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The Treasury

Submission to the Parliamentary Joint Committee on Corporations and Financial Services’ inquiry into Financial Products and Services in Australia

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1. INTRODUCTION

This submission provides an overview of the framework applying to the regulation of financial services and markets in Australia, and addresses certain terms of reference to assist the Parliamentary Joint Committee's inquiry (the inquiry).

The submission provides background to the underlying philosophy of the current regulatory regime. The current regulatory regime is largely based on the recommendations of the 1997 report of the Financial System Inquiry (FSI), otherwise referred to as the Wallis Report. It is based on the premise that free and competitive markets can produce an efficient allocation of resources and provide a strong foundation for economic growth and development. In this context, the general case for regulation is founded in market failure, which occurs when factors are present that prevent efficient market outcomes.

The submission also considers a number of areas relevant to the committee's terms of reference, including:

- licensing of financial service providers, including the current regulatory framework and current issues relating to competence, capital requirements and the Australian Securities and Investments Commission's (ASIC) role in relation to licensing;
- disclosure regime, including the current regulatory framework and the work of the Rudd Government's Financial Services Working Group in facilitating short, simple and readable disclosure documents for financial services products;
- the role of advisers, including the current regulatory framework for the giving of advice and current issues impacting on the quality of advice, including sales culture and remuneration arrangements;
- general regulatory environment for financial products and services, including product design, restrictions and investor suitability;
- role of advertising and marketing campaigns, including the current regulatory regime and possible enhancements to it; and
- compensation arrangements for investors, including current professional indemnity insurance arrangements and alternative models such as a compensation scheme.

Finally, the submission outlines Government action in response to some issues raised in the recent corporate collapses, and provides some general information in relation to financial literacy. The submission does not, however, express any views as to whether further legislative or regulatory change is needed.

2 UNDERLYING PHILOSOPHY OF MARKETS REGULATION

The stability, integrity and efficiency of the financial system are critical to the performance of the entire economy. Well-functioning and credible financial markets are necessary to attract domestic and foreign investment which contributes to the broader objective of creating employment and delivering sustained economic growth.

The financial system can be viewed as a framework for creating and exchanging financial promises. Financial promises are embodied in agreements containing commitments to make payments at specified times, in specified amounts and in specified circumstances. Financial promises incorporate different types of risk, including the risk that the promise will not be kept. Identifying, allocating and efficiently pricing risk is a crucial function of financial markets. Allocating and pricing risk is essential for financial markets to fulfil their primary role, which is to deliver an efficient allocation of capital in the economy.

Generally, it is considered that financial markets function most effectively to achieve these outcomes when they are allowed to operate freely, uninhibited by intervention that may ultimately prevent the optimal allocation of capital. However, sometimes factors may be present that impede financial markets from functioning effectively and producing best possible outcomes. These factors are known as market failures. The general case for government intervention in markets is founded on this concept.

Broadly, there are many forms of market failure, including anti-competitive behaviour stemming from uncompetitive market structures, the inability of a market to correctly price all the costs and benefits of transactions, the provision of public goods and incomplete information. In the context of financial markets, the most prominent form of market failure is imperfect information which often takes the form of an information asymmetry between two sides of a transaction, for example, between an investor and a financial adviser or product provider. In this situation, a financial product or services provider has a clear informational advantage over the consumer. Of particular relevance for this inquiry are the investor protection issues that arise from information asymmetry.

The current regulatory system for financial services and markets in Australia is largely based on the recommendations of the Wallis Report. One of its central recommendations was that certain products or services should be subject to prudential regulation. Prudential regulation is warranted only where there is the potential for systemic instability, and where it is difficult for retail investors to make informed decisions. The report specifically recommends that prudential regulation should be limited to deposit taking services, life and general insurance products, and superannuation. Prudential regulation should not apply to market-linked investments such as managed funds, unit trusts and other investment products. Instead, regulation for these markets and product providers should focus on reducing the information disadvantage faced by consumers. Furthermore, the Wallis Report recommends that financial safety regulation should be proportional to the intensity of the potential for market failure.

A key regulatory principle of the Wallis Report is that although there is a need to reduce certain risks that arise purely because of market failures, governments should avoid imposing regulation that seeks to eliminate the financial risks of participating in financial markets. This type of regulation induces a ‘moral hazard’, by creating complacency about risk among investors, and may ultimately encourage the risky behaviour it is trying to deter. Furthermore, it also removes the financial market’s ability to identify, allocate and price risk. If regulation goes too far, the burden of ensuring that financial promises are kept is shifted to the regulator, which effectively results in the community collectively underwriting financial risk through the tax system.

One of the most complex issues faced by financial market regulators is how to balance the need to address market failures and provide an appropriate level of protection to investors with the need to avoid inefficient regulation. The Wallis Report recognises that regulatory efficiency is a crucial factor in the overall performance of an economy.

3. LICENSING OF FINANCIAL SERVICE PROVIDERS

[related to TOR 2 and TOR 5]

The role of the licensing regime

The primary function of the licensing regime is to protect retail investors. The regime is also designed to enhance market integrity, which is reflected in the need for both retail and wholesale providers to be licensed. The regime acts as a gate-keeping mechanism and sets a threshold for entry into the financial services industry.

The *Corporations Act 2001* (Corporations Act) generally requires anyone carrying on a financial services business in Australia to obtain an Australian Financial Services Licence (AFSL) from ASIC. ASIC conducts background checks on applicants, ensures that all AFSL applicants and holders meet certain criteria, and that there is no reason to believe that they will not meet the obligations under the Corporations Act.

Adequate licensing thresholds provide a basic screening process to facilitate retail investor confidence that financial services providers have appropriate skills, experience and qualifications, are of good character and that they are required to provide services with honesty and integrity.

The licensing regime also enhances ASIC's ability to supervise the financial services industry. In certain circumstances, ASIC can suspend or cancel an AFSL, on a temporary or permanent basis.

Financial services licensing regimes are not infallible. Like many other licensing regimes, they focus on certain characteristics at the time of application, and cannot ultimately prevent instances of fraudulent or incompetent actions. Licence suspensions or cancellations may only occur after a loss has been suffered. A licence is not an endorsement by ASIC of a licensee's business model, its quality of service, or of the products sold or services offered by the licensee.

The current regulatory regime

The licensing regime and the conduct and disclosure requirements for financial service providers are set out in Chapter 7 of the Corporations Act, as well as the some of the powers of ASIC.

A person who carries on a financial services business must obtain an Australian Financial Services Licence (AFSL), unless the person is exempt. A common exemption is where a person is an authorised representative of a licensee.

The licensee that authorises its representatives must ensure that they are competent to provide the services, and are generally liable for their actions. The approach is based on the premise that the principal conducts the relevant business through its employees and agents and is under a legal obligation to control and supervise the employees or agents, and this obligation creates incentives for the principal to have appropriate controls and systems in place to meet this obligation. The authorised representative system is intended to increase the number of financial services and product providers, not all of whom would be willing to obtain their own licence.

ASIC must grant an AFSL if certain criteria are satisfied. This includes that ASIC is satisfied that there is no reason to believe that the applicant is not of good fame or character. ASIC must also have no reason to believe that the applicant will not comply with its licensee obligations. As long

as these criteria are met and the application is made properly, ASIC must grant the applicant a licence, as it does not have the ability to refuse a licence on any other grounds.[1]

When applying for a licence, the applicant must provide a statement declaring what type of services or products their business will be providing. This is necessary to ensure that ASIC grants the correct authorisation and imposes appropriate conditions on a licence according to the type of business the applicant intends to conduct. This process does not involve ASIC evaluating the merit of the applicant's business model.

Once an applicant has been issued with a licence, it must comply with certain statutory obligations which apply on an ongoing basis. These obligations include:

- licensees must do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly;

- licensees must have in place adequate arrangements for the management of conflicts of interest in relation to activities undertaken by the licensee (or a representative of the licensee). ASIC provides guidance to help licensees develop adequate arrangements to manage conflicts of interest;

- compliance with the licence conditions and financial services law, including taking reasonable steps to ensure its representatives comply with the law;

- unless the licensee is regulated by APRA, it must have adequate financial, technological and human resources to provide the financial services covered by the licence and to carry out supervisory arrangements;

- licensees must maintain the competence necessary to provide the financial services, including ensuring that its representatives are trained and educated at a level that is adequate for their role and responsibilities. ASIC sets out minimum requirements for demonstrating competence while recognising that the requirements depend on the nature, scale and complexity of the business;

- ASIC imposes minimum training requirements for licensees and their representatives. These training requirements are sets of knowledge and skills that must be satisfied at one of two levels by advisers, depending on the products advised on and whether an adviser provides general or personal advice. Briefly the requirements are:

  – type of product: Tier 2 products are generally simpler and better understood than tier 1 products. Therefore tier 1 products are subject to more specific training requirements. Tier 1 includes products like debentures and most types of managed funds. Tier 2 includes products like general insurance products and basic deposit products.

  – knowledge/education requirements: Advisers on tier 1 products are required to have generic knowledge relevant to the products they advise on and the markets in which they operate. Advisers on tier 2 products are not required to meet the generic knowledge requirements. This reflects the fact that tier 2 products are generally not susceptible to market fluctuations, so that training on the broader economic environment is less relevant. All advisers must have specialist knowledge about the

[1] ASIC must not grant a licence contrary to a banning or disqualification order.

specific products they advise on and the markets in which they operate. In terms of education levels, the characteristics of tier 1 qualifications are *broadly* equivalent to the 'diploma' level and the characteristics of Tier 2 qualifications are *broadly* equivalent to 'Certificate III' level under the Australian Qualifications Framework (AQR).

  - a range of skill requirements apply to advisers who provide personal advice.
  - in general, advisers meet ASIC's training standards by satisfactorily completing training courses listed on its Training Register relevant to their advisory activities.

- licensees that provide services to retail clients must have dispute resolution and compensation arrangements in case of loss or damage suffered by clients because of breaches of its obligations under the Corporations Act. As well as having an internal dispute resolution arrangement, licensees must also be a member of an ASIC-approved external dispute resolution scheme and have in place adequate professional indemnity (PI) insurance (see Section 8: Compensation arrangements)
- licensees must inform ASIC of any breaches of its obligations.

The Corporations Act also imposes restrictions on the use of certain words and expressions by licensees and their representatives. These restrictions apply to words and phrases such as 'independent', 'impartial', and 'unbiased'. The purpose of these restrictions is to prevent such terms being used in a manner that may confuse or mislead investors.

ASIC has the power to immediately suspend or cancel an AFSL, if the licensee:

- ceases to carry on business;
- is insolvent;
- is convicted of serious fraud;
- is incapacitated; or
- lodges with ASIC an application for ASIC to do so.

