Submission to the Financial System Inquiry
By Austin Donnelly
and the Australian Investors Association Ltd.

A one page summary for quick reference
To facilitate a quick reference to various parts of the submission set out below is a one page summary.

Expertise on which the submissions are based
The submission is based on the 41 years varied investment experience of Austin Donnelly and his research work associated with writing 43 books on investments and other subjects. It is also based on five years experience of the Australian Investors Association in studying the billions of dollars which the investing public of Australia has lost primarily because the regulators have not enforced the law.

Culture of concealment
The underlying theme of the submission is that the ASC and ISC by allowing fund managers and advisers to conceal a good deal of material information which they are required by law to disclose has caused the retirement years of thousands of Australians to be blighted. This matter is discussed in pages 4 to 8 and 12.

Examples of failure to disclose required information

There has been a widespread failure of prospectuses and recommendations of advisers to disclose the information which they are required to disclose by law. This matter is dealt with in pages 9 and 10. Page 5 to 8 are also relevant. There is an urgent need for the ASC to discontinue its role as joint publisher of a booklet on selecting investment advisers which contains seriously inaccurate statements (see page 13).

Commendable action by regulators
On page 15 we place on record our appreciation of some recent commendable actions by the ASC and the ISC. But a great deal more including a change of attitude by the regulators and the end of the culture of concealment is needed.

Self regulation
As there is a great deal of evidence that self regulation does not work even in industries where there is a far greater sense of professional responsibility, it should not be considered in the investment industry. In particular it would be disastrous if self regulation powers were given to an association of investment advisers of which most of the members operate on a commission basis with interests not only different from but directly opposite to those of investors. (page 20)

Other matters
Other matters discussed include the need for the Reserve Bank to be more interested in the culture of concealment (page 14), need for some changes to the law (page 16), need to extend requirements for disclosure to the real estate industry (page 17), a discussion on whether there should be one regulator or several (page 18) and example of how a prospectus of a leading US fund shows how to disclose material information on page 19. Recommendations are set on page 21.

Background information on Austin Donnelly and the AIA

The investment experience and knowledge on which this submission is based may be better appreciated after considering the following background information .

Austin Donnelly

Experience ... Over 41 years experience in various parts of the investment industry including stockbroking, unit trust management, merchant banking, portfolio management and corporate and personal money management. Has been semi retired since July 1994 working as a consultant to Donnelly Money Management Pty Ltd including editing the investment newsletter, Donnelly's Investing Times as well as a large amount of honorary work for the AIA.

Publications ... Author of 43 books with the 44th now with the publishers and several others scheduled for publication next year. Hundreds of articles including some published in several overseas countries and the writing of over 200 issues of investment newsletters .

Work on behalf of aggrieved investors ... On behalf of aggrieved investors who were the victims of the laissez faire approach of the regulators, has achieved a 100 percent success rate in a number of cases as a negotiator or expert witness in achieving satisfactory out of court settlements in recovery of losses due to the failure of advisers and fund managers to disclose material information. This followed a number of overseas currency loan cases, including the hallmark case of Chiarabaglio V Westpac in which his expert evidence was a crucial factor in the recovery of many millions of dollars. After conducting a one person campaign for a fair go for investors through books, articles and media interviews for many years formed the AIA five years ago.

Authoritative comments ... His articles in 1987 made him one of the very few writers to warn both US and Australian investors that a serious slump was imminent as well as warning of the property trust debacle in 1990.

Qualification ... Bachelor of Commerce (Uni of Queensland) Fellow of the Institute of Chartered Accountants in Australia, Associate of the Securities Institute of Australia. Former State President and Chairman of the Research Committee of the Australian Society of Secretaries. Previously qualified for membership of the Australian Institute of Cost Accountants and the Chartered Institute of Accountants.

The Australian Investors Association

A non profit organisation ... This national non profit organisation founded by Austin Donnelly in 1991 is the voice of the investing public. It is dedicated to getting a fairer go for investors through prevention and cure. On the prevention side it has issued over 30 Investor Alerts to warn investors of traps for the unwary and areas of serious deficiencies in information about various investments - including one in November 1993, a couple of months before the early 1994 market slump warning that share prices were at dangerously high levels.

World leader ... Despite limited resources it has many significant achievements to its credit and provides services which are not available in Britain the US Canada or New Zealand. It has helped to overcome the deep despondency of many retired people whose lives had been blighted by the failure of regulators to enforce the law.

How failure of law enforcement has enriched investment people and impoverished investors

Retirees standard of living slashed by large losses of capital

In the last ten years many thousands of citizens have suffered losses totalling billions of dollars in the share market crash of 1987 and subsequent downturns including the 1994 slump and in the unlisted property trust debacle of 1990-91.

In almost all cases the reason for those crippling losses often 50 per cent and more of capital was that many fund managers in prospectuses and advisers in recommendations to investors failed to meet their legal obligation of disclosing all material information. The nature of that duty and examples of material information that were not disclosed are discussed in pages 5 to 8.

Fund managers and advisers enriched by impoverishment of investors

The extent of this enrichment at the expense of the investing public can illustrated as under:

1. Many commission based advisers without any relevant qualifications or real experience in investment who not too long ago were selling real estate, life insurance, cosmetics or other products are earning well over $200,000 per annum.
2. Executives of fund managers are receiving remuneration of several hundred thousand dollars a year which in most cases would be several times the amount people of similar qualifications and ability would receive in other industries.
3. Fund management companies have been reporting earnings that are three to four times as great as the rate achieved by most listed companies.

These extremely generous financial rewards being earned by fund managers and their advisers were despite the fact that overall the industry added no real value because, with the exception of a small minority, most managers and advisers failed to do as well as the overall market average.

