Chapter 5

Issues raised during the inquiry

5.1 Before outlining specific regulatory concerns the committee examines two broad issues behind the debate on the regulation of financial products and services. The first relates to the industry's historical beginnings, particularly the emergence of financial advisers as a sales force for product manufacturers, which is a legacy potentially inconsistent with contemporary expectations that financial advisers provide a professional service that meets their clients' best interests. The sales-advice conflict frames the committee's later examination of the effect of sales imperatives on the quality of financial advice, and whether the current regulatory framework needs to better reflect the expectation for professional, unbiased conduct in the industry.

5.2 The second broad issue concerns the question of whether advice about financial products, or the financial products themselves, are responsible for poor investment outcomes. This question is important because the answer dictates whether the focus of regulation needs to be on improving the quality of financial advice, or identifying and restricting the sale of poor financial products.

5.3 The committee then canvasses various claims about deficiencies in the current regulation of financial product advice, principally with the conduct and disclosure-based approach to managing conflicts of interest. There were also contributions critical of the minimal competency requirements of the licensing regime; a lack of regulation over margin lending; and deficiencies with professional indemnity (PI) insurance as a consumer compensation mechanism. Suggestions for reform stemming from these concerns are contained in Chapter 6.

5.4 The alternative view that the content of the regulatory regime requires little or no change is also discussed in this chapter. Those advocating this position called for recent problems in the financial services industry to be put in perspective, claiming that inadequate regulatory enforcement has been responsible for failing to protect investors from rogue elements giving poor financial advice, rather than the entire regulatory system failing consumers.

5.5 Finally, the committee notes concerns about poor financial literacy amongst consumers and discusses the extent to which the regulation of financial product advice should intervene on this basis.

A sales or advice industry?

5.6 The financial advice industry has significant structural tensions that are central to the debate about conflicts of interest and their effect on the advice consumers receive. On one hand, clients seek out financial advisers to obtain professional guidance on the investment decisions that will serve their interests, particularly with a view to maximising retirement income. On the other hand, financial advisers act as a critical distribution channel for financial product manufacturers, often through vertically integrated business models or the payment of commissions and other remuneration-based incentives.

5.7 Australian Securities and Investments Commission (ASIC) noted the historical basis for the links between manufacturers and advisers:

> Remuneration of distributors of financial products was historically set by the product manufacturer. It was based on the value of products sold and deducted from the amount paid by the consumer for the product. These remuneration settings encouraged product distributors to sell certain products.
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> As the market for financial advice services has grown, the historic connection with product manufacturers and this remuneration structure has conflicted with investors' needs for quality unbiased advice and their perception that this is what financial advisers provide.[1]

5.8 ASIC described the industry as still being characterised by its distributive function:

> Today financial advisers usually play a dual role of providing advice services to clients and acting as the sales force for financial product manufacturers. Approximately 85% of financial advisers are associated with a product manufacturer, so that many advisers effectively act as a product pipeline. Of the remainder, the vast majority receive commissions from product manufacturers and so have incentives to sell products ... This structure creates potential conflicts of interest that may be inconsistent with providing quality advice and these conflicts may not be evident to consumers.[2]

5.9 The conflicts of interest inherent in these arrangements are currently subject to disclosure and conduct regulation that seeks to manage these conflicts and protect investors from poor advice, while maintaining market efficiency (see paragraph 2.2). The regulatory framework has not compelled the industry to shift from acting as a distribution network to providing a professional, unbiased service. Instead, the transition from product sales to professional advice seems to be occurring gradually as a consequence of some sections of the industry's desire to improve consumer confidence in their services. In evidence to the committee, MLC commented that the FSR regime does not reflect the industry's increasing focus on advice:

> It is a product-based regime. We are really moving into the advice world and trying to rearrange the way we focus on the customer away from the product in the conversations that are going on out there between advisers and clients.
>
> ...

1 ASIC, *Submission 378*, p. 48.

2 ASIC, *Submission 378*, p. 38. See also Industry Super Network, Submission 380, p. 4 and p. 8.

> ...for the last many decades the industry has been based on product, distribution and sales of manufactured services. In the last seven or eight years it has quite significantly changed. Now advisers are concentrating on giving quality advice to the client; that is separate to the product outcomes in many cases and we just need to continue that journey.[3]

5.10 Australasian Compliance Institute (ACI) noted: 'Quality financial advice is intended to be about financial strategy and not just individual products'.[4] The Institute of Chartered Accountants in Australia (ICAA) expressed a similar view:

> The Institute's view is that the primary role of financial advisers is to provide financial advisory services, the emphasis is on providing financial advice and that the "sale" of a product is a potential end by-product of the process. The service to the client is advice. The investing in a investment product or setting up an insurance policy while a legitimate outcome of the advice it is not the principal objective. Specifically the role of the financial adviser is to provide strategic advice and this advice revolves around personal goals and objectives, structuring, taxation, wealth creation, wealth protection, estate planning, risk management and not the sale of products.[5]

5.11 These comments support the view that the need for greater professionalism and a focus on clients' interests should be reflected in a regulatory regime that matches these objectives. That is, the tension between the industry's dual sales and advice functions should be clearly resolved in favour of regulations that mandate a higher level of professionalism and better protect consumers from the negative consequences of conflicted advice. Others argued that the present system has generally worked well for consumers and that the entire industry should not be overhauled in response to the actions of fringe elements. This debate is explored later in the context of the adequacy of the regulations managing conflicts of interest (beginning at paragraph 5.24), and the deficiencies with enforcement of the existing regime (beginning at paragraph 5.104).

5.12 The committee notes that poor advice can have varying consequences, from catastrophic losses to sub-optimal returns from poor investment performance or excessive fees. Industry Super Network's submission described the varying effects of conflicted financial advice:

> The examples of Storm Financial and other collapses present the committee and the broader community with the most egregious examples of the effects of conflicted financial advice on the savings of Australians. However, ISN submits that the 'slow burn' effect of commissions and conflicted advice on the superannuation savings of millions of working Australians, demonstrates that these scandals are not isolated examples of poor practice

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3 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 4

4 ACI, *Submission 397*, p. 5.

5 ICAA, *Submission 363*, p. 6.

> but evidence of the "structural corruption" caused by conflicted remuneration practices.[6]

5.13 This report will consider the extent to which the sales and distribution function of the industry is harmful to Australian investors seeking professional advice, and the most appropriate regulatory measures to address poor financial advice.

Poor advice or faulty product?

5.14 The other central issue relates to the question of whether poor or catastrophic investment outcomes are due to a failure of financial advice, or the products in which clients invest.

5.15 Financial Planning Association of Australia (FPA) suggested that advisers and their clients can be the victims of misinformation from product providers:

> ...a financial planner is there to provide advice and to necessarily recommend a product based on what they know and what they understand around that product at that time. Mostly those products fulfil their obligations. They fulfil what it is they said they were going to do, but there are instances ... where the product promised has not been delivered, and the managed investment scheme examples are two good points. They were robust investments where the corporate entity made certain decisions which were not fully disclosed and were not fully understood. The financial planner was not privy to what was going on and the company itself ended up collapsing and taking everything with it.[7]

5.16 Boutique Financial Planning Principals Group (BFPPG) also claimed that planners can be victims of poor products:

> ...a product provider can misrepresent a poorly designed investment product, a research house can rate the product well, and a financial planner can recommend the product to a client based on the manufacturer's misrepresentation and the research houses' ratings.[8]

5.17 ASIC emphasised that it has no power to intervene to prevent people from investing in risky or flawed products:

> Consistent with the economic philosophy underlying the FSR regime, ASIC does not take action on the basis of commercially flawed business models. A significant feature of the recent collapses leading to investor losses, is flawed business models, that is, models that could only prosper if asset prices continually rose and debt markets remained open and liquid.

