Appendices

Appendix 1
The Financial Planning Association

The Financial Planning Association (FPA) is the national body representing professionals in the financial services industry who specialise in giving financial planning advice.

The FPA came into existence on 1 January 1992 and now has 6,700 individuals and 350 licensed principal advisory organisations as members. The FPA represents some 70 per cent of the financial planning industry, on the basis that all major financial planning networks, all major banks and life offices advisory arms are members of the FPA, as well as most small independent licensed advisory organisations.

The FPA has a number of professional designations including Affiliates, Practitioner (Associate, Senior Associate and Certified Financial Planner) and Principal Member.

The mission of the FPA is to advance financial planning as a distinct profession dedicated to best serving the financial well-being of all Australians. The FPA's objectives include -

◊ continued input into Government through the preparation of high quality submissions on legislative and regulatory matters;

◊ a commitment to the ongoing awareness and education of the public about the benefits of financial planning;

◊ continuing to raise standards of financial planning advice through high quality education and continuing education;

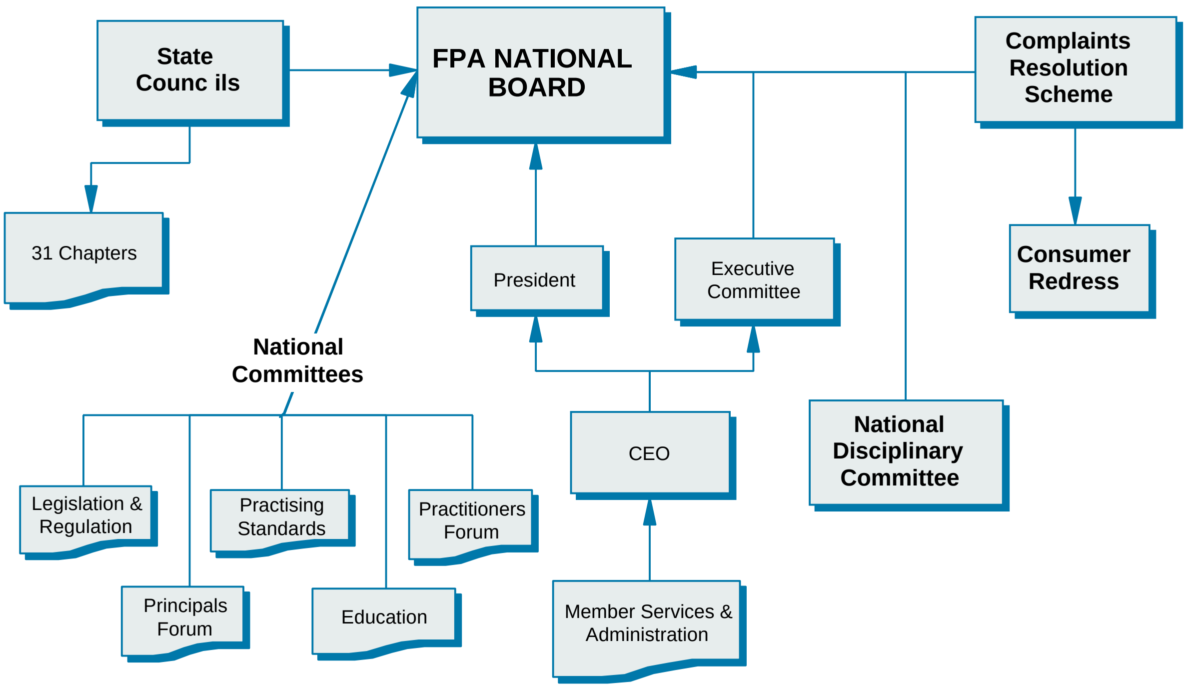
◊ strict compliance with the Code of Ethics and Rules of Professional Conduct;

◊ to create an association which is pro active to the varied needs of its members and is recognised as a leading professional association.

A recent FPA Survey showed that FPA members service more than 2 million people and are responsible for personal portfolios of some $76 billion. This represents a formidable contribution to national savings and investment.

In servicing the public and business community's needs for sound financial planning members have an obligation to maintain high standards of technical competence, fair dealing and integrity. Members are required to act at all times with due care, skill and diligence in the interest of their clients, observing all legislation and regulations governing their activities, and maintaining and improving their professional knowledge, skills and experience.

The FPA has an established administrative framework and sound financial resources to fulfil its objectives. It conducts a wide range of activities for its members through its network of 31 Chapters which hold regular forums, workshops and functions and through its committees dealing with education, regulation and other issues. Figure 3 shows the



structure of the FPA.

The FPA's primary activities include -

◊ a Disciplinary System with power to impose sanctions;

◊ a Complaints Resolution Scheme with independent adjudication on small claims at no cost to clients;

◊ 8 unit Diploma of Financial Planning offered through RMIT University Distance Learning facility;

◊ a Continuing Education regime;

◊ development of Competency Standards for financial planning in Australia and New Zealand

Figure 3
The FPA's Structure

- ◊ consultations with government bodies on regulatory and other issues, including the ASC and ISC on regulation of advisers, and the DSS & ATO;
- ◊ review of Principal member compliance procedures and systems;
- ◊ Financial Planning Magazine issued monthly keeping members up to date on a range of issues;
- ◊ an annual national convention attracting planners from all parts of Australia.

Professional financial planning is a world wide phenomenon with the international Certified Financial Planner Board of Standards Inc (of which FPA is a member) overseeing the development of best practice standards and cross border recognition of the Certified Financial Planner (CFP) designation. The FPA meets regularly with other members of the International Council comprising industry organisations from the USA, UK, Canada, NZ, Japan and observers from France and Italy.

Appendix 2
Advice & the Australian Financial System

1 Functions of the Financial System

The Australian financial system has undergone enormous change during this century. Global economic pressures and improvements in technology have substantially broadened the range of products available, their complexity and the range of institutions that offer them. Despite these changes the basic functions of the financial system remain and can provide the basis for a sensible regulatory framework. The basic functions of the financial system are-

◊ financial intermediation;

◊ risk and liquidity management;

◊ financial advice; and

◊ the payments system.

Financial intermediation is the process by which financial institutions (banks, insurance companies, fund managers, finance companies etc) seek funds from investors and apply those funds to the capital formation process, providing debt and equity capital to businesses and individuals. Financial institutions carry out the intermediation function in various ways - banks taking deposits, insurance companies receiving premiums, fund managers issuing units and so on. Financial products have developed over time to provide new and more efficient means of financial intermediation. Despite individual product differences, the function of financial institutions is to match providers of funds (investors) with users of funds in the capital formation process.

Risk and liquidity management is the function performed by financial markets in providing a means of exchange and trading of financial instruments. Financial markets, formal or informal, provide for the trading of a variety of instruments (eg shares, derivatives, currency, commodities etc). They provide a means of managing risks and obtaining liquidity, but unlike financial intermediation, do not bring new funds into the financial system.

The *payments system* underlies the efficient operation of the financial system by providing a “clearing house” for all transaction payments between individuals, businesses and financial institutions via the banking system.

Figure 2 is a diagrammatic representation of the flow of funds in the financial system, the key activities of financial institutions and markets and the role of financial advice.

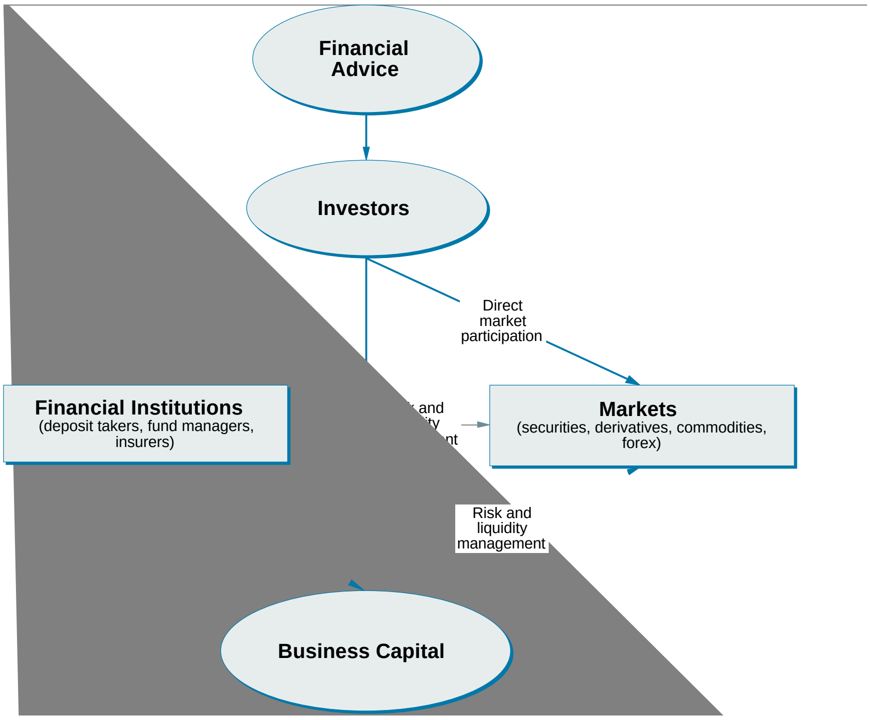


Figure 2 The Financial System

Advice has emerged as playing a key role in the financial system. Financial advisers provide far more than a product distribution system; advice is a value added service that makes the financial system more accessible to Australian investors and contributes to a more efficient allocation of funds within the financial system. Advice can help overcome information imbalances that exist between investors and financial institutions and enhance competition between financial institutions by increasing market transparency. Advice both contributes to the efficiency of the financial system and assist individuals in achieving their long term financial goals.

2 Developments in the Financial System

In the first half of the century the financial system was characterised by a small number of institutions, mostly banks and life insurance offices, operating in a small market and offering a small range of products. Banks had access to low cost funds and there was little competition for the investment dollar. Banks were restricted in the commercial terms they could offer including interest rate ceilings on loans and deposits, restrictions on banks entering certain areas of finance and controls on growth in bank lending.

By the 1970s, while the banks were restricted in what they could offer, non bank financial institutions (finance companies, building societies, credit unions and friendly societies) were offering more competitive rates on deposits and offering a wider range of investment products. Although the first investment trust was established in 1936, it was not until the 1970s that unit trusts became a popular form of investment. It was also during the 1970s that life offices expanded beyond their traditional insurance products to offer single premium insurance bonds.

The 1980s saw the removal of interest rate and other controls on banks and the floating of the Australian dollar. This was followed by development of a stream of new and innovative bank products such as variable payment and fixed rate home loans, expanded home loan facilities, cheque access to savings accounts, cash management accounts and automated teller machines. Australians benefited from a wider range of products and greater availability of finance, as well as greater transparency in the pricing of bank products and services.

The 1980s also saw many other developments outside the banking sector. There was a boom in the popularity of unlisted property trusts, the expansion of the futures market and a massive increase in share market activity ending with the share market crash of 1987. There was also a rapid expansion in the range of non guaranteed investment products, such as international equity trusts, master trusts, capital stable funds and bond funds. These developments were not driven solely by deregulation but also by government policies on savings, taxation and social security which created demand for certain types of financial products.

The financial system today is characterised by a wide range of financial products and services of varying complexity offered by a range of institutions operating under different regulatory regimes. The larger institutions are increasingly moving away from their traditional businesses because of falling margins and using their strong brand names to market a wide range of products and services. Developments in electronic commerce and new delivery systems have facilitated this move to direct marketing of financial products and services.

In contrast to the distinct businesses that life companies and banks once carried on, they now actively compete in the same markets. At the same time, the regulatory system still classifies these financial institutions as fundamentally different in nature.

There has also been a blurring of the traditional securities and futures markets in Australia with the introduction of new risk management products such as Share Ratios, Low Exercise Price Options and Individual Share Futures. This blurring of product boundaries has created a more competitive environment and provided a wider range of products and services for investors.

Growth in the size and complexity of the financial markets has been matched by increasing investor awareness and involvement, as reflected in the mass media attention given to finance and investment issues. Despite this trend there remains in Australia, a generally low level of understanding of how the financial markets operate and the role of risk in investment markets. This has contributed to the low level of savings and investment in Australia which has implications for our economic future. The financial markets still remain a mystery to many Australians and there is an overwhelming view that investors need to be “protected” in this environment.

