Chapter 6

Suggestions for regulatory reform

6.1 This chapter examines a number of suggestions for rectifying the regulatory deficiencies that are claimed to impede protecting investors from poor advice. In broad terms, the changes suggested relate to:

- raising standards of advice;
- making disclosure more effective;
- removing conflicted remuneration practices;
- ensuring better transparency, competency and accountability through the licensing system;
- reforming lending practices;
- limiting access to complex and/or risky investment products; and
- introducing a last resort statutory compensation scheme for investors.

Standards of advice

6.2 The previous chapter outlined concerns about the effect of conflicts of interest on the quality of advice provided by financial advisers. The committee heard a number of proposals to raise standards in this area, which fall within three categories:

- imposing a higher legislative standard through a fiduciary duty for financial advisers to place clients' interests first;
- providing consumers a distinction between sales-based advice and independent advice;
- improving enforcement of current advice standards through annual reports to ASIC and/or risk-based auditing.

Fiduciary duty

6.3 A number of witnesses appearing before the committee supported the imposition of an explicit fiduciary duty on financial advisers, requiring them to give priority to their clients' interests ahead of their own. Australian Securities and Investments Commission (ASIC) was amongst its proponents, claiming that a legislative fiduciary duty would overcome the inadequacy of disclosing conflicts:

> An additional legislative requirement to put the interests of clients first where there is a conflict would lead to a higher quality of advice and the emergence of a professional advice industry.
>
> It would mean that where there is a conflict between the interests of the client and the interests of the adviser, the adviser must give priority to the interests of their client. For example, under the current test, an adviser may have a reasonable basis to recommend a client invest in any of three different products. Of the three products, the adviser could recommend the product that delivers the adviser the greatest fee revenue, provided that this conflict of interest and the amount of the fee is clearly disclosed to the client. However, under the higher standard proposed above, they would be required to recommend the lower fee product because the adviser is required to prioritise the interests of their client (i.e. in paying the lowest fees possible) before their own interest in receiving higher remuneration.[1]

6.4 ASIC said that the imposition of a legislative fiduciary duty would likely change remunerative practices, even without a ban on commissions:

> ...once you are in a fiduciary relationship, if you are going to take commissions or some other benefit, that benefit belongs to your client. It is not yours; it is your client's, unless your client through disclosure but more importantly through informed consent allows you to keep it. The standard and the way you discharge that duty is that, if you are running a large organisation, for practical purposes you would be hard pressed to say, 'Yes, you can still have commissions,' because in each individual case you run a risk. So the change we would see to industry practice would be that a lot of the front-end, trail and ongoing commissions would probably not sit well with a clarification of that duty.[2]

6.5 ASIC noted that the higher standard would not require advisers to provide the 'best advice' to clients, or that every product available in the market would need to be considered.[3]

6.6 Professional Investment Services did not oppose the introduction of a statutory fiduciary duty, indicating that such a duty already exists.[4] Trustee Corporations Association of Australia argued that advisers should always place their clients' interests first:

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1 ASIC, *Submission 378*, p. 43.

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

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

4 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 113.

> ...it is just unthinkable to me that you can give advice to a client without giving it in the client's best interest and preferring your own interest over theirs. It is implicit in an advisory role.[5]

6.7 Industry Super Network recommended that section 945A be replaced by a requirement to act in clients' best interests:

> The key elements which this obligation will be:
>
> - It will be owed by an individual planner to his or her client. Licensees would also continue to hold responsibility for advisers operating under their licence.
> - The best interests obligation would require the planner to give clients their undivided loyalty, which means the financial planner must strive to avoid any actual or perceived conflict of interest.
> - The method of payment for financial advice must reflect the planner's undivided loyalty to their client. An individual adviser or a licensee cannot receive any payments from product providers or fund managers. Payment for advice must be made by the client and would ideally be based on the amount of time or advice provided. Up front commissions or fees would not be permitted.[6]

6.8 Industry Super Network stated that this requirement would force licensees to include a variety of product types on its approved product list and would preclude volume based payments.[7] They clarified that this requirement would require advisers to put their clients' interests ahead of their own, rather than selecting the best investment products:

> In order to satisfy the 'best interests' obligation, an adviser's work would be measured against a standard of reasonable skill, care and diligence to be expected of an ordinary prudent person acting in the capacity of a qualified adviser. However, the obligation to act in the client's best interests would not require financial advisers to predict the best or highest performing products. Superannuation trustees are subject to a 'best interests' obligation which does not expose them to liability for failing to pick the best performing investment managers for their fund in any year. The best interests obligation is not retrospectively evaluated based solely upon the performance results of the superannuation fund, but rather by examining whether the trustees exercised a reasonable standard of skill, care and diligence in selecting and monitoring investment managers.[8]

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5 Trustee Corporations Association of Australia, *Official Committee Hansard*, Sydney, 4 September 2009, p. 21.

6 Industry Super Network, *Submission 380*, p. 14.

7 Industry Super Network, *Submission 380*, p. 14.

8 Industry Super Network, *Submission 380*, p. 15.

6.9 Australasian Compliance Institute (ACI) supported a fiduciary duty being imposed on individual advisers.[9] FPA commented:

> ASIC has talked about attributing a fiduciary responsibility to the function of advice, and we think that that is going to be quite hard to monitor and manage. We would prefer that the role of fiduciary were attached to a person, not to a function or interaction. We believe the person should have that responsibility...[10]

6.10 Association of Financial Advisers (AFA) told the committee that the category 'financial adviser' should be legislatively defined before a fiduciary duty could be imposed by legislation.[11]

Dual standards of advice

6.11 Another possible reform involves applying different standards to advisers claiming to offer unbiased financial advice, as opposed to those whose primary objective is selling financial products. The notion of imposing different standards depending on how advisers identified themselves has been suggested previously. In 2006, the government floated a proposal to separate sales and advice by exempting those offering straight product recommendations/sales from the Chapter 7 requirements on financial product advice in the *Corporations Act 2001* (Corporations Act), subject to clear disclosure requirements.

6.12 Treasury explained to the committee that there were concerns about that proposal that meant it was not pursued further:

> One [issue] was that consumers may not necessarily appreciate the difference between the advice stream and the sales stream, and you would need to have very, very clear warnings or some kind of communication tool so that everybody would know precisely what it was that they were doing. And there was not confidence that we could come up with that.
>
> The second big issue was that, if that kind of structure were adopted, one outcome might be that the number of participants in the market going for the full advice model would decline significantly and that a lot would shift into the sales stream, because the sales stream would not be accompanied by the kinds of regulatory requirements in terms of training, competence and so forth. So there was a concern that an outcome that might occur is that there might be plenty of sales people out there but not many people who were offering the genuine advice. The concern that was mentioned earlier about real, genuine advice only being available to affluent clients was another issue.[12]

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

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

11 AFA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 33.

12 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 19.

6.13 ASIC also outlined this latter concern:

> Those who opposed this proposal suggested that most investors would use the 'sales' part of the industry (given the high concentration of advice businesses that are tied to product manufacturers) and therefore would receive lower quality 'advice'.[13]

6.14 The United Kingdom's regulator, the Financial Services Authority (FSA), has proposed that financial services firms be required to identify whether their services are either 'independent advice' or 'restricted advice'. Treasury explained this approach to differentiating different types of advice:

> The UK ... decided to focus on separating out independent advice and restricted advice. Independent advice means that you have to look completely across the market. So it is very broad. You have to give unrestricted advice. You have to basically have knowledge of all of the products that might provide suitable outcomes for your clients. The restricted advice model is where you are clearly stating that you are offering a lesser range of products, and you have to clearly articulate that upfront to the consumer.[14]

6.15 However, officials stressed that it was not easily transferable to Australia:

> Looking at the UK model, you cannot adapt it straight across to the Australian model because, for example, in the appropriate advice regime we do not require that every single product in the market be considered. So there is not an exact or straight translation.[15]

6.16 The Institute of Chartered Accountants in Australia (ICAA) commented that 'the introduction of a two-tiered model would just add further complexity and confusion for the consumer'.[16]

6.17 A number of proposals aired during the inquiry proposed imposing dual standards within the broader framework of a dual licensing system. These suggestions are discussed later in the report, starting at paragraph 6.105.

Risk-based audits

6.18 The previous chapter outlined the views of those who believed that problems with the quality of financial advice are mainly due to inadequate enforcement of the existing regulations, particularly section 945A of the Corporations Act requiring advice to be appropriate to the client. To improve enforcement in this area, some have suggested that ASIC take a more rigorous and targeted approach through risk-based surveillance activities. For example, AMP recommended that:

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

14 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 8.

15 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 8.

16 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 11.

> ...an appropriately resourced ASIC adopt a risk based approach to monitoring and supervision to more effectively monitor and assess management of conflicts by Licensees.[17]

6.19 Similarly, the Investment and Financial Services Association (IFSA) recommended that ASIC:

> ...adopt a risk-weighted approach to monitoring and supervision based on improved benchmarking of industry practice to more effectively monitor and assess management of conflicts of interest by Licensees and Licence applicants.[18]

6.20 They suggested that the following factors be considered as part of a 'risk-weighted approach to monitoring and surveillance using its existing powers':

> ...in relation to Licensees that provide financial advisory services, the type of information which ASIC could consider to better assess this risk includes:
>
> • Extent to which ASIC has had prior constructive dealings with the Licensee
>
> • Prevalence of leverage across clients
>
> • Membership of professional or industry associations and their compliance history with such bodies
>
> • Details of management qualifications/experience
>
> • List of approved products and the basis for approval
>
> • Products most frequently recommended
>
> • Internal processes for the delivery of complex or high-risk advice strategies
>
> • Number of complaints lodged against the Licensee and their type
>
> • Number of advisers/authorised representatives
>
> • Number of Certified Financial Planners
>
> • Number of SoAs produced
>
> • Amount of funds under advice.[19]

6.21 AXA suggested that ASIC's monitoring activity was tilted too much towards larger licensees, and more attention should be given to 'other risk indicators such as complaints, the complexity of products being recommended and reports from industry participants'.[20]

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17 AMP, *Submission 367*, p. 12.

