



**The National Institute of Accountants
Faculty of Financial Services**

**Parliamentary Joint Committee on Corporations and Financial
Services: Inquiry into Financial Products and Services in
Australia**

July 2009



The National Institute of Accountants

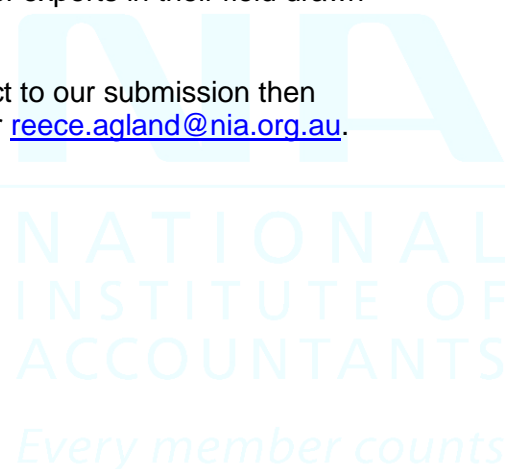
The National Institute of Accountants (NIA) welcomes the opportunity to respond to the Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into Financial Products and Services in Australia*.

The NIA is one of the three professional accounting bodies in Australia, representing over 20,000 accountants, business advisers, academics and students throughout Australia and internationally. The NIA has been around in one form or another since 1923. The NIA prides itself in not only representing the interests of its members but also the accounting profession in general as well as the public interest more broadly.

Accordingly, our submission is made from both the perspective of our members, many of whom are licensed financial advisers or advise in relation to Self-Managed Superannuation Funds (SMSF); and with regard to matters which affect the public interest. The NIA has taken the opportunity to not merely comment on what has happened in the past but also to think more broadly and offer an alternative approach to the provision of financial service advice. We have taken the approach of trying to look at what is the most effective means to provide clients with independent, quality financial advice and develop recommendations aimed at achieving that.

This submission has been produced by the NIA's Faculty of Financial Services. The NIA has established a number of Faculties to foster debate and develop broad ranging proposals in a number of important areas of public policy debate, including Taxation, Accounting Regulation and Financial Services. The Faculties are made up of experts in their field drawn from the accounting profession, academia and industry.

If you have any queries or require further information with respect to our submission then please don't hesitate to contact Reece Agland (03) 8665 3115 or reece.agland@nia.org.au.



Copyright

© National Institute of Accountants (ABN 81 004 130 643) 2008. All rights reserved. Save and except for third party content, all content in these materials is owned or licensed by the National Institute of Accountants (ABN 81 004 130 643).



Introduction

The NIA appreciates the opportunity to respond to the inquiry and the chance it provides to open the debate about the provision of Financial Services in Australia. It is fair to say that the Global Financial Crisis (GFC) has shone an at times unflattering light on the financial product and advice sector of the Australian economy, particularly in relation to the collapses of Storm Financial, Timbercorp and Great Southern. The NIA though believes it is unfair to taint the whole sector by these failures, just as HIH was not a reflection on the whole of the Australian insurance industry. The NIA's preferred approach is to look to see if there are systemic issues that need to be addressed and to find means to address those failures.

Prior to the GFC and the headline grabbing collapses of the companies named above, the NIA was of the view that there were structural weaknesses in the financial advice sector, brought about by the power imbalance exerted by the financial product providers and by the regulatory requirements set out in the *Financial Services Reform Act*. The NIA has long held the view that the current regime has led to a situation whereby many financial advisers are captured by the financial product providers and that the commission system creates an inherent conflict of interest that exacerbates that capture. The NIA does not believe the vast majority of financial advisers provide or seek to provide poor financial advice, however, their relationship with and payment by the product providers dilutes the necessary element of truly independent advice that is crucial for the ongoing success of the sector.

We also do not blame the majority of financial product providers who honestly seek to develop new and innovative products to grow the wealth of their investors, as well as themselves. However, the natural desire to maximize their return and the pressures of the market place do not necessarily equate with good public policy. The NIA believes that regulation of the sector should focus more on how good, independent advice can be provided to the public and less on trying to control the product providers.

The NIA's intention is to draw the light onto some of these issues and offer what we believe are alternate pathways to success. We welcome the opportunity to discuss further any elements from our submission.

List of recommendations

Terms of Reference 1: Role of Financial Advisers

- Focus needs to be on Client needs not the regulatory framework
- The NIA is advocating three tiered structure:
 - Tier 1: generic advice providers, AKA "Registered Financial Advisers";
 - Tier 2: client focused financial planners, AKA "Licensed Financial Advocate"; and
 - Tier 3: Sellers of financial products on behalf of the financial product providers, AKA "Authorised Financial Product Representative".

Terms of Reference 2: General regulatory environment

- A *Registered Financial Adviser* (RFA) would be the term that covers those who can provide general and generic financial advice, explain superannuation and other products but not be able to create financial plans or advise clients as to which financial product they should invest in. They would need to be RG 146 compliant and accredited by their professional body as an expert in financial advice.
- *Licensed Financial Advocate*: A Licensed Financial Advocate (LFA) would be able to provide the full range of services that an RFA can as set above but would also have the power to develop a financial plan and to liaise with Licensed Product Providers or their representatives as to financial products suitable for the clients and be able to recommend which particular products is right for the client. They would be advocates on the part of the client not product sellers.
- The *Authorised Financial Product Representative* would be a class of persons who are authorised representative of the financial product providers. They would be responsible for the development and selling of financial products offered to the public.

