



Australian Investment Managers' Association

Australian Investment Managers' Association

AIMA is the industry association for the major investment management organisations in Australia. It represents 62 member companies which manage \$300 billion of assets for around 10 million consumers (at December 1995). Its mission is to advance the integrity and efficiency of the Australian capital markets to the benefit of all investors.



Investment Funds Association of Australia

IFA is the industry association for professional managers of unit trusts and other investment funds. The 55 members manage \$130 billion of assets for around 2.5 million unitholders (at December 1995). IFA aims to build public confidence in the managed investment funds industry by providing positive leadership and support to its members.



Life, Investment and Superannuation Association of Australia

LISA is the industry association representing the life insurance, investment and superannuation interests of its 38 member companies, who currently manage in excess of \$116 billion of assets on behalf of around 10 million customers. Its objectives include promoting the benefits to Australia and to consumers of long-term saving, particularly through managed funds and creating and sustaining a positive profile for the industry.

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Executive Summary

Criteria for an Improved
Regulatory Regime

Current Regulatory
Model

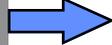
Proposed Regulatory
Model

Summary of International
Experience

This submission presents the views of AIMA, IFA and LISA in response to the Wallis Inquiry's call for submissions

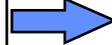
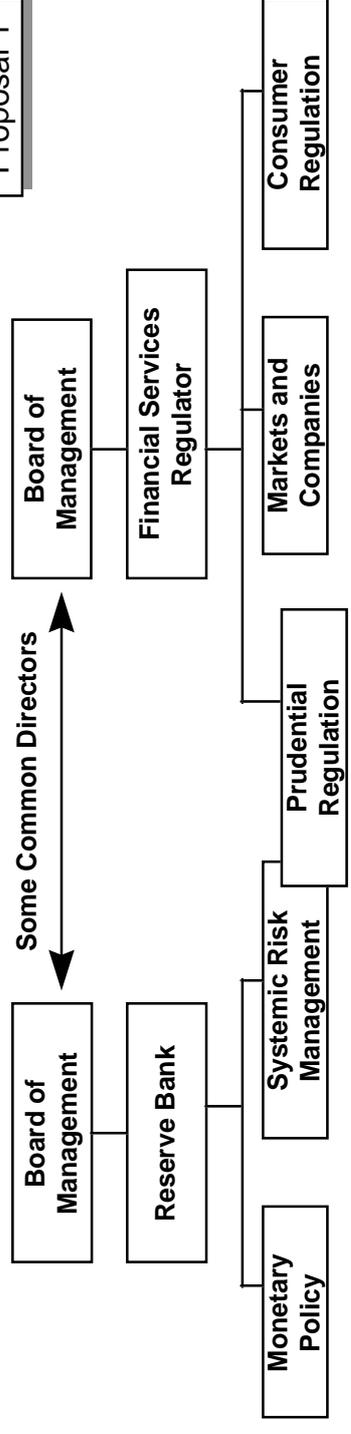
Mission of the Inquiry

"The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness"



We propose that the Reserve Bank retain responsibility for managing systemic risk and the integrity of the payment system. All financial services businesses will be supervised by a single governing regulator - the Financial Services Regulator. Overlapping responsibilities will need careful management between the two bodies; this will require significant input by the Reserve Bank to the prudential supervision of major deposit taking institutions.

Proposal 1



15 proposals discussed
beginning on page 26

Five key issues have emerged from our analysis that will ensure an efficient, responsive, competitive and flexible system that encourages saving

Key issues

Consistent and minimal regulation

The customer should not have to deal with a variety of inconsistent and complicated regulatory frameworks when buying financial products. The current framework has different prudential, disclosure and advice rules for the same product from different institutions - minimising regulation reduces costs and makes Australia internationally competitive.

Organisational responsibility

Organisations must accept more responsibility for their actions as opposed to blindly following “black letter” law. They should be free to make commercial decisions and be accountable for them. Health warnings may be required on certain products. Complaint mechanisms with ‘teeth’ will ensure fair treatment.

Focused supervision

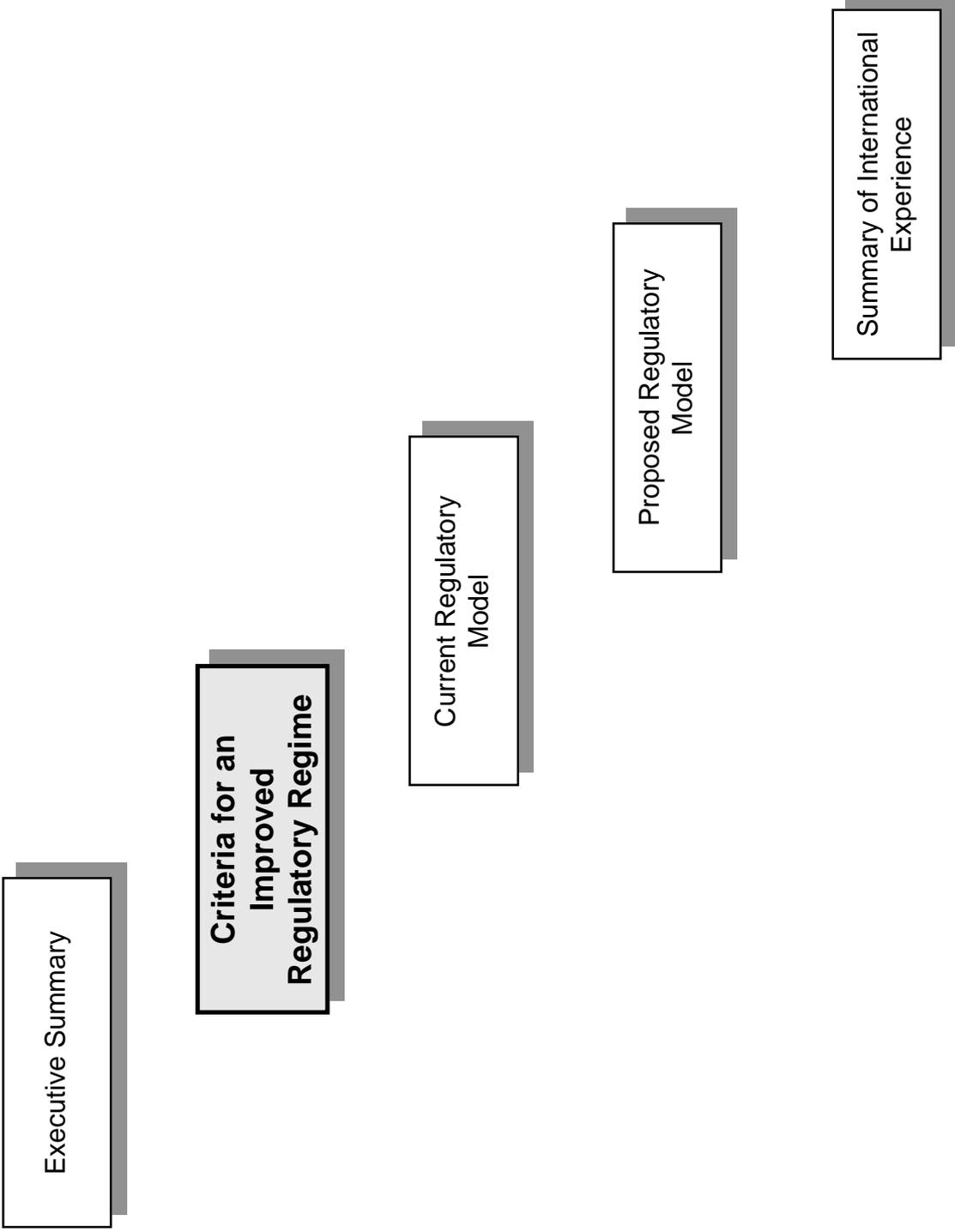
The Government has a limited budget to spend on supervision. This should be focused on organisations with the weakest capital ratios or those producing high risk products. We should recognise more clearly than we do at present that shareholders have a self interest to be vigilant in supervising their companies.