Table 2 Developments in the Financial System

1909	Government employees pension scheme
	Restricted Private Super Pension Schemes
1936	Australian Fixed Trust established - “earn double bank interest rates”
1950s	AFT Launches a range of unit trust products including balanced funds
1959	First unlisted property trust by Australian land Trusts
1959	Official short term money market established
1960	Sydney Futures Exchange established
	First mortgage trust by AFT
1960s	Defined Benefit Schemes
	Massive growth in unlisted property trust market
1965	Commercial bill market recognised
	Savings banks offer personal loans
1968	Savings banks offer investment accounts
	Finance companies emerge
1973	Universal age pension introduced
1974	Bankcard was launched
1970s	Unit trusts re emerge as a popular form of investment
1970s	Life offices introduced single premium insurance bonds with tax bonuses
1976	Australian Savings Bonds introduced
1976	Options market commenced trading
1981	Unlisted property trusts re emerge as popular forms of investment following introduction of the aged pension incomes test
1981	Hill Samuel launch the first cash management trust
	Mergers of CBC and National, and Bank of NSW with CBA
	Friendly Society Bonds actively marketed by IOOF and ARPA
1980s	GEM “Split” property trust with separate income and growth units
1983	Relaxation of offshore investment restrictions
1983	Ten (10) new banks licences issued
	Unit linked insurance bonds introduced
	Norwich Union actively markets “financial planning” services
1983	Rollover funds introduced in response to age pension “assets” test
1983	Emergence of “independent” advisory networks (Robert Morrison, Paul Terry, Godfrey Weston)
1985	Capital gains tax introduced
1986	Major foreign banks established
1987	Dividend imputations introduced
1987	Stock market crash
1987	ASX formed & electronic trading introduced (SEATS)
1988	Fund of Funds launched by Bain & Company
	First discretionary master trust launched
1990	Property market crash
1991	Unlisted property trust crisis
1990s	Balanced Trusts launched by Westpac, Bankers Trust, Rothschilds and Barclays offering diversified portfolios
1990s	Regular savings plans introduced by fund managers
1990s	Increased direct marketing of funds management products
1992	Allocated pensions officially endorsed

Table 2 Developments in the Financial System

	Investment Link launched
1994	Electronic clearing and settlement systems introduced by ASX (CHESS)

It is likely that these trends will continue at an even faster pace than they have already. Improvements in technology will continue to provide new and more efficient ways to access the financial system, new and more complex financial products and a wider range of choices for investors. Globalisation of the financial system will place increasing pressure on Australian financial institutions to be more efficient and provide internationally competitive products and services.

It is essential that the Australian regulatory system provide a basis for an internationally competitive financial system, through cost efficient and regulation which is comparable on an international basis.

3 Advice and Financial Planning

3.1 Developments in the Advice Market

There is a wide range of activities encompassed by financial advice including strategic advice, asset allocation advice, investment advice as well as limited product advice such as that provided by the employees of a particular institution. Financial planning is a specialist form of advice.

In the post war era there were few investment advisers and most were tied to a small range of branded investment products. Those Australians requiring investment advice generally sought advice in specialist areas from stockbrokers, accountants, real estate agents, banks, trustees, life companies and the like. At the same time there was also a high level of direct marketing of investment products by life companies and fund managers.

The demand for advisers grew in the 1970s and 1980 with the development of new investment products and the increasing complexity of Australia's tax and social security system. As a result many advisers moved away from single product advice (such as in the life area) to provide advice on a wider range of financial products. As the number of trusts outside the institutional sector increased during the 1980s, the need became apparent for "independent" investment advisers to advise on a wider range of investment products and the number of advisers grew rapidly.

Today a single market for advice is emerging in which a wide range of generalist and specialist services are available. Because of the diverse range of activities that financial advice covers it is difficult to get an accurate picture of the size and composition of the advisory industry today, but the following statistics provide some guide -

◊ ASC statistics estimate that there are around 1,751 licensed dealers and investment advisers and approximately 30,000 proper authority holders, which includes fund managers and their representatives;

- ◊ ISC estimates of the number of life agents in 1995 was between 4,000 and 10,000, although many of these also hold proper authorities;

- ◊ A recent survey of FPA membership indicated that there were 350 organisations in the industry and 6,700 individuals providing advice on behalf of those organisations. The FPA estimates that this covers approximately 70% of the financial planning industry, many of whom would be regulated by both the ASC and the ISC.

- ◊ Others sources of financial advice include accountants, lawyers and real estate agents. An ASSIRT survey indicated that accountants are the most widely used source for investment advice in Australia with 30% of Australians seeking investment advice from their accountants.

While the advisory industry comprises a range of different occupational groups, it has now become an industry focussed more on the service it provides (financial advice) rather than product sales. The degree of overlap that now exists between the two main groups of advisers - sixty five per cent (65%) of securities advisers are also life intermediaries - is evidence of the movement away from limited product sales to advice across a wider range of products and services. Refer Appendix 6.

This change has been driven by consumer demand for advisory services separate from “product sales” and also by improvements in direct product distribution by fund managers. As fund managers are able to access consumers more easily, the role of advisers as distributors has become less important, and the provision of value added advisory services more important. Advances in technology and communications have facilitated these changes.

There is a move among some advisers to charging on a fee for service basis rather than through fund manager commissions. Similarly there is a trend away from single product advice to advice on a range of products (evidenced by the increase in multi agents); also towards advisers becoming life brokers rather than life agents, severing ties with product manufacturers.

The increased complexity of the financial system and the wide range of choices available to consumers, have highlighted the role of advisers in helping consumers to navigate their way through the system and make decisions that suit their financial and personal goals. The complexity of the taxation and social security system has also increased the need for strategic financial advice separate from product sales.

Today only one third of investors do not use a sales intermediary in purchasing managed funds. While improvements in direct distribution of financial products are expected to continue, the majority of investors are likely to require assistance from brokers and financial planners because of the importance given to financial decision making. (***BT Strategic Insight June 1996***)

3.2 What Is Financial Planning?

Financial planning is a relatively recent professional occupation arising out of the demand for financial advice tailored to an individual's particular circumstances. It is based on the assumption that most consumers expect their adviser to provide solutions based on a complete portfolio service. This approach to advising is called strategic financial planning and may encompass investment planning, risk management and insurance, salary packaging, superannuation, retirement and estate planning.

Financial planning begins with **the client** and seeks to take people from where they are to where they would like to be in the future by following some basic steps:

Step 1: Where the Client is Now

Analysis of the current financial position to establish the value of existing assets, the extent of present commitments, the income needs and tax situation of the individual's current lifestyle.

Step 2: Where the Clients Wants to Go

Objectives are then determined by estimating future income needs, living expenses, education funding, major expenditure requirements, costs of borrowings and family/business plans. These should be determined for the short, medium and long term.

Step 3: How to Get There

A financial plan is then compiled to enable the achievement of objectives and a portfolio recommended which may include a range of investments, superannuation and insurances designed to meet specific needs.

Step 4: Ongoing Service

Financial planning is an ongoing process which requires regular reporting to the client, periodic review and adjustment.

This "needs based" approach can be applied to satisfy the full range of client goals on a comprehensive basis, to meet a sub-set of the client's goals on a more limited basis or a single client goal or need.

At the implementation stage, most financial plans will contain a combination of “securities” (shares, debentures, bonds, managed funds such as property, equity or cash management trusts) and “life insurance products” such as annuities, insurance bonds, allocated pensions, term and disability insurance, superannuation and roll-overs. This demonstrates the fact that advice is a function in its own right within the financial system and not just a distribution system for financial institutions.

3.3 The Importance of Advice in the Financial System

Advice, particularly, financial planning advice has emerged as an important part of the financial system. Advisers are often thought of as intermediaries because they also act as a distribution system for financial institutions, but their primary function is to provide advice and facilitate access. What advisers and planners do is assist consumers in making decisions about how they should best access the financial system to meet their financial needs and objectives - whether they should directly invest in the markets, whether they should use a fund manager, and what product choices they should make.

With the increasing complexity of the financial system, the choices available and compulsory savings, advice is playing an ever important role for consumers. An ASC survey in 1995 indicated that advisers are seen as the most important source of information and advice regarding investments. Despite improvements in direct distribution of managed funds, two thirds of investors still seek some assistance from advisers (BT Strategic Insight, June 1996).

Financial advice plays a key role in contributing to the efficiency of the financial system by -

◊ helping consumers to understand how the financial system works, the relationship between investment risk and return and providing strategies for wealth creation and protection;

◊ redressing the imbalance of information between consumers and financial institutions by enhancing the information provided by financial institutions on their products;

◊ assisting consumers to compare financial products and instruments (making the market more transparent) thereby increasing competition between financial institutions that offer them;

◊ facilitating the allocation of investor funds to more efficient and competitive financial institutions and markets;

◊ helping to sustain investor confidence in periods when the financial system is unstable;

◊ helping consumers understand risk and to take informed risks to take advantage of new investment opportunities;

◊ contributing to increased savings in the economy and in the transition to self funded retirement.

Without professional advice many consumers tend to rely on outdated notions of risk and security in the financial system and are likely to make less than optimal choices about how to invest their funds. Because of the importance of financial advice, it is critical that the regulation of advice is an integral part of financial system regulation, and that regulation is consistent across all forms of financial advice.

Appendix 3
Development of Financial System Regulation

Financial system regulation today is the result of the accumulation of laws and regulations introduced over the past 50 years or more in response to developments in market sectors, specific events in the financial markets and changing community standards and investor needs.

Regulation in the early part of the century focussed on the main institutions in the financial system, banks and life offices, and the narrow range of products that they offered. As the share market developed, regulation of public company fundraising was introduced along with regulation of markets and intermediaries. The emergence of unit trusts as a new form of investment gave rise to special legislation for pooled investment schemes.

Because of the political and administrative processes involved in introducing new laws there has been a substantial time lag between market changes and regulation, varying approaches of different governments and a focus on particular markets segments rather than the financial system as a whole. This Inquiry provides the Government with an opportunity to undertake a comprehensive review of financial system regulation.

1 Deregulation or Reregulation?

There is no doubt that the development of new products and markets within the financial system has been facilitated by the removal of Government restrictions in the banking sector, particularly in the 1980s. At the same time as the banking sector was being de regulated, however, a vast array of new regulations with an investor protection focus were introduced in other parts of the financial system. These included the *Insurance(Agents & Brokers) Act*, *OSSA*, the *Insurance Contracts Act*, new prospectus disclosure requirements under the *Corporations Law* and increased enforcement powers for the *Australian Securities Commission.* In each case, the introduction of new regulations focussed on a particular industry segment or activity within the financial system, with little regard to the implications for the system as a whole. Refer Table 4.

Table 2 contains a summary of our present regulatory system, the government regulatory authorities involved in the administration of financial system regulation and the requirements that apply. It represents the result of a long period of “re regulation” over the past two decades. Because of the important role that institutions such as banks and life offices played in the formation of the financial system, and the dominance of those institutions today, much of the regulation that is presently in place is institutionally based.

On reviewing the financial system as a whole it becomes apparent that the accumulation of regulation over many years has produced many overlaps, gaps and inconsistencies in regulation.

Contributing to these problems have been -

◊ the breaking down of traditional institutional boundaries within the financial system and the emergence of financial conglomerates offering a wide range of products and services;

◊ the rapid development of new financial products and the increasing complexity of those products;

◊ the changing philosophies of governments over time and varying regulatory philosophies among regulatory authorities;

◊ constitutional limitations on the scope for national regulation of financial services.

There does not appear to be an overall guiding philosophy for financial system regulation and little focus on the implications of specific regulations for the financial system as a whole. In recent times regulatory changes have been driven by concern about the risk faced by investors in the financial system and protection against investor losses. The result is a very high level of regulation for all activities within the financial system and increasing encroachment on the operation of businesses in the financial system.

From a consumer’s perspective it is unclear how much this increase in regulation has achieved. For example, while product disclosure standards have been increased substantially in recent years, it is not clear whether consumers have benefited from increased disclosure standards and whether disclosure plays a useful role in investor decision making. Anecdotal evidence suggest that current disclosure standards are not effective.

The result of this ad hoc approach to financial system regulation and rapid changes within the financial system, are:

◊ standards of disclosure for financial products based on the institutions that offer them and their legal structure, resulting in varying disclosure standards for products with similar commercial features and that directly compete in the market;

◊ varying prudential standards, governance structures and obligations for financial institutions that compete in the same markets and offer comparable products and services;

◊ varying conduct, disclosure and prudential requirements for financial advisers who provide similar services and compete in the same market; and

◊ restricted access to certain markets due to regulatory boundaries (eg only banks have access to the payments system).