ASIC can suspend or cancel a licence, after a hearing, if a licensee, in any of the following cases:

- has not complied with its obligations;
- ASIC has reason to believe that the licensee will not comply with its obligations;
- ASIC is no longer satisfied that the licensee is of good fame and character;
- a banning order is made against the licensee or key representative; or
- the application was materially false or misleading.

ASIC may also make a banning order against a person, if:

- ASIC suspends or cancels an AFSL;
- the person has not complied with its obligations;

- ASIC has reason to believe that the person will not comply with their obligations;
- the person is insolvent;
- the person is convicted of fraud;
- the person has not complied with financial services law; or
- ASIC has reason to believe that the person will not comply with financial services law.

ASIC is required to keep certain registers relating to financial services licensees. These registers contain the details of financial services licensees and their authorised representatives, as well as the details of all restrictions, suspensions, or banning orders placed on licensees. They provide, among other functions, an important and accessible means of information for investors who want to check on persons offering financial services.

Issues

Recent corporate collapses such as Storm Financial have brought significant scrutiny and focus on the current licensing regime. Debate has focused on whether the current licensing regime provides an adequate threshold for entry into the financial services industry, or if the current requirements can be enhanced. Specifically, there have been calls to enhance the competence of advisers through increased training and education standards. There also appear to be public misconceptions about the role of the licensing regime and what it means to be granted a licence by ASIC.

COMPETENCE OF ADVISERS

Some submissions to the inquiry have called for enhanced training and educational requirements for financial advisers. These calls commonly reflect the view that current standards are too low and do not reflect the importance of the role played by financial advisers in securing the wealth and future financial health of individuals.

Currently the minimum training standards are set by ASIC. In addition to enhancing standards, some submissions have flagged the possibility of a wider set of people being involved in setting education and training standards.

There are two questions to be considered in this context. The first issue is how training standards are set, and secondly, issues relating to increasing existing minimum training standards.

The setting of standards

Some submissions to the inquiry raise the idea of introducing a Professional Standards Board (PSB). Part of the role of the PSB would be to develop and issue a common framework for the development and implementation of professional standards for financial advisers. Its role could also include promoting investor education, as well as developing and enforcing a code of ethics for financial advisers.

Internationally, the United Kingdom (UK) regulator, the Financial Services Authority (FSA) is planning to introduce a Professional Standards Board (PSB) for financial advisers in the UK. The

FSA will consult on whether it should be established as an independent statutory body, its role and responsibilities and the costs and benefits of the options.[2]

Generally a PSB would be composed of members with relevant expertise in this area. This may have the advantage of establishing a body with a dedicated focus on professional standards, and relevant expertise.

A PSB would incur additional costs, both during its establishment and on an ongoing basis. Often a PSB also sets codes of conduct and deals with breaches of the Code. This would introduce potentially complex issues concerning the interaction between the role of the PSB and ASIC. The role and powers of the PSB would need to be very carefully defined to avoid overlap between the responsibilities of the two organisations, which could result in a duplication of roles and possibly some confusion for industry and investors. This would require close consideration before the proposal could be more fully considered.

It would be appropriate, in this context, to consider whether the current processes for determining standards needs to be enhanced in this way, and whether the additional costs are warranted.

Raising training standards

Some submitters suggested that existing training and education standards are too low and need to be raised. Other submitters thought that a review of standards would be appropriate.

Some parts of the industry already undertake additional training, either through training requirements set by industry associations, such as the Financial Planning Association (FPA), or at their own initiative. However, the increased standards only cover certain parts of the industry, and standards would vary.

In the UK, the FSA is enhancing the entry level of professional qualifications for investment advisers. By end 2012, UK investment advisers must obtain the Qualifications Credit Framework (QCF) Level 4 or equivalent. In the UK, level 4 is judged to be the vocational equivalent to the first year of a bachelor’s degree. The minimum qualification will apply to both new and existing advisers.[3] This measure is part of the FSA’s objective that, in time, financial advice is seen as a profession on par with other professions. This measure is also part of a broader package of reforms.

The FSA noted the significant impact the change would have on industry. Out of a number of the FSA changes, the largest one-off cost for intermediaries is the cost of advisers attaining a QCF Level 4 qualification. However, research suggested that while it is unlikely that any individual requirement (such as the new training requirements) would cause significant numbers of intermediaries to leave the industry altogether the combination of new requirements may have this effect.[4] [5]

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[2] Consultation paper 09/18, Distribution of retail investments; Delivering the RDR, Financial Services Authority, June 2009, Chapter 5 and Annexure 2.

[3] New entrants to the industry will be expected to study towards a new benchmark qualification once finalised in 2010.

[4] In developing the cost-benefit analysis, the FSA consulted leading academics and commissioned work from Oxera and Deloitte.

[5] Consultation paper 09/18, Distribution of retail investments; Delivering the RDR, Financial Services Authority, June 2009, Chapter 5 and Appendix 2.

The FSA considers the benefits of its reform package, as a whole, in reducing product bias. This has flow on effects to reducing compensation payouts resulting from mis-selling. It may also increase investors' trust in advisers, thereby increasing participation.[6]

While in general increased costs would be passed to consumers, the FSA overall sees significant scope for the benefits to consumers of its proposals to greatly exceed the compliance costs. This relates to all FSA proposals, and not just increasing training standards.[7]

The Investment and Financial Services Association (IFSA) submission notes that a cost benefit analysis should be undertaken before any increase in entry level requirements for financial advisers is supported. Here IFSA consider relevant factors to be the impact on the supply of financial advice and financial advisers, on the cost of financial advice, and on the level of competition in the industry.[8]

The advantages of raising the standards of training and education for advisers are likely to have a positive impact on the quality of advice received by investors, and may reduce the instances where investors are given inappropriate advice. It may improve investor confidence in the advice process, which may translate to an increased number of investors seeking advice. It may also give greater credibility to the financial services industry.

On the other hand, a significant increase in the training and education requirements for financial advisers may have an impact on the supply of financial advisers in the market. As it raises the barrier to entry for new market participants, it may discourage new entrants to the market and may restrict competition in the industry. It also may impact on the supply of established, experienced financial advisers, some of whom may be required to re-train. This could be a particular issue for financial advisers nearing retirement age. The introduction of higher training standards has cost implications for financial services providers. Such costs are likely to more directly affect smaller, independent financial planning businesses compared with larger institutions, which may have the effect of reducing competition in the industry. Furthermore, the increased costs are likely to be passed on to consumers in the form of higher charges for advice. This affects the rate of return on investments and access to and availability of advice.

Access to advice, as well as its quality, are both significant issues which need to be balanced in this context. The extent to which the above will impact on the market would largely depend on the scope of the proposal, the current state of the market and existing industry training standards. However, the benefits of improved standards should not be underestimated but any changes should be appropriately balanced to reflect the above factors.

In its submission to the inquiry, ASIC has indicated that it is reviewing current training standards with a view to their improvement and will consult on its proposals. ASIC has stated it is conscious of some industry concerns that such changes will increase the cost of advice, and that this would therefore raise access to advice issues.[9]

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[6] Ibid.

[7] Ibid.

[8] Investment and Financial Services Association, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services, July 2009, 34.

[9] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 42.

ASIC'S ROLE IN RELATION TO LICENSING

Approval of business models

There is some evidence of public misperception of the licensing regime and what it means for a financial services business to have an AFSL issued by ASIC. The Chairman of ASIC, Mr Tony D'Aloisio, noted during ASIC's hearing for this Inquiry on 24 June 2009 that it is not currently ASIC's role to approve business models of financial services licensees. However, many investors seem to be of the view that ASIC has some role in this, which is reflected in many submissions from individual clients of Storm Financial (Storm).

The existing licensing regime, and the fundamentals on which the regime is based, does not lend itself to ASIC approving business models. ASIC would in effect be making decisions on which business models are acceptable. ASIC would need to adopt a risk averse approach in doing so, with the consequence of stifling innovation and competition in the market.

ASIC approval of business models would introduce a kind of prudential regulation for all financial services providers. This undermines the current regulatory principle which limits prudential regulation to financial products and services that are of systemic importance.

This proposal could also introduce a moral hazard problem, providing a level of assurance to investors likely to alter their behaviour by increasing their appetite for risk in their investment decision-making. It is also unlikely that such ASIC vetting would prevent all future collapses.

We would expect the proposal to impose high compliance costs on business. This would be true both at the initial stage of applying for a licence, as applicants would be required to demonstrate that their business model was compliant with the regulatory requirements, as well as on an ongoing basis. These costs would to the extent possible be passed on to consumers, resulting in an increase in the cost of financial services.

Finally, the proposal would require an expansion of the expertise and resources available to ASIC. This would need to be Government funded or through cost recovery from licensees.

In this case, it is unlikely that the benefits would exceed the costs.

Individual licensing

The current licensing regime is based on ASIC granting a licence to a person or an entity. Licensees may have people act on its behalf in providing financial services. ASIC does not approve those people (i.e. the licensee's authorised representatives). This is why the licensee is generally responsible for the representative's conduct.

ASIC has noted that this limits its ability to control the individual participants in the industry.[10] A change to refocus the licensing regime on individuals, and require individual licensing, would involve significant costs to industry and ASIC. It would also reduce key incentives for the principal to have appropriate controls and systems in place to supervise its representatives.

[10] Ibid, 26.

ASIC has instead suggested that the Government should fully assess certain suggested modifications to ASIC's licensing and banning powers, which would allow it to act further against individuals.[11]

Capital requirements

ASIC is to consider strengthening the financial resource requirements and reviewing other licence conditions. Depending on the outcome of that activity, it may ask the Government to consider changes to allow ASIC to set appropriate financial resource requirements for AFSL holders.[12]

4. DISCLOSURE REGIME

[related to TOR 1, TOR 3, TOR 6 and TOR 7]

The need for a disclosure regime

Financial products are generally complex in terms of their characteristics. Matters that investors may need to consider include risk return profile, fee and benefit structures, early exit penalties and taxation consequences. For the investor, the array of facts and information with which they are confronted can be daunting. This is generally characterised as a problem caused by information asymmetry between the product provider and the investor, where product providers have a clear advantage in terms of their familiarity and understanding of the product they are offering to investors.

Government intervention is warranted to ensure that key product features are properly disclosed to potential investors. The objectives of the disclosure requirements are generally twofold:

- to support the price discovery process in financial markets. The efficient allocation of resources through the financial markets is crucially dependent on pricing decisions made by investors. Appropriate pricing decisions can, however, only be made where investors are in full possession of the facts. Disclosure requirements are consequently often targeted at achieving the full disclosure of necessary information to investors.

- to establish an appropriate level of investor protection by ensuring that investors have access to all the information they need to make an informed decision on whether or not to acquire a given financial product.