Informed buyer responsibility

The consumer will have access to regulated and unregulated products. A simple, consistently applied disclosure regime across all financial products is needed. A succinct disclosure statement should be the benchmark. There are many examples of no disclosure in financial transactions e.g. deposits, lottery tickets/TAB, home and car purchases, financial products on the Internet etc.

A focus on higher savings

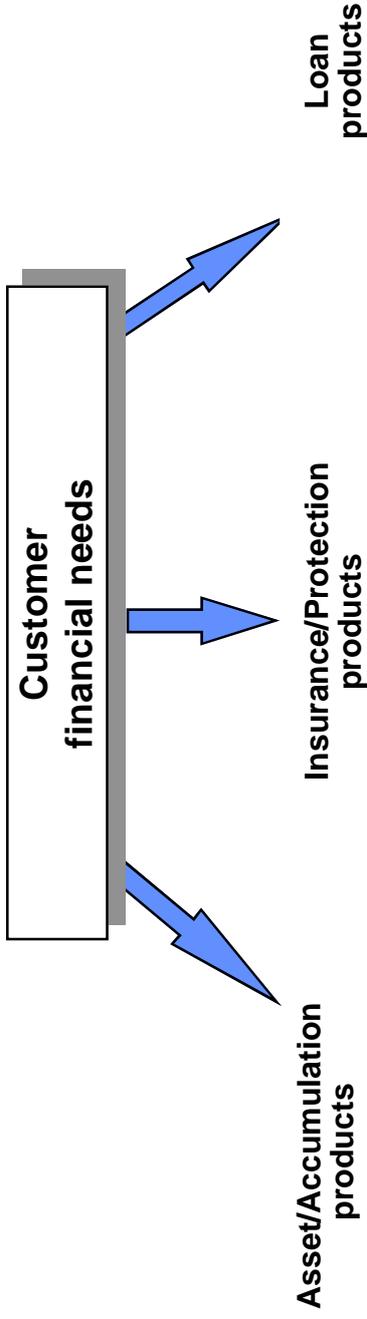
We need to re-establish a savings culture in Australia. The contradictory and complex regulatory system for financial products is an impediment to savings. So too is the Australian taxation system, and its interaction with social welfare. A major reform project is needed.



Criteria for an improved regulatory regime - The Customer comes first!

- 1 The Customer should not have to deal with a variety of inconsistent and complicated regulatory frameworks when buying financial products**
- 2 There is an urgent need (for the Government) to re-establish a savings culture in Australia**
- 3 Customers need confidence to manage their financial affairs effectively in a complex financial services market**
- 4 Customers need to be encouraged to take responsibility for their own actions .
Effective disclosure is the key - brief clear and simple**
- 5 Within 5 years all consumers will have access to global financial products from their homes. Australian regulation should encourage not discourage the purchase of local products**
- 6 An improved regulatory regime will need to ensure that institutions can produce products efficiently in a competitive environment**
- 7 Consistent advice and disclosure regulation is likely to be best developed by an umbrella regulator rather than by co-operation between several different regulators.**

The Customer should not have to deal with a variety of inconsistent and complicated regulatory frameworks when buying financial products



Criterion 1

Individuals will invest and save more if

- they have confidence in the institutions
- products are simple and have a track record of delivering
- they have access to advice which is regulated and appropriate for their needs
- they have access to a complaints mechanism which works - and has 'teeth'
- product disclosure is readable and consistent between products