18 IFSA, *Submission 317*, p. 23.

19 IFSA, *Submission 317*, pp 29-30.

20 AXA, *Submission 385*, p. 16.

6.22 CPA Australia stated that: 'ASIC currently appears to employ a reactive rather than a proactive approach to enforcing the regulation'.[21] They recommended that ASIC use the information provided by applicants to target their enforcement:

> Whilst it is not ASIC's role or responsibility to approve a business model in order to approve an application for an AFSL, ASIC could use the Business Description core proof to evaluate the risk that an applicant may breach their obligations once licensed. Any applicant who was deemed to be at risk could be reviewed by ASIC within a 12 month period of being granted an AFSL. The review should include ensuring all relevant processes and licence requirements are still in place and a review of random selection of Statements of Advice (SOA). This will aid in identifying if the providing entity is making reasonable client inquires, if they are considering and investigating the subject matter of the advice as is reasonable in all the circumstances and if the advice is 'appropriate' for the client.[22]

6.23 CPA Australia further recommended that licensees be required to submit an annual return outlining information about their clients, recommended products and fees charged. The document could be lodged as part of existing AFSL reporting processes.[23] Noting that the one-size-fits-all strategy needed to be eliminated by enforcing section 945A, their submission stated:

> It is of concern that there is anecdotal evidence that many licensees who have been in practice for many years have had little or not contact with ASIC since being granted an AFSL. It is unrealistic for ASIC to audit each AFSL on an annual basis, however CPA Australia believe that there is still a need for ASIC to have regular contact with all AFS licensees.
>
> A more efficient and far-reaching solution would be for every licensee to complete an AFSL annual return. The annual return should cover key information and statistics, which ASIC would review and use to compare against industry averages and best practice. It would be an efficient method to identify an AFSL who may be at risk of breaching their obligations due to their business practices. For example, if there was a disproportionately high number of clients in one product type, this could be seen as a result to investigate further.[24]

6.24 In evidence to the committee they said that problems such as Storm Financial could have been identified earlier using these strategies:

> If ASIC had the information and you could see a licence holder was recommending a lot of margin loan products and it just turned out that a large proportion of their client base was retired, then that would warrant

21 CPA Australia, *Submission 311*, p. 5.

22 CPA Australia, *Submission 311*, p. 6.

23 CPA Australia, *Submission 311*, pp 7-8.

24 CPA Australia, *Submission 311*, p. 7.

> grounds to go in and have a closer look, look at the basis for advice and whether it is appropriate or not.[25]

6.25 Commonwealth Bank of Australia's (CBA) submission also recommended that licensees be required to periodically report to ASIC standard information about their business models, with particular emphasis on the nature of advice given to clients.[26]

6.26 ICAA also suggested more extensive auditing of advice:

> A consideration could be to include an "advice audit" as a component of the compliance audit. This is not a preferred solution, as it would result in increased compliance costs. However it would provide a solution to monitoring the practical application of the compliance processes within the AFSL. In addition, it may well remove any real or perceived conflicts of interest that may occur within an AFSL operation between the compliance function and other divisions of the business.[27]

6.27 Australasian Compliance Institute (ACI) suggested that licensees be required to submit to an independent review of a proportion of advice cases annually, undertaken by a person accredited by a professional body. ACI also suggested that ASIC or a professional body 'engage in proactive activities like shadow shopping'.[28]

Committee view

6.28 The committee supports the proposal for the introduction of an explicit legislative fiduciary duty on financial advisers requiring them to place their clients' interests ahead of their own. There is no reason why advisers should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide advice not in their clients' best interests, yet comply with section 945A of the Corporations Act. A legislative fiduciary duty would address this deficiency.

Recommendation 1

6.29 The committee recommends that the Corporations Act be amended to explicitly include a fiduciary duty for financial advisers operating under an AFSL, requiring them to place their clients' interests ahead of their own.

6.30 The committee draws no conclusion about whether such a duty would automatically preclude the payment of commissions to financial advisers. A recommendation on payments from product manufacturers to financial advisers is made at paragraph 6.101.

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25 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 64.

26 CBA, *Submission 357*, p. 8.

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

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

6.31 For reasons of complexity outlined in further detail below at paragraph 6.149 in the context of licensing, the committee does not support proposals to impose different standards of advice depending on whether someone is performing a sales function or offering 'independent' advice. The committee also recognises that a similar proposal has been previously discarded after concerns that the industry would become dominated by sales-based advisers.

6.32 The committee is firmly of the opinion that ASIC needs to undertake the enforcement of legislative standards of advice with a more rigorous and targeted approach. ASIC should perform effective risk-based surveillance on the advice provided by licensees and their authorised representatives, focussing particularly on licensees that have come to the attention of the regulator previously; recommend a high proportion of high risk products; have limited products on their approved product list; disproportionately recommend one type of product; or have limited experience or qualifications. The committee considers it important that ASIC establishes robust audit processes to be undertaken by suitably qualified field staff. The committee is also of the view that more regular, preferably annual, shadow shopping exercises should be conducted to identify breaches of the legislative standard and provide an important deterrent for licensees.

6.33 If additional funding is required to undertake these activities then it should be provided, particularly recognising the additional credit and market regulatory responsibilities ASIC will soon be required to perform.

6.34 The committee is not of the opinion that the benefits of receiving annual returns from licensees outlining advice practices would justify the administrative burden this would create for ASIC. There are more efficient ways of taking a risk-weighted approach to surveillance than receiving information from every licensee in Australia.

Recommendation 2

6.35 The committee recommends that the government ensure ASIC is appropriately resourced to perform effective risk-based surveillance of the advice provided by licensees and their authorised representatives. ASIC should also conduct financial advice shadow shopping exercises annually.

6.36 The committee also notes that the monitoring and enforcement of standards can be improved through the oversight of a professional standards body, which is the subject of a recommendation at paragraph 6.160.

Disclosure

6.37 Although there was a broadly held view that disclosure had been ineffective in managing conflicts of interest, necessitating other more robust measures, the committee did receive suggestions about what the purpose of disclosure should be and how it might be improved.

6.38 MLC was of the view that disclosure should complement the overriding requirement to act in the client's interests, rather than providing a cure-all solution. MLC summed up the opinion of many with the following comment:

> Acting in the client's interests has got to be the first and foremost driver of the client's outcomes, and disclosure needs to support that. The idea that we can find a 70-page document disclosing enough information to protect everybody's interests and give the client meaningful information is flawed.
>
> ...
>
> Clients get confused [by disclosure] ... at the end of the day what we have to be doing, as an industry and as an organisation, is acting in the client's interests. If you can combine that premise with disclosure that allows the client to make decisions or at least find more information if they want to, then you have a better regime than one that simply says, 'I've disclosed it so therefore the job is done.'[29]

6.39 Mr Peter Worcester of Worcester Consulting Group commented that disclosure documents could be simpler:

> I would like to use the idea of when you go to your doctor and he is going to operate on you. He gives you a two-page informed consent. He says what it is going to cost, what the procedure is, what might go wrong and what is the probability of it going wrong. I tend to believe that we should chuck out those 50-page statements of advice and have a two-page document.[30]

6.40 Boutique Financial Planning Principals Group (BFPPG) suggested that full disclosure should be replaced:

> There is a simpler approach that will provide the consumer with a better outcome:
>
> - Replace the requirement for full disclosure of the basis of advice with the requirement that the advice must be defensible. There must be a reasonable basis for the advice, and the financial planner must be able to defend the advice if required by the client, ASIC or FOS.
> - The advisor can then provide the consumer with documentation on the basis for the advice at a level that is suitable to the client's needs.[31]

6.41 The Commercial Law Association of Australia recommended that a mandatory one page disclosure document be required, containing information on product risk, the effect of major market fluctuations and fee costs.[32] ICAA suggested

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29 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp 7-8.

30 Mr Peter Worcester, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 102.

31 BFPPG, *Submission 251*, p. 15.

32 Commercial Law Association of Australia, *Submission 389*, p. 3.

that consideration be given 'to ensure common fee terminology is used to assist comparability'.[33]

6.42 The committee is aware that the Financial Services Working Group (FSWG), comprised of Department of Finance, Treasury, and ASIC officers working with other industry stakeholders, is developing 'simple, standard and readable product disclosure for specific financial products'.[34] ASIC informed the committee that:

> The FSWG is now working towards achieving simplified, mandatory disclosure ... it is devising:
>
> (a) short and simplified PDS disclosure requirements for margin loan products, superannuation and 'simple' managed investment scheme products. This simplified form of disclosure will include:
>
> (i) prescribed content requirements;
>
> (ii) a maximum page limit (4 pages for margin loans; 10-12 pages for superannuation and 'simple' managed investment scheme products);
>
> (iii) a new incorporation by reference regime identifying what information, when incorporated by reference, may be considered as part of the PDS; and
>
> (b) sample PDS documents as a guide for industry on the type of content and level of detail that would be expected in a shorter, simpler PDS.[35]

6.43 Treasury told the committee that the work of the Financial Services Working Group on disclosure was an alternative approach to the problematic task of separating sales from advice:

> That is one of the reasons that we turned to the concept of the Financial Services Working Group looking at the actual disclosure documents. It is taking it from a different direction. First, we were trying to separate them and then we said, 'If we can't separate, let's make sure the consumer understands what they are getting into and understands what this is.' If the documents are easy for them to read and they understand that a person is getting all these commissions and they will only offer you products of this sort and they understand exactly what they are getting into, at least we are one step closer to where we are trying to get to.[36]

6.44 Aside from the work of the FSWG, ASIC proposed that advisers be required to disclose more prominently restrictions on the advice they are able to provide consumers—in particular, the limited range of products an adviser tied to a product issuer is able to advise on. The submission stated:

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33 ICAA, *Submission 363*, p. 11.

34 ASIC, *Submission 378*, p. 62.

35 ASIC, *Submission 378*, pp 62-63.

36 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 21.

> Currently disclosure about relationships with product issuers tends to be buried in the fine print of a licensee's FSG and there is no legislative requirement for a financial adviser's marketing material (as distinct from FSGs and Statements of Advice (SOAs)) to disclose the association with a product issuer. Many advisers do not disclose this relationship on their website. By the time a potential client receives an FSG or SOA, they may have already gone a long way down the path to making a decision to use the services of the adviser.
>
> In order to bring the potential conflict to the attention of the client before they make a purchasing decision about the adviser's services or a particular product, prominent disclosure in marketing material could be required, for example, on advertisements, shopfronts, letterhead, websites etc.
>
> Advertising and marketing material could also state that the adviser can advise on a limited range of products and a list of these products is available on the adviser firm's website or on request.[37]

6.45 This proposal would seek to address ownership-based conflicts of interest by further clarifying for consumers the extent and effect of that relationship on the products able to be recommended by their adviser. It would also flag situations where advisers are permitted to recommend single products only (such as agribusiness MIS) as a licensing condition.