Table 3 Development of Financial System Regulation

1945	Banking Act
1946	Life Insurance Act 1945 Appointment of Life Insurance Commissioner
1960	Reserve Bank Act 1959 Reserve Bank established
1961	Uniform Companies Act 1961
1970	Securities Industry Acts introduced in NSW, followed by other states, and state Corporate Affairs Commission begin actively policing the securities industry
1971-1972	Uniform Companies Act amended to include regulation of accounts and audit, takeovers, insider trading and investigations powers
1974	Trade Practice Act Trade Practices Commission
1974	Interstate Corporate Affairs Commission
1979	NCSC established and uniform state legislation for companies and the securities industry
1980	Companies Act 1980 (Cth)
1981	Acquisition of Shares Act 1981 (Cth)
1984	Insurance (Agents and Brokers) Act Insurance Contracts Act
1987	Occupational Superannuation Standards Act Insurance & Superannuation Commission
1991	Corporations Law Australian Securities Commission New Prospectus Disclosure Requirements
	Banking Industry Ombudsman
1992	Australian Financial Institutions Code Australian Financial Institutions Commission
1991/92	New Property Trust Regulations
1992	Council of Financial Supervisors
	Life Insurance Complaints Tribunal
1994	Superannuation Industry Supervision Act 1993
1994/95	New Enhanced Disclosure Regulation
1996	Collective Investments Bill
1995/96	New Life Act Life Code of Practice

Table 3 Development of Financial System Regulation

1996	National Consumer Credit Code

					COMMISSION			
es	Corporate Form & Governance	Disclosure	Markets	Intermediaries	Prudential Supervision	Prudential Supervision	Competition	Consumer Protection
of for r c) ure ling ne *nts*	• Formation and governance of companies and other fundraising vehicles (trusts etc) • Internal administration (directors duties,) • External administration (insolvency, winding up and reconstructions) • Title to and transfer of rights in securities; • Acquisition of securities (takeovers); *Corporations Law* *ASC Act*	• Prospectus disclosure requirements for retail fund raising • Ongoing disclosure, reporting and accounting requirements.	• Regulation of the formation and conduct of securities and futures markets	• Licensing of securities and futures dealers and investment advisers (including superannuation) • Conduct obligations for dealers and advisers (suitability, contract notes etc) • Client disclosure requirements • Restricted selling practices (hawking, advertising)	• Prudential supervision of credit unions and building societies (liquidity, capital adequacy, disclosure, audit, structure) • Policy setting and national co-ordination role • Registration and supervision of "special service providers" • Implementation of national standards for friendly societies *Financial Institutions Code*	• Day to day supervision of building societies and credit unions (registration, administration and supervision) FINCOM VICFIC NT WAFIA QOFS ACT SAOFS TOFS • Individual state regulators for friendly societies	Regulation of competition across all sectors of trade and commerce. Regulated conduct includes - • price fixing • third line forcing • collective boycotts • misuse of market power • exclusive dealing • price discrimination • substantial lessening of competition; *Trade Practices Act*	Administrator and monitor of consumer protection generally with relevant conduct including- • misleading and deceptive conduct • false representations

The lack of co-ordination in introducing new regulation is due partly to the number of regulatory agencies involved in regulating the financial system (and in law reform) and also the conflict between state and federal governments about who should be responsible for regulation. The consequences of the current approach to regulation of the financial system are -

- ◊ a lack of competitive neutrality amongst financial institutions competing in the same markets (life companies, banks, fund managers etc) lessening competition between financial institutions;

- ◊ poor transparency between products in the financial system, contributing to consumers making poor choices about allocation of funds within the financial system; and

- ◊ excessive costs of regulation for many financial institutions, especially those that operate across traditional product boundaries, costs which are in turn passed on to consumers.

1.1 The Absence of a Functional Approach to Regulation

The FPA believes that the cause of these problems is the absence of a single framework and policy for financial system regulation. The current fragmented approach is aligned to the major institutions in the financial system (as defined by law) rather than the major functions within the financial system, and is driven by the differing objectives of the major government regulators. While some aspects of the current regulatory system are functionally based (such as prospectus disclosure requirements for fundraising) they are not consistently applied across the system as a whole.

Despite the commonality of functions carried out by all financial institutions in the financial system, there are a multitude of systems that regulate them. For consumers who are users of products and services this makes comparison of the features and merits of those products extremely difficult. It also places unnecessary costs on institutions that operate across traditional institutional boundaries and creates an uneven “playing field” in the market for financial products and services. The result is a less competitive market and an inefficient allocation of resources within the financial system.

In 1991 the Martin Committee recognised some of these problems and recommended the formation of the Council of Financial Supervisors (COFS) for “better co-ordination of financial supervision and to address unintended gaps, duplication and inconsistencies in regulation”. Chaired by the Governor of the Reserve Bank, COFS comprises the ASC, the ISC and AFIC which, combined, account for 94% of Australia’s financial assets. Despite the Council's views that the system has worked well, it has not undertaken any serious review of the regulatory system as a whole nor sought to address its deficiencies. In response to the collapse of Barings, the Reserve Bank, the ISC and the ASC (initially supporting the Society of Corporate Treasurers) each issued separate standards and guidelines on the use of derivatives (essentially a risk management issue) adding to the multiplicity of regulation in the financial system. This example shows that there is only limited co-ordination of activities which can be addressed by COFS.

2 The Regulation of Advisers

2.1 Dual Life Insurance and Securities Regulation

The regulation of financial advice was the result of perceived inadequacies in product marketing and distribution methods used by financial institutions and intermediaries. The regulation of advice has also developed along product and institutional lines rather than along functional lines. Reflecting the origins of the advice industry (securities and life products), two main streams of advice regulation have emerged -

◊ regulation of "dealers" and "investment advisers" in relation to securities (shares, options, prescribed interests and debentures), targeting stockbrokers, distributors of investment management products and investment advisers, now embodied in the *Corporations Law*; *

◊ regulation of distributors (agents and brokers) of life insurance contracts, now embodied in the *Life (Agents & Brokers) Act* and the *Life Insurance Act*.

* (There is also a separate system for the regulation of advice on futures contracts under the *Corporations Law*.)

While these two regulatory systems have imposed more and more obligations on advisers in relation to disclosure and conduct, there remains little or no regulation of other forms of financial and investment advice in other product categories such as property investment. This is one result of a product based approach to advice regulation.

In these two streams of regulation - securities and life products - significant convergence has occurred in the products offered by financial institutions and the providers of advice on those products. Sixty five per cent (65%) of financial planners now provide advice on both securities and life products. This overlap, combined with the steady increase in the obligations on advisers under each regime, has brought about the realisation that two systems are no longer workable or justifiable on cost grounds.

The FPA has for some time now sought to highlight problems with the current system of dual regulation of advisers by the Australian Securities Commission (ISC) and the Insurance and Superannuation Commission (ISC). Some of the major differences include -

◊ the legislative distinction between "agent" and "broker" in relation to advice on life products whereas no such distinction exists for advisers on securities;

◊ differences in who is responsible and liable for the conduct of advisers depending upon whether advice is provided in relation to life products or securities;

◊ differences in (and duplication of) entry standards and ongoing requirements for life brokers, life agents, securities dealers and investment advisers (many in the industry cover all classifications);

◊ differences in disclosure requirements depending upon the capacity in which advice is provided (flowing from the liability framework) and differences in conflict of interest disclosure requirements;

◊ responsibility for supervision of advisers in relation to life products by product manufacturers (life companies) and overlapping responsibilities where advice is provided in relation to the products of more than one life company;

◊ different conduct of business requirements relating to record keeping and reporting requirements (customer advice records, fact finds etc);

◊ duplication in adviser surveillance visits;

◊ different policies and regulatory approaches by the Government regulatory authorities.

Appendix 7 contains a more detailed analysis of the difficulties associated with dual regulation of advice.

2.2 The Costs of Dual Regulation

While decisions about regulation require consideration of both the costs and benefits of regulation, this sort of analysis has not generally been undertaken by the regulatory authorities. There are a number of costs associated with regulation, including administrative costs to government, compliance costs incurred by businesses and economic costs in the form of reduced competition and misallocation of resources.

For the advisory industry the costs associated with the current system of regulation are significant. They include -

- ◊ a share in the costs of administration of advice regulation by the ASC and the ISC, roughly estimated at between $10 million and $12 million per annum;

- ◊ the cost to advisory organisations of duplicated entry fees and application costs, duplicated reporting requirements, internal costs of running dual documentation and compliance systems; resources costs associated with internal administration of compliance supervision and staff training under two systems;

- ◊ the cost to life companies in supervising agents, reviewing compliance systems, ascertaining competency standards, and particularly the duplication in costs for supervision of multi-agents;

- ◊ a competitive advantage for -

    - ◊ single life product advisory organisations (tied agents) over multi agents,

    - ◊ advisory organisations who do not provide advice on both securities and life products;

    - ◊ advisory organisations operating outside the two systems (property investment advisers);

  resulting in a lessening of competition between advisory organisations;

- ◊ lessening of competition between product manufacturers (life companies) because of the additional costs borne by them in the supervision of multiple product advisers.

A recent FPA survey estimated member compliance costs in 1995/96 at around $41 million, representing 16% of total operating costs. These costs have nearly doubled since 1993 as a result of increasing regulation of advisers.

While it is difficult to quantify regulatory costs, it is clear that there have been significant increases in recent years at the same time as there has been downward pressure on fees. More important than organisation compliance costs, however, is the potential economic cost to consumers. When assessing the benefits of regulation for consumers, there does not seem to be any benefit to consumers from regulating advisers under more than one system.

Product based divisions for advice regulation discourage advice on a wider product range and reduce consumer choice; whereas the regulatory system should enhance competition and consumer choice.

2.3 The Limits of Harmonisation

The FPA believes that the differences between the two regulatory systems are too fundamental to be overcome by co-ordination. The current harmonisation program undertaken by the ASC and ISC is capable only of addressing the symptoms of the problem not its cause. Harmonisation has the capacity to alleviate differences in conduct obligations and some disclosure requirements but not the more fundamental differences in the two systems.

Notwithstanding a significant commitment of resources to harmonisation, the process has been characterised by a series of compromises between two regulatory authorities whose approaches and philosophies are quite different. The result is, at best, a “band aid” solution.

The only complete solution that will facilitate change and the emergence of a truly competitive advice industry is the establishment of a single system of regulation for financial advice. Not only will that overcome the current duplication of regulatory systems, but it will also capture new and emerging areas of financial advice. Such an approach is consistent with a move to functional regulation for the financial system as a whole.

Appendix 4
A Framework for Financial System Regulation

1 Introduction

The FPA believes that regulation of the financial system should be developed as a single system and subject to a single guiding policy. That system may be made up of several parts and a number of Government regulatory agencies may be involved in its administration, but there must be a single overriding policy and a single set of objectives for which the Government is responsible. That philosophy and those objectives should guide the development of the various parts of the regulatory system and their management on an ongoing basis, including the regulation of financial advice.

Regulation of the financial system should be based on the functions performed within the financial system not upon the institutions participating in the financial system or the traditional classification of those institutions. The rationale for this approach is that the main functions of the financial system will not fundamentally change over time, but recent history has shown that the institutions in the financial system, and the products and services they offer, can change rapidly. With rapid change in the financial markets and increasing complexity of the products and services available, there is a need for regulation to keep pace with and be adaptable to financial system innovation and change.

The following provides the FPA's views on an appropriate policy and objectives, and a suggested "functional" framework for financial system regulation. The cornerstone of the FPA's regulatory philosophy is comprehensive disclosure and less direct government intervention in the conduct of businesses within the financial system.

2 Policy and Objectives

The FPA believes that the policy of financial system regulation should be the efficient operation of the markets to achieve regulatory goals and for the Government to intervene only to address market deficiencies and enhance market performance. It follows that the objectives of financial system regulation should be -

◊ the efficient allocation of resources within the financial system;

◊ monitoring systemic risk within the financial system; and

◊ adequate protection for consumers of financial services.

Each of these objectives needs to be considered in determining the most appropriate means of regulating activity within the financial system. If responsibility for achieving these objectives is split among a number regulatory authorities, there is a high risk that regulation will be uncoordinated and fail to meet its overall objectives.

2.1 Efficiency

Regulation should aim to achieve the most efficient allocation of resources within the financial system, that will contribute to overall economic efficiency. This requires maintaining high levels of competition among market participants; a competitive market may help to achieve many of the desired outcomes of regulation, such as disclosure and fairness in pricing.

It is especially important that the regulatory system is competitively neutral as between organisations that perform similar functions in the financial system. If regulation creates a competitive advantage for some organisations over others, there will be an inefficient allocation of resources within the financial system. Competitive neutrality is one of the strongest arguments in support of a system of “functional” regulation. A system of “functional” regulation ensures that the same regulatory requirements apply to similar functions in the financial system, whereas institutional regulation results in different regulatory requirements applying to organisations that carry out the same or similar functions in the market.

In assessing the appropriateness of regulation of certain financial system activities, there must be an assessment of both the costs and benefits of that regulation. This has not generally been done in the past. Excessive costs of regulation for certain financial products will price them out of the market and hence reduce the range of choices available to consumers.

To achieve efficiency in the financial system all regulatory arrangements must be justified in terms of their cost. If the costs of regulation become too great, fewer organisations will seek to participate in the system and consumers will have fewer choices in the financial system. Instead, they will put their funds in other areas outside the financial system or invest overseas where the costs of investing are lower.

2.2 Systemic Risk

Regulation should provide the framework for a proper assessment and management of systemic risk within the financial system. Regulators should be able and willing to take action in response to systemic risk, but should not provide a guarantee of financial institutions.

Under the current regulatory system many consumers still incorrectly believe that certain financial institutions and the products they offer are guaranteed by the government. This creates a "moral hazard" in that consumers do not make their own assessment of the risk associated with those financial institutions but rely instead on an implied guarantee in making investment decisions; in turn, governments are placed under pressure to prevent failure of financial institutions.

The proper assessment and management of risk by financial institutions should be based on the functions and activities carried out by them not by their origins or traditional classification as "bank" or "life insurance company". All financial institutions should be regulated under a single regulatory system and subject to consistent prudential standards across defined product areas. Prudential controls imposed on financial institutions will therefore vary according to the products they offer and the guarantees provided by the institution.