How inaction by the ASC encouraged flouting of the law

Advisers and fund managers found that no action was taken by the regulators in relation to their failing to disclose information about equity trusts in the 1987 share market crash. This encouraged them to then swing over to flouting the law by not disclosing that information in relation to property trusts in the period between 1987 and mid 1990. To the best of our knowledge there has not been one case of action taken against advisers or fund managers who failed to meet their obligations to disclose material information in those circumstances or in the later 1994 share market slump.

ASC surveillance concentrates on form rather than substance

The ASC surveillance of advisers' offices has to a considerable extent been completely futile in terms of seeing that they comply with the law. One reason is that the majority of time is spent on looking at matters such as compliance manuals, registers, training procedures and others. Though those matters are important up to a point, they pale into insignificance compared with the one vital question. That question is do the reports of advisers show that they met their obligation to disclose material information of the type discussed in pages 5 to 8. An effective investigator in selecting at random a few advisory reports would find that the practice in relation to medium risk investments such as equity trusts or property trusts is to simply list the benefits with little or no reference to the disadvantages, risks or other material information.

Attitude of regulators fosters a culture of concealment

To paraphrase the old saying "when ignorance is bliss, 'tis folly to be wise" the failure of the regulators to enforce the law encourages many fund managers and advisers to work on the basis that when it is far more profitable to conceal material information, 'tis folly to disclose it - especially when the performance record of the regulators shows that continued concealment of material information does not result in any action by them.

The way in which fallacies and myths become enshrined in the conventional wisdom

There is probably no other industry which would compare with the investment business in the area of so many widespread fallacies and myths becoming enshrined in the conventional wisdom. Some of the most dangerous of these fallacies include the claim that though share values move up and down, all will be well if you stay in for three to five years. Believe it or not this statement is now being made in prospectuses and in comments by advisers when the reality is that, at the very time they are making this statement, the share market is lower than it was almost nine years ago. Moreover there have been periods of up to 15 years in which the All Ordinaries Index and many equity funds failed to achieve any net sustained gain.

Another is that you can't go wrong in the so called blue chips or market leaders. But a glance at indices published in the financial press every day show that over the last 25 years the overall return on the 50 leaders has lagged behind the return on the rest of the market by about one quarter. In the 1974 slump the leaders declined by over 70 per cent compared with a decline of about 40 per cent in non leader stocks.

Claims made by fund managers and advisers that the expertise of managers will ensure a better return are false as the record shows quite clearly that most managers fail to do as well as the market average, partly because of the significant charges involved.

The regulators are aware, or should be aware, or could be aware from a short study of readily available figures and charts on market movements, that myths, fables and fallacies abound in the investment business. As they are charged with the duty of seeing that fund managers and advisers comply with the law, they should be constantly aware of the need for prospectuses and advice to include facts rather than fallacies and fables that have been become enshrined in the conventional investment wisdom. Nowhere does the law state or imply that material information means what happens to be the conventional investment wisdom or the flavour of the month in investment circles.

How the culture of concealment is developed

The regulators apparently accept as their standards for disclosure of material information what happens to be the consensus or the generally accepted practice in the investment industry. Apart from being in conflict with their duties to see that material information is disclosed, this attitude is completely contrary to what the Full Court of the High Court of Australia stated in the Rogers -v- Whitaker case (see page 6).

The present situation

Because this culture of concealment has developed and strengthened under the liassez faire attitude of the regulators, they are in effect saying this to the industry. "It is in order for you to conceal material information provided your concealment is no greater than what other industry people are concealing.

What the law provides about disclosure of material information

A summary of what the law provides in relation to disclosure of material information is set out below:

Fiduciary position of advisers

The common law duty of care owed by advisers to clients.

Corporations Law obligation to act honestly and fairly

To do this an adviser has a duty to give to clients all of the pros and cons of various investments the risks as well as the benefits. Simply emphasising the benefits with the full extent of the risk involved being ignored or downplayed is not adequate. So too supporting a recommendation by performance figures for a number of years, whether that period be three, five, ten or twenty years, without drawing attention to earlier or later periods in which the performance was vastly different is not an adequate disclosure.

Corporations law requirement to disclose all material information

As the result of the provisions of the Corporations Law there is a need for advisers to disclose to clients all material information. By making it an offence to fail to disclose material information of which they are aware or ought reasonably to be aware it is obviously not good enough for advisers to rely on what happens to be the popular conception in relation to investments, or to rely on information provided by others, or to include popular but incorrect statements, when a look below the surface would show that those statements are incorrect.

Examples of such incorrect statements include claims that you cannot go wrong in "blue chip" shares or prime property; that those investments are a protection against market decline; that all will be well in shares or property if you hold the investment for three or five years; or that investing in unit trusts managed by well known managers will enhance the safety of your investments and produce higher returns.

Material information includes the full extent of possible losses

Investment decisions basically involve weighing up possible benefits against possible risk, including risk of market fluctuations , and the degree to which individual investors can afford to expose their capital to those risks. Investors are entitled to know the full extent of risk involved which includes what, on the basis of past experience, is the worst capital loss that may be faced if markets are adverse.

By any reasonable standard, full information on possible risk constitutes material information which must be disclosed to clients.

Trade Practices Legislation

Some provisions of the Trade Practices Legislation also impose on advisers , as well as other parties, an obligation to see that adequate information is available to clients.

Disclosure of Risk

The wording of several Federal Court and High Court cases make it clear that vague general statements or statements which have the effect of half truths do not constitute adequate disclosure of risk - and that risk, i.e. the chance of a bad result, must be disclosed even if the probability of that occurring is very low. Some examples are shown below.

Chiabaragablio V Westpac Banking Corporation

It is not good enough to give an impression of even fluctuations about a horizontal axis when the record shows that there have been very severe declines with no complete recovery for several years .

