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Senate Standing Committees on Economics
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Parliament House
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10 March 2017

Dear Senators,

AFA Submission – Consumer protection laws framework in the financial services sector

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are required to be practising financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

Summary of the AFA's position

Consumer protection laws in the financial services sector have changed substantially over the last decade. The most significant reforms have been the implementation of the Future of Financial Advice (**FoFA**) laws and the National Consumer Credit Protection (**NCCP**) laws which have respectively raised the standards and administration requirements of financial advice and credit advice provided to Australians. The Australian Consumer Law reforms tightened up deficiencies in trade practices and the *Privacy Amendment (Enhancing Privacy Protection) Act 2014* brought our system of protecting the privacy of Australians into a technologically accelerating age.

Several governmental and non-governmental agencies have been established or augmented in the last decade to complement the Australian Securities and Investments Commission (**ASIC**) to monitor and enforce the consumer protection laws. These have included:

- the merger of several industry dispute resolution schemes to form the Financial Ombudsman Service (**FOS**);
- the enhancement of the Credit and Investments Ombudsman's powers and jurisdiction;
- the Tax Practitioners Board (**TPB**) overseeing the regulation of the tax consequences of financial advice;
- the creation of the Office of the Australian Information Commissioner (**OAIC**); and
- the enhancement of the powers and jurisdiction of the Australian Transaction and Reporting Centre (**AUSTRAC**).

The result is that Australia has some of the most rigorous regulation, policing and protections of consumers of financial and credit services in the world. The AFA supports high standards of consumer protection because without consumers of financial services, there can be no demand for financial advice. As the AFA's vision is *great advice for more Australians*, the AFA has led and continues to support the raising of professional standards to complement consumer protection laws. The AFA has established several communities of practice to help our Members develop high standards of financial advice that exceeds the minimum legal requirements.

As with any reform, there have been unintended consequences that have resulted and some gaps in consumer protection laws and framework remain. These gaps include:

- the current inability for ASIC to intervene in financial product issuance and distribution for reasons beyond disclosure breaches;
- inconsistent historical funding and resources for ASIC to monitor and enforce the laws;
- conflicted remuneration bans do not apply to some services or products in the banking and institutionally-aligned sector;

- inconsistent application of FoFA laws by large institutional licensees; and
- the inability for ombudsman schemes to provide compensation to consumers where the financial services provider has entered administration or insolvency.

Most of these gaps and inconsistencies have begun to be addressed by ongoing reform measures, including:

- Treasury's proposals to:
  - establish an Industry Funding Model for ASIC;
  - enhance financial product design and distribution obligations; and
  - give ASIC greater intervention powers over financial products;
- ASIC's proposals and guidance around:
  - risk management requirements of managed investment scheme operators;
  - client review and remediation programs; and
  - regulation of innovative financial services (fintech); and
- recent moves to:
  - establish a compensation scheme of last resort; and
  - address remuneration in retail banking.

The AFA is contributing, or has recently contributed, to those consultations. The AFA does not support a compensation scheme of last resort.

In addition to the above-listed gaps and inconsistencies, the AFA considers that there are a number of other areas that require further consideration or interim implementation to better protect consumers in the financial services sector and accordingly outline recommendations below for the Senate Committee's attention.

Particular recommendations of the AFA

The AFA considers that to better protect consumers of financial services in Australia, the following measures should be implemented by the Federal Government:

1. Extend unfair contract terms laws to life insurance contracts;
2. Provide the necessary funding to implement the Australian Law Reform Commission's (**ALRC's**) recommendations about how to better protect older Australians;
3. Mandate a wider application of the Life Insurance Code of Practice to ensure consistency with community standards;
4. Review wholesale client thresholds to ensure consistency with contemporary income and wealth levels;

5. Conduct a financial impact study of the Ramsay Review's preliminary recommendations to merging FOS and CIO, establish a Superannuation Ombudsman Scheme and raise jurisdictional limits;
6. Extend the ban on conflicted remuneration beyond just financial advice to retail clients;
7. Refer to the ALRC the issues of unpaid Determinations, corporate phoenix activity and the effect of director's duties on unpaid determinations; and
8. Require life insurers to underwrite all life insurance products at the time of application instead of at the time of claim.