The focus of this section is on the investor protection function of the disclosure regime. Disclosure regulation requires financial institutions and intermediaries to make information available to investors about the characteristics of products they offer. Disclosure allows investors to make better informed choices based on a full understanding of the characteristics of a product, as well as by allowing the comparison of products. It also requires the disclosure of information about fees and commissions and the remuneration paid to financial advisers and brokers, so that investors can determine the independence of advice received.

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[11] Ibid, 30-33.

[12] Ibid, 12.

It is noted that it is the quality and the usefulness of information that is important, not quantity. Excessive or complex information can be counterproductive, as it may confuse investors and discourage them from using disclosure documents.

Current regulatory regime

The disclosure requirements for financial services are contained in Chapter 7 of the Act. They apply whenever a financial services licensee provides certain financial services to its clients.

The main services to which the disclosure requirements apply are the issue of a financial product and advice provided in relation to a financial product. Generally speaking the disclosure requirements only come into effect when a licensee is dealing with a retail client as defined in the Act. The definition includes a number of aspects, the main ones being that a person is not a retail client if the price of the financial product is $500,000 or more, the client has net assets worth at least $2.5 million, or had gross income of at least $250,000 in each of the last two years. The policy rationale underlying this distinction is that it stands as a proxy for the experience and understanding of the client in relation to investment markets. Persons who are not retail clients are considered to be sufficiently experienced and familiar with investment markets and therefore do not require the benefit of the disclosure regime.

The disclosure regime operates through a number of disclosure documents which must be given to a retail client in defined situations. The main documents are:

- the Financial Services Guide (FSG);
- the Statement of Advice (SoA); and
- the Product Disclosure Statement (PDS).

For each document the law defines, among other things, when it must be given, how it must be given and what its contents must be. All disclosure documents are subject to the condition that they must be expressed in a clear, concise and effective manner.

Financial Services Guide

The FSG provides retail clients with information about the nature of the services being offered by the financial product provider and the basis for payment for such services.

An FSG must be given *before* the financial service is provided. Exceptions have been made for time-critical situations, so that the FSG may be provided in writing following on from an oral statement containing the relevant information.

The FSG must, among other things, contain:

- The title ‘Financial Services Guide’, a date, the name and contact details of the providing entity, whether that may be a licensee or an authorised representative, the kinds of financial services the licensee provides, and on whose behalf the provider is acting in providing the services.
- Details of any associations or relationships that might reasonably be expected to be capable of influencing the providing entity in providing the advice, for example, any relationship that may potentially cause a conflict of interest.

- Information about the amount of all the remuneration, commissions and other benefits that the providing entity will, or reasonably expects, to receive. This includes, for example, fees payable by the client, commissions received from product issuers (including upfront and trailing commissions), and 'soft' dollar commissions or benefits.

Statement of Advice

Chapter 7 of the Act distinguishes between different kinds of advice. Different regulatory requirements apply depending on the kind of advice offered.

The provision of purely factual information is not considered to fall within the ambit of the regulatory regime and is not subject to any regulatory requirements.

'General advice' refers to the provision of financial advice that does not take into account a client's personal circumstances or their financial situation, needs and objectives. Regulations require that any financial services provider issuing general advice must also issue a warning to the client that the advice does not take into account their financial situation, needs or objectives.

'Personal advice' is financial product advice given to a person where the provider of the advice has considered one or more of the person's objectives, financial situation and needs, or a reasonable person might expect the provider to have considered one or more of those matters. The law prescribes that the financial advice provider must have a reasonable basis for the personal advice given to a retail client (see Section 5: The role of financial advisers and advice regime).

Disclosure requirements apply in situations where a licensee gives personal advice to a retail client. In particular, the licensee is required to give the client an SoA. An SoA must, among other things, include:

- the advice and information relating to the basis for the advice;
- information about the remuneration, commission and other benefits that the providing entity will, or reasonably expects to, receive, that might influence the advice; and
- details of any interests, associations or relationships that might reasonably be expected to influence the advice.

Additional disclosure requirements apply when there is a recommendation to switch products. Reduced disclosure requirements apply for certain situations where advice is provided on small scale investments. Exemptions from the SoA requirements exist in certain circumstances for execution-related telephone advice, as well as for advice relating to certain financial products traded on a licensed financial market and for a range of simple products such as basic bank accounts, motor vehicle insurance, home contents insurance, travel insurance and others.

Product Disclosure Statement

The PDS regime is intended to provide a comprehensive regime for disclosure by product issuers and advisers to their retail clients of all of the key information about the financial product.

A PDS must be given when a 'regulated person' provides personal advice in relation to a financial product or offers to issue, offers to arrange to issue, or issues a financial product to a retail client. This requirement applies to most financial products with the exception of securities, which are subject to the prospectus disclosure provisions of the Act.

The law also regulates disclosure throughout the life of a financial product from point of sale disclosure through to continuing disclosure and periodic reporting requirements.

The content requirements for PDSs are very comprehensive. A PDS must, among other things, include:

- name and contact details of the issuer;
- information about significant benefits and risks;
- information about fees, commissions and charges;
- information about any other significant characteristics of the product;
- any other information that may reasonably be expected to have a material influence on the decision of a reasonable person whether to acquire a product;
- information about any significant taxation implications of the product;
- information relating to the dispute resolution scheme covering the product; and
- information relating to any cooling-off period applying to the product.

Significant amendments have been subsequently introduced to the disclosure requirements for fees, commissions and other charges, prescribing extensive detailed requirements and a standard disclosure format to facilitate comparison between products.

Limited exemptions exist from the PDS requirement, notably for simple bank account products and for certain offers of listed financial products. The content requirements for general insurance product PDSs have been reduced.

Issues

Some submitters to this inquiry commented on the ineffectiveness of the current disclosure regime and the need for documents to be understandable. Already, it is generally acknowledged that current disclosure documents, especially SoAs and PDSs, are too lengthy and complex. It is not uncommon for PDSs to have more than 100 pages. It is unlikely that documents of such length will be read by many investors. This outcome defeats the purpose of the disclosure regime, and is a weakness in the current investor protection regime.

It is noted that the Wallis Report included among its key recommendations short and comparable disclosure documents for retail financial products, to assist consumers in making informed decisions. There have been subsequent attempts to shorten disclosure documents. These include regulatory measures (for example regulations made in 2005 providing for short-form PDSs), ASIC guidance (for example Regulatory Guide 90 issued in August 2005 containing a short sample SoA for a limited advice scenario) and industry self-regulatory proposals (for example the simplified SoA template developed by the FPA in 2007).

However, it does not appear that these measures have been generally successful in reducing the length of disclosure documents. It is therefore likely that any attempt to shorten disclosure documents will need to be prescriptive in nature in order to be successful.

On 6 June 2007, the Australian Labor Party made an election commitment to an overhaul of financial disclosure documentation, so that disclosure documents are simple, readable and standardised. On 5 February 2008, the former Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry, and the Minister for Finance and Deregulation, the Hon Lindsay Tanner MP, created the Financial Services Working Group, comprising officials from Treasury, the Department of Finance and Deregulation and ASIC. The over-arching aim of the Working Group is to facilitate short, simple and readable disclosure documents for financial products.

Financial Services Working Group

The Financial Services Working Group is examining disclosure documentation in a staged process. As a first step, the Working Group developed a concise 4-page PDS for First Home Saver Accounts (FHSA) in 2008.

The Financial Services Working Group developed and consumer tested the 4 page PDS so that it gives consumers a summary of all the key information they need to make an informed decision. PDS "mock-up" examples were developed for the FHSA by an independent design consultancy and tested with consumers.

A number of major banks including Commonwealth Bank, ANZ and AMP Banking, as well as a range of credit unions began offering FHSA products with the 4 page PDS from 1 October 2008.

Currently the Financial Services Working Group is examining disclosure documents for other financial products, including margin lending. Legislation was introduced into Parliament on 25 June 2009 which inserts margin loans into the existing regulatory framework for financial products in Chapter 7 of the Corporations Act. Margin loans have in the past not been subject to any specific regulatory regime.

As part of the new regulatory regime, the Government has decided to develop a simplified product disclosure statement (PDS) for margin loans, designed to assist investors in understanding the key features and the risks attached. The PDS will be prescribed through regulations, which will prescribe a short PDS written in plain English and will also provide detailed guidance on the contents to be included.

In order to achieve a concise size, the PDS will need to incorporate some information by reference. This is a mechanism which allows information to be located elsewhere (for example, online or in a separate hard copy) but legally forms part of the PDS by providing a reference to where the information can be found. This is useful, for example, for handling information that changes frequently, such as the interest rate for a margin loan. A number of regulations will be required to prescribe the detailed requirements for incorporating information by reference.

The Financial Services Working Group hopes to expose draft regulations and a sample PDS for public comment in the second half of 2009.

The Financial Services Working Group is also currently progressing work on simplified PDSs for superannuation and simple managed investment products. It is anticipated that substantial progress on these documents will be made in the second half of 2009.

The Financial Services Working Group was originally also asked to consider SoAs and FSGs. Given the phased approach to delivering disclosure outcomes, these documents will be considered after work on the superannuation and simple managed investment products PDSs is completed.

ASIC's disclosure project

To complement the work of the Financial Services Working Group, ASIC will commence a project to explore whether more effective disclosure can be achieved. Depending on the outcome, ASIC may recommend further changes to the policy settings of the FSR disclosure regime, which would require law reform.[13]

5. THE ROLE OF FINANCIAL ADVISERS AND ADVICE REGIME

[related to TOR 1, TOR 3 and TOR 6]

Role of financial advisers

Persons who provide financial product advice to retail clients must comply with certain conduct and disclosure obligations. These obligations are designed to ensure that retail clients receive professional and reliable advice about financial products. The complexities of investing in financial products and, in some cases a clients limited financial experience and literacy, means he or she is not always able to assess whether the advice received is appropriate or whether it is conflicted. For persons seeking investment advice, the amounts of money involved are often a relatively large proportion of their wealth and its misappropriation or poor allocation can have a significant impact.

Current regulatory regime governing advice

Under the Corporations Act, the disclosure and conduct obligations vary according to whether the advice is personal advice or general advice.

General advice

General advice is any advice that is not personal advice. The provision of general advice must also include a warning to the client that the advice does not take into account their objectives, financial situation or needs. Before acting on the advice, the client needs to consider the appropriateness and suitability of the advice in relation to their personal financial situation and needs.

Personal advice

Personal advice is generally financial product advice given where the provider of the advice has considered one or more of the client's objectives, financial situation and needs; or where a reasonable person might expect the provider of the advice to have considered those matters.

Where personal advice is given:

- it must be suitable;
- a Statement of Advice (SOA) must be provided (see Section 4: Disclosure regime);
- where the personal advice is based on incomplete or inaccurate information, the client must be warned that this is the case.

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[13] Ibid, 63-65.