6 Industry Super Network, *Submission 380*, p. 11

7 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 47.

8 BFPPG, *Submission 251*, p. 12.

> Responsibility for flawed business models lies with management and the board.[9]

5.18 Preventing such investment losses is the role of the financial adviser, rather than the regulator. Indeed, most agreed that the crux of the problem is the advice that accompanies a decision to invest in certain products. The consequences of product failure will be greatly mitigated if the investment is only one part of a diversified portfolio that matches the client's tolerance for risk.

5.19 For instance, MLC argued that products are generally safe as long as clients are advised to invest in them appropriately.[10] CPA Australia told the committee that the regulatory focus needs to be on the advice attached to investment products:

> ...products range from a simple bank account term deposit through to some very sophisticated structured products. Those sophisticated structured products may be appropriate for particular sophisticated investors who have advice. Whilst there are questionable products and structures out there, it is really about whether or not people are being put into those or recommended those products appropriately or not. It is a question of appropriate advice.[11]

5.20 Mr Peter Worcester of Worcester Consulting Group agreed with this view:

> ...the whole thing needs to be client focused. For that client is that total mix of product appropriate? If you think about it, who cares whether you buy share fund A, share fund B or share fund C? It is not going to make an actual material amount of difference. But if you are geared 200 per cent in share fund A versus having 50 per cent in share fund A and 50 per cent in cash, then your starting focus is on the client issue.[12]

5.21 The committee has focussed mainly on the regulation of advice given about investment products, rather than the products themselves. Some discussion is given to the possibility of restricting certain kinds of products to sophisticated investors (see paragraphs 6.166 to 6.169).

Regulatory issues

5.22 The committee received evidence suggesting that the current regulatory arrangements are failing to protect consumers from poor financial advice and its consequences. The following issues were of particular concern:

- Current disclosure and conduct standards are inadequate mechanisms for managing financial advisers' conflicts of interest.

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9 ASIC, *Submission 378*, p. 20.

10 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp. 14-15.

11 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 65.

12 Mr Peter Worcester, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 98.

- The licensing system is deficient, in that competency requirements for licensees and/or their authorised representatives are too low, oversight of individual advisers is too diffuse, and consumers are unable to readily identify varying capabilities.

- Lending practices by institutions lending for investment purposes have been below community expectations and not subject to appropriate regulatory control.

- Professional indemnity insurance is designed to indemnify advisers, and is unsuitable for compensating investors that have suffered losses as a consequence of poor advice that does not comply with the adviser's legislative obligations.

5.23 These issues are examined below. The perspective of those who believe the problem is one of proper enforcement, rather than the regulatory settings themselves, is considered further on beginning at paragraph 5.104.

Managing conflicts of interest

5.24 Conflict of interest was a consistent policy concern raised during the inquiry. Many were of the view that the existing legislative requirement to disclose conflicts of interest and provide advice to a standard that is appropriate to the client has not been effective. That is, the efficient markets approach has not prevented advice conflicted by remunerative or ownership arrangements from manifesting itself as poor quality or inappropriate advice to consumers.

5.25 ASIC commented that the Wallis inquiry approach may no longer be appropriate given the breadth of retail investors today:

> [ASIC is] querying whether it has gone far enough in protecting retail investors, given the important role, which was not foreseen by the Wallis inquiry, that retail investors would play in the market. They had not foreseen and could not have foreseen the impact that the superannuation levy has had on investment in our markets. In that situation, you have a much broader range of retail investors and retirees. You have groups of people who lose money at the wrong time in their life and it is no answer to them to say: 'Well, it was a risk, you know. There was disclosure. You should have read the disclosure statement.' The fact is that they cannot easily come back into the workforce.[13]

5.26 ASIC's submission added:

> While increased intervention could impact on market efficiency, the benefits it will deliver, in terms of increased investor protection from loss

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13 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 7.

> and increased investor confidence causing retail investors to re-enter the market, may outweigh the costs...[14]

5.27 Australasian Compliance Institute told the committee that efforts to ensure affordable advice should be balanced against the need for investor protection:

> The remuneration model for financial advisers is acknowledged as problematic and potential conflicts of interest that may be present in the model are often justified on the basis of making the advice affordable for consumers, who would not be able to or perhaps not want to pay upfront the ‘real’ cost of the advice.
>
> However, many of the investors currently receiving advice may be considered some of the most vulnerable in the market (i.e. they have a low understanding of the market and its various products and are heavily reliant on the advice they receive) and so considerations for their protection are important.[15]

5.28 The debate about the effect of remuneration and ownership-based conflicts was extensive, and is included in the following section of the report. The committee then outlines evidence to the inquiry on the effectiveness of disclosure and conduct regulations in managing these conflicts.

Remuneration-based conflicts

5.29 A significant conflict of interest for financial advisers occurs when they are remunerated by product manufacturers for a client acting on a recommendation to invest in their financial product. There are a number of ways in which advisers can be remunerated directly or indirectly by product manufacturers for their clients' financial decisions. They include:

- trail commissions charged at ongoing intervals (usually annually) as a percentage of assets;
- up-front commissions charged as a percentage of the initial investment;
- volume bonuses and sales target rewards; and
- 'soft dollar' incentives.[16]

5.30 These payments place financial advisers in the role of both broker and expert adviser, with the potentially competing objectives of maximising remuneration via product sales and providing professional, strategic financial advice that serves clients'

14 ASIC, *Submission 378*, p. 11.

15 ACI, *Submission 397*, p. 5.

16 Soft dollar incentives refer to non-monetary rewards such as holidays, tickets to sporting events, golf days etc.

interests. The committee received considerable evidence on the nature and effect of these conflicts, including on the quality and cost of advice, and whether it is possible for them to be managed appropriately.

5.31 In their submission, ASIC described the conflicts associated with commission-based remuneration. They noted that it can lead to advice that is not in the best interests of the client:

> Commission payments can create real and potential conflicts of interest for advisers. They could encourage advisers to sell products rather than give strategic advice (e.g. advice to the client that they should pay off their mortgage), even if this advice is in the best interests of the client and low risk. Commissions also provide an incentive to recommend products that may be inappropriate but are linked to higher commissions. Higher commissions might be provided for selling higher-risk products, perhaps because other advisers are unwilling to sell these products due to the high risk (e.g. Westpoint).
>
> Products that might be in the interests of the client but do not generate a high commission return (such as industry superannuation funds) might not be recommended to clients.[17]

5.32 Industry Super Network wrote:

> The dominant remuneration structure in the financial advice industry remains based on a commission or asset based fee payment made by a product provider to the financial adviser.
>
> While notionally a payment for advice, asset based fees are a de facto sales commission. Currently, the way that most financial advisers are remunerated means that their interests are more closely aligned with the sales and distribution function of large financial institutions than with their clients.[18]

5.33 They provided the committee with a comprehensive list of the problems associated with commissions:

> ISN submits that commission based fees are problematic because they:
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> - Cause a conflict of interest because the adviser is paid by the product provider not the client, and so will only be paid for recommending a certain product and receives payment only after a recommendation is implemented
> - Are often combined with other conflicted remuneration structures such as shelf fees and volume rebates
> - Are anti-competitive in the sense that products with higher commissions are favoured; good products which do not pay a

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17 ASIC, *Submission 378*, p. 50.

18 Industry Super Network, *Submission 380*, p. 8.

commission will seldom be recommended even if they are superior.

