CHAPTER FIVE - A NEW RETAIL INVESTMENT COMMISSION

The ISC favours the establishment of a new Retail Investment Commission (RIC), to be the sole retail conduct of business regulator for financial advice, product disclosure and complaints handling in relation to savings products. While the creation of a new agency does not assist in reducing the number of financial regulators, it would help reduce the number of regimes, and the ISC considers the institutional structure of regulation to be a second order issue compared with the ultimate objective of improved coordination and harmonisation of regulation.

This chapter sketches a broad outline of how an RIC might work in practice, drawing on UK experience with their Personal Investment Authority (PIA) and advice provided by Professor David Llewellyn. Clearly, many details remain to be filled in.

5.1 LEGISLATIVE AND ADMINISTRATIVE STRUCTURE

The RIC would be established under a new Act which subsumed or replaced, where relevant, existing legislation, statutory instruments and agency guidelines, including:

- ASC - provisions of the Corporations Law, Practice Notes, Policy Statements etc relating to the regulation and supervision of securities advisers. Proposals in the Good Advice Report;

- ISC - proposed Consumer Division of the new Life Insurance Act, Insurance Contracts Act, Agents & Brokers Act in relation to life insurance, insurance codes of practice and complaints schemes, life adviser registration scheme;

- ASC, ISC, RBA, ACCC, States - fair trading provisions and codes in relation to retail savings/payments, including product disclosure (prospectus material, charges and commissions), misleading and deceptive conduct, and codes of practice/complaints handling for credit institutions and electronic commerce. The ISC would also favour the State Credit Acts being removed, and the Uniform Credit Code not proceeding.

The RIC would be a Sydney based statutory authority lying outside the Public Service Act, but within the Treasury portfolio and Council of Financial Supervisors. It would be funded by levies on product providers and financial advisers. There would be a board comprising:

- 3 representatives of the financial regulators
- 3 representatives of product providers
- 3 representatives of financial advisers
- 3 representatives of consumer groups.

The ISC would see the RIC as lying wholly within the overall regulatory framework for financial supervision, because the need for conduct of business regulation in the financial sector to be practitioner based is far greater than the risk of regulatory capture. Also, the ISC considers that legalistic approaches to consumer protection are inappropriate in the financial sector and have, in the past, resulted in too many instances of excessive litigation in response to minor technical breaches.

The RIC would be staffed by people with financial sector experience and expertise, and exchanges of staff with the prudential regulators would be encouraged.

5.2 MANDATE AND COVERAGE

The broad mandate of the RIC would be to regulate product providers and financial advisers for fair, open and honest conduct in the sale of savings products to retail customers. In doing so, the RIC would be required to have regard to:

- prudential security - regulation of business conduct should not be allowed to compromise the safety or soundness of the product providers concerned (the first pillar of consumer protection in the financial sector is maintaining the capacity of financial entities to meet their promises);

- competition and innovation - regulation of business conduct should be directed towards making the market itself work better and encouraging, not detracting from, competition and innovation (the rationale for consumer protection in the financial sector is not paternalism, but the existence of serious market flaws);

- consistency and neutrality - the treatment of functionally similar financial products should be broadly consistent to avoid consumer confusion, competitive inequalities and excessive compliance costs in the marketplace; and

- commercial freedom - regulation of business conduct should not be commercially intrusive or heavy-handed (eg, price and product controls should be avoided, and market developments should be accommodated unless they are unfair or anti-competitive).

The case for a separate agency for retail (versus wholesale) regulation of business conduct is that the rationale, objectives, techniques and culture of regulation in the two sectors are significantly different. Professor Llewellyn notes that market defects are worse in the retail sector, the need for explicit regulation is more pressing, and consumer willingness to pay the costs of regulation is greater[1]. In particular, in the retail sector:

[1] Llewellyn, D (1996) 'Rationale and Institutional Structure of Financial Regulation', Commissioned Report for the ISC, August, pp 29-31.