The AFA is committed to supporting improvements in these key areas and considers that these reforms need support from the Government as a matter of priority to ensure that the standard of protection to Australian consumers is improved. While the current consultations and the research / reviews recommended in this submission are conducted, the AFA also recommends that immediate protection could be extended to Australian consumers if the following were done:

- Review the wholesale client net assets test and product value / price test to consider the quantum that they should be had indexation been applied to the original thresholds when they were introduced sixteen years ago;
- Grant ASIC the ability to vet and approve any financial product that intends to be classified as a wholesale product and anything that classifies itself as an 'alternative investment / asset class';
- Define real property as a presumed class of financial product that can be rebutted where the property is a principal place of residence or owner-operated business, which would bring any property investment scheme – whether commercial or residential – into the ambit of ASIC;
- Require real estate agents who deal in investment properties to hold an Australian Financial Services Licence and thereby come under the watch of the same regulators (ASIC and the TPB) that financial advisers and accountants are policed by;
- Remove the exempted services exclusions for accountants under Corporations Regulation 7.1.29 to ensure that all dealings with superannuation are captured by the same rules that apply to financial advisers; and
- Overturn the previous exemptions on the ban on conflicted remuneration for basic banking products, general insurance, consumer credit insurance products and general advice about certain products.

Approaching consumer protection reform in a holistic manner is necessary to protect consumers. Failure to do so may leave gaps in the consumer protection framework for misconduct to operate in.

The reasons why the AFA recommends the above-listed changes are as follows.

Extend unfair contract terms to insurance contracts

Unfair contract terms should statutorily be extended to life insurance contracts. This is a long overdue gap in the consumer protection framework, which was begun, but not resumed, either side of the 2013 Federal Election. The Productivity Commission recommended it in 2008 and in 2009 the Senate Economics and Legislation Committee recommended the same, noting that consumers are not provided with adequate protection in insurance contracts under existing law.[1]

The differential cost of policy premiums for individual policies is not a justification for not subjecting standard form policy series contracts – especially group insurance and default superannuation held insurance – to this important consumer protection measure. Surely insurers should be subject to the same consumer protection laws that apply to all other consumer goods and services.

The AFA accordingly recommends the Federal Government re-open the previous attempts to extend unfair contracts terms to life insurance policies. This is a glaring gap in the Australian Consumer Law and should be rectified without delay to ensure that consumers have greater negotiating ability about how their lives are protected.

Implement the Law Reform Commission's elder abuse protection proposals

In December 2016, the Australian Law Reform Commission issued a Discussion Paper outlining a series of interim recommendations on how to better protect older Australians. Several of the AFA's recommendations to the ALRC were captured in the Commission's proposals, which in a financial services sector consumer protection context included:

- Developing a National Plan to address elder abuse;
- State and territory public advocates or public guardians should be given the power to investigate elder abuse where they have a reasonable cause to suspect that an older

[1] Senate Economics Legislation Committee Report on *Trade Practices Amendment (Australian Consumer Law) Bill 2009*, paragraphs 10.8-10.14.

person is unable to protect themselves from the abuse or neglect, or the risk of it because of care and support needs;

- In responding to the suspected abuse or neglect of an older person, public advocates or public guardians may refer the older person or the perpetrator to available health care, social, legal, accommodation or other services assist the older person or perpetrator in obtaining those services;
- Any person who reports elder abuse to the public advocate or public guardian in good faith and based on a reasonable suspicion should not, as a consequence of their report, be:
    - liable, civilly, criminally or under an administrative process;
    - found to have departed from standards of professional conduct;
    - dismissed or threatened in the course of their employment; or
    - discriminated against with respect to employment or membership in a profession or trade union.
- A national online register of enduring documents, and court and tribunal orders for the appointment of guardians and financial administrators, should be established, and the making or revocation of an enduring document should not be valid until registered;
- State and territory governments should introduce nationally consistent laws governing enduring powers of attorney (including financial, medical and personal), enduring guardianship and other substitute decision makers;
- Enduring attorneys and enduring guardians should be required to keep records, and enduring attorneys should keep their own property separate from the property of the principal;
- The *Code of Banking Practice* should provide that banks will take reasonable steps to prevent the financial abuse of older customers and the *Code of Banking Practice* should increase the witnessing requirements for arrangements that allow people to authorise third parties to access their bank accounts; and
- The witnessing requirements for binding death benefit nominations should be equivalent to those for wills.