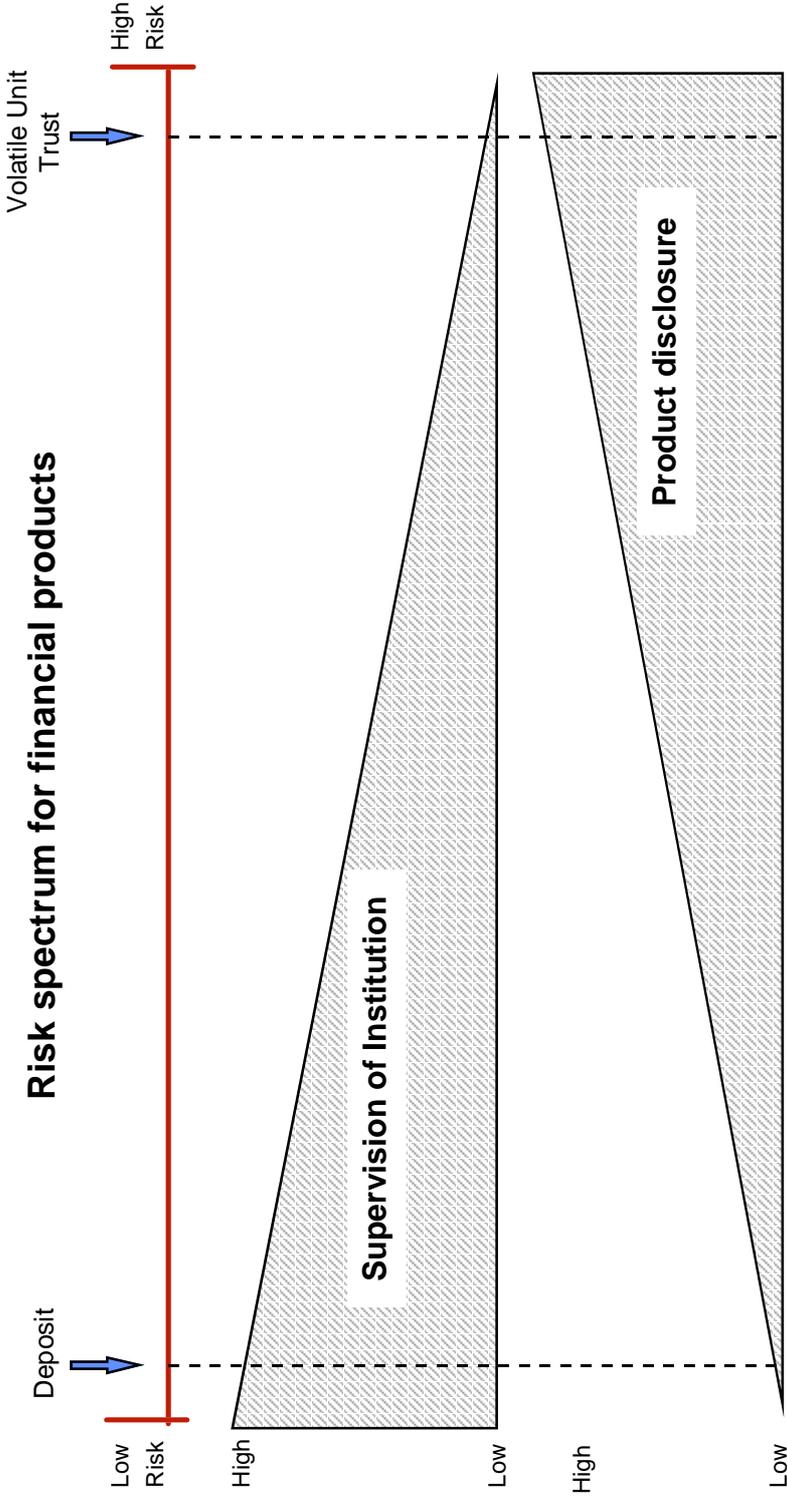
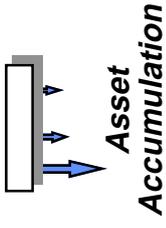
Individuals will insure most effectively if

- they are aware of the asset that needs to be protected
- they have confidence in the institutions insuring the assets
- they have access to advice which is regulated and appropriate for their needs
- they have access to a complaints mechanism which works - and has 'teeth'
- product disclosure is readable and consistent between products

Individuals will borrow most effectively if

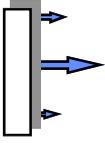
- they understand the price they pay for the loan and how this price may vary
- product disclosure is readable and consistent between products

Asset Accumulation products lie on a continuous risk spectrum. Regulatory requirement should be consistent with the products position on the spectrum



- The customer relies heavily on the financial system for low risk products e.g. the customer does not want detailed disclosure on a deposit with a bank because they expect that the bank is closely supervised and hence safe.
- The customer needs more disclosure if they are carrying more of the risk e.g. a customer investing in an international equity trust will need to understand that there is currency as well as share volatility.

Customers rely on insurance companies meeting their promises

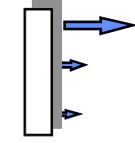


**Insurance/
Protection**

10

Criterion 1b

- **Supervision** - The supervisor should establish a consistent level of security for all types of insurance. The organisation can hold more capital if required. Rating agencies could potentially provide a service to customers to help them assess the effect of additional capital
- **Disclosure** - product documentation should be readable and consistent to enable sufficient understanding of product features and ensure that the customer is able to compare between products.



Loans

Loan and credit products appear not to be an issue for the Wallis Inquiry. A regulated framework already exists which is product rather than institution focussed

Supervision - no specific requirement other than that required by Corporations law

Disclosure - no additional requirements above existing uniform consumer credit law - Federal legislation would be more efficient than the current State based legislation

There is an urgent need (for the Government) to re-establish a savings culture in Australia

This can be achieved by -

Criterion 2

- **making it easy for the customer to purchase financial products**
 - regulation should allow for new technology
 - unnecessary hurdles to purchases should be removed
 - disclosure should allow comparability of products
 - regulation should not bias toward any particular distribution system
- **ensuring customer confidence in the system**
 - reliance on the system
 - disclosure that can be understood and trusted
 - remedies for non-performance that are cheap, quick and consistent
- **promoting competition for all forms of savings**
 - institutions to be able to build products in the most efficient regulatory environment
 - regulations for similar products should be the same across all institution types
 - regulation should not impede development of new products
 - competition laws should be consistent with other industries
- **producing effective taxation incentives**
 - savings should be encouraged not discouraged through the tax system

Customers need confidence to manage their financial affairs effectively in a complex financial services market

Customer needs

can only be achieved by

Reliances

- overall reliance in the integrity of the market
- institutions
 - ▶ are financially adequate to meet commitments
 - ▶ should encourage rating agency assessments
 - ▶ are competent to perform their function
 - ▶ have disclosures that are trustworthy

consistent prudential regulation across **suppliers**

Disclosure

- starts with the assumption that the reliances shown above can be taken for granted
- the greater the possibility of a variation in outcomes the greater the level of disclosure
- be readable and consistent to enable sufficient understanding of product features and the ability to compare between products. Benchmark is one page disclosure.

consistent disclosure standards across **products**

Advice

- access to advice if requested
- consistent competency standards for advisers
- advice that is appropriate

consistent licensing and control of **advisers**

Remedies for non performance

- easy access to complaints resolution mechanisms that are impartial, quick and have “teeth”
- consistent and predictable outcomes
- suppliers are required to remedy if proved at fault
- non-performance is measured against disclosure and prescribed operating standards.

non statutory product focused **complaints mechanisms**

Customers need to be encouraged to take responsibility for their own actions. Effective disclosure is the key - brief clear and simple

- Disclosure should enhance the customers' ability to be able to make quality decisions
- Rules on disclosure should be non prescriptive with regard to content and layout
- The greater the level of risk or unpredictability of outcomes, the greater should be the disclosure to highlight these
- Disclosure may need to be road-tested with the customer

Within 5 years all consumers will have access to global financial products from their homes. Australian regulation should encourage not discourage the purchase of local products