Terms of Reference 3. The role played by commission

- The financial advice industry needs to move from commissions to a fee for service industry to unwind many of the conflicts of interest inherent in the system. This change though needs to be brought about by the industry and advisers and not through regulatory mandate.

Terms of Reference 4: The role played by marketing and advertising campaigns

- NIA makes no specific recommendations, other than it should not be subject to additional regulation.

Terms of Reference 5: The adequacy of licensing arrangements

- Consideration must be given to requiring RG 146 to include compulsory subjects covering the “History of financial products and markets” and in “Professionalism and Ethics.”
- Consideration should also be made for requiring tier two advisers to undertake approved university education and practical experience requirements.

Terms of Reference 6: The appropriateness of information and advice provided

- Risk profiling of clients needs to be emphasised and properly policed by ASIC

Terms of Reference 7: Consumer education

- Focus needs to be on consumer knowledge not education, important role to be played by RFA's in this process.

Terms of Reference 8: The adequacy of professional indemnity insurance

- Professional Indemnity Insurance needs to be addressed, recommended levels set out in TOR 2.

Terms of Reference 1. The role of financial advisers

In relatively wealthy societies, such as Australia, where the issue for many people is not living from day to day but how to achieve a certain lifestyle and maximize their wealth, financial advisers play an important and growing role in achieving this. The role of the financial adviser should be one that concentrates on the current and future financial wellbeing of their clients. They should be the acknowledged expert in their field and have the confidence of the community. Most importantly the NIA is of the view that financial advisers must be independent and professionally minded. The role of the financial adviser, over say a financial product seller, should be to act in the sole interest of their client without unnecessary external influences on their advice.

It is fair to say that the confidence of the community has been shaken by recent events and questions have long existed about whether the structure of the sector is right to achieve the role set out above. The NIA does not wish to denigrate the financial advice sector and does not believe most of the fault lies with the advisers, rather that the way the *Financial Services Reform Act* (FSRA) has structured the industry has caused systemic failures that can only be overcome by reviewing and restructuring the whole system.

The concerns the NIA has over the structure that was created under the FSRA is that it is focused more on regulating entities than creating a system of independent advisers, it also takes various types of advisers and providers and tries to fit them into a “one size fits all” box.

Focusing on regulating entities has caused the system to be bogged down in paperwork and regulations as to what can be said and how it is said, but not ensuring whether that advice and marketing material is useful to the client. It is like trying to regulate the legal profession by limiting the size of advice or ensuring that advice is in the right format. The focus is in the wrong place. However, as long as the focus is on regulating the providers then this will continue to be the case.

The NIA understands the attraction of a “one size fits all” regulatory environment, it creates uniformity which should in theory create a more effective and efficient regulatory environment. The downside of such a process though is that it can cause people and processes to be shoehorned into a system that does not create a proper fit. This appears to have happened with the FSRA, with too many different types of service providers being shoehorned into the system (and more are proposed to be added). One of the outcomes of this is that it becomes difficult for consumers to know who to approach in relation to different types of services. The NIA would like to see further separation of those termed “financial advisers” to make it clear to the public who and what they are dealing with.

The NIA believes that we need to go back to basic principles. What are we trying to achieve? Are we mainly concerned with regulating entities or are we concerned with ensuring the public has access to appropriate advice? The current system favours the first, the NIA favours the latter approach.

In particular the NIA is concerned at the ability of a member of the public being able to access independent, generic advice about financial issues, without having the pressure of having something sold to them. The current regime has meant that to provide even simple financial advice, a person must go through an expensive process to set up a separate

financial advice business, comply with complex disclosure requirements and be subject to ASIC oversight or be an authorised representative of a license holder and beholden to the license holder. This may sound fine from a regulatory point of view, but from a commercial point of view it is disastrous. The only way money can be recouped by advisers is through selling a large amount of product and not wasting time on non-commercial generic advice. Therefore the adviser must be either licensed and therefore need to sell product, or they are not licensed and cannot say much of anything. This is leaving a hole where clients need information the most, of a generic, non product based variety. If we want people to be more financially literate, then they need someone they can discuss financial issues with.

The NIA is not advocating a return to the “incidental advice” exemption for accountants (though we do note that many members complain that financial planners now have an incidental advice exemption for tax) nor are we seeking to dilute the qualification and experience requirements. Rather what we are seeking is a system that does not impose a huge cost burden on those who provide generic advice while maintain strict controls on those who sell various financial products.

The NIA is advocating three tiered structure:

- Tier 1: generic advice providers, AKA “Registered Financial Advisers”;
- Tier 2: client focused financial planners, AKA “Licensed Financial Advocate”; and
- Tier 3: Sellers of financial products on behalf of the financial product providers, AKA “Authorised Financial Product Representative”.

