to their own loss. While retail clients need to be more accountable for their own affairs, accountability is in part reduced when they seek and pay for professional advice. **Of greater concern is the number of poorly qualified / experienced advisors who are not capable or do not act in the best interest of their clients.**

Retail clients do need to understand that they need to take more responsibility for their own destiny; however, before they can be more accountable, information must be presented in a consistent user friendly manner. The industry as a whole must address the communication issues confronting it and seek to ban or cap practices that are not fully transparent such as excessive deferred fees, back end fees, excessive upfront fees, early exit fees and excessive switching fees when the client has already paid initial investment fees.

Excessively lengthy and complex legal terms and conditions contained in most Product Disclosure Statements (PDS) foster an environment of distrust and helplessness. Retail clients are intimidated by the material presented to them and are reluctant to inform their advisors they simply do not understand the information presented. It is clear the freedom that currently exists in disclosure is not working and is more a tick box / legal protection focus designed to ensure that all aspects of the requirements of the Corporations Act are covered rather than the clear communication of a clients financial position.

Greater comfort and clarity for all could be achieved if all PDS documents (and all Statements of Advices) adhered to a single national presentation guideline and a single set of Terms and Conditions promoted by ASIC and endorsed by the Financial Ombudsman Service. This would be an extension of the current requirement that the costs section of a PDS must include certain words and information in a table in a specified format, by law. The intention would be to expand on the cost initiative to a wider range of matters that need to be disclosed in a one or two page summary that addresses a range of key product characteristics. It is appreciated that this approach is an enormous challenge but reporting key logical information against industry norms would assist clients assess whether the recommendations reflect their objectives and risk appetite.

It is acknowledged that ASIC and the industry bodies have tried to come up with template SoAs without great success, however, the main objective must be to ensure effective communication to the end user (the unsophisticated retail paying client). This difficult challenge must be faced and a resolution achieved.

My view is that (similar to the product summary discussed above) the promotion of a summary document that summaries all major structural considerations and investment allocation decisions can be agreed on to highlight a clients overall position. Additional material would be provided to support a more detail analysis of the major structural and investment decisions recommended.

Financial literacy is a critical skill; however, not everyone may have this view or be prepared to invest the time, energy and money to gain the necessary skill level to make fully informed decisions. While access to simple information should be provided it is unrealistic to assume education alone will prevent a repeat of the problems we currently face. It is currently too easy for unscrupulous people to exploit the lack of financial literacy.

Despite unacceptable practices such as excessive exit fees and back-end loading of fees and excessive deferred fee structures being known, no industry or regulatory body has effectively challenged these known unscrupulous practices within their membership or those under their regulatory control. Nor has there been any effective education provided to retail clients.

Certain practices (such as those mentioned above) should be banned or at a minimum, caps put in place. Going forward industry bodies should speak out more against unacceptable practices and withdraw membership for those failing to adhere to preferred / reasonable fee charging arrangements. It is not acceptable to hide behind the claim these are commercial matters and not something industry bodies or the regulator should get involved with. These practices exploit the lack of financial literacy and harm the reputation of all advisors and the industry. Leadership and action is required.

It is essential retail clients can rely on the professionalism, qualifications and skill of their advisor. Advisors must be accountable for maintaining a high degree of skill and adhere to a strict ethical code. Industry bodies and the regulators must ensure relevant and effective continuous education occurs and that harsher penalties on those failing to maintain their skill levels and for those breaching their ethical responsibilities.

It would appear the current internal review, external review, industry and regulatory reviews processes have failed at ensuring the standards of advisors and quality of advice is adequate. Reliance on "tick the box" compliance instead of genuine peer reviews or external quality reviews

appears to be an issue requiring investigation. The lack of consequences for individual advisors and licence holders found to have breached their responsibilities has left the community disenchanted with the industry.

Another area of concern for the industry is the complex paperwork required to establish accounts and enact investment decisions. Proprietary solutions and perceived constraints (due to AML and Privacy Laws) placed on sharing client data amongst AFSL holders should be addressed to eliminate the barriers being imposed to access and implementing investment choice.

Each AFSL holder should be able to rely on other AFSL holders compliance with their licence (which is subject to annual audit and certification), furthermore, **the data relates to the client and if instructed to do so by the client all client data should be passed on.** The current system results in enormous duplication and is a barrier to competition as retail clients and advisors are reluctant to implement change due to the administrative burden imposed. It would be in the interest of all retail clients if, ALL client data, following client instruction, could be transferred electronically (to an industry standard) amongst other AFSL holders upon request. A change to the law to implement this change could be done prior to any other major conclusions being reached.

