Submission by CHOICE
to the
Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Services and Products

August 2009

CHOICE is a not-for-profit, non-government, non-party-political organisation established in 1959. CHOICE works to improve the lives of consumers by taking on the issues that matter to them. We arm consumers with the information to make confident choices and campaign for change when markets or regulation fails consumers.

Our policy voice is widely recognised. We campaign without fear or favour on key consumer issues based on research into consumers' experiences and opinions and the benefit or detriment they face. Our current campaigns cover food, health, financial services, product safety, communications and consumer protection law.

CHOICE conducts research, publishes policy reports and online information, gives presentations and keeps the media informed of our policy views. We provide representatives for many industry and government committees and independent bodies considering matters of concern to consumers.

To find out more about CHOICE's campaign work visit www.choice.com.au/campaigns and subscribe to CHOICE Campaigns Update at www.choice.com.au/ccu.

Introduction

> *"As the system stands it does not work in the interest of consumers. The government wants people to fund their own retirement and I believe most people would do this if they could, yet legislation prevents us getting the sound advice we need. I feel completely abandoned by a succession of governments who have not addressed this problem. We are not wealthy people; we have got what money we have by hard work. We feel there is no one we can turn to for financial advice who we can be sure will act in our interests and not their own. Are we asking too much?"*
>
> Anonymous consumer, July 2009

Australians are exhorted on a daily basis to take responsibility for their financial security during their working life and beyond. And we do a pretty good job of it. With more than $1 trillion in superannuation accounts Australia has one of the highest retirement savings rates in the world and, in addition, around 36% of adults directly own shares.[1] But managing one's financial affairs is not a simple matter and too often CHOICE is contacted by members of the public who have suffered significant financial losses when the timely assistance of quality financial advice may have averted tragedy. Since significant deregulation of the financial services sector more than twenty years ago the range and complexity of financial products available to the average Australian has been utterly transformed. At the same time the complexity and riskiness of these products have increased. The need for independent, impartial and unbiased financial advice has never been stronger and yet the financial services industry is for the most part failing to provide this.

Numerous submissions to this Inquiry made by former Storm Financial clients portray the extreme financial and psychological devastation that can accompany bad financial advice, particularly approaching and during retirement. We hope that the recommendations contained in this submission will contribute to a better, more trustworthy financial advice industry. This submission analyses the pitfalls of the regulatory system that has contributed to the demise of Storm Financial clients and many others like them. We focus on the conflicts of interests that are failing consumers.

In this submission we have outlined the following proposals for law and policy reform;

1. Establish legal fiduciary obligations on the financial adviser, either a fiduciary relationship like that adopted in the US or the UK approach that requires the adviser to operate in the best interests of their client;
2. Grant ASIC the capacity to exclude particular conflicts of interest where it is satisfied that the conflict is inconsistent with the fiduciary duties an adviser owes a client;
3. Ensure a level playing field for adviser remunerations through equal tax treatment of all remuneration models (ie. either fixed fees should be tax deductable, or commissions and percentage-based fees should lose their tax deductable status);
4. Create a National Compensation Fund for Financial Advice; and
5. Improve Professional Indemnity Insurance to better protect consumers.

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[1] Australian Prudential and Regulatory Authority, March 2009, *Statistics: Quarterly superannuation performance,* p7; Australian Stock Exchange, 2008, *Australian Share Ownership Study*

1. The role of financial advisers

There is no direct legal definition of financial adviser. Rather the law placed certain obligations on a person who provides general' financial product advice or 'personal' financial product advice. For the purpose of this submission we use 'financial adviser' to refer to any person who provides general or personal financial advice. The *Corporations A*ct places specific obligations on licensed providers of financial advice, for example they must deal with their clients fairly, meet legal obligations and professional standards and be a member of an independent complaints scheme. The latter ensures that consumers have recourse to a low-cost independent arbiter, which forms an important feature of licensed advice.