The NIA would like to see a situation where clients are able to access general financial information with a trusted adviser without having a financial plan provided to them (See “Registered Financial Advisers”). More specialist financial advice and financial plans would then be provided by a licensed independent adviser (See Licensed Financial Advocate). We believe the financial advocate’s role should in many ways reflect that of a “buyers advocate” in the property market. The buyers advocate’s role in the property market is to determine what the client wants/needs, how much they have to purchase and what areas they want to purchase in. The advocate then acts on their behalf dealing with sellers of property either directly or through the sellers’ representative. They advise the client if it is a good deal and what they need to be careful of. And in the end they represent the buyer wants the right “product” is found. They act on behalf and for the client, that simple. A buyer’s advocate should not be related to or remunerated by the seller of the product and if this was the case, people would be alarmed at the conflict of interest.

Yet we expect licensed financial planners to play a similar role to the buyers advocate yet be remunerated by the seller of the product and in many cases trained by and authorized by the seller. This is a fundamental flaw in the role of the adviser versus the commercial reality of the licensing arrangement. The NIA believes that one of the fundamental problems besetting the financial advice sector is this issue of a close and often financial interest between the developers and sellers of financial products and those that are advising clients. Unless this relationship is severed, other issues such as remuneration and training will have little effect preventing a new set of failures in the future.

Finally there is still a role for those who are tied to the product providers and would be expert in individual financial products or particular classes of such, however, they would be limited to dealing with the Licensed Financial Advocate rather than directly with the client (except for certain sophisticated investors).

Terms of Reference 2. The general regulatory environment for financial products and services

When looking at the issue of regulatory environment for financial products and services in Australia, it is clear that the issue is not a lack of regulation. The original FSRA was a hefty document that has been subject to many amendments since, ASIC has strong regulatory powers and the process for becoming licensed is so overwhelming most don't even bother to become licensed in their own right. Regulation though cannot and will not prevent financial collapse, poor advice, greed or stupidity. The purpose of regulation should be to frame the market place in such a way to promote positive behaviour, limit the opportunities for abuse and to publicly deal with those that breach the public good. One of the major problems with the regulatory environment for financial products and services is that it has become focused on process not behaviour.

What we mean by focusing on process over behaviour is that there are a numerous requirements that must be met to be licensed and many rules about how documents must be prepared once in the system. The FSRA and the regulation of financial services in Australia is aimed at getting people to jump through a number of hoops, climb certain barriers and wade through waves of paperwork. If you are able to do this then you are allowed to offer your services and sell your products. Such a process may work in selecting the elite to join the SAS but does nothing to ensure quality or professionalism in the provision of financial advice. It rewards those with persistence and resources, and discourages others for no reason other than the hassle and costs of the licensing arrangements.

The NIA would like to see a change in the focus of the regulatory environment more towards looking at the behaviour that is to be encouraged and those to be discouraged and creating a structure that is client focused not regulator focused.

The NIA believes that the primary regulatory issue is how do we ensure that clients receive appropriate financial advice?

The answer, we believe, is not to create a complex licensing arrangement that pushes advisers into the arms of the financial product providers and discourages people seeking their own independent license. Instead it should focus on what sort of advice clients need. As noted above the NIA believes there are two principal types of advice that clients need.

The first is general financial advice from a trusted adviser. This is basic advice about how markets operate, what different products are and how they work, what is a full recourse loan and similar basic advice. While a lot of this kind of advice can be provided under the current law, the demarcation point between generic advice and advice requiring a license is not always clear. This prevents advisers from providing the full range of advice they should be able to because of a fear of being prosecuted. The NIA also believes that such persons should be able to discuss the full range of issues surrounding superannuation. Superannuation is the one financial product that nearly all Australians have, yet it is poorly understood. For people to better understand how superannuation works and how they can best be able to benefit from it they need people to discuss their options with. Such an adviser though should at minimum be RG 146 compliant, this will ensure a base set of knowledge.

The second, and not necessarily from a different adviser, financial advice that clients need is someone who can provide them with a financial plan and to act on their behalf to source appropriate products to fit those needs. Such a person needs to be highly skilled, professional and most importantly independent. One of the major problems with the current regulatory environment is that many of the licensed advisers or authorised representatives are trained by and remunerated by particular product providers and are limited to advising about those products. This limits the advice that can be provided and creates a set of responsibilities and duties not with the client but with the provider of the product. Any review of the system needs to separate the advice providers from the product providers.

The NIA believes that there needs to be statutory rules separating the product providers from those responsible for advising on products to clients, or if this cannot be achieved, that there is a clear distinction between advisers authorised by the product developers and advisers who are not linked to any product developers.

One of the consequences of the existing regulatory environment is that the number of people licensed in their own right has been significantly less than ASIC had originally projected. Instead, many who may have otherwise sought their own license have gone down the more efficient and less costly route of becoming an authorised representative. This is normal human behaviour. When faced with a task they will often choose the one that is easier and more efficient over the one that may provide greater reward but requires significant more effort and time, particularly where the rewards are not certain and may take a long time to recoup the initial time and cost. The problem with such an outcome is that it leads to a form of capture of these advisers by the license holder who provides their authority. They are no longer advisers in the true sense but merely conduits for the sale of financial products.