- Are economically inefficient in the sense that they are not tied to the provision of a quantity of advice – commissions are paid irrespective of ongoing provision of advice services.
- In some cases commissions lead to bad advice because they encourage the planner to steer consumers into strategies which inflate their investments or exposure, to increase up front commissions (for example, the gearing strategies used in the Storm cases)
- Are difficult for consumers to understand; this reduces the capacity for consumers to compare prices or to digest the financial impact that commissions have on their investments
- Are more erosive on retirement savings and other investments than one off advice fees (the longer term the investment, the more erosive commissions are)
- Are designed to suit the business models of financial advisers, rather than serve the needs of the client.[19]

5.34 Q Invest commented that remuneration-based conflicts have been practically difficult to manage:

> It is indeed a truism that "No man can serve two masters" – and this is more so in the financial planning industry. As an industry, financial advisers are at a crossroad and each of us needs to honestly decide: Who is our master – the client or the product issuer? Experience has shown us that attempting to serve both places the financial planner in an untenable position.[20]

5.35 CHOICE claimed that commission-based remuneration encouraged advisers to churn clients through investment products to generate the maximum amount in fees.[21]

5.36 Not all evidence to the committee regarding commissions was negative, though. Some argued that the conflicts commissions create can be managed and that consumers should be able to make an informed choice about the remuneration model that suits them, particularly when seeking affordable payment structures.[22] Commonwealth Bank of Australia (CBA) stated that commissions subsidise the cost of advice:

> Research commissioned by Colonial First State suggests that it costs advisers an average of $3,570 to produce a full service financial plan.

19 Industry Super Network, *Submission 380*, p. 9.

20 Q Invest, *Submission 374*, p. iii.

21 CHOICE, Submission 361, p. 9.

22 See for example, ING Australia, *Submission 383*, p. 6; AFA, *Submission 344*, pp. 8-9.

> However, few investors, in fact around just 3% of superannuation members who had recently switched super funds, were prepared to pay this amount.
>
> This reality results in subsidies being employed to ensure that consumers have sufficient access to advice. These subsidies take many forms and may include commissions and other payments by product manufacturers to either independent or aligned advisers; salaries paid to advisers employed by product manufacturers, including superannuation fund providers, or associates of product manufacturers and ownership of dealer groups by product manufacturers, superannuation funds or associates. These subsidies are present in most types of product/adviser relationships, including the retail investment and superannuation markets and the industry and public sector superannuation fund markets.
>
> The presence of subsidies provides net benefits to consumers by enabling the provision of cost effective advice.[23]

5.37 Other contributions also sought to emphasise that alternative remunerative structures are also capable of creating perverse incentives. Professional Investment Services claimed that:

> ...conflicts are inherent both directly and indirectly across the different remuneration methodologies, including instances like salaried advisers. There are conflicts associated with all the different types of remuneration methods, even to the extent that on an hourly fee base, if you have not dealt with lawyers or accountants over time where you think they have pushed the hours out to get greater fees, then I am sure you have not lived.[24]

5.38 AXA's submission included a similar view:

> ...fee for service charged on the basis of time has in some sectors resulted in unnecessary servicing. On the other hand, fixed fees can lead to under servicing and performance based fees can lead to unnecessary risks being taken.
>
> Ultimately, what is important is that customers understand and direct the costs they pay for advice, administration and products, both upfront and ongoing. Effective disclosure is essential to this.[25]

5.39 This debate is explored further in the following chapter, starting at paragraph 6.54, in the context of proposals to ban commission-based remuneration.

Ownership conflicts

5.40 The other conflict of interest for advisers stems from the relationship between product manufacturers and the adviser's licensee. Specifically, advisers who are

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23 CBA, *Submission 357*, pp. 6-7.

24 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 112.

25 AXA, *Submission 385*, p. 10.

authorised representatives of licensed advisory groups owned by product manufacturers in a vertically integrated business model are conflicted.

5.41 Industry Super Network noted the dominance of large vertically integrated financial institutions in the financial planning industry:

> These large conglomerate institutions typically own all aspects of the financial services value chain from banking, wholesale funds management, product manufacture, administration and retail distribution including financial planning. The bulk of the financial planning industry is concentrated in the hands of relatively few institutions. Rainmaker Information reports that 73% of adviser groups are institutionally owned, if taken by adviser numbers, or 78% if taken from funds under advice. Many financial institutions operate a number of different sub-brands within their groups...

5.42 They added:

> The institutional ownership of the bulk of financial planning dealerships is significant because it reinforces the concern that financial advisers are compromised by the commercial imperative of selling and distributing the products manufactured by their parent or related party organisations.[26]

5.43 ASIC commented on the practice of re-branding aligned financial advisers and noted that 'consumers might not appreciate that they are getting advice from an adviser that is owned by a product manufacturer'.[27] On the disclosure requirements regarding ownership they said:

> In 2008, ASIC conducted a review of branding disclosure of 35 bank or institutionally-owned advisers and found that while advisers disclosed the relationship in the FSG as required by the Corporations Act, the information was often not prominently disclosed.[28]

5.44 BFPPG noted:

> Institutionally owned (or partly owned firms) such as Garvan, owned by National Australia Bank; Hillross, owned by AMP; BT, owned by Westpac; Ipac, owned by AXA etc, form the major portion of the industry. These firms serve as the distribution arm for their owners' products. Where the firm is not wholly owned by an institution there are usually financial arrangements in place that favour the distribution of the institution(s)' products. A key objective for the relevant institutions is to generate funds under management.[29]

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26 Industry Super Network, *Submission 380*, pp. 4-5.

27 ASIC, *Submission 378*, pp. 38-39.

28 ASIC, *Submission 378*, p. 39.

29 BFPPG, *Submission 251*, p. 6.

5.45 They suggested that a client being unable to recognise ownership bias is a 'bigger, and more subtle problem' than that created by commissions.[30]

5.46 ACI stated:

> Our members would ... question whether a company that issues a product should be licensed to provide personal financial advice to existing and prospective clients for just its own product and if in this instance this could genuinely be considered "advice".[31]

5.47 Others claimed that the conflicts of interest associated with vertically integrated product/advisory models are outweighed by the benefits to consumers. For example, Investment and Financial Services Association (IFSA) commented that:

> ...while vertical integration in the financial services industry is common, and undoubtedly gives rise to potential conflicts of interest, it is important to also consider the significant benefits that consumers receive from this integration, namely:
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> • Strong risk management – through imposing standards consistent with those across the group;
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> • Security – through more substantial capital backing;
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> • Economies of scale – through a larger organisation with more capital and purchasing power;
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> • Accessibility – through more efficient processes supported by other parts of the group; and
>
> • Affordability – often vertically integrated businesses are able to cross-subsidise other parts of their business, reducing costs for consumers that access those subsidised services.[32]

5.48 ING Australia commented:

> While we understand that institutional ownership of advice groups brings with it an obvious conflict of interest, we believe the benefits of this structure outweigh an appropriately managed conflict...
>
> ING Australia believes that institutional ownership of financial advisory firms can assist in ensuring quality advice by providing the operational framework, expertise and support (both financial and professional). Large institutions are less likely to put at risk their reputation and brand and they have the scale and resources to ensure that their products and services meet a very high standard and comply with their legal obligations.[33]

5.49 AMP also emphasised the consumer protection associated with this model:

30 BFPPG, *Submission 251*, p. 9.

31 ACI, *Submission 397*, p. 5.

32 IFSA, *Submission 317*, p. 21.

33 ING Australia, *Submission 383*, p. 3.

> As an integrated organisation AMP is better able to ensure consumer protection through higher standards of training, monitoring and supervision than the minimum standards prescribe. AMP is also vigilant in protecting its brand and reputation in the event of a failure in process.[34]

5.50 Guardian Financial Planning also suggested that the backing of large financial institutions offered clients protection:

> Financial institutions have the structures in place to ensure compliance with regulations, legislation and other internal checks, including business values. The outcome is that institutions tend to look after their brand and their customers. That sees advisers aligned to institutions protected and governed by explicit policies around hiring practices, supervision and compliance, education and professional development.
>
> The other critical element is capital backing. In those instances where the checks and balances fail institutions stand behind their mistakes. Having deep capital reserves adds another layer of protection for consumers.[35]

5.51 BFPPG responded as follows:

> It has been argued that there is an inherent weakness in small independent AFSLs because of a lower level of capital adequacy. In fact the most often quoted reason for using a small independent AFSL is the advantage of advisor independence, and typically the experience and personal service that goes with being small. Consumers see these important factors as being greater than the disadvantage that these businesses are less highly resourced and less capitalized.[36]

5.52 Highlighting recent poor practices from large licensees with a reputation to protect, they noted:

> The small AFSL often has family assets supporting the business, works longer hours, takes a lower level of income to build the business and has a closer and more personal relationship with clients. Reputation is even more important for the small AFSL because of the positive impact of referrals to the business from client advocates and the negative impact of one mistake that can put them out of business.[37]

Disclosure

5.53 Evidence to the committee strongly suggested that the current disclosure requirements had not been an effective tool for managing conflicts of interest.