- consumers purchase financial products less frequently, and this relative absence of repeat orders limits their ability to learn from experience;

- the handicap caused by asymmetric information and unequal bargaining power is more pronounced;

- there is a lack of skills and capacity to monitor the performance and soundness of companies in the period after the purchase is made;

- the consequences of a claim not being paid or a promise not being honoured are more serious in terms of the loss of personal wealth; and

- the need to rely on intermediaries (financial advisers) introduces new uncertainties and risks, eg in terms of the quality and independence of advice.

In relation to coverage, the products falling within the RIC's jurisdiction would include bank and NBFI deposits, life insurance policies with an investment element, retail (public offer) superannuation, other retail managed funds (eg, unit trusts), and retail securities. This net is wider than that cast by the PIA in the UK, where credit institutions (banks and NBFIs) are excluded. Pure risk insurance (eg, term life products, general insurance products) may be included or excluded (this would need to be determined).

The RIC would license and supervise financial advisory principals, and not directly regulate their individual representatives. At present, the principals concerned are ASC licensed securities dealers and investment advisers, and ISC licensed life companies and life brokers. Large multi-agencies would be expected to register as principals under the new regime; the position of tied agents is more problematic and requires further consideration. General insurance brokers may be included or excluded (again, this would need to be determined).

There are a number of boundary issues which need to be resolved irrespective of whether the present regimes continue or a new RIC is established, eg: generalised v. personalised advice; the treatment of stockbrokers; incidental advice from accountants and lawyers; and the treatment of advice relating to negative gearing and to real estate.

The areas covered in the regulation of retail business conduct would include inter alia:

- product disclosure, including charges and commissions
- training and competency
- status disclosure
- same day sales, free look periods
- 'know your client' (fact find) processes
- record keeping
- complaints handling
- enforcement, including black listing.

5.3 RULES v. PRINCIPLES

The ISC is conscious of criticism by company CEOs to the effect that consumer protection in the financial services sector is too extensive and prescriptive. While this point is not disputed, it should be noted that the reasons for this are not all related to excessive enthusiasm on the part of the regulator. For example:

- there is clearly an element of voluntary over-compliance with regulatory requirements. Compliance officers in companies can be overly cautious. Some companies may choose to set standards above the minimum. There may be commercial reasons for over-compliance (eg, the ISC suspects that some ‘fact finds’ which exceed requirements in the life Code of Practice are designed to build customer profiles and facilitate cross-selling);

- the industry may be merely getting the regulation it deserves. Prescriptive regulation is more common where industry conduct has a poor track record. Perhaps the industry should attempt to earn a less prescriptive approach, rather than simply demand it. A willingness to comply with the spirit of regulation would make it easier for governments to wind back the letter of regulation; and

- experience suggest that, in the absence of an official rule book, company lawyers and compliance officers will craft their own internal rule book. In doing so, they will seek to enlist the assistance of the regulator: does the regulator have a mental check list? would the regulator endorse the company’s check list?

Notwithstanding these points, the ISC now favours a regime for financial advice and product disclosure which is less reliant on prescriptive rules and more oriented towards broad principles.

Professor Llewellyn has identified the following defects in a prescriptive approach[2]:

- industry criticism of the regime as excessive can undermine the credibility of regulation, and create an adversarial or confrontational relationship between the regulator and the regulated;

- a focus on processes rather than outcomes can encourage a perverse culture of ‘box ticking’, and compliance with the letter rather than the spirit of the rules;

- firms cannot choose their own least-cost way of meeting the broad objectives, and as a consequence their compliance systems lack the flexibility to adjust to customer preferences and market developments;

---

[2] *ibid*.

- over time, there is a tendency for 'rules escalation' whereby new rules are added as problems emerge, but relatively few are withdrawn. Then the sum total of regulation can become excessive even though each rule may have its own rationale;

- there is a loss of information and feedback because of the high degree of conformity involved. If firms had more choice about how to meet the policy objectives, more would be learnt about consumer preferences in regulation and the different properties of alternative approaches; and

- consumers may be deterred from making purchases because the product is more costly, or the compliance process (eg, a 'fact find') is unduly intrusive and time consuming. The rigidity of the process can stifle cost restraint and product innovation.