Suitable personal advice

The requirement for suitable personal advice is designed to address 'the lack of sophistication of retail investors who, irrespective of the level of risk disclosure, may not be able to adequately analyse their investment needs or develop strategies to achieve their investment goals'.[14]

A person must only give personal advice if:

1. the adviser determines the retail client's 'objectives, financial situation and needs as would reasonably be considered to be relevant to the advice' (personal circumstances) and makes reasonable enquiries in relation to those matters (the 'know your client' rule), and

2. taking those matters into account, the adviser has considered and investigated the subject matter of the advice (the 'know your product' rule), and

3. the advice is appropriate to the client, having regard to that consideration and investigation (the link between the 'know your client' rule and the 'know your product' rule).

The level of inquiry and analysis required will vary from situation to situation and will depend on the advice requested by the client. The obligation to have a reasonable basis for the advice must be read together with the obligation to warn the retail client where the advice is given in circumstances where the advice is based on incomplete or inaccurate information in relation to the client's 'objectives, financial situation and needs'.

The requirement to consider and investigate the subject matter of the advice depends on the circumstances, such as whether the adviser has previously provided advice to the client, the potential impact of inappropriate advice, the complexity of the advice and the financial literacy of the client. The adviser must consider and investigate financial products and strategies but this does not need to include a detailed consideration of products that the person is not authorised to advise on. However the adviser will need to possess general knowledge about the broad range of products and strategies available to ensure the advice is appropriate. If none of the financial products the adviser is authorised to provide advice on is appropriate, the adviser must not recommend that a client buy any financial product.

Personal advice is 'appropriate' for the client if it satisfies the client's relevant personal circumstances. Personal advice does not need to be perfect, best or ideal to comply with the Corporations Act.

These rules apply to financial planners, as well as others such as bank employees, if they are giving personal advice, but for these purposes are generally referred to as advisers.

Issues

There is an ongoing debate about the quality of advice being given, and whether it is being inappropriately influenced by other factors.

ASIC has noted that, overall, it believes that the current standards in the advice industry are adequate, but there are some instances of poor quality advice leading to investor losses.[15]

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[14] Financial Markets and Investment Products: Promoting competition, financial innovation and investment, Corporate Law Economic Program, Proposals for Reform: Policy Statement No 6, Commonwealth, Treasury, 1997, 103.

There are concerns, expressed in the media and in submissions to the inquiry, that the structure and integration of the financial industry, remuneration arrangements (such as commissions), sales focus of advisers and imposed sales targets, are giving rise to a mis-alignment of advisers' interests with those of investors, and that this is impacting on the quality of advice received.

In Australia, we are aware that there are significant links between product manufacturers, financial planners and platform providers. Most large financial planning firms (i.e. dealer groups) are owned by diversified financial services groups that also include funds management entities (i.e. product manufacturers). It is common practice for financial planning firms in these groups to receive a significant proportion of their revenue in the form of fees and commissions from related product manufacturers.[16]

An ASIC exercise suggests there is also some evidence that remuneration and association based conflicts are inappropriately influencing advice.[17] Concerns are being raised that advice has the flavour of selling rather than the giving of impartial advice.

The current regulatory measure is for advisers to disclose any conflicts of interests; so that the investor can appreciate what factors may be influencing the advice. Under Chapter 7 of the Corporations Act all financial services licensees must have adequate arrangements to manage conflicts of interest. The law does not provide further detail on how licensees can comply with this obligation. However, ASIC has published a regulatory guide (RG 181) to aid licensees in complying with this obligation. Therefore, for example, licensees must:

- disclose the extent to which the licensee (or any associated person) is likely to receive financial or other benefits depending on whether the advice is followed; and
- disclose the extent to which the licensee (or any associated person) is related to or associated with the issuer or provider of the financial products that are the subject of the financial product advice.

As noted earlier in the disclosure section, there is a current body of work underway to improve the effectiveness of disclosure, which includes short, simple and readable disclosure documents for financial services products.

The submissions flag various legislative or regulatory changes that may improve the quality of advice. They are broadly grouped into:

- changes to the regulation of financial advice and services;
- changes to remuneration structures; and
- competence of advisers (see Section 3: Licensing).

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[15] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 37.

[16] Sale and distribution of investment products to retail investors, Australian Securities and Investments Commission, June 2009.

[17] Shadow shopping survey on superannuation advice, Report 69, Australian Securities and Investments Commission, April 2006, 2.

CHANGES TO THE REGULATION OF FINANCIAL ADVICE AND SERVICES

Two-tier financial services structure

Some submitters raised the idea of creating a two-tier structure for financial services providers. The proposals varied widely but the fundamentals involved distinguishing between sales and advice functions, commission based and fee for service remuneration, supervision and training requirements.

The FPA and Association of Financial Advisers (AFA) have suggested that the term 'financial planner' or 'financial adviser' should be restricted.[18] MLC has suggested that 'affiliated' advice business should be separately identified from an 'independent' advice business.[19] A few submitters also raised concerns about the current restrictions on the use of the term 'independent' which they consider means that very few providers can use this term.

The current restrictions on the term 'independent' mean that, for example, advisers cannot call themselves independent if they receive commissions (except those commissions rebated in full to the client) or other benefits and gifts from issuers of financial products which may reasonably be expected to influence the adviser. To this extent, there is already some delineation between providers who offer services unaffected by commission type remuneration arrangements and those with a sales focus. It does not however delineate in other aspects (such as the level of training or supervision).

In 2007, the UK's FSA considered distinguishing between professional and general financial planners. Broadly, the proposal involved professional planners being able to use the term 'independent', based on remuneration being fee based (and not influenced by the product provider), offering a full and detailed financial planning service, with higher professional standards and additional qualifications. General advisers would continue to be able to use the full range of commission-based remuneration arrangements but could not hold themselves out as independent. The FSA noted that the increased regulatory costs and professional requirements could lead to increased costs to a firm, so that this type of full professional advice may be limited to only those who can afford it.[20]

The FSA's consultation process revealed substantial concerns against a two-tiered approach to full financial advice. However, many submitters to the FSA paper sought to distinguish between higher professional qualifications and remuneration practices not influenced by the product provider. The FSA did not proceed with the proposal and instead sought to distinguish independent advice and sales advice.[21]

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[18] Submission by Financial Planning Association, Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia, July 2009, 51-52 and AFA submission to the Parliamentary Joint Inquiry into Financial Products and Services, July 2009, 6-7.

[19] Submission by MLC, Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia, 19.

[20] Discussion Paper 07/01, A review of Retail Distribution, Financial Services Authority, June 2007, 7-8.

[21] Feedback Statement 08/6, Retail Distribution Review, including feedback on DP07/01 and the Interim report, Financial Services Authority, November 2008, Annex 1, 6-7.

In Australia, the FPA have a designation of 'certified financial planners' for planners who meet certain requirements. A certified planner must meet higher professional requirements, including compliance with the FPA's Code of Ethics. There is clearly some recognition that there is benefit in distinguishing planners based on qualifications, professional standards and other requirements.

If consideration were to be given to some form of two-tiered structure in Australia, the starting point might be the current 'independence' definition. Any reform in this area would need to be considered in the context of other reform (such as whether sales and advisory functions were connected to particular sub-sets of providers). The overall costs and benefits would need to be fully assessed in that context. However, it appears there is scope to create a clearer landscape for investors on what type of services are being offered but it is open on how best to achieve this.

Separation of sales practices from advice

Many submitters raised concerns about addressing advice practices that are essentially product sales and not impartial advice.

Some submitters thought the issue could be addressed by distinguishing between planners who promoted a single brand (a distribution channel), rather than advisers advising on a range of products. The difference is perhaps not always as straightforward as this, but there appears to be capacity to enhance investor understanding in this area.

Previously consideration was given to creating a new category of sales advice. In November 2006, a proposals paper was issued under the title of the *Corporate and Financial Services Regulation Review Proposals Paper*. The paper proposed that the law should be changed to allow financial service providers to provide sales recommendations outside the current regime for the provision of financial product advice, subject to the condition that sales people making such recommendations must issue a warning to clients.

It was considered that, if adopted, the proposal might provide greater transparency where the provider was offering only one or two lines of financial products. Under the proposal, it would be made clear to the consumer whether they were receiving independent financial advice, or whether they were receiving product related sales advice. The current regulatory framework does not make a clear distinction between these two services.

The response to the proposal by industry groups varied widely, with some groups supporting some of the proposals and others arguing the proposed reforms should go further.

The option for reform attracted significant diverse views and was not progressed at the time. The proposal has not been directly revisited in recent times, although it is possible that some related issues may be considered by the Financial Services Working Group.

In the UK, the FSA has recently proposed a new advice landscape that is clearer for consumers, which is composed of 'independent advice' and 'restricted advice'. Firms will be required to make clear to consumers, before providing advice, which of these services they are offering.[22]

Independent advisers must provide advice based on a 'comprehensive and fair' analysis of relevant markets. Independent advisers must have sufficient knowledge of all of the types of products which

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[22] Consultation paper 09/18, Distribution of retail investments; Delivering the RDR, Financial Services Authority, June 2009, Chapter 2.

could give a suitable outcome for their clients. Firms providing advice on their own products are not precluded from the independence definition. However, to meet the definition, they cannot limit themselves to providing advice solely on their own products. The key point is that an adviser must consider all relevant solutions when making a recommendation. The FSA notes that one of the challenges facing advisers will be to ensure they have sufficient knowledge of all products available.[23]

'Restricted advice' applies to advice that does not meet the definition of 'independent advice'. Restricted advice describes advice that only applies to a limited range of products in a certain market. However, firms offering restricted advice will take into account the personal circumstances of their client when making a product recommendation.[24]

The UK measures are part of a package of reforms designed to improve the quality of advice and reduce the incidence of mis-selling, which may reduce the cost of compensation paid to consumers and also increase consumer confidence. It involves short-term costs to the regulator and to industry, for example possible exit of independent advisers and increases in product prices. In the longer term, cross-subsidies between consumers may be unwound, which may be a cost for smaller investors but a benefit for larger investors.[25]

If Australia were to consider something similar to the UK model, which still includes an 'appropriateness' test for 'restricted advice', consideration would need to be given to what criteria surrounded offering a restricted range of products (given that the current advice model does not necessarily require that all available products across the market be considered).

Any reform in Australia would need to be informed by how best to distinguish between advice and sales functions to best enhance investor understanding of the different services on offer. There would need to be a full assessment of the possible impacts on the industry of such a split. This includes the benefits of the proposal, the effects on the availability of advisory services in the overall market and the implications for investor protection.

Acting in the best interests of the client

Some submitters suggested that the Corporations Act should impose a duty for advisers to act in the client's best interest and that it was, in fact, a reasonable expectation of clients.

Under the Corporations Act, the duty of advisers is to ensure personal advice is appropriate (i.e. fit for its purpose) but it does not need to be the best or perfect advice to comply with the Corporations Act.