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34 AMP, *Submission 367*, p. 2.

35 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 87.

36 BFPPG, *Submission 251*, p. 11.

37 BFPPG, *Submission 251*, p. 12.

5.54 One problem is that the present arrangements enable or encourage licensees to take a risk-averse approach to compliance, rather than providing disclosure material that is focussed on informing consumers. In their submission ASIC noted that disclosure documents are often lengthy and complex, reflecting the nature of the products and providers' all-encompassing approach to legislative compliance. Such material is unlikely to serve informed decision-making where consumers are disengaged or unable to comprehend it.[38]

5.55 FPA suggested that excessive disclosure and the expense that accompanies it was a consequence of the industry's risk-averse approach to complying with FSR:

> ...financial services reform scared the pants off the whole financial planning industry and has led everyone to over-comply, to over-advise and to over-disclose in order to protect the most critical thing a financial planner and their licensee have—that is, their reputation. As I was going to mention earlier, this has created a real fear factor. We are continuously debating rigorously with ASIC on the interaction between principles based regulation, which we all support, and the black and white letter of the law, which is sometimes needed to try and understand what the principles are. So in an effort to deliver principles based regulation, which we continue to support, there have been grey areas: what is the difference between general and personal advice? What is limited personal advice? What is scalability of advice? What is the difference between a statement of advice, a record of advice and a statement of additional advice? These poor people sit there trying to deliberate while they service their clients. What they end up with is a one size fits all, highly costly, overregulated but very complying system.[39]

5.56 Argyle Lawyers also told the committee that disclosure had become too compliance-focussed:

> ...compliance documents that currently exist have become a mechanism for the licensee ensuring that it has met the act and will not breach the law rather than providing consumers with the ability to make an informed decision and make choices. The classic example of that is the statement of advice, which is 125 pages long and that nobody is going to read.[40]

5.57 BFPPG also described the risk-averse approach to disclosure:

> The requirements relating to SOAs have skewed advice so that emphasis is now on the protection of the financial planner against all possible future problems and then the production of those long, complicated SOAs in the most efficient manner. In other words, if in doubt, put it in the SOA – the result has been over complicated and extremely long SOAs that are of little value to the client. In addition, the cost of producing them in an efficient

38 ASIC, *Submission 378*, pp 58-59.

39 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, pp 40-41.

40 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 112.

manner has put an unnecessary financial strain on financial planners and made the provision of simple one–off advice more costly.[41]

5.58 They argued that the motivations of advisers are not necessarily apparent to their clients:

> Currently, it is very difficult for consumers to identify whether they are dealing with a financial product salesperson or an independent financial planner committed to putting their interests first. There is ample evidence that financial product salespeople hold themselves out to be independent in a misleading manner so as to make it easier to make a sale...
>
> ...the sale of financial product is not, of itself, a problem. It is the sale of the product under the guise of independent advice by a salesperson with a vested interest in the sale itself that is the problem. Consumers should be able to ask the question 'Why am I being sold these products – Is it because the financial planner is putting me first or is he putting himself first?" and the answers should be clear and obvious.[42]

5.59 Argyle Lawyers criticised the emphasis on form over substance encouraged by the current framework:

> ...the regulatory system currently encourages a tick-the-box approach to compliance, without promoting an ethical or integrity foundation within financial services for the provision of advice. The evidence associated with the recent financial product and advisory collapses suggest to us the existing legal compliance frameworks alone are insufficient to pick up and identify systemic instances of unethical conduct within financial advisory firms.[43]

5.60 Other evidence suggested that there are inherent limitations on what disclosure can do to protect consumers, no matter what the disclosure regulations provide for in terms of brevity and clarity. ASIC's submission suggested that 'disclosure can be an inadequate regulatory tool to manage the conflicts of interest created by commissions'. They indicated that this is due to 'the strength of the conflict and consumers' difficulty in understanding their impact'.[44] In evidence ASIC commented on the difficulty of ensuring that complex remuneration structures are clearly disclosed:

> ...when you have multiple types of remuneration that are predominantly paid by the product manufacturer to the adviser and to the licensee for the sale of that product, on top of volume bonuses and potential conferences that you can go to, that complexity leads to the consumer's lack of understanding of how much it is costing them at the end of the day. So you

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41 BFPPG, *Submission 251*, p. 14.

42 BFPPG, *Submission 251*, p. 18.

43 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 108.

44 ASIC, *Submission 378*, p. 51.

> do come across people who believe to a large degree that, because they have not written a cheque, they have not had to pay for the advice that they have received.[45]

5.61 They also noted that disclosure, even if clear, is limited in its capacity to convey conflicts:

> Yes, I have disclosed it, but is it an informed consent? Or is it really that, as the investor, when I have seen these fees, I have turned my mind to the fact and said, 'Could this guy have distorted his advice because of these fees?' And that is extremely difficult for an investor to do unless they are really experienced, because the person you are with is a trusted adviser.[46]

5.62 In their submission ASIC also described the problem of consumers not understanding the restricted nature of the advice they may be receiving, notwithstanding the legitimate reasons these restrictions serve. ASIC stated:

> The scope of advice provided by an adviser may be restricted. For many reasons licensees restrict the range of products financial advisers can advise on e.g. through an approved product list. This restriction may be to ensure the products recommended meet minimum standards, to ensure the advisers are adequately trained on the products they advise on and to give the professional indemnity insurer comfort about the risks of negligent advice being given. The range of products that an adviser is permitted to advise on can also be influenced by which products are more profitable to the licensee (e.g. where there is a commission from a product manufacturer or a relationship with a product manufacturer). The restricted nature of the advice is often not evident to consumers.[47]

5.63 CHOICE told the committee that disclosure had in fact been counter-productive:

> The requirement to disclose conflicts is often more of a hindrance than a help. People are poorly equipped to identify, accept and account for the impact of conflicts on advice, mainly because consumers simply do not expect conflicts in the first instance. Disclosures are not sufficient to counteract a client's own understanding of the role of an adviser. There is also evidence to suggest that disclosing conflicts can perversely increase consumer confidence in the advice rather than act as a stark warning on the quality of advice.[48]

5.64 The Accounting Professional and Ethical Standards Board outlined the different adviser/client relationships:

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45 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 15-16.

46 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 16.

47 ASIC, *Submission 378*, p. 38.

48 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 98.

> The first one is what I would call the broker agent salesman. This is where the adviser is authorised to act on behalf of another. The adviser clearly has a conflict of interest and he must fully disclose that. The second role is the steward, which is probably what many of the investment advisers are. In this case the adviser has agreed to act on another's behalf. There is a basis of trust and confidence, and the interests of the adviser should be aligned with those of the other party. You then have a third higher level, which is a fiduciary relationship. In that case the adviser has accepted a legal responsibility to act on another party's behalf. The adviser can have no conflict of interest whatsoever, which is typically seen in a trustee relationship, a director or a power of attorney.

