Submission
to the
Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Services and Products
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The views expressed in this submission are solely those of the author

1. Background

The Parliamentary Joint Committee on Corporations and Financial Services terms of reference includes an examination of the role of financial advisers, the regulation of financial products and services including commission arrangements, and the promotion of such products. The Inquiry's scope was extended to include an examination of specific providers who had collapsed such as Storm Financial, Opes prime and the practices of banks and other financial institutions in relation to margin lending associated with those businesses.

The current debate has centred on the retail end of the issue. That is, an examination of the advisers and planners, the people who sold the products. There is a dearth of focus let alone debate about the creators of the products, the people who designed and costed the products. There is a danger that the debate has focused on the sellers of the investment and little said about the "controllers" "creators", "promoters" "providers" of the products, akin to "finance factories". Ultimately every financial product is promoted through information, brochures provided by such entities.

Blaming the high commissions, relatively low level of training in the industry maybe convenient but does not address the issue. Why are commissions so important? Is it because the basic salary rates are low? Why were assets valued so highly? Was it because the promoter was keen to get their commissions and to sell over priced assets as a financial product? And finally, should the creator of such products who often buy assets, revalue the assets to meet their financial needs then factor in high commissions why should they not be examined?

Australians are now purchasing financial products almost as common as buying a mobile phone contract or buying any other product or service, its time the law reflected this fact.

This is a unique opportunity to de-mystify the entire industry, bring it to basics and create a culture of "labelling" and disclosure which we expect other industries to comply with from food to mobile phone to consumer credit. Importantly, those at the front line, the planners and advisers the retailers should not bear the brunt of further regulation without a propionate review and regulation of the wholesalers and manufacturers of these products.

The background in which the Inquiry is taking place is a global credit crisis brought about by the bursting of an asset bubble, much of which was created by the financial products the Inquiry is examining. It would be unfortunate if the Inquiry did not examine the conduct of the creators and promoters of the products.

2. The Financial Product Industry

Governments throughout the world have actively promoted the idea of building personal wealth to fund retirement. The privatisation of public utilities and business globally introduced millions to the share market. Australia is no different. It's a case of setting the environment before educating the people. So what exactly were all these people buying?

Australians have been urged to take responsibility for their financial wellbeing. By July 2009 more than a $1 trillion have been deposited in superannuation accounts. This in addition to Australians achieving the highest retirement savings rates in the world with another 36% of adults directly owning shares.

Being responsible for one's financial wellbeing is an opportunity for the sellers of financial products. Most people would know that high returns equals high risk. Most would understand that certain investments such as utilities like power, water, airports, bridges, tollways is almost a licence to print money. But how many people read the small print?

Assuming they read the small print, what are the chances they would understand what the terms mean?

Assuming they decide to seek professional advice from their lawyer or account that has nothing to do with the product on sale, how much would they pay?

It's more likely than not they will seek relatively inexpensive quick advice from their financial planner or adviser. What are the chances that these people know the terms of the product? Do they know that the underlining asset was purchased by the investment promoter for a fraction of the valuation they now claim the asset is worth. And what about the promoter's margin let alone the adviser's commission will this be known, let alone understood by the customer?

3. Financial Products

Financial products are no longer limited to bank or superannuation or even real estate, virtually anything can be converted into a "financial product" from tea trees, emu eggs, olives, shopping centres, to forward selling of tolls collected.

This has been recognised in law Section 763A of the Corporations Act 2001 to include:

... a facility through which, or through the acquisition of which, a person does one or more of the following:
makes a financial investment ...;
manages financial risk ...;
makes non-cash payments ...

... a particular facility that is of a kind through which people commonly make financial investments, manage financial risks or make non-cash payments is a financial product even if that facility is acquired by a particular person for some other purpose.

4. The Industry

The industry is not limited to advisers and planners as noted by the terms of reference. Although advisers and planners are at the forefront of the retail end of the industry and are more likely to be blamed when things go wrong, the other side of the industry is perhaps even more important. Without the creators of the products, the advisers and planners have little to sell. The “Finance Factories’ make the products sold by the planners and advisers.