There has been much debate about the nature and definition of the term 'financial adviser' and 'financial planner'. The Australian Securities and Investments Commission (ASIC) consumer website (www.fido.asic.gov.au) uses the terms 'licensed investment adviser', 'licensed adviser', 'financial adviser', 'professional financial adviser' and 'financial planner' interchangeably. We note that none of these terms are defined in the *Corporation Act*, nor are they restricted terms. Were such a term to become restricted, our preference is that only advisers licensed to provide personal advice should be able to use the description 'financial adviser'.

In Regulatory Guide 146, ASIC outlines areas of specialist knowledge including Financial Planning, Securities, Derivatives, Managed Investments, Superannuation, Insurance, Deposit products, Foreign Exchange and First Home Saver Accounts. These may be considered specialist services of licensed financial advisers and we see no need to restrict these terms.

While the legal and policy structures are essential to understanding the role of financial advisers, another way to understand the role of financial advisers is to review what financial advisers are not. For example, financial advisers are not sales representatives of product manufacturers. Nor do financial advisers replace financial counsellors, the National Information Centre on Retirement Income (NICRI) or Centrelink FIS officers, who provide an essential community service. These services support consumers with differing needs (to those met or potentially met by financial advisers) in parallel to any services provided by licensed financial advisers. Recent changes to the intra-fund advice rules should also encourage better advice within superannuation products. We believe the government has a role to ensure adequate access to these services. We therefore recommend the government review current funding of these service to ensure that the Australian population are able to access the financial assistance services they require. Should additional advice service be needed, we encourage the government to explore alternative means for low-income people to access free or low-cost personal financial advice.

1.1. Independent, Impartial and Unbiased

An important aspect of the *Corporations Act* is section 923A which provides the legal basis for advisers to use the terms 'independent', 'impartial' and 'unbiased' to describe their advisory practice. Financial advisers can only use those words if they're free from conflicts of interest caused by links to product manufacturers, and if they refuse (or immediately rebate to customers) commissions and other payments and gifts from the financial institutions and fund managers whose products they recommend. CHOICE supports the restriction of the terms, which was introduced in 2002; nevertheless we understand that the number of advisers who meet this legal definition is extremely low. Research by FSI Consulting, a company that provides consultancy services to the financial industry, claims that only around 11 financial advisers in Australia can legally call their services 'independent', 'unbiased' or 'impartial'. In other words next to none of an adviser base of more than 16,000 provide advice that is broadly in line with community expectations of financial advice.

The majority of planning companies in Australia are owned by or aligned to large financial institutions, banks and fund managers. While an increasing number sell their advice to consumers on a 'fee for service' basis, most also receive commissions from financial institutions for the products they recommend.

The *Corporations Act* establishes worthy goals for advisers and establishes legal definitions that are in line with community expectations of financial advisers. And yet these goals appear not to be vigorously pursued by the adviser community. We would like to see more consumer education around these terms and greater incentives, such as those outlined below, for advisers to be independent, impartial and unbiased.

1.2. Reasonable basis test

As a provider of a regulated financial service, financial advisers are licensed by ASIC and have legal obligations to their client. Specifically, in providing personal advice to a retail client, the (licensed) financial adviser must:

(a) make reasonable inquiries into the relevant personal circumstances of the client and have a reasonable basis for the advice (s945A);
(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).

In this submission, we challenge whether the reasonable basis test is sufficient regulatory obligations on financial advisers. Current thinking in the United States is looking at expanding the fiduciary responsibilities between adviser and client, while the United Kingdom requires financial advisers to act in the “best interests” of their clients - not just have a reasonable basis for advice.

2. The role played by commission arrangements

The key points in this section are that:

- Commissions create an unacceptable conflict of interest;
- ASIC should be given the power to outlaw particular conflicts of interest where it is satisfied that disclosure and management will not prevent inappropriate or biased advice; and
- The tax deductibility of all adviser remuneration models should be the same, which means either fixed fees should be tax deductable or commissions and percentage-based fees should lose their tax deductable status.