6.46 Another suggestion was for advisers to be required to conduct a personal stress test on clients to more effectively disclose product risk. Institute of Actuaries of Australia recommended:

> Many financial planners already adopt a process of scenario analysis or stress testing when advising individual clients. The Institute's proposal is that this current "best practice" be required as mandatory practice for all financial planners.
>
> A prescribed Personal Stress Test would provide customers with a simple objective measure of adverse outcomes as relevant to their individual circumstances. The adoption of standard assumptions and trigger events will ensure that the test will not be onerous for advisers.
>
> The Institute believes that a Personal Stress Test would be a more effective means of communicating the risk associated with significant adverse outcomes.[38]

6.47 This suggestion was supported by Worcester and Resnik:

> We believe that an appropriate way for a financial planner to ensure that a (gearing) investment strategy is appropriate is to apply a stress test to both:
>
> • The client's assets and liabilities, including their home, and home mortgage, and

37 ASIC, *Submission 378*, p. 45.

38 Institute of Actuaries of Australia, *Submission 319*, p. 5.

> • The client's income and expenditure, both at the consumption level (salary and living expenses, including mortgage payments) and at the investment portfolio level (dividend income and margin loan costs).[39]

6.48 IFSA was of the view that undertaking a risk assessment was an inherent part of providing appropriate advice to clients:

> The central objective of conducting a risk assessment is reaching a clear understanding about how much risk of financial loss a client is willing to accept to achieve their financial goals.
>
> Appropriate advice therefore involves calibrating an individual's financial goals against their risk profile.[40]

6.49 Australasian Compliance Institute called for the implementation of a risk rating system for financial products, applied consistently across the industry.[41]

Committee view

6.50 The committee suggests that the Corporations Act be amended to require advisers to disclose prominently in marketing material the restrictions on the advice they are able to provide consumers and any potential conflicts of interest. This is particularly important in the case of advice from vertically integrated financial institutions, where conflicts of interest attributable to the ownership structure will exist even if commission payments to advisers are eliminated as a form of remuneration.

Recommendation 3

6.51 The committee recommends that the Corporations Act be amended to require advisers to disclose prominently in marketing material restrictions on the advice they are able to provide consumers and any potential conflicts of interest.

6.52 Although disclosure is somewhat limited in the extent to which it can protect consumers from poor financial advice, clear and concise disclosure is still an important tool to assist consumers to recognise conflicts of interest and understand the cost of advice. The committee supports the current efforts of the Financial Services Working Group to reduce the length and complexity of disclosure material. The committee understands the high cost of compliance and is of the view that, along with other measures recommended in this report, the government should direct the Financial Services Working Group to develop mechanisms to reduce compliance costs over time.

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39 Worcester and Resnik, *Submission 293*, p. 3.

40 IFSA, *Submission 317*, p. 25.

41 ACI, *Submission 397*, p. 9.

6.53 The committee rejects proposals suggesting that financial products should be given a 'risk rating' by ASIC or any other government-authorised entity. It would be inappropriate for ASIC to be assessing and labelling the risk of financial products, not to mention a serious drain on resources.

Remuneration

6.54 The inquiry attracted considerable debate about whether banning commission-based remuneration is required to overcome the conflicts of interests it creates. Some argued that disclosure and conduct requirements have failed to adequately manage conflicts and a ban is now warranted, while others claimed that removing these payment methods would increase the cost and accessibility of advice for consumers. There was also discussion about whether enabling payments to be made as a percentage of funds under management represented an effective compromise between removing conflicts and maintaining affordability.

6.55 A number of contributors also proposed making the cost of financial advice tax deductible for consumers to make fee-for-service charging more appealing.

Bans on commissions

6.56 The committee received considerable evidence suggesting that the most effective way to improve the quality of financial advice for consumers is to remove conflicts of interest altogether by banning commissions and other conflicted remunerative practices. The regulation of remuneration practices was consistently raised during the inquiry.

6.57 ASIC submitted that commissions create conflicts of interest that are inadequately managed by disclosure, and suggested that the committee consider recommending a ban on a range of remunerative practices:

> While the reforms to clarify the fiduciary-style duty of advisers will have a significant impact on the ability to use commission remuneration, the Government should still assess changing the policy settings of the FSR regime so that advisers cannot be remunerated in a way that has the potential to distort the quality of advice given.
>
> This would mean that the following forms of remuneration would not be permitted, particularly in relation to personal advice:
>
> (a) up-front commissions;
>
> (b) trail commissions;
>
> (c) soft-dollar incentives;
>
> (d) volume bonuses;
>
> (e) rewards for achieving sales targets; and

(f) fees based on a percentage of funds under advice.[42]

6.58 ASIC proposed that people who do not hold themselves out to be advisers, or those providing execution-only services, be able to continue to receive commissions. ASIC also indicated that the government would need to consider whether to ban advisers receiving commission payments altogether, or permit them to return them to clients in full.[43]

6.59 This proposal was supported by a number of other submitters.[44] CHOICE supported a ban on 'remuneration incentives that are inconsistent with fiduciary duties an adviser owes a client'.[45]

6.60 Quantum Financial Services called for the 'rivers of gold' to be turned off:

> It is a sad fact that, in financial planning, he who pays me is my boss. No-one would consider allowing lobby groups to pay fees to politicians, yet we allow product manufacturers to pay financial planners and dealer groups. By 'rivers of gold', we mean commissions and any other type of financial arrangement between product providers, platform and dealer groups and advisers. The only parties who resist this reform are those who financially benefit from the rivers of gold.[46]

6.61 Other evidence to the committee suggested variations on the proposal to ban commission payments entirely. MLC supported banning volume based arrangements; Axiom Wealth proposed that rebates from platform providers and volume-based rebates be banned, or refunded to clients in their entirety; Australasian Compliance Institute told the committee that it is essential that clients be given the ability to stop trail commissions; and Australasian Compliance Institute also recommended that product manufacturers not be able to advise on their own products.[47]

6.62 ICAA argued that the attachment between manufacturers and advisers needs to be removed:

> ...it is important that the remuneration models are based on the payment from the client and not from the product manufacturer. It is important that the linkage between the product manufacturer and the adviser is removed.[48]

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

43 ASIC, *Submission 378*, p. 54.

44 See for example Strategy First, *Submission 178*, p. 11; Symes Warne and Associates, *Submission 169*, p. 3.

45 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 99.

46 Quantum Financial Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 44.

47 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 7; Axiom Wealth, *Submission 394*, p. 4; ACI, *Submission 397*, p. 6 and p. 4;

48 ICAA, *Submission 363*, p. 8.

6.63 However, they stated that the issue should be resolved by the industry, rather than banned by legislative action. ICAA claimed that commissions would simply continue under another guise were this to occur.[49]

6.64 Treasury supported a shift away from commissions, indicating a preference for a self-regulatory approach but noting the possible drawbacks:

> ...we are certainly in favour of moving away from that area. But the question is: what is the best way of doing it? We are quite encouraged by the fact that the industry has already started to do that in its own right. But I note that, for example, what the FPA and IFSA are doing is not quite exactly the same. Obviously you would need a single system for that to work. Then the question would be: if they cannot cover the whole of the industry, and I think it would be necessary to cover the whole of the industry, what can the government do to assist to ensure that that is across the whole industry? If the government makes an assessment that the industry based system will not be effective then you have to move further down that regulatory line to make it more effective.[50]

6.65 BFBPG advocated that incentive-based commission payments be phased out gradually:

> BFPPG accepts that making a rapid change from a commission–based model to a fee–basis model could be detrimental to clients and the process should be managed over a short but definite time and, with all stakeholders involved, through the development of improved fee and remuneration models that drive down costs and improve transparency.
>
> There has been recent argument that commissions should be banned immediately rather than eliminated over a period. There are still many financial practices that rely on commissions for their income. It is reasonable to accept that banning commissions within a short time frame would jeopardise the continued viability of those businesses. The real risk, however, is that the clients of those practices would suffer as their financial planners struggled to replace their remunerations models.[51]

6.66 MLC noted that even if commissions are banned, they would continue to be embedded in existing investment products:

> The challenge in many legacy products and in history is that there are a lot of payments still being made from products and we cannot change the past. All we have tried to do is put a line in the sand and take a view that we can change going forward.[52]

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49 ICAA, *Submission 363*, p. 8.

50 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 9.

51 BFBPG, *Submission 251*, p. 8.

52 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 10.

6.67 In contrast, the committee was also warned of the potential negative consequences from removing commission-based payments for advisers. In particular, it was suggested that mandating up front fee-for-service payments by banning commissions will make the cost of advice prohibitive to many. IFSA was one organisation that argued that removing existing fee structures would increase the cost to consumers:

> There are a number of subsidised arrangements that exist in the value chain of a financial product. Some of those have been widely criticised by some of the submissions here. But the reality is that if you begin to strip out some of the fees, such as volume based fees— which we support—you push more and more down directly to the consumer and you make it very expensive for them; you make it frighteningly expensive for them. That means that they simply will not seek the advice.[53]

6.68 Professional Investment Services emphasised the problems a sudden upheaval of remuneration structures could create:

> ...if you go and completely change the economics of the industry overnight it causes upheaval to many trusted relationships with those who are being charged correctly and whose interests are being looked after by their advisers.[54]

6.69 They also noted that a vertically integrated business supposedly removing commissions does not mean conflicts have also been removed:

> ...conflict also exists where advice is provided 'free' with no direct cost to the client, such as through a product provider, institution or industry fund. In these instances the cost of advice is subsidised by the product provider, institution or industry fund, which generates fees through the distribution of aligned products, or within the management fee for institutionally owned products. The conflict is not direct payment by the product provider, but indirect through employee remuneration (wage or bonuses) or through product placement restrictions, whereby the adviser can only recommend products included in the APL which may be restricted to institutionally aligned products. This indirect conflict operates in a similar fashion to those inherent in commission arrangements.[55]

6.70 The inference that may be drawn from this argument is that removing commissions would favour vertically integrated advisory firms over those that are not tied to a single product manufacturer but receive remuneration via commissions from various providers.