Legislation needs to anticipate that

1. within 2 years financial kiosks will be available in main streets which will access international financial products, and
2. within 5 years consumers will be able to access global financial products from their home television using remote controls

which means

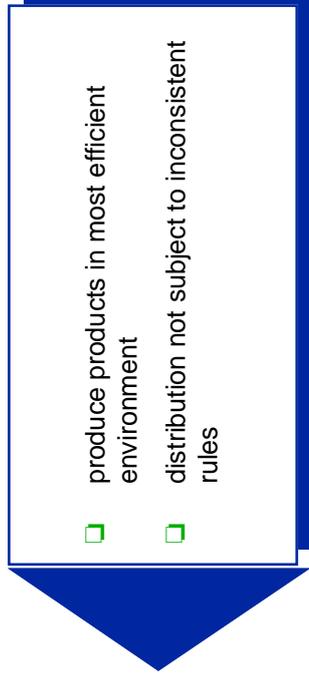
- the environment will be one of buyer beware since
 - ▶ some products unregulated
 - ▶ global brand products may be subject to different regulatory standards
 - ▶ no advice required or available
 - ▶ impossible for Australian regulator to control
- Australian financial products need to be as simple to purchase as international products
- regulation needs to facilitate total transactions taking place electronically
- prudential supervision of Australian companies should not place them at an international disadvantage

An improved regulatory regime will need to ensure that institutions can produce products efficiently in a competitive environment

Criterion 6

Factors for institutions to judge an improved regulatory model include

- **Stability of regulation**
- **Known performance criteria**
- **Freedom to make commercial decisions subject to accountability for results**
- **Minimum administrative burden imposed by regulation**
- **Freedom to make early use of new technology e.g. electronic prospectus**
- **Freedom to compete across whole financial system**
- **Acceptance by customers of reasonable responsibility for their own decision making**



Consistent advice and disclosure regulation is likely to be best developed by an umbrella regulator rather than by co-operation between several different regulators

- **A fragmented approach to harmonisation of product disclosure and advice regulation will not work because**
 - **it is normally reactive i.e. after the event**
 - **the regulators speak 'different languages'**
 - **little incentive to harmonise**
 - **focus will be on marginal product differences rather than on similarities**

- **An umbrella regulator can provide a harmonisation filter to lock in consistent product disclosure and advice rules**

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Summary of International
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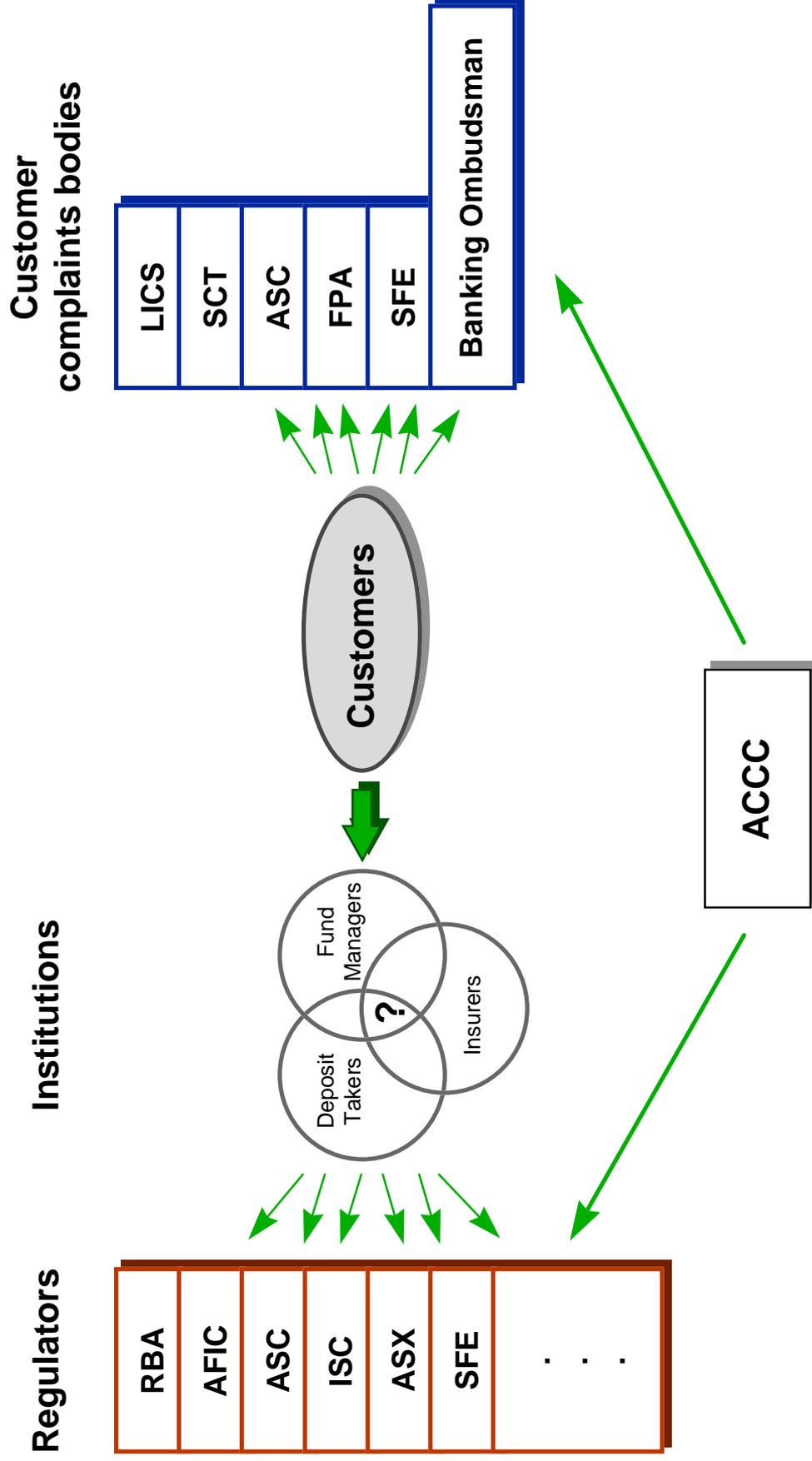
The current regulatory and legislative regime is inconsistent and institutional rather than focused on balance sheet strategies and type of product

LEGISLATIVE REQUIREMENTS					
ACTIVITY	Bank	Funds Manager	Super Fund Trustee	Life Office	Company or Mutual Organisation
Structure	Company	Company	Company or individuals (trust)	Life Insurance Act (Statutory Fund)	Life Insurance Act (Statutory Fund)
Capital Adequacy	Banking Act (CAR & PAR)	Corporations Law	SIS Act (Approved Trustee-\$5mNTA)	Life Insurance Act Trade Practices Act	Life Insurance Act Trade Practices Act
Prospectus Issue	Corporations Law & Trade Practices Act	Corporations Law & Trade Practices Act	SIS Act Trade Practices Act	Life Insurance Act Trade Practices Act	Life Insurance Act Trade Practices Act
Regular Communications	Trade Practices Act	Corporations Law & Trade Practices Act	SIS Act Trade Practices Act	Life Insurance Act Trade Practices Act	Life Insurance Act Trade Practices Act
Payment of Benefits	n/a	Corporations Law	SIS Act	Life Insurance Act	Life Insurance Act

Each regulator has established different and inconsistent prudential supervision/disclosure and advice rules. The result is that, for similar products, significantly different capital, disclosure and advice is required.

