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Joint Parliamentary Committee on Corporations and Financial Services

Inquiry into Financial Products and Services

Submission by Legislative Review Task Force[1]

Executive Summary

This submission makes the following recommendations:

1. The current legislative scheme for the regulation of financial services often produces disclosure which is unhelpful to or goes unread by retail investors. Ways should be explored to improve the usefulness of disclosure to investors.

2. Substantial improvement in investor protection will only be achieved by a fundamental change in the ethical and professional standards of the financial services industry including the reinforcement of the principle that the clients interests are paramount, and the restriction of the term 'adviser' to persons not dependant on commissions.

3. It should again be examined whether the sale of some products should, regardless of the amount or quality of disclosure or advice, be restricted.

4. The most effective advice will only be provided when investors are encouraged through an education process to take a full and active part in the investment process.

Legislative Background and the Disclosure Dilemma

It is of course the case that the current regulatory regime in Chapter 7 of the Corporations Act contains comprehensive disclosure requirements supported by extensive ASIC regulatory guides.

Disclosure by corporations and other investment vehicles has been criticised as incomplete and inaccurate, or even if complete and accurate so voluminous as to be incomprehensible or too daunting to the average investor. Critical analysis has generally only occurred in circumstances of financial failure. In such circumstances lack of disclosure will be invariably blamed for the fact that investors have lost money, when many investors incorrectly assume that all investments should succeed no matter what risk is assumed. This criticism has only become more intense as the complexity and risk profile of products has increased and the consequences of failure become more profound and widespread.

The current regime in Chapter 7 of the Corporations Act has not escaped such criticism. Disclosure is criticised as being too lengthy and unlikely to be read by the average investor. In particular product issuers and their advisers are urged to have more regard to the legislative requirement to be 'clear, concise and effective'[2] However, the blame for the nature of disclosure is perhaps directed a little unfairly.

Chapter 7 of the Corporations Act proceeds on the basis that decisions by a retail investor as to whether to invest in financial products, should be left to the investor, provided, that there has been full and adequate disclosure and in particular the provision of a product disclosure statement (PDS) or in the case of securities, a prospectus, which complies with the Act.

Section 1013D(1) of the Corporations Act requires a Product Disclosure Statement to contain such of certain specified information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product including:

> ‘(a) a statement setting out the name and contact details of:
>   (i) the issuer of the financial product; and
>   (ii) if the Statement is a sale Statement — the seller; and
>
> (b) information about any significant benefits to which a holder of the product will or may become entitled, the circumstances in which and times at which those benefits will or may be provided, and the way in which those benefits will or may be provided; and
>
> (c) information about any significant risks associated with holding the product; and
>
> (d) information about:
>   (i) the cost of the product; and
>   (ii) any amounts that will or may be payable by a holder of the product in respect of the product after its acquisition, and the times at which those amounts will or may be payable; and
>   (iii) if the amounts paid in respect of the financial product and the amounts paid in respect of other financial products are paid into a common fund — any amounts that will or may be deducted from the fund by way of fees, expenses or charges; and
>
> (e) if the product will or may generate a return to a holder of the product — information about any commission, or other similar payments, that will or may impact on the amount of such a return; and
>
> (f) information about any other significant characteristics or features of the product or of the rights, terms, conditions and obligations attaching to the product; …’

In addition providers are required to include

> ‘any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product’[3].

These requirements are of course in addition to extensive requirements in the Act and Regulations and ASIC policy and in addition to common law requirements.

Having laid down these requirements the Act imposes substantial civil and criminal penalties for a failure to comply.

In particular section 1022B provides among other things that

I. the person by whom, or on whose behalf, a PDS was prepared; and

II. each other person involved in the preparation of the PDS who, directly or indirectly, caused the disclosure document or statement to be defective or contributed to it being defective;

are liable for loss arising from a defective PDS.

Is it any wonder then that issuers and their advisers will, when faced with a choice between brevity and excessive disclosure elect for the latter. Indeed notwithstanding the requirement of the legislation for presentation in a clear concise and effective manner,the excessive disclosure approach is likely to be supported by the courts.

The disclosure regime is of course accompanied by a comprehensive licensing regime for financial services providers including advisors.

This submission does not attempt to describe or highlight all aspects of the current regime or to reference particular instances of failure, but merely to highlight some aspects we consider to be important.