Improved electronic communications exists but largely remains underutilised due to reliance and/or protection of proprietary systems. The industry inaction with regard to adopting open standards for reporting and transactional processing should be addressed by implementing legislative changes to enforce technology compliance. Changes that require all retail products and services to adhere to one or more global communication standards could be made. Such a change would provide greater transparency, speed, accuracy and completeness. Compliance to global industry standards like SWIFT, FIX & SWIM will not only assist retail clients but will enhance the industry's global reach. Promoting adherence to specific standards would also assist in platform competition and likely lead to a reduction in prices as new technology providers would create alternative independent platforms accessing a variety of products.

Products that fail to adhere to communication and other reporting standards should be barred from retail distribution. Transitional arrangements would need to apply. Modern technology and communications enable advisors and retail clients to be better informed with up-to-date information. When combined with improvements to transaction processing and the transferability of client data, clients and their advisors would be in a far better position to respond and make changes to their position. Changes like these also link to and support the government's commitment to invest in a national broadband solution.

A formal classification process of all retail investment products should also be considered and investment products should be subject to quarterly

classification to a set of national classification standards. These standards should highlight to investors the product's characteristics such as overall risk profile, volatility, liquidity, income performance, capital performance.

In addition financial advisors should be required to complete an assessment process to confirm they understand the features of the product and the implications of the classification given to each characteristic of the product they are recommending. Advisor knowledge of investments products and in particular the risks inherent in each product are essential to ensuring investment choices are appropriate for clients and corrective action (relative to an individual client) is identified early and implemented.

Summary of key aspects for consideration

1. Legislation should not attempt to cater for the lowest knowledge level.
2. The current licensing of advisors and products is considered appropriate but could be enhanced by improved compliance to "quality and appropriateness of advice".
3. The regulator (following industry consultation) should be empowered to promote a simplified "product summary reporting framework" standard. This summary should be required to be including in all PDS documents and signed by the client.
4. The regulator (following industry consolidation) should develop a set of standard terms and conditions that all retail products either adopt or explain variances to. The standard T&C's would be endorsed by ASIC and promoted by FOS. Adherence to these standards should be voluntary or non-adherence results in the product not being suitable for a retail investor.
5. Legislation should focus on the obligations of advisors to report to a simplified "retail client summary reporting framework" standard. The framework would be developed by the regulator (following industry consultation and retail client input) to ensure retail clients are informed in a consistent format of their **overall structural and risk position following the implementation of an advisor's recommendation**. Areas to address include: risk profile, protection strategies, investment profile by asset class, risk return weighting, product provider diversification, fees charged, fees received by the advisor and some sensitivity analysis on debt ratios, income and capital particularly when gearing, futures, CFD's, options or warrants are involved.
6. There should be a clear separation of fees/advice into a) structural financial advice b) investment advice c) risk advice d) superannuation advice and e) services including administration and platforms. Internal procedures, compliance and regulatory reviews should monitor the application of these fundamental distinctions.
7. Ultimately, the real issue is not how an advisor receives their fees but whether the value delivered to the end user for the fees charged is reasonable. This relates recommendation relates to investment advice fees charged not transactional advice activity or administration services.
8. Annual reporting of all fees charged & product fees received in relation to a client should be reported to the client to assess the value received.
9. As part of the financial literacy of retail clients the regulator should attempt to publish a guide to fees i.e. standard service/fee schedule by region. Such information should promote greater competition when combined with improvements in a client's ability to change advisors.

10. Insurance products should not be exempt from any changes; all financial products should be treated consistently.
11. The communication regime for advice given in relation to real estate should also be reviewed. Real estate is often the largest asset for many people and yet is not subject to the same stringent advice requirements as other investment choices.
12. A new advisor designation such as PFA– Professional Financial Advisor & IPFA Independent Financial Advisor should be considered to assist clients identify an individual as having the highest qualifications in all aspects of financial planning and those who are truly "independent".
13. Financial literacy must be taught via the education system and the curriculum should be linked to a national product and retail client reporting system suggested.
14. The ability for a retail client to change an advisor and for an advisor to change between licences is essential to improving the accountability of the industry to their service and price. A faster, less paper intense solution for retail clients to change advisor and for an advisor to change licence holders is an essential component to competition and improving the standard of service delivered.
15. Improved disclosure of fees to a national standard. Each aspect of the financial advisor service should be grouped, and fees charged identified minimum criteria include – licence/dealer group fee, structural advice, platform access, investment advice, performance fees and administration services.
16. Consider banning volume bonuses and requiring all payments to advisors be tagged with client account information to facilitate rebates and/or reporting.

Information requested by the Inquiry

The role of financial advisors

The role financial advisors perform varies greatly based on qualifications, the AFSL they operate under and the region they deliver their service to. However, notwithstanding these constraints all financial advisors should have an overriding responsibility to their clients to whom they charge a fee. It is clear that this overriding responsibility has not always been fulfilled as some advisors have acted to fulfil other goals such as sales targets.

A clearer distinction between an independent financial planner and a qualified advisor employed by, reliant on or associated with a product provider who is primarily responsible for selling in-house products is required. It is understood that this was attempted two or more years ago, however, the objective is worthwhile pursing again.