The AFA has since made a subsequent submission supporting the Commission's proposals and clarifying some remaining aspects sought by the Commission – particularly about SMSFs, authorised representatives, enduring documents and sureties to protect the elderly. The AFA calls on the Federal Government to also support the Commission's proposals and implement them as soon as possible – including provisioning for the proposals in the 2017 Federal Budget.

Mandate a wider application of the Life Insurance Code of Practice

The Life Insurance Code of Practice was established because it was a commitment required from the FSC as one element of the package of reforms contained in the Life Insurance Framework (LIF) negotiated between the Minister, the FSC, AFA and Financial Planning Association (FPA) in November 2015.

As we outlined to the FSC in our submission on the draft of the Code, this Code could represent a catalyst to form a new culture within insurers; one that positions the consumer's health and wellbeing alongside sustainable financial performance and therefore restore the social licence granted to life insurers to protect Australian's families when they are at their most vulnerable. To address the under-insurance problem in Australia, people need to trust insurers to be fair and reasonable. A Code could be the vehicle to restore this trust and social license – provided the Code is constructed to hold insurers to account for their commitments to consumers' best interests. The Code must be updated to capture these commitments.

Whilst some of the AFA's recommendations were captured in the Code, the Code does not require enough of life insurers to clearly provide a commitment to winning back their social license and community trust. Further, it ignores the interaction between insurers, financial advisers and the end client. As 50% or more of Australia's life insurance is arranged through the expert advice and support of financial advisers, the Code needs to include commitments to consumers and the financial advice profession. The commitments to consumers are as yet insufficient in substance to drive cultural change; and the role of the life insurance advice profession has been ignored.

This Code needs substantial improvements before it can achieve the intent with which it was promised. A review of the Code has been scheduled to take place by July 2019 and the AFA has been invited to be involved. If the Code is not improved shortly after the review to ensure a comprehensive application and to restore insurer's social licence by delivering improvements in insurer practices, the AFA considers that the Government should consider intervening and develop a statutory Code to replace the industry initiated code. A statutory Code is going to be part of the standards that financial advisers are required to comply with in future under professional standards reforms and should the insurer cohort not improve protections voluntarily, they too should be subject to a statutory Code like advisers will be.

Review wholesale client thresholds

Advisory and dealing financial services to SMSF trustees are subject to retail client and wholesale client thresholds under sections 761G, 761GA of the Corporations Act 2001 and the associated Corporations Regulations 2001.[2] As noted by ASIC in Media Release 14-191MR[3] there are some particular legal uncertainties about the application of the net assets test thresholds when dealing with and advising on SMSFs. ASIC has given guidance that a person can "make their own commercial decisions" whether an SMSF is classified as a retail client based on the $10m net assets test under section 761G(6)(c)(i) or the lower general net assets test of $2.5m net assets under section 761G(7)(c)(i).

Advice firms and accounting practices have developed differing guidance to their representatives about when an SMSF must be considered a retail client. This has resulted in differing practices about when SMSF trustees are provided with Statements of Advice, when compliance with the Best Interests Duty is required, give general advice warnings, provide appropriate financial advice and prioritise the SMSF trustee's interests when dealing with an SMSF.[4] If an advice firm's or an accounting practice's policy is to apply the general net assets test, all SMSFs with net asset above $2.5m do not get the benefit of these protections. Further, and as confirmed by ASIC in MR14-191, SMSFs classified as wholesale clients gain access to a wider range of investments – including in particular those considered too risky for protected retail clients to invest in as they are only available to wholesale clients.