A duty to give advice in the client's best interest has raised some concerns, particularly expressed by the FPA. There are concerns around what the imposition of a 'best interests' test would mean, though this is not a problem unique to this issue. Concerns have been raised (for example) about

[23] Ibid.

[24] Ibid.

[25] Ibid, 7.

how the 'best' product or strategy is selected, given the long term nature of financial planning, and how to objectively measure a 'best' piece of advice.[26]

Issues have also been raised about whether the obligation means that advisers must consider all available products across the market (and not just products on an approved list). This may present a practical difficulty with the use of approved product lists. The approved product list is driven by the structure of the legal obligations in which a licensee is responsible for the actions of its representatives. The use of approved product lists is a way for a licensee to manage this legal obligation and to allow due diligence to be conducted on the products selected.

ASIC has suggested that the Government assess whether clarifying the standard of care for advisers, by introducing a legislative fiduciary style duty, would improve the quality of advice.[27] This would require advisers to act in good faith in the best interest of their clients and, where there is a conflict between their clients' interests and their own interests, to give priority to their client's interest. There would be no ability to contract out.[28]

ASIC has indicated that it would not necessarily mean that the advice given is the best advice and the adviser would not have to consider every possible option available to the client. ASIC notes that further guidance would need to be provided on the meaning of advice that is in the best interests of the client.[29]

Similar obligations operate in some other jurisdiction, such as in the United States and UK. In the United States investment advisers are a fiduciary, which is described as an obligation to act in the client's best interests, with duties of undivided loyalty and good faith. Advisers must disclose any facts that might cause the adviser to render advice that is not disinterested. The obligation impacts on a number of areas relating to disclosure, portfolio management, personal trading, brokerage arrangements and performance calculations.[30] There are also plans to extend this fiduciary obligation to US broker-dealers.[31] The UK requires that a firm must act honestly, fairly and professionally in accordance with the best interests of its client.[32]

If such an obligation were to be statutorily imposed in Australia, there would need to be substantial consideration given to how the obligation would operate and the scope of the duty.

In a general sense, the imposition of such a test in the context of advice may strengthen the quality of advice and require greater attention to issues of conflicts, and the prioritisation of such conflicts.

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[26] In its submission the FPA acknowledge and accept the fiduciary obligation but propose that it be based on an obligation to put the 'client's interest first' (Submission by the Financial Planning Association of Australia, Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia, July 2009, 45).

[27] It is possible for a fiduciary duty to arise between the adviser and client at common law.

[28] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 43.

[29] Ibid, 44.

[30] Information for Newly-Registered Investment Advisers, U.S Securities and Exchange Commission.

[31] Financial Regulatory Reform: A New Foundation, Department of the Treasury,

[32] FSA Handbook, Conduct of Business Rules, 2.1.1.

This could overall improve investor confidence and encourage investors to seek advice. It may also further embed cultural change about the primary obligations of advisers to clients.

Generally the change may incur compliance costs and those costs would be passed to investors, which could significantly increase the cost of advice, affecting access, particularly by the more vulnerable investor. The extent of the costs and benefits relate to the operation of the duty.

CHANGES TO REMUNERATION STRUCTURES

Submitters raised significant concerns that adviser remuneration is leading to conflicted advice and therefore inappropriate recommendations. Concerns were also raised about the fees Storm charged, which were linked to funds and assets under advice. This was said to encourage Storm to recommend strategies that involve debt and gearing to maximise adviser revenue.

In general, the Corporations Act does not directly regulate fees, commissions and other charges. Instead, it deals with issues raised by these payments through a general obligation to manage conflicts of interest. In addition, the law mandates disclosure of all payments of fees, commissions and other charges in various disclosure documents. In some instances, there are prescriptive and detailed requirements on how these matters should be disclosed.

This approach is based on the principle that well-informed investors are in the best position to decide whether payment of a particular fee, commission or other charge is in their best interest.

Under Chapter 7 of the Corporations Act it is a licensing obligation that all financial services licensees must have adequate arrangements to manage conflicts of interest. The law does not provide further detail on how licensees can comply with this obligation. ASIC has published a regulatory guide (RG 181) to aid licensees in adhering to this obligation. It relates to all kinds of conflicts of interest, including those created by commissions paid to financial advisers by fund managers.

In Australia and overseas, there have been some recent moves to adopt fee for service models instead of commission based payments.

In May 2009, the FPA recommended that, from 1 July 2012, fee based remuneration become the standard model for financial planning advice for FPA members. The approach outlines six key principles that transition away from product provider influence over financial planner remuneration and requires planners to set their own charges for their advice and services, and then negotiate those with their client. The arrangements apply to new clients from 2012.[33]

The FPA's key principles focus on consumer understanding, including that consumers are able to understand and compare fees, which are true to label and the separation of advice and product fees.[34]

The FPA said despite the convenience and tax benefits of a commission payment model, the cost and value of the advice given is not necessarily understood by clients. The FPA also acknowledged that it may be difficult to apply the new arrangements in certain circumstances, such as legacy

[33] FPA Consultation Paper, Financial Planning Remuneration, April 2009, 8.

[34] Ibid, 8-14.

products using old systems, and existing legacy products would need to be grandfathered.[35] Further, the FPA proposal does not specifically deal with risk products, as a number of its members have emphasised the difficulty of delivering risk products to clients without commission structures.[36]

The FPA move does not equate to a ban on commissions and it does not affect the ability of advisers to use an asset based fee model. The FPA considers that the use of asset-based fees will ensure consumers can access affordable financial advice.[37]

In June 2009, the Investment and Financial Services Association (IFSA) released a draft charter that applies to superannuation. Under the charter, from July 2010, super members that receive personal financial advice will be asked to agree both the amount and method of payment. If members wish to cease their relationship with their financial planner they will be able to turn this fee off. However, it only applies to new personal superannuation accounts and corporate super plans.[38] This represents a move to separate product from advice fees.

In June 2009, the UK's FSA set out its proposal for 'Adviser Charging'. The goal of the FSA in relation to adviser remuneration is to remove or minimise conflicts of interest that exist in the current remuneration system by bringing the current commissions system to an end. Instead adviser firms must set their own charges which will be known as 'Adviser Charging'. Adviser charges must be set out as agreed upon upfront by clients, as opposed to the current system where adviser remuneration is dominated by commissions which are set by product providers to secure distribution of their products. The Adviser Charging arrangements would apply to all financial advice firms including both independent and restricted advice firms and vertically integrated firms. Adviser fees, whether they be paid in directly as a fee, or as a deduction from investments, should reflect the services being provided to the client and not the product recommended. The arrangements would apply from end 2012 but not to business completed before this time.[39]

In June 2009, the United States Department of Treasury proposed that the Securities and Exchange Commission (SEC) be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest.[40]

Views on a transition to fee based remuneration are not unified. The Association of Financial Advisers (AFA) does not consider that fee based advice will translate to better quality advice. AFA consider that the more fundamental issues involve how to best manage remuneration based conflicts and that access to advice may be reduced without remuneration choice.[41]

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[35] Ibid, 5.

[36] FPA media release, Members' remuneration concerns addressed, 20 May 2009.

[37] FPA media release, Association of Financial Advisers wrong on remuneration, 5 May 2009.

[38] IFSA's draft Super Charter, A new commitment to superannuation members, 17 June 2009, 2.

[39] Consultation paper 09/18, Distribution of retail investments; Delivering the RDR, Financial Services Authority, June 2009, Chapter 4.

[40] United States Department of Treasury, Financial Regulatory Reform: A New Foundation, 71-72.

[41]AFA Media release, In defence of fees and commissions, 9 June 2009.

The Commonwealth Bank of Australia (CBA) consider that the cost of providing financial advice is high. The CBA note that subsidies ensure that consumers have sufficient access to advice. Subsidies take many forms and include commissions and other payments by product manufacturers and salaries paid to advisers employed by product manufacturers. To the extent that these subsidies have the potential to influence advisers, proper conflict and disclosure mechanisms must be in place. The CBA consider that in some of the corporate collapses relevant to this inquiry, which employed high commission payments, proper disclosure and conflicts management were missing.[42]

The issues relate to addressing conflicts of interest through remuneration structures which may result in a misalignment of adviser/client interests and affects the quality of advice. In this context, consideration could be given to:

- simpler fees disclosure;
- agreed remuneration between the consumer and adviser; or
- legislate to ban payments that create conflicts of interest and affect the quality of advice. Clients must pay advisers direct for the costs of the advice.

Simpler fee disclosure

The Financial Services Working Group is looking at the disclosure of commissions for advice, and resulting conflicts of interest, in a subsequent stage of its work.

This could result in simpler fee disclosure that may assist investors to better understand the nature of fees and commissions, fee comparability and the potential for conflicts. Such an approach would impose a relatively low level of compliance costs and would not significantly affect access to advice.

Customer agreed remuneration

The FSA started to consider the issue of remuneration practices in 2007, when it initially proposed Consumer Agreed Remuneration (CAR), where advisers and consumers agree on the level and pattern of remuneration, and products are priced by product manufacturers to exclude the costs of adviser remuneration. The proposal allowed fees or commissions to be paid but only if agreed between the consumer and adviser.[43]

The FSA did not proceed with this proposal. Many submitters to its consultation were concerned that adviser remuneration could never really be ‘customer agreed’. The FSA agreed that, at least in the short term, it was unrealistic to expect consumers to behave this way.[44] On balance, similar concerns about the ability of remuneration to be ‘customer agreed’ are likely to be raised in Australia. Nevertheless it could be considered whether it is viable in the Australian context.

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[42] Commonwealth Bank of Australia, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, June 2009, 6-7.

[43] Discussion Paper, 07/01, A review of retail distribution, Financial Services Authority, June 2007, 52-53.

[44] Feedback Statement, 08/06, Retail Distribution Review, including feedback on DP07/01 and the Interim report, Financial Services Authority, November 2008, 32-33.

Legislative ban on certain fees and commission

This approach would result in a ban on certain fees and commissions that create conflicts of interest which impact on the quality of advice. It could include payments like up-front commissions, trail commissions, volume bonuses, soft-dollar incentives, sales bonuses and fees based on funds under advice. ASIC has suggested that the Government consider this proposal.[45]

Such a ban would eliminate a source of conflicts of interests, or perceived conflicts of interest. The approach better aligns the incentive of the adviser to give appropriate advice and removes an element of product bias. This may foster investor confidence and encourage investors to seek advice. Fee based service arrangements would alter the focus of product providers to the quality and price of its products, rather than on its adviser remuneration.