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

54 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, pp 114-115.

55 Professional Investment Services, *Submission 336*, p. 12.

6.71 Guardian Financial Planning observed that banning commissions would not necessarily prevent inappropriate advice:

> ...Storm was charging a percentage amount, which was a fee on the amount of advice. They were not receiving a product commission of seven per cent ... the debate at the moment is about commissions or fees. That is actually not going to prevent that sort of behaviour in future. It is possible to be charged a fixed flat dollar fee independent of a product and still, through the unethical actions of an adviser, be ripped off or cause people to suffer a loss. Our concern would be that the focus on fees and commissions is not going to prevent this. We could outlaw commissions tomorrow and have everything as a flat dollar fee. Will that prevent another Storm occurring? No it will not.[56]

6.72 ING Australia supported the notion that consumers 'should be able to determine remuneration arrangements that suit them best, which are based on their circumstances and ability to afford the advice'.[57] AFA commented that 'banning commissions will take away a consumer's fundamental right to choose' and make advice less affordable:

> ...banning commissions may make comprehensive financial advice unaffordable for consumers at the very time they need it most, and that the fees versus commissions debate is fixated on price when it should be focussed on value and the quality of the advice provided. It is important that in considering the remuneration structures of advisers, recognition is given to the contribution the existing structures have made to facilitating access to advice.[58]

6.73 AFA also contended that perceived conflicts of interest are 'evident in both remuneration structures'.[59] Similarly, Axiom Wealth indicated that a pure fee-for-service model would discourage people from seeking advice, fearing their adviser would simply maximise the time they spend on the client. They cited practices in the accounting, legal and medical professions as examples of over-servicing encouraged by fee-for-service remuneration.[60] Financial planner Mr Dean Glyn-Evans explained some of the practical problems with fee-for-service:

> You run the risk of ending up in the unenviable position of many accounting and legal practices today. They have to regularly increase their fees to help cover the interest charged on the bank overdraft they are forced to take out in order to keep their business afloat, until clients eventually get around to paying their fees. This is not smart business and I am afraid that

56 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 88.

57 ING Australia, *Submission 383*, p. 5.

58 AFA, *Submission 344*, p. 8.

59 AFA, *Submission 344*, p. 9.

60 Axiom Wealth, *Submission 394*, p. 7.

> many financial planners who resort to fee-only advice, will eventually find themselves in a similar black hole.[61]

6.74 He also suggested that over-servicing would occur, mainly through frequent and unnecessary reviews of client portfolios.[62]

6.75 Alternatively, Mr Robert Brown acknowledged the problem of over-servicing, but considered it preferable to the alternatives:

> Some accountants and lawyers do pad timesheets, proving that conflicts of interest exist in all commercial transactions. The trouble with conventional financial planning is that complex and confusing conflicts exist on several levels, not just one. While time-related charging has its problems, at least the client is assured that the adviser is selling advice, not products, and that a third party is not in the mix influencing the outcome.[63]

6.76 The Institute of Actuaries of Australia also rejected complaints about expensive commission-free advice:

> ...the whole issue around those who are less affluent is a bit of a furphy. Who are we talking about for starters? We are talking about 90 per cent of people whose best investment advice is to pay off the mortgage or put money into super—none of which would give any sort of commission or trail to an adviser. So we are talking about that 10 per cent who are left—in which case they are more sophisticated and in which case people should know how much they are paying for advice. Advice is expensive. For a financial planner the hourly rates might look high, because there are overheads, research and that sort of thing. But I think people have to see what that advice is. The profession has to stand on its own two feet. People need to understand that this is the cost of that advice.[64]

6.77 They added that:

> Long term it is highly unlikely it would cost them more upfront. Asset fees are insidious. As actuaries we live on compound interest. If you look at the effect of a small asset fee on an asset over a long period of time then you will see that it is an enormous amount of money. Once it is in an investment there is a certain inertia and it will stay there. People will not know how much they are paying. It is an insidious way of pulling out fees.[65]

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61 Mr Dean Glyn-Evans, *Submission 384*, p. 3.

62 Mr Dean Glyn-Evans, *Submission 384*, p. 4.

63 Mr Robert Brown, *Submission 342*, p. 5.

64 Institute of Actuaries of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 84.

65 Institute of Actuaries of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 85.

6.78 CHOICE acknowledged that up-front fees might discourage consumers, but stated that this problem could be overcome:

> [We] simply do not accept that the overall cost of advice will go up if we move to a fee-for-service arrangement. That does not mean that there is not this sort of 'money illusion' to overcome—this sense that people do not want to pay big lump sums for advice up-front. Again, I think this is part of the structural change in the industry. Through this process we will be holding the hands of consumers as well as holding the hands of financial advisers. Just because you are charging, for example, a lump sum fee for advice does not mean that a customer is in effect paying that all in one hit. You could easily have an arrangement where the payment is made over a period of time, as happens in other industries quite regularly. So there is the issue of the total cost of the advice, which I simply do not accept would go up, and then there is the issue of how it would be paid. I think there are all sorts of ways to accommodate the needs of both consumers and advisers.[66]

6.79 ASIC also downplayed the effect on the cost of advice:

> The exact impact of the proposal is difficult to predict without further regulatory impact analysis. However, at this stage, ASIC considers that it would probably cause some consolidation within the advice industry but that it is unlikely to increase the actual cost of advice (as opposed to the perceived cost of advice).[67]

6.80 The affordability of advice for the looming influx of people retiring with substantial superannuation lump sump payments has been of concern. Treasury informed the committee that efforts have been made to improve access to limited, affordable advice for retirees:

> ...[the] move we made to allow superannuation trustees to offer limited advice is specifically designed to target those kinds of investors who are often also older investors. Suddenly at age 55 they find themselves with a lump of money which they need to invest somehow, and they may not be well equipped to make the relevant decisions. So through the working group we have given that relief to superannuation trustees to provide certain categories of advice easily and cheaply to these investors.[68]

6.81 Citing the expense of providing compliant full personal advice, MLC urged the government to 'examine limited advice models, beyond superannuation, in consultation with the industry'. They added:

> Further, MLC recommends greater regulatory clarity around limited advice models in order to better facilitate the provision of low cost, effective advice to customers for whom this is the best solution.[69]

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66 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 105.

67 ASIC, *Submission 378*, p. 54.

68 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 22.

69 MLC, *Submission 346*, pp 31-32.

6.82 Finally, the committee received evidence about whether insurance products should be exempted from any ban on commissions (and other additional regulatory obligations), on the basis that insurance products are not responsible for catastrophic investor losses. National Insurance Brokers Association of Australia suggested that regulatory changes should not apply to their industry:

> Insurance brokers have a good track record in relation to regulatory compliance and there is little evidence of consumers being adversely affected by insurance broker negligence, poor advice, fraud or bankruptcy. Insurance broker effectiveness is evident by the relatively few claims that are considered by their external dispute resolution (EDR) scheme IBD Limited (which became part of Financial Ombudsman Service, FOS, on 1 January 2009) and from the size of those claims.[70]

6.83 AFA also argued that life insurance should be excluded:

> One of the unique aspect's of Life Insurance is that it is not guaranteed that every person will be offered cover under the policy of their choice, if at all. Under non-commission based arrangements, the customer would be required to pay a significant upfront fee to the adviser for advice on their insurance. If the customer was subsequently declined cover by the insurance company, they would have incurred significant expense and arguably received no benefit in that they were declined cover. This is clearly an undesirable outcome for both the consumer and for the advice industry.
>
> The substantial increase in up-front costs that would result if commissions were prohibited will result in considerably less insurance being sold through advisers and a significant reduction in the number of people receiving advice on their insurance needs. The result will be a widening of the already significant protection gap in Australia.[71]

6.84 This argument was rejected by Quantum Financial Services:

> Historically insurance products have been sold via the commission model and many financial planning practices and insurance broking business are dependent on the continual flow of commissions to sustain the value of their businesses.
>
> In our opinion, this is not sufficient reason to exclude insurance products as supposedly a special case.
>
> We frequently hear the excuse that Australians are 'underinsured' as the reason for insurance products to be excluded for any proposed industry changes. We do not accept this argument. Insurance is a product like any other – it is subject to the same forces of demand and supply.[72]

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70 National Insurance Brokers Association of Australia, *Submission 314*, p. 2.

71 AFA, *Submission 344*, pp 8-9.

72 Quantum Financial Services, *Submission 56*, p. 15.

Consumer choice and asset-based fees

6.85 Other recommendations made during the inquiry sought to balance these considerations by proposing payment structures that are affordable, while also meeting the objective of being explicitly set and agreed to between client and adviser. FPA told the committee that it is guided by the principle that clients should control the fees they pay for advice:

> ...payment for advice should come from the client and that that is the most important thing you could possibly do, and not only that payment must come from the client, that it must be aligned with a service and you should be able to switch that payment off if you are no longer getting that service. We have moved the debate to direct negotiation between client and adviser, which is where all our efforts are focused.[73]

6.86 A number of submitters indicated that asset-based fees could enable this. FPA commented:

> The reason we wish to preserve the role of an asset based fee, so long as it meets the premise that the client pays for it, the client negotiates, it is fully transparent and so forth, is that we are very concerned that middle Australia, the large bulk of the population who could very well do with advice or want advice, will not be able to afford advice if it is purely delivered on an hourly basis ... We need some flexibility for people to choose how they pay for the advice and to choose how they can access that advice and therefore be able to afford advice.

6.87 They added:

> ...if we are forced into an hourly basis, as in the legal and accounting professions, which are different from financial planning in terms of the work transacted, then indeed we will find it very difficult to deliver that advice to a vast number of Australians who will be priced entirely out of the market.[74]

6.88 MLC explained to the committee that there is a clear difference between a fee agreed to by the client and a commission built in to the investment product:

> The client can simply decide to stop paying the fee. They can contact the institution and the fee will stop being paid, whereas the only way to stop the commission being paid in many products is to remove yourself from the product altogether.
>
> With a one per cent fee and a one per cent commission people say to me that it is just a commission by another term. It is not, because the one per cent fee is agreed, but the one per cent commission is not necessarily. The one per cent fee is seen by the client, but the one per cent commission is not necessarily. The one per cent fee can be stopped by the client, but the

73 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 31.