This issues goes back beyond 2014. As referred to in the ASIC Media Release, a 2011 Treasury options paper called *Wholesale and retail clients: Future of financial advice*[5] acknowledged confusion about how the wholesale investor tests applied when providing financial services to superannuation trustees. ASIC also stated that it was aware of general uncertainty in the market about when a financial service relates to a superannuation product, and in particular SMSFs. The

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[2] Regulations 7.1.28, 7.6.02AA, 7.6.02AB, 7.6.02AC and 7.6.02AD of the *Corporations Regulations 2001.*

[3] Media Release 14-191MR, *Statement on wholesale and retail investors and SMSFs*, Australian Securities and Investments Commission (issued 8 August 2014), available at http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-191mr-statement-on-wholesale-and-retail-investors-and-smsfs/

[4] Respective to the order of requirements listed in the paragraph above, sections 946AA (SoA), 961B (Best Interests Duty), 961G (appropriate advice), 961J (priority rule) and 949A (general advice warnings) of *Corporations Act 2001* only apply to financial services provided to retail clients. Once an SMSF client is categorised as a wholesale client – whether by the $2.5m or the $10m net assets tests under section 761G(6)(c)(i) or 761G(7)(c)(i) respectively, the provider of the service no longer has to comply with those provisions.

[5] See paragraph 2.6, *Wholesale and retail clients: Future of financial advice,* Department of Treasury, (issued January 2011) available at http://futureofadvice.treasury.gov.au/content/consultation/wholesale_retail_op/downloads/wholesale_and_retail_options_paper.pdf

AFA considers these uncertainties and confusion to be exposing elderly Australians to predatory conduct by people who seek to exploit their wealth without being required to provide the same level of consumer protections that licensed financial advisers must.

Review unpaid Determinations, corporate phoenix activity and director's duties

Over the past decade, many financial advisers have been held to be responsible for large portions of consumer losses where the loss was as a result of a financial product failure (e.g. agribusiness, Westpoint, and several MIS schemes). Part of this is due to a lack of recognition of the difference between a failure of product and a failure of advice within Ombudsman Determinations which in turn discourages a better understanding and application of contributory negligence principles in determining awards of compensation as well as the elements of causation, such as proximate causation and ultimate causation.

Whilst some financial advisers acted inappropriately when advising clients to invest in managed investment schemes, so too did many accountants who have avoided a similar requirement to compensate their clients. The dispute resolution framework failed those people. Likewise, for the self-invested who attended seminars held by the representatives of the failed schemes. When the schemes were legally allowed to enter liquidation without any intervention by ASIC prior to collapse or during, the Directors of those schemes largely escaped convictions prosecuted by the regulators and also avoided compensation claims by investors.

The AFA supports the principle of external dispute resolution and in many cases Ombudsman Determinations are correctly decided and consumers equitably compensated. As highlighted by the Financial Ombudsman Service in the 'Unpaid Determinations' Circulars published for the last couple of years, Ombudsman Determinations are not always able to be enforced against financial services providers. Further, there has never been a financial impact analysis or an assessment of how Ombudsman scheme jurisdictional limits affect the accessibility of financial advice. These unintended consequences of the dispute resolution regime show that gaps and inconsistencies exist in the consumer protection framework.

The corporations law system makes it too easy for the directors of licensees to choose non-compliance with Determinations – incentivising directors of licensees to elect to place their company into administration despite a rigorous investigation and finding of misconduct by an Ombudsman scheme about the actions of representatives of the licensee.

The scheme of last resort should be a measure of last resort – or a final measure – after other options that contribute to the unpaid determination outcome have been explored and rectified. Failing to do so will result in a significant moral hazard risk arising where:

- Ombudsman schemes continue to place liability for failed products at the feet of any involved financial adviser, or at least allow pursuit of them to such an extent that even if the claim against them fails they are liable for substantial costs defending the action;
- Directors of licensees may place liquidation as a higher priority when a determination does not go in their favour knowing that the bill will be picked up by the compensation scheme of last resort; and
- Those same licensees will resurrect their companies from liquidation with the same address, same directors, same clients and the assets of the failed company but none of the liabilities.