In the UK, the PIA has embarked on an Evolution Projection with the intention of shifting away from prescription towards principles in its regulatory approach. The PIA's Second Regulatory Plan (July 1996) states that:

> The content of the rules, as opposed to their style and presentation, is an important strand of the Evolution Project. PIA wants to examine the scope for making greater use within its regulatory approach of generally stated principles and rules, as distinct from prescriptive detail. Specifically, it wants to see whether there are areas and ways in which firms could be given greater discretion to achieve high standards of investor protection...The argument in favour of greater discretion is simple but cogent: it is that efficient and experienced firms operating in a fast-moving and competitive market place can and should be given flexibility to decide how best and most effectively to meet the regulator's standards for protecting investors. They should then be judged on whether or not they achieve those standards - not on how they do so.

Professor Llewellyn canvasses an approach which he calls 'contract regulation' as an intermediate path between rules and prescription on the one hand, and principles and discretion on the other. Under this approach, the regulator would specify a set of principles and 'best practice' guidelines, but not in a prescriptive or detached form. The company would have some discretion in how to meet the principles and follow the guidelines; the regulator would have some discretion in how to monitor performance and assess compliance.

Under the Llewellyn approach, the degree of 'regulatory intensity' (ie, the extent and stringency of regulation) need not change; that issue is resolved separately. However, the shift away from a prescriptive set of rules does raise some new issues:

- there is less transparency, and so the competence and accountability of the regulator is a larger issue;

- there may be a loss of consistency and certainty which causes concern for companies (who see the playing field as tilted) and consumers (who see the relationship between regulator and regulated as too cosy); and

- enforcement may be more problematic, and the role of company compliance officers may become more ambiguous, indeterminate or confused. Economies of scale in monitoring and enforcing could be lost (on the other hand, those firms which freely chose to adopt higher standards would require less scrutiny, and attention could be concentrated on the marginal players).

In regard to enforcement, a shift from rules to principles (processes to outcomes) will need to be accompanied by the development of performance indicators, ie a set of objective measures which could indicate the overall level of a product provider's or financial adviser's standard of business conduct. This is easier said than done, particularly given the wide variety of financial products available, and the unknown influence of extraneous factors, such as the changing economic environment, on performance.

Some examples of possible performance indicators, in relation to both product providers and financial advisers, would be:

- levels of charges and commissions
- incidence of early discontinuances
- incidence of 'same day' sales
- incidence of withdrawals in 'free look' period
- levels of complaints going to external schemes
- surveys of customers.

5.4 SCOPE FOR SELF-REGULATION

In the previous chapter, the ISC's reasons for favouring industry based complaints handling were outlined. The ISC also favours industry based codes of practice. In these two areas of complaints and codes, the preferred model is to have Government mandated and endorsed, private sector developed and operated schemes which are simple, practical and flexible. Over time, there may be scope to shift more conduct of business regulation onto industry associations and professional bodies.

However, there are some difficulties in the self-regulatory approach, eg:

- where the number of regulated entities is very high (eg, superannuation), moral suasion and peer pressure may have less force at the marginal (cowboy) end of the industry;

- the 'gridlock' problem - ie. the unwillingness to move first for fear of losing market share - would be worse;

- where compensation for consumers is funded by professional indemnity insurance (eg, financial advisers), there is some concern about how well this fits in with alternative disputes resolution; and

- professional bodies have been known to use self-regulatory arrangements as barriers to entry (ie, care needs to be taken to ensure that self-regulation is not anti-competitive).

Notwithstanding these difficulties, the ISC would see a new RIC as not only involving a shift from rules to principles, but also encouraging over time a greater degree of self-regulation, in its approach to regulating retail business conduct in the financial sector.