5.65 They added that these relationships are not made clear to consumers:

> The current legislative framework misleads the public by not clearly differentiating these three roles. It enables the salesman in a profession effectively to pass themselves off as a licensed investment adviser, which enables them to gain the trust of their client.[49]

5.66 ACI recognised the difficulty of disclosing complex remuneration arrangements:

> ...some of these remuneration models are so complex in themselves that disclosure does not ensure that a client understands and can make a judgment about the effect of the fees on the advice they are being provided; the total of the fees; or how it affects their return on the investment.[50]

5.67 MLC agreed:

> ...there is a significant number of payments moving between parties in the industry that the client has no chance of being able to understand so they think that they might be getting an independent outcome when, in fact, they are not.[51]

5.68 MLC suggested that clients understood the proprietary, vertically integrated model, where advisers work for the manufacturer. They also understand independent advisers, but the confusion 'lies in the middle'.[52]

Conduct standards

5.69 The committee also heard that the legislative standard of advice provided under section 945A is insufficient to ensure advice is given in the clients' interests

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49 Accounting Professional and Ethical Standards Board, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 73.

50 ACI, *Submission 397*, p. 6.

51 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp 5-6.

52 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp 4-5.

(outlined at paragraph 2.20). ASIC told the committee that the standard does not meet consumers' expectations:

> It appears that there is a mismatch between the client's expectation that the adviser is providing a 'professional' service (e.g. advice that is in their best interests) and the obligations of the adviser under the Corporations Act (that the adviser provides advice that is appropriate to the client and manages conflicts). Investors may see advisers as similar to lawyers and accountants in terms of duties and professionalism.[53]

5.70 ASIC told the committee that:

> ...the law at the moment is uncertain as to whether the fiduciary duty exists or not. We take the view that it may well exist, but it is unclear.[54]

5.71 Industry Super Network stated that the current standard allowed advisers to make recommendations knowing that there are better alternatives:

> To give a concrete example of the flaws in the reasonable basis test, a financial planning dealership might only have their own managed investment product on their approved product list. However, this product might be more expensive or offer a higher commission than most other managed investment products on the market. It would be possible in most cases for a planner to recommend their own product and demonstrate that it is appropriate for the client who needs a managed investment product, although the planner is aware that there are many other similar products which would be cheaper for the client or have less beneficial remuneration for themselves.[55]

5.72 Concerns have also been raised about the compatibility of the 'appropriateness' test with advice given under licensing arrangements where only one type of product may be recommended. The problem was highlighted during the committee's inquiry into agribusiness managed investment schemes (MIS), where the schemes were sold to investors through AFSL holders licensed to advise only on agribusiness MIS.[56]

5.73 During that inquiry, a number of people queried whether it was possible to provide appropriate advice to clients when a single product may be recommended, also raising concerns about the transparency of these limitations. ASIC informed the committee that it is technically possible to provide compliant advice in those

53 ASIC, *Submission 378*, p. 39.

54 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 10.

55 Industry Super Network, *Submission 380*, p. 17.

56 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, pp 49-51.

circumstances, without commenting about specific examples.[57] In evidence to this inquiry, ICAA repeated their concerns:

> It is not possible to provide holistic advice if your only product solution is one particular product.[58]

Committee view

5.74 The committee is of the opinion that disclosure documents are too long and confusing for conflicts of interest caused by commission-based remuneration and vertical ownership structures to be properly understood by consumers. The documents are so inaccessible that they are probably not read at all by most people. There are also limits as to the usefulness of disclosure, however clear and concise, in an environment where clients have already committed in their mind to their trusted adviser's chosen strategy. Present conduct standards are useful in that they prohibit clearly inappropriate advice being given to consumers, but the threshold is low enough to allow advice that favours the adviser's interests above those of the client. Therefore, consumers are not necessarily getting advice that is in their best interests but, because of the limitations of disclosure, often do not realise this. Recommendations for improving the regulation of financial advisers to better protect investors are included in Chapter 6.

5.75 It should be recognised that the limitations of the current regulatory approach enable poor advice that is mainly incremental in its effect, rather than being catastrophic for investors. Conflicted advice that meets the current legislative requirements is more likely to lead to sub-optimal investment strategies or excessive fee arrangements, than to cause the sort of catastrophic outcomes described earlier in this report. Without making any particular judgement about specific cases, the committee is of the general view that situations where investors lose their entire savings because of poor financial advice are more often a problem of enforcing existing regulations, rather than being due to regulatory inadequacy. Where financial advisers are operating outside regulatory parameters, the consequences of those actions should not necessarily be attributed to the content of the regulations. Potential shortcomings of regulatory enforcement are discussed later in this chapter, starting at paragraph 5.104.

Competency under the present licensing system

5.76 Another area of regulatory concern was the competency of licensees and individual financial advisers under the present licensing arrangements. The major criticism of the current system is that licensees' minimum training standards for advisers are too low, particularly given the complexity of many financial products. ASIC's guidance on how licensees can meet the obligation to ensure

57 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, pp 49-51.

58 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 5.

authorised representatives are adequately trained and competent was outlined at paragraph 2.27.

5.77 ICAA commented on the increasing complexity of the financial services industry and suggested that deficiencies exist in the education framework for financial planners. They suggested that the current requirements are inconsistent:

> Currently the education requirements introduced through FSR are at a minimum level and the training courses available range from a few days to completion of a post graduate diploma or under graduate degree. All of these course options meet the regulatory requirement of a financial planner becoming compliant with ASIC Regulatory Guide 146. Australians cannot have a professional relationship with an adviser when there is such disparity in the education levels of the advisers in the industry.[59]

5.78 Association of Financial Advisers (AFA) agreed that 'the education bar needs to rise' to deal with an evolving profession.[60] ING Australia also stated that 'the current adviser training requirements are too low'.[61] Financial Ombudsman Service (FOS) told the committee that some complaints they receive indicate that the advisers in question do not understand the products they are selling.[62] AMP agreed:

> ...the minimum entry levels for financial advisers are too low and this is a significant contributing factor to advisers providing advice on products that they do not fully understand.[63]

5.79 They also noted industry inconsistencies:

> Each Licensee is left to set its own benchmark (at or above the prescribed minimum standard) for assessing adviser capability. Whilst some Licensees prescribe rigorous training standards, supplemented with 'on-the-job' supervision, there is inconsistency across the industry.[64]

5.80 Argyle Lawyers claimed that low competency levels correlate with unethical conduct:

> ...the minimum competency levels that exist within ASIC Regulatory Guide 146 at the moment are completely inadequate to allow advisers, for example, to position themselves to deal with the complex ethical issues they face when giving advice, and the younger and more inexperienced they are

59 ICAA, *Submission 363*, p. 6.

60 AFA, *Submission 344*, p. 12.

61 ING Australia, *Submission 383*, p. 6.

62 FOS, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 27.

63 AMP, *Submission 367*, p. 7.

64 AMP, *Submission 367*, p. 7.

> the more likely they are to make the wrong decision and the more likely they are to be influenced by peers and superiors to take the wrong action.[65]

5.81 Others suggested that the competency requirements for licensees are also too relaxed. For instance, AXA claimed that it was too easy for prospective licensees to demonstrate that they can meet their obligations, without having the skills or resources to actually do so.[66]

5.82 ASIC made the following comment about their responsibility when granting a licence:

> ...we are required to grant a licence if the conditions in the legislation are met. The two substantive conditions are that the key people are of good fame and character and the other one is that we have no reason to believe that they will not comply with their licence conditions. The test of having a state of mind that somebody will not comply before they have even started business is extremely difficult...[67]

5.83 In their submission ASIC stressed that granting a licence in no way provides an endorsement of the applicant's business model. ASIC also noted that a high threshold must be reached for them to suspend or cancel a licence, and that it is difficult to remove licensees in anticipation of a breach of their conditions.[68]

5.84 The committee also received complaints suggesting that the licensing system enabled too many people with minimum competency to use the term 'financial planner' in a way that is misleading to consumers. FPA stated that 'there are too many people out there holding themselves out to be financial planners when in fact they are not; they are doing a whole range of other things'.[69] BFPPG also complained that the term is able to be used too broadly:

> The public can readily identify other professions: doctors, lawyers etc by their title. There are, however, thousands of individuals holding themselves out to be financial planners who meet the barest minimum training or ethical requirements. In most cases these people are associated with single product areas of advice or advice that is focussed strongly into one type of asset class or investment type. There are real estate agents who call themselves financial planners so that they can offer advice on the investment of excess funds after the purchase or sale of a property. There are property developers who call themselves financial planners so that they

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65 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 108.