It remains the AFSL holder's responsibility to ensure their authorised advisors only deliver services or recommendations that they are qualified in and **are appropriate for the client**. The ability and willingness of the AFSL holders to ensure their advisors are competent to these two aspects and in particular the delivery of appropriate personal advice is a critical aspect of the licensing regime.

The current licensing and hierarchical approval structure is considered an appropriate financial service model but adherence to licence obligations is essential to the success of the model. All parties involved in the compliance review process (advisor, internal audit, external audit, industry bodies and regulators) must perform sufficient and adequate quality reviews to ensure the licensing framework performs as intended. Severe penalties need to be imposed on individual advisors as well as AFSL holders for breaches of trust and licence obligations.

The role of auditors in ensuring AFSL holders are meeting their obligations and in particular the advice given to clients is reasonable and appropriate is critical to the success of the framework. Auditors and/or industry body peer reviews must be more proactive in their review of potential conflicts and the appropriateness of advice to clients.

The additional cost and the skill levels of auditors to perform reviews of advisor advice versus the benefits of implementing such a system would have to consider before implementing. However, without this type of quality assurance process and notification of potential concerns to the regulator, fundamental failures like Storm will continue to occur.

It is my belief that there should be a clear separation of fees into;
1. Structural financial advice,
2. Investment advice,

3. Risk advice,
4. Superannuation advice, and
5. Services including platform and administration fees.

Internal procedures, compliance and regulatory reviews should monitor the application of this fundamental distinction in particular where advisors recommend products promoted or associated with their own licence.

The investment decision process and skills required to perform this task require specialist knowledge and is a specialist field in its own right. Is it really feasible for all advisors to be both structural experts and investment experts capable of making appropriate assets allocation and risk management decisions? In some cases the answer would be yes but not all.

Is it not more appropriate for the ”structural advisor” to review on behalf of their client the appropriateness of the investment decisions made relative to the risk and income/capital objectives of that client? The investment advisor should be paid a fee for investment advice.

The inquiry should assess the merits of performance fee arrangements, which if allowed should only be based on exceeding industry/risk weighted returns and possibly performance payments should be deferred to ensure returns are sustained. The concern with performance fees is greater investment risk will be taken to enhance returns to secure additional fees; however, there are often no penalties for under performance or for losing capital. Performance fees based on risk adjusted returns and a payment deferral arrangement attempt to address these concerns.

Investment decisions should have minimal influence on overall structural decisions. While some investment products open up alternative risk management solutions, risk management and an appropriate overall risk level is a structural decision. Appropriate structural decisions should not be influenced by product i.e. the first step should be to indentify the need/objective to be addressed, and then find a solution.

Where an advisor charges fees for ongoing review or receives trail commission from investments made by their client, the advisor is responsible for ensuring the ongoing structural advice / investment decision is appropriate for their client.

Qualifications distinguishing these two aspects at different levels e.g. Diploma, Degree, Masters could assist clients assess the skill and fees being charged by their advisors. Monies spent on improving financial literacy should be focused on guiding the community on what questions to ask when identifying an advisor and what distinguishes different advisors.

Historically, advisors have been resistant to assessments that may classify them and lower their income generating ability. This concern should be

secondary to the need to ensure retail clients are being advised by appropriately skilled people who remain up-to-date with structural and investment strategies and issues.

Financial advisors have an enormous responsibility with regard to the financial affairs of individuals and as such need to maintain the highest level of integrity and skills to deliver the services they offer. Advisors failing to act with integrity and licence holders failing to enforce integrity, breach a fundamental duty to their clients and should be severely punished by both industry bodies and the regulator. To date both industry bodies and the regulator have failed to address selling practices that suggest the client's interests have not been paramount.

General observations from the recent crisis include:

a. Structural advice decisions, particular those surrounding gearing, were flawed in their risk assessment (and the implementation of protection strategies).
b. Inappropriate advice and a lack of understanding of the product/advice recommended.
c. Existing Statement of Advice documentation failed to adequately inform clients of their position, risk or fees.
d. AFSL Holder's income and advisor's income linked to specific structural advice strategies without regard to appropriateness while appearing to meet legal "compliance".
e. Lack of product knowledge by advisors with regard to counterparty risk, ownership structure/entitlements, investment risk, liquidity, maintenance costs (capital guarantee arrangements).
f. Inadequate overall structural wealth management skills in particular asset protection strategies.
g. Inadequate disclosure of early exit penalties. Cost of exit or deferred fees were not fully understood by clients and in some instance even advisors. It may be possible to argue in some circumstances that the product was an inappropriate investment choice given the client's circumstances.
h. Operational scale issues, inability of advisors and licence holders to perform adequate reviews on mass for individual client positions and implement corrective action.
i. Providers of leveraged products turning a blind eye to appropriate reviews of applications received via their distribution network i.e. 1) limited independent verification of data submitted 2) appropriateness of gearing to income and asset levels and 3) continuing to extend credit when breaches occurred.
j. Rogue advisors – moving between licences to avoid problems. Consider introducing a requirement to have a reference from the Responsible Manager of the previous licence before ASIC approve movements between licences. This would require a register of all people licence to give advise i.e. employees as well as authorised representatives. All advisors should hold a unique registration number which tracks their employment/advisory history.