74 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, pp 31-32.

> commission cannot necessarily; and if the relationships falls away the fees stop as well, which is not the case with the commission. It is actually putting the client in much more control.[75]

6.89 Axiom Wealth also favoured this method:

> Where a client has chosen to have an on-going advice relationship with a planner, we believe advice fees based on funds under management (FUM) represent the most equitable arrangements for clients and advisers. We would argue that fees charged on this basis provide the best alignment of client and adviser interests, and remunerate adviser "proactivity" – which clients rate as a highly valued service.[76]

6.90 They added that FUM-based fees can be terminated 'without upsetting any of the underlying investment arrangements that might be in place'.[77]

6.91 However, ASIC did not support this approach:

> Remuneration based on the amount of funds under advice can also create conflicts of interest. Advisers who are remunerated by reference to funds under advice have an interest in selling investment products to their clients and encouraging their clients to borrow to invest.[78]

6.92 CHOICE did not support the argument for asset-based fees either:

> The problem with any asset based charge is that it carries the same taint of conflict as commissions. There are incentives on advisers to favour strategies that involve debt in gearing to build assets that generate fees for advisers. If the industry transitions from asset based commissions to asset based fees, the disclosure may be better and consumers should have the ability to turn off those fees, but the market distortions arising from asset based charges will remain.[79]

6.93 Mr Robert Brown also described the potential problems created by asset-based fees:

> Asset-based percentage fees for service remove the temptation to sell high commission products, but they still require a planner to sell a product or accumulate funds under management (whether or not the client needs this). In addition, asset-based fees for service give the appearance of independence, without actually being so. Therefore, in some circumstances they can be more dangerous than commissions, and can even can lead to the

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75 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 11.

76 Axiom Wealth, *Submission 394*, p. 3.

77 Axiom Wealth, *Submission 394*, p. 7.

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

79 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, pp 98-99.

> derivation of higher levels of remuneration than would be possible via a commission model.[80]

6.94 Q Invest considered it inequitable:

> We do not consider it appropriate for financial planners to base their remuneration on a percentage of assets as this necessarily results in different clients being charged differently for substantially the same level of service. This inequitable practice dilutes the value of advice by perpetuating the notion that financial planners are product distributors and it should be avoided.[81]

6.95 Industry Super Network also opposed asset-based fees, stating that conflicts of interest remain and such fees still encourage product sales ahead of strategic advice. They suggested that they would only be appropriate in the following circumstances:

> Where the client and adviser agree on an asset based fee, this must be agreed and approved by the client at least annually. ISN proposes that clients should opt-in, on an annual basis and in writing, to receive and pay for financial advice. This is typical in client-professional adviser relationships and ensures that consumers are only paying for advice that they desire and receive.
>
> Therefore, while a product provider can facilitate payment of the advice fee directly from the client's account; this must be based on a written authority from the client, with an annual renewal.[82]

Tax deductibility

6.96 There was also considerable support for fee-for-service advice payments to be made tax deductible. The committee heard that this would not only make this form of remuneration more affordable, but would provide equitable treatment to that applying to commission payments, which may be claimed as a business deduction presently. ICAA stated:

> ...it will introduce consistency and equity. In some cases the commission and the commission payments are actually deductible. You have a conflict there between deductibility of a commission remuneration versus fee for service. Also, from an administrative perspective, if you have a fee-for-service model then if I am providing advice I need to, as currently, put down the advice that I am actually providing and see what is tax advice and what is not tax advice and then I develop my invoice. So you have got some administrative issues there in terms of delivery of the service and, again, that adds to the costs associated with it.[83]

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80 Mr Robert Brown, *Submission 342*, p. 4.

81 Q Invest, *Submission 374*, p. iv.

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

83 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 6.

6.97 BFPPG commented:

> In the continuing argument about commissions v fees it makes little sense for an upfront commission paid to a financial planner to be tax deductible to the product manufacturer but an upfront fee paid to a financial planner not to be tax deductible to the client.[84]

6.98 Q Invest supported the proposal:

> There is a clear public policy benefit to be gained by encouraging consumers to seek professional advice to prudently plan their financial future – and financial independence. Secondly, many remuneration structures which operate on a commission model effectively enable a tax deduction to be claimed for the commission payment, thereby providing an incentive to pursue the type of remuneration model associated with some of the recent collapses.[85]

6.99 The committee also heard support for this proposal from CHOICE, Axiom Wealth, AXA, Industry Super Network, Strategy First Financial Planning and MLC.[86]

Committee view

6.100 The committee notes that remuneration structures that are incompatible with a financial adviser's proposed fiduciary duty (Recommendation 1) should be removed. The committee acknowledges that some in the industry have already indicated a willingness to move away from commission-based remuneration practices. The committee welcomes this and recommends that government consult with and support industry in effecting this transition.

Recommendation 4

6.101 The committee recommends that government consult with and support industry in developing the most appropriate mechanism by which to cease payments from financial product manufacturers to financial advisers.

6.102 The committee is of the view that the proposal to make the cost of financial advice tax deductible for consumers has merit. It could potentially encourage more people to seek financial advice and would match the deductibility presently afforded to manufacturers paying commissions to advisory firms. However, the committee also recognises that tax deductions could represent a subsidy for financial advisers, with the market willing to bear higher costs knowing that a proportion will be returned at the end of the financial year. Nonetheless, the committee recommends that the

84 BFPPG, *Submission 251*, p. 17.

85 Q Invest, *Submission 374*, p. ix.

86 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 110; Axiom Wealth, *Submission 394*, p. 3; AXA, *Submission 385*, p. 12; Industry Super Network, *Submission 380*, p. 15; Strategy First Financial Planning, *Submission 178*, p. 14; MLC, *Submission 346*, pp 33-34.

government consider the implications of this proposal as part of its response to the Treasury review (the Henry review) into the tax system.

Recommendation 5

6.103 The committee recommends that the government consider the implications of making the cost of financial advice tax deductible for consumers as part of its response to the Treasury review into the tax system.

Licensing

6.104 The committee received a number of suggestions to vary the current licensing arrangements for financial advisers. They included:

- more clearly conveying the conflicts and competencies of advisers through separate licensing arrangements;
- raising industry standards by increasing competency requirements, particularly the minimum educational qualifications for advisers;
- increasing licensees' capital adequacy requirements;
- licensing individual planners;
- introducing an industry-based professional standards body to establish, monitor and enforce standards for financial advisers; and
- enabling accountants to provide some limited advisory services restricted to licensees.

Separate licence categories

6.105 Recommendations for separate licence categories depending on the characteristics of the advisory business are closely related to proposals for a dual standard of advice discussed earlier at paragraph 6.11. The basis for this idea is that there would be one category of licensee where advisers working under that licence identify themselves as a product salesman if they receive payments from product manufacturers, and a higher category for those providing independent advice free from such a conflict of interest. The licence category would more transparently convey to consumers the nature of the advice they are receiving.

6.106 Suggesting that removing product alignment from the financial planning industry is impractical in the immediate term, Strategy First Financial Planning proposed that a clear distinction be created between 'financial product advisers' and 'financial advisers', accompanied by a public education campaign.[87]

87 Strategy First Financial Planning, *Submission 178*, pp 8-9.

6.107 MLC provided a specific legislative proposal for the committee's consideration. They recommended that the regulatory regime provide for two separate models for financial advisory firms, either 'affiliated' or 'independent'. These would be 'categorised to reflect their operating structure and providing a meaningful descriptor for investors'. Individual advisers would also be required to identify as an 'affiliated financial planner' or 'independent financial planner'. These terms would be defined under the Corporations Act and regulated by ASIC.[88] In evidence to the committee MLC explained that under this model an 'independent' advisory firm and its authorised representatives would only be able to receive fees from clients. Those accepting payments from product manufacturers would be classed as 'affiliated'.[89]

6.108 MLC suggested that their suggested model could overcome the reason why many Australians do not seek financial advice:

> ...they find it difficult to understand the system and trust it. One of the reasons why they do not trust it is that there are confusing payments going on between different parts of the value chain, and it is hard for them to understand what influence that might have on the advice that they are getting. By clearly identifying the two different models the client can walk in the door with a NAB/MLC affiliated financial planner and they should not be surprised if they end up with some services from that group. It is also much easier to have the conversation: what does that mean; how does that impact on the advice that I am getting; am I happy with the advice that I am getting: I know that there is an association there. Right now the client has little chance of understanding the relationships that exist between the licensees, the advisers and the manufacturers in the current model.[90]

6.109 CPA Australia suggested that any distinction should occur on the basis that independent advisers may only be so-called if they have complete control over the products they can recommend, unrestricted by an approved product list determined by someone else.[91] However, CPA Australia speculated that independent advisers 'may very well become quite a niche market' and questioned whether they would provide affordable advice to the broader public.[92]

Raising competency standards

6.110 A considerable amount of evidence to the committee contended that the minimum training and qualifications for advisers should be raised, while many others warned about the increased costs for consumers if higher standards were to be imposed.

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88 MLC, *Submission 346*, p. 3.

89 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 7.

90 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 6.

91 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 66.

92 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 67.

6.111 ICAA advocated a minimum undergraduate degree level qualification including a practical and experience component.[93] MLC told the committee that new people entering the industry should be required to hold an undergraduate degree, with some financial planning qualification in addition to that.[94] Professional Investment Services suggested increasing both educational and training requirements:

> PIS supports increasing the minimum training and qualification requirements of those providing advice to include an undergraduate or postgraduate degree in a financial services related field, such as a Bachelor of Commerce or Business (financial planning) or Master of Financial Planning through tertiary education. Furthermore, a practical training and development year (akin to the practical legal training year completed by the legal profession or the professional year completed by chartered accountants) following tertiary education, involving continued training, mentoring and reflective supervision, during the first year of advising would also serve to increase professional competence and promote consumer confidence in the financial services industry.[95]

6.112 Argyle Lawyers recommended that mandatory ethics training be introduced for financial advisers, responsible managers and new entrants to the industry as part of ASIC's RG 146 requirements.[96]

6.113 There was some opposition to these proposals, though. Guardian Financial Planning argued that the current licensing arrangements already require that advisers be adequately qualified for their role:

> ...the legislation currently encourages a licensee ... to make sure that advisers are not authorised to advise on things that they are not competent to advise on, that their qualifications back that up and that their continuing professional development is targeted towards the competencies they need to discharge their duties to their client base. I would suggest most licensees probably operate in a very similar fashion, because the personal liability that one takes as being a responsible manager and an office holder of the licensee is fairly significant. I think most people take that very seriously.[97]

6.114 IFSA warned of restricting financial planner numbers when seeking to raise qualification standards:

> ...we need to take a view about appropriate transition periods to get there so that ... we do not compound this issue of availability of advisers in the market.[98]

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93 ICAA, *Submission 363*, p. 7.