This outcome though should not be a surprise. It is an obvious outcome of a regulatory regime that is focused on process over outcome. The issue is not one of banning authorised representatives, or even increasing the educational and training requirements on them. The issue is accepting that an authorized representative is never going to be truly independent adviser and not treating them as such. They are representatives of the license holder seeking to advance the business of the license holder and the system should treat them as such rather than a Jekyll and Hyde creation that on the one hand represents the clients interest but also represents the interest of their license holder. Only once this is recognized and they are regulated as representatives not client advisers can some of the problems inherent in the current system be overcome. This is particularly so in relation to the agricultural based products that were sold to clients. The authorised representatives acted as sales agents to clients on behalf of the product providers and not as client advisers.

In the model envisioned by the NIA you would not have a one stop shop as currently exists, where a client talks to their financial planner and the planner then recommends one or more products from a set number of product providers. Instead, the model as envisioned would have the client have a relationship with a financial advocate, who would set down with the client, work out their financial needs and develop a true financial plan, setting out their risk profile, the resources they have available and the general type of product they are interested in/willing to invest. The Advocate would then approach the various product providers or their authorised sellers setting out the clients plan, without the clients personal details and seek them to make offers to match the client's needs. The advocate would then receive these, determine the best three (or more) for the client and then discuss with the client the pros and cons of the various offers. The financial advocate would then have to be barred from having

links to any product provider and receive no commissions. This service would need to be on a fee for service type of arrangement.

There would still be a market for companies that offer various financial products and be authorised representatives of the product providers. They, though, would not deal directly with the clients, rather work through the financial advocate.

The downside of such a system is that it is likely to be more expensive and clients would have to be willing to pay upfront fees for the advice and recommendations as to products. It will also add extra layers of complexity as consumers would have to understand what is the difference between someone who can only provide generic advice from someone who can provide the full range of advice, from those who sell financial products. However, given time those issues will reduce as people better understand how the system work.

The NIA accepts though that there are some individuals who are highly knowledgeable about financial products and do not need an intermediary to deal on their behalf. Such sophisticated investors should be able to seek products directly from a license holder or their authorized representative.

Therefore the NIA believes that if there is support for real change to the current financial advice system then the following changes should be implemented.

Registered Financial Adviser

A Registered Financial Adviser (RFA) would be the term that covers those who can provide general and generic financial advice, explain superannuation and other products but not be able to create financial plans or advise clients as to which financial product they should invest in. They would need to be RG 146 compliant and accredited by their professional body as an expert in financial advice.

The requirements to be an RFA should include:

- Be registered with ASIC
- Be degree qualified (Finance, Accounting or Commerce) or extensive experience and be RG 146 Compliant and be accredited by their professional body as an expert in financial advice
- Have PI Insurance to \$1 mil
- Do 30 hours relevant CPE over 3 years
- Be a member of recognised Professional Body subject to Code of Ethics and Disciplinary Process (professional accounting body, FPA, Law society)
 - Registration and compliance may be done by Professional bodies
 - Must include Quality Assurance reviews either by a recognized professional body or if their body does not provide such, then by ASIC
- Be a member of FICS or similar body
- Charge on a fee for service basis only – no commissions
- Sign a client charter

They should be able to advise on the following issues:

- Generic financial advice which does not lead to or is not intended to lead to the recommendation of a particular financial product purchase;
- Advice about what different products and markets are, how they operate and issues that should be considered before purchase
- Discuss with their client what their risk profile is
- Discuss the clients superannuation situation, what the various options are, and if the client opts into a SMSF, how this can be done, but not advice on the investments in a SMSF (other than those not requiring licensing)
- Where a SMSF is to be established PDS type statement to be provided to client setting out extent of any advice, confirmation of client that this is what they want to do and disclosure as to fees
- Review financial products recommended by a Licensed Financial Advocate to determine if they fit the risk profile of the client though they would not be able to recommend alternate products if they are of the view the recommended product does not suit the client

The NIA envisions that these advisers are likely to be drawn from those that already offer advice to clients in other fields such as accountants, lawyers and potentially real estate agents. It would replace the so called accountant exemption and certain other exemptions.

Licensed Financial Advocate

A Licensed Financial Advocate (LFA) would be able to provide the full range of services that an RFA can as set above but would also have the power to develop a financial plan and to liaise with Licensed Product Providers or their representatives as to financial products suitable for the clients and be able to recommend which particular products is right for the client. They would be advocates on the part of the client not product sellers.

The LFA would have to meet the following requirements:

- Be licensed with ASIC
- License holder would need to have at least \$5m insurance coverage
- Be degree qualified, RG 146 compliant plus an additional education requirement to ensure higher standard of knowledge than currently required under RG 146
- Have an established code of ethics and conduct
- External body to review complaints
- Member of FICS or similar body
- Charge fee for service, no commissions, no financial relationship with any particular product provider or adviser.
- Subject to a client charter

The NIA envisions that these advisers would come largely from the current range of independent licensed advisers, existing financial planning businesses and likely many current authorised representatives who wish to provide independent advice. There would need to be a transitional period to bring those who are currently licensed or authorized representatives to meet the new requirements, particularly in regards to tertiary education. It

should also be a requirement that there be some form of practical experience before a person can become an LFA.