The regulatory system should emphasise to consumers that all financial institutions and the products they offer have degrees of risk. Through improved disclosure consumers should be provided with information that allows them to make an informed assessment of such risks. Consumers should be made aware of the risks associated with financial institutions (including banks) through regular disclosure of key financial indicators (eg solvency and capital ratios) and greater reliance on ratings agencies.

Restrictions on the activities of financial institutions (including capital and solvency requirements) which are designed to prevent failure of financial institutions are increasingly placing too high costs on the financial system and distorting the allocation of resources within it. Nevertheless it is important that consumers have confidence in the financial system so that they continue to invest and save. This should be achieved through -

◊ disclosure by financial institutions of key solvency and other ratios;

◊ rating of financial institutions by rating agencies;

◊ the imposition of prudential standards appropriate to the types of products offered by financial institutions;

◊ monitoring of major financial institutions for systemic risk management.

The regulatory system should distinguish between those organisations that act as financial intermediaries in the financial system (receiving funds from consumers and investors in the form of deposits and investments) and those that act solely as service providers and do not hold or manage funds. Where a financial institution holds or manages funds, there is a risk of loss arising from the ability of that institution to repay those funds as promised, which depends upon the stability of the financial institution itself. For a service provider, such as an advisory organisation, where funds are not held by the organisation there is no risk of loss of funds that relies on the financial stability of the advisory organisation itself, hence prudential controls should not apply.

2.3 Consumer Protection

The regulatory system should provide an adequate (but not excessive) level of investor protection which should be achieved primarily through improved disclosure and also by providing access to effective dispute resolution and redress mechanisms. Regulation should not seek to protect consumers from taking appropriate and informed risks nor to provide consumers with guaranteed outcomes.

The consumer protection aim of regulation should be to achieve greater equality of information and bargaining power between consumers and participants in the financial system. Regulation should aim to overcome information deficiencies that retail consumers experience both in terms of access to information and its quality and therefore disclosure is an important regulatory tool.

The regulatory system should encourage consumers to better understand the risks that accompany certain financial transactions and the potential rewards, and to make informed decisions. Consumers need to be made more aware of the fact that managed risk can greatly enhance investment performance. Financial advice plays an important role in more informed decision making by consumers.

In determining the appropriate level of consumer protection, there must always be an assessment of the benefits and the costs of regulation, both directly to industry participants and more broadly to the economy as a whole. Regulation that seeks to provide guaranteed outcomes for consumers, restricts the way in which financial institutions carry on their business and imposes additional costs of regulation on the financial system, reducing the efficiency of the system as a whole.

Regulation that facilitates an active and competitive advisory industry will assist consumers in making informed choices, which will have positive flow on effects to other functions within the financial system. In regulating advisory services the primary “consumer protection” objective should be to minimise losses being incurred by consumers as a result of inadequate information, by financial intermediaries acting improperly and from inappropriate advice.

Consumer protection objectives of regulation can be achieved most effectively through -

◊ consistent minimum standards applying to financial system functions, with greater emphasis on clear and simple disclosure;

◊ increased knowledge by consumers about the financial system and the need to exercise reasonable care in financial decision making;

◊ access to effective and low cost dispute resolution and redress mechanisms outside the court system;

◊ effective enforcement of regulatory requirements through penalties and sanctions as a disincentive to serious misconduct.

3 A New Functional Regulatory Framework

3.1 Proposed Framework

The regulatory framework should be designed and managed according to the main functions of the financial system and to the achievement of regulatory objectives Figure 1 (page 5) contains the FPA's suggested framework for financial system regulation and the allocation of regulatory responsibilities.

Under this proposed framework there will no longer be separate systems of regulation for the various financial institutions such as banks, building societies, credit unions and life insurance companies. Instead they will be regulated according to the activities that they perform in the market. Regulatory requirements will be imposed in relation to the various functions within the financial system consistent with the overall philosophy of regulation and its objectives. While some regulatory instruments, such as capital or solvency requirements, may apply to financial institutions rather than to individual activities, the application of those instruments should be based on the activities of the institution and the range of products they offer rather than their traditional classification as a "bank" or "life insurance company".

The FPA proposes a single Financial Markets Regulator for the regulation of fund raising by all financial institutions, corporate governance, markets, market intermediaries, and financial advice. The creation of a single financial Markets Regulator will minimise overlaps and duplication and provide a consistent approach to financial regulation. The central bank should be responsible for monetary policy, oversight of the payments system and systemic risk management. The Australian Competition and Consumer Commission (ACCC) should remain responsible for competition and fair trading and systemic consumer protection issues. These agencies would report to the Treasurer. Their objectives must be consistent with the policies set by government and there must be co-ordination of their activities.

The proposed Financial Markets Regulator should be recognised as a new body, not as an extension or adaptation of any of the existing regulatory authorities. The predominant features of such a regulator should include -

◊ a close working knowledge of the financial system and specialist knowledge of the various activities and functions within the system;

◊ an ability to interact with market participants by location in the major financial markets (Sydney and Melbourne);

◊ an understanding of consumer issues and mechanisms to integrate consultation with market participants and consumers and their representatives;

◊ expertise in assessing the costs and economic implications of regulation, as well as legal issues;

◊ strong enforcement capacity and specialist investigative skills.

The FPA believes a single Financial Markets Regulator is necessary for a number of reasons. Firstly, because for regulation to be effective one organisation must be responsible for determining how best to meet the regulatory objectives and also for assessing the costs and benefits of regulation in any given circumstance. Where these responsibilities are shared between a number of regulators different philosophies and cultures will emerge, as history has shown, and there will be conflict in competing regulatory objectives and jurisdiction.

Second, the market and consumer protection objectives of regulation will not be achieved through segregation. To make judgements about what is a reasonable level of consumer protection, a regulator must have a close working knowledge of the market and the operation of the financial system as a whole.

Third, for regulation to be effective a single organisation must have responsibility for all aspects of a particular function within the financial system. For example, the regulation of fund raising will only be effective if one organisation is responsible for the various elements of regulation such as disclosure and prudential supervision. Splitting these responsibilities means that regulators will make decisions about disclosure without regard to prudential supervision of fund raising institutions and vice versa.

The creation of a single Financial Markets Regulator will not mean that expertise in particular areas is lost, nor that all financial products available to consumers will be regulated in exactly the same way. Product and regulatory specialisations would be retained within the new Financial Markets Regulator, in the same way that existing regulatory bodies have specialist expertise in distinct areas of activity (eg futures markets and funds management), and it is likely that this expertise would be sourced from existing regulatory authorities and brought together under a new body.

The FPA strongly believes that only such fundamental change to regulatory responsibilities will bring about the change necessary to create a competitive and efficient financial system in Australia. Continued separation of regulatory responsibilities within the financial system will create conflicts in the objectives of regulation and reduce the effectiveness of the regulatory system. Enhancement of the role of the Council of Financial Supervisors would perpetuate the artificial distinctions between institutions and fail to address the fundamental problems that exist in the current system. It would create yet another bureaucracy, further duplication in regulatory responsibilities, conflicting regulatory philosophies and cultures and a regulatory system even less able to respond to market change.

4 Principles of Financial System Regulation

Achieving the FPA's vision for financial system regulation involves not only developing a new regulatory framework and a single Financial Markets Regulator, but also reviewing many of the regulatory requirements that presently apply to participants in the financial system. Given the extent of legislation and other regulations that apply this will have to occur over the medium term to allow appropriate transition to changing requirements.

The creation of a new regulatory framework guided by a single philosophy will facilitate this process and the FPA has not attempted, in this submission, to provide a comprehensive guide to the changes that should occur. The FPA believes, however, that financial system regulation should be guided by the following core principles -

◊ disclosure should be a key component of all aspects of financial system regulation, including prudential supervision, fund raising and financial advice;

◊ industry bodies should play a greater role in the establishment of best practice standards and in the development of the regulatory system;

◊ there should be active enforcement of regulatory requirements and strong penalties for non compliance;

◊ there should be easy and cheap access to remedies for consumers outside the court system;

◊ consumers should be educated to understand investment risk and its role in decision making, that there are no guarantees against losses and they should be encouraged to make informed decisions;

◊ regulatory requirements should be descriptive (“fuzzy law”) not prescriptive (“black letter law”) so that they are adaptable to a changing financial system and capable of application to a range of circumstances;

◊ regulation should not impose detailed operating standards on businesses in the financial system and should be capable of application to both a paper based and electronic environment.

All regulatory arrangements in the financial system should be explicitly related to the agreed regulatory objectives and be justified in terms of their costs and benefits for the efficient operation of the financial system. In order that regulation of the financial system is adaptable to change in the markets there should be a strong role played by the market and its participants in the regulatory system.

Appendix 5
A Universal Model of Advice Regulation

1 Introduction

This section sets out the FPA's model for a universal system of regulation of all forms of financial advice. The framework for this proposed new system is -

◊ a single system of regulation for financial advice (broadly defined) regardless of the financial instrument, transaction or product on which advice is provided and separate from the regulation of those products or instruments;

◊ a single body of law which sets out the regulatory requirements applicable to all forms of financial advice, including licensing of advisory organisations and minimum standards of conduct and disclosure by advisers;

◊ oversight by the Financial Markets Regulator, responsible for regulation of the financial system; and

◊ an enhanced role for industry, initially through formal consultation with the government regulator in setting minimum standards and, in the longer term, by establishing a process for the formal recognition of industry bodies and the delegation of certain regulatory functions.

The FPA's proposed approach would bring together the main areas of regulatory responsibilities of the ASC and the ISC, and also capture other forms of financial advice activity that are presently unregulated. This broader scope is aimed at achieving a "level playing field" in the regulation of advice and a more consistent consumer protection framework.

The broad principles that apply to regulation of the financial system as a whole should also apply to the regulation of financial advice, but recognising the distinct roles played by advisers and imposing regulatory requirements that are appropriate to that role. This means that the overriding philosophy should be competitively neutral and cost efficient regulation, and a consistent consumer protection framework across all forms of financial advice.

Under this proposed new system, the regulation of financial institutions and their products would be separate from the regulation of financial advice. While it is likely that product distribution and advice will continue to coincide, it is important to recognise that each activity gives rise to different regulatory issues. Integral to this approach is for consumers to be able to distinguish between the direct purchase of a financial product and the provision of advisory services. This will be achieved through mandatory disclosure requirements that will clearly identify the nature of services offered and will assist consumers in making informed decisions.

The key principles of advice regulation under a universal system will be -

◊ licensing of principal advisory organisations by the government regulatory authority based on minimum standards set in consultation with industry;

◊ improved disclosure including -

  ◊ disclosure to new clients;

  ◊ risk disclosure and warnings; and

  ◊ conflict of interest disclosure;

◊ minimum personal competency standards;

◊ a primary duty to the client;

◊ licensee responsibility for and supervision of their representatives;

◊ appropriate advice; and

◊ comprehensive dispute resolution and redress mechanisms.

2 Scope of Advice Regulation

2.1 Who is regulated?

Under the FPA’s proposed regulatory model all organisations *"in the business of providing financial advice"* would be regulated, whether those organisations are operated by an individual as a sole trader, through a partnership, company or some other legal structure.

By regulating all advisory organisations and making those organisations responsible for the activities of the individuals representing them, the regulatory system also encompasses the activities of individuals within the industry. The proposed system does not, however, seek to directly regulate each and every individual who provides advice as was proposed under the LISA Registration Board.

This approach of regulating principals (not their representatives) is similar to the current approach under the *Corporations Law*. The FPA's reasons for preferring this approach to a system of individual licensing are -

- ◊ the business entity (partnership, company or sole trader) is responsible for the actions of its employees;
- ◊ the responsibilities of the organisation do not change, even though its employees (representatives) may change;
- ◊ compliance goes beyond the qualifications of the individuals who provide advice and includes issues relating to systems and procedures established by the organisation;
- ◊ there are fewer advisory organisations than advisers in the market, hence the administration of the regulatory system is more efficient if based upon organisations not their representatives;
- ◊ the majority of providers of financial advisory services are structured as companies; and
- ◊ consumers can more clearly identify who is responsible for advice.

The ability of consumers to identify the organisation providing them with advice is extremely important. While advice remains a very personalised service, individuals within an organisation change over time and consumers need to know who they should go to with enquiries and if they have a complaint. One of the major problems with the current system is the uncertainty amongst consumers about who is responsible for the advice they receive.

The FPA is opposed to the development of a government mandated, industry run registration board governing all individuals in the advisory industry (as was proposed by the life industry). Such a system would be cumbersome to administer and impose substantial costs on the industry which cannot be justified by the regulatory benefit, particularly when personal competency standards can be achieved by simpler means.

The FPA's model would allow for a variety of legal structures and business arrangements to be utilised for the conduct of an advisory business, including franchise arrangements. Development of specific legislative provisions should take into account such structures and there should be specific provisions allowing for the appointment of corporate representatives.