This change would, however, fundamentally affect provider firm product strategies and business, and adviser remuneration. It is common practice for financial planning firms in these groups to receive a significant proportion of their revenue in the form of fees and commissions from related product manufacturers. ASIC's submission to the inquiry noted that fee for service remuneration was currently estimated at 16 per cent of adviser revenue.[46] [47]

The current commission system is part of the broader construction and operation of the financial services industry. The requirement for a fee only structure could contract the advice market and this contraction may fall largely on less affluent clients who are unable to pay up front fees. Some clients may be unwilling to pay upfront fees, in particular in cases where smaller investments are involved. Even if outcomes are broadly the same, it would be a difficult perception change for clients paying up front fees.

There would be likely compliance costs and complexity of introducing new systems and procedures. Increase in compliance cost may increase the price of advice, affecting access to advice.

ASIC has indicated that the impact of the proposal is difficult to predict without further analysis. At this stage, ASIC considers it probably would cause some consolidation in the advice industry but it is unlikely to increase the cost of advice (as opposed to the perceived cost of advice).[48]

Parts of industry have started the transition to fee based remuneration, though the views of industry still diverge on this matter. Consideration needs to be given to the implications for different firms of moving away from provider-driven commissions. It may be worth allowing some time for industry to implement such a move and further explore the implications of taking legislative action.

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[45] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 53-54.

[46] Ibid, 49 per Investment Trends October 2008, Planner Business Model Report, 27.

[47] Planners expect fee for service revenue to rise to 25 per cent of all revenue by 2011. Ibid, 114 per Investment Trends October 2008, Planner Business Model Report, 27.

[48] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 54.

6. GENERAL REGULATORY ENVIRONMENT FOR FINANCIAL PRODUCTS AND SERVICES

[related to TOR 2]

In Australia, investors can purchase a broad range of financial products and no product is banned. The starting point for investor protection is a well informed consumer, with clear disclosure. Disclosure is the current focus of regulation in this area, rather than regulating the product itself. For example, when personal advice is given, the adviser must have a reasonable basis for the advice (the 'suitability' rule) and ensure that the advice is appropriate for the client. A retail client may, however, choose to purchase the product without advice, and the product issuer or distributor is not involved in the retail client's purchase decision. Suitability requirements usually apply in relation to recommendations made, though the suitability tests vary from jurisdiction to jurisdiction.[49]

There are always questions around whether certain products should be available to retail clients, due to their complexity and/or risk. A few submissions flagged this issue but nevertheless it is an issue that is regularly raised. There were also questions raised in relation to Westpoint, Storm and Opes Prime (Opes) about whether clients appreciated the risks involved.

In Australia, the evolution of the financial services market has been characterised by innovation. Wholesale type products have been adapted to work in the retail market, generally with positive outcomes for retail investors. An early example of this was the cash management trust; giving retail investors exposure to securities and rates of return that were previously not available to them on a small scale. Another innovation has been the funds management platform where increased scale has allowed access to products and managers previously only available to wholesale investors.[50]

In some instances, the transfer of products from the wholesale to retail market has not been successful. A recent example of this includes the taking of the wholesale 'stock lending' model to the retail market, as in the case of Opes.[51]

Overall, financial product innovation has reduced costs, and increased investor choice. Innovation is a tool that contributes to an efficient financial system and promotes international competitiveness. Policies should continue to encourage the development of new products in the future. However, the global recession has highlighted the need for care to be taken, to ensure that innovation is not inappropriately implemented (such as in the case of the taking of the wholesale 'stock lending' model to the retail market). Here, there is a need to ensure that the risks are properly managed.

In this context, it is useful to note some points on possible regulation in this area, including:

- requirements relating to product design;
- limiting certain products (based on complexity and/or risk) to certain classes of investors; and

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[49] Basel Committee on Banking Supervision, the Joint Forum, Customer Suitability in the retail sale of financial products and services, Bank for International Settlements, April 2008, 2.

[50] Helping Retail Investors, Mr Jeremy Cooper (former Deputy Chairman of ASIC, 2009 SPAA National Conference

Adelaide Convention Centre, 11 March 2009.

[51] Ibid.

- extension of suitability requirements to product issuers and manufacturers.

Requirements relating to product design

In a general sense, it appears countries do not impose specific requirements on the product design process, particularly around retail products. [52]

For collective investment schemes in Europe and some parts of Asia, certain aspects of schemes marketed to retail investors are more tightly controlled.[53]

In the UK, the FSA's approach is that it 'expects' firms to ensure that products are soundly designed, even where manufacturers distribute solely or mainly through intermediaries. This relates to the FSA's "Treating Customers Fairly (TCF) initiative", which essentially means that, although the FSA does not regulate the design of financial products, it does expect firms to treat their customers fairly when considering the design of those products. One of the FSA's six TCF consumer outcomes is that products sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly. It is not possible for the FSA to prescribe TCF in a way that applies to all firms, but it will typically cover issues such as the marketing strategy, developing product literature and the training implications, particularly for complex or new products.[54]

While there are a range of activities ASIC undertakes to assist and protect retail investors, it may be worth investigating the FSA's experience with this initiative and whether it could be usefully applied in the Australian context. It could facilitate market led initiatives, in the areas (for example) of product suitability and advice, and also embed cultural change.

Like any initiative, there would be costs to the regulator and industry, such as industry reviewing and embedding processes in their systems. It would also need to be a long-term initiative.

Overall, at a general level, requirements or restrictions around product design may restrict innovation and the range and costs of products available. It also does not address the key issue relating to individual suitability for particular products.

Limiting certain products to certain classes of people

There are often calls for bans on certain products for certain classes of people, particularly retail clients.

For almost any product it is possible to identify some investors for whom the product may not be suitable. Limiting products that are only suitable to all investors (or even just retail investors) is generally not in the interests of the broader market and may result in a limited range of standardised products. It is also not consistent with Australia being a financial services hub, and promoting

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[52] Basel Committee on Banking Supervision, the Joint Forum, Customer Suitability in the retail sale of financial products and services, Bank for International Settlements, April 2008, 22.

[53] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 97-98.

[54] Basel Committee on Banking Supervision, the Joint Forum, Customer Suitability in the retail sale of financial products and services, Bank for International Settlements, April 2008, 22.

international competitiveness. It also reduces choice and does not take account of individual capacity.

The alternative argument is that there is benefit in mitigating the risk that retail investors will invest in products they may not understand or fully appreciate the attached risks.

As the needs of each investor are different, it may be more appropriate to focus on an individual's suitability for a product.

Investor suitability

Some jurisdictions impose some form of 'suitability' requirement. In these cases, the requirement is usually imposed at the time of a recommendation. This is consistent with the 'suitability' (or 'reasonable advice basis') rule in Australia for when personal advice is given to retail clients (which involves the recommendation of the product).

In the European Union (EU), MiFID require firms to assess the 'suitability' of a service or transaction when providing services that entail an element of recommendation on the part of the firm (i.e. investment advice and portfolio management).[55] However, the EU also extends this rule beyond recommendation situations. In the EU, where a firm does not make a personal recommendation to a client who seeks and obtains services other than financial advice or portfolio management (e.g. where he/she asks simply that an order be executed), MiFID requires the firm to apply an 'appropriateness' test. The test assesses whether the client has the knowledge and experience to understand the risks involved in the transaction for the sale of any investment product or service.[56] [57] Under MiFID, in the case of execution-only services (but in non-complex products only)[58] the 'appropriateness' test is not applied.[59] [60]

In this context, Australia could consider the adoption of a 'suitability' or 'appropriateness' test outside of recommendation situations. This, for example, would include a product distributed by a representative of the product manufacturer who provides some general advice about the product (but without considering the investor's personal circumstances). A 'suitability' test in these

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[55] MiFID Article 19 (4).

[56] MiFID Article 19(5).

[57] Should the firm consider that, on the basis of the information obtained from the client, the investment product or service is not appropriate to the client or potential client, the firm is required to warn the client. In cases where the client does not provide the information needed to perform the test, or provides insufficient information, firms are required to warn the client that the firm does not have sufficient information to determine whether the service or product envisaged is appropriate.

[58] Non-complex products include shares admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS (undertakings for collective investment in transferable securities) and other non-complex financial instruments.

[59] Basel Committee on Banking Supervision, the Joint Forum, Customer Suitability in the retail sale of financial products and services, April 2008, Bank for International Settlements, 12.

[60] The test is not applied provided that the service is provided at the initiative of the client, that the client has been clearly informed that the firm is not required to assess the suitability or appropriateness of the instrument or service offered and accordingly that the client will not have the benefits that would otherwise be provided by suitability and appropriateness determinations.

circumstances would apply the personal advice regime to all advice and other services (such as execution-only services). The 'appropriateness' test, however, does not encompass all of the features of personal advice but does focus on whether the client has the necessary experience and knowledge to understand the risks involved in the product. It has the ultimate aim of reducing the risk that investors will invest in products where they do not understand the risks.

The possibility of some form of 'appropriateness' test raises several questions. It may well have benefits for investors, in that product issuers and distributers are required to assess the 'appropriateness' of the product to the individual, which may reduce the risk that investors invest in products where they do not appreciate the risks of the product. It may place more onus on product issuers to consider suitability at the product design phase.

On the other hand, there would be additional compliance costs which we would expect to be passed to investors, which may reduce the affordability of investments. There will be questions about whether product issuers and distributers are best placed to make this assessment, and such changes would invariably involve new systems, training and procedures to reflect the new requirements. Some of the costs may be reduced by applying the test to specific products or in specific circumstances.

The Government has also introduced an unsuitability test for consumer credit products, including margin lending. In relation to margin lending, a new responsible lending requirement is included to ensure that borrowers do not take on loans which they are unable to service. The requirement states that margin lenders must not provide a margin loan if it is unsuitable for the client. A specific definition of unsuitability is provided, according to which a loan is unsuitable if a client would suffer substantial hardship as a consequence of a margin call being issued. A number of key factors that need to be considered by lenders in assessing whether the proposed loan is unsuitable will be provided in the regulations. ASIC will be given powers to add other factors as they arise over time. These factors will include, in particular, situations where investors have engaged in 'double gearing' and provided their residential property as security for a loan to fund their equity contribution for a margin loan. This is considered to be a major risk factor as consumers may lose their homes if they are unable to service the loans. Lenders are required to make the assessment in writing and provide it to the borrower upon request.

The inability to service loans and 'double gearing' has been raised in the context of the Storm collapse. The new unsuitability test is a factor to consider in weighing up whether additional suitability obligations are required.

7. ROLE OF ADVERTISING AND MARKETING CAMPAIGNS

[related to TOR 4]

The need for advertising restrictions

ASIC has noted that advertising and marketing campaigns can be extremely influential in the decision to invest and can facilitate investment without advice.[61]

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[61] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 67-68.

Current regulatory regime

The Corporations Act includes some specific requirements in relation to advertising of financial products and securities. For financial products other than securities (such as shares and bonds), the main requirement is that the advertisement must mention that a Product Disclosure Statement (PDS) is available and that anyone considering acquiring the product should read the PDS first. Here the PDS should primarily influence an investment decision and not an advertisement.