Client Charter

Both RFA's and LFA's should provide their clients with a *client charter*. This should set out that the adviser is working for the interests of their client foremost, that any and all (including potential) conflicts of interest will be made known to the client, including any processes to promote independence. Should set out the appeal process the client can make if they wish to complain. It would set out the clients rights and the obligations of the adviser, including a fee schedule

Authorised Financial Product Representative

The Authorised Financial Product Representative would be a class of persons who are authorised representative of the financial product providers. They would be responsible for the development and selling of financial products offered to the public. They would need to be:

- Be licensed with ASIC
- would need to have at least \$50m insurance coverage
- RG 146 compliant plus an additional education requirement to ensure higher standard of knowledge than currently required under RG 146
- External body to review complaints
- Member of FICS or similar body

The NIA envisions these would come from the existing product providers and those advisers who are more interested in selling product and commission income than in setting out and developing financial plans.

Licensed Financial Product Providers

This would be a simple transfer of the current licenses of those who create and promote financial products such as AMP, Commonwealth Bank and the like.

The NIA accepts that the above is a radical shift from the current situation and would be opposed by some of those entrenched in the system. At the very least the NIA would like to see consideration given to working with the professional accounting bodies and other interested parties to better regulate the issue of non product specific advice and the provision of advice in relation to superannuation. We are of the view that it is vital for clients to have access to properly trained advisers who are not product sellers and who are not remunerated by the product providers in order for there to be a form of independent advice that clients can rely on.

Terms of Reference 3. The role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers

Fee for services vs Commissions

The NIA was initially reluctant to comment on the issue of remuneration models as it has the potential to side track discussion and for parties to engage in trench warfare in relation to well defined positions. Furthermore, the NIA is cogniscent of the argument that it is not for the accounting profession to determine how financial advisers are to be paid. However, the NIA is of the view that the remuneration issue goes to the heart of some of the problems in the financial advice sector, therefore, despite the risk of inflaming a well rehearsed debate, we have made a number of comments and suggestions.

The issue for the NIA is not one of trying to straight jacket financial advisers and dictate on high how they should be remunerated. The issue is whether certain remuneration models lead to perverse outcomes for clients and whether the professionalism of financial advisers can be improved by looking into the behaviour aspects of different remuneration models. Excessive concentration on the issue of remuneration though distracts from a holistic approach to reform and can blind to the need of other measures to improve professionalism in financial advisers. As the Financial Planning Association (FPA) said in its recent consultation paper to members “The FPA believes that remuneration is only a minor component of professionalism and is not in itself any indicator of professional practice.”¹

The debate about remuneration, we believe should focus first on the behavioural impact of different remuneration models. The two basic models most used are commissions versus some form of fee for service. Does one remuneration model display behaviour traits that are potentially negative to the client more so than another?

While people become involved in commercial arrangements for many reasons, the basic reality is that all things being otherwise equal, the majority of people will favour activity that provides them with the greater reward over the same work but for less money. Behaviour is also affected by who is the one providing the payment. People respond differently to those responsible for their financial wellbeing. No matter the professionalism of the person, it is natural to have concern about ensuring the one who pays for your wage is happy with your performance.

This is the principal concern the NIA has with commissions compared to a fee for service arrangement. Either one can lead to professional services, either one can lead to unprofessional service and over charging, however, one inherently causes people to favour the client while the other causes a conflict between the interest of the client, the interest of the product provider and the interest of the adviser.

A commission is generally paid by the product provider or a third party linked to the product provider. To get the commission you have to sell the product, the more product you sell the more remuneration you make. This creates certain behavioural responses that encourage the selling of more and more product.

¹ *Financial Planner Remuneration – Consultation Paper*, Financial Planning Association, April 2009

A fee for service model also elicits a behavioural response, that is, to provide as much advice as possible to increase bankable hours. However, the adviser will also be aware that it is not just the amount of advice that they provide that will keep the client happy but the usefulness of that advice to the client. Furthermore, with a fee for service situation there is a behaviour response from the client to prevent over servicing, they are paying for the advice and generally will only pay for the advice they find useful. They will stop seeking advice once they are satisfied with the service provided or if they think a person is padding out the advice they will find another adviser they trust. Commissions lack this inherent safeguard, as the client has no control over the fee the adviser provides and the product provider has little incentive to stop over servicing of clients.

The second behaviour problem associated with commissions is that it creates a relationship between the adviser and product provider. The adviser also has a relationship with their client. The adviser must therefore manage two set of relationships and keep both groups happy. However, as they are paid by the product adviser there will be a natural inclination to keep your paymaster happy. The NIA is of the view that commissions therefore create an inherent behavioural skew that weakens the client – adviser relationship. In a fee for service model it is clear that the relationship is between the client and the adviser only. I pay you to provide me a service. There are no conflicting relationships and no reward based mechanisms creating an incentive to sell particular products or amounts of products.

The accounting profession in Australia uses a fee for service model; this is because it puts to the heart of the relationship the best interest of the client without competing influences. In Australia lawyers are paid on a fee for service basis also, though in the US lawyers can earn large commissions from cases. This has not caused lawyers in the US to be less professional (in most cases) nor less technically competent, but it does skew their behaviour in a way that encourages certain types of legal action and discourages others, based not on their legal merit or worthiness of the cases but on the fact a large reward can be earned. This has in turn caused other behavioural actions such as over servicing by doctors to try and avoid legal costs and the closing down of certain industries that have been sued out of existence. What this example is used for is to show is that commissions can and do skew behaviour, regardless of the professionalism or skill of those receiving the commission.

