CHAPTER FOUR - CONSUMER PROTECTION OVERLAPS & INCONSISTENCIES - OPTIONS

4.1 CURRENT REGULATORY FRAMEWORK

Introduction

As discussed in Chapter 1, the existence of market flaws means that consumer protection is a key objective of financial supervision. Broadly speaking, consumer protection per se is not a contentious issue because it can improve market efficiency as well as social justice; but the nature and extent of consumer protection is contentious because of the potential compliance burden and competitive inequality involved. Duplication and inconsistency in regulation should be avoided because they can:

- cause customer confusion in that the customer can be overloaded with information, resulting in uncertainty as to which regime is relevant;
- impose additional compliance costs (which in part at least will be passed on to consumers), ie. practitioners can be burdened with excessive licence fees, red tape and paperwork generally;
- result in double jeopardy, or at least unequal enforcement, whereby monitoring and compliance may be much harsher under the tougher regulator; and
- create competitive inequality, ie. the uneven distribution of the regulatory burden may unfairly favour one industry or group over another.

An important empirical issue requiring consideration is the extent to which regulatory overlaps and inconsistencies in consumer protection are really creating significant costs in practice, as distinct from merely presenting a picture of untidiness and causing minor irritation. However, quantifying the costs of regulation is notoriously difficult.

The chapter focuses on three main areas: the regulation of financial advice, product disclosure and complaints handling. It concludes by canvassing some options for rationalising and streamlining consumer protection in the financial sector.

Consumer protection regulators in the financial system

At the Commonwealth level, there are at least four regulators that have consumer protection responsibilities: the Australian Competition and Consumer Commission (ACCC), the RBA, ASC and the ISC. The ACCC, using its generic or economy-wide powers under the Trade Practices Act (TPA), is responsible for ensuring that consumers generally are protected against unfair trading practices. The RBA is involved with the banking and EFT codes of practice, and the banking ombudsman scheme. The ASC provides consumer protection through the Corporations Law to ensure that retail investors who make use of investment advice are properly informed.

The ISC presently also has a strong consumer protection role in respect of insurance policyholders and superannuation fund members, in addition to its prudential supervision function of ensuring that insurance companies are likely to remain solvent and that superannuation funds are prudently managed. In addition, all States in Australia have Credit Acts/Codes, and Fair Trading Acts administered by various State Consumer Affairs Bureaus.

Some of the broad features of the consumer protection regulation undertaken by each of these organisations are set out below.

Australian Competition and Consumer Commission

For the ACCC, most interest lies with section 52 of the Trade Practices Act which prohibits misleading and deceptive conduct and has a very wide application which includes, for example, prospectus material. The Corporations Law Simplification Taskforce is presently preparing a report on the application of section 52 to prospectus material and to other securities dealing.

States

The States and Territories have their own consumer protection laws which are usually provided under each State's Credit Act, Credit Code and Fair Trading Act. Most States and Territories have introduced, or are in the process of introducing, uniform consumer credit legislation, following a SCOCAM (Standing Committee of Consumer Affairs Ministers) initiative. The legislation generally aims to regulate consumer credit contracts and related transactions on a common basis, and encompasses the uniform Consumer Credit Code.

The Consumer Credit Code involves a formal agreement by all States and Territories to adopt 'template' legislation (which uniformly applies the Code) and is scheduled to commence on 1 November 1996. The Code will cover all credit which is to be used predominantly for personal, domestic or household use. The Code will regulate all credit providers, including banks, building societies, credit unions and finance companies as well as stores, solicitors, accountants and individuals who provide credit and charge interest for the use of that credit.

The States and Territories also have their own Fair Trading Acts. The uniformity of these laws is somewhat 'hotch-pot' according to the Honourable Mr Justice White, a Judge of the Supreme Court of South Australia[1] . However, one reason for this situation is that, under the Constitution, the Commonwealth is empowered to legislate only on specific subject matter within its power and there is no express 'consumer protection' head. However, despite the apparent hotch-pot nature of State consumer protection laws, there are in many instances commonalities in such laws at the State and Commonwealth level.

[11] J. Goldring, L. Maher & J. McKeough *Consumer Protection Law in Australia*, Butterworths, Sydney, 1987.

Australian Securities Commission

The ASC regulates misleading conduct under s 995 of the Corporations Law, which is intended to protect investors from receiving misleading investment advice. Investment advisers found guilty of contravening s 995 may incur a fine.

The ASC also relies on a $20,000 security bond arrangement to ensure that aggrieved consumers have access to adequate compensation through an administrative process rather than through the courts. However, the bond arrangement has been criticised as impractical and the ASC, as it moves to implement its Good Advice proposals, is likely to replace it with a requirement that all security advisers hold professional indemnity insurance.

Other measures proposed by current ASC initiatives as part of the Good Advice process relate to complaints handling and adviser/product disclosure. The ASC will require licensees providing securities advice to retail investors to have adequate internal complaints handling mechanisms. The issue of whether there should be mandatory external complaints handling in the retail financial advice industry has been deferred for the time being.

The ASC disclosure requirements include requirements under the Corporations Law and a proposed consumer information guide (Advisory Services Guide (ASG)). Section 849 of the Corporations Law requires disclosure of conflicts of interest, such as fees, commissions and other benefits and interests of an adviser and associates. An ASG is proposed for all retail investors of life insurance, superannuation and securities products. The Guide will disclose an adviser’s capacity, the services they offer and their charges, to enable consumers to compare services and products and make informed decisions.