The current regulatory regime is creating barriers to the efficient provision of financial products and services

Institutions are converging but regulatory bodies and complaints mechanisms are complex and only slowly converging (e.g. ISC/ASC harmonisation)



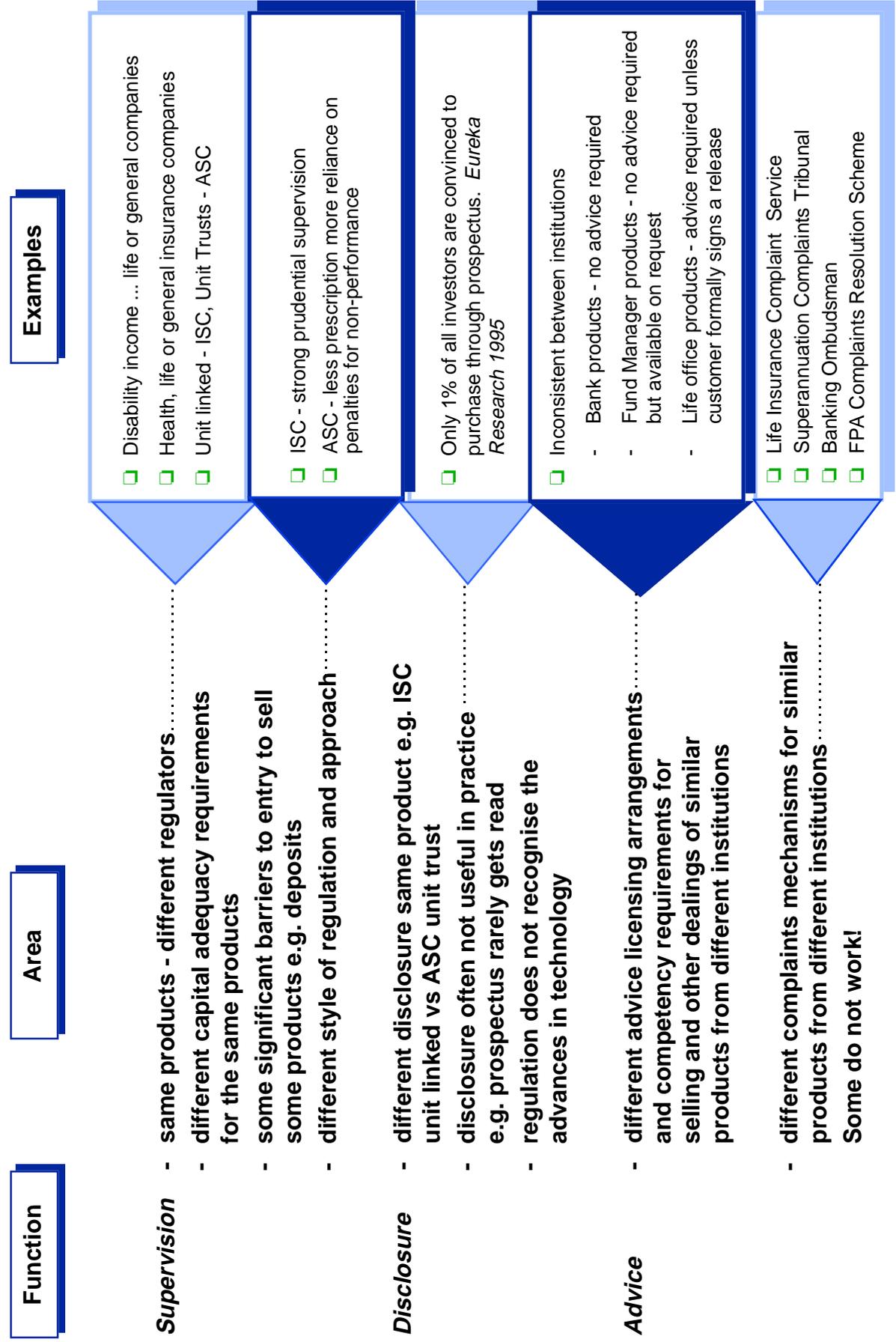
The current regulatory regime is creating unnecessary problems.

The current regulatory regime is -

- *expensive* Additional costs required to comply with each regulator
- *difficult to use* Complication and subsequent confusion from different disclosure regimes inhibits sales of products
- Regulation assumes that paper is the standard technology
- *not in the public interest* Because of confusion, consumers are hindered in their buying decisions
- Because of different disclosure/advice rules some institutions are hindered in their ability to sell products effectively e.g. Life Insurance vs Fund Management products
- *non competitive* Institutions are often hindered in their ability to produce products in the most efficient environment because of high entry costs e.g. to banking and life insurance
- Superannuation funds are currently able to provide products with little prudential supervision e.g. guaranteed pensions, top up insurance
- *creating conflicting complaints systems* Complex array of statutory and non statutory mechanisms lead to inconsistent treatment of customer complaints and potential arbitrage, i.e. consumer can put one system up against another or customers may select inappropriate scheme

Overall - these problems lead to reduced customer confidence and hence reduced savings

The current regulatory regime has substantial anomalies which leads to duplication, confusion and complexity