66 AXA, *Submission 385*, p. 20.

67 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 3.

68 ASIC, *Submission 378*, p. 26.

69 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 34.

> can package the sale of their property development into superannuation funds. There are many other examples.[70]

Committee view

5.85 The committee acknowledges concerns that the minimum qualification threshold for advisers is low. However, these concerns need to be considered in light of the requirement for licensees to demonstrate that their authorised representatives have the capabilities to provide the financial services covered by the conditions of their licence. Accordingly, licensees are required to ensure higher competency standards as the complexity of the advisers' role increases. Consideration also needs to be given to the affordability of advice should educational standards for advisers be increased, as well as the transition arrangements that would need to be implemented. These matters are discussed in Chapter 6, starting at paragraph 6.110.

5.86 The committee recognises that it is very difficult for ASIC to deny an application or cancel a licence if they think the licensee will be unable to meet their obligations, which somewhat undermines the safety provided by a licensees' requirement to ensure its authorised representatives have sufficient competence. The committee makes a recommendation with respect to this at paragraph 6.157.

5.87 There are also very legitimate concerns about the varying competence of a broad range of people able to operate under the same 'financial adviser' or 'financial planner' banner. The licensing system does not currently provide a distinction between advisers on the basis of their qualifications, which is unhelpful for consumers when choosing a financial adviser. These concerns are addressed by the committee's recommendation at paragraph 6.160.

Lending practices

5.88 The practices of some lending institutions that lent money for investment purposes were discussed during Chapter 3. This section addresses the problems with the regulation of margin lending more generally. ASIC's submission identified two main issues associated with lending institutions lending to fund retail investment. They are:

1. a lack of regulatory control over the provisions of credit for investing; and

2. corporate governance and risk management failures by lenders that encouraged high risk lending and meant that loans were poorly managed.[71]

5.89 On the first issue ASIC noted:

> ...lenders of investment credit such as margin lenders do not have the same obligations in relation to conduct and disclosure under the Corporations Act

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70 BFPPG, *Submission 251*, p. 21.

71 ASIC, *Submission 378*, pp 87-88.

as AFS licensees, and borrowers do not have the same protections as investors in financial products.[72]

5.90 ASIC also commented on relaxed lending practices when markets were rising:

> While Australian lending institutions have not engaged in some high risk lending practices that occurred overseas, recent retail investor losses have shown that in some cases Australian lending institutions may have failed to apply their usual standards in the bull market. This was particularly so where the retail investor dealt with the financial institution indirectly through an intermediary. In some cases this has resulted in higher risk lending to retail investors and inadequate management of existing loans.[73]

5.91 The submission also expressed concern about the risks inherent in lending institutions outsourcing suitability, risk management and monitoring responsibilities to intermediaries such as financial advisers.[74]

Committee view

5.92 The committee notes that these problems are reflected in the extensive evidence it received concerning the supply of margin loans to Storm Financial clients. Margin lending practices in this instance were below the sort of responsible conduct the community expects from lending institutions and beyond the scope of ASIC to regulate as a financial product under the *Corporations Act 2001* (Corporations Act). The gap in regulation to protect margin loan customers has been addressed in margin lending reforms that were passed by the parliament on 26 October 2009. These reforms are discussed further in the next chapter, starting at paragraph 6.161.

Investor compensation

5.93 In the event that consumers suffer catastrophic losses as a consequence of negligent advice, attention turns to the avenues available for investor compensation in these circumstances. Presently, there is no statutory compensation scheme for this purpose. The compulsory professional indemnity (PI) insurance regime provides only limited protection, and evidence to the inquiry suggested that it is not suitable, or indeed intended, for such a role.

5.94 ASIC confirmed that 'there are significant limitations on the effectiveness of PI insurance as a compensation mechanism for retail investors'. The consumer is not directly involved in the insurance contract, which provides licensees with insurance against losses owing to 'poor quality services and misconduct'. Insurance policies may exclude certain circumstances, depending on the extent of cover the insurer is willing

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72 ASIC, *Submission 378*, p. 88.

73 ASIC, *Submission 378*, p. 89.

74 ASIC, *Submission 378*, p. 89.

to provide. Fraud is generally not covered and contracts do not apply where the licensee has ceased business.[75]

5.95 Insurance Council of Australia also stressed that PI insurance has limitations as a guarantee mechanism:

> ...you cannot make a commercial product into a compensation mechanism. If there is the policy decision that a compensation mechanism is necessary to maximise the chances of a wronged consumer being paid compensation then you need to look at the pros and cons of a compensation fund.[76]

5.96 This suggestion is examined in the following chapter, starting at paragraph 6.171.

5.97 ACI also questioned the usefulness of PI insurance for consumers:

> ACI regards this benefit of PI insurance as being questionable for consumers. If the adviser is properly supervised then they should have limited scope to amass huge indemnity requirements. However, if there is a need to call on the PI cover then the PI cover must meet its purpose. It seems that frequently it is very difficult to claim against, suggesting that it simply adds costs for no consumer benefit. If this is the case there may be little point continuing with it in its current form.[77]

5.98 AMP agreed:

> In some of the recent collapses, PI cover has shown to be inadequate in providing sufficient levels of compensation for affected clients. Unscrupulous licensees can avoid their responsibilities and the existing compensation model tends to punish those that comply with the regulations while also failing the consumer.[78]

5.99 Maurice Blackburn Lawyers were particularly critical of PI insurance as a compensation mechanism:

> Some of the reasons for the inadequacy of PI insurance are as follows:
>
> 1. The effect of exclusion clauses forming part of PI insurance policies which limit the application of the policy, particularly where the exclusion pertains to one of the key financial services that the insured provides to consumers. Exclusions also often limit the application of the policy to financial products on an approved products list;
>
> 2. Monetary limits on liability which significantly limit the amount that can be recovered under PI insurance policies and, in particular, where such

75 ASIC, *Submission 378*, p. 83.

76 Insurance Council of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 78.

77 ACI, *Submission 397*, p. 11.

78 AMP, *Submission 367*, p. 11.

> limits include the legal costs of defending claims brought against the insured; and
>
> 3. The requirements of a “claims made” insurance policy whereby notice of a claim needs to be made within the period stated in the insurance policy giving rise to the impediment that the notification period may already have expired before the client is aware that they have suffered a loss.[79]

5.100 Maurice Blackburn also complained of the difficulties clients face in obtaining information about relevant PI policies:

> As the law currently stands, there are very limited avenues available to plaintiffs to obtain information in relation to the insurance status of defendants or proposed defendants prior to the commencement of proceedings or throughout its conduct. This significantly hampers our ability to advise our clients on such aspects as recoverability and to properly assess the prospects of recoverability. Often it is not until considerable funds have been spent in pursuing an action that it is revealed that there is no responding insurance policy or there is a limit on the liability in a responding insurance policy.[80]

5.101 Compounding these limitations is a greater reluctance from insurers to provide PI on the terms it was previously available, due in part to the financial crisis and recent product/adviser failures. Association of Financial Advisers submitted that 'The increase in claim limits for external dispute resolution schemes such as the Financial Ombudsman Service (FOS) has resulted in higher claims being paid, resulting in a less profitable industry.'[81] Insurance Council of Australia told the committee that insurers had limited the amount of cover they are willing to provide and the conditions under which cover will be available.[82] ASIC confirmed that the market for PI insurance for financial advisers had 'hardened'. They indicated that premiums were to increase; new policies are excluding margin loans; automatic run-off cover will be limited; insurers are reviewing product lists and excluding certain products; and some insurers are not writing new cover or are withdrawing from the financial adviser market.[83]

5.102 Q Invest argued that the current requirements are too prescriptive:

> The current requirements, whilst innocuous at first glance, overlook certain commercial side effects which have a deleterious effect on competition, affordability and, ultimately, the cost of advice borne by consumers.[84]

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79 Maurice Blackburn Lawyers, *Submission 399*, pp 2-3.