Insurance and Superannuation Commission

The ISC’s approach to consumer protection also targets specific market sectors, namely insurance and superannuation, with measures which can be classified into three broad categories: the regulation of financial advice and intermediaries; product disclosure; and oversight of complaints handling arrangements.

Measures designed to protect consumers against misleading advice and conduct are generally provided under the *Life Insurance Act 1995*, the *Insurance (Agents and Brokers) Act 1984*, the *Insurance Contracts Act 1984*, and the *Superannuation Industry (Supervision) Act 1993*, all administered by the ISC, and also under the non-statutory insurance Codes of Practice.

What the above discussion clearly indicates is that there are considerable overlaps in consumer protection legislation both at the Commonwealth level alone, and as between Commonwealth agencies and State bodies. The ASC and ISC have regulatory overlaps in product disclosure and the conduct of financial advisers. The two agencies are working together to remove such overlaps as part of their joint harmonisation project (refer below). Overlaps also exist between the financial sector provisions of the ASC/ISC and the generic provisions of the ACCC/States. This is mainly manifest in duplication of consumer rules covering undesirable sales practices such as misleading and deceptive conduct.

4.2 FINANCIAL ADVICE AND ADVISERS

Emergence of Financial Advice Industry

The emergence of a separate financial advice industry in Australia since the mid 1980s can be attributed to three significant economic and social developments. First, with rapid technological and commercial changes in the financial system following deregulation, including increased product differentiation, investment products became more varied and complex, and consumers became more wary and confused. Relatively unsophisticated consumers were confronted with a bewildering range of complex investment products, leading to a growing demand for expert advice. Consumer choice was also made more difficult by a rapidly evolving array of inter-related taxation, superannuation and social security rules.

Second, the rapid expansion of the managed funds industry occurred without investment scheme operations having direct access to traditional retail distribution systems, such as bank branches and life insurance agents. The retail managed funds industry had its origins in the wholesale investment banking industry, and therefore lacked an established retail distribution network of its own. Retail managed funds these days are essentially distributed by financial planners.

Third, a shift in Government policy towards self-provision of retirement income, the continuing trend of an aging population, earlier-age retirement and the traditional Australian preference for retirement benefits to be taken as lump sums rather than income streams, also contributed to the emergence of a market for specialist financial advice catering for small retail investors and their rollover ‘nest-eggs’. This is particularly the case where taxation and social security complications are involved.

Other market developments

In the post 1980s period, banks and life offices shifted their competitive focus from market share and corporate size per se, to return on scarce capital and profitability. The shift in emphasis from marketing effort (which raises costs) to price restraint meant that these institutions came under pressure to reduce their distribution costs. Therefore, instead of financial products continuing to be sold wholly through the traditional distribution networks (eg, life insurance sold by tied agents and banking products sold through branch networks), a hybrid approach to product distribution has been developed to contain costs and improve profitability. Life offices and banks have restructured their distribution networks and/or driven their networks harder via cross-selling. This process is not yet complete.

A further development is the trend for specialised advisers distributing a narrow product range to diversify by reconstituting themselves as multi-agents, life brokers, or financial planners selling a diverse range of financial products. There has also been a strong shift by financial advisers from a product sales focus to a genuine advisory role.

Over the past five years, the number of life offices dealing only with sole agents has diminished. Today hardly any life offices use a sole agency network as the only means of distributing their products. However, the process of restructuring their distribution arrangements is not an easy one for companies which do not want to see their sales slump in the transitional period (ie. the industries have a ‘gridlock’ problem).

Reviews of financial advice industry

In 1992, the then Trade Practices Commission published a report following its inquiry into sales practices in the life insurance industry. The TPC Report highlighted that inadequate information had put some consumers at a disadvantage in the market for life insurance products. During 1994-1995, the ASC conducted a thorough review of the licensing regime for securities advisers, involving wide consultation, with a view to improving the quality of advice securities advisers provide to investors.

These two extensive reviews into the financial advice industry resulted in major initiatives such as the life insurance Code of Practice, the ASC Good Advice Report and a current exercise between the ISC and ASC to harmonise their respective regimes.

Prior to the announcement of the Financial System Inquiry, two other initiatives relating to the regulation of financial advisers were underway. The first was an industry based project to develop a registration scheme for life insurance advisers (agents, brokers and their representatives). This project has been put on hold at the Government’s request pending the completion of the Inquiry. The second was an ISC review of its Agents and Brokers Act, which has already sought and received some stakeholder (particularly industry) input, but which is now also on hold pending the completion of the Inquiry.

The project to develop a registration scheme for life advisers has two aspects which are relevant and notable here: one is the useful work which has been done on adviser core competencies, and which is suitable for incorporation into the life insurance Code of Practice; the other is the focus on the individual advisers (ie. natural persons) involved in face-to-face selling, which is inconsistent with the ASC’s and ISC’s preference to licence and supervise principals (who may be small niche players, but are commonly medium to large advisory firms).

Gaps, overlaps and inconsistencies

Despite initiatives by the ASC and ISC to harmonise their requirements, the current regulatory regimes for financial advisers continue to display inconsistencies, overlaps and gaps (see Appendix F). These exist partly because the advice industry is not homogenous but takes manifold forms, and because there are some unique market characteristics in the industries the ISC supervises. However, they also reflect some lack of regulatory coordination and consistency.