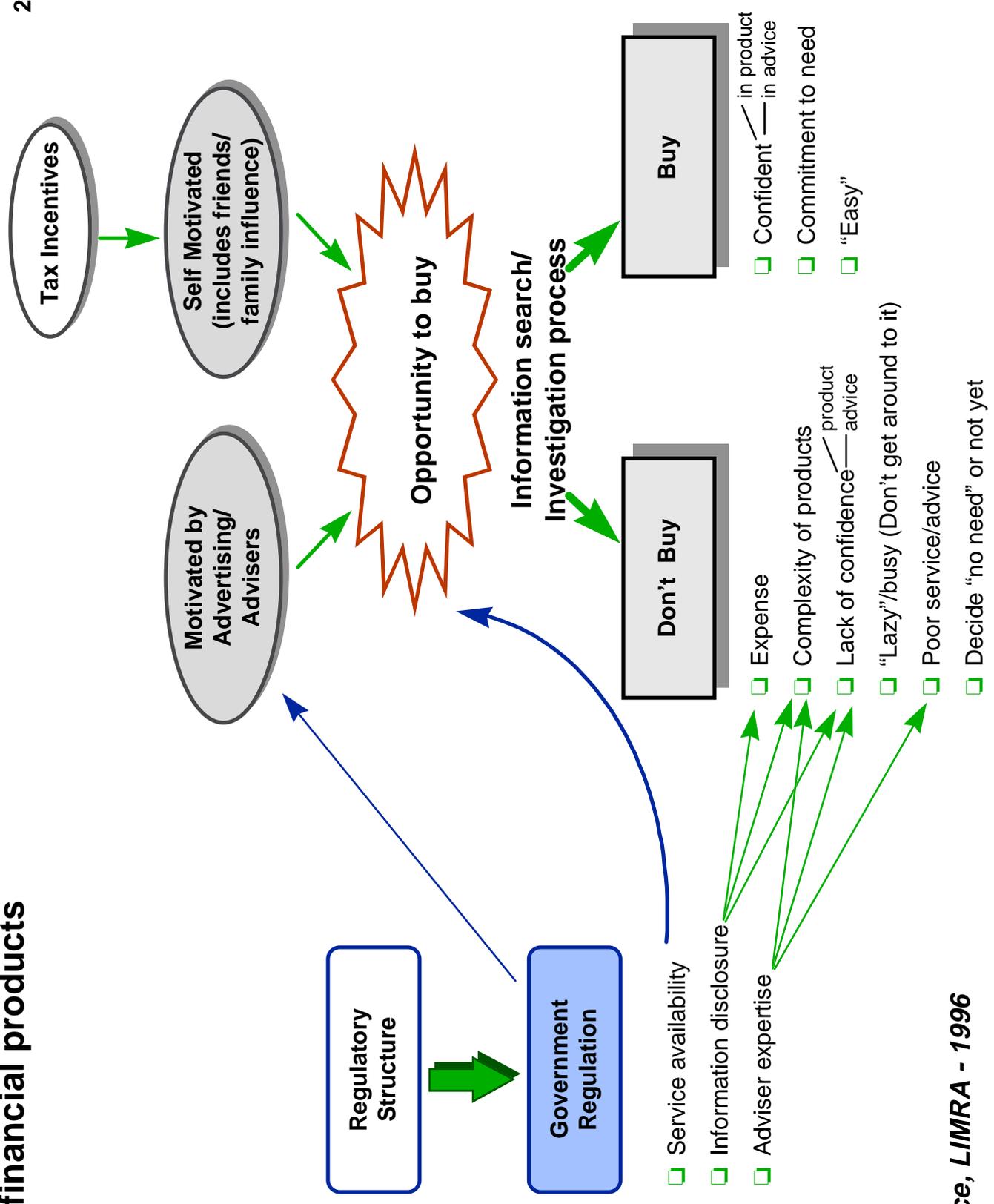
Customer research indicates that the current regulatory regime is complex and confusing

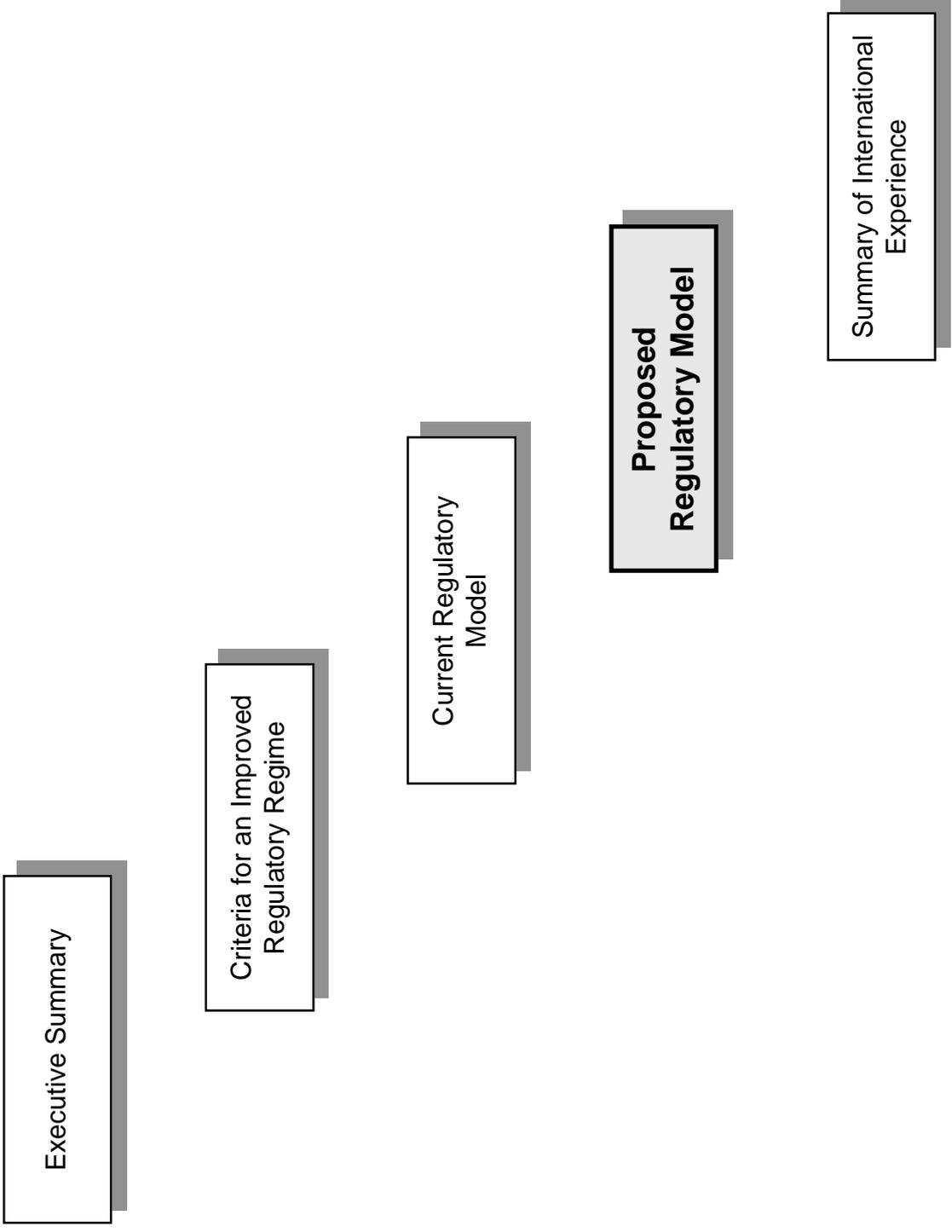
The following summarises the general conclusions that can be made from recent customer research

- “ ■ Customers are not generally aware of the “behind-the-scenes” issues whether it be industry regulations and regulatory structures or factors more directly related to their adviser and the service he/she offers (e.g. whether they are an agent or broker, the number of companies’ products they can sell, the relationship between advisers and product manufacturers).
- Customers do not classify their financial needs into clearly defined product categories. They are therefore looking for professional assistance that can cover the full product range. They seek this assistance from a wide range of different types of professionals.
- Purchasers rely very strongly on professional advice, yet they find it difficult to find someone they can trust and to evaluate someone’s skills and advice.
- There is a clear need to reduce complexity for customers wherever, or however, this occurs.
- The introduction of technology-based modes of contact may have a significant impact on customers’ behaviour and the industry. It particularly has potential as an information dissemination mechanism and there is a demand from customers for service that allows them to readily compare products across a wide range.”