94 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 13.

95 Professional Investment Services, *Submission 336*, p. 18.

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

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

98 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 56.

6.115 ICAA suggested that increasing educational standards for advisers would require a three to five year transition period.[99] Professional Investment Services contended that improved standards 'must be balanced against the existing regime', suggesting:

> Where the committee supports further education, it is recommended that the committee consult with the industry and industry bodies to assess the barriers, overall impact and benefit of increasing education requirements. This may require allowing for a 'grandfathering' process to promote smooth transition from the existing to the new regime.[100]

6.116 However, FPA challenged the notion that lifting standards would increase costs across the industry:

> From our point of view, our 9,000 practitioner members would probably meet all those requirements already. I am not sure that if you are talking about genuine financial planners you are asking them necessarily to increase their costs or commitments.[101]

6.117 IFSA also warned that:

> Any minimum entry level should not be set so high that it dramatically impacts on the cost of advice or the number of individuals that are able to provide financial advice – especially where the majority of advisers are trained to an appropriate level and operate within a robust structure that supports the advice they provide.[102]

6.118 Treasury told the committee that attaining the right balance between adequate training and affordable advice is difficult:

> ...we are hearing complaints that advice is too expensive, particularly for the mum and dad type investor with smaller amounts to invest and that for them it is too expensive getting access to advice. On the other hand, of course, we want to ensure that advisers are properly trained and know what they are talking about. That is the fundamental bind we, the policy and the law, are caught in here: striking that balance between making advice affordable and on the other hand ensuring that the advice is competent.[103]

6.119 ASIC informed the committee that they are reviewing RG146, 'with a view to improving training standards and will put forward proposals for change in consultation with industry and stakeholders'.[104] In evidence ASIC also indicated that

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

100 Professional Investment Services, *Submission 336*, p. 18.

101 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 35.

102 IFSA, *Submission 317*, pp 33-34.

103 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 11.

104 ASIC, *Submission 378*, p. 42.

there would need to be consultation with the industry about how the transition to higher standards could be managed, particularly for existing advisers.[105]

6.120 At the licensee level, IFSA recommended that change should be considered:

> Given the nature of some of the product and service provider collapses which have occurred, IFSA believes that it may be appropriate for ASIC to consider enhancing the financial services licensing process to ensure that Licensees and their Authorised Representatives are appropriately resourced and sufficiently competent to offer the range of financial services and products for which they have, or wish to obtain, a licence.[106]

6.121 AXA claimed that it was too easy for AFSL applicants to demonstrate that they can meet their obligations, without necessarily having the skills or resources to do so. They recommended:

> The process for obtaining an AFSL should be enhanced to require applicants to provide further detail and commitments regarding the establishment of governance processes and the systems and resources necessary to meet its responsibilities as a registered licensee.[107]

6.122 AXA also suggested that responsible managers be given greater authority and be held accountable for failures of the licensee to meet its obligations.[108]

6.123 ASIC recommended that legislative changes be considered to empower ASIC to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations in the future. This is a lower threshold than the current 'will not comply' and would allow ASIC to take a more proactive approach to prevent likely breaches of licence conditions before they occur.[109]

Capital adequacy requirements

6.124 Another proposal for protecting investors is to raise capital adequacy requirements for licensees. In their submission MLC indicated that adequate capital backing is the best protection for consumers where compensation is being sought for 'inappropriate adviser activity'.[110] AMP recommended that financial requirements be increased:

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105 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 18.

106 IFSA, *Submission 317*, p. 14.

107 AXA, *Submission 385*, pp 20-21.

108 AXA, *Submission 385*, p. 21.

109 ASIC, *Submission 378*, pp 30-31. See sections 913B and 915C of the Corporations Act.

110 MLC, *Submission 346*, p. 3 and p. 16.

> If all licensed entities were required to maintain a minimum level of Net Tangible Assets, a greater level of security could be achieved for all consumers.[111]

6.125 AXA supported increased capital adequacy requirements:

> The Government and ASIC should consult with the industry to identify a more appropriate level of capital adequacy for licensees which would afford greater comfort that the risk management, compliance, and adviser training and supervision functions are fully resourced to the standard necessary to meet these enhanced obligations.
>
> AXA considers the current capital adequacy requirements are too low, resulting in some licensees not having access to adequate resources to be able to discharge their duties.[112]

6.126 BFPPG argued against this proposal:

> The way capital is employed is far more important than the size of the capital and we all know from experience that those with lesser capital tend to be better at managing their capital and spending their money. There is not much point in having sufficient capital to take clients on a Mediterranean cruise when, a short time later, the business collapses and those clients lose their wealth.[113]

6.127 ASIC told the committee that it is exploring options for reform, though they may be limited:

> ...ASIC is currently reviewing the financial resource requirements for non-APRA regulated AFS licensees, with a view to improving investor and systemic protection. However, ASIC is not a prudential regulator and ASIC is not able to set prudential requirements for AFS licensees. This will limit the type and nature of the financial resource requirements we can impose. At this stage of the project, it is too early to tell whether this limitation will prevent ASIC imposing appropriately rigorous resource requirements on some or all AFS licensees.[114]

6.128 In its previous inquiry into agribusiness MIS, the committee received evidence that prudential oversight of these schemes was needed to ensure they held sufficient working capital to meet existing commitments, without relying on new sales for that purpose. ASIC noted that the committee may consider extending prudential regulation to these entities, while Macquarie Agricultural Funds Management

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111 AMP, *Submission 367*, p. 10.

112 AXA, *Submission 385*, p. 22.

113 BFPPG, *Submission 251*, p. 13.

114 ASIC, *Submission 378*, p. 30.

suggested that licensees be required to demonstrate they can meet current obligations without relying on new sales, as part of their licence conditions.[115]

6.129 The committee noted in its agribusiness MIS inquiry report that it would reserve recommended legislative changes until it had considered the product safety issues relevant to this inquiry.[116] The committee makes a recommendation in relation to agribusiness MIS at paragraph 6.154.

Licensing individual planners

6.130 One area of concern raised during the inquiry was the effectiveness of licensees being responsible for the actions of their authorised representatives. The committee heard that deficiencies in the oversight of individuals' conduct could be overcome via individual licensing for financial advisers.

6.131 Financial adviser Mr Benjamin Hancock expressed firm views on this issue:

> I believe that the legislative framework whereby financial advisers are nothing but representatives of corporate licensees impedes the elevation of the profession beyond that of the insurance salesmen of old.
>
> This is true regardless of the morality and ethical awareness of the financial advisers operating within this system, where the licencee itself sets the parameters and entrenches bias into the practices of their representatives.
>
> As with the accounting industry, I strongly believe that financial advisers should be individually licensed in much the same way as the Tax Agents' Board registers those accountants adequately qualified and experienced to act in that capacity.[117]

6.132 He noted that this arrangement would leave financial advisers responsible for their own ethical behaviour.[118]

6.133 Mr Ian Bailey also supported licensing individuals, stating that it would compel a more professional approach from advisers needing to demonstrate they are a suitable risk for PI insurers.[119] Mr Bruce Baker told the committee that individual licensing would provide a higher prevalence of 'real financial advisers'.[120]

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115 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, p. 38.

116 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, p. 47.

117 Mr Benjamin Hancock, *Submission 308*, p. 3.

118 Mr Benjamin Hancock, *Submission 308*, p. 3.

119 Mr Ian Bailey, *Submission 112*, p. 3.

120 Mr Bruce Baker, *Supplementary Submission 15g*, p. 8.

6.134 FOS was of the view that individual licensing would not represent good value for money:

> That is a huge undertaking and I wonder whether that would have significant benefits. You might be better off putting the resources somewhere else, because you can set up licences until the cows come home. Maybe putting the resources into being able to follow up more of the issues they identify through their information that comes into them, and also it might be cheaper for you to put the resources into something like a last resort compensation scheme and say, 'We're going to do the best we can on licensing. Most of the time it works pretty well, but when someone falls through all the cracks there will be a bit of a safety net there at the bottom.'[121]

6.135 Argyle Lawyers also noted that 'individual licensing of each and every financial adviser in Australia is impractical'.[122]

6.136 Instead of focussing on licensing all advisers, ASIC proposed that it be given extended powers to take action against individuals they deem to be operating at or near the fringes of the industry. ASIC sought the following 'negative licensing' powers:

> ASIC believes the Government should consider the merits of enhancing ASIC's power to act against individuals by amending the banning power in s920A as follows:
>
> (a) clarify that ASIC is able to ban an individual (after a hearing) where a person is 'involved' in a contravention of a financial services law by another person i.e. its authorising licensee or another person;
>
> (b) enable ASIC to ban an individual (after a hearing) where ASIC has reason to believe that the person is not a 'fit and proper' person to engage in financial services; and
>
> (c) replace the existing grounds for banning a person where ASIC has reason to believe that the person 'will not comply' with s 912A or a financial services law with the slightly lower standard of 'may not comply' or 'is likely not to comply'.[123]

6.137 Securities and Derivatives Industry Association argued that 'bad apples' reporting should be facilitated to protect both consumers and licensees:

> Unlike other countries, like the US and the UK, Australia has no proper regime for the reporting of misconduct by individuals on leaving a firm so that future employees and consumers can be protected from these individuals. SDIA has for years advocated a system of compulsory

121 FOS, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 33.

122 Argyle Lawyers, *Submission 322*, p. 8.

123 ASIC, *Submission 378*, p. 31.

> reporting of specified matters on termination and the protection for licensees in making and having access to those reports.[124]

Professional Standards Board

6.138 A more widely held view was that improved accountability for licensees could be achieved via the establishment of an industry-based professional standards body, also frequently referred to in evidence as a professional standards board (PSB). This entity would share responsibility with ASIC for establishing, monitoring and enforcing competency and conduct standards for financial advisers. Such an arrangement could also enable the use of terms such as 'financial adviser' and 'financial planner' to be restricted to those qualifying as members and prepared to comply with the conditions imposed by the PSB.