The NIA believes commissions create a fundamental conflict of interest that for some advisers is causing them to be less concerned about the individual clients concerns. The recent case of Storm financial is a classic example of this. The *FSRA* is meant to ensure that the adviser must take into account the individual concerns of the client such as risk profile, investment complexity and their overall goals. Storm seems to have offered the same or essentially similar advice to clients regardless of the clients individual needs or circumstances, including encouraging elderly people to become highly leveraged at a time when they should be more concerned about income earning rather than debt repayment. With high pressure sales tactics they were able to get the clients to sign up to advice that many have since said did not take into account their individual needs and invested them in products that if they had known the full extent of their exposure they would not have invested in.

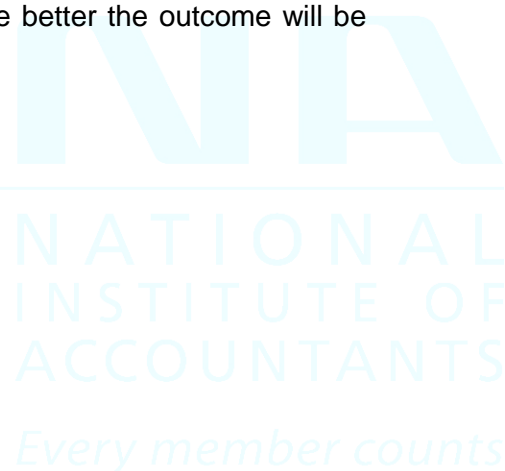
The argument against moving from commissions to fee for service is generally said that there is a reluctance of clients to pay upfront for the costs of this type of advice, that clients expect such advice to be “free” (in the sense of not coming out of their own pocket). This has never really been tested so it is hard to say whether there is any truth to the claim. The

counter argument is that if people don't pay for something they do not value it properly. If financial advisers truly cannot convince clients of the worth of the advice such that they would be willing to pay for it, then that reflects on their need to better improve their relationship with the client so that they see the value.

The truth though is that the concern about clients not willing to pay upfront fees for service can be alleviated in a way that still ensures the clients interest are at the forefront. One way to do this is for the adviser to provide the client with a list of their fee for service and the approximate hours it will take to do the work and what the fee would be. The adviser could then get the client to authorise that this fee is to be taken out of any commission that is received for the sale of the product. Any excess commission would be transferred to the client or if it is insufficient to cover the full costs then any excess amount would be billed to the client.

There are various models that could be adopted and the NIA does not wish to divert attention in trying to canvass all remuneration options. The point the NIA wishes to make to the inquiry is that we believe there is an inherent and unavoidable behavioural aspect of commissions that conflicts with what we believe should be the primary goal of any adviser, in being concerned solely with the interest of their client.

In the end it is for the financial advice industry to understand the need to focus more on client needs, to improve its professionalism and deliver better outcomes. It is heart warming to see groups such as the FPA focusing on the issue of professionalism and understanding the problems that commissions can cause through the inherent conflicts of interest they cause and the behaviour they can induce. Behaviour change is not achieved just by setting rules and requirement. It is paramount that those subject to it understand the underlying rationale. The more financial advisers concentrate on achieving outcomes for their clients and less with protecting an outmoded form of remuneration, the better the outcome will be for them as well as their clients.



Terms of Reference 4: The role played by marketing and advertising campaigns

The NIA does not intend to make any formal comments in relation to the role of marketing and advertising campaigns. The NIA is of the view that these are commercial issues and not appropriate issues for further regulation. The NIA believes that the core issues of focus of the inquiry relates to the structure of the financial services industry in Australia, ensuring truly independent advisers exists, moving away from commissions as the primary source of remuneration and creating further separation of the financial product providers from the advisers.

Looking into marketing and advertising could have the effect of diverting attention from the core issues. Furthermore, it is difficult to see how any regulation of the marketing and advertising will improve the outcome for clients. It is attempting to regulate process and not behaviour. It will simply create a new set of rules to be followed which smart people will find a way of getting around. It merely creates a temporary roadblock. The ACCC has sufficient powers now to take action against deceptive conduct.

Terms of Reference 5: The adequacy of licensing arrangements for those who sold the products and services

The NIA has already commented extensively on our concerns with the regulatory structure in existence today and what we believe is a preferred model. The current licensing arrangements are too focused on setting up road blocks and requirements that must be met and less with the behavioural issues that surround the advice being provided. It is clear to the NIA that this is the wrong way to regulate this sector.

One point the NIA would raise is that as part of the RG 146 requirements there needs to be compulsory subjects covering the history of financial products and markets and on ethics and professionalism.

Until the recent collapses brought about by the GFC many advisers would have been unaware of the turbulent history of financial products apart from some vague memories of the Great Depression and the collapse of Wall Street that preceded it. Their recent memories would have been of regular and consistent growth and a belief amongst many that the errors of the past could not befall the current system. Any serious study of financial product history though would show that there have been many boom and bust periods, what an asset bubble is and dangers they pose, what a Ponzi scheme is and other recurring events in financial products and markets. History cannot prevent people making the same mistake twice but can provide them with tools to better predict behaviour and understand how the system works.