1. Entry and Supervision

- licensing conditions

  There are different entry requirements for securities advisers and life insurance brokers in the areas of financial soundness and competency (educational, experience and training) requirements (see Appendix F). The Good Advice standards are generally more stringent than the current life broker registration requirements (which are under review). As mentioned above, the proposed registration scheme for life advisers, now on hold, is inconsistent with the current practice of regulating principals, rather than their individual representatives.

- training and competencies

  The objectives of the two regimes appear to be comparable in this area. The ASC's Good Advice Report lists the components of the personal competency framework to include knowledge of investment markets, relevant law and taxation, ethical principles, analytical, interpersonal and communication skills. Many of these competencies are addressed in the Core Curriculum for life insurance advisers (largely fleshed out as part of the industry project to register life advisers) in the Code of Practice. This is being currently subjected to accreditation under the Government's national training arrangements. Training and competencies of investment advisers is an area being reviewed under Exposure Draft 5 of the harmonisation initiative between the ASC and ISC.

- SIS intermediaries

  Intermediaries dealing in, or advising on, superannuation interests (eg. financial planners selling retail superannuation) are currently exempt from the requirement to hold a dealers licence but are required to comply with the Conduct of Business Rules under the Corporations Law. The absence of statutory backing, however, means that the ASC is unable to conduct its monitoring and surveillance activities effectively, to ensure that all superannuation intermediaries fully comply with the relevant Conduct of Business Rules when advising investors on SIS products. The ISC and ASC as part of the harmonisation exercise have agreed that the ASC should have full responsibility for regulating SIS intermediaries.

- enforcement

  The Code of Practice requires a life company or broker to establish detailed monitoring procedures to ensure compliance by its agents. There is also a proposed requirement for life companies to establish a Compliance Committee, comprising a majority of independent directors, with the responsibility of oversighting compliance with the disclosure rules and the Code of Practice. While the ASC Good Advice Report refers to a requirement that a licensee's management policies and procedures must address key compliance issues, it does not favour a prescriptive approach, but will seek certification from a licensee (or its directors) that their systems are adequate to meet their obligations.

2. Status Transparency

- disclosure of capacity and financial interest in sale

  While both the ASC and ISC have for some time prohibited financial advisers from misrepresenting the capacity in which they are dealing with clients, there were no prescribed rules relating to disclosure of capacity. However, both the Code of Practice and the ASC's proposed 'Advisory Services Guide' will require more information to be given on the capacity in which the financial adviser is acting. This information includes identification of the individual providing advice; details of the type of products/services on which advice can be given; and the means of remuneration (eg. commissions etc - note that life brokers cannot receive volume bonuses, but securities dealers can).

  Notwithstanding the closeness of these requirements, attention has been drawn to differences in relation to the level at which disclosure is made; ie while under ISC requirements the life company representative provides personal details, under the ASC proposals disclosure is at the dealer level. Even so, under their harmonisation initiative, the ASC and ISC are proposing that a single Advisory Services Guide would meet both requirements.

- use of description 'independent'

  The ASC Good Advice report sets out guidelines for the use of the term 'independent'. For example, licensees using the term should avoid any commissions, trailing commissions or soft dollar arrangements from product providers which are reasonably likely to create a product bias; should operate free from any direct or indirect restrictions or inducements relating to the securities recommended; and should operate without any conflicts of interest created by ownership links.

  Although the ISC does not have any formal guidelines in relation to the use of the term 'independent', it has developed a number of benchmarks against which the independence of advice can be judged. The benchmarks are similar to the ASC guidelines and include: that the primary duties are owed to the client and this is disclosed to the client; that there are no agency arrangements with life companies; and that measures are in place to provide an effective professional service, such as professional indemnity cover, subscription to an approved complaints scheme and proper record keeping standards.

3. *Sales Practices*

Both the ISC and ASC share the broad objective of ensuring that advice on securities, life insurance (including risk products) and superannuation products is appropriate to investors' individual needs and circumstances, and also meets the legitimate expectations of retail investors (eg. in regard to quality and impartiality).

- 'know your client'/needs analysis/fact find

The life insurance Code of Practice requires advisers to conduct a 'fact find' or needs analysis to ensure the customer is able to make an informed choice based on their personal circumstances.

Section 851 of the Corporations Law imposes an obligation on securities advisers to provide recommendations that are appropriate to the client's individual needs and circumstances.

- reasonable basis for recommendation

The ISC and ASC have similar requirements for there being a reasonable basis for the recommendations made to customers. These are covered under section 851 of the Corporations Law (interpreted under ASC Practice Note 41) and by paragraph 12 of the life insurance Code of Practice, which provide for the 'fact find' requirements mentioned above.

- record keeping requirements (paper trail) v. rebuttable presumption

The ASC requirements in the Good Advice proposals are not prescriptive in relation to record keeping, and are directed more towards encouraging good practice. The ISC has taken a more prescriptive approach to record keeping in the Life Code, ensuring there is a paper trail throughout the entire sales process, but it is intended that this will be reviewed in the interests of harmonisation.

The ASC recommended in its Good Advice Report that the Law be reformed to incorporate a rebuttable presumption in favour of the client where the securities adviser has not maintained relevant records, and the ISC is proposing to canvass this approach in the review of the Life Code of Practice.