2.2 What is financial advice?

A critical part of the FPA's proposed model of regulation is the scope of activities within the term financial advice. The FPA considers that *financial advice* encompasses -

> *Any recommendation made personally to a consumer on which that consumer could reasonably be expected to act in relation to an investment or financial decision, including any recommendations relating to shares, debentures, collective investments, futures or options contracts, life insurance, superannuation, property or other financial instruments, transactions or investments.*

but excludes -

> *The provision of information and/or explanations concerning the features of particular financial transactions, instruments or investments.*

Such an approach would bring together regulation of advice on life insurance products under the *Life Insurance Act* and on securities under the *Corporations Law*. It would also regulate a broader range of activities than existing legislation. By focussing on "financial advice" as the regulated activity, the full range of advisory services available to consumers which have a potential impact on a person's financial well being would be regulated on an equal footing. As new products emerge within the financial system, any advice provided in relation to them would be regulated under this approach.

2.2.1 Advice unrelated to product

It is important that regulation of financial advice encompass advisory activities that have no product specific element, such as strategic advice on asset allocation and gearing. Strategic advice is as important to an individual's future financial position as the selection of specific investments. Flawed strategic advice can have catastrophic results.

The following are some examples of advice not involving specific investment products.

Example 1: Client wishes to retire. After a proper needs analysis including a forward projection to look at their situation, say in five years time, it is concluded that the client's capital will erode too quickly to ensure long term financial security. An adviser might recommend that the client continue working for the next five years giving the opportunity for further growth in their employer superannuation.

Example 2: Client has a significant health problem (eg rheumatoid arthritis) making it unlikely that they can continue working. They can take early retirement from their employer. After a thorough needs analysis it is discovered that a superannuation disability benefit is available which provides 75% of salary from the date of disability to retirement. Meanwhile the employer continues to make superannuation contributions for the member. An adviser could recommend that the client give notification of the illness and obtain income replacement benefit from the employer superannuation fund, as opposed to encouraging retirement in order to make a sale.

Example 3: Client says s/he is paying too much tax and would like to negatively gear to gain a tax advantage. After completing a needs analysis the adviser discovers that the client's cashflow is very tight and recommends that any surplus cashflow be directed to reducing non deductible debt.

2.2.2 Real property investment advice

Specific advisory activities that would be caught under the FPA's proposed approach and which are not presently regulated include advice in relation to property investments. The FPA is particularly concerned to capture advice provided by real estate companies who market their services as investment advice services. The underlying objective of many such services is to market a specific negatively geared property investment with no analysis of the individual consumer's needs. This is demonstrated in the following item which is an actual advertisement.

Buy an investment property before June 30 and get up to a $7000 return.

You don't need lots of money to make money. In fact, you don't even have to have paid off your house. All you have to do is come to one of our free investment seminars. We'll show you all the ins and outs of property investing. Not only will you learn how to save thousands on your tax bill, but how to select investment properties that could secure your financial future.

BOOK NOW INTO OUR FREE HOME INVESTMENT WORKSHOPS

REF: SMH 1/6/96 AVL0007

This advertisement purports to offer financial advice and should be regulated on an equal footing with other forms of financial and investment advice.

The ordinary activities of real estate agents who buy and sell properties for domestic use should not be regulated as financial advice. The basis for such activities is well understood by consumers and these services are not generally marketed as investment advice. Any legislative definition of financial advice would need to exclude such activities

2.2.3 The "information and/or explanation" exclusion

Under the FPA's approach there should be an express exclusion for "information and/or explanations" of investment product features. The FPA accepts that there are legitimate ways for product manufacturers to directly market and distribute their products to consumers without also having to provide advice to those consumers. However, product manufacturers that make recommendations to consumers must be regulated as advisory organisations. Refer section 3 Relationship to Product Manufacture for details.

The FPA recognises that uncertainties currently surrounding the definition of advice in the *Corporations Law* and *Life Code of Practice* should be clarified. Such an exclusion provides some guidance on the limits of what "advice" is and how far product manufacturers and salespeople can go before being subject to advice regulation.

2.3 Consumers of Financial Advisory Services

There is an issue as to whether financial advisory services provided to all consumers should be subject to regulation or whether there should be regulation only of advice provided to certain consumers, such as retail consumers.

Common law principles and the general prohibition on misleading and deceptive conduct provide a level of protection for all consumers. Special regulation of financial advisory services is required because many consumers do not have the requisite knowledge, experience or ability to make informed judgements about the quality of advisory services offered and there is an imbalance of information and power between the providers of advisory services and consumers of those services.

The FPA believes, however, that certain consumers (such as professional, institutional or wholesale investors) are more able to make judgements about the quality of services and can demand certain standards of conduct and disclosure from advisers. Special advice regulation should not apply where the consumers of advisory services are able to protect themselves, because the costs of regulation outweigh the potential benefits for those consumers.

There should be a process whereby certain clients can elect not to have the benefit of full protection under the law. Where such an election is made the advisory firm would not have to comply with the special conduct and disclosure obligations that apply under the regulatory regime. The election process should be accompanied by clear warnings about the implications of the election for the consumer and the associated risks. Those consumers would still have the benefit of the common law and the prohibition against misleading and deceptive conduct.

3 Relationship to Product Manufacture

The interaction between advice and product manufacture is an extremely important part of the FPA’s proposed system of regulation.

The system distinguishes between the giving of financial advice and the offering by financial institutions of financial products and instruments (product manufacture). This does not mean that an institution cannot both provide advice and manufacture products. It does mean that consumers must understand what services they are receiving and they should have the benefit of the same regulatory system regardless of whether advice is provided by an advisory organisation or by a product manufacturer.

Under the proposed system product manufacturers may distribute their product directly to consumers and provide information and explanations of product features; in doing so they must comply with relevant regulatory requirements relating to product disclosure (eg. prospectuses) and marketing restrictions (eg. advertising and sharehawking). Providing such information and/or explanations will not <u>of itself</u> attract advice regulation.

If, however, product manufacturers do more than provide "information and/or explanations" and give advice, they must be licensed as an advisory organisation and they must comply with all of the conduct requirements applying to advisers. Product manufacturers that provide advice will assume a primary duty to act in the interests of the client in providing that advice and not in their own interests in selling a product.

The FPA recognises that financial institutions that both provide advice and manufacture products have a potential conflict of interest, but believes that this should not preclude product manufacturers from giving advice, provided -

◊ they are regulated on an equal basis with other advisory organisations (eg holding a licence, complying with conduct and disclosure rules etc); and

◊ conflicts of interest are addressed by appropriate and complete disclosure to prospective advice clients.

The regulatory system should not seek to limit the scope of activities of organisations in the financial system, nor to dictate how such organisations should structure their operations to address conflicts of interest. Provided they are properly regulated, financial institutions should be allowed to determine the appropriate structure for their operations according to general corporate governance principals.

Under the proposed system individuals who provide advice as representatives of product manufacturers will be subject to the control of that product manufacturer and must meet the regulatory requirements for advice. Representatives of advisory organisations will be subject to the control of the advisory organisation not the product manufacturer(s) on whose products they give advice. This is in line with the current system of regulation of investment advisers and dealers under the *Corporations Law*.

4 The Role of the Government Regulator

The key regulatory requirements under the FPA's proposed system will be contained in a single body of law and administered by a single government authority. Having a single government authority will mean that the administration of the regulatory system will not be split between a number of government authorities as it presently is between the ASC, the

ISC, AFIC and others.

Regulatory responsibilities for advice should form part of the broader responsibilities of the single Financial Markets Regulator because advice is an integral part of the financial system and because of the inefficiency of having separate system of regulation. Refer Appendix 4.

Primary responsibility for regulation will lie with the government regulatory authority including licensing advisory organisations, setting minimum standards of competence, conduct and disclosure and monitoring the effectiveness of the regulatory system. The government regulator will be responsible for surveillance of advisory organisations. It will maintain an active and rigorous surveillance program focussing on compliance with minimum standards of competence, conduct and disclosure by advisers.

Active enforcement by the government regulator will continue to play an important role in the regulatory system, including -

◊ taking action to enforce penalties for non compliance with legal requirements;

◊ the exercise of banning powers by the government regulator.

The law will provide civil and criminal penalties for non compliance with the legal obligations of advisory organisations and the government regulatory authority will be responsible for taking enforcement action.

Only the government regulatory authority will have the power to exclude (ban) an organisation or an individual from the financial advice industry. The law will provide the grounds on which the regulator can make a banning order and natural justice principles will apply. One of the weaknesses of the current system is that there is no power to ban individuals from the life industry, and life companies are often prevented from disclosing misconduct for fear of legal action. The banning powers proposed by the FPA would be similar to the powers of the ASC under the *Corporations Law* and cover <u>all</u> advisory organisation and individuals.

5 Enhanced Industry Role in Regulation

The FPA's strongly believes that industry should play a greater role in the regulation of advice and also in the regulation of other activities within the financial system. The benefits from greater industry involvement include -

◊ regulatory requirements that are more responsive and relevant to industry practices;

◊ the ability for regulation to change as industry changes;

◊ more cost efficient regulation; and

◊ industry directly bearing the costs of regulation.

In the long term, these goals would be best achieved through a "partnership" or co-regulatory approach where the Government regulatory authority and industry bodies share responsibility for regulation. While a “co-regulatory” model of regulation may not be achievable in the short term, the FPA believes that it is an important long term goal for the future; industry and government should establish a formal process for achieving that goal.

The FPA proposes a staged approach to achieve greater industry involvement in regulation. Table 18 shows the key stages that the FPA envisages. The first stage, proposed under the FPA’s model , involves industry bodies contributing to the development of minimum standards for advice regulation (competence, conduct, disclosure etc) and other regulatory issues through a formal process of consultation with the regulator. The second stage would involve the formal recognition of industry bodies by the government regulator according to specific criteria and an approval process developed by the regulatory authority. The third stage would involve the delegation of specific regulatory functions by the government regulator to approved industry bodies based upon the industry body’s capacity to undertake particular regulatory functions. Refer Section 7 for details.

Through a gradual transfer of responsibilities from the government regulator to approved industry bodies, this staged process will allow industry bodies to make the changes necessary for them to take on greater responsibilities. A staged approach will also facilitate the development of a workable regulatory system and one which has broad acceptance within the industry and among consumer groups.

6 Proposed Regulatory Requirements

The following is a more detailed explanation of the regulatory requirements that the FPA believes should apply to financial advisory organisations under its proposed model. While there are similarities to the principles that apply to securities advisers under the *Corporations Law* and for life insurance advisers under the *Life (Agents & Brokers) Act* and the *Life Code of Practice*, under the FPA’s model there is much greater reliance on clear and simple disclosure and less prescriptive regulation.

6.1 Licensing Principal Advisory Organisations

Under the FPA’s proposed regulatory system all principal advisory organisations must hold a advice licence before entering the market. The government regulatory authority would after formal consultation with the industry set minimum entry standards and for assessing the suitability of advisory organisations to hold a licence. Carrying on a financial advice business without a licence would be an offence, with criminal penalties in the law which the government regulator could enforce.

6.1.1 The Impact of Occupational Licensing

In recent times, occupational licensing has been criticised for raising barriers to entry and reducing competition for services. The FPA accepts that the long term goal should be to phase out government licensing, in line with the recommendation of the Hilmer Report, and that greater reliance should be placed on entry standards set by industry self regulatory bodies rather than by the government.

The FPA believes, however, that for the present time government licensing is necessary because there are no recognised minimum professional standards in the advice industry and because there are strong consumer and community expectations that providers of financial advice should be competent. Without minimum standards under a licensing system consumers may find it difficult to make their own assessment of the competence of advisers and advisory organisations.

Because of the diversity and number of organisations in the industry and the bringing together of a number of advisory groups under a single regulatory system, the FPA is confident that licensing of advisory organisations will not have any substantial anti competitive effect on the industry. As industry bodies play a greater role in regulation in the future, it may be possible to move away from a government controlled licensing system towards greater reliance on minimum entry standards set by approved industry bodies.

6.1.2 No Categories of Advice Licence

Under the FPA’s model of advice regulation there would be no sub categories of advice licence for the various types of advisory services available in the market (eg a financial planning licence, stockbroking licence etc).

The FPA recognises the difficulties in classifying the industry into specified sub categories and believes that this is not necessary for an effective regulatory system. Instead, the FPA believes that industry bodies should play a greater role in educating consumers about the nature and range of services available and greater emphasis in regulation should be placed on clear and simple disclosure. This approach is preferred to a system where the law or the government regulator specifies categories of advisory services because -

◊ there are not always clear distinctions between types of advisory services and accurate categories are difficult even for the market to determine;

◊ simplified labels (in the form of sub categories) are not always the best way to convey information to consumers about the services that they are acquiring;

◊ industry participants have a better knowledge and understanding of the market and its complexities than government regulators, and so, are better placed to explain the nature of services available;

◊ the nature of services available in the market change over time and outdated categories can become entrenched in legislation and difficult to change.

Under the FPA’s model consumer recognition of the types of advisory services will be achieved through:

◊ the *promotion by approved industry bodies of the services their members offer*, the standards of competence required of members and the quality of service that members provide. For example, "financial planning" will be promoted to consumers by the FPA as an advisory service which covers the full range of a consumer financial needs.

◊ the *initial disclosure obligation of advisers* indicating to prospective clients the nature of services they offer, product range, conflicts and so on (see Client Disclosure at section 6.3).