Commission based remuneration creates an ethical dilemma for financial advisers because it places the interests of the adviser in direct conflict with the interests of their client. That’s because the payment to the adviser is set and paid by the product manufacturer. In other words commissions encourage adviser loyalty to the product manufacturer instead of loyalty to the client.

Structural conflicts of interest are endemic in Australia’s financial services sector and have impacted negatively on the quality of advice and products provided to consumers. The UK Government has embarked upon a major review not of disclosure but of financial services distribution. In the words of UK Financial Services Authority (FSA) Chairman Callum McCarthy, 'We have a business model for the retail distribution of financial services…which has so many unattractive features that many regard it as broken.'[2]

The main feature McCarthy points to is conflicts of interest between firms and consumers. He confesses that the regulatory response has been ineffective, in part because it has produced 'excessive paperwork' for investors. The similarities with Australia are obvious.

Instead of asking how we can better disclose commissions, we believe it's time we asked the sorts of questions that McCarthy has put to the UK financial services industry. 'Is it really in the interest of product producers, who have so much riding on their brand reputation, to continue to use commissions as an incentive when it so clearly risks inappropriate consequences?'

Economic research from the US by George Loewenstein from Carnegie Mellon University has demonstrated that not only is disclosure a poor response to conflicts of interest in retail markets, it can actually exacerbate their negative impact. Disclosure of conflicts can lead consumers to place more rather than less trust in advisers. And disclosure entrenches the bias of advisers, allowing them to feel they've 'done the right thing' while keeping the conflicts in place.

Disclosure is also a poor solution to conflicts because it generates information that consumers cannot use. For example, should a consumer apply a greater discount to the value of financial advice if faced with an upfront commission, a trail commission, or a buyer-of-last-resort arrangement? What combinations of these conflicts might produce the most bias? What does it actually mean, in dollar terms, to apply a discount to advice in this way? The answer to these questions is not contained in a disclosure document.

Not only do commissions increased complexity, we believe they also increase the cost of advice. Supply-side competition in any sector is notorious for driving up costs for consumers and has the effect that intermediaries – in this case the financial adviser who, in theory, are supposed to be independent expert financial advisers - behave as agents for fund managers.

CHOICE does not believe that conflicts of the magnitude presented by commissions can be addressed through disclosure. Instead, we believe that government, together with industry and consumers, should be working towards a regulatory system that requires the removal of conflicts of interest like these. For this reason we recommend that ASIC be given the power to outlaw particular conflicts of interest where it is satisfied that disclosure and management will not prevent inappropriate or biased advice. We propose two law reforms to facilitate this systemic removal of conflicts of interests;

1. Establish legal fiduciary obligations on the financial adviser, either in a US style fiduciary relationship or UK approach that requires the adviser to operate in the best interests of their client.
2. Establish ASIC powers to exclude conflicts that are inconsistent with the fiduciary duties an adviser owes a client.

In recommending this approach we note that this is broadly in line with current thinking in the United States where there are proposals to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest. In its report *Financial Regulatory Reform: A New Foundation*, the Obama administration proposes to the following;

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[2] Is The Present Business Model Bust? - Speech By Callum McCarthy, Chairman, Financial Services Authority, Gleneagles Savings & Pensions Industry Leaders' Summit, 16 September 2006 http://www.exchangehandbook.co.uk/index.cfm?section=news&action=detail&id=61995.

New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:

- *requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;*
- *providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and*
- *prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.*[3]

Similar provisions to prohibit conflicts of interests are now needed in Australia.