4.3 PRODUCT DISCLOSURE

Introduction

Product disclosure in the financial sector generally refers to the minimum information a product provider needs to include in promotional material to consumers so they are well placed to make informed decisions. The issue is not whether clear product disclosure per se in the financial services sector should be mandatory, but the degree and form of regulation and prescription required, and questions of consistency in relation to functionally similar products.

At the same time, the use of the phrase ‘functionally similar savings products’ by those arguing for a level playing field overlooks the wide diversity in the real world product range; for example:

- products vary according to degree of institutional safety and taxation status;
- some products have a contractual basis and a legal status which confer unique rights;
- certain products (eg. regular premium life policies) are unique in the complexity of their design and the manner of their distribution; and
- some products are effectively ‘locked in’ by contract, exit costs, or preservation requirements under the SIS Act or trust deed.

For these reasons, products may be functionally similar in a superficial sense, but also have unique features which make them look different to consumers and which explain their differential regulatory treatment. For disclosure purposes, the ISC takes the view that retail investment products should be categorised under several broad headings; however, any categorisation will be incomplete or inappropriate in one way or another. Two distinctions which are particularly relevant are: first, whether the return promised is capital guaranteed or market linked; and second, whether the benefit/charges design is simple or complex. Generally speaking, disclosure requirements should be lighter for simple, capital guaranteed products (eg. bank deposits), and heavier for complex products (eg. regular premium life insurance) and market linked products (eg. unit trusts).

ISC product disclosure rules - under the life circular GI.1 and the SIS s 153 determination - presently distinguish between regular premium life office products (where the presentation is more prescriptive) and other life office and retail superannuation products. In addition, they include a mandatory Key Features Statement (or KFS), which is a short (five or six page), easy-to-read summary of the product’s benefits, costs, risks, options etc. The ISC has over the years moved to a prescriptive KFS requirement, not from a philosophical disposition, but because of empirical experience and, in particular, the persistent failure of the industry to satisfy the spirit of its disclosure obligations in promotional material.

Standard unit trusts are subject to broad product disclosure requirements under s1022 of the Corporations Law; for example, a prospectus must be dated and the interest of directors and experts must be disclosed. There are no requirements with regard to the disclosure of fees and other expenses associated with the investment scheme. However, most prospectuses show a management expense ratio or MER of the scheme, calculated as the total fees and expenses charged to the scheme divided by the average value of assets of the scheme for the previous five years.

It should be noted that the previous Government decided that the life insurance and retail superannuation disclosure regimes would not be reviewed until September 1997. Subject to any new Government decisions, the ISC would not expect to make any changes to its requirements prior to that time.

There is clearly scope for further harmonisation, and in addition, the ISC would favour exemption of prospectus type material from TPA and State legislation to avoid double jeopardy and duplication. The ISC is sympathetic to calls for less prescription, but notes that the track record of the industry and the culture of its compliance officers make this difficult in practice. That is, although senior management are comfortable with general disclosure requirements, operational staff tend to prefer more detailed guidance.

Different supervisory approaches to product disclosure

The ISC, in response to some life company recalcitrance over the past eight years, has progressively required the industry to improve product disclosure at point-of-sale, particularly for regular premium products. To meet the principal problem with regular premium products - high upfront commissions to life agents - the ISC required life companies to disclose the amount of commissions in dollar terms in the form of a table, which also showed the surrender values over the life of the policy on certain standard assumptions.

In relation to of retail investment products more generally, the major difference is the more prescriptive approach of the ISC relative to the ASC. This is essentially <u>empirical</u> rather than <u>philosophical</u> (ie how much prescription proves to be necessary and what kind of detail actually works in practice). Moreover, the ISC has limited resources and perforce must prescribe and monitor compliance. The ASC on the other hand has comparatively more resources and can follow up general principles with direct supervision and enforcement. Also, the ASC is different in having a wider range of products (share issues as well as collective investments) to cover.

While the ISC has been forced by experience to progressively take a more prescriptive approach, the ASC has adopted a more 'hands off' approach to disclosure with little prescription of what should be contained in prospectuses for collective investments subject to the Corporations Law, but placing the onus on prospectus issuers to meet the general requirements of <u>Section 1022</u>.

In relation to disclosure of fees, charges and commissions the ISC has taken the view that these should be illustrated in reasonable detail and preferably in **dollar terms**. The expression of fees and charges in dollar, rather than percentage, format has been shown (eg. in market research in Australia and the UK) to be far more meaningful to the average consumer. This has proved to be highly controversial with some elements of the life industry. On the other hand, the ASC has accepted fee disclosure through use of the Management Expense Ratio (MER), which is less prescriptive and does not involve disclosure of dollar amounts. The ISC also considers that the MER in its current form is flawed in failing to account for entry and exit costs.

The differences in supervisory approach to product disclosure by the ISC and ASC appear to reflect not only different track records in terms of sales conduct in the respective industries, but also the cultural divide between life company boards/CEOs who favour minimal prescription, and life office lawyers and compliance officers who prefer a more detailed checklist of product disclosure requirements, and who (in the absence of prescription) will create their own internal rule book.

Practical scope for achieving greater consistency

The ISC would propose that **regular premium products**, which for practical intents and purposes are currently only issued by life offices, be retained (by whatever regulator has responsibility) under a separate regime and subject to the prescriptive dollar disclosure of charges and commissions. It is these regular premium products which - because of their high up front charges and low early surrender values - have been involved in the worst cases of high pressure selling and agent misrepresentation.