The “Finance Factories” secure the underlining asset or opportunity, place it into a corporate and / or trust entity, revalue the assets, then set up a series of other entities to convert the asset into a product, set up a management entity, amongst other entities to ensure that the asset has liquidity, so that the asset is available to raise further funds whether debt or in another form.

Securitisation is perhaps the most popular form followed by MIS and various forms of collateral debt or infrastructure / income steam obligation instruments.

5. The Financial Product Factory

Investment banks, brokers, business promoters, property and business managers have created an entire industry a “factory” creating and supplying products to both wholesalers and retailers. Financial products need to be considered like another product. The difference is that people’s life efforts are often at risk.

The manufacturers of the product are always seeking to secure opportunities and package them into a financial product. Whether it’s a toll way an airport, share market speculation, it does not matter. Manufacturers can secure the opportunity at one valuation re value it at many multiples package it within a complex ownership and management structure then distributed it through the retail end of the market.

At the retail end of the market, the planners and advisers are the gate keepers to the products, currently regulated through a licence regime. The product disclosure requirements have not created a better informed market. It has provided an opportunity to provide more information not user friendly information.

6. Financial advisers

The advisers and planner industry is claimed to be worth billions in income earned yet there is no clear legal definition of a financial adviser. The Corporations Act requires that licensed providers of financial advice, must be fair with their clients, comply with legal obligations and professional standards, and be a member of an independent complaints scheme.

The Australian Securities and Investments Commission (ASIC) consumer website tends to group ‘licensed investment adviser’, ‘licensed adviser’, ‘financial adviser’, ‘professional financial adviser’ and ‘financial planner’ together as if they are the same people doing the same job.

Section 923A Corporations Act provides advisers a guide on how to use such terms as ‘independent’, ‘impartial’ and ‘unbiased’ to describe their service. Generally, financial advisers are required to use these terms if there is no conflicts of interest.

Very few advisers could use this term. The reason is that the business model adopted by the bulk of advisers is commission driven. Like their real estate counterparts, the industry is commission based. The difference between the two industries is that the law recognises this for real estate agents in contrast to the finance industry.

If the industry is commission driven it’s not surprising that the majority of planning companies in Australia are owned by or aligned to large finance product providers.

7. Reasonable basis test

Providers of a financial services, are required to be licensed by ASIC and to provide personal advice to a retail client, by making “reasonable inquiries into the relevant personal circumstances of the client and have a reasonable basis for the advice (s945A); and to (b) warn the client if the advice is based on incomplete or inaccurate information (s945B); and (c) give the client a Statement of Advice (s946A).”

What exactly is a “reasonable inquiry”? This test has built in it a range of unrealistic assumptions. If the advisers are not charging for the “reasonable inquiries” then they are getting paid in another form.

So how much effort must the adviser put into conducting “reasonable inquiries” is it worth their effort or is it a tick the box requirement. Perhaps the law should specify that the adviser cannot act for any other parties benefit but their clients, which would require a declaration that the adviser is there for the best interests of their clients exclusively.

8. Commissions and conflicts

There is no better way to drive sales than by commission. Whether driving sales by an electrical retailer or a real estate agent. Low salary package topped with bonuses and commissions is common in many industries. The problem is that buying a TV set from a sales assistance because of the commission they receive is different from investing your pension or life savings.

Commissions generally are unacceptable as they bring about a conflict of interest distort the market place and benefit those that may behave less than in a competitive manner. It is preferable that the law provide ASIC with the power to outlaw all commissions unless the client has signed an acknowledgment that they were informed of the conflicts of interest in advance of the advice being given.

9. Approaches to Remuneration

It is noted that sectors of the industry are promoting the idea of "asset / funds based fees". Such fees are usually based as a percentage of the total funds the client had placed on the advice of the adviser. As the asset base grows presumably because of good or sound advice then the amount grows paid to the client.

The problem is that if the client has a small asset base at first will they get the same service as those with a larger asset base.

Because government and the industry has been successful to convince all Australians to become "investors" to such an extent that buying investment products is like buying another product. There needs to be fewer obstacles or distortion in fee and service structure leaving the smaller asset base customer in the cold.