2.1. Commissions and conflicts

In recent months CHOICE has been collecting case studies to support our contention that commissions need to be removed from the advice industry. The following case studies are presented anonymously as these were the conditions under which they were collected, however CHOICE holds contact information for each consumers

Pressure to sell assets

On seeking out an adviser for a friend approaching retirement, the following case study reveals how an adviser can pressure a prospective client to convert non-cash assets into commissionable cash assets:

> [The financial planner] *discussed with me my friends' broad financial situation and I explained they owned four homes. He responded that he would need assurance they **would be prepared to sell one or more of these homes** before he was prepared to have discussions with them. (i.e. his motive was to move them out of direct real estate, which is not commissionable to him, into managed funds which are commissionable). I replied that any decision to de-weight in direct property should be the **result** of a financial analysis, not a precondition of attending an appointment. On hearing this he detected that I understood how the industry worked and declined to see the client.*
>
> *Clearly this planner wasn't interested in dealing with anyone who was not going to invest in managed funds, the products that paid him commission.*

Churning clients:

Consumers often reported to us being pressured to switching their superannuation fund. This case study explains the opaque advice that accompanied a recommendation to switch:

> *"We wanted some advice on how to invest our money and save for a deposit on a house. [The adviser] made a big show of telling us that all his customers were satisfied, and that he had a money back guarantee - he did not disclose his fees up front, nor did he even hint that he might get a commission from selling financial services products. Instead, he was very keen for us to move our superannuation into new funds that he nominated, and to invest in a housing development he had an interest in. He also wanted us both to attend various expensive seminars which we assumed he also got*

[3] Department of the Treasury *Financial Regulatory Reform: A New Foundation,* June 2009

commission on. After we realised that every piece of advice he gave us led to a commission for him we opted to use his 'money-back guarantee' and to leave his practice, very unsatisfied, but luckily no poorer. We later found that he got a big commission from persuading people to shift their super to his nominated funds, and that if he had persuaded us to buy insurance, he would get not just one but several annual payments as we kept up the insurance premiums. We felt lucky that we had woken up before we had made many financial decisions, all to his advantage, not necessarily to ours."

In fact pretty much whenever a client changes planners they will get switched into products on the new planners approved product list and that is what pays the best commissions, soft dollars, loans etc for the new advisers practice as a whole

Encouraging gearing:

The collapse of Storm Financial has exposed the flaws of their business model that relied excessively on gearing in a rising market. CHOICE believes that it remains common practice for financial advisers to encourage gearing that is not in the interests of clients, as the following case study demonstrates;

"Once we explained we wanted to lie low for a bit the financial adviser pushed even harder trying to convince us to borrow $$ to make more $$ - this was 6 months ago?? I'm surprised he didn't recommend Storm Financial to us"

Cost and value of advice:

The value of advice provided under trail commission payments (and the same applies for asset based fees) can be difficult to determine in advance of purchasing the product. For example, one consumer contacted us to advise that after purchasing a managed investment product a limit was subsequently placed on the number of hours of advice the client could receive. The consumer explains;

"Recently they have imposed a 5hrs/annual limit on the personal advisors time to be spent on the portfolio. This represents an hourly rate of $774.80 which appears extortionate!"

High Commissions:

Conflicts of interest can lead to dangerous or poor quality financial products being sold to consumers. The collapse of the Westpoint property scheme in 2005 provides a striking example. Timbercorp and Great Southern are the same 10 and 12 % commissions were the norm. Westpoint investments were sold through financial advisers who earned up to 13% in commissions. These abnormally high commissions almost certainly influenced how many advisers presented Westpoint as an investment opportunity. Some advisers may not have clearly explained that the investment would be unsecured. Because it is unsecured the product was not suited to people close to retirement that require more conservative investments, but this is exactly the group that was sold Westpoint products. Inappropriate advice was given to sell the product and many consumers have lost some or all of the money they invested.

2.2. Alternative Approaches to Remuneration

CHOICE has stated publicly its dislike of commissions and other fees that can bias advice, such as asset-based fees which charge a percentage of funds under advice. Commissions may be upfront or trailing payment set by the product manufacturer. In our view, trail commissions are not about servicing the client; they are about attracting and retaining planners. Trails provide nil benefit to consumers. They are simply a cost and are a glaring example of a way in which the industry subtracts value for consumers.

