CHAPTER 7: DISCLOSURE AND DISTRIBUTION REQUIREMENTS FOR LIABILITY PRODUCTS

7.0 INTRODUCTION

This chapter examines in broad terms the product disclosure and distribution requirements for liability products. Apart from bank deposits, these products have traditionally been provided by non-bank financial institutions. Chapter 8 discusses - again in broad terms - the disclosure approach that is, or will be required through the Consumer Credit Code, for asset products in the retail sector. Both chapters focus on the need for a more targeted and orderly basis for disclosure and distribution regulation.

Consistent with the National's broad approach to a single supervisor, it recommends that all consumer regulation be placed under the single entity as detailed in Chapter 6. (The potential difficulties of achieving this in relation to State and Territory legislation is discussed in the next chapter.)

7.1 DISCLOSURE REQUIREMENTS

7.1.1 The Current Position

Dealing first with product disclosure requirements, in general terms, the current regulatory regime applying to financial services products is based on the type of institution that offers the product, rather than an assessment of the specific nature of the product itself. As a result, the disclosure requirements, for example, in retail banking, life insurance, superannuation and unit trust products are governed by the different legislation that applies to banks, life insurance companies, superannuation trustees and unit trust managers respectively.

As matters have developed under the current system, depending on the nature of the institution, the "content" of the disclosure requirements, and the applicable regulator, can also vary significantly.

By way of example, Appendix 5 summarises the key legislative regimes, regulations and requirements that currently apply to the "point of sale" prospectuses/offering documents for retail financial services products offered by banks, life companies, superannuation trustees and unit trust managers. It also describes in broad terms the nature of the requirements under each regime.

It is also worth noting that the same differential treatment applies to "ongoing" disclosure requirements for these products, for example, annual reporting requirements and benefit payments.

7.1.2 The Problems

The National offers products across the full range of financial services outlined in Appendix 5. The current "institutional" system of regulation that has evolved can result in products that are similar in nature being disclosed in a range of different ways. This is neither justified from a customer perspective, nor cost efficient from a business perspective.

To illustrate how the current model causes products that are very similar in what they provide to the customer to be disclosed in a variety of different ways, it is useful to compare unit trusts and investment linked life insurance without guarantees.

Both unit trusts and investment linked life insurance products without guarantees could broadly be described as non-guaranteed wealth creation products. In general terms, there are no actuarially managed or sophisticated minimum solvency requirements. Rather, the investor essentially receives the market linked value of their investment.

However, as can be seen from Appendix 5, the disclosure requirements which apply to these products are distinctly different. Unit trusts are required to have prospectuses pre-registered with the Australian Securities Commission which meet the general disclosure test under the Corporations Law, with significant penalties under that law for non-compliance. Investment linked insurance products are required to have a disclosure document meeting the more prescriptive guidelines set out in the ISC Circular G.I.1 (including detailed standards as to

disclosure of the key features of the product), which as noted in the Appendix at this stage do not strictly have force of law.

Since the jurisdictions of each regulatory body tend to overlap, a number of laws can apply to a single product. Indeed, as can be seen from Appendix 5, this is the case in many instances. In some cases, the position is particularly difficult, for example life-based superannuation products, which are subject to three sets of regulation. These regulations can, and frequently do, involve different legal criterion and can be inconsistent.

Furthermore, the involvement of multiple regulators, or in the case of the Insurance and Superannuation Commission, different departments of the same regulator (e.g. life group vs. super group) can lead to conflicts and anomalies. A recent example of this was seen in the issue of the ISC's s153 determination (supergroup) and Circular G.I.1 (life group), where there were considerable difficulties in ascertaining in many cases how they applied to life based super products, with the result that certain products have to comply with both sets of requirements.

These difficulties are compounded by the fact that, as described in earlier chapters, there can also be different and inconsistent prudential/structural and advice rules, which can impact on what is disclosed.

In the National's experience, these problems result in a more costly, less efficient financial services sector, with resources concentrated unnecessarily in dealing with additional compliance costs and duplication.

The National offers both unit trust products and investment linked products (which have a different taxation treatment). However, because of the different disclosure rules, the National is required to have different due diligence and compliance procedures in place for the issuing of the respective offer documents for what are, from the consumer's perspective, fundamentally similar products.

The inconsistent treatment of what are essentially the same products can mean that institutions are placed in an advantageous (or disadvantageous) market position on a basis that has no connection with the relative merits of the products.

The National acknowledges that the regulators have recently tried to achieve greater consistency. However, as has been described, there are still considerable differences. The lack of consistency between different regimes does nothing to assist consumers in understanding the nature of what is being offered to them.

In considering the content required by the disclosure requirements themselves, we are of the view that highly prescriptive requirements, such as those under the SIS legislation and ISC Circular G.I.1 described above, involve unnecessary compliance costs and encourage a "checklist" approach, rather than focus on what investors should be told with regard to the nature of the product.

This view is consistent with that of various committees involved in the formulation of the Corporations Law - with its move away from the more prescriptive requirements under the Companies Code. While the more prescriptive requirements under the new rules introduced recently by the Insurance and Superannuation Commission are perhaps explicable for historical reasons, they are not the approach that should be adopted moving forward to a consistent disclosure regime across all products.

As a final comment, the current laws need adjustment to facilitate advances in technology - for example, the ability to issue electronic prospectuses on the internet.

7.1.3 What should be the key drivers?

In determining what should be the future direction of the disclosure requirements it is important to identify the key "drivers" for an appropriate disclosure regime for financial services products. In the National's view, they should include the following general principles:

- Customers should not have to deal with inconsistent and complicated regulatory regimes when purchasing financial services products.