Tannhauser V Westpac Banking Corporation

Disclosing to clients detailed figures for only a few years which were relatively favourable is unsatisfactory when the worst result in the past, which occurred only a few years earlier, could have been clearly portrayed by an example similar to one which was tendered in evidence by an expert witness called by the claimant.

Rogers V Whitaker

1. A failure to disclose a certain type of risk because that is the commonly accepted practice in the profession, trade or industry does not constitute the fulfilment of a duty of care.
2. A risk of a significantly bad result must be disclosed even if the probability of that result occurring is very low.

The impact of the legal provisions and wording of Court judgments

The impact of the matters above on the duty of fund managers and advisers could be summarised as under:

1. There is a duty to disclose all material information which includes information on the full extent of risk involved in terms of the worst loss that may be incurred on the basis of past experience.
2. That duty is there despite the fact that among a considerable portion of the fund managerial and advisory industry, it has been common practice for many years to conceal or fail to disclose a good deal of information about the extent of risk involved.
3. The fact that the permissive approach of the ASC has allowed many prospectuses to conceal much material information does not alter the duty of advisers to convey all material information, such as the material in the examples set out on the next two pages .
4. In any claim by investors for recovery of losses, a crucial element is whether all of the material information, including the following examples, was disclosed.

Examples of what should be disclosed - shares and equity trusts

Consideration of the above information shows that the material information which an adviser should disclose to clients should include the following :

Capital loss ... Though shares generally provide a better performance than other types of investments, periodical slumps have caused losses of up to 75 per cent for some leader stocks, about 45 per cent for non leader stocks and about 61 per cent for the All Ordinaries Index.

Duration of slumps ... Complete recovery from slumps has taken up to ten years.

Wide variations ... The long term average capital gain has been about 6.5 per cent to 7 percent per annum. But as many investors may experience results that differ from the average, the wide variation in results must be disclosed. Even over periods as long a five years, price changes have varied from a massive gain of over 330 per cent to a loss of 57 percent.

Long periods of no joy ... There have been periods of up to 15 years for the All Ordinaries Index and 23 years for the All Mining Index in which there has been no sustained net gain.

Market risk ... A spread of investments, either over a number of stocks or through a unit trust, can reduce one kind of risk, i.e. specific risk, namely the risk of serious loss through failure or serious problems faced by one company. But a spread of investments does not provide protection against the risk of an overall market decline, which has often been the major cause of bad results.

How results are affected by market position at time of investment ... Share markets, like other markets, have a tendency to regress to the mean, i.e. to return towards the long term trend rate of increase in values. History shows that periods of high capital gain have always been followed by periods of low gain, or a sideways movement, or capital loss. That has been so even if the period of relatively high gain has continued for 10 years, or 15 years, or 20 years. So a statement in a prospectus or in comments by an adviser which shows results for

a period of whatever length in which capital gain has been well above the long term average, without also showing results of lower gains or capital losses in earlier period, does not constitute disclosure of all material information.
Doubts about maintaining high rates of capital gain ... At a time when sharp price rises in a boom have pushed prices up to levels at which they are well above the long term average on such objective indicators as average dividend yield or in relation to the long term trend, advisers would be aware, or ought reasonably be aware, that there could be serious doubts about the ability of the market to maintain these high prices and a greater than normal probability that a market slump could occur. So advisers have a duty to convey that information to clients. If they have formed an opinion in good faith that for particular reasons the share market, despite objectively high prices, may continue to rise for some time ahead, that opinion could be conveyed to their clients. But they would also have a duty to inform clients of the facts which market history reveals, which are referred to above, so that clients may consider that material information as well as the opinion of the advisers.

Examples of what should be disclosed - property trusts

Property market risk ... Because there is not one centralised market, as in shares, which is the subject of daily media attention, the wide fluctuations in property market values may not be so apparent. But they are a fact of life because any investment that offers the prospect of capital gain through increase in market values, must also carry the risk of capital loss through market declines.
Extent of Capital loss ... Though property investments generally provide a better performance than several other types of investments, periodical slumps have caused losses of up to 40 per cent or more. Indeed decline in market values has been one of the major factors in many spectacular company failures.
Duration of slumps ... Complete recovery from slumps has taken up to several years.
Wide variations ... For most investors well timed and well selected property investments have produced good long term capital gain. But as many investors may experience results that differ from the average, the wide variation in results must be disclosed.
Distortion of Markets ... Over the last 20 years, property markets have been seriously distorted in a way which, for considerable periods, has resulted in an artificial inflation of market values and the price paid for units by investors in unlisted property trusts. This has resulted from valuations based on nominal rental values in lease documents rather than the much lower true rental figure because of the non disclosure to valuers of substantial incentives paid to attract tenants. The reported income of unlisted trusts has also been overstated because of the accounting treatment of these incentives.
Dual market risk for listed property trusts ... Investments in listed property trusts, as well as being exposed to the risk of property markets, are also, to a considerable extent, exposed to the risk of share markets on which they are listed.
Doubts about redemptions of unlisted trusts ... Because most of the capital was invested in illiquid assets there were significant doubts about the capacity of the unlisted trusts to continue redeeming units, especially because of the possibility that increased requests for redemption could coincide with a market slump.
Abrogation of rights to redeem ... In July 1990 the right of investors to redeem their units at any time was abrogated because of the effect of two factors. One was the decision of the regulators to allow trust deeds to contain provisions for the

suspension of redemptions. The second was the fact that, at that time, the deeds of most trusts could be amended without prior approval of, or notification to, unitholders.

Doubts about maintaining high rates of gain ... Property markets, like other markets, have a tendency to regress to the mean, i.e. to return towards the long term trend rate of increase in values. The record of the industry up to the mid to late eighties showed that of the public trusts which had been operating for more than 12 years, none had produced long term gain of more than about 4 per cent per annum compound. So there was a distinct likelihood that the high rates of gain of up to 15 per cent per annum compound which were reported by many newer less experienced trusts, were unlikely to be maintained. As a regression to the mean would mean a significant decline in value, this constituted a significant risk of loss of capital.