Due to the number and diversity of those buying such products there needs to be a fee for service perhaps hourly or fixed lump sum.

10. Providers and retailers

The current industry is made up of suppliers/providers (creators or promoters of the product the "provider") who control the supply of the product, the managers of the products (fund managers, airport, shopping centre, farms, hotel, infrastructure and other service managers the "managers") and the retailers (planners and advisers)

The retailers are at the frontline selling the product to the customers. If the regulation aims at supervising the retailers it misses the key to the problem. If the problem has been the sophisticated complicated over priced over valued products laden with fine print then it's the people who created the products that need regulation. The providers control the supply of the products, who gets to sell them and how much they will earn

It's not the regulation of their conduct it's the price, structure and fees that need regulation.

How can a provider have purchased an asset then revalue to increase the "book" value of the same asset within months sometimes weeks then put it in a trust, give a generous management contract to a related entity often with a high exit fee clause, then when the asset/product does not perform blame the adviser and planner?

How can the provider not be subject to the same level of scrutiny as the people on the frontline?

11. Valuations to be realistic

The provider of the products should be required to justify their valuation of the assets they are selling through their products and avoid the complexity of terms, structures focused on commissions.

It would appear that many well known brands have either failed or simple did not live up to expectations and appear to be sophisticated pyramid schemes, with little capital appreciation, or increase in wealth or cash flow, as management fees, commissions and establishment fees seem to dominant the cost structure of such products. It would appear that the products exist and are management not for the benefit retail investor.

In many instances the promises could never realistically be delivered and the products were created for the benefit of the providers and through the commissions offered to the planners and advisers who in turn would be unlikely to have understood the design of the product. The retailers received the commission; they drove the dream, created by others who should also be held accountable.

The result is more than the loss of funds which culminated with the credit crisis, it's a loss of confidence and trust critical for any financial system.

12. Logic in the chaos, meaning in the confusion

Financial product design and valuation has increasingly become very complex. Yet the fundamental underlining concept is the same. An investor hands over the cash and receives either a portion of an asset that may or may not generate cash flow or the investor buys a steam of income. Rarely, an investor may be fortunate to buy both. From this proposition financial engineers and their lawyers create a web of entities to own, manage the asset, deal with the investors and the alike, an entire global industry has emerged to create and manage what is essentially quite straight forward.

The rise of complex financial products is linked to the way assets are being valued. Before this complexity became a hallmark of the industry assets and risk was valued based on competitive forces. Today they are based on market distortion; marketing hype and promises that are rarely based on realities.

There is perhaps no better example of this is than the promise of rising stock markets as a given or that collateralised debt obligations (CDOs) also known as structured asset-backed security (ABS) supported by collateral that was said to exist and was valued by an independent party who used a realistic formula.

To add spice to the CDO product each CDO did not represent the same type of real estate mortgages, that would be too obvious and understandable but they assigned different risk classes, sometimes referred to as "tranches" were in fact what you were buying was a packet of "all sort" lollies, some were good others not so good.

If you get a CDO with a "senior" tranch then you get the money first, if not you miss out. These products were justified on the grounds that they spread risk but for the un-initiated as the credit crisis has shown the CDOs were created for the benefit of the promoter/provider who in turn factored in large commissions otherwise how could a product be sold if the buyer knew what the true risk was?

If anyone asked the question as to risk they were referred to a credit rating agency who in turn failed to account for the large risks or to declare that they too had substantial accounts with the creators of the CDOs.

13. Sophistication for the few

The complexity of the products is perhaps driven by marketing or simple the way the market deals with ownership, risk and valuation. Whatever the underlining reasons, these products are currently an acquired taste, and should therefore be required to be labelled as such. The warnings should not be in small print, or at the end of the document the warnings should be akin to those found on cigarette packets.

14. Protecting the uninitiated

The financial services laws and *Corporation Act* have a regime of disclosure rules which appear to be onerous. The idea behind these laws is to inform the market, to disclose the risks and the basis of the valuation and the purpose the investment

The *Corporations Act* goes as far as providing opportunities to be exempt from the prescribed rules on prospectus through the "sophisticated investor" provisions. Perhaps investment products in general should be approached the same way.