For single premium products provided by life offices and other funds managers including public offer superannuation schemes, the ISC would propose a common regime obtained by aligning its requirements with those of collective investment schemes under the ASC regime. In terms of charges and commissions, this would probably mean common use of the MER expressed in percentage terms, although the MER should be modified to incorporate the annual equivalent of the entry/exit costs based on a hypothetical five or seven year term, and other component items covered by the ISC's recent SIS determination. This would in effect represent the evolution of the MER into a more comprehensive measure. The ISC would also recommend that a new regime retain the five or six page key features statement (KFS), which is a critical element in its life insurance and public offer superannuation product disclosure rules.

A common regime should apply to short-term capital guaranteed products, including deposits and relevant life policies and superannuaton products.

Harmonisation in product disclosure could be achieved either through a single regulator for consumer protection forcing a single regime, or through separate authorities negotiating a consistent approach. Either way, the ISC would support a move to a regime which is less fragmented and which puts less reliance on 'black letter' detail, providing it can be shown to be effective in practice.

4.4 COMPLAINTS HANDLING

Introduction

It was inevitable that greater complexity in financial products and increased interest by consumer groups would focus attention on the handling of customer complaints, both within individual companies and through external, independent adjudicators. It is also apparent that the court based system for resolving disputes is very costly for consumers, in terms of both money and time, and somewhat daunting under the Trade Practices Act (TPA) and Insurance Contracts Act. For instance, under the TPA it is usually only worthwhile for consumers to go to court where there has been a loss of, or claim for, at least $10,000. In addition, the formalities of the court based system can be intimidating for consumers who have minor complaints.

Alternative dispute resolution schemes can improve access to justice by providing a fast, independent, affordable and relatively simple way of resolving a wide range of consumer problems. Usually they are provided at no cost to the consumer.

The development over recent years of better internal arrangements for handling complaints and new external disputes handling schemes across much of the financial services sector has been a notable achievement. Schemes are currently in place for the banking, life insurance, general insurance, and superannuation industries as well as for members of the Financial Planning Association and National Insurance Brokers Association. The ASC has also indicated it will require its licensees to have internal complaints handling procedures and professional indemnity insurance (the question of mandatory external complaints handling for ASC licensees has been deferred).

With the exception of the Superannuation Complaints Tribunal which is a statutory scheme, the external complaints handling mechanisms are industry based and funded schemes developed in consultation with government authorities and consumer representatives. Membership of an ‘approved scheme’ is mandatory for banks and insurance companies and brokers under the banking and insurance Codes of Practice; the Financial Planners Association (FPA) Complaints Resolution Scheme only covers FPA members; the SCT covers all regulated superannuation funds with more than four members. For the most part, therefore, complaint schemes are a matter of industry design, subject to regulatory approval and ongoing independent oversight by specially selected governing committees.

The schemes deal case-by-case with the treatment of individual customers in relation to particular transactions, but not with the merit or otherwise of the financial entities’ commercial policies and practices as they apply equally to all customers. For example, the general level of fees and charges cannot be a subject of complaint.

The schemes in no way prevent the consumer from alternatively or subsequently pursuing their common law and statutory rights within the court system. In many cases, these schemes consider disputes that would not warrant the expense and delays of litigation, even if a customer could afford it. Both service providers and customers benefit from dispute resolution schemes. For example, they encourage better customer/service provider relations, help in identifying systemic organisational problems and result in improved internal dispute resolution arrangements.

Industry pride in the ‘ownership’ of these schemes has been a key factor contributing to the high degree of industry co-operation, voluntary compliance and their success generally. The largely self-regulatory nature of the arrangements has also provided the flexibility to adjust more speedily to market developments.

Side benefits from such schemes include what we understand to be a common practice of companies studying the published determinations and reforming their practices accordingly (however, some companies remain sceptical). The schemes have proven to be adaptable, and have tended to evolve over time, becoming more independent, expanding their coverage and raising their profiles.

While there is ongoing improvement in the arrangements, a number of issues have arisen relating to variations in design details, gaps and overlaps in coverage, and the merits of a single statutory scheme or single gateway for the entire financial sector.

Convergence in design details

Customer dispute schemes vary in the manner in which they operate and the extent of their coverage (eg, types of complaints, criteria used, cut-off dates and time taken to resolve disputes, and dollar limits).

While these variations in operational approach and jurisdictional coverage do not cause any practical problems for the schemes, they can be a little confusing for consumers and companies, and raise issues of horizontal equity.

Gaps, and overlaps

Some gaps and overlaps in the dispute resolution arrangements applying at present include:

1. an absence of government approved external complaints schemes for AFIC institutions (ie. building societies, credit unions, friendly societies), ASC institutions (finance companies, collective investment schemes), excluded superannuation funds (intentionally excluded) and niche players such as non-bank mortgage providers;

2. overlaps in coverage, including for example, insurance products sold through bank branches, superannuation products issued by life offices, and financial advice from a firm owned by a product provider; and

3. incomplete coverage of the financial planning industry, ie. there are currently no avenues of non-court based redress for a consumer who has a complaint against a financial planner that is not a member of the Financial Planning Association.

The various schemes have indicated that overlaps are not causing practical problems for the schemes themselves (eg disputed demarcations), because schemes are taking a common sense, informal approach towards handling the complaint or referring it on.

The obvious options to simplify the current dispute resolution arrangements are to either further harmonise efforts in the area of scheme design and coverage, or to develop a single dispute resolution body for the financial advice industry. These options are discussed below in section 4.8.