Market risk ... A spread of investment either over a number of properties or through a property trust can reduce one kind of risk, i.e. specific risk, namely the risk of serious loss through failure or serious problems faced by one property. But a spread of investment does not provide protection against the risk of an overall market decline which has often been the major cause of bad results.

Widespread failure of prospectuses to disclose required information

Almost complete failure to disclose

The situation would be serious if only a few prospectuses issued by fund managers failed to disclose the material information discussed in preceding pages. But the situation is that a perusal of hundreds of prospectuses issued by scores of of fund managers over recent years indicates that very few, if any, meet their obligation to disclose material information.

The culture of concealment has been developed to such an extent that the regulators seem to consider requests for them to ensure that material information is disclosed as a way out suggestion.

Failure to disclose impact of timing

Apart from the failure to disclose specific examples of information discussed in preceding pages, few if any prospectuses disclose the important point that timing has a very great impact on investments. For example, a five year investment made in September 1987 produced a capital gain of over 300 per cent, but a five year investment made in September 1987 resulted in a capital loss of 33 per cent.

Many recent prospectuses have endeavoured to make the point that timing does not matter by quoting the results for investments made at any time over the last 10 to 15 years. But what they fail to disclose is that the last 10 to 15 years overall have been unusually good and that extremely different results would appear if they used similar figures for the preceding 10 to 15 years.

Failure to warn of greater danger when prices are very high

In periods when prices have risen very high and a slump is a matter not of it but when, most prospectuses have failed to give any indication that shares or equity trusts which are normally a medium risk investment become a high risk investment under such circumstances. They fail to disclose the significant information disclosed by Vanguard Investment Group of the United States which is referred to on page 19.

Recent survey of prospectuses of leading fund managers

Recently a number of prospectuses issued by some of the largest and best known institutions show that there has been no improvement in the general position described above. Several of these prospectuses strongly implied that if investors stay in the share market for about five years all will be well - despite the fact that

at the time the prospectuses were issued the market was lower than it was eight to nine years ago.
Several of the prospectuses warned that share markets can be volatile in the short term. But they failed to disclose that shares and equity trusts have produced losses over periods as long as 15 years.

Concealment of material information is a thriving business
The above facts indicate that despite repeated requests by the Investors' Association to the ASC to ensure that fund managers in prospectuses met their legal obligation to disclose material information, the culture of concealment is going from strength to strength.

Widespread failure of advisers to disclose required information

In Appendix No. 1 on page 22 there is a copy of "Investors Voice", the newsletter of the Australian Investors Association, August 1996 issue. The checklist for deciding whether advice is adequate and objective contrasts the type of comments in reliable advice as distinct from that in unreliable advice in relation to a number of standards - the overall tone of comments, share investments, general reference to risk, direct investment compared with managed funds such as unit trusts, different risk qualities of various investments, negative gearing, protection against inflation, and the need for costly continuing management.
If the regulators were taking appropriate action against the very large number of commission based advisers who failed to disclose information, the information in the column headed type of comment in reliable advice would be seen in all reports. The sad reality is that because it is more profitable not to disclose that information and, by not taking action the regulators encourage the non-disclosure of that information, the vast majority of recommendations do not include that information.

Examples illustrate the very wide extent of concealment of material information
Over the last few years a large number of reports by many advisers throughout Australia have been examined by the Australian Investors Association and by me. They include wording which is used in standard reports by organisations with up to hundreds of proper authority holders employed by them. This means that over the last few years the type of inadequate information which we have examined would have been given to thousands of investors.
Typical of the completely unsatisfactory situation encouraged by laissez faire attitude of regulators is the following extract from the report of a well known investment advisory organisation. It is the only reference in the report which describes share investments or equity funds.
We recommend equity trusts and direct shares because of the long term benefits of investment in shares. Shares provide high returns and significant tax advantages from dividend imputation. They are one of only two asset classes which provide protection against inflation through growth in income and capital. Equity trusts and direct shares provide investors with a diversified, conservative portfolio of blue chip Australian companies. An attractive feature of Australian shares is franked income which receives favourable tax treatment.
You will see that there is no reference to risk, risk of loss of 40 per cent or more in periodical slumps, the fact that there have been periods of up to 15 years in which the All Ordinaries Index achieved no net sustained gain and other material information referred to elsewhere in this submission.

Almost complete absence of any reference to material information about the risk involved

We have seen many reports running to 20 or 30 pages in which the word risk does not appear once. In other reports it is glossed over by incorrect claims that it is minimised by expertise of fund managers or by holding investments for up to five years.

Regulators practice of heeding the industry but ignoring investors

Consistent record of favouring views of fund managers and advisers
There have been some commendable steps in the right direction by regulators in recent times. These are discussed on page 15. But in general the consistent record has been one of heeding the views of the industry, namely fund managers and advisers and almost completely ignoring the recommendations of investors and the wording in a number of Federal Court of Australia and High Court of Australia judgements.

Too close association with Financial Planning Association (FPA)
Though it is reasonable for regulators to receive and consider submissions from financial planners and fund managers, the Investors Association believes that the close association of the ASC with the FPA is not justified. One publication of the ASC stated that the FPA plays an active role in the development of ASC policies and practices. With due respect to the people of good will among the membership of the FPA, this is the reality . However well meaning they may be people deriving income from commission cannot truly be described as independent. As pointed out earlier in this submission, this means that their interests are not only different from investors, but to a considerable extent directly opposite of investors.
On page 13 there is a discussion of the need for the ASC to cease its role as joint publishers with the FPA of a booklet on the selection of investment advisers.