Generally, advertising activities are regulated under the prohibition against misleading or deceptive statements in the Corporations Act. The Corporations Act provides ASIC with a specific power to issue a stop order where an advertisement contains a misleading or deceptive statement.[62]

ASIC intends to publish a new regulatory guide on the standards of advertising it expects.[63]

Issues

ASIC has suggested that the Government consider granting ASIC the power, by legislative instrument, to require product providers to include specific content requirements in their advertising and marketing material. This would allow ASIC to take action to ensure that certain advertisements contain information relevant to investors, such as who a product is suitable for, disclosure against key benchmarks and warning about key risks. ASIC considers that concerns about the arbitrary use of such power are allayed by the requirements of the *Legislative Instruments Act 2003*, which require consultation and can be disallowed by Parliament.[64]

ASIC has also suggested that the Government should enhance the existing stop order power under Chapter 6D by making this consistent with the power under Part 7.9 of the Corporations Act.

Further, ASIC has suggested that changes be made to require prominent disclosure of restrictions on the advice that can be provided by an adviser in marketing and promotional material. This includes, for example, disclosure about relationships with product issuers in an adviser's marketing material.[65]

These issues will need to be considered by Government.

8. COMPENSATION ARRANGEMENTS - PI INSURANCE

[related to TOR 8]

The need for a compensation regime

Australian financial services licensees are required to comply with certain requirements under the Corporations Act relating to product and service disclosure, the giving of appropriate advice and

[62] Ibid, 73.

[63] Ibid. 72.

[64] Ibid, 72-73.

[65] Ibid, 45.

other conduct rules. However, licensees do not always have assets to meet claims arising from clients' losses which result from misconduct in the course of providing financial services. Compensation arrangements are in place to reduce the risk that AFSL holders will not have sufficient funds to pay out claims made by investors.

Compensation arrangements are intended to provide an appropriate level of protection but without imposing an unjustified burden on participants in the sector or increased risk-taking either by the investor or the licensee. The ability to meet successful compensation claims is an essential element of investor protection and promotes confidence in Australia's financial services market.

Current regulatory regime

Chapter 7 of the Corporations Act requires that licensees which provide financial services to retail clients have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under Chapter 7 by the licensee or its representatives.

From 1 July 2008, following a one year transitional period, licensees are required to hold either adequate professional indemnity (PI) insurance or have ASIC-approved alternative arrangements in place.

The arrangements must meet the requirements in the *Corporations Regulations 2001* where licences need to obtain PI insurance cover that is adequate having regard to the nature of the licensee's business and its potential liability for compensation claims. There are exemptions from the compensation requirements for some licences that are regulated by APRA or related to an entity regulated by APRA. Detailed guidance on the implementation of these arrangements was released by ASIC in November 2007.[66]

Implementation of the PI arrangements is occurring as a two phase process. Phase 1 commenced on 1 July 2007, with a one year transitional period until 1 July 2008. For Phase 1, ASIC considered it would be adequate for licensees to have PI insurance based on what is available in the market, subject to some minimum 'adequacy' requirements. ASIC provides guidance on what it deems to be adequate insurance in this context.

Phase 2 of the compensation arrangements involves ASIC establishing and enforcing (subject to the availability of appropriate insurance coverage) an even higher standard of compensation cover from the beginning of 2010. At this time, ASIC expects that licensees will have PI insurance that reliably delivers on all aspects of the policy objective. Discussions are ongoing with the insurance sector and industry about the approach to be adopted in Phase 2, particularly given the hardening of the insurance market in the current economic climate.

Issues

The current arrangements, which mandate professional indemnity (PI) insurance as the compensation mechanism for retail clients, have been operational for two years. Consumer groups and plaintive law firms have argued that PI insurance protects the licensee rather than the individual investor, and does not offer sufficient coverage. Some submissions to the inquiry raise questions about whether the existing PI insurance arrangements are adequate.

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[66] Compensation and insurance arrangements for AFS licensees, Regulatory Guide 126, March 2008 (initially issued November 2007), ASIC.

The Insurance Council of Australia has suggested that a compensation scheme should be considered to complement existing PI insurance arrangements, if the Government objective is that investors receive compensation in all cases where it is awarded.[67] The Financial Ombudsman Service (FOS) supports the establishment of compensation fund to provide a safety net for consumers of financial services.[68]

In the past, suggestions of a compensation scheme have been met with caution, and some opposition, from members of the financial services industry in particular, concerned about the additional regulatory burden, increased costs and cross-subsidisation issues. The Securities and Derivatives Industry Association (SDIA) considers that, in the absence of a Government sponsored compensation fund, PI insurance is the best and most equitable measure to ensure consumers are compensated. Further, SDIA considers a Government or industry fund would raise 'moral hazard' issues.[69]

At the time PI insurance was introduced, it was acknowledged that it would not provide compensation in all situations of loss caused by a licensee, but for a range of reasons, was the preferred option, particularly as many advisers already held professional indemnity insurance as best business practice. It also reflected the objective that the measure reduces the risk that compensation claims would not be met by the relevant licensee.

No insurance or other arrangements can cover an investor for all or any losses incurred. The current regime provides a certain level of comfort by increasing the likelihood that sufficient funds will be available to pay out claims by retail investors. However, there remain areas where insurance coverage is not, or is less likely to be, available. These include:

- a licensee has ceased business, for example retirement or insolvency, by the time the claim is made (as opposed to when the event giving rise to the claim occurred);[70]
- the service provider is unlicensed;
- fraud is committed which is not covered by the insurance. Insurance policies generally do not cover fraud by the principal;
- other exclusions or restrictions in policies may rule out payment.

Coverage is also clearly affected by the type, and cost of policies, available in the market.

One of the more difficult aspects in this area is the lack of data on the extent to which the gaps in PI insurance arise. Further, the extent of uncompensated investor losses is difficult to quantify.

It is also noted that only 12 months have passed since the end of the transitional period into the current arrangements and ASIC's transition into phase 2 of the compensation arrangements is still to be implemented. An assessment of the impact of any phase 2 arrangements would be valuable to

[67] Submission by the Insurance Council of Australia, Parliamentary Joint Inquiry into Financial Products and Services, July 2009, 3-4.

[68] Submission by the Financial Ombudsman Service, Inquiry into collapses in the Financial Services Industry, 8.

[69] Submission by the Securities and Derivatives Industry Association, 31 July 2009, 5.

[70] Cover may be available if the AFSL holder had run off cover under its insurance policy.

determine the size and scope of any problem or gap areas. ASIC will work with the industry to ensure the scope of the current compensation arrangements is maximised within the constraints of the 'hardening' market.

ASIC has noted that, notwithstanding the hardening of the insurance market, recent ASIC inquiries indicate that the PI insurance market is functioning appropriately for AFSL holders. That is, financial advisers, in particular, are able to obtain cover, albeit at an increased premium.[71]

However, ASIC has suggested that the Government may wish to review the effectiveness of PI insurance as a compensatory mechanism and consider possible alternatives such as a statutory compensation scheme.[72]

If a statutory compensation scheme were to be considered, there are a myriad of issues that need to be addressed. This includes any number of scheme design issues, its coverage, compensation payments, scheme operation and funding.

Broadly, the arguments for and against such a scheme involve:

For:

- Depending on scheme design, it could offer a greater level of protection for retail investors who suffer losses due to misconduct by AFSL holders. It may also simplify the process for investors to obtain compensation;
- A compensation scheme may encourage more participation by retail investors by providing an increased level of confidence in financial markets. This would be particularly beneficial in the current economic climate and recent corporate collapses, where confidence in the market place has eroded, and there is need to encourage participation to assist market recovery.
- Some advocate a 'last resort' type scheme, which is viewed as a positive step in protecting those left without compensation, that is by protecting investors who have a valid claim as their provider has been found to have committed breaches under the law, but where there are no funds available to satisfy payment of the claim. For example, following the collapse of Westpoint, at least one financial services provider walked away from its obligations by closing its operations.
- It could harmonise all compensation arrangements across the financial services sector (i.e. integrate the NGF and other market compensation funds).[73]

[71] PJC Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, 84.

[72] Ibid, 85.

[73] The National Guarantee Fund (NGF) provides investor protection by providing a means of redress for clients of stockbrokers in specific circumstances, including where a stockbroker makes an unauthorised transfer of securities and stockbroker insolvency relating to property entrusted to the stockbroker. Other market compensation schemes provide compensation to retail clients of stockbrokers in relation to fraud and defalcation but do not cover insolvency. All are compensation funds that deal with market related services.

Against:

- Establishment and operating costs may be significant (depending on the scope and design of the scheme) and may require Government funding depending on the final framework for a scheme.
  - If the costs are borne by industry, this may increase the cost of advice, and may affect access to advice.
- The scheme could create a moral hazard problem, in that its existence may lead to increased risk-taking (by both providers and investors) and unscrupulous behaviour (particularly by providers) because of the belief that any resulting claims and losses would be covered by a safety net. The design of any scheme would need to mitigate some of these concerns, for example, capping of compensation payouts.
- Expectations may be unreasonably high that all losses would be covered. This is not realistic or appropriate.
- Industry have argued that a scheme would in effect subsidise the less well-managed sections of the financial services industry and introduce a moral hazard problem by encouraging reckless behaviour based on the assurance that compensation will be available through the scheme.

The UK has a statutory fund of last resort, the Financial Services Compensation scheme (FSCS), for customers of authorised financial services firms. The last resort scheme pays only in certain circumstances, generally in cases of insolvency, and only pays compensation if a firm is unable, or is likely to be unable, to pay claims against it. Financial services firms in the UK are generally also required to hold appropriate levels of PI insurance. Further detail on the UK scheme is provided at Attachment A.

The current compensation arrangements have been in operation for only two years, with one year being a transitional period. There is an argument that more time is needed to assess how these arrangements are impacting on investors and industry, and on the levels of appropriate compensation payouts.

There is a need for a balanced approach in considering any new or extended arrangement. It would be necessary to fully assess the costs and benefits, as well as the scope of any compensation arrangement. Generally, experience suggests that for a fund to be viable, it would need to be limited in some way, for example, a last resort type scheme that applied in the insolvency context only.

9. GOVERNMENT ACTION

The Government has responded to certain issues raised in the context of recent corporate collapses. This includes the national regulation of margin lending, national regulation of consumer credit, amendments to debentures regulation, advertising and related ASIC action.

Regulation of margin lending

Following the collapse of Opes and Storm, many retail investors have suffered substantial losses due to margin loans. These cases have raised concerns about investors' understanding of how margin loans operate and to what risks they are exposed when they take out a margin loan. This in turn has highlighted the current absence of investor protection regulation concerning margin loans, as margin lending to date has not been subject to the credit regime operated by the States.