Again a study of ethics and professionalism does not ensure ethical or professional behaviour but it does give people an understanding of the difference between acting professionally and acting for your own financial advantage. It may have provided advisers with better tools to determine what their clients' interests are and how to recognize conflicts of interest and the appropriate actions required to deal with them. It may also have been able to equip them with knowledge in which they could question some of the practices being imposed on them.

The NIA also believes that for financial advisors to be properly 'professionalised' there needs to be a move to a system of tertiary qualifications with additional professional body mandated post graduate education. While education in itself does not remove poor advice or fraudulent behaviour, it does raise the quality of understanding of the advisers and will provide clients with a higher degree of comfort with their advisor.

It is not realistic to expect such a change to happen quickly. There are many in the current system that would find requiring a tertiary qualification difficult to achieve but who have vast and useful experience. A similar change though happened with the Tax Agent registration requirements. This provided a time period to move to tertiary education (either university degree or TAFE Advanced Diploma) and grandfathered in those that were then registered without requiring further training. It also required specific study in tax and corporate law. A similar model could be looked at for financial advisers where by minimum tertiary education is required (though not necessarily just a university qualification), particular subjects must be included in that education and a minimum level of experience also required before a person can be licensed. The NIA's three tier model foreshadows such a movement to require tertiary education and we would see the above coming in for the tier two type of advisers (LFA's). Any move to a tertiary education minimum would require further discussion with those involved in the sector.

Terms of Reference 6: The appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;

Many of the recent collapses in the financial product market have raised questions about the appropriateness of some of the advice that is alleged to have been provided by some advisers. Until such matters are addressed by the courts it is not appropriate to talk about specific occurrences, however, there are some particular practices that need to be reviewed.

Appropriate risk profiling: The FSRA does require advisers to be cognisant of the risk profile of clients and RG 146 does provide some training on this. Unfortunately it appears that this, along with many other FSRA requirements, was merely dealt with on a tick and flick basis by some advisers rather than through serious consideration. Of particular concern has been the suggestion in many of the complaints about advice, that those in, or nearing, retirement were being advised to invest in products that were heavily geared and in many circumstances did not provide financial rewards for many years. It is generally accepted that those in, or near, retirement have different risk profile from someone who is only recently entering the workforce. Such clients are generally less concerned with capital growth and more concerned with income generation as they move from receiving a wage to receiving a pension or other wage substitute.

The NIA is of the view that imposing new and more cumbersome rules is not the best way to deal with these issues. Nor is the solution to simply ban certain products (as this may deprive some people of appropriate advice). The NIA's view is that ASIC must be provided with greater powers to enforce the current risk profiling requirements and is funded to take action against advisers who promote inappropriate products to the clients risk profile. ASIC will need to provide further guidance on how risk is to be assessed and the dangers of certain products to certain clients. If ASIC is seen to be targeting inappropriate risk profiling of clients, advisers will likely change their behaviour and pay greater attention to this issue, thus negating many of the concerns that exist.

One option may be to require advisers to put in writing their determination of the clients risk profile and why the product advised was appropriate to that risk profile. This could then be kept on record until such time as ASIC reviews the adviser, where upon they could have regard to the risk profiles generated and determine if the product was right for that client. This though may add unnecessary burden to the process.

Highly Geared investments: One related area where there has been concern at the appropriateness of the advice provided by advisers relates to the issue of highly geared investments. Gearing is not necessarily a bad thing; many financial experts will tell you it is one of the keys to making profit in a growing marketplace. The issue that is of concern relates to the level of gearing and the type of clients this level of gearing was promoted to. It has been reported that clients have been recommended to gear investments, particularly in the form of margin lending, at excessively high levels. The higher the gearing or the greater exposure to margin lending is the more any downturn in a market will affect the client. While growth is multiplied due to gearing so are losses. This does not appear to have been appropriately explained to some clients.

Again the issue is to not ban geared investment or margin lending, as they are effective means of growing financial wealth. What is needed is a better understanding for whom these types of products are best, what the danger signs are and most importantly what is in the best interest of clients.

The NIA is of the view that simply adding new regulatory powers or increasing the level of education of providers will be insufficient to prevent a repeat of the current problems recurring in the future. As noted in the beginning the core issue is placing the client at the heart of the issue. This can only be done where the adviser is not remunerated by or linked to the provider of the financial product. Only by removing that link will the adviser be truly free to determine the clients risk profile and whether certain products are in the client's interest rather than simply another client to whom they can sell a product to. Therefore the NIA believes that adopting the proposals outlined under Terms of Reference 2 is the only way to ensure clients are provided appropriate advice.

Terms of Reference 7: Consumer education and understanding of these financial products and services;

Knowledge is important to the understanding of any undertaking; the more knowledgeable a person is the more likely they are to make the right decisions. However, too much emphasis can be placed on education as the primary source of knowledge. Education is only one of several sources of knowledge. Knowledge is also gained through experience, both of your own and by others. Knowledge is sourced by watching others and through the media. Therefore the NIA is of the view that the emphasis should not be on consumer education but improving consumer knowledge. It is a subtle but important difference. Education is based largely on direct learning where as knowledge can be imparted through multiple means and not necessarily consciously.