Some products such as Managed Investment Schemes, products supported by complex ownership and management structures may perhaps not be made available to the retail end of the market. There is a danger that if every perceived "ill" is legislated out of existence it does not resolve the cause of the ill. In this instance the ill appears to be that the un-initiated are buying products which cannot be understood and therefore, the decision as to "is it good value" "how safe is this "and "can I afford to lose my money" can never be answered accurately.

15. Replace the Commissions?

Much has been said about a commission driven business model. The regulator ASIC and many in the industry including suppliers such as AMP have admitted that there is a problem. But this is half the story. There is only a problem because the products are priced and even structured to be commission driven. Is the regulator and some of the suppliers saying that the way the products are priced needs to be looked at seriously?

16. Attracting qualified people

Assuming commissions are replaced by fee for service. Assuming that the service is comprehensive and detail who will conduct such a service? Will there be enhanced qualification criteria for a licence? Importantly will such qualified experience people work for the current base rate salaries on offer without the bonus and commission structure?

17. Cost of retail regulation

Regulation like the law is sometimes perceived as the means of resolving any issue. The fact is that the industry does not need more regulation it needs transparency, accountability from the product provider and a culture less based on fees for dreams and more based on fees for creating income.

18. Cost of litigation and Regulation

The current victims of the investment schemes whether they are sourced from investment banks, or well known firms such as Allco, Babcock & Brown, Tricom, Opes prime, Westpoint and the like have a legitimate claim to seek answers. Many have sought to join a number of class actions.

The question which has arisen is whether more regulation is the answer.

There is a misconception in the community that the regulator micromanages both the providers and the retailers of the products. In the perfect world that may be the case, it is unreasonable and perhaps not even feasible to expect ASIC to provide such a service.

ASIC has investigative powers even powers to prosecute and stop products in the market place. There needs to be some education campaign so that investors become aware that the buyer beware principle is alive and well in the industry. The cost and complexity of civil litigation makes it prohibitive to seek any remedies. Considering that the investor has usually lost most of their wealth in the investment they have very little to pursue litigation.

Some investors have noted that the “system is against them” the fact is that in such circumstances the system is in effect against them they are left to enforce their rights on their own. It should be noted that as investors they took the risk, they could have gained much benefit if they did would they be prepared to pay the regulator for a job well done? Should those who engage in the industry pay a fee?

If investors and the community in general seek protection at that level, they need an independent entity to tell them that they are not buying an airport rather a piece of an entity that owns the airport but not the management of the airport, and by the way the manager who collects the rent, etc gets their money first and if the manager leaves they get money for leaving, is this the level of regulation required?

This is surely beyond the role of the regulator. Other than ensuring that the disclosure provided by the creators of the product is simple, accurate, follows a standard template so that the client can judge it against others, what else should the regulator do. Why should the tax paper many of which are not active in this industry pay so that investors receive this protection?

This task is labour intensive and the regulator cannot be expected with its existing resources to “keep” the industry honest. If this is the level of regulation demanded by the investors it should come at a cost, a cost that should be borne by the investor, perhaps a small surcharge on the amount invested. In return the regulator could be more pro-active as in the case of APRA levies on Authorised Deposit taking Institutions (ADI) to help pay the cost of regulation.

If investors would like the comfort they receive when they bank to be same as when they invest in financial products, then like the banks, it should be paid by the investors.

19. Reform the Industry

The industry is in need of reform. This may require political and regulatory will, allocation of resources, interfering in the affairs of influential and proactive entrenched entities. But it is possible. It has been done in other similar situations, where the culture has now changed.

The makers of these products are doing it for their own benefit. The pricing, complexity and sophistication of the products means that the creators need marketing channels to sell their product. To attract such people the creators offer gift, bonuses, and commissions. Ideally these people can refer to themselves as advisers or at best are perceived by the public as “planners” “advisers”.