4.5 OPTION 1 - A SINGLE REGULATOR FOR CONSUMER PROTECTION

First, there is a threshold issue of whether consumer protection regulation should be generic (economy wide) administered by the ACCC, or financial sector specific.

Generic versus financial sector regulation

The advantages of generic regulation under the TPA would include:

- consistency and competitive neutrality across a broad range of functions;
- simplicity (and less consumer confusion) in that the regulatory framework could be limited to broad objectives and principles;
- automatic coverage could be widespread over a number of different markets;
- less risk of regulatory 'capture' (ie, regulation in the interests of the industry rather than the public); and
- greater certainty and lower compliance costs to industry from a uniform regime.

Some disadvantages of generic regulation include:

- uncertainty for both companies and consumers about the precise application of provisions to particular circumstances if the regulatory framework is too broad;
- lack of appropriate, targeted coverage in that regulation cannot be tailored to individual financial markets and products and their particular characteristics and weaknesses (in extreme cases, this could compromise prudential security);
- the regulator's resources being thinly spread, so that it cannot take a systematic approach in supervising an industry from a long term perspective, but randomly targets problem areas for concentrated short term scrutiny and intervention;
- an essentially court-based, adversarial and ad hoc approach to enforcement with little reliance on industry co-operation and voluntary compliance in response to accountability measures and moral suasion;
- fines and the costs of redress can be expected to be met by remaining investors to their detriment; and
- loss of financial industry specific regulatory expertise and knowledge (institutional memory).

The key concern with a generic approach to regulation, in relation to sensitive industries with complex products such as in the financial sector, is that it is premised on different markets having similar characteristics and weaknesses, developing at a uniform rate, and reacting to change in a like manner. Generic regulation would likely gloss over the differences in product design and risk/return profiles of the product providers, and could therefore inhibit innovation and efficiency in the financial markets. Furthermore, the ISC would argue that applying a generic form of regulation to a highly complex and dynamic sector of the economy, such as insurance and superannuation, would allow market players to exploit gaps in a regulatory regime that is not tailored to meet the specific characteristics of that market. Consumer protection in the financial services sector is a response to market defects which are peculiar to the complex products involved.

A further concern with the generic approach is that it tends to became legalistic over time compared with, say, industry based self-regulation. A natural tendency of generic regulation is to concentrate on law enforcement. This lends itself to random punishment as the regulator pursues trouble spots and law breakers in different parts of the regulatory system. It is doubtful whether the legalistic and broad brush approach inherent in generic regulation could cope and keep pace with a rapidly changing industry characterised by product diversity and innovation.

For the reasons above, the ISC holds the view that specialised financial regulation tailored to unique industry characteristics is fairer to consumers, more efficient in lifting service standards and more likely to have credibility in the eyes of both consumers and companies.

Advantages of a single financial consumer regulator

A model for a single regulator for consumer protection in the retail financial services sector can be found in the Personal Investment Authority (PIA) in the United Kingdom. The PIA is one of three self-regulating, privately funded organisations under the UK Securities and Investment Board. The PIA regulates the retail investment advice industry (including product disclosure but excluding risk products) for the life office and unit trust sectors, in particular. It also authorises and supervises independent financial adviser companies.

Using a modified version of this model to account for local conditions, consumer protection responsibilities in the areas of financial advice and product disclosure could be transferred from existing regulators (primarily the ASC and ISC) to a new, single regulator. It would be important to ensure that such a regulator has a clear status and mandate, is properly co-ordinated with other regulatory agencies, stays in touch with industry developments, and is cost effective. This could be achieved through a statutory mandate, a board comprising a mix of industry and regulatory expertise, with some broader public interest representation, and by ensuring that the agency is a member of the CFS and accountable to the Treasurer (this model is elaborated in the next chapter).

Certain advantages would attach to a single regulator for financial consumer protection - particularly in relation to the licensing and supervision of financial advisers operating in both the securities and life insurance segments of the market:

- it would have a mandate to remove the duplication of regulation which presently exists as a result of having two separate regulatory regimes (ASC and ISC) applying to the sale of retail investment products, which in some cases and respects are functionally similar;

- there would be more commonality in approach to financial consumer protection (eg, in respect of the balance between broad principles and prescriptive rules) and less jurisdictional conflict;

- it would assist in avoiding unfair competitive inequalities and minimising gaps, overlaps and inconsistencies in supervisory arrangements because financial consumer protection would be concentrated in one organisation;

- there could be greater public transparency and simplicity in financial consumer protection arrangements, which may increase their credibility in the eyes of both consumers and companies;

- it would reduce the **compliance costs** which arise from financial advisers operating across two different regulatory jurisdictions. There is a significant amount of paperwork and administration required by the dual regulatory regime which would be reduced by having a single regulator. Increases in cost are passed on to the various economic stakeholders in the business depending on the competitive environment; but some part at least is ultimately passed on to the consumer;

- it could reduce the scope for product providers to rearrange their product range so as to avoid the need to deal with the harsher regulator (ie. **regulatory arbitrage**). Alternatively, inconsistent regulation can create unfair **competitive inequalities** where product re-badging is not a commercially practical option;

- there would be less risk of retail investment products 'slipping between the cracks', where they are not effectively supervised by either the ISC or the ASC. An example is non-life public offer SIS superannuation products, where advisers are presently only regulated by administrative arrangements between the ISC and ASC;