Fund managers and non disclosure of material information
It is obvious that in not requiring fund managers to disclose relevant material information in prospectuses issued by fund managers, the ASC has virtually ruled that common practice among product sellers is good enough for the regulator.

The tendency of regulators to drift into the role of advocates
Because of this close association with industry interests the ASC seems to have drifted, probably unwittingly, into the role of advocate for industry interests. An example of this is the response of the ASC in a letter dated 24th January 1994. The ASC stated that no action would be taken because the investments recommended by the adviser were popular at the time. It is no part of a regulators duty to condone the action of the adviser in failing to disclose relevant information as required by law just because the investments were popular at the time.
The fact is that, to the best of our knowledge, there has not been one case of action against the large number of advisers who failed to disclose a good deal of material information in relation to property trust investment. This seems to indicate that the ASC acts on the basis of weak industry excuses rather than whether advisers disclosed material information as required by law.

Lack of investors voice in advisory committee
The investing public is encouraged that the AIA and other consumer organisations are represented in the National Investment Liaison Committee recently set up by the ASC. But a great concern is that the voice of the investing public is not represented in the committee which advises the Attorney General on Corporations law. With due respect to the integrity of the individual members of that committee, the reality is that as a considerable number are fund managers or their advisers , their viewpoint tends to be that of the producer of investment products rather than the consumer.

The attempt by ASC Chairman to defend the culture of concealment

Comments at Senate Committee hearing

At a Senate Committee hearing last year, the Chairman of the ASC, Mr Alan Cameron, was asked why the ASC did not enforce the law by requiring prospectuses to include material information of the type discussed in this submission. His amazing reply was that the need to disclose that type of material information was only the view of Mr Donnelly and that if the ASC were to attempt to require such disclosure it would not be upheld by the courts because no other experts would support that disclosure.

What is material

The fact is that most if not all specialists who are in a position to be independent would provide expert evidence supporting the fact that the relevant information is material and should be disclosed. Some other specialists may offer contrary evidence but it would be unlikely to be accepted by the courts as they would not be independent because they have been the major beneficiaries of the culture of concealment by way of management fees, commisions or consulting fees.

Apart from holding a view which would find little if any support among independent specialists, Mr Cameron is in effect arguing that the information is not material. In other words he is saying that there is no materiality in facts such as these: that share market slumps have caused losses of 40 per cent of capital or more and have taken ten years to recovery, that price movements over five years have varied from a gain of 330 per cent or loss of over 55 per cent and that there have been periods of up to 15 years in which the market has achieved no sustained net gain. That view is illogical and indefensible.

How the ASC attitude differs from the law - See pages 5 to 8

How the ASC-industry view stands alone

The reality is that the only people who support the view of the ASC would be those who benefited to the extent of many millions of dollars and continue to benefit through the non-disclosure of that information.

No support for the ASC view by industry people facing litigation

In the last few years there has been a 100 per cent success rate in achieving satisfactory out of court settlements in cases for recovery from fund managers and advisers of losses due to non disclosure of material information. The parties who have agreed to settlement rather than defend the matter in court include:

- Two of the largest banks
- Some large financial institutions
- Very prominent investment advisers

So when their minds are concentrated by the prospect of having to appear in court, industry people do not support the ASC view but accept that of the courts, the AIA and the investing public and all reasonable opinions.

A copy of an article in the January issue of the AIA newsletter can be seen in appendix 2 of the submission.

Inaccurate statements in booklet of which the ASC is joint publisher

A booklet entitled "Don't Kiss your Money Goodbye" published jointly by the Australian Securities and the Financial Planning Association has been widely circulated. I have recently proposed that the National Investment Liaison Committee strongly recommend to the ASC that it withdraws joint publication of this booklet and draw the attention of the Financial Planning Association to many important statements in the booklet which are inaccurate or inadequate. The following is a summary of those items:

Independent advice ... The booklet fails to make the very important that for advice to be reliable, the first essential is that it be independent. It does not point out that the vast majority of investment advisers, including the majority of members of the Financial Planning Association, derive all or most of their income from commission. So the reality is that however good their intentions may be, people operating in that way cannot be described as independent because recommendations for or against certain types of investments can produce significant financial benefit or detriment to them.

Description of members of the FPA as professionals ... That statement is inaccurate because many members have had no professional training and before suddenly becoming investment "experts" were engaged in occupations such as selling sewing machines, real estate, life insurance, used cars or panel beating or other business far removed from the areas in which experience in investment matters can be obtained. Moreover, even those with adequate qualifications and experience who derive income from commissions, lack one important aspect of professionalism, namely being in a position to be completely independent.

Code of ethics and professional conduct ... The statement that FPA members must observe the FPA code of ethics and professional conduct is correct only in a superficial sense. While the contents of those documents are commendable, the reality is that their enforcement seems to leave a good deal to be desired. To the best of our knowledge the FPA has not taken any action against any one of the large number of advisers whose failure to disclose all material information has caused serious losses to investors over the last ten years.

Different and opposite interests of advisers ... The booklet fails to make the very important point that, as indicated earlier in this submission, that because of commission the interests of advisers are not only different from but frequently, directly opposite to those of investors Knowledge of risk ... The statement in the booklet that "you should be able to work out the risk associated with the investments recommended to you" is completely incorrect. To work out risks involves a knowledge of matters including he material information discussed in this submission. That statement is as illogical as it would be to say that a layman without any medical training should be able to work out the risks associated with brain surgery, cancer treatment or other involved medical practices.