The general regulatory environment for these products and services

The approach of licensing products and service providers is an appropriate regulatory position; however, there remains an enormous gap between the intent of the regulatory framework and its successful application. Clear and informative communication to the end retail client remains the greatest challenge for the industry and regulator.

It may be appropriate for all retail products to be approved by an independent rating agency licensed by ASIC who would be accountable for updating ratings, say quarterly, and subject to ASIC review. The rating agency would adhere to an agreed classification process that rates the product along various standard characteristics that link to the summary product reporting recommended that are familiar and understood by the retail client.

Presently, PDS documents do not fulfil their objective due to their overly complex wording and lack of transparency in fee disclosure, particularly hidden fees such as early exit fees. Simplifying the content and standardising the reporting to an agreed compulsory template (even if only a summary information page) will enhance user understanding and lead to greater competition by assisting with comparative analysis.

The regulators ability to enforce the law is currently too cumbersome. The regulator or the regulatory process lacks sufficient power to implement swifter penalties for minor breaches and major breaches take far too long to be resolved (e.g. Tricom ASX determinations). While additional resources have been applied to compliance and enforcement, the regulator needs a greater ability to issue corrective sanctions more quickly in order to have the fine/sanction linked to the breach. This may require an appeal process to be implemented.

The role of the auditor in ensuring an AFSL holder fulfils their obligations and in particular that the advice given to clients is reasonable and appropriate is critical to the success of the framework. Auditors and the industry bodies must be more proactive in their review of potential conflicts and the appropriateness of advice to clients. In addition to ensuring the necessary review procedures exist in an organisation, individual sample testing of client advice records should be conducted. Without this quality assurance process and notification of potential concerns to the regulator fundamental failures like Storm and Westpoint will continue to occur.

Improved communication between participants in the industry and the regulator needs to occur across all levels and not just with large institutional service/product providers.

The perceived conflict with the ASX overseeing compliance within its own market must be addressed. It is irrelevant whether there is or is not a conflict, as the perception of conflict has harmed relationships with participants and the market place. Furthermore, ASIC's views on the application of the law and rules cannot be truly and accurately reflected while ASIC does not have the authority to intervene.

A new forum is required for all market and clearing participants to contribute to the compliance regime including structuring appropriate penalties relative to client and market risk. This would assist in rebuilding relationships and improve the application of compliance resources from all stakeholders into genuine market and system integrity issues.

Another area that should also be reviewed by the committee is the application of the sophisticated investor classification. While some recent changes have been made to the system making it less cumbersome there remains a fundamental flaw in the logic that a person with either the required assets or income is sophisticated and therefore capable of understanding their investment decisions. The current approach ignores the experience of an investor and in doing so penalises competent people who do not qualify as sophisticated from gaining access to sophisticated offerings which are often priced very attractively.

The role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisors

Conflicts will always exist in any commercial operation. A fee for service arrangement does not stop over charging or lack of value for fees charged.

There is a mountain of differing opinions and submissions to the inquiry as to whether financial advisors should receive trail commissions or only be able to charge a fee for service. Detail below is my views on this issue as I do not believe a simple ban is feasible. In addition, while the commission issue is significant, this issue should not become all encompassing and override the inquiry.

Businesses and advisors that have focused on maximising annuity income over client service lack integrity. By placing self-interest ahead of their client they have breached their duty to their client. This fundamental flaw in character is not resolved by banning one form of income over another, however, safe-guards should be implemented to ban certain practices and to cap certain forms of arrangements that are currently used to exploit that lack of financial literacy of many retail clients.

Challenging other fundamental structural issues underlying the current financial delivery model must also occur for the inquiry to be considered a success.

Issues such as;

- excessively complex investment documents and Statement of Advice documents,
- advisor skills and independence,
- lack of transparency in product fees and advisor fees in particular hidden early exit fees and back-end loaded fees,
- advertising that an in-house planner or advisors charges fee for service where in fact a percentage of assets, in effect a trail, is charged,
- the need for improved balanced communication that clearly discloses risk (relative to all aspects of a person's position) and reward,
- the effective requirement for in-house planners and advisors to only recommend the 'house' product or greater than 20% of product chosen are from associated or are in house products,
- providing attention to and disclosure of "risk adjusted returns" and ensuring these relate back to the clients agreed profile,
- clearer guidance for clients and advisors on what is an appropriate investment relative to their individual financial position,

- technology improvements - compulsory adoption of global communication standards to reduce administration fees and improve the speed, range and transparency of reporting,
- improve independent classification of all retail investment products along a variety of criteria to enable comparability and to ensure consistency in valuation frequency and reporting,
- improve the ability for retail clients to change advisors by allowing and requiring (under client approval) all AFSL to share all client data held. Remove any impediments or perceived impediments with regard to Privacy and AML laws.