The problem with consumer education tools, though important, is that they force people to try and learn something. Educators will tell you it is more important for people to understand the importance of why they are learning and how it will help them than on the simple act of

learning. Furthermore, people find financial products quite confusing and in many cases boring. They are not interested in the intricacies of different financial products; they want to know how it will make them wealthier. Thus it does not make sense to force consumers to learn in-depth knowledge of financial products and to ban them from investing in them until they have passed some kind of mandated course. What consumers need to know are what are the risk factors, what are the things that should concern them and a basic understanding of how it works. In the end the best source of knowledge to them will come from a trusted adviser not from formal education. They need to be equipped to ask their advisers the right questions and understand the terms that the adviser uses in providing those answers.

Therefore, the NIA believes the most important means to improve consumer knowledge and understanding of financial products is to ensure they have access to a trusted adviser, one who is independent and who is authorized to be able to talk to them about financial products and the operation of the financial markets without having to worry about ASIC taking them to task for helping a client. Any formal education is likely to be lost on consumers unless it is directly relevant to them at the time and even then may be quickly lost.

Terms of Reference 8: The adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers

The NIA does not intend to make any major statements in relation to the issue of professional indemnity (PI) insurance other than to say that in the proposals outlined by the NIA under Terms of Reference 2 we have stipulated what we believe are the appropriate levels of PI insurance for those different types of advisers.

The NIA requires all its members in Public Practice, which includes financial advice, to have a minimum \$500,000 PI insurance. The NIA is of the view that PI is vital for those providing services to the public and believes that there should be a review of the adequacy of PI insurance requirements for financial advisers. The NIA though is not an expert in the issue of insurance and would recommend that the review look to funding a specific review of the appropriate level of insurance commissioned to experts in the field.

Terms of Reference 9: The need for any legislative or regulatory change.

The NIA is of the view that there needs to be significant regulatory and legislative change and not merely the patching up of a system we believe is fundamentally flawed. As has often been noted in this submission, the core issue is how to provide clients with appropriate and useful advice and to provide it in a way that is independent of financial influence from the financial product providers.

As noted in Terms of Reference 2, the NIA believes that the current system of licensing and of authorising representatives needs to be dismantled. In its place we recommend a three tiered structure:

- Tier 1: generic advice providers, AKA “Registered Financial Advisers”;
- Tier 2: client focused financial planners, AKA “Licensed Financial Advocate”; and
- Tier 3: Sellers of financial products on behalf of the financial product providers, AKA “Authorised Financial Product Representative”.

The NIA would also support a review of the requirements set out in RG 146, particularly with a look to include subjects relating to the History of Financial Products and Markets and on Professionalism and Ethics. It may also be necessary to require more extensive training for what the NIA has termed Tier 2 advisers to ensure they have a well rounded training that is of a high standard.

While the NIA supports the move to a fee for service model from a commissions based model, this is an issue for the industry to come to terms with rather than for regulatory or legislative change.

Conclusion

The NIA is pleased to be provided an opportunity to express to the PJC our views as to how to reform the provision of financial advice. The NIA believes that the problems that exist in the current system are not just the result of poor advice, but as a result of a structure that has made it difficult for advisers to become truly independent advisers. The regulatory environment created by the FSRA has led many advisers who may otherwise have become licensed in their own right to instead take the cheaper and easier route of becoming authorised representatives. This system limits the advice they can provide, makes them captive to the interests of the financial product providers and instils a sales mind frame instead of an advice mind frame. Unscrambling this system to ensure that there are more independent financial advisers, based as we see it on an “advocate” model, is the key to ensuring that appropriate financial advice can be provided and the interests of the client can once again be paramount.

The NIA accepts that some of the proposals recommended would not be universally welcomed and that any changes will need to take time to develop. The last thing the NIA wants to see is change that is not well thought out. Ultimately though, the NIA is of the view that any regulatory system adopted needs to be less concerned with developing processes to make it difficult to become an adviser or merely add to the cost of advice and should instead focus on behaviour. Changing behaviour is the key. Ultimately this is achieved not simply by regulatory means but also by those in the industry taking charge of the issue. Those in the industry need to focus on quality advice, on becoming more client focused and less on the return to the adviser. Financial advice needs to move from being an industry to being a profession. This requires those involved to drive the change.

Contact - The National Institute of Accountants

NIA Head Office

Level 6, 555 Lonsdale Street
Melbourne Victoria 3000
Australia
Tel: 61 3 8665 3100
Fax: 61 3 8665 3130
Email: natoffice@nia.org.au
Website: www.nia.org.au

NIA Divisional Offices are located in the following cities:

Melbourne
Sydney
Brisbane
Adelaide
Hobart
Perth
Canberra

The NIA also has offices in:

Kuala Lumpur
Hong Kong
Beijing

For enquiries within Australia call 1800 625 625 or the nearest NIA Divisional Office.
International enquiries can be directed in the first instance to the NIA head office.

NIA

NATIONAL
INSTITUTE OF
ACCOUNTANTS

Every member counts