Advisers as marketing arm for fund managers ... The booklet fails to point out a fact which has been widely commented on in the financial press, namely that to a considerable extent many advisers are the marketing arm of fund managers. This has led to the almost universal recommendation for investors to invest through unit trusts on which advisers may receive remuneration of several thousand dollars for a few hours work rather than invest directly in shares from which they would receive little or no commission. In addition to commission other benefits, including overseas trips and lavish entertainment at sporting events are other factors which lead some advisers to reflect the views of the fund management industry rather than an independent assessment. The fact that the reports of the FPA indicate that about 40 per cent of members are associated with fund managers is also relevant.

Misinformation, integrity of markets and the Reserve Bank

Effect on integrity of capital markets

Though the main thrust of this submission is an attempt to achieve a fair go for investors by enforcement of the law, many of the issues raised have broader implications in terms of the integrity of capital markets. As this is an area of considerable interest to the Reserve Bank of Australia, we would suggest a more active role by that institution.

Council of Supervisors not sufficient

The role of the Reserve Bank in the Council of Supervisors is commendable. However it would seem that the Reserve Bank has probably been assured by the regulators of the investments, namely the ASC and the ISC that all is well in supervision of investments when this submission shows clearly that this is not the case.

Serious lack of confidence in regulators by the investing public

Because of the failure of the regulators to enforce the law in relation to investments and their virtual role as an advocate for industry interests in relation to complaints made by investors, there is among the investing public an almost complete lack of confidence in the regulatory system. This should be a matter of extreme concern to the Reserve Bank of Australia.

Allocation of resources

Capital markets play a crucial role in the allocation of resources in the economy. If resources are to be allocated efficiently and if the economy is to work effectively, then decisions in capital markets should be based on sound information. Instead they are based to a considerable extent on inaccurate, inadequate and misleading information. As one example of this, the billions of dollars which poured into unlisted property trusts some years ago was primarily the result of the culture of concealment manifested by inadequate and inaccurate information in prospectuses and advice which was virtually sales talk for the particular investments without any reference to the risks involved. This would have led to making the boom in property, and indeed in the whole economy, much stronger in the latter years of the last decade and the recession that followed much worse.

The need for a more active role by the Reserve Bank

If the Reserve Bank has issued statements warning of these excesses and of the fact that markets invariably regress to the mean and that in booms prospects of a serious slump had been greatly increased, it may not have had to go to the extent of increasing interest rates so much in combating the slump caused to a considerable extent because of misinformation in capital markets.

Though the Reserve Bank may consider that it is not its business to intervene in areas which it would see as the responsibility of other organisations such as the ASC, it should seriously consider this question. Is the billions of dollars unnecessarily lost by investors who were not given the facts with resultant worsening of the early 90's slump too large a price to pay for professional reticence?

Some recent commendable action by regulators

In a submission which unfortunately has to concentrate on the failure of regulators to enforce the law and the way in which they have encouraged the development of the culture of concealment, we would like to place on record our appreciation of some commendable steps which have been taken by the regulators in recent times.

ASC Advisory Committee

The Australian Investors Association and the investing public were very pleased at the decision by the ASC to set up the National Investment Liaison Committee which comprises representatives of consumer organisations, including the AIA. We hope that this will ensure prompt action by the ASC to remedy problems brought to their attention by that committee. For example, if that committee agrees with our view that the ASC withdraw from its role as joint publisher of the booklet discussed on page 13, prompt action in that area would be a very significant step forward.

Other action by the ASC

There have been a number of recent cases in which the ASC has taken strong action against advisers or property authority holders. There have been a number of cases in which they have also arranged for investors to be reimbursed for their losses. One particularly commendable action in recent times was the action taken against a large institution and one of its property authority holders in relation to negative gearing investments recommended in most inappropriate circumstances. We would hope that this may be followed by action against advisers, including many leading organisations, whose recommendations are virtually nothing more than sales talk with no disclosure of material information.

The ISC

Most of the comments in this submission refer to the lack of action by the ASC in relation to failure of prospectuses and investment advice to disclose material information as required by law. To some extent the same problem arises in the area of the ISC in relation to disclosure of material information in investment bonds provided by insurance companies and in superannuation.
In the latter area we would like to place on record our appreciation of a number of steps taken by the ISC in relation to publication of documents clearly setting out the obligations of trustees, particularly in do it yourself superannuation funds and the corrective actions that have been taken in many cases.

ASC and ISC harmonisation of practices

The AIA and the investing public appreciate the steps taken by the ASC and the ISC to harmonise their position in many areas.

Need for changes to the law in some cases

Main problem is enforcement of the law

The main thrust of this submission is that there is no need for extensive changes to the law. What is needed is that the law is enforced. This does not involve any extension to the powers of regulators or any increase in resources for the regulators.
What we are suggesting is realistic enforcement and a more practical outlook. For example in surveillance visits of the ASC about a third of the time now spent on the less important matters of form, registers, compliance manuals, etc., could be directed to examining what advisers are telling clients, is the enforcement action which is needed. But there are some areas in which changes to the law are needed. These are discussed below.

Independent audits

The AIA has recommended to the former Attorney General that for reliable financial statements there is a need for truly independent audits. Currently auditors are not truly independent because their remuneration is set by the directors of the company. In practice, though not in theory, they are appointed by the directors. The AIA strongly believe that the only way in which independence

can be achieved is an amendment to the law to require that auditors be appointed by and responsible to a public authority, that they cannot derive income from consulting work for audit clients, and that no auditor or firm should be auditor of a public company for more than four consecutive years.
In no other area does the community accept a situation where those inspected have the right to appoint the inspectors and it is not good enough in the area of public companies.

More democratic election of directors
The AIA recommends that to ensure that the views of minority shareholders are reflected on the board, directors be elected by a system of cumulative voting and that all directors come up for re-election every year. Under cumulative voting a minority holding 10 per cent of shares could be assured of getting its nominee onto the board if there were ten directors to be elected. By contrast, under the present system a minority holding 49.99 per cent of the votes could fail to get any nominee on the board unless the majority holders agreed.