- Product disclosure must be:

- understandable,
- consistent across different products, and
- provide sufficient understanding of product features to enable an ability to compare between products.

- The new disclosure rules should recognise advances in technology including "electronic" commerce and prospectuses on the Internet.

- There should be a requirement for disclosure that helps consumers understand the prudential position of the institution offering the product for the purposes of general education (current laws do not address this issue).

7.1.4 What should be the future direction?

In the National's view, four general principles should underpin the future direction. These are:

- The product disclosure regime for retail financial liability services should be product rather than institutionally focused. This should help the key consumer driver of consistency across different product types.

- There should be a single supervisor to administer product disclosure.

- There should be consistent tests applying to product types across all institutions. Again, this will help the key driver of consistency of information. It should also have the secondary benefit of reducing compliance costs.

The test should consist of "two tiers" with respect to the level of information provided in its application to relevant products.

The National considers that the prudential requirements justify that for fixed price style products offered by core institutions, there should be a reduced disclosure requirement consisting of:

- the type of product;
- the cost of the product, including fees; and
- guarantee details (if any).

Also included in this category would be the products of non-core institutions, where they provide a "capital guarantee" **for which the regulators require capital backing at similar levels to a core institution** (currently, building societies, credit unions and the new providers under the Life Office Act).

The second tier products e.g. other savings products of life companies, unit trusts and risk products should meet a broader general "prospectus style" test.

The disclosure tests should also accommodate advances in technology for the dissemination of information (e.g. electronic prospectus).

There will need to be recognition of the distinction between "wholesale" and "retail" investors. What investors qualify as wholesale or retail will need detailed consideration. It should have regard to matters such as the monetary size of the transaction, the nature of the risk being faced and the nature of the investor (that is whether in broad terms they can be considered an "institutional" investor eg, super fund trustees).

- There should be a short (1 page) notice for all institutions (to be displayed in branches or on electronic delivery platforms or, with contract, if no physical/electronic network exists) showing the following:
  - credit rating,
  - capital/reserves,
  - cash and near cash,
  - ownership structure,
  - for core institutions impaired assets, and
  - a reference to seek further information if needed.

7.2 DISTRIBUTION REQUIREMENTS

7.2.1 The Current Position

In considering distribution requirements (again in general terms), the current regulatory regime applying to financial services products is based on the type of institution that offers the product, rather than an assessment of the nature of the product itself.

Also under the current system, the nature of the requirements can differ significantly, depending on the nature of the institution.

Appendix 6 summarises the key legislative regimes, regulator and distribution requirements that apply to the sale of retail financial products offered by banks, life companies, superannuation trustees and unit trust managers.

7.2.2 The Problems

The National sells products across the full range of financial services described above. The "institutional" based system of regulation leads to both advice being provided, competency standards and any complaints being dealt with, in a range of different ways which is neither justified from a customer or compliance/cost perspective.

An example of this which can be seen from Appendix 6 is again the position of unit trusts and investment linked life insurance products without guarantees.

In the case of unit trusts, advice is not mandatory. However, if it is given, it must meet the "know your client" rule standard. These products must be sold through licensed dealers, investment advisers and their representatives.

For investment linked insurance products, the sale must broadly be through an agent of the insurance company or a licensed insurance broker. The sale is subject to the prescriptive requirements under the Life Insurance Code of Practice (which again currently does not have the force of law). Advice is now broadly mandatory unless the client chooses not to have

advice. Complaints may be dealt with through the self-regulatory life insurance complaints board.

In the National's experience, these differences in regulatory approach can again result in more costly and less efficient provision of advice to consumers. From a cost perspective, resources are expended unnecessarily on compliance costs associated with ensuring that the requirements of the different regimes are met.

Again, there have been significant endeavours in recent times by the regulators to achieve greater consistency - for example, the draft ASC/ISC paper on the regulation of investment advice. However, as the law currently stands, there are considerable differences in the regulatory requirements.

7.2.3 What should be the key drivers?

In the National's view, the key drivers in determining the future direction of the distribution requirements for financial services products should include the following general principles:

- Customers should have access to advice when they require it;
- The advice should be tailored to meet their needs;
- Providers of advice should be subject to appropriate regulation and, in particular, consistent competency standards to match the advice provided;
- The new distribution rules should recognise the advances in technology and electronic commerce; and
- Customers should have access to an effective and cost effective complaints mechanism.

7.2.4 What should be the future direction?

After examining problems under the current regime and what should be the key drivers for distribution, the National believes that nine general principles should underpin the future direction. These are:

- There should be a consistent set of principles governing the distribution of financial services products;

- Consistent with our comments in Chapter 6, there should be a single supervisor responsible for the distribution of financial services products;

- Persons providing advice need to be suitably qualified and trained with regard to the nature of the advice and the products they are selling - that is, a hierarchy of training along similar lines to that underpinning the tiered approach to "disclosure";

- Advice should not be mandatory. Customers should be able to choose whether or not they want advice;

- If advice is provided, it should be appropriate to the circumstances of the customer and the product being sold;

- The adviser must act in a consistent capacity in relation to its sale of products. An adviser must disclose the capacity in which it acts to clients;

- Liability for advice will depend on the capacity in which it is given and rest with the distributor rather than the product manufacturer;

- There should be a single complaints mechanism to deal with consumer complaints for financial services products; and

- There should be one set of remedies and penalties in relation to misconduct by distributors, whatever the product being sold.