6.2 Minimum Competency Standards

Under the FPA’s proposed model the law will require all licensed financial advisory organisations to identify and approve all individuals who are allowed to give advice on their behalf (representatives). Representative approval will be similar to the issue of "proper authorities" under the *Corporations Law*, but the definition should be narrowed so that it clearly only applies to those individuals who give *advice* on behalf of the licensee.

Licensed advisory organisations will only be able to issue approvals to representatives who are competent to provide financial advisory services of the kind that the licensee provides; licensees must ensure that their representatives are at all times competent to perform those tasks. Minimum personal competency standards would be developed by the government regulator after formal consultation with industry bodies and other stakeholders. These competency standards should impose minimum levels of competence across the industry and should be enforceable under the law. There would be penalties for breach of this requirement and a due diligence defence available to advisory organisations that take reasonable steps to ensure their representatives are competent.

The assessment of individual competence should be the responsibility of advisory organisations and should be undertaken in accordance with guidelines provided by industry bodies. It is envisaged that industry bodies would develop guidelines for their members on the procedures for assessment of personal competency standards, for the appointment of representatives and for their ongoing training.

The FPA does not believe a central database of advisers is necessary (such as the ASC's register of proper authorities) since it is costly to maintain. The key requirement in relation to individual advisers should be for -

◊ organisations to maintain up to date lists of representatives; and

◊ the government regulator to maintain a list of banned advisers so that industry bodies, advisory organisations and consumers can make relevant inquiries.

6.3 Disclosure

Disclosure forms a key element of the FPA's proposed model of advice regulation. Simple and clear disclosure is an effective, low cost regulatory tool that encourages a diversity of products and services in the financial system. Disclosure, combined with consumer education, facilitates consumers making informed decisions about how to participate in the financial system even with the benefit of advice.

6.3.1 New Client Disclosure

Under the FPA model the law will require all financial advisory organisations to make general disclosure to prospective clients including -

◊ an explanation of the services offered and the modus operandi of the organisation;

◊ how the organisation is remunerated for its advisory services (including all costs and charges);

◊ any general conflicts of interest that the organisation has (eg it is related to a product manufacturer);

◊ any limitations on the advice that is offered (ie it is only in a specialised area of financial advice or limited to certain types of financial products);

◊ how client complaints are handled; and

◊ the industry body (if any) of which the organisation is a member.

This requirement would be similar in substance to the provisions under the *Life Code of Practice* and the ASC's proposed *Advisory Services Guide.* However, the law will contain only the broad principles of disclosure and should be sufficiently flexible to allow disclosure to prospective clients to be made electronically or in hard copy form; it should not prescribe in detail the form or content of the disclosure document. The government regulatory authority will after formal consultation with the industry set minimum standards in relation to this disclosure requirement.

Neither the law nor the government regulator should specify how an advisory organisation should represent itself nor what may be included in other promotional material or stationery used by advisory organisations. The ASC's *Practice Note 18 - Identification of Licensees and their Representatives* is an example of how a regulator's "guidance" on general legal principles can become de facto law and how such guidance can be impractical in a market context. The requirement to disclose certain basic information to new clients, together with enforcement of the general prohibition against misleading and deceptive conduct should be sufficient.

6.3.2 Risk Disclosure and Warnings

Under the FPA's proposed model a new element of disclosure, relating to risk, would be introduced as well as warnings to clients regarding the limitations of certain advice. Advisers would have to disclose to clients, in simple and clear terms, the risks associated with particular recommendations. This risk disclosure would encompass the risk associated with particular types of investment products (eg the volatility of the share market) as well as the risk of an undiversified portfolio (eg all property) and the risk that certain investments may not produce a sufficient return to meet the client's needs (eg all cash).

The aim of these requirements is to ensure that consumers better understand the implications of their financial decisions. By providing consumers with a better basis for comparing investment products and their risks, competition between financial institutions and market transparency will be enhanced. The FPA believes that the individual and the economy as a whole will be better off by consumers understanding and taking investment risk.

Advisers will also be required to provide warnings about the limitations of advice provided where a full needs analysis has not been undertaken, or where investment choices are limited. Similar warnings would be required of financial institutions where products are sold without advice.

Minimum standards would be set by the government regulator after formal consultation with the industry and other stakeholders. Particular care would need to be taken in developing these minimum standards to ensure that they do not become excessive and lead to information overload for consumers.

6.3.3 Conflict of Interest Disclosure

The law will require all advisers making recommendations to disclose to their client any specific conflicts of interest that arise in relation to a recommendation, as well as the total costs and charges associated with a recommendation. This provision would be similar in substance to the requirement under s849 of the *Corporations Law* and proposed section 230H(4) of the *Life Insurance Act*.

This requirement would capture, amongst other things, the payment of commissions by a product manufacturer to an advisory organisation and other incentives and overrides, or non financial benefits provided. It is not intended to duplicate the general conflict of interest disclosure that advisers make to new clients.

6.4 Primary Client Duty

The proposed regulatory system will recognise all advisory organisations as a form of fiduciary. Advisory organisations (and the individuals that provide advice on behalf of organisations) will have a duty by law to act at all times in the interests of their client when providing advice.

This duty is consistent with the nature of the conduct and disclosure requirements applicable to all advisers and will address the potential conflict of interest that product manufacturers experience when giving advice. At present, despite their legal obligations to clients they retain a primary duty to their principal, the product manufacturer. This is incompatible with the principles of advice regulation.

If consumers are to better distinguish advisory services from other services in the financial market place, particularly product manufacture, it is essential that the provision of advisory services be accompanied by a primary duty to the client.

6.5 Responsibility and Liability

6.5.1 Liability for representatives

The law will provide that licensed financial advisory organisations are responsible for their representatives. This is similar to the current system of liability under the *Corporations Law* and consistent with the liability that employers have for acts of their employees and agents.

Imposing this responsibility creates a strong incentive for advisory organisations to ensure that their representatives comply with the minimum standards at law when providing advice and to ensure that they are properly trained to do so. A clear chain of liability is especially important when the regulatory system relies on individual advisory organisations to monitor the conduct of their representatives. Without this liability there would be less incentive on licensees to place controls on their representatives and representatives would be left largely to their own devices in providing advice to clients.

6.5.2 Supervision and Training of Representatives

The law will require advisory organisations to adequately supervise their representative in the provision of advisory services to provide reasonable assurance to the organisation that they are complying with the law. The government regulator would, after consultation with the industry, set minimum standards for advisory organisations in relation to training and supervision.

This requirement would be similar to the licence condition in regulation 7.3.02(1) of the *Corporations Regulations* , although it would go further than the existing requirement. Like the competency requirement, it would be a requirement of the law itself (not a licence condition) and there would be penalties in the law for breach of the obligation. A due diligence defence would be available to advisory organisations, recognising that while organisations can take steps to ensure proper system are in place, it is not always possible for them to avoid inadvertent breaches.

6.6 Suitability of Advice

Under the FPA’s proposed model the law would require an adviser to have a reasonable basis for recommendations made to clients and those recommendations to be appropriate to the particular client’s needs. The key elements of this requirement would be as follows -

◊ advice must take into account the adviser’s knowledge about the particular client’s financial needs and circumstances (although the extent to which an adviser must make enquiries will vary with the overall circumstances of the advice);

◊ the adviser must be aware of the options available to the client, including products available in the market (although the adviser may not have a detailed knowledge of <u>all</u> options or products available); and

◊ in formulating the recommendation, the adviser must give reasonable consideration to the client's needs and circumstances and the appropriateness of the available options to those needs and circumstances.

This would not be a "best advice" requirement. The proposed law would be similar to the principles embodied in s851 of the *Corporations Law* and proposed s230H of the *Life Insurance Act*, but would provide greater flexibility in its interpretation than is presently the case. The present interpretations by the ASC and the ISC of the "suitability of advice" requirement have become de facto law and fail to recognise the range of circumstances in which advice may be provided. This rigid approach to compliance has the potential to limit the range of services available to consumers in the financial system because product manufacturers are cautious about providing additional information or limited advice on products they offer for fear they may be in breach.

Consumers often seek advice on specific listed securities from stockbrokers or on specific investment products from a product manufacturer, and do not expect (and are not prepared to pay for) the sort of extensive needs analysis and portfolio review that would be undertaken by a financial planner.

There should be recognition of the variety of ways in which to comply with the "suitability of advice" requirement under the law. It should depend on the circumstances in which advisory services are offered, what the consumer is seeking and the disclosure made by the adviser about the advisory services being provided. Similarly, a reasonableness test should be applied to the rule so that if a client expressly declines to provide certain financial information that should not prohibit an organisation from providing advice.

The law should not contain prescriptive rules on how the "suitability" requirement should be met (whether in written form or otherwise) or the procedures and steps that must be undertaken by the adviser or the organisation to meet their legal obligations. These requirements would restrict the development of new advice delivery mechanisms outside a paper based environment.

The government regulator would, after consultation with the industry and other stakeholders, set (flexible) minimum standards relating to the requirement for appropriate advice, taking into account the range of circumstances in which advice may be provided. This combined with improved disclosure will provide adequate consumer protection.

6.7 Dispute Resolution and Redress Mechanisms

Under the FPA's proposed model, all financial advisory organisations will be required by law to -

- ◊ have adequate internal procedures for the efficient and fair resolution of complaints by clients;
- ◊ be members of an independent external dispute resolution and redress scheme; and
- ◊ make adequate provision for any compensation claims made by clients.

The law itself will not prescribe how these obligations should be met by advisory organisations. Instead the government regulator will consult with industry in the setting of minimum standards in relation to each of these requirements. These minimum standards would identify the size of claims that could be made, the framework for dispute resolution and the rights of the various parties.

Industry bodies may provide dispute resolution and redress mechanisms for members (such as the FPA Dispute Resolution Scheme) which meet the minimum standards set by the government; licensed advisory organisations may alternatively seek access to other independent schemes.

The FPA does not support the creation of a single centralised dispute resolution scheme for advice provided there are minimum standards for such schemes and all advisory organisations in the industry are covered. Having a number of dispute resolution schemes for advisory services need not produce the overlaps and uncertainties that exist in the current system of regulation, provided advisory organisations are members of only one such scheme.

It is only where such schemes operate on a product basis that difficulties emerge. Under the proposed model complaints against a single advisory organisation would be dealt with by only one dispute resolution scheme even though advice may have been provided on a range of financial products.

7 Staged Progression to a Co Regulatory Model

Under the FPA's proposed model, industry bodies will have an enhanced role in regulation. In the short term through formal consultation by the government regulator in setting minimum standards. In the longer term, a "co regulatory" model will be established through formal recognition of industry bodies and the delegation of certain regulatory functions to those bodies.

7.1 Formal Recognition of Industry Bodies

The Government regulator would develop criteria for the formal recognition of industry bodies to ensure that they have appropriate minimum standards and attributes for a self regulatory organisation. The approval process would have regard to the standards set by industry bodies for membership by advisory organisations, adviser conduct, ethics and disciplinary procedures as well as their capacity to actively monitor their membership for compliance. To gain approved status an industry body would have to be able to demonstrate to the government regulator that it is sufficiently resourced to take on the role of an approved industry body.

Under the FPA model there would be no arbitrary restrictions on the number of approved industry bodies. There may be a number of approved industry bodies that meet the criteria (reflecting particular specialisations and practice areas within the broad scope of financial advice) and industry bodies would need to decide whether they wanted to take on such a role. This is the same principle that applies to the approvals of securities and futures markets under the *Corporations Law.*

Because the law will provide a single regulatory framework and a single set of principles governing all forms of financial advice and because there will be oversight by the government regulator, the existence of a number of industry bodies will not create inconsistencies. Competition amongst industry bodies will enhance their performance.

The process of approving industry bodies should be open and transparent. It should be an open and consultative process whereby any party with an interest has the right to comment. A public hearing process, similar to the review of broadcasting licenses, could be used to consider initial applications and for ongoing reviews. There should be a regular process of review of industry body approval to assess their continued suitability

The following are suggested criteria for the approval of industry bodies under the FPA's ideal model. If the proposed system were adopted by the Government further detailed consideration would need to be given to these criteria and their formulation.

7.1.1 Organisation Entry Standards

An industry body's rules should have criteria for membership relating to an organisation's ability to carry on an advisory business including -

◊ the competence and ethical standing (good fame and character) of the organisation's principals;

◊ the adequacy of its compliance systems and procedures, including its standards for staff assessment, training and supervision;

◊ the adequacy of its resources to provide particular advisory services.

Capital adequacy, and other measures that create barriers to entry, should be discouraged as entry requirements for advisory organisations unless their activities encompass the holding of client funds.

7.1.2 Setting Competency Standards

An industry body's rules should specify the competencies required by advisers who are appointed as representatives of advisory organisations (ie individuals). Competency requirements will be based on the nature and scope of advisory services offered by members and while they may differ as between industry bodies, they must meet the minimum standards imposed by law.

An industry body would also be expected to provide guidelines on the qualifications, training, experience, and ethical standards required of advisers and the means by which advisory organisations should assess competence. Industry bodies may run their own training courses or assessment procedures, or may outsource training and educational programs provided the relevant competency standards are set and reviewed by the industry body.