The proposed amendments to the Corporations Act[74] ensure that all arrangements with the relevant characteristics of a margin loan are captured under the new national regime. Complications arise in this area because alternative legal structures not based on an explicit loan agreement have been used by providers such as Opes and Tricom. The definition has been framed in a manner to include these alternative 'margin loan' type structures.

As a 'margin lending facility' is a financial product under the Corporations Act, providers of financial services in relation to margin loans will be subject to the licensing, conduct and disclosure requirements in Chapter 7. It also subjects them to supervision and enforcement action by the national regulator, ASIC.

Margin loan borrowers will as a consequence benefit from the general investor protection regime contained in Chapter 7. This includes a number of important measures. For example, lenders and advisers will have to be licensed and regulated by ASIC, investors will have access to independent, free and fast dispute resolution services and advisers will be required to only provide advice that is appropriate to the client's needs and circumstances.

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 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.

A number of key factors that need to be considered by lenders in assessing unsuitability will be prescribed in regulations, including in particular situations where consumers have engaged in 'double gearing'. This term refers to situations where consumers borrow funds to finance their equity contribution for a margin loan. In some cases borrowers may use their residential home as security for the loan, which is considered to be a major risk factor as consumers may lose their homes if they are unable to service the loan.

The amendments also regulate the notification of margin calls to clients, especially where the loan has been arranged through a financial planner. There have been situations where it has been unclear whether it was the lender or the planner who was responsible for notifying clients when a margin call occurred. Failure to notify a client in time can result in losses for the client. The amendments require that lenders must notify clients when a margin call is made, unless clients explicitly agree to notifications being provided through their planner.

In addition to the measures outlined above, a new margin loan disclosure document is being designed. This document will inform potential borrowers in concise and clear language of the key factors they need to consider before they take out a margin loan. It is currently being designed in

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[74] Schedule 1 of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. The Bill was introduced into the House of Representatives on 25 June 2009.

close cooperation with margin lenders and other stakeholders and will be separately introduced through regulations.

The new margin lending regime will apply to margin lenders and advisers 12 months after the legislation comes into force. This transitional period is intended to give industry sufficient time to prepare for the introduction of the new regime, in particular the new responsible lending requirements.

National regulation of consumer credit

The National Consumer Credit Reform Package was introduced into Parliament on 25 June 2009 and delivers on the first phase of the Council of Australian Governments' agreements of 2008 for the Commonwealth to assume responsibility for the regulation of consumer credit.

Phase One of the Reform Package includes:

- a comprehensive licensing regime for all providers of consumer credit and services;
- responsible lending conduct requirements on licensees – not to provide credit products and services that are unsuitable for the consumer's needs and that the consumer does not have the capacity to repay;
- improved sanctions and enhanced enforcement powers for the regulator, ASIC;
- expanded consumer protection through court arrangements, remedies for consumers and penalties for misconduct; and
- an expanded scope for the National Credit Code to include credit provided to purchase, renovate, improve or refinance a residential investment property.

The national regime also replicates the State-based Uniform Consumer Credit Code as the National Credit Code.[75]

Debentures regulation and advertising

The four major high-profile property development company collapses started with the Westpoint Group, followed by Fincorp, ACR and Bridgecorp. Each of the collapses involved property development companies offering investments through debt instruments and promising high returns. In each case, the investments were aggressively advertised either directly or through financial advisers.

Prior to each collapse, ASIC took various actions against each of the companies in a range of problem areas, including misleading advertising, insufficient disclosure, misleading statements or omissions in prospectuses. This mainly took the form of stop orders on prospectuses. In doing so, ASIC also issued media releases.

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[75] The national regulation of consumer credit (and margin lending) is particularly relevant to the additional term of reference, which was subsequently added to the inquiry. The TOR covers the involvement of the banking and finance industry in providing finance for investors, in and through Storm Financial, Opes Prime, and in relation to margin lending arrangements.

In recognising unlisted and unrated debentures as a problem sector requiring increased investor awareness, ASIC issued in November 2007 its regulatory guide (updated in March 2008) in relation to the sector. The guide sets out requirements that debenture issuers must meet with the aim of improving investor protection. The guidelines strengthen disclosure requirements and require issuers to provide important information designed to help retail investors and their advisers better assess risk and reward prospects in unlisted unrated debentures.

In December 2007, ASIC also issued regulatory guidelines on the advertising of unlisted and unrated debentures by issuers, publishers and the media. The guidelines state that all advertisements for debentures offered to retail investors should include a prominent statement to the effect that investors risk losing some or all of their principal investment. Additional rules apply to the quoting of interest rates, credit ratings and avoidance of terms such as “secured” and “guaranteed”.

The Government has also proposed amendments to harmonise the legal regime to require all promissory notes to be subject to the full range of investor disclosure and protection measures currently only applicable to debentures. This will include the requirement to have a trust deed and trustee arrangement, and to issue a full prospectus.[76]

10. FINANCIAL LITERACY

[related to TOR 7]

ASIC has taken on the national leadership role for advancing financial literacy in Australia. The decision to transfer the functions and operations of the Financial Literacy Foundation to ASIC consolidates the Government's financial literacy response under Australia's corporate, markets and financial services regulator.

As the industry regulator, ASIC promotes informed participation in the financial system and is ideally positioned to take the lead in advancing financial literacy in Australia. By bringing together the twin functions of financial literacy and consumer protection, the Government is strengthening the role of ASIC in safeguarding Australia's economic reputation and wellbeing, through proactive education strategies and regulation.

The Australian Government Financial Literacy Board, which is chaired by Mr Paul Clitheroe, continues to provide independent and strategic guidance on financial literacy to the Government and ASIC.

ASIC continues to carry forward a Professional Learning Package for teachers of consumer and financial literacy, which will help teachers to deliver financial literacy education from kindergarten right through to Year 10. From 2008, financial literacy education has been incorporated into the core curriculum.

Students will learn about financial literacy when they study a range of subjects — English, maths, science, information and communication technology, and civics and citizenship. The Professional

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[76] Schedule 3 of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. The Bill was introduced into the House of Representatives on 25 June 2009.

Learning Package will help young people to develop one of the most important life skills they can learn — how to manage their money.

ASIC will look to extend this success by further developing school-based initiatives, particularly in the upper-secondary sector and in indigenous education. ASIC will also look to develop initiatives targeted at tertiary students and people in the workplace in the near future.

The Australian Government’s commitment to promoting financial literacy in the schools sector has been internationally acclaimed. At the October 2008 OECD International Conference on Financial Education, the Australian model of integrating financial literacy into the education curriculum was used as an example of world's best practice.

ASIC is developing interactive website resources which are designed to take consumers on a journey from engagement through to the acquiring knowledge stage through to setting goals and supporting them in the implementation of those goals.

ASIC is also working at developing multi-sector co-operation and partnerships to foster and improve the quality of financial literacy initiatives undertaken by government, industry, educators and the community sector. For example, ASIC regularly consults nationally via its Financial Literacy Community of Practice (CoP), which is a monthly discussion forum designed to strengthen links between all stakeholders who work on financial literacy issues.

ATTACHMENT A: UK COMPENSATION SCHEME

The Financial Services Compensation Scheme (FSCS) is the UK's statutory fund of last resort for customers of authorised financial services firms. The scheme is a last resort scheme and pays only in limited circumstances, generally in cases of insolvency. The FSCS only pays compensation if a firm is unable, or is likely to be unable, to pay claims against it. FSCS is a non-profit independent body and is set up under the *Financial Services and Markets Act 2000* (FSMA). Financial services firms in the UK are generally also required to hold appropriate levels of professional indemnity insurance.

The FSCS is a broad ranging scheme, protecting consumers in relation to:

- Deposits - with a capped limit of £50,000 per person (approximately A$100,000)
- Long term insurance (pensions and life) – no capped limit[77]
- Investment business - capped limit of £48,000 per person [78] (approximately A$96,000)
- Home finance (i.e. mortgage) advice and arranging (since 31 October 2004) - capped limit of £48,000[79] (approximately $A96,000)
- General insurance policies advice and arranging (since 14 January 2005) – no limit.[80]

Key features of the scheme are as follows:

- The scheme began operation in 2001.
- The scheme is funded by levies on authorised financial services firms based on five broad contribution classes (life and pensions, deposits, investment, general insurance and home finance), with sub classes covering both provider and intermediary activities (excluding deposits). Levies comprise two amounts covering scheme management costs and compensation payments.
- To reduce cross subsidisation, each subclass has an annual threshold. Other classes can only be required to contribute if the threshold in a particular subclass is exceeded.

[77] 100% of the first £2,000 plus 90% of the remainder of the claim.

[78] 100% of the first £30,000 and 90% of the next £20,000.

[79] 100% of the first £30,000 and 90% of the next £20,000.

[80] 100% of the first £2,000 plus 90% of the remainder of the claim. Compulsory insurance is protected in full. There are some changes to these limits, coming into force from 1 January 2010. The changes mean the compensation limit for investments, home finance advice and deposits will be the same at £50,000 and all claims for non-compulsory insurance will be paid at 90%, with no upper limit. (FSA implements changes to simplify Financial Services Compensation Scheme, 24 April 2009).

- Before a claim can be made, a financial services firm must be declared, following an investigation by the FSA, to be in default.
- The global financial crisis created an unprecedented set of demands on the FSCS in 2008/09. In the six months from the end of September, the FSCS paid out more than £21bn.
  - This is in contrast to the period from its inception in 2001 until September 2008 when they paid out some £1bn in compensation in total.[81]
- In 08/09, five banks were declared in default with total compensation of £20.9 bn paid.[82] There were 119 other non banking defaults with total compensation amounting to over £92m (approximately equivalent to A$184 million).[83]
  - Total compensation payments for the 2007/08 year amounted to £82.93 million (approximately equivalent to A$165.86 million).[84]
- Total actual management expenses for 2008/09 were £31.47m (excluding loan and other interest) (approximately equivalent to A$62.94 million).[85]
  - Total management expenses in 2007/08 were £25.86 million (approximately equivalent to A$51 million).[86]

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[81] FSCS Annual Report and Accounts 2008/09, 9.

[82] In Australia, the Financial Claims Scheme (FCS) was established by legislation in October 2008. Its purpose is to protect depositors in authorised deposit-taking institutions (ADIs) - such as banks, building societies and credit unions - from loss on their deposits (up to a specified limit) and give them prompt access to their deposits if their ADI becomes insolvent. The FCS also protects certain policyholders and other claimants (certain individuals, small businesses, family trusts and not-for-profit organisations) who make valid claims on a general insurance company in a situation where the insurance company is insolvent.

[83] FSCS Annual Report and Accounts 2008/09, 19.

[84] FSCS Report and Accounts 2007/08, 27.

[85] FSCS Annual Report and Accounts 2008/09, 45.

[86] FSCS Report and Accounts 2007/08, 27.