To avoid these practices continuing, the AFA recommends that the Australian Law Reform Commission (**ALRC**) be tasked with researching possible changes to the *Corporations Act 2001* that could:

- restrict licensees entering liquidation specifically to avoid paying an award of compensation;
- place conditions upon directors' limited liability rules to place a more direct obligation upon directors who put their companies into liquidation whilst an Ombudsman case is open or Ombudsman scheme award of compensation has been made, and
- examine how to effectively prevent phoenix companies re-joining the same or a different Ombudsman scheme as well as the general issue of regulatory approval for phoenix activity.

The AFA considers that these three areas contribute to the problem of unpaid Determinations because it is far too easy for recalcitrant directors of licensees to hide behind their fiduciary duty to their shareholders whilst disregarding their licencing requirements and conditions. These recommendations seek to prevent the recurrence of historical examples where managed investment schemes, financial planning practices, mortgage brokers and other licensees place themselves into voluntary administration only for a similarly named or located and managed company to take over their customers and re-join the same or another EDR scheme.

The AFA supports the ALRC being given the task of investigating structural contributors to unpaid Determinations as well as exploring other options to mitigate against the risks of unpaid Determinations. The AFA considers that there may be changes to directors' duties and liability available as well as widening administrators' and regulators' powers to be explored in order to prevent companies with open Ombudsman disputes from choosing non-compliance, as well as to mitigate the risk of further managed investment schemes choosing liquidation over investor's rights.

Whilst we acknowledge this may be seen as a departure from corporate law doctrines, the AFA considers there is a public benefit in exploring the elements that present financial services companies from entering voluntary administration where there are open disputes or unpaid Determinations or where managed investment schemes have been mismanaged. We are not proposing that all voluntary administrations be subjected to the same rules or investigation, nor that this extend into other industries at this point – just in relation to the specific problems of unpaid Determinations and failed managed investment schemes.

The AFA seeks to ensure that a holistic approach is taken to the problem of unpaid Determinations before any further consideration is given to the proposed compensation a scheme of last resort. The integrity of the dispute resolution system absolutely requires compliance with awards of compensation that have been fairly and independently determined.

Another consideration with the compensation scheme of last resort proposals is the effect such a scheme may have on the accessibility of quality financial advice. Although licensees would likely bear the initial cost of the compensation scheme, the costs will more likely than not flow down the chain raising costs across all licensees, practices and ultimately affecting the accessibility of quality financial advice. At a time when costs for financial advice are rising due to professionalisation, an industry levy to fund ASIC is imminent and other regulatory pressures are creating costs, any decision on a compensation scheme of last resort should be made only after thorough consideration of the contributing factors to unpaid determinations.

The impact of merging FOS and CIO, establishing a Superannuation Ombudsman Scheme and raising jurisdictional limits

Related to the above proposal, the AFA is cautious about proposals to merge FOS and CIO, to establish a Superannuation Ombudsman Scheme in replacement of the existing tribunal and to raise the jurisdictional limits of the end-schemes. The AFA supports alternative dispute resolution framework and has made a number of recommendations for improvements in the existing scheme, such as:

- Establishing an independent process to set jurisdictional monetary caps and limits;
- Requesting the ALRC to review the practice of splitting claims at Ombudsman schemes;
- Creating guidance for 'fair in all the circumstances' decisions for Ombudsman schemes to adhere to;

- Introducing a summary decision process for fee disputes that gives fair hearing to disputes about fees less than the current case cost of $3,000; and
- Establishing a Determination review system with limited grounds for review with cross-jurisdictional functions to ensure procedural fairness is applied to all participants in that part of the consumer protection framework.

The AFA considers that these are measures that could be explored before going down the costly path of creating a whole new system with new challenges and new unintended consequences. While those measures are implemented and given time to show their effectiveness, the AFA recommends the Federal Government assess the financial impact of the proposals to merge schemes, create new schemes or raise jurisdictional limits.

The AFA is particularly concerned about the issue of raising jurisdictional limits affecting the future accessibility of quality financial advice. Whilst the large institutional advice licensees are permitted to 'self-insure' under ASIC's Regulatory Guide 126 and section 912B of the *Corporations Act 2001*, everyone else needs to take out 'adequate' professional indemnity insurance (otherwise known as PI).