Cease and desist orders
To ensure that malpractices once discovered are not allowed to continue for some time while legal processes are conducted, we believe there should be amendment to the law to give power to the ASC and the ISC to issue cease and desist orders when necessary. We understand that such a provision exists in legislation in relation to AFIC.

Consumer representation on statutory advisory committee
The Corporations Law should be amended to provide that the committee which advises the Attorney General on Corporate Law should include at least 40 per cent representation from community organisations, including the Australian Investors Association.

Need to extend requirements for disclosure to real estate industry

Present situation
Though for reasons outlined in this submission the enforcement of the law in many areas is not effective, the fact is that in relation to investments in shares or prescribed interests such as unit trusts and life insurance products, in other words all of the investment products which come under the surveillance of the ASC or the ISC, there are requirements in relation to disclosure of information and other matters in the interests of investors.
But there are no similar requirements in relation to people who are selling or recommending real estate investments. Indeed in the process of their work, many of the people who sell or recommend real estate investments are also giving advice in relation to other investments which come under the control of the ASC or the ISC. For example, in recommending investments in real estate or negative gearing into real estate, these people advise against investing in shares or unit trusts, investment bonds of life insurance companies, superannuation and other investments products by pointing out the alleged deficiencies of these investments compared with the superior qualities of the real estate investments which they are recommending.

Extent of the problem
This is a very great problem especially as people under virtually under no legislative control who recommend real estate investments and negative gearing in that area have the benefit of exploiting very serious myths and fallacies which are very widely believed - e.g. the fact that real estate investment is superior because it is an investment in bricks and mortar whereas other investments are in little bits

of paper, that real estate values never go down, that location is all important and timing does not affect real estate investments in the same way that it affects shares and other investments.

In recent years very large amounts of money have been lost by investors persuaded to go into negative gearing real estate investments on the basis of false claims such as those referred to above. Moreover they have not been given material information on how the multiplication effect of negative gearing multiples losses as well as gains and there is a risk that losses can exceed 100 per cent of capital.

One regulator or several?

The case for one regulator

The problem discussed on the previous page concerning people selling real estate not being subject to the same legal requirements as those involved in promoting or advising on other investments comprises a good argument for one regulator who is responsible for investor protection in relation to all types of investments. That argument was strongly advanced several years by one of the best know figures on the American investment scene, namely Dr H Kaufman.

The need for the Reserve Bank to be more actively interested in the type of information that is available about capital markets is also an argument for one regulator to supervise the functions now carried on by the ASC, the ISC, the AFIC, the State regulators of the real estate industry and regulators of other investments such as franchises.

Arguments against one regulator

The main argument against the concept of one regulator is that the regulators of specific sections of the capital markets have experience and expertise in those areas which one "super" regulator may lack.

It is possible that people more familiar with the detailed operations of the Reserve Bank may also argue that their functions are so specialised that it is important for the Reserve Bank to be left to carry out its present functions without having their attentions diverted to other areas.

The possibility - the Reserve Bank and one regulator of all other investments

Another possibility which could well be the most practicable would be for the Reserve Bank to continue its present functions with one "super" regulator to regulate all of the other investment areas referred to above. If this system were to be adopted it would be important for the Reserve Bank, for the reasons outlined on page 14, take a more active interest than at present through its activities on the Council of Supervisors.

A matter of priorities
However desirable it may be to reduce the number of supervisors, that is far from the top priority in the area of regulation of the investment business. As indicated earlier in this submission, there is an urgent need to require that the current regulators enforce the law. This does not involve, with two or three exceptions, the need for any change to the law nor the greater devotion of any allocation of resources to regulators. All it calls for is that regulators enforce the laws, bring an end to the culture of concealment and concentrate in surveillance on matters of substance rather than form.

Enforcement of regulation should not be deferred pending other decisions
Time taken for consideration of questions such as whether there should be one supervisor for all investments should not be allowed to delay the action to ensure that laws are enforced and that regulators regulate effectively. The impoverishment of the investing public and the enrichment of investment industry people with the regulators encouraging fund managers and advisers to flout the law has already gone on for far too long.

Prospectus of leading US Fund shows how to disclose material information

Example of Vanguard Group prospectus
The fact that the type of disclosure advocated in this submission is consistent with successful management of funds can be seen from the following extract from a prospectus dated 26th April 1996 issue by Vanguard Balanced Index Fund managed by Vanguard Investment Group.That Group is the second largest mutual fund manager in the US.
Investment Risks
"As with any investment program or, the Fund entails certain risks. As a mutual fund investing 60% of its assets in common stocks, the Fund is subject to stock market risk - i.e., the possibility that stock prices in general will decline over short or even extended periods. The stock market tends to be cyclical, with periods when stock prices generally rise and periods when stock prices decline.
To illustrate the volatility of stock prices, the following table sets forth the extremes for US stock market returns as well as the average return for the period from 1926 to 1995, as measured by the Standard and Poor's 500 Composite Stock Price Index. (The Standard and Poor's 500 Index is shown here, because the S&P Index, unlike the Wilshire 5000, has been in existence for all of the periods shown.)

Average Annual US Stock Market Returns

(1926 - 1995)

Over various Times Horizons

	1Year	5 Years	10 Years	20 Years
Best	+53.9%	+23.9%	+20.1%	+16.9%
Worst	-43.3%	-12.5%	- 0.9%	+ 3.1%
Average	+12.5%	+10.3%	+10.7%	+10.7%

As shown, common stocks have provided annual total returns (capital appreciation plus dividend income) averaging +10.7% for all 10 year periods from 1926 to 1995,

The return in individual years has varied from a low of -43.3% to a high of +53.9%, reflecting the short term volatility of stock prices. Average return may not be useful for forecasting future returns in any particular period, as stock returns are quite volatile from year to year. (Moreover, because the Fund invests in common stocks in the Wilshire 5000, which includes large, medium and small capitalisation companies, the Funds stock holdings may be more volatile than the results shown here.)
The wide variation in share market results over a 10 year period from minus 0.9% to plus 20.1 per cent per annum is the type of fact which the culture of concealment in Australia hides from the public.