80 Maurice Blackburn Lawyers, *Submission 399*, p. 3.

81 AFA, *Submission 344*, p. 13.

82 Insurance Council of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 74.

83 ASIC, *Submission 378*, pp 83-84.

84 Q Invest, *Submission 374*, p. viii.

Committee view

5.103 The committee notes that PI insurance is not intended to be a catch-all scheme designed to compensate investors whenever they have a successful claim against an adviser. It merely ensures that advisers can meet their obligations if a finding is made against them, if occurring in circumstances covered by the relevant insurance policy. Investors are not protected in a number of important situations, notably where the licensee has become insolvent, disappeared or behaved fraudulently. Alternative compensation mechanisms warrant consideration to address these shortcomings. The committee looks at these proposals in the next chapter, starting at paragraph 6.171.

Enforcement issues

5.104 In contrast to the perspective that regulatory deficiencies are causing a failure to protect investors from poor advice, there is a strong view that the present regulatory system is adequate and the failure is one of enforcement. The committee was told that some perspective is required when assessing problems within the sector, which are limited to the actions of a small number of rogue operators. Current conduct and disclosure regulations, properly enforced, are sufficient to address these issues.

5.105 FPA indicated that the current regulatory system had withstood a very challenging period:

> ...as a result of the global financial crisis financial services reform has been stress tested like you would never believe and it has withstood the tests of a very significant set of events. We believe therefore that financial services reform and its application to financial planning is robust.[85]

5.106 AFA also suggested that the problems exposed by Storm needed to be kept in proportion:

> ...if they operated outside the law and did not overlay their ethical and moral position, do we then want the other roughly 16,000 advisers who are doing the right thing to take a far more onerous path—those who have not had parliamentary inquiries created because of their conduct? I think there is a need to separate that out.[86]

5.107 CPA Australia also indicated that the problem needed to be kept in perspective:

> Overall the vast majority of advisers and licence holders are doing the right thing. The level of abuse or people breaking the rules is relatively small. Admittedly, we have had some pretty high, public incidences where advisers, business models or products have fallen over, with Storm and so

85 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 27.

86 AFA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 34.

on, but ... we are seeing serious issues with [only] a handful. The vast majority of our members are doing the right thing.[87]

5.108 AXA stated:

AXA believes that the failures which are the subject of your inquiry have resulted primarily from a combination of the excessive promotion of credit in conjunction with investing, poor and unethical business practices and in some cases poor advice. It appears that in many cases the investment strategies presented to clients included excessive levels of risk in the context of the client's personal circumstances and a level of risk that they did not fully understand as a consequence of gearing.

AXA also believes that these practices are not typical in Australian financial services, and do not point to a wholesale failure of the Australian financial system or the regulation thereof.[88]

5.109 Professional Investment Services expressed the same view:

Almost every industry has its bad eggs. In my time in the industry, the majority of advisers put their clients' interests first at all times ... Whilst it is important for the committee to focus on the terrible issues at hand, I would encourage them not to use a sledgehammer to crack a pea...[89]

5.110 They added:

...without quality advice to consumers, they would be left to their own accord and make many, many more costly mistakes.[90]

5.111 Similarly, Guardian Financial Planning noted that advisers tied to large dealer groups were not responsible for the sort of catastrophic advice that affected Storm investors:

The industry is made up of around 17,000 practitioners who fall into two broad camps—noninstitutional operators, known as independent financial advisers, and those that are backed by a financial institution, often referred to as aligned or tied advisers. The majority of advisers are said to be aligned to institutions such as AMP, AXA, the banks or businesses such as ours. Historically, they seem to have been the focus on media, professional bodies and regulators. However, it is a small number of non-institutional operators who have been at the forefront of the highest profile collapses. Those operators represent a small minority of advisers. For example, as best

87 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 62.

88 AXA, *Submission 385*, p. 4.

89 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 111.

90 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 111.

> we understand the details, Storm Financial had around 13 advisers. The industry has some 17,000 advisers.[91]

5.112 They argued that the focus should be on identifying and weeding out fringe elements in the industry.[92]

5.113 IFSA warned the committee against 'overcompensating for the last mistake', stressing that section 945A of the Corporations Act 'is not an insignificant weapon to defend and advocate on behalf of consumers'.[93] CPA Australia also suggested that the problem has been one of adequate regulations not being enforced:

> Storm was giving the same advice, irrespective of the client circumstances. It was often margin loans which possibly exceeded their capacity to pay or even their need for the underlying investment. It would appear Storm were doing a one-size-fits-all approach to advice. Everyone was doing the same, getting the same advice and clearly, whilst they might have been doing the right thing around disclosure and so on, that is not in line with section 945A of the Corporations Act where there has to be a sound basis for the advice. I guess we fail to see if someone was looking at a licence holder, I would have thought serious questions would have been asked earlier as to how a one-size-fits-all advice model works for all their clients.[94]

5.114 They suggested that ASIC's approach of acting on complaints had been too reactive, possibly due to resource constraints:

> They really need to toughen up on the proactive, doing things earlier, and if that means more resources, and it would seem as though it would, then that is where the energies should be, because at the moment ... they seem to come in either after the fact or when they go in early we do not see anything actually happen that changes the course of events that subsequently follows.[95]

5.115 ICAA noted that the annual audit for AFS licensees does not include a proper examination of the advice being provided by their authorised representatives:

> Currently there are extensive requirements as to how a business applies for an AFSL and there are ongoing requirements and obligations. However it could be argued that there seems to be a gap in the on-going compliance requirements and what is included as part of the compliance audit. An AFSL is required to be audited that involves conducting both a financial and compliance audit to check whether the licensee is complying with its licence conditions and the requirements of the Act. Currently the audit and

91 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 86.

92 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 87.

93 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 53.

94 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 62.

95 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 68.

> monitoring does not examine in depth the advice being provided by the representatives of the AFSL.[96]

5.116 Q Invest wrote:

> In our view, most participants in the financial services sector willingly comply and apply their best endeavours to meeting their obligations.
>
> We question whether additional disclosure obligations would have saved investors from the collapses we have witnessed.
>
> In our opinion, enforcement and appropriate action in terms of the spirit of those obligations is what was missing.[97]

5.117 They suggested:

> ASIC should strive for a primarily preventive function, through greater monitoring, supervision and enforcement of obligations imposed on AFS licensees and other entities falling within its jurisdiction. The reality is that there are enough laws in existence to cover every conceivable instance of misconduct within the financial services industry today. It needs to be recognised, therefore, that what we need now is a regulatory body who will be ready, willing and able to take the necessary steps to ensure that all the participants in the industry are complying with those laws.[98]

5.118 IFSA also told the committee that higher standards would not prevent non-compliance, with ASIC needing to be able to 'respond pre-emptively'.[99] However, ASIC told the committee that they have limited scope to intervene before breaches occur:

> The FSR regime is largely self-executing: AFS licensees and other participants are expected to comply with the conduct and disclosure obligations in the law. ASIC oversees compliance with these obligations and then takes appropriate enforcement action when there is non-compliance. ASIC's power to take action ahead of non-compliance is limited.[100]

5.119 ASIC reported that it will undertake targeted surveillance of randomly selected licensees to assess the quality of advice being provided, in addition to shadow shopping exercises.[101] Suggestions for a more targeted risk-based approach are examined in the following chapter, starting at paragraph 6.18.