These are some of the other impediments contributing to lack of competition, access to up-to-date information that hinder the ability for a client and an advisor to implement change quickly.

It should be accepted that the Statement of Advice legislation is not working. Currently SoA's are too lengthy and often more focused on litigation protection rather than clarity of structural and investment outcomes.

Greater thought and guidance needs to be given to

1) when a SoA is really required (would a Record of Advice suffice)
2) the level of detail required and
3) format of the SoA. While difficult to create it is my view that agreed standard formats aids industry efficiency, assist with financial literacy and clear communications.

Where an advisor charges fees for on-going review or receives trail commission from investments made by their client, the advisor is responsible for ensuring the ongoing structural advice / investment decision is appropriate for their client.

Where upfront fees are charged these fees should be held in trust and drawn on over a period the fee covers or two years to ensure product promoters and advisors deliver on fees charged.

Another area of concern across the industry is the disproportionate sharing of risk between promoter/advisors and the retail client investor. Promoters of products and financial advisors receiving large upfront fees or payments have little or no exposure to the overall performance of the investment or delivery of the service being promoted.

Recognising and attempting to address the need to share the execution risk with the retail client is not only a commercial matter but an industry integrity matter. The level of fees and the exposure shared by the promoters of a product may need to be better disclosed or a specified amount (e.g. 50%) placed in a trust account and paid to the advisors / promoters over a specified period e.g. two years and subject to a performance target being reached.

It is my view that the method of receiving fees is not as critical as ensuring the retail client receives the appropriate level of service for the fees paid and advisors are more accountable for monitoring (where fees are received for this service) their clients position and demonstrating they have responded where necessary to changing circumstances.

Other matters for the inquiry to consider prior to making a conclusion on this issue:

- Ensuring access to quality advice continues for clients with minimal assets to invest. Those retail clients least able to pay for good structural and investment advice are just the people who need access to good advice in order to maximise opportunities given their circumstances.
- Banning all hidden fees, deferred fees, exit fees (other than a small admin charge of say $100) or "event" fees that restrict an investors flexibility to alter their investment decision should be done as a priority and not be deferred until all fee matters are resolved.
- The use of caps on commission payments may be an effective way of delivering a workable compromise e.g. maximum upfront fee of 2.0%, with a dollar cap of say $20,000 for managed funds, maximum annual admin/advisor fee of say 0.5% pa, these fees could be scaled based on funds invested and when combined with bans recommended above provide simply transparent reporting to clients.
- Caps should also apply to investment switching decisions as the client has often paid significant fees upon their initial investment. Alternatively, fee refunds could apply or fees charged in excess of 2.0% are placed in a trust account and drawn on over 24 months. These later ideas would create additional administration and accountability controls. The benefit may not warrant the cost.
- Demonstrating a consistent regular income is important for a business in terms of securing funding to assist with expansion and giving employees comfort over their employment. Monthly advisor fees / commission / rebate payments assist with this so a total ban could significantly impact the financial stability of many small advisory businesses.
- There is an enormous cost (IT, Training, Administration) in facilitating distribution for multiple products and platforms. Electing to focus on best of breed is a legitimate business strategy in order to provide a cost effective service to clients. Full investment choice is not feasible without the introduction of standard electronic communication protocols.
- Product distributors <u>should pay their distribution network</u> for the cost of learning their administration systems, processing procedures and product characteristics. Therefore, a total ban on product providers making any form of payment to advisors is not recommended.
- Any changes must be backed by a well thought through transitional / grandfathering rules.

- Instead of % of funds invested product distributors could reimburse their distribution network on a fixed $ per account (caps in place) and a fixed $ for administrative tasks completed on an account. This approach would result in a more effective cost allocation based around the level of activity or service delivered. Clients who drive activity would pay higher fees then those who do not.
- Disclosure of fees payable over 1, 3, 5 years including exit charges. It is not acceptable to say there are too many variables to enable such disclosure.
- Sensitivity disclosures should be compulsory in some instances and should be based around standard assumption e.g. +/- 5% Capital growth and 5% / 0% income. Such disclosure may not be necessary if certain types of fees are banned.
- Standardising pictorial communication using colours and images such as a thermostat to help clients assess their overall: investment risk, asset allocations, debt exposure, income and asset to debt ratio, level of income and asset protection, as well as disclosure of recommendations to key sensitivities on interest rates, income and capital growth assumptions.
- Ban product overrides and require all payments to distributors to be tagged with client information to facilitate reporting and/or fee rebates.