Warning that high share prices mean increase risk
In February 1996 the Vanguard Investment Group issued a bulletin to all its investors. Entitled "Realistic Expectations for Stock Market Returns", it included comment on the long term volatility of stock reflected in the above figures. It went on to point out that bear markets are part of investing and demonstrates that though a rate of stock return for the next 10 years could not be precisely forecast, a reasonable range of probable returns would risk.
A copy of this bulletin is included, with the approval of Mr Jeremy Duffield Chief Executive Officer Vanguard Investment Group Australia Ltd in appendix 3.
Why self regulation will not work

Discussion about FPA becoming a self regulatory organisation
For some time there was a good deal of public discussion about the regulation of the investment advisory industry being delegated to the Financial Planning Association. That was an extreme concern to the investing public and the Australian Investors Association. This was particularly so when, through joint publication of a booklet and the statement by the ASC that the Financial Planning Association played an active role in the development of ASC policy and practices, the investing public saw the ASC as being unduly influenced by the financial planning orgainsation (and by the fund managers) while it was continuing to ignore the voice of the investing public, namely the AIA. Moreover it was continuing to ignore the wording of several Federal and High Court judgements to which reference has been made earlier in this submission.
Again with due respect to honourable people of good will in the Financial Planning Association, the point has been made earlier that the vast majority of members of the Financial Planning Association have interests which are different from, and to a considerable extent opposite to, those of investors because their income comes from commission.
Moreover to the best of our knowledge no action has been taken by the Financial Planning Association against the large number of its members who failed to disclose material information which led directly to losses of billions of dollars by investors.

The weakness in the concept of self regulation
The record of self regulation in other areas, such as the legal and accounting professions, leaves a good deal to be desired. For example, the investing public is perplexed by the apparent failure of the accounting profession to take any action against auditors of some public companies who gave unqualified reports on financial statements which portrayed a situation far removed from reality. With human nature being what it is, there will always be serious inhibitions in the attitude of any self regulatory organisation to take the sort of action against other members which may be warranted in the public interest.

Is self regulation an extension of the ASC obsession with "facilitation"
The ASC Chairman has often been reported as saying that he sees the role of the ASC as being "business facilitators". To the extent that being a business facilitator

involves cutting red tape and streamlining procedures, it is commendable. It is quite obvious that the record shows very clearly that failure to grasp the nettle in enforcing the law against influential fund managers and investment advisers, apparently as part of business facilitation, represents a failure of the ASC to fulfil its primary duties as a law enforcement agency. Unfortunately rather than being proud of their role of facilitators, the ASC should admit that in the last 10 years they have facilitated a massive plunder of the investment public by a large number of fund managers and investment advisers.
In effect, rather than enforce the law, they have set up their own ASC law which has superseded the law made by the legislators. In effect they have said to the investment industry; "The law requires you to disclose material information, but, in the words of a former political person, don't you worry about that. We're not going to enforce the law and if you find it more profitable to conceal material information go right ahead because we will not take action against you as long as you do not conceal more than the rest of the industry."

Recommendations
General nature of recommendations ... The nature of the recommendations relate to the need for the ASC and ISC to ensure that the law is enforced and to end the culture of concealment in which fund managers and advisers are allowed, in fact encouraged, to conceal material information which the law requires them to disclose.
Direction by government where necessary ... As the enrichment of people in the investment industry and the impoverishment of many investors continued several years after the previous government was asked to direct the ASC to ensure that material information was disclosed, that the Attorney General should use his powers to direct the ASC when necessary if the situation is not remedied within a very short time.
ASC created law not good enough ... The government should inform the ASC that its practice of replacing the law of the land by ASC created law must cease. The ASC should be instructed by the government that it must cease its practice of creating law in two ways - firstly by not enforcing the law which encourages industry people to flout the law and secondly its promotion of the culture of concealment based on its interruption of the law which differs from what the legislation provides and what the courts have stated (see pages 5 to 8 and 12).
Surveillance by ASC ... As the present practice of surveillance which concentrates almost entirely on matters of form such as compliance manuals etc and ignores the reality of what fund managers and advisers are failing to tell their clients has been a multi-billion dollar failure the ASC should be instructed that their reluctance to be prescriptive is inconsistent with their duty of enforcing the law.
Changes to the law ... The changes to the law which we recommend relate to the appointment of auditors, more democratic election of directors and power for the ASC and the ISC to issue cease and desist orders and consumer representations on the committee which advises the Attorney General on Corporations Law (see page 16).
Other specific recommendations ... Other recommendations which we make are as under:

· That assuming the present system of regulation were to continue that the Reserve Bank should enquire into what has really happened in the investment world in terms of the culture of concealment rather than accept through the Council of Supervisors a picture portrayed by the ASC which is unrealistic.

· The requirements for disclosure which apply to investments regulated by the ASC and the ISC should be extended by appropriate legislation to the real estate industry.

· Under no circumstances should self regulation be introduced, particularly any self regulation which would give self regulatory powers to an association of investment advisers the majority of whom operate on a commission basis and whose interests are different from and indeed directly opposite to those of investors. (page 20)

Appendix One (referred to on page 10 of submission)

The Investors' Voice - August 1996

Recommendations

Appendix Two (referred to on Page 12 of submission)

Complete turn around in situation of aggrieved investors

Successful settlements provide platform for future justice

Appendix Three (referred to on Page 19 of the submission)

Realistic Expectations for Stock Market Returns

Need for changes to the law in some cases

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