PI must cover Ombudsman compensation award caps. The average annual PI premium cost for a self-licensed financial adviser is currently about $5,000 to $15,000. If Ombudsman awards go up, so will PI premiums. That's a simple fact of insurance – raise the level of potential liability for the insurer and the cost increases as well.

As PI premiums are an overhead of advice firms, the cost of operating under higher jurisdictional limits will ultimately be borne by advised clients. Raise the cost of providing advice too much (which we know will already be affected by the proposed ASIC Industry Funding model, increasing professional standards costs, increasing compliance costs and the costs associated with any compensation scheme of last resort) and you risk that the people who need financial advice most will not be able to afford it. This raises the spectre of possibility that accessibility to Ombudsman dispute resolution services may become more for the wealthy as wealthy people will only be able to afford to engage financial advisers in future.

The AFA is working to ensure the continued provision of great advice for more Australians. AFA Members are working together to re-design business models and adapt to the future of financial advice. Our communities of practice continue to be a leading forum for exchange of ideas and to raise the standard of advice above the minimum legal requirements. Without a proper assessment of the impact of the already-begun and proposed reforms – including the Ombudsman scheme proposals – and especially the impact on future accessibility of advice, the Federal Government risks that the reforms will narrow the benefits of advice to only the wealthy and unnecessarily place strain upon the federal purse.

The AFA supports strengthening consumer protections and we have made a number of recommendations to do so. Unless that strengthening is approached holistically and with appreciation of the consequences, the risk is that consumer protection will change in nature from a public benefit to a private one – and be available to only those who can afford to engage in the first place.

The ban on conflicted remuneration is not comprehensive which presents an incentive for misconduct

Some of these issues discussed immediately above should theoretically be addressed by the FoFA laws ban on financial product issuers being able to offer conflicted remuneration, and the trend in the institutional and listed managed investment scheme has followed the new requirements. No retail investment product providers in the market offer commissions to financial advisers for new accounts and many are gradually – where legally supported to – turning off legacy / trailing commissions.

But this is only one sector of the distribution market – financial advisers (and with limited licensee accountants who recommend products as well). Property spruikers are not captured by the ban on conflicted remuneration; accountants who 'act under the client's instruction' are also excluded; wholesale client advisers and whole product providers are not captured by the same rules that apply to the majority of financial advisers and accountants.

At the centre of the issue is that the ban on conflicted remuneration does not extend to wholesale clients, which as noted above particularly exposes older Australians to operators who engage in wholesale investor schemes. Conflicted remuneration is defined in section 963A of the *Corporations Act 2001* as:

> *any benefit, whether monetary or non-monetary, given to a financial services licensee, or a representative of a financial services licensee, who provides* ***financial product advice to persons as retail clients*** *that, because of the nature of the benefit or the circumstances in which it is given:*
>
> *(a) could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to* ***retail clients****; or*
>
> *(b) could reasonably be expected to influence the* ***financial product advice given to retail clients*** *by the licensee or representative.*

The repeated use of the words retail clients and financial product advice means that – except for life insurance products – conflicted remuneration is only banned where financial product advice is given to a retail client. It is true that a financial product provider must not give (and implicit in that phrase, or offer to give) conflicted remuneration to an adviser or their licensee,[6] but that is only in relation to distribution of a product where financial product advice is given to a retail client. If a wholesale client was advised to purchase an interest in a financial product, the adviser can be remunerated with conflicted incentives such as high commissions.

Further, direct representatives of financial product providers who are authorised to provide general advice about a managed investment scheme or to deal in a financial product can also receive commissions if they can show that:

- all attendees were wholesale clients; or
- that no financial product advice was provided and instead only factual information was provided to the attendees.

Both of these exemptions are currently facilitated through a certification process permitted by:

- section 761G(7)(c) and Regulations 7.1.28 and 7.6.02AF prescribing the use of accountant's certificates of no more than 2 years old certifying a client as a wholesale client; and
- the practise amongst some licensees and unlicensed companies authorising the use of 'Nil Advice Records' or 'Execution-only Acknowledgements' where the investor / seminar attendee signs a document agreeing that they were not provided with any financial product advice and any remuneration flowing from their investment relates to a 'dealing service' or 'information only service'.