Whatever the conclusion is on fees, it is likely significant structural changes may need to occur in order to address the various issues identified. These structural changes will significantly impact business models and product providers and as such considerable resistance is likely.

Excuses such as cost to implement, administration time and the time required to implement technology and procedural changes while relevant should not be impediments to change.

The industry must remember that the paying customer deserves to receive a fair service for the fees charged and it is the advisors/AFSL holder's responsibility to monitor and report on this as well as be accountable for any overcharging.

Educating retail clients on the types of service offerings available and providing a price range (relative to the region they reside in) would greatly assist the retail client challenge their advisors on the value they deliver.

It is also worth reiterating that challenging an advisor is only part of the solution. It is essential that a client can seamlessly replace an advisor without considerable cost or effort. Such a situation requires regulatory change or clarification with regard to the operation of Privacy laws and AML laws.

The role played by marketing and advertising campaigns

Provided no misleading or inaccurate statements have been included in the marketing material / campaign, I do not believe this is a significant contributing factor to the current problem due to the documentation processes that follow a marketing campaign. Providing the ability for a client to review or seek additional independent advice before investment proposals are implemented is more important.

The behaviour and actions taken by advisors and licence holders with regard to servicing the client remains more relevant. Ensuring the advisor and/or licence holder acted in a professional manner and the advice given was appropriate and fully explained to the client should be the primary area to address.

Marketing material and tactics used to induce clients need to be investigated promptly by the regulator when concerns are raised. The speed of investigation is critical to identifying early any unacceptable practices of a product promoter, an advisor or an AFSL dealer group.

It is accepted that some marketing campaigns can be very enticing and some people can be seduced by the marketing initiatives used. However, only advisors give advice and it is this advice that warrants detailed scrutiny not the marketing material (assuming the material is not misleading or inaccurate).

Possible solutions include

- Introduction of product reporting framework.
- Introduction of retail client reporting framework.
- Requiring client to sign and initial each page of summary SoA which would conform to an industry standard and disclose some industry comparative information.
- Allowing retail client 7 days to withdraw approval for implementing investment strategy. 7 Days allows for an external review or advice. To facilitate immediate investment or implementation this requirement could be waived by the client.

<u>Misleading / Inaccurate marketing issues</u>

I refer to my earlier comments that the integrity of the licensing framework requires all those who participate in the industry to adhere to the spirit and intent of the structures put in place. Breaches or concerns should be reported to ASIC who respond promptly. It would appear that ASIC have been under resourced in the past to effectively investigate and respond promptly.

Product providers also should be more accountable for ensuring the distribution network they utilise acts within their authorised limits and all

applications have been received have been sold by a qualified and authorised person. This self regulation while desirable is unlikely to be a reliable method for preventing inappropriate practices. Breaches in this area should incur substantial penalties and Directors and Officers knowingly disregarding this quality control should be personally liable.

Chartwell and some groups involved in distributing Westpoint were not correctly licensed or failed to operate within their licence. How this can occur and how product providers could accept investments from some of the parties involved should be investigated.

The industry must protect its reputation by promoting a culture of whistle blowing where concerns exist and quality assurance processes should also extended to identify rogue advisors. Preventing rogue advisers moving between license holders should be seen as a regulatory and industry priority.

Consideration should be given to introducing a requirement to have a reference from the Responsible Manager of the previous licence holder before ASIC approve movements of advisers. This would require a register of all people licence to give advise i.e. employees as well as authorised representatives. All advisors should hold a unique registration number which tracks their employment/advisory history.

The adequacy of licensing arrangements for those who sold the products and services

As previously stated the regulatory structure currently in place is considered an acceptable framework to work to but improvements are required.

Retail client protection could be enhanced if all investment products included an educational guide and assessment process for distributors. This guide should link to the simplified reporting standards recommended. All retail products should be classified as suitable for retail distribution before an AFSL holder could sell the product.

As it is only individual advisors who can sell products and all advisors work for a licence holder, the obligation of assessing the skill of those selling products sits with the licence holder. While an individual advisor should ensure they understand the product they are selling it is the licence holder's responsibility to ensure that all advisors **do** understand the product before selling it.

Whether individual licence holders are capable of adequately determining whether their advisors understand a product fully is questionable. Therefore, the annual external audit review should include reviewing advisors for competency in relation to the products they have sold.

Given the complexity in current investment products and the investment strategies underlying the investments within the product, it should be incumbent on the product provider to provide a *Distributors Product Guide* that contains sufficient information to fully educate sellers of the product and an assessment process to assist licence holders confirm that their advisors are appropriately trained and skilled to sell the product.

The investment guide should link to the product summary guide recommended in this submission. The product guide would summarise the product being offered against a range of key characteristics including liquidity, on-going financial commitments, fees, volatility of investment strategy, counterparty risk, ownership structure and entitlements, investment protection and risk.

The aim of the model described above is to ensure product creators are more accountable for fully explaining their product and risks attached to their product as well as implementing an appropriate training and assessment process for sellers of their product.