6.139 Tying a number of aspects of the debate together, FPA recommended that financial planners be defined in legislation and subject to higher standards through licence and professional oversight:

> We believe that the term 'financial planner' or 'financial adviser'—they are interchangeable—should be defined. There should be a fiduciary responsibility attached to that person. There should be a competency level that is higher than Regulatory Guide 146 attached to that person. And there should be a professional obligation attached to that person through membership of a professional body—in other words, they have to meet with requirements over and above the law.[125]

6.140 Australasian Compliance Institute proposed that individual advisers be supervised by a professional body, or bodies, approved by ASIC. They suggested that these bodies be given following responsibilities:

- Maintenance of a register of advisers including details of qualifications and disciplinary actions taken against them by the professional body.
- Setting (with ASIC input) the standards for qualifications, skills and knowledge for advisers with the possibility of the establishment of "tiers" of skills/knowledge that correlated to levels of complexity and risk in financial products they are permitted to advise on.
- Supervision of training diaries/records.
- Requirement for adherence to a "Code of Conduct" with appropriate powers of disciplinary actions against advisers including those that may preclude them being able to continue to give advice.

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124 SDIA, *Official Committee Hansard*, Canberra, 28 August 2009, pp 61-62.

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

- Accrediting.[126]

6.141 AXA also advocated the benefits of such oversight:

> Professional bodies exist in financial services, but membership by licensees and advisers is not mandated. This could hamper the evolution of the industry towards becoming a profession, with more uniform standards and codes of conduct which would benefit consumers by improving the quality and consistency of financial advice. AXA submits that the current environment would be enhanced by requiring licensees to adopt a common framework on issues which go to the heart of professionalism, and by requiring advisers to belong to a recognised professional body.[127]

6.142 ING Australia also argued that a professional standards body was the appropriate mechanism for improving competence and standards in the industry:

> We believe that current adviser training requirements are too low and that standards could be raised via the establishment of a professional financial advice body recognised by the government. While the terms and conditions of membership would be a matter for the professional body, it should ensure that advisers are properly accredited and their professional standards monitored and elevated on an ongoing basis...
>
> Significantly, such a professional body would be empowered to expel members who do not meet its benchmarks for competence and code of conduct. Moreover, only planners that are members of the professional body should be able to call themselves a "financial adviser" or a "financial planner".[128]

6.143 BFPPG suggested that only members of a professional standards board be permitted to call themselves financial planners.[129] They argued that a professional standards board would provide more effective oversight than ASIC:

> The PSB would be more capable of managing the quality of advice and the standards of the profession than ASIC or such other organisation that can only administer the law. A professional body is not restricted to enforcing the law but can act in advance of problems whether they involve "legal" behaviour or not. A PSB can also receive intelligence from its members, develop meaningful standards, counsel members and use the threat of expulsion if members are in a position where they may bring the profession into disrepute.[130]

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126 ACI, *Submission 397*, p. 3.

127 AXA, *Submission 385*, p. 16.

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

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

130 BFPPG, *Submission 251*, p. 19.

6.144 Quantum Financial Services recommended that an independent PSB be established 'to oversee the development of professional standards and act as a guardian of the public interest'.[131] It would introduce a compulsory code of ethics and only members would be permitted to call themselves 'financial adviser' or 'financial planner'.[132]

6.145 Mr Bruce Baker proposed two professional standards bodies:

> There is probably merit in having a Professional Standards Board for product sales people and a Professional Standards Board for independent advice providers, in recognition that these are two very different roles AND to help minimise the risk of the Professional Standards Board for independent advice providers becoming a captive of product providers.[133]

6.146 Treasury suggested that a professional standards body may have merit, subject to its relationship with ASIC:

> ...a major consideration we would have to take into account is how it would work in conjunction with the role of ASIC. You could see an overlay in roles; you could see confusion for industry and investors; and obviously it would occur additional costs. You also have to ask yourself: do you put it within ASIC or do you have it as a separate body, which means that ASIC and the body have to work closely together to try to avoid duplication? The fundamental question [is] are the additional costs of that warranted; will it particularly address the issues that are being raised?[134]

6.147 Officers also stated that such a body would need to build acceptance:

> ...any new organisation will have to build that confidence. They will not necessarily have the confidence from day one, and there is always a question mark as to whether they will build it. It depends on whether the industry, consumers and investors actually accept what they come up with.[135]

Accountants

6.148 Evidence to the inquiry also included a proposal to provide a licensing exemption for accountants providing limited advice. The Accounting Professional and Ethical Standards Board suggested that unlicensed accountants be able to provide 'incidental investment advice' to their clients as part of their broader service, in order

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131 Quantum Financial Services, *Submission 56*, p. 32.

132 Quantum Financial Services, *Submission 56*, p. 21 and p. 32.

133 Mr Bruce Baker, *Submission 15*, p. 6.

134 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 17.

135 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 17.

to 'break the grip of the product providers over the financial services industry'.[136] They indicated that the current restrictions applying to accountants are impractical:

> ...accountants have drilled into them that you cannot give investment advice otherwise you have no PI cover or anything else, particularly at the lower level. Certainly when you get into a more trusted adviser relationship I think a lot of people end up giving advice even though they are not supposed to. It is very hard to have a relationship with someone for 30 years where you know more about their affairs than they do and then tell them, 'Sorry, I can't give you advice on that.' Effectively a lot of advice gets given.[137]

Committee view

6.149 The committee does not support creating separate licensing categories to distinguish between advisers operating in a sales capacity or those offering 'independent' advice. This would create an added layer of complexity to the licensing system, would require an extensive public education campaign, and would potentially be confusing. The committee is of the view that bringing additional professionalism and transparency to the industry can be achieved more effectively through alternative recommendations contained in this report.

6.150 The committee is also of the view that licensing individual planners would be far too costly to justify any regulatory improvements that may result. However, the committee supports ASIC's recommendation (outlined at paragraph 6.136) that it be easier for the regulator to ban individuals operating at the fringes of the financial services industry, by bolstering ASIC's banning powers under section 920A of the Corporations Act.

Recommendation 6

6.151 The committee recommends that section 920A of the Corporations Act be amended to provide extended powers for ASIC to ban individuals from the financial services industry.

6.152 With regard to capital adequacy requirements, the committee is unconvinced that increased capital adequacy requirements for licensees would be of overall benefit to consumers. Although there may be some consumer protection advantages, with large entities potentially having better capacity to discharge their licensing duties and meet any compensation claims, any consolidation of the industry away from smaller boutique advisory firms would not necessarily be in consumers' interests. Further, ASIC is not a prudential regulator and the committee does not consider that the cost of AFSL holders being brought under APRA's regulatory jurisdiction is warranted.

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

137 Accounting Professional and Ethical Standards Board, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 77.

6.153 The committee also noted that it would discuss any need for additional capital adequacy oversight of agribusiness MIS in this report, having wanted to see if similar product safety issues emerged during this inquiry that might influence the committee's recommendation. Ultimately, the committee has concluded that improving the regulation of financial advice in relation to financial products is more effective than regulators attempting to ensure, through additional regulation, that products are 'safe' for investors. Notwithstanding this and the fact that ASIC is not a prudential regulator, the committee is of the view that the unique nature of agribusiness MIS warrant some regulatory intervention to ensure that these schemes do not, over time, develop a ponzi-like character by relying on new product sales to prop up existing schemes. Accordingly, the committee recommends that, as part of their licence conditions, ASIC require agribusiness MIS licensees to demonstrate they have sufficient working capital to meet current obligations.

Recommendation 7

6.154 The committee recommends that, as part of their licence conditions, ASIC require agribusiness MIS licensees to demonstrate they have sufficient working capital to meet current obligations.

6.155 A licensing exemption for accountants was also raised with the committee. While the committee understands that there are grey areas for accountants when interpreting and complying with the financial services carve-out, which limits the nature of the advice they are able to provide clients, the committee is of the view that accountants wishing to provide financial product advice as defined under the Corporations Act should obtain an AFSL to do so.

6.156 The committee recognises extensive support throughout this inquiry for increasing the minimum training and qualification standards for financial advisers, but also acknowledges that such a measure would potentially have implications for the cost of advice, and would need to overcome difficult transition issues with respect of people already established in the industry. The committee supports ASIC's consultation with industry over the most sensible way to raise training and qualification standards set by Regulatory Guide 146, in conjunction with the committee's recommendation on a professional standards board at paragraph 6.160. With respect to licensee standards, the committee also supports ASIC's recommendation that it be able to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations in the future, rather than the current legislative standard of 'will not comply'. The committee is of the view that this is an important measure to allow ASIC to be more proactive in preventing likely breaches of licence conditions before they occur.

Recommendation 8

6.157 The committee recommends that sections 913B and 915C of the Corporations Act be amended to allow ASIC to deny an application, or suspend

or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations under the licence.

6.158 Finally, the committee is of the opinion that a professional standards board (PSB) overseeing conduct standards for financial advisers should be established. This reform would increase professionalism within the industry by ensuring that those wishing to call themselves 'financial advisers' or 'financial planners' would be required to obtain PSB membership and adhere to its standards. An industry-based, independent PSB, working in conjunction with ASIC, would establish, monitor and enforce competency and conduct standards amongst members and have the power to sanction or remove those who do not comply. The committee considers that such an entity would be more effective at identifying and addressing problems early, receiving better intelligence at industry level and not being constrained by meeting high legislative thresholds before taking action.

6.159 ASIC would need to work in conjunction with a PSB to avoid duplication and overlap of their respective oversight functions.

Recommendation 9

6.160 The committee recommends that ASIC immediately begin consultation with the financial services industry on the establishment of an independent, industry-based professional standards board to oversee nomenclature, and competency and conduct standards for financial advisers.

Lending practices

6.161 The committee's examination of the Storm Financial and Opes Prime collapses raised a number of issues concerning the lending practices of some institutions, particularly margin lending and securities lending for unsophisticated retail investors. The previous chapter noted a lack of regulatory control over margin lending and loose practices by some lending institutions.