The currently permitted 'exempt services' under Corporations Regulation 7.1.29 are also exempt from the ban on conflicted remuneration and the requirement to hold adequate professional indemnity insurance as well as in some cases having to hold an AFS licence. In the AFA's view, these 'exempt services' provide an incentive for accountants to operate on the basis that they are only 'acting under the client's instructions' when dealing with SMSF clients, clouding any assessment of whether financial product advice was provided. This is because evidence such as a 'client instruction sheet' can serve to dispute or rebut any suggestion that the accountant provided a recommendation or any opinion that influenced the client's investment decisions.

In other words, there are loopholes in the law and the licensing system – post-FoFA – that enable conflicted remuneration to be paid to distributors of financial products and establishers of SMSFs when particular people invest their funds under the right circumstances or they can otherwise

[6] Section 963K of *Corporations Act 2001.*

compartmentalise their engagement with the consumer. This is the business model of many property investment seminars which are targeted at higher value clients who 'direct the company' to establish a self-managed superannuation scheme. Whilst this is a business model that ASIC has flagged is under scrutiny[7] and some prosecutions, infringement notices and bans have been successfully issued by ASIC, the practice continues because there are incentives to.

It is possible one of the attractions to the business model is widespread recognition that real property is not itself a financial product.[8] Further, as noted above regarding wholesale client rules applying to SMSFs, there is "*ongoing legal uncertainty about when a financial service relates to a superannuation product*"[9] and "*the confusion about how the wholesale investor test applie[s] in the context of superannuation trustees.*"[10]

Whilst these ambiguities in the financial services laws exist – especially the wholesale client thresholds – and the inconsistencies between the licensing regimes of real estate agents, accountants and financial advisers continue, consumers will be at risk of predatory fringe dwellers like Century 21, Jamie McIntyre, Westpoint, dividend stripping schemes, 'tax free' SMSF retirement schemes, personal services income schemes that use SMSFs, and other operators who ASIC and the ATO is currently pursuing. The AFA considers that it is better for the public that these operators should not even be allowed to operate in the first place, rather than have to be shut down through lengthy surveillance and enforcement processes after people have already been burned.

One way to immediately act on these issues is to shut down the incentives that attract the fringe dwellers to operate such schemes in the first place. The AFA's recommendations about how the Federal Government can do this are:

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[7] See *ASIC goes undercover to expose property spruikers*, Australian Financial Review (16 February 2017), available at http://www.afr.com/real-estate/asic-gets-tough-on-unlawful-property-spruikers-20151126-gl8fuf and *ASIC gets tough on unlawful property spruikers*, Australian Financial Review (6 December 2015), available at http://www.afr.com/real-estate/asic-gets-tough-on-unlawful-property-spruikers-20151126-gl8fuf

[8] Australian Securities and Investments Commission, Information Sheet 216 (issued December 2016) available at http://asic.gov.au/for-finance-professionals/afs-licensees/applying-for-and-managing-an-afs-licence/limited-financial-services/afs-licensing-requirements-for-accountants-who-provide-smsf-services/

[9] See paragraph 2.6, *Wholesale and retail clients: Future of financial advice,* Department of Treasury, *(January 2011)* available at http://futureofadvice.treasury.gov.au/content/consultation/wholesale_retail_op/downloads/wholesale_and_retail_options_paper.pdf

[10] Australian Securities and Investments Commission, Media Release 14-191MR, *Statement on wholesale and retail investors and SMSFs*, (issued 8 August 2014), available at http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-191mr-statement-on-wholesale-and-retail-investors-and-smsfs/