A product provider cannot be held accountable for a licence holder failing to educate their distribution network if appropriate educational and training material was provided.

The role of banks and other organisations including industry and regulatory bodies that elected to turn a blind eye or not investigate the quality of performance of their distribution networks or industry participants must also be reviewed and addressed.

A better process for grievances or concerns to be presented to the regulator is required. The regulator should be given sufficient resources to perform a speedy investigation; assessment and either implement corrective action or implement monitoring procedures to address any concerns. Action and leadership is required.

The appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served

While the issue of appropriateness is individual to each consumer it is clearly apparent from the losses encountered that many consumers (and advisors), despite ample disclosure, failed to understand the risk inherent in their investment products and or strategies. Whether this is because the advisors were effectively product sales people as distinct from genuine financial advisors should be investigated. I support the call to distinguish product sales people from genuine financial advisors.

While a significant task, I recommend a standard client reporting framework is also created and implemented. The framework is intended to ensure consistency in disclosure and interpretation. Implementing a national standard would assist in improving the financial literacy in the community. The framework should be linked into the education system to ensure financial skills and awareness is acquired as early as possible. The framework would be subject to annual updates following a consultative process with all stakeholders. ASIC would administer the reporting framework.

Hindsight reviews are ineffective unless lessons are learnt and corrective action put in place. A more holistic analysis of wealth creation is required that focuses on ensuring that all structural and investment decisions for a client are appropriate for that client given their particular circumstances and effectively communicated to the client. Appropriateness is largely dependent on a clients risk tolerance, assessed by conducting risk profiling and comparing to guidance on acceptable risk levels for various income and capital levels. This step should be an essential part of the summary client reporting framework recommended. Reporting a risk weighted returns should also be compulsory.

It should also be accepted that in some cases not all financial services provided to a client are provided by one advisor and that some clients may elect to withhold certain information from their advisors. In these circumstances it is not feasible to hold an advisor accountable for outcomes beyond their knowledge and control, provided the advisor attempted to extract the basic information required for the standard reporting framework and the client has advised that they have failed to provide all the required information.

If a national insurance fund is established clients should be made aware that unless they provide adequate information to an advisor to make a full analysis of their overall financial position they would only have limited access to the national scheme. Unless an advisor was fraudulent or

misrepresented critical facts that result in a loss, a client should NOT have access to any national insurance fund.

A standard reporting framework is intended to flag when decisions are outside accepted norms or the clients stated objectives. By standardising reporting and terminology and linking to the educating system retail financial literacy should increase. While wealth destruction will not be prevented, however, the frequency and size of negative events should be reduced.

The standard reporting process would also ensure a responsibility exists on advisors to assess the performance of their decisions against 1) the product advertised characteristics and b) the entire portfolio to the clients stated objectives.

Consumer education and understanding of these financial products and services

Financial literacy is a critical skill; however, not everyone may have this view or be prepared to invest the time, energy and money to gain the necessary skill level to make a fully informed financial decision.

While access to simple information should be provided, it is unrealistic to assume education alone will prevent a repeat of the problems we currently face. It is currently too easy for unscrupulous people to hide behind the lack of financial literacy of their clients. Therefore, the providers of financial advice need to be more accountable and quality review processes more effective in eliminating unacceptable practices.

For this reason it is essential retail clients can rely on a professional and an appropriately qualified financial advisor. Advisors must be accountable for maintaining a high degree of skill and adhere to a strict ethical code. Industry bodies and the regulators must ensure relevant and effective continuous education occurs and that harsher penalties on those failing to maintain their skill levels and for those breaching their ethical responsibilities. The regulator and regulatory process needs to be more responsive in addressing breaches.

As stated above, I recommend the introduction of a standard reporting framework. The success of improving financial literacy in the short term is low. However, the proposed framework is intended to ensure consistency in disclosure and interpretation and provide a long-term financial literacy curriculum that can be incorporated into the educational system.

The standard reporting framework should be linked into the education system and available on-line. Over time the community's financial literacy should improve. The reporting framework would be subject to annual updates following a consultative process with all stakeholders. ASIC would administer the reporting framework.

The simple principle of a higher return comes at greater risk must be clearly communicated to the retail client as part of the reporting framework.

A retail investor's risk appetite does not necessarily equate or reflect their risk tolerance. Therefore it is essential the financial advisor must conclude on the risk tolerance of a client and make appropriate structural and investment decision, then continue to monitor these decisions against original objectives and changing circumstances.

As discussed above, given the complexity in current investment products and the investment strategies within a product, it should be incumbent on the product provider to provide a *Distributors Product Guide.* This guide

should contain sufficient information to fully educate sellers of the product and provide an assessment process to assist licence holders confirm that their advisors are appropriately trained and skilled to sell the product. This document and assessment process should also be made available to clients.