- it would be more in conformity with what appears to be a general preference of financial consumers towards a one-stop shop for independent, competent and ethical advice covering a broad product range, rather having to cope with an array of competing regulatory jurisdictions;

- agencies could concentrate more on their core business where their comparative expertise is greater, eg. the ISC is first and foremost a specialised prudential supervisor, whereas the ASC is more an economy wide company and market integrity supervisor. The new agency would concentrate on functional supervision of financial conduct and products;

- it could seek to regulate life agent conduct more directly (eg. though a multi-agency principal) and not via obligations on the product providers, eg. life companies monitoring of their multi-agents has not worked well in practice, and many agents clearly resent being supervised by life companies and would prefer to present themselves as working for the consumer; and

- a single regulatory scheme would have the capacity to close (where appropriate) the gaps in the regulation of advice and advisers that exist under the current system: eg practitioners currently complain about the absence of conduct rules applying to bank deposits, negatively geared property investments, and financial advice provided by solicitors and accountants.

Disadvantages of a single financial consumer regulator

The arguments against a single financial regulator for consumer protection would include:

- the 'blurring' argument has been exaggerated - in fact, product distribution in the managed funds industry is still significantly fragmented by diversity and specialisation because of the wide range of retail investment product types. (For example, life risk products are not functionally similar to savings products, and regular premium products have no close substitutes. Similarly, a market-linked life policy is dissimilar to a unit trust in some significant respects);

- there is no evidence that a separate, cohesive financial advice industry presently exists (although there is a trend). For example, relatively few large financial advisory firms are independent of product providers, whether banks, life insurance companies or funds managers, and this creates the potential for conflicts of interest and biased advice;

- the 'competitive inequality' argument for a single regulatory scheme can result, even if that is not the stated objective, in 'lowest common denominator' regulation since it is easier in practice to achieve uniformity by reducing standards;

- it could result in a cumbersome and bureaucratic organisation which is overly powerful and lacks accountability;

- there is no objective, empirical evidence that the dual system of regulation is currently causing major costs for consumers or industry participants (ie, apart from assertions from some sections of the industry). Following the reviews of regulatory arrangements by the ASC and ISC, measures are now being taken to achieve as much harmonisation as is practical and appropriate and the results of this initiative could resolve most of the unnecessary duplication or inconsistencies in requirements; and

- a single regulatory scheme would internalise, but not automatically eliminate, differential treatment, and could even exacerbate customer confusion and contribute to less informed choices by giving the appearance that there are no significant differences in products or product providers. The commercial arrangements in the marketplace do not themselves fit neatly into boxes, but are inherently untidy.

4.6 OPTION 2 - INTER-AGENCY HARMONISATION

Introduction

The ASC and ISC have undertaken an initiative to promote greater consistency and harmonisation of their regulatory requirements for retail investment advice in the (broadly defined) managed funds industry. The agencies are currently liaising and co-operating as closely as their respective mandates, resources, and existing legislative frameworks permit. It could be argued that an incremental approach whereby further efforts are made by regulatory agencies to harmonise bilaterally are most appropriate, because radical change can involve significant transitional costs in terms of administrative stress and commercial disruption.

Examples of recent harmonisation efforts

(i) Complaints handling

In response to the concerns about the proliferation of complaints schemes, the ISC has initiated a biannual ‘roundtable’ process, and has already convened three financial sector complaints schemes roundtable meetings in the last year (August 1995, September 1995, May 1996) to discuss the major issues relating to possible consolidation or convergence, and improved coordination and liaison. The next meeting will be held in November 1996. The roundtable membership includes representatives of the various complaints handling schemes, the ASC, the Australian Competition and Consumer Commission, and the Federal Bureau of Consumer Affairs.

The points arising from the meetings indicate that the various industries attach significant importance to maintenance of their individual schemes, while accepting the desirability of appropriate harmonisation and effectively dealing with any overlaps that exist. The former is not surprising given the fact that ‘ownership’ of self-regulatory schemes can be a major force behind their effectiveness.

A Complaints Schemes Summit in August was also organised by the ISC, so that the government agencies could discuss some broader areas of complaints handling with the industry sponsors of the schemes, ie. the peak industry bodies including LISA, ICA, NIBA and FPA. This was necessary because the industry schemes themselves do not have the mandate to canvass higher level issues in Roundtable meetings, such as scheme design, as these more properly fall within the domain of the peak industry bodies as sponsors of the complaints schemes.

(ii) Regulation of investment advice

The ISC and ASC have been involved in a harmonisation process to simplify and reduce the cost of compliance in the areas of disclosure of capacity and sales conduct requirements. A key objective in the short term is to have common requirements under the ASC Good Advice Regime and the ISC life insurance Code of Practice. The proposals apply to those who advise on managed funds investments and are to take effect within the existing legislative and administrative framework.

(iii) Product Disclosure

The ASC and ISC have different product disclosure requirements. The two agencies recognise that reconciling these differences is a complex task. Progress on levelling disclosure requirements for functionally similar investment products has been disappointing, and the ISC accepts that the degree and pace of harmonisation in this area needs to be pushed along, and that a greater sense of urgency is now required.

Further harmonisation efforts

While these initiatives are already achieving a more streamlined and organised approach to regulation in relation to retail financial advice, there are further areas in both regimes, outside the existing regulatory and administrative framework, which have the potential to be harmonised (eg. adviser licensing).