7.1.3 Practice Rules and Guidelines

To gain recognition an industry body should have practice rules and guidelines relating to standards of conduct and ethical behaviour, disclosure, the suitability of advice requirement, supervision and training, internal dispute resolution mechanisms, and internal compliance procedures and systems.

7.1.4 Complaints Handling and Dispute Resolution

To be approved, an industry body's rules would have to provide members access to an independent dispute resolution scheme which may be their own scheme, or a separately operated scheme. In either case the industry body will have to ensure that these arrangements are satisfactory for the resolution of complaints against members and provide satisfactory redress for clients.

7.1.5 Disciplinary Procedures

Industry bodies would be required to have their own internal disciplinary procedures in relation to non compliance with membership rules and with sanctions including censure, suspension, fining and expulsion. Disciplinary action taken by industry bodies will have to be reported regularly to the government regulator and referrals where there are reasonable grounds to suspect a breach of the law.

7.2 Delegation of Regulatory Functions

The third stage of progression to a co-regulatory model of advice regulation involves the delegation of day to day government regulatory functions to approved industry bodies. The delegation of functions would be on a selective basis and would differ according to the capacity and suitability of relevant industry bodies to undertake regulatory functions. The functions delegated could include -

- ◊ setting entry requirements for member organisations and assessing the suitability of advisory organisations to be licensed;
- ◊ developing competency standards for recognition by the Government regulator;
- ◊ developing practice rules and guidelines which meet the conduct and disclosure requirements of the law;
- ◊ undertaking compliance reviews of members (surveillance) to ensure standards are being met.

In the long term, member surveillance should represent a key part of the role of industry bodies, although the FPA recognises that it will take some time to transfer this responsibility.

In this context, the primary role of the government regulatory would be to ensure that the programs developed by industry bodies are adequate. The government regulatory body would retain the power to undertake surveillance of advisory organisations, which would only be used in a limited number of cases.

For the “partnership” arrangement to be effective, it is important that the guidelines established by approved industry bodies not become “de facto” legislation. Under the FPA’s proposed model of industry “co-regulation”, compliance with industry body guidelines will not be a breach of the law although it may provide evidence of whether a legal requirement has been breached. If they are directly enforceable at law they are likely to become more bureaucratic and less relevant to industry practices.

Where specific regulatory functions are delegated to industry bodies the government regulator would have to enter into a memorandum of understanding with the approved industry body regarding their respective roles and responsibilities.

Appendix 6
1996 Principal Member Survey

1 Clients

Total clients	2.036 Million
Total "active" clients (reviewed at least yearly)	895,000
Total funds held by active clients	$75.692 Billion
Average funds per active client	$84,570

2 Compliance Costs

Total 1992/93 (13% of total operating costs)	$22.09 Million
Total 1994/95 (16% of total operating costs)	$33.98 Million
Total 1995/96 (16% of total operating costs)	$40.99 Million

<u>Trends in regulatory costs</u>

ASC as a percentage of total compliance costs

1992/93	84%
1994/95	75%
1995/96	64%

<u>ISC as a percentage of total compliance costs</u>

1992/93	14%
1994/95	21%
1995/96	33%

<u>Unnecessary costs of regulation</u>

Those who consider they incur such costs	69%

Those who don't	13%
Total unnecessary costs 1995/1996	$10.553 million
<u>Including</u>	
Administration	$3.888 million
Training	$2.756 Million
Monitoring	$3.861 Million

3 Proper Authority Holders

Total proper authority holders	9,612
Total advising PAHs	6,178
Proportion who provide life insurance advice	65.35%

Appendix 7
Regulation of Securities Advisers and Life Intermediaries

1 Introduction

The following is a comparison of the regulation of securities advisers and life insurance advisers under the *Corporations Law* and the *Life (Agents & Brokers) Act* and the *Life Insurance Act* based on an discussion paper released by the Financial Planning Association in 1995. It focuses on those areas of difference (rather than the common ground) between the two system to highlight the difficulties they create for the advisory industry. While it does not fully take into account the results of the ASC and ISC's harmonisation program, it is clear that there are some fundamental differences which cannot be overcome by the harmonisation.

Box 1 summarises the similarities between the two regulatory systems. Each regulatory system is based on the need for competent and ethical advisers in the industry, full disclosure of conflicts of interest, advice to be properly researched and suitable to the individual's needs and an efficient system of investor redress.

Box 1 Comparison of ASC and ISC Licensing Objectives

ISC	ASC
"to protect the interests of consumers in a manner consistent with continued development of a viable, competitive and innovative life insurance industry"	**"to promote investor confidence and market efficiency"**
• high quality advice so products are appropriate to consumer needs • advisers maintain a minimum standard of service for customers • the industry plays an active role in overseeing the conduct and competence of advisers • advisers are competent in arranging the issue of life policies • there are adequate procedures for dealing with inquiries and complaints by consumers • there is access to an adequate external dispute resolution mechanism	• high quality advice giving process • investors are informed and active participants in the advisory process • regulation is cost efficient • minimum standards for personal and organisational competence for securities advisers • ASC maintaining a role in enforcement and surveillance of conduct requirements • effective complaints resolution mechanisms for investors

* The ISC objectives have been taken from the *Life Code of Practice* and ASC from the Licensing Review Report "Good Advice".

Despite much common ground there remain significant differences. Those differences begin with the scope and coverage of the regulation, determining what kinds of transactions are excluded (eg annual premiums under $500 for life insurance advisers) and the circumstances in which certain advice is excluded (eg incidental advice). While these differences are not always significant, they combine to create unnecessary confusion and uncertainty, which adds to compliance costs.

2 Liability and Legal Relationships

The notion of adviser as "agent"

One of the most significant differences in the regulation of life insurance advice and securities advice derives from the different approaches under each regime to characterisation of the intermediary who gives the advice. Characterisation as an "agent" of the company on the one hand, or the client on the other, has a fundamental effect on the way in which the advice process is regulated.

Life insurance advisers are categorised as either life agents or life brokers (the former being the "agent" of the life company and the latter being the agent of the client). Unless a life insurance adviser is registered as a broker, it is deemed to be an agent and must enter a formal agency arrangement with a life company. The legislation specifies who must be a broker and who must be an agent; the real practical difference between is that a broker cannot receive incentives and overrides from product manufacturers. While a broker can receive ordinary commissions from a life company, it cannot receive additional benefits. If it does it must become an agent, making the life company responsible for its activities.

This characterisation as "agent' or "broker" developed as part of the traditional life industry where most agents were tied to a particular life company and oriented towards selling a product, rather than providing advice. The receipt of incentives and overrides is seen as a key part of this link to product manufacturers. However, this orientation has gradually moved away from a single product sales focus and multi-agents have become the norm. Furthermore, many life agents and brokers also provide advice on securities and must hold a dealers licence of an investment advice licence under the *Corporations Law*.

Despite the legal characterisation of life agents, many agency arrangements seem indistinguishable from the arrangements that exist between some unit trust managers and securities advisers. Whether securities advisers are independent or linked to a particular product manufacturer is a question of disclosure; there is no difference in the conduct obligations that apply or the licensing classifications that apply under the Corporations Law. There is also an arbitrary distinction between “dealers” and “adviser” under the Corporations Law based on remuneration, but in either case the lability framework does not change.

This represents a fundamental difference in approach to the regulation of life insurance advisers and securities advisers which impacts upon a whole range of specific obligations and requirements.

The life company as regulator of its agents

Under the *Life Insurance Act* an agent's primary duty is to the life company and the life company is liable for the acts of its agent. This means that under the ISC regime primary responsibility for ensuring compliance by a life agent with its various obligations is placed on the life company not the agent itself. In the case of a broker, these same monitoring and compliance responsibilities fall upon the broker itself not the life company whose products it recommends, which is the same for securities licensees (dealer or adviser) under the *Corporations Law*. This creates a fundamentally different liability and responsibility framework for advisers because of an arbitrary distinction in the *Life Insurance Ac*t based on adviser remuneration structures.

The substantive obligations to consumers do not vary as between agents and brokers, but who is liable and responsible for compliance does. See Box 2 Life Company Monitoring Responsibilities.

Box 2 Life Company (and Broker) Monitoring Responsibilities

"Responsibility for compliance with the Code rests with individual life companies and brokers. Each life company and life broker must have appropriate documented procedures in place to monitor the performance of its life insurance advisers .."

Monitoring responsibilities include -

- *ensure* fact finds are properly undertaken;
- monitor the appropriateness of advice provided;
- closely monitor complaints about the conduct of advisers;
- *ensure* there are appropriate pre recruitment screening procedures;
- verify that advisers are trained to the necessary level of competence;
- *ensure* adequate documentation is maintained.

Record keeping responsibilities include -

- internal complaint handling mechanism statistics;
- all infringing conduct, particularly repetitive infringements;
- remedial action and its effect;
- details of the training of life insurance advisers.

This divergence in approach creates disharmony because different parties assume responsibility for compliance in the context of different products, even though the advice given may be functionally the same. In the past where tied agents predominated and the life and securities industries remained quite separate, this created few real difficulties. However, the changing industry context suggests this approach is no longer appropriate because -

- unlike the industry of the past most agents are no longer tied to a single product manufacturer but more commonly operate as "multi-agents" (entering into agency arrangements with several life companies) and also provide securities advice in a financial planning context;[1]

- the wide ranging statutory obligations owed by life agents to consumers (their clients) means that the common law agency principles (ie duty of care to the life company) have been substantially diluted in the consumer's favour; and

- the provision of advice is functionally distinct from the manufacture of investment products even though many product manufacturers also give advice. This distinction has been reinforced by the regulatory systems which now require advisers to focus on consumers needs and rights, in spite of product or ownership ties.

Problems of duplication and disharmony

In an environment where most organisations have both a multi agency and hold a securities license, making life companies (product manufacturers) responsible where an agency arrangement exists creates enormous problems. These include -

- with more than one life company responsible (and potentially liable) for a range of compliance obligations owed by its multi-agents there will be confusion about which life company should be doing what, and resulting in duplication in effort and costs (see Figure 1 below);

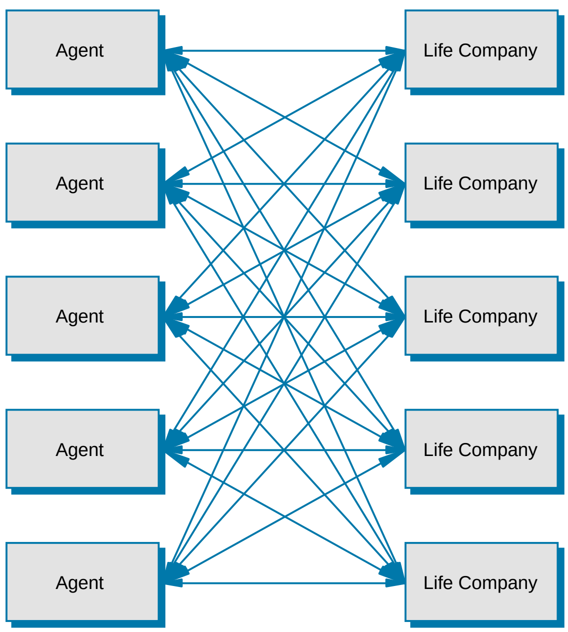


Figure 1 The Multi Agent Liability Framework

[1] There are no statistics on the number of tied agencies that still exist in Australia, but it is thought

- where multiple life companies are responsible it is possible that some (if not all) will read down their responsibilities to the most cursory compliance checks and many life agents will not be adequately monitored for compliance;

- because many life agents are also securities advisers there is a duplication in regulation (and its associated costs) between the ASC and the ISC;

- making life companies (product manufacturers) responsible for compliance and monitoring may weaken some of the consumer protection initiatives because of the tension of interest between product sales and the provision of high quality, unbiased advice;

that most agents are multi agents.

- where financial planning organisations are both life agents and securities advisers, different entities assume supervisory and training responsibilities relative to different products (for the same advisory service) with the result that the lines of responsibility are further complicated and more duplication occurs;

- it is difficult for a financial planner that is both a life agent and securities adviser to issue business documentation (eg letterhead, business cards etc) which is not confusing to the consumer because of the existence of multiple responsible bodies (eg the licensee and the life company) and complies with two sets of rules.

The ISC is keen to retain the "agency" distinction because of the apparent efficiencies it provides for regulation. Instead of having to regulate and monitor potentially thousands of agents directly, they can do so indirectly through a relatively small number of life companies. While superficially attractive this approach ignores the difficulties likely to be faced by life companies and the inherent conflict they have in monitoring their agents for compliance with consumer protection laws. The experience of many Australian regulatory authorities, such as the TPC and the ASC, as well as overseas authorities is that rigorous independent monitoring and enforcement is a key part of an effective regulatory system - without it the regulation of life insurance advisers is likely to fall short of expectations.

There does not appear to be any tangible consumer benefit arising from this system of classifying life insurance advisers (as brokers or agents) and it is not clear what the characterisation truly adds from a consumer's perspective. These difficulties can only be overcome by fundamental change if the regulatory framework and not by harmonisation.