The investment guide should link to the product summary guide (recommended in this submission) and address a range of key characteristics including liquidity, on-going financial commitments, fees, asset allocations, volatility of investment strategy, counterparty risk, ownership entitlements and protection, risk and protection strategies utilised.

The adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers

I am not in a position to provide any significant feedback in regards to this point due to the unique nature and application of Professional Indemnity arrangements to each AFSL holder. I imagine many policies would not be activated if it is found that the AFSL holder failed to maintain and apply an effective compliance regime.

Changes suggested such as imposing a levy on AFSL holders to cover the exposure from rogue advisors while simple in their application fail to address underlying problems and implement corrective solutions and unfairly penalise those AFSL holders and advisors meeting their obligations.

While it is essential to ensure any PI insurance is capable of meeting the exposure faced by the retail client from inappropriate advice, mass retail exposure, like those seen with Storm & Chartwell, the focus should be too identified and prevent these events occurring rather than rely on insurers.

The need for any legislative or regulatory change

The current framework is adequate but needs refining to address observed deficiencies and lack of accountability.

Key areas of regulatory change include

- The regulator (following industry consultation) should be empowered to promote (a standard simplified "Summary product reporting framework" including standard terms and conditions within a PDS. Adherence to these standards should be voluntary or non-adherence results in the product not being suitable for a retail investor.
- Legislation should focus on the obligations of advisors to report to a standard simplified "retail client reporting framework". The framework would be developed by the regulator (following industry consultation) to ensure retail clients are informed of overall structural and risk matters in a consistent format. Areas to address include: risk profile, protection and investment profile by asset allocation and risk/reward.
- There should be a clear separation of fees/advice into a) structural financial advice b) investment advice c) risk advice d) superannuation advice and e) services including administration and platforms. Internal procedures, compliance and regulatory reviews should monitor the application of these fundamental distinctions.
- As part of the financial literacy of retail clients the regulator should publish a guide to fees. i.e. standard service/fee schedule by region. The aim being to educate retail clients on appropriate services available and fee expectations.
- Each aspect of the financial advisor service should be grouped and fees charged identified minimum criteria include – licence/dealer group fee, structural advice, platform access, investment advice, performance fee advice, administration services.
- The legal impediment (in particular obligations imposed by AML and Privacy laws) preventing each AFSL holder being able to rely on each other's compliance with their licence (which is subject to annual audit and certification) results in enormous duplication and is a barrier to competition. Retail clients and advisors are reluctant to implement change due to the administrative burden imposed. It would be in the interest of all retail clients if, ALL client data, following client instruction, could be transferred electronically amongst other AFSL holders upon request.
- Enforce the adoption of Global communication standards. Legislative changes to enforce technology functionality and capabilities. Changes would require all retail products and services to adhere to one or more global communication standards would provide greater transparency, speed, accuracy and completeness. Compliance to global industry standards like SWIFT, FIX & SWIM will not only assist retail clients but will enhance the industries global reach. Promoting adherence to specific standards would also assist in platform competitions and likely

lead to a reduction in prices as new technology providers would create alternative independent platforms accessing a variety of products.

In conclusion I believe any changes should be focussed on building a more collaborative and holistic investment advice process and communication framework that promotes financial literacy & transparency. This holistic approach and the communication framework should be linked to the education system so as to, over time, ensure the country builds a more robust financial system that provides all individuals a greater chance of achieving financial security and independency.

The adoption of global electronic communication standards and ensuring the sharing of client data amongst AFSL holders would lower the cost of delivery for the client and encourage greater completion through facilitating client choice. Both these matters could be addressed prior to the inquiry concluding on some of the other more structural changes recommend in this submission.

Appendix I - BIO David Fotheringham

Independent strategic consultant
DJ & MD Consulting
"Execution By Design"
4 George St Camberwell VIC 3124

Qualifications

B.Business Accountancy - RMIT
Chartered Accountant
Graduate Diploma in Applied Finance
PMP – Project Management Professional
Graduate Diploma in Corporate Governance
Former Responsible Executive for Tolhurst Ltd

Memberships

Institute of Chartered Accountants Australia
Institute of Company Secretaries
Project Management Institute
Securities, Derivatives Industry Association (SDIA)
FINSIA

Employment History

Current	Independent Consultant
April 05 – April 09	Director & COO Tolhurst Ltd – Stockbrokers & Financial Planners
Sept 04 – April 05	Independent Consultant (Aust)
Aug 98 – Sept 04	Independent Consultant (UK) - London Major Clients The Economist BBC Worldwide BBC World Webgravity Xecutive Recruitment IBnet Safehouse International

Prior to Aug 98

AUSDOC Group Ltd – Group Financial Controller
Meyrick Webster Chartered Accountants –
Manager (currently part of HLB Mann Judd)
Coopers & Lybrand – Senior Accountant
– Audit & Micro Computers (currently part of PriceWaterhouseCoopers)