- Review the wholesale client net assets test and product value / price test to consider the quantum that they should be at had indexation been applied to the original thresholds when they were introduced 16 years ago;
- Grant ASIC the ability to vet and approve any financial product that intends to be classified as a wholesale product and anything that classifies itself as an 'alternative investment / asset class';
- Define real property as a presumed class of financial product that can be rebutted where the property is a principal place of residence or owner-operated business, which would bring any property investment scheme – whether commercial or residential – into the ambit of ASIC;
- Require real estate agents who deal in investment properties to hold an Australian Financial Services Licence and thereby come under the watch of the same regulators (ASIC and the TPB) that financial advisers and accountants are policed by;
- Remove the exempted services exclusions for accountants under Corporations Regulation 7.1.29 to ensure that all dealings with superannuation are captured by the same rules that apply to financial advisers; and
- Overturn the previous exemptions on the ban on conflicted remuneration for basic banking products, general insurance, consumer credit insurance products and general advice about certain products.

These interim measures will protect consumers better than the current enforcement regime is doing. More importantly, it will protect consumers while:

- the ALRC completes a review of director's duties, corporate phoenix activity and the effect of both on unpaid determinations;
- the various proposals around merging or creating ombudsman schemes are fully investigated; and
- ASIC's product intervention powers are expanded.

Failure to implement the above recommendations will result in piecemeal protections and likely result in unintended consequences and loopholes remaining.

Implementing these changes will not prevent mums and dads and other people investing into the property market or acquiring other investments. Instead, it will ensure that the agents and other people who those investors transact through or engage with will be required to all act under the same rules.

Underwrite all life insurance products at the time of application

It is absolutely clear that the best way to reduce the risk of a policy not paying out at claim time is to see a financial adviser to arrange life insurance needs. It will take longer to put the insurance in place because it will be carefully underwritten in line with the consumer's individual medical and family history before it is offered to them. This gives consumers greater certainty that they are covered if they have a claim.

However, not everyone obtains insurance through a financial adviser. The AFA supports the rights of consumers to choose their purchasing channel; but this must be an informed decision if it is to be fair for the consumer. Most people do not know that at claim time if a direct insurer determines you had health issues back when you purchased the policy – or even in the years before – they may only refund the premiums and not pay out the insurance benefit.

The AFA considers it unconscionable that the family of a person who held a direct or group life insurance policy can have the claim denied because of a failure of the insurer to investigate the person's medical history at the time they applied for the insurance. Whilst the AFA acknowledges that direct and group insurance policies to varying degrees of prominence disclose that the insured has a duty to disclose pre-existing or historical medical issues, many consumers would not know the level of detail required to not be captured by exclusions on their policies.

Nor would it be fair to expect consumers to know what an underwriter would class as serious or not serious. Most people would not feel they would have to declare some issues if they no longer suffered from them or had recovered from them in the past – and mental health is an example of people downplaying, and insurers inflating, the importance of past mental health issues. Because of the ability to go back and underwrite from the time someone started to buy the policy, and even years before, consumers are not aware they may not be covered and the AFA thinks this is unfair and unreasonably weighted in favour of the insurer.

This is a serious gap in the consumer protection framework and should be rectified by insurers in order to restore their social licence. It should not be permissible to bypass underwriting at commencement of a policy, deferring it to the time of claim, consumer confidence and trust in life insurance.

It is critical to ensuring the integrity of the system that consumers rely upon in their times of need that underwriting at application be extended to all insurance contracts. Continuing failure to do so has downstream implications for government social support and health systems as well as for the integrity of the consumer protection framework.

Concluding comments

The AFA considers the Australian consumer protection regime to be one of the most robust and rigorous in the world, largely as a result of recent reforms to financial advice laws, credit advice laws, tax advice las, trade practices, and privacy. Those reforms have built upon a legacy of improvements to dispute resolution, financial transaction reporting and stronger disclosure requirements. Whilst these form a strong framework to protect Australian consumers of financial services, more can be done to fill the gaps that time has revealed.

The AFA recommends that further reform of consumer protections requires a holistic approach involving a mixture of immediate statutory amendments, some short term reviews to review the consequences of ongoing proposals for change and better regulator resourcing. The AFA considers these reforms necessary to deliver on the economic benefits that Australia's largest sector can provide to the economy.

If you require clarification of anything in this submission, please contact us on 02 9267 4003.

Yours sincerely,

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