Source, LIMRA - 1996

Influences on why people do, or do not, buy financial products





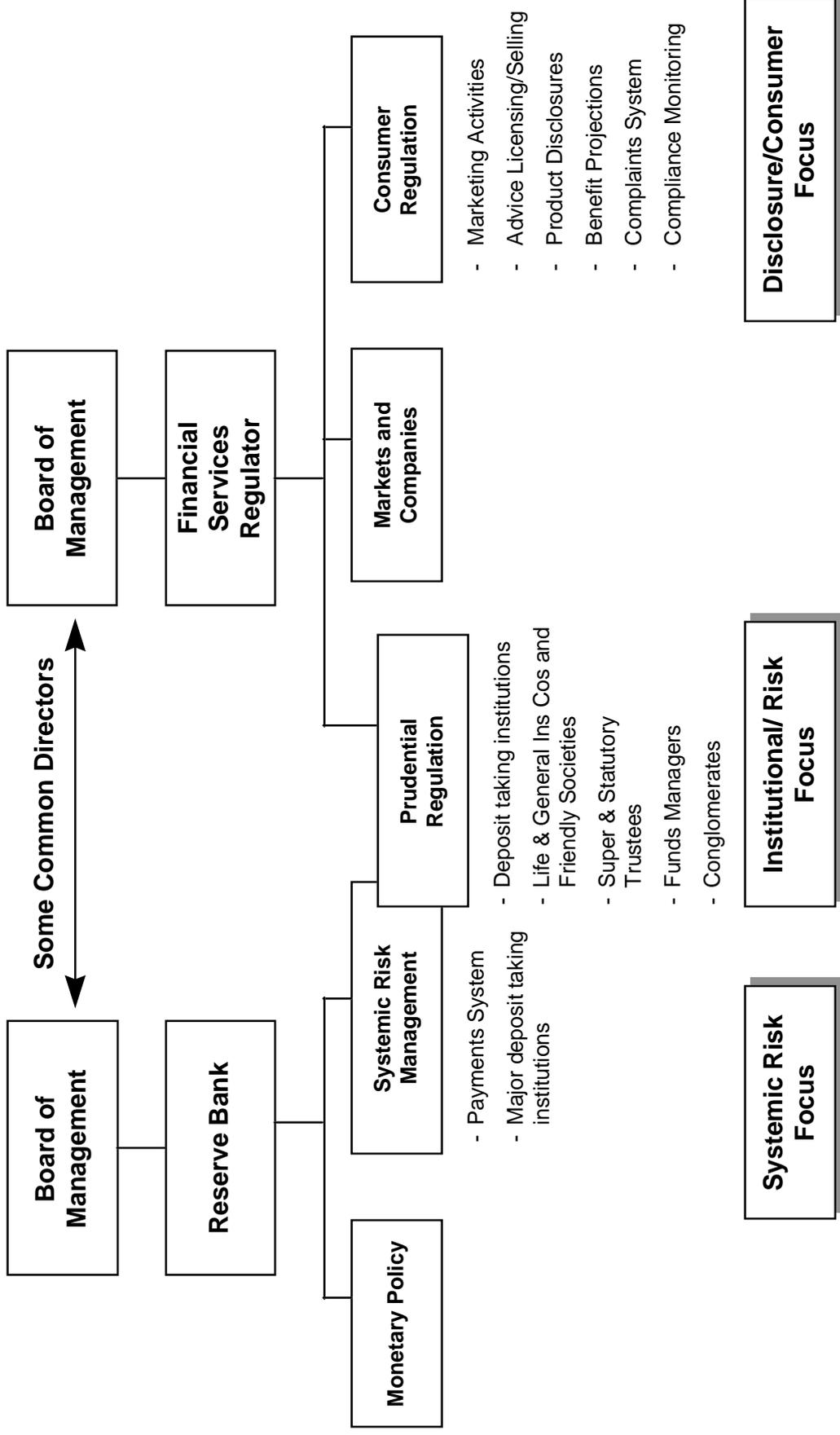
Proposal

- 1 We propose that the Reserve Bank retain responsibility for managing systemic risk and the integrity of the payment system. All financial services businesses will be supervised by a single governing regulator - the Financial Services Regulator. Overlapping responsibilities will need careful management between the two bodies; this will require significant input by the Reserve Bank to the prudential supervision of major deposit taking institutions.**
- 2 As Central Banker, the Reserve Bank will need to maintain responsibility for managing systemic risk and the integrity of the payment system**
- 3 The Financial Services Regulator and the Reserve Bank will need to manage some significant overlapping of responsibilities**
- 4 The Financial Services Regulator should be based in Sydney or Melbourne and report to a Board of Management**
- 5 The Financial Services Regulator will ensure the consistent supervision of institutions that produce the range of financial products**
- 6 The Financial Services Regulator will supervise advice and disclosure standards and the complaints mechanisms for the whole financial services industry**
- 7 In order to avoid duplication with more broadly based consumer regulation, an exemption from the corresponding sections of the Trade Practices Act will apply to the financial services industry**

Proposal

- 8 The proposed model integrates superannuation funds into the regulatory environment
- 9 The proposed regulatory model will allow a financial services conglomerate structure
- 10 The Government should proceed with the broad thrust of the Collective Investment Bill as released in 1995. This will ensure that collective investment schemes are more efficient, accountable, effectively supervised and consistent with other forms of investment
- 11 The general distinction between the wholesale and retail market should be retained
- 12 The Government should review certain taxes which distort the market.
- 13 Any financial services business should be able to take deposits as long as they meet appropriate capital and other prudential requirements
- 14 The ASC model of supervision (commercially oriented, less prescriptive) is the preferred approach for the regulation of advice across the whole financial services industry
- 15 There needs to be a clear distinction between accountability for advisers for advice and suppliers for product performance

We propose that the Reserve Bank retain responsibility for managing systemic risk and the integrity of the payment system. All financial services businesses will be supervised by a single governing regulator - the Financial Services Regulator. Overlapping responsibilities will need careful management between the two bodies; this will require significant input by the Reserve Bank to the prudential supervision of major deposit taking institutions.