We are very concerned that the industry is attempting to transition from commissions to asset based fees. Asset-based fees are paid by the client to the adviser as a percentage of the total funds under advice. While asset based fees at least can be turned off by the client as they are paid by the client rather than the product manufacturer they have many of the same market distorting features as commissions have. Our preference is for fixed fees which could be either a fixed lump sum or hourly rate charged by the adviser to the client. As the table below demonstrates, fixed fees present none of the failing of commissions and asset-based fees.

Failing	Commissions	Asset-based % Fees	Fixed Fees
Adviser incentivised to recommend sale of non-financial assets (like real estate) to invest in financial assets	High	High	None
Adviser incentivised to recommend inappropriate products with big commissions	High	None	None
Adviser incentivised to churn clients through products	High	None	None
Adviser biased against liquid/safe assets which pay low or no commissions	High	Moderate	None
Adviser incentivised to recommend gearing	High	High	None
Lacks transparency in total remuneration to the adviser	High	Moderate	None
Value of advice relative to the cost of the advice is difficult for the client to determine	High	Moderate	None

One consumer explained their view on commissions as follows;

> *It is impossible to follow all commissions and take them into account when choosing financial advisers and assessing financial advice. Only fee for service and a ban on commissions will protect the public.*

CHOICE agrees. We believe that the only payments a financial adviser should receive are payments from their clients and these payments should be completely transparent. This is the only way to ensure unbiased recommendations of investment and/or wealth protection strategies. Fund managers attract planners with high commissions, with soft-dollar bonuses and other perks, and by providing administrative support platforms which lock them in. The value of advice for consumers barely rates a mention

Until fixed fees receive the same tax treatment as commissions and asset-based fees we believe the industry is unlikely to develop in this direction. Commissions and asset-based fees currently enjoy tax deductable status because they are linked to an income stream. We believe the tax deductibility of all adviser remuneration models should be the same, which means either fixed fees should be tax deductable or commissions and percentage-based fees should lose the tax deductable status.

3. Consumer education and Financial Literacy

The Committee will no doubt hear two schools of thought on the question of financial literacy, one that says the system works fine but people don't have a good enough understanding of it; and another that says the system doesn't work. CHOICE is in the latter school. As it currently operates, the regulatory system shifts risks from adviser to client (even though consumers seek out advisers to help mitigate risk) through a system of 'anything goes as long as you disclose'. It is this system that we believe is failing consumers of financial products and services. We do not believe that the system of disclosing conflicts of interest is a sufficient form of consumer protection. No amount of consumer education or resourcing will alter the structural conflicts of interest that make good-decision making impossible and undermine consumer confidence in the financial advice industry.

4. The adequacy of compensation arrangements

Victims of Storm Financial who were considering seeking compensation for bad financial advice would have found the following information at ASIC's website;

> "If you lodged a complaint with the Financial Ombudsman Scheme against Storm before it went into liquidation on 26 March 2009, the Ombudsman will still have jurisdiction to hear the complaint. ***However, there is no guarantee that any claim will be able to be paid, even if the Ombudsman finds in your favour.*** An Ombudsman award may still be helpful to you if you need to prove you are a creditor of the firm, as the administrator may accept it as a 'proof of debt'."[4]

CHOICE contends that it is an unacceptable situation that successful claims for compensation can go unpaid. We believe that current compensation arrangements in the financial advice industry are inadequate. The following summarises the argument in our submission of 2007 to the then Parliamentary Secretary for Financial Services (available at choice.com.au) on this matter.

1. Where a licensee is solvent, the ASIC approved external dispute resolution schemes such as the Financial Ombudsman Scheme should be the main compensation mechanism.

2. Where a licensee is insolvent or unable to pay, a broad compensation scheme like the stock exchange's National Guarantee Fund should apply. That scheme should include:
   - A broad ability to hear claims
   - A "reasonable grounds to believe" misconduct test
   - Subrogation of rights in order to recover some funds

3. Mandatory professional indemnity insurance should underpin EDR determinations, court judgments and in some cases recoveries by the compensation scheme.