6.162 In June 2009 the government introduced a bill into parliament to amend the Corporations Act so that margin loans are regulated as financial products under the Act.[138] The bill was passed by the parliament on 26 October 2009. Accordingly, anyone providing or advising on margin loans will be required to be licensed to do so, either by applying for an AFSL or varying their existing one. The bill also introduced certain additional obligations on margin lenders. One is a responsible lending requirement:

> A new responsible lending requirement that applies specifically to margin loan lenders is imposed seeking to ensure that clients are not given loans which they are unable to service. Lenders will be required to assess whether a proposed loan is unsuitable for the client, such that in the event of a

138 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. The amendments cover both standard margin loans and securities lending agreements.

> margin call the client would not be able to service the loan or would only be able to do so with substantial hardship. If a loan is assessed as unsuitable, it must not be provided to the client.[139]

6.163 The amendments also require margin call arrangements to be clarified, stipulating that 'lenders must notify clients when a margin call is made, unless clients explicitly agree to notifications being provided through their planner'.[140]

6.164 In their submission to the inquiry ASIC commented that margin lenders will be able to rely on information about borrowers' suitability that has been passed on from financial advisers.[141] CBA also raised concerns about the provision relating to the clarification of margin calls, suggesting that the amendments should simply have required lenders to directly notify borrowers of margin calls in all instances.[142]

Committee view

6.165 The government's margin lending reforms, in conjunction with a fiduciary duty for financial advisers and improved enforcement by ASIC, will assist in minimising the types of conduct that led to the catastrophic investment losses examined during this inquiry. The committee does acknowledge, though, that further improvements may be required should problems arise from the continuing role of financial adviser intermediaries in the margin lending process. Of particular concern is their role in passing on information about borrowers to the relevant lending institution, as well as being able to be granted responsibility by clients for informing them of margin calls on behalf of the lender. The committee expects the government to pursue necessary further amendments should these issues remain problematic.

Product limitation

6.166 Rather than bolstering the conduct and disclosure requirements for the provision of risky investment products such as margin loans, a contrary view was that they should not be available at all to unsophisticated investors. For example, Mr Peter Worcester of Worcester Consulting Group told the committee that margin loans are unsuitable for retail clients. He said:

> ...margin lending is the last resort when all else fails because it is the dumbest thing to do. It is the dumbest thing to do. Why? It is a high interest rate with no long-term horizon that you can control, for not necessarily the

139 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, *Explanatory Memorandum*, p. 14.

140 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, *Explanatory Memorandum*, p. 14.

141 ASIC, *Submission 378*, p. 92.

142 CBA, *Proof Committee Hansard*, Canberra, 28 October 2009, p. 45.

> appropriate level of diversification. It is the last resort of good advice. It is certainly where you get the maximum amount of commission, though.[143]

6.167 The Institute of Actuaries in Australia indicated that some limitations should be considered:

> ...there are certain products that are complex, that are very difficult to communicate and that have certain risks in them that are outside the norm. One of the learnings out of this last period is that we need to think very carefully about which of those products should and should not be used and in what circumstances.[144]

6.168 The Commercial Law Association of Australia made the following comment:

> It may well be that some products should not be available to retail products no matter what the disclosure and advice given. We note that ASIC has indicated that it is considering whether the sale of some managed investment schemes should be restricted. We would support the examination of products generally to consider whether there are any which should be placed in a restricted sale category. We do however see the need to reconcile the requirement that ASIC be a registration body only on the one hand, with the concept that it be a 'gatekeeper' on the other.[145]

6.169 ASIC did not consider greater restrictions on margin lending products to be necessary:

> We note that the new margin lending regime is likely to be more liberal than that in some other jurisdictions. Some jurisdictions (including the US, Singapore, Hong Kong and Canada) impose specific restrictions on retail investor margin lending, such as limits on leverage. Other jurisdictions, such as the UK, do not have specific regulation, but general obligations mean that retail investors are not generally offered margin loans. At this stage, ASIC does not believe that these sorts of limitations, which are inconsistent with the fundamental settings of the FSR regime, are necessary in Australia.[146]

Committee view

6.170 The committee is of the opinion that it is not for the parliament or the government to determine for whom particular investment products are appropriate. This is a decision for individual investors, in consultation with a financial adviser bound by a fiduciary duty to put their clients' interests ahead of their own.

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143 Mr Peter Worcester, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 96.

144 Institute of Actuaries in Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 87.

145 Commercial Law Association of Australia, *Submission 389*, p. 4.

146 ASIC, *Submission 378*, p. 92.

Investor compensation

6.171 The problems with PI insurance as a compensation mechanism, discussed in the previous chapter from paragraph 5.93, elicited a number of recommendations to establish a statutory compensation scheme for investors. Other suggestions for improving access to compensation are included below.

6.172 The committee notes that the UK has established a statutory compensation scheme. ASIC reported:

> ...the UK Financial Services Compensation Scheme (Compensation Scheme) was set up to assist retail clients who had suffered loss from bad investment advice, misrepresentation, or where a firm has gone out of business and cannot repay money owed to retail clients. The scheme covers transactions in relation to deposit-taking, investments, insurance and mortgages.[147]

6.173 The UK scheme investigates and determines eligibility for investors and is funded by levies that reflect the riskiness of their activities. Compensation is capped to leave investors with some exposure and encourage prudent investing.[148]

6.174 CHOICE supported a similar regime for Australia, stating that:

> A last resort compensation scheme is an essential element of the compensation regime. It would provide compensation where licensees have breached their licence conditions and are otherwise unable to compensate consumers—for example, due to liquidation. The scheme would bring Australia's financial services compensation arrangements into line with those of other international financial services hubs such as the United Kingdom and with other sectors of the Australian economy that already have schemes in place—for example, the Australian Stock Exchange.[149]

6.175 The FOS also argued in favour of a safety net of last resort compensation scheme, with establishment costs funded by government and operating using industry levies. They indicated that large events could provide compensation using borrowed money recuperated using post-event levies.[150] The committee received a detailed proposal for the establishment of a financial services compensation scheme, conducted by Professional Financial Solutions on behalf of FOS. It recommends the scheme be industry-based and approved by ASIC, funded by levying AFSL holders and backed by legislation requiring licensees to be members of the scheme. Additional funding after large compensation claims would be raised through special levies. Consumers would receive compensation from the scheme if they have received a determination against a licensee in their favour and that licensee is unable to meet the

147 ASIC, *Submission 378*, pp 85-86.

148 ASIC, *Submission 378*, p. 86.

149 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 99.

150 FOS, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 25.

claim. To mitigate moral hazard issues, payments would be limited to a proportion of the compensation claim, decreasing as the claim rises beyond certain thresholds.[151]

6.176 Treasury outlined the costs and benefits of the proposal:

> ...there are obviously clear benefits for the consumer-investor. The question is: how expensive would that be? How expensive would it be to the industry? Therefore, how much extra cost would go onto the person receiving the advice? Therefore, would that cut back on the amount of advice that could be received? Again, it is a very major balancing decision.[152]

6.177 Securities and Derivatives Industry Association opposed such a scheme:

> Professional indemnity insurance is the best and most equitable method of ensuring consumers are adequately compensated. A centralised compensation fund would present the danger of moral hazard, where those guilty of misconduct are able to escape responsibility for compensating those affected by their actions.[153]

6.178 Insurance Council of Australia cautioned that a statutory compensation scheme would need to be designed carefully:

> It is important to identify the scope of the problem—for example, the actual number of consumers being left uncompensated—so that a compensation fund can be designed appropriately ... a fund based on overestimates of the problem to be addressed would be a burden for the government to administer and for the industry to fund, with consumers ultimately paying the cost.[154]

6.179 Alternatively, Professional Investment Services proposed that advisers be able to take action against failed product manufacturers on behalf of their clients:

> Licensees should be given the capacity to act on behalf of their clients and investors to undertake proceedings against financial services product providers for the recovery of damages for corporate misconduct and product failures, similar to ASIC's powers. At the moment, we have to wait for people to come to sue us before we can join a product provider who has actually failed in their duty. We do not have the authority to take them on ourselves.[155]

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151 Professional Financial Solutions, *Proposal to Establish a Financial Services Compensation Scheme*, October 2009. Provided as additional information to the committee by FOS.

152 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 24.

153 SDIA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 61.

154 Insurance Council of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 73.

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

6.180 Maurice Blackburn Lawyers proposed the following measures to improve the efficacy of PI insurance:

> 1. Consider making legislative provision for disclosure of details of PI insurance cover or extending the current regulatory provisions in respect of preliminary discovery to include third party discovery to enable the production of any relevant insurance policies held by defendants or proposed defendants at an early stage in litigation;
>
> 2. Consider legislating to make remedies available to third parties against insurers who fund unmeritorious defences, particularly where limits on liability exist in the insurance policies, to enable plaintiffs to have a right of recourse against such insurers;
>
> 3. Consider establishing a compensation fund from which compensation to consumers could be made;
>
> 4. Consider amending legislation to ensure regulation of requirements on licensed financial service providers and other professionals to have adequate insurance policies which do not contain exclusion clauses that exclude them from the provision of services which they are licensed to provide; and
>
> 5. Improve and enhance monitoring of compliance with regulatory procedures.[156]

Committee view

6.181 The committee recognises that the deficiencies of PI insurance make a last resort statutory compensation fund covering licensee wrongdoing appealing. There are, however, a number of significant issues that would need to be overcome in any scheme's design. Capping payments would largely address moral hazard issues, but of particular concern is the very difficult task of formulating an equitable levy system that does not compel licensees with a cautious approach to cross-subsidise riskier activity. There must also be concerns about the cost that would ultimately be passed on to consumers, and whether it would be justified by the protection it offers.

6.182 The committee is of the opinion that more work is needed to determine whether a tailored statutory compensation scheme would be desirable and cost effective in Australia. This should include consultation with industry about how levy arrangements might be designed to ensure they are fair and equitable across the industry.

Recommendation 10

6.183 The committee recommends that the government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

156 Maurice Blackburn Lawyers, *Submission 399*, pp 5-6.

Financial literacy

6.184 In paragraph 5.133, the committee noted its view that ASIC could be doing more to educate key, higher risk, older demographic groups—such as retirees—by promoting sensible investment messages.

Recommendation 11

6.185 The committee recommends that ASIC develop and deliver more effective education activities targeted to groups in the community who are likely to be seeking financial advice for the first time.