3 Individual Entry Requirements

The competence of individuals is critical to effective regulation of financial advisers (whether life agents, brokers or securities advisers) and yet different approaches are being taken to establishing the competence of individual industry participants.

The life industry supports a system of individual annual assessment of life agents and brokers through the establishment of a government mandated industry run registration board (Life Insurance Advisers Registration Board). The Registration Board will provide a system of annual registration for all life agents, brokers and broker's representatives. The scheme is conservatively estimated to cost $2.1 million per year and require at least 13 full time staff to administer. Estimates of the scheme's costs are based on the expectation of between 4,000 and 8,000 individuals seeking registration.

The ASC rejects individual licensing and registration as inefficient and costly preferring the current system of licensing principals, who in turn are responsible for the competence of their individual representatives. For financial planners who are both representatives of securities advisers as well as life insurance advisers, this difference means that there will be two separate systems of competence testing which will create additional costs for advisers, for the industry and ultimately for consumers.

The life industry and the ISC initially supported the registration scheme proposal as a means to eliminate some of the problems of duplication in regulation identified above - by establishing a single registration board, life companies would not be responsible for basic competence testing which would avoid duplication and ensure consistent standards. While initially appealing for these reasons, increasingly parts of the industry are becoming critical of the proposed scheme and realise its potential costs and complexity.

The ASC criticism of a centralised system of licensing individual advisers is based on its past experience (and that of its predecessors) where each State Corporate Affairs Commission issued dealers and investment representatives licenses to all individuals, as well as principal licensees. That system was considered to be bureaucratic, costly and with minimal effect on the competence of industry participants.

The ASC has acknowledged the failure of licensees to implement proper screening programs resulting in a highly variable standard of competence across the industry. Instead the ASC is in the process of introducing personal competence requirements for advisers, with guidelines as to the standards to be adopted by licensees. With delays to the introduction of the Registration Board to ISC is now working with the ASC in developing these minimum competency standards.

While harmonisation of standards may be achievable there still remains the difficulty in supervision of compliance and many advisers will be subject to competence standards and requirements set by life companies as well as their own organisations under the dual regulatory regimes.

4 Disclosure Obligations

Both the ASC and the ISC have rules (and proposed rules) relating to the disclosure obligations of advisers, which can be categorised broadly into pre contract disclosure of capacity and conflict of interest disclosure. Harmonisation may alter how those requirements apply.

Disclosure of Capacity

While the disclosure obligations imposed by the ASC and ISC are very similar, there remain some differences which are confusing and create uncertainty. Under ISC requirements a life insurance adviser must state whether he or she acts primarily for a life company or for the consumer (See Box 3). This requirement exists even though the adviser (whether acting as agent or broker) has the same suitability obligations to the consumer. For example, the adviser would state that in relation to any life insurance products on which advice is provided the adviser has a primary duty to the life company but in relation to any securities (which may be substitutes) the adviser has a primary duty to the consumer; even though in both cases, the suitability requirements are fundamentally the same.

This disclosure of "primary duty" runs counter to the express obligations of advisers (as to suitability etc) and is more likely to confuse than assist in the decision making process of a consumer when choosing an adviser. This is particularly so where the adviser is both a life agent and a securities adviser. Notwithstanding harmonisation of these initial disclosure requirements, this distinction in the duties of advisers remains.

Box 3 Disclosure of Capacity

ISC	ASC
At the earliest possible opportunity a life insurance adviser must provide written advice[2] to a customer of: • the name and address of the adviser • means of remuneration of the adviser • who is responsible for the adviser's conduct • whether the adviser's primary duty is to the life company or the customer • any product restrictions on the adviser	The ASC has proposed the introduction of an Advisory Services Guide[3] to be provided before any services are offered, containing: • the type of advisory services offered and any associated services • means of remuneration of the advisory firm • the capacity in which the service is offered and any group affiliations • the type of investment products on which advice is offered (and product restrictions) • referral arrangements • other key business terms (such as how instructions are to be received)

Conflict of Interest Disclosure

Securities advisers are also required by s849 of the *Corporations Law* to disclose conflicts of interest, including fees commissions or other benefits capable of influencing the adviser in making the recommendation. Guidance on the ASC's interpretation of this requirement is set out in *Practice Note 23* which will be updated as part of the Licensing Review implementation and the harmonisation process.

In contrast neither the *Life Code of Practice* nor the *Life Insurance Act* contains any requirements regarding conflict of interest disclosure by life insurance advisers (including fees, commissions etc) other than the general fees disclosure which is made as part of the initial disclosure of capacity (see Box 3). While the proposed consumer protection provisions of the *Life Insurance Act* (s230H) do contain disclosure requirements similar in form to s849, it remains to be seen whether those provisions will be introduced in respect of some or all life insurance products. Box 4 provides a comparison of the relevant provisions.

Full disclosure in relation to fees, commissions and other benefits obtained by advisers plays a critical role in consumer protection in the area of advisory services. The failure of the ISC to introduce full disclosure in relation to life products would create a severe disadvantage to other advisers.

---

2 See Life *Code of Practice* par 10. This must also be set out in the Customer Advice Record Par 19.

Box 4 Conflict of Interest Disclosure

ISC	ASC
Section 230H(4) of the Life Insurance Act will require a document containing a recommendation (if *prescribed by the regulations*) to - "(a) set out details of : (i) any benefit or advantage, whether pecuniary or not and whether direct or indirect, that the adviser has received, or will or may receive, in connection with the issue of a life policy to the person to whom the recommendation is made; and (ii) any other pecuniary or other interests, whether direct or indirect, of the adviser or an associate of the adviser that may reasonably be expected to be capable of influencing the adviser in making the recommendation; or (b) if there is no such benefit, advantage or interest - include a statement to that effect by the adviser."	Disclosure under s849 must be made of - "(a) any commission of fee, or any other benefit or advantage, whether pecuniary or not and whether direct or indirect, that the securities adviser or an associate has received, or will or may receive, in connection with the making of the recommendation or a dealing by the client in securities as a result of the recommendation; and (b) any other pecuniary or other interest, whether direct or indirect, of the securities adviser or an associate, that may reasonably be expected to be capable of influencing the securities adviser in making the recommendation. "

5 Conduct of Business Requirements

Both ISC and ASC requirements are based on the general principle of suitability - *reasonable basis for recommendations* - although the interpretation of this principle and the practical rules for compliance are quite different for securities advisers and life insurance advisers. See Box 5.

Box 5 The Suitability Principle

ISC	ASC

[3] There are currently no requirements on pre contract disclosures although many advisers do provide this information to consumers in various forms. The Guide will be introduced through a licence condition.

An adviser must (par 12 of the Life Code of Practice) - • analyse the needs, circumstances and objectives of the customer to ensure advice is on a reasonable basis and is not inappropriate; ¥ take reasonable steps to ensure that the customer can sufficiently comprehend the advice and the basis for the advice to place the customer in a position of informed choice.	Section 851 provides that a person does not have a reasonable basis for making a recommendation unless .... in order to ascertain that the recommendation is appropriate having regard to the information he/she has about the person's investments objectives, financial situation and particular needs, the securities adviser has given such consideration to and conducted such investigation of the subject matter of the recommendation as is reasonable in all the circumstances.

Securities advisers under the *Corporations Law* are subject to a broad, non prescriptive legislative requirement which is the subject of interpretation under ASC *Practice Note 41*. This Practice Note provides the ASC's interpretation of s851 in practical situations and while it is not law, it is an influential guide on what advisers must do and there at present some difficulties in the rigid interpretation that is applied under that practice note. It does not, however, set out prescriptive rules on how advisers should document the process of assessing suitability.

The *Life Code of Practice* also provides interpretation of the principle. It also prescribes in detail the steps that must be followed by an adviser to ensure that he or she has a reasonable basis for making a particular recommendation. In the case of a life agent, the life company plays a supervisory role in this process.

There are also other restrictions on selling practices such as requiring all recommendations to be in writing (para 18) and prohibiting same day sales (para 11) in relation to life insurance products which do not apply to securities.

Box 6 Fact Find Requirements

ISC	ASC

There must be a "fact find" undertaken and recorded in a *Fact Finder* -	An adviser should obtain the following information (PN 41) -
• financial and family circumstances; • needs and objectives for income, capital growth, security, liquidity and investment time frame; • investment preferences and tolerance to risk; • retirement benefits expected; • other details relating to employment, partner, retirement age etc;	• assets and liabilities; • expenditure and income, capacity to save and tax status; • need for income, capital growth, security, liquidity, and flexibility to convert to cash and investment time frame; • personal circumstances, individual values and tolerance to risk; • existing asset and income protection, and superannuation cover; • age, family commitments, social security etc. In relation to market and product information - • economic and accounting information relating to markets and industries and securities respectively; • sources include prospectuses, ASX reports, fund managers reports and other reports and analyses by market specialists.

Real difficulties arise in relation to the rigidity of the procedures set down in the *Life Code of Practice*, even though the content of the various requirements (see Box 6) varies according to the products which may be the subject of the recommendation. Where the regulatory objective associated with the giving of advice and making of recommendations is the same, these differences are difficult to justify and provide scope for confusion and different levels of consumer protection.

While the requirements are largely similar, even small differences in wording and emphasis tend to suggest a different standard applies to advice given in relation to different products, with the potential to create confusion and uncertainty. Given that the objective is high quality advisory services there seems to be no reason for such differences to exist, since they serve only to confuse advisers in meeting their compliance obligations and consumers in participating in the process.

Customer Advice Records (CAR)

The most striking difference between the two regimes relates to the procedural requirements associated with record keeping and the provision of copies of those records. In the case of life insurance products, the life company whose products have been recommended (or ultimately selected by the consumer) is entitled to a copy of the Customer Advice Record (CAR). Box 7.

In a common situation where multiple products are recommended (including life insurance and non life investments) there will potentially be a CAR sent to a number of life companies in relation to all life insurance products recommended, as well as the consumer who has the benefit of a 14 day cooling-off period. In relation to any non life investments recommended as part of the same advisory service, a CAR is not required to be given to the fund manager or the consumer, and there is no cooling-off period. In that case the adviser will retain the records (in its capacity as representative of the licensee) and may or may not provide written documentation of the recommendation to the consumer.

At present the nature and extent of regulatory intervention in the advisory process depends largely on the final product selected by the consumer, even though the advisory service offered may be essentially the same for a range of products. Many of these differences stem back to linking the advice giving process to the product issuer instead of the advisory organisation.

6 Surveillance and Enforcement

Surveillance and enforcement are considered to be important components of an effective regulatory system, and yet the approaches of the ASC and ISC are fundamentally different. The difference in approach is explained by reference to -

- the organisations' different traditions and philosophies;
- the extent and nature of resources available to each organisation;
- the regulatory framework which is in place.

For example, the ASC's approach to regulation is less reliant on prescriptive rules because it is backed by an established surveillance and enforcement capability. The ISC, on the other hand, relies less on surveillance and enforcement and more on co-operation and its powers of persuasion with the life companies. It is able to do this because the regulation of most life insurance advisers is indirectly through life companies and hence the ISC relies largely on the monitoring conducted by the life companies themselves.

Despite this traditional approach, the ISC has announced a more active program of monitoring of compliance with the *Life Code of Practice*. It is difficult to see with the resources the ISC currently has how it will do this effectively. Reliance on a system of prescription which has limited enforcement back-up or independent monitoring and runs the risk of appearing the provide investor protection when in fact it cannot.

Box 7 Procedural Requirements for Advice Records

ISC	ASC
There must be a Customer Advice Record beginning with a clear boxed statement that it is an important document which should be read and it should restate the 14 day cooling-off period.	There is no C*orporations Law* requirement equivalent to a CAR, although *PN 41* states that at any time an adviser should be able to provide sufficient written information about the recommended securities so that the basis of the recommendation can be understood.
The *Customer Advice Record* must contain • capacity of the adviser (see above); • summary of information; • products identified as suitable to the customer's needs /objectives and why; • recommended products; • an explanation of the reasoning of the recommendation and why it is likely to satisfy the customer's needs/objectives; • a statement that the Fact Finder is available on request; • additional information where the advice does not wholly meet the customer's needs/objectives, if the customer elects to purchase a policy other than as recommended or where it involves termination or replacement of an existing life policy; • where insufficient information is provided in the "fact find" there must be warnings that the advice may not be appropriate and that there may be a financial risk as a result.	The Corporations Law allows recommendations to be made orally or in writing. There are no requirements as to record keeping or confirmation of recommendations. The ASC will introduce a licence condition requiring records to be kept (computer or otherwise) of recommendations made and for recommendations to be confirmed in writing to the client. The written confirmation requirement may be expressly waived by a client. The form of record keeping will not be prescribed by the ASC.
The *Customer Advice Record* must be sent to the customer no later than the day on which the cooling-off period commences. There is no requirement for this to be signed by the customer but the ISC considers this to be good practice.	No comparable requirement.
The *Customer Advice Record* must be dated and signed by the adviser and forwarded to the life company(ies) of the recommended products (or the life broker where there is no agency arrangement) and retained by the life company/broker.	No comparable requirement to send written advice record to the fund manager (product manufacturer) whose products are recommended.