[4] http://www.asic.gov.au/asic/asic.nsf/byheadline/Storm+financial?openDocument accessed 28 July 2009

4.1. Mandatory professional indemnity insurance

Current arrangements for Professional Indemnity Insurance (PII) are limited to requiring licensed financial advisers to take out. For PII to work as a compensation mechanism, the following is required:

- Consumers must have a right to know the name of the insurer and the terms of the policy. At present consumers can spend tens of thousands of dollars in legal fees just to get this information.

- Licensees must be required to provide the name of their insurer and the general terms of the policy in their Financial Services Guide. This should be in a standard format to be settled by ASIC.

- Government and ASIC must tightly prescribe the terms of mandatory PII to stop insurers trying to “screw down” contract terms to limit their liability.

- A broad form civil liability policy with mandatory fraud and fidelity extensions is necessary to meet the needs of both licensees and consumers, rather than the typical narrow negligence policy commonly in use at the moment.

4.2. Insurance is not enough – we need a compensation fund

Even with the changes recommended above, PII will not cover all losses. Insurers regularly deny claims where a licensee has been acting outside license conditions or selling non approved products, as has happened in Westpoint. We also think that consumers who have suffered loss because of wrongdoing by financial advisers and service providers should be entitled to compensation for losses even where the guilty party is unable to pay, for example due to insolvency.

A last resort compensation fund is an essential element of the compensation regime. Such a fund would not be designed to compensate consumer for poor performing investments. The fund would compensate consumers where licensees have breached their license conditions and are otherwise unable to compensate consumers.

We were very pleased when the Rudd Government announced the Financial Claims Scheme to provide consumers of failed ADIs with timely access to their funds and to provide compensation to policyholders of failed general insurers. This extends the compensation regime and adds to that provided by the ASX National Guarantee Fund and the Superannuation Industry Supervisory Act.

This missing link in compensation arrangements policy is any form of compensation for consumers of investment products, where licensees have breached license conditions and been unable to pay such as occurred in the recent Westpoint, Fincorp, ACR collapses.

CHOICE has identified the following core feature of a National Compensation Fund for Financial Services;

1. Provides for compensation for consumer losses where licensees have acted contrary to the law and are unable to pay compensation e.g. due to insolvency
2. Covers losses sustained by retail clients who deal with licensed intermediaries and licensed product issuers.

3. Covers all breaches of financial services law and where licensees act outside their license conditions.
4. Applies across the market
5. Puts investors back in the position they would have been in if they had not suffered the loss flowing from the licensee's breach of the law.
6. Provides a maximum guarantee up to the retail client limit $500,000.
7. To minimise risky behaviour by clients as a result of the compensation scheme, payouts would be tiered and capped with only the first portion of the loss fully compensated.

5. The need for any legislative or regulatory change

Corporate collapses are not new to the Australian economy. Even in our recent past, Australians have witnessed severe breakdowns in financial products. Storm Financial is an extreme event on a continuum of regulatory failure built on the inherent conflicts in the industry. We are calling on the Committee to make the following recommendations in order to improve the regulation of conflicts of interest in the advice industry in the wake of major collapses like Westpoint and Storm Financial.

In this submission we have outlined the following proposals for law and policy reform;

- Establish legal fiduciary obligations on the financial adviser, either a fiduciary relationship like that adopted in the US or the UK approach that requires the adviser to operate in the best interests of their client;
- Grant ASIC the capacity to exclude particular conflicts of interest where it is satisfied that the conflict is inconsistent with the fiduciary duties an adviser owes a client;
- Ensure a level playing field for adviser remunerations through equal tax treatment of all remuneration models (ie. either fixed fees should be tax deductable, or commissions and percentage-based fees should lose their tax deductable status);
- Create a National Compensation Fund for Financial Advice; and
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