An analogy of the current situation is the way doctors in the past received gifts, and prescribed certain branded drugs prior to the introduction of new laws to regulate the behaviour of the drug companies.

In this instance planners and advisers should be considered much like the doctors, and the drug companies as the creators of the products the investment banks and promoters. It is now un-acceptable for any doctor to receive valuable gifts, commissions or any form of payment, and yet doctors do provide advice on both the type of drug and brand in their prescription. The law is clear about the division between the creators of the product and the advisers (the doctors) and the retailers (the pharmacists) it had taken almost a century for the regulation to be put in place, but it was done much to the annoyance of many stake holders. Today it is rarely considered a controversial issue.

Financial planners and advisers cannot be both the doctor and the pharmacists and also act as the agent of the drug company. They should not have any alliances or links with the suppliers they should be purely advisers. Otherwise they should be able to be “retailers” and prohibited from giving advice other than as sales assistance. It is unrealistic for any customer of these products who does not pay a fee for service to expect that the adviser/ planner is not receiving a commission. If so then who pays the adviser/ planner?

Advisers will want to replace their commissions, at the same time it's important that good people are attracted to the industry. The solution may lay in the new laws regulating real estate agents in New South Wales. Like financial planners and advisers, employed real estate agents are on very low base salary, and rely heavily on bonuses and commissions. As a consequence, agents have distorted market valuation perhaps contributing to the high cost of real estate especially in urban areas. With banks eager to enhance the assets on their books they offered more funds to the home buyers thus further driving the cost of housing.

The new law targets this practice of telling people a lower price to get them to the auction, then driving up the price at the auction. If the legislature and government can outlaw such practices with success in the medial and real estate industries then why not in the investment sector?

20. Recommendations

1. Fiduciary Obligations of Providers
Establish legal fiduciary obligation between the financial product provider and the end customer so that there is no ambiguity as to the liability of the provider and provide certainty as to the role of the adviser

2. Fee for Service
Fee for service should be encouraged as the remuneration model of preference so that the customer can judge what is driving the advice.

3. Finance Products Surcharge (FPS)
Charge a "regulatory fee" along the lines APRA levies on Authorised Deposit Taking Institutions (ADIs) levied on all financial products to pay for the regulation and supervision of the industry.

4. Product Monitor and Register
Create a National Financial Product Monitor to enable customers to better judge both the provider of the product, their performance and to better determine the risk inherit in the product.
5. Insurance for advisers and planners
Introduce Professional Indemnity Insurance to financial advisers and planners and limit this to specific written requests for advice based on information provided by the customer.

6. Template Disclosure to the Customer

A template which outlines succinctly in a user friendly manner the assets the investor is buying into, the valuation of the asset how that valuation was conducted and who did it and a simple breakdown of the product cost structure.

7. Finance ombudsman
Establish a finance ombudsman funded by the Finance Products Surcharge as an independent body appointed by a panel of customers industry representatives, ASIC and the ACCC to investigate and mediated or arbitrate disputes between the parties.

8. Banking Advisers and Planners
Banks should be prohibited from creating and supplying finance products (other than banking related products). This would reduce any distortion or confusion that the products are related to banking activities and regulation.

9. Consumer education and Financial Literacy
A percentage of the financial product surcharge (FPS) go towards a national financial education and literacy campaign incorporated within the High School Commerce, Economics and Business Studies courses in addition to providing a national campaign

10. Separate sellers from advisers
Advisers should be prohibited from selling or brokering any products.

11. Customers Declaration
Risk acknowledge declaration should be provided to every customer in plain English user friendly layout which outlines precisely what is being sold (is it a physical asset or rights to the entity which owns the asset etc) the true cost of the product, perhaps along the lines of what is provided to mobile phone customers.

21. The Author

The writer is a lecturer in Business Law, School of Business Law and Taxation Australian School of Business University of New South Wales admitted as a solicitor and barrister of the Supreme Court of New South Wales, High Court of Australia, Arbitrator to the Local Court of NSW (Civil Claims) 2003-007, member Law Society of New South Wales Arbitration President Arbitration Panel, author of a number of commercial law texts, chapters, articles, conference and discussion papers.