Potential improvements to current regime

Clearly the current disclosure and licensing regime has not been effective in all cases to protect investors from unexpected loss. No regime however extensive ever will. The regime is not designed to protect investors from normal market fluctuations or business consequences or the results of their own informed decisions. It does however, seek to ensure adequate disclosure and that financial services providers carry on their business efficiently honestly and fairly.

We consider that there are potential improvements to the regime which can reduce but not remove the potential for future investor loss.

1. A disclosure regime more directed to the needs of a retail client.

One of the main problems with disclosure is the fact that, particularly with complex products, there is too much information for the average investor to absorb. Even relatively sophisticated investors are likely to skim over the voluminous disclosure, note some of the main points, and either rely on an adviser or trust in the integrity of the issuer.

Perhaps it time to again considering mandating some form of one page disclosure up front to answer some basic questions that investors should know:

For example: Is this a high risk product? What effect will a major market move have on my investment? What are the total fees I will likely pay each year?

Consideration should be given to a requirement of special risk or health warnings for particular types of products. Investors are unlikely to pay undue attention to such warnings when otherwise inclined or advised to enter into particular products. However a cigarette type warning 'This product may be harmful to your financial health. Use at your own risk.' in large bold print should make the investor pause.

2. A more client focused, professional and independent body of advisors

Apart from the disclosure requirements the other major aspect of the investor protection regime is the licensing system for advisers and other financial services providers and the requirement for a statement of advice. Whilst advisers are required to consider the personal circumstances of a particular retail client before giving advice, in practice this can become a process of slotting a client within one of a predetermined range of profiles for risk appetite. Greater emphasis needs to be given to determining the real investment needs of a particular client. In speaking of advisors we are particularly referring to financial planners and the like who are seen as having a measure of independence rather than persons who provide advice incidentally to the sale of financial products.

More fundamentally, we also suggest that there should be a move to a more professional approach by advisors. This must be more than a merely referring to the financial advice industry as a profession. It requires recognition by advisers and their representative bodies of the need for strong enforceable ethical standards and that the first and only consideration when giving advice should be the interests of the client. Obviously moves to increase the independence of advisers by a move away from commission based systems and the separation of advisers and product issuers would assist that process. The current representative bodies need to be encouraged and supported in this process. We believe that real advances in the quality of investor protection depend on the role and professionalism of advisors.

In this regard, consideration should be given to reinforcing the common law obligation of advisers to act in a fiduciary relationship with their clients and to limiting the use of such terms as 'advisor' to those who do not have an interest in the products being sold by way of commissions.

A move to a more profession based approach also implies a greater concentration on the competency and ethics of a particular advisor (ie, the professional) rather than primarily the licensee (ie, corporate entity). Consideration would need to be given as to whether this role would be performed by ASIC or perhaps more appropriately, the relevant industry bodies.

Two particular matters should be considered:

- a requirement for advisors to show numeric and mathematical skills to a standard level
- If commissions are received, a requirement for a table of all products on which an advisor receives commission giving detail of both initial and trailing commissions.

3. Restrictions on some products

Clearly the Government regulator has a role in limiting financial products offered to investors. Currently this role is largely limited to products which are fraudulent, where the necessary licences are not held, where disclosure is deemed inadequate or the law otherwise not complied with.

The current legislative regime proceeds on the basis that subject to proper disclosure all products should be available to all investors. It is left to investors as to what advice to obtain or indeed whether to follow that advice. In the past, some products, eg, over the counter derivatives, were generally not directly available to retail clients.

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

4. An education program for investors

There is much emphasis on the need for education by those providing advice. However little is said about the need for investors to educate themselves about the products in which they are investing. At a minimum, investors need to be appraised of the need for committing the time required to read the disclosure documents about their investments. If they are unable or unwilling to do at least that, it has to be questioned whether they should be making the investment at all. It has been said that good advice depends on an active interaction between the adviser and the investor. An education program to encourage an awareness of this by investors would be in order.

More generally there needs to be continuing education of investors about the risks and rewards of investing and the relationship between return and risk.

We trust the above is of assistance to the Committee. The Task Force is happy to appear before the Committee to answer any questions.

1 The Commercial Law Association of Australia (CLA) was formed 46 years ago as a bridge between business and the law. Its members include accountants lawyers and business persons. As such, the CLA has a strong interest in the enactment and administration of laws which are clear and effective and conducive to commercial certainty. The Legislative Review Task Force (LRTF) of the CLA is charged with reviewing and commenting on legislation and legislative proposals with these objects in view.

2 Corporations Act s.1013 (3).

3 Corporations Act s.1013C(3)