Advantages of inter-agency harmonisation

The arguments which have been put forward in support of continued bilateral harmonisation across the sectors with particular reference to ASC/ISC harmonisation include the following:

- bilateral harmonisation is a measured and manageable process which has been shown to work in practice;
- although there are differences in the cultures and priorities of the ISC and ASC, each regulator does have the same underlying broad objective, and there is considerable goodwill and willingness to cooperate; and
- in a sense, the process of harmonisation (not the structure of regulators) is the real work that needs to be done to reduce compliance costs on the distribution side of the managed funds sector. Creating a mega-retail advice body may add impetus to this process but will not, of itself, achieve the necessary outcomes. In fact, it is arguable the momentum built up by the ASC and ISC in this area could be lost if there are major structural changes resulting in a change of personnel.

Disadvantages of inter-agency harmonisation

The arguments which support the proposition that bilateral harmonisation alone is not enough include:

- even if the legislative requirements adopted by the ASC and ISC were identical, the different institutional cultures could influence the nature and degree of regulation. Interpretation of the relevant law and corresponding use of legislative powers both contribute to the stringency of regulation. While the ISC and the ASC operate to achieve very similar aims by regulating financial advisers, different approaches to practical implementation and enforcement are adopted. A single regulator as opposed to a system of inter-agency harmonisation could force the degree and pace of standardisation and thus better allow for complete uniformity in the regulation of all financial intermediaries;
- under a system of bilaterally harmonised regulation, the problem exists of maintaining regulatory consistency over time, which is difficult given the dynamic nature of financial institutions/products; and

- the ISC and ASC presently have different philosophies regarding the appropriate degree and nature of official intervention. It will be difficult for these philosophies to be reconciled given that there is pressure on the ISC to respond to market failure in an interventionist way. This results primarily from the attention attracted by certain misguided strategies pursued by some life insurance companies and their representatives in the late 1980s and early 1990s, and the importance attached to compulsory superannuation for attainment of Government retirement income policy and national saving objectives. In contrast, the ASC have been less subject to such pressures. Thus, while there are two supervisors with different philosophies and mandates it is arguable that the appropriate degree of harmonisation will not be achieved.

On balance, the ISC considers that inter-agency harmonisation on its own does not go far enough, and that a single regulator for consumer protection would have an advantage in terms of forcing a greater degree and faster pace of regulatory harmonisation.

4.7 SINGLE SCHEME FOR COMPLAINTS HANDLING

The integration of existing complaints schemes into a single scheme or ombudsman for the entire financial services sector has been mooted as a solution to consumer group perceptions that a proliferation of schemes is leading to overlaps, inconsistencies and customer confusion.

It is assumed the single scheme would have to be established by legislation and staffed by a secretariat of persons employed under the *Public Service Act 1922*. The jurisdiction of the scheme, and its functions and powers, would be defined in the relevant statute.

Advantages of a single statutory scheme

Arguments that could support a single scheme are that:

- it would provide one point of contact for consumers to make complaints and have their disputes handled, thereby obviating the possibility of confusion among consumers about exactly where they should lodge their complaints;

- the potential for customer confusion is exacerbated by the development of financial conglomerates offering a range of products where the distinctions among the product providers and the products themselves have become increasingly blurred;

- differences among schemes could result in unequal outcomes for consumers depending upon the industry, product, and nature of complaint involved;

- it would remove overlaps in coverage associated with the existence of various schemes;

- it would prevent consumers from attempting to ‘double dip’ by forum shopping around the various schemes in order to secure a more favourable outcome;

- it would assist in minimising jurisdictional conflict; and

- it could be more cost-efficient through economies of scale and scope.

Disadvantages of a single statutory scheme

Against this it can be argued that:

- there is substantial diversity in the type of complaints, transaction sizes, and appropriate remedies associated with the various products and services provided by the industries which make up the financial services sector;

- there may be Constitutional barriers to achieving mandatory full coverage of the financial system by a statutory-based single scheme which retains the essential characteristics of ADRs (ie, cheap and convenient access, informality and speed);

- industry and product diversity requires significantly different expertise to assess complaints, make the appropriate decisions, and determine reasonable solutions (for example, where there is a suspicion of fraud in general insurance, specialised expertise is needed to investigate this type of complaint);

- the practical difficulties of diversity and the need for specialised expertise would mean that a single scheme would effectively need to operate with discrete and autonomous units each with specific arrangements, thereby providing few of the benefits which, at first blush, might be seen as being associated with a single scheme;

- there is little hard empirical evidence of major customer confusion or co-ordination and liaison problems, under the present arrangements;

- there is broad agreement among the schemes that they should seek convergence in scheme design details to the extent practicable and appropriate: eg time limits, coverage and reporting;

- industry goodwill and co-operation associated with industry ‘ownership’ of specific schemes have been critically important to achieving compliance/effective arrangements and have been responsible for the success of the industry-based schemes;

- industry based schemes have already established a good track record in terms of benefits to consumers and perceptions by the industry of their role in establishing better customer relations;

- a statutory scheme of this nature would be open to legal challenge by product providers: and

- a single statutory scheme could become very legalistic, inflexible and unwieldy and become more costly and slow in its dispute resolution processes as a consequence.

Because of these reasons, the ISC - which has considerable experience in this area - is not in favour of amalgamating existing industry based schemes into a single statutory-based complaints handling body.