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96 ICAA, *Submission 363*, p. 13.

97 Q Invest, *Submission 374*, p. ii.

98 Q Invest, *Submission 374*, p. viii.

99 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 50.

100 ASIC, *Submission 378*, p. 20.

101 ASIC, *Submission 378*, pp 41-42.

5.120 The enforcement of disclosure requirements was also referred to in evidence. SDIA suggested that compliance documents of 70 pages and more cannot be considered clear and concise, as they are required to be.[102] BFPPG expressed the view that ASIC was not properly enforcing the requirement to disclose ownership conflicts:

> ASIC has not been rigorously enforcing the regulations in the key area of ownership. The regulations are clear: all financial planners must disclose their ultimate licensee ownership. It follows that the disclosure must be made in a manner that is meaningful for the client. The reality, however, is quite different. The majority of clients have no idea who the ultimate licensee is. In many cases they believe they are dealing with independently owned firms when in fact they are dealing with institutionally owned firms.[103]

5.121 ASIC noted that it cannot review all disclosure documents and that it 'adopts a risk based methodology to assist with which disclosure documents it should review'.[104]

Committee view

5.122 As the committee alluded to above, improved enforcement of existing regulations is essential in minimising catastrophic investment losses that occur as a consequence of financial advice that is manifestly poor and inappropriate. Current regulations already prohibit advisers from recommending an investment strategy that is inappropriate for their clients' circumstances and places them at risk of financial ruin. The committee is of the view that ASIC has been too slow in its enforcement of section 945A of the Corporations Act, which requires advisers to provide advice that is appropriate to clients' needs. Proposals for more effective, proactive enforcement and the committee's view on these are included in the following chapter, commencing at paragraph 6.18.

5.123 In making these comments, the committee does not preclude recommending legislative changes in the next chapter that will improve the overall quality of advice clients receive from financial advisers. Regulatory amendments will potentially complement improved enforcement measures designed to protect investors from advice that may have catastrophic consequences. They will also address the incremental yet pervasive detriment to consumers caused by poor, conflicted advice as described above at paragraph 5.75.

Financial literacy

5.124 Recent catastrophic investor losses demonstrate that many investors do not have the expertise to filter poor financial advice using their own knowledge about sensible investing. Many retail investors do not understand the nature of investment

102 SDIA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 66 and p. 70.

103 BFPPG, *Submission 251*, p. 22.

104 ASIC, *Submission 378*, p. 61.

risk and the importance of spreading risk across diversified asset classes, instead relying on third parties to steer them in the right direction. As was made apparent during evidence to this inquiry, many investors seek financial advice for the very reason that they have minimal financial literacy, and therefore place complete faith in the investment advice they receive.

5.125 ASIC agreed that many consumers do not have the levels of financial literacy needed under the current system:

> The FSR regime places the onus on investors to take responsibility for their own investment decisions. The onus is on the retail investor to recognise when they need to seek financial advice and to have a sufficient education, understanding and motivation to read and comprehend the disclosure documents they will receive when they receive advice and/or invest in products (e.g. SOAs, FSGs, and PDSs). This presumes that most Australians will have a reasonable level of financial literacy and understanding.[105]

5.126 Their submission stated that the requisite financial literacy to cope with investor information is often not present:

> ...the 2006 ABS Adult Literacy and Life Skills Survey found that 46% of Australians aged 15-74 do not have the level of literacy needed to understand narrative text, such as in newspapers or magazines, to the minimum level required to meet the complex demands of everyday life and work in the emerging knowledge-based economy. This suggests that many people would have difficulty understanding the disclosure documents they would receive when they invest or make other financial decisions.[106]

5.127 ASIC further noted that the infrequent nature of investment decisions mitigates the opportunity for people to develop financial literacy.[107]

5.128 IFSA also stated that 'we have had a whole generation of people forced to be investors' and many do not have any understanding of the complexities of their second largest investment, superannuation.[108] Their submission acknowledged that the literacy problem represents a 'complex and generational challenge', but emphasised its importance as a consumer protection mechanism:

> We believe that it is important to recognise that while improving financial literacy will almost certainly assist with consumer protection, initiatives focused on consumer protection are unlikely to address the complex and generational challenges associated with improving financial literacy.[109]

105 ASIC, *Submission 378*, pp 75-76.

106 ASIC, *Submission 378*, p. 76.

107 ASIC, *Submission 378*, p. 77.

108 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 57.

109 IFSA, *Submission 317*, p. 27.

5.129 MLC noted that poor financial literacy is the reason why financial planners are increasingly important:

> The big issue and gap that I see that needs to be addressed is the Australian superannuants' understanding of risk and the risk that they are taking with their retirement moneys. What we have seen through the crisis is a lot of people that are approaching retirement or are older and in retirement were probably more exposed to markets than they understood, or at least the impact of the market changes was much greater than they thought. That is a big challenge and it has led to our conclusion that the best way to do it is to get Australians to talk to a financial planner.[110]

5.130 FPA suggested that:

> We have a long way to go in helping consumers become more capable in terms of their financial obligations, responsibilities, preparation, planning and all those sorts of issues. There is a whole body of work in there.
>
> I think if you have a professional financial planner with a robust regulatory environment and an informed client, you are going to get the best outcome.[111]

5.131 ICAA warned against believing that consumers should be expected to protect themselves in the immediate term:

> Many people ... talk about consumer responsibility, saying that consumers should take more responsibility. The reality is that it is not going to happen in the current environment where you have got limited consumer literacy. So you cannot pass it off and say consumers need to take more responsibility. Yes, consumers need to increase their education and understanding themselves, but that is a generational issue. That will happen probably 10 or 20 years down the track when my kids are coming out of high school and so on.[112]

5.132 AFA commented that financial advisers are educators and need to be responsible in that role:

> There is a need, obviously, for consumers to take responsibility for the financial decisions that they make but equally there is for advisers, who are in a sense the client's first educator when they get into that relationship.[113]

Committee view

5.133 The committee notes that ASIC is presently delivering a number of financial literacy programs via initiatives such as school curriculum-based programs and their

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110 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 12.

111 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 45.

112 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 12.

113 AFA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 30.

own consumer information website, FIDO. While these are certainly useful approaches, the committee is of the view that ASIC could be doing more to target key, higher risk, older demographic groups by promoting sensible investment messages, including through the mainstream media. The committee makes a recommendation about investor education in Chapter 6.

5.134 Notwithstanding this, the reality is that better investor education is not the only answer to protecting investors from poor financial advice. It is a solution often proposed by those in the industry wishing to maintain the regulatory status quo, but is not in the committee's view effective at protecting the most vulnerable investors. The complexity of investment strategies leaves the prospect of clients determining the quality of financial advice they receive, through the filter of personal knowledge, beyond the capacity of many. Most clients quite legitimately trust in the knowledge and professionalism of their financial adviser to provide them with good advice, and do not have the confidence in their own understanding of the subject to challenge the advice they are given. Therefore the regulatory system should, to a reasonable extent, protect consumers from poor advice, rather than relying on consumer's being sufficiently financially literate to determine for themselves whether their adviser's recommendations are in their interests.

5.135 The next chapter examines proposals for the more effective regulation of financial services.