As Central Banker, the Reserve Bank will need to maintain responsibility for managing systemic risk and the integrity of the payments system

- There is a considered international view that the Central Bank is in the best position to manage systemic risk
 - *“Removing the Federal Reserve from supervision and regulation would greatly reduce our ability to forestall financial crisis and to manage a crisis once it occurs” (Alan Greenspan Federal Reserve Chairman 1994).*
- The payment system requires certainty that deposit takers are able to meet their obligations. The Central Bank is expected to be able to provide liquidity to the system if required.
- Only the Central Bank can provide international credibility to the payments system
- Australian regulation needs to recognise that there is an internationally accepted standard for the regulation of deposit takers

We propose an evolutionary rather than revolutionary change to the role of the Reserve Bank

The Financial Services Regulator and the Reserve Bank will need to manage some significant overlapping of responsibilities

- The Reserve Bank and the Financial Services Regulator will need to work together to determine how best to manage systemic risk and contagion
- In practice, given the significance of the major deposit taking institutions to the management of systemic risk, it is expected that the Reserve Bank and the Financial Services Regulator would jointly supervise these institutions
- The Reserve Bank will retain its responsibilities for managing systemic risk and the integrity of the payment system
- The following will ensure consistency of prudential regulation:
 - There should be some overlapping Board members
 - Processes will be established to ensure that the Financial Services Regulator and the Reserve Bank work together e.g. combined audit of some financial institutions.

The Reserve Bank will need to retain focus on the major deposit taking institutions

The Financial Services Regulator should be based in Sydney or Melbourne and report to a Board of Management

Proposal 4

- The Financial Services Regulator should report to its own industry representative Board.

The Board would include representation from key shareholders, i.e.

- ▶ the suppliers
- ▶ the advisers
- ▶ the consumer, and
- ▶ the Government

The RBA Board may be a model

- The Financial Services Regulator will take over supervision of State based financial institutions which overcomes a further element of duplication and cost.

To provide perspective and ensure credibility, the Financial Services Regulator should be based in either Sydney or Melbourne

The Financial Services Regulator will ensure the consistent supervision of institutions that produce the range of financial products

<i>Business</i>	<i>Description of products</i>
<i>e.g.</i>	
<i>Deposit business</i>	Deposits involve a fixed claim on the institution which assumes the capital risk. Interest earnings are declared in advance and do not necessarily depend on the underlying earnings of the institution.
<i>Insurance and Savings business</i>	All insurance, annuities and protection products. Savings products with capital backing will be included if they are not otherwise classified as deposit products.
<i>Funds Management business</i>	Non guaranteed, unit linked type products with no capital backing

Consistent supervision will include adopting consistent capital and other requirements across institutions providing similar products. The style of regulation needs to be consistent.

The Financial Services Regulator will supervise advice and disclosure standards and the complaints mechanisms for the whole financial services industry

Function

***Non Statutory
Complaints Mechanisms*** **Resolve individual complaints in expedient and cost effective manner for financial services customers**

Principal Advisers **Issues authorities and tests competencies to ensure consistent provision of financial advice**

Disclosure will be product focussed and will enable consumers to make informed decisions between similar products from different types of institutions.

Rules on disclosure should be non-prescriptive. The documentation should be brief, clear and contain appropriate “health” warnings.

In order to avoid duplication with more broadly based consumer regulation, an exemption from the corresponding sections of the Trade Practices Act will apply to the financial services industry

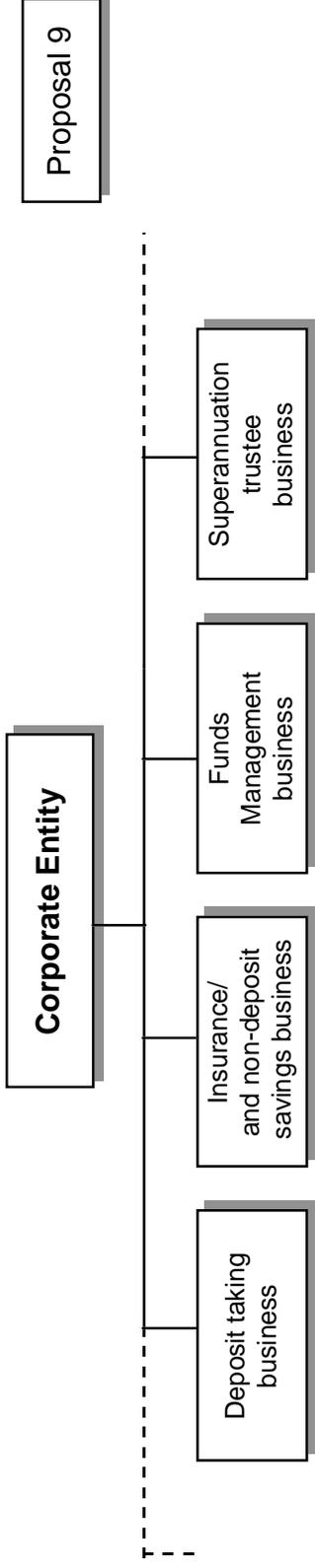
- **Specialist financial industry skills are required to ensure that the regulator is able to balance between consumer and institutional interests.**
- **Experience has been that non-statutory complaints mechanisms with consumer, and industry representatives are more effective than the statutory mechanisms.**

Consumer protection in the financial services industry requires specialist industry skills. We believe that focus is best achieved by including these within the Financial Services Regulator.

The proposed model integrates superannuation funds into the regulatory environment

- The Financial Services Regulator will regulate superannuation operating standards for superannuation funds as defined in legislation
- Any institution will be able to provide superannuation products without the need for a trust structure as long as they comply with the prescribed operating standards e.g. proposed RSA structure
- Superannuation funds will be able to provide products to their members in line with the superannuation operating standards but they will need to meet the same standards applying to other institutions providing those products -
 - ▶ e.g. the provision of guaranteed pensions or top up insurance will require the same disclosure, capital adequacy and reporting requirements as if another institution were to offer these products.

The proposed regulatory model will allow a financial services conglomerate structure



- Each business is regulated appropriate to its products
- The Financial Services Regulator will manage contagion by -
 - requiring a greater level of supervision on deposit products and separating these from other group businesses by firewalls
 - requiring firewalls around insurance funds (which may include asset accumulation style insurance products), superannuation trusts and unit linked style products.
- Firewalls can be
 - subsidiary/corporate structures
 - statutory funds
 - Trusts/responsible entity structures
- Firewalls ensure that
 - there is a minimum of contamination between very different classes of business and
 - the regulator is able to effectively supervise the various classes of business
- Group businesses can distribute another Group business' products provided there are adequate disclosures that intercompany guarantees do not apply

Other structures are possible and the organisation will have the flexibility to organise itself into the most efficient structure for its portfolio of business

The Government should proceed with the broad thrust of the Collective Investment Bill as released in 1995. This will ensure that collective investment schemes are more efficient, accountable, effectively supervised and consistent with other forms of investment

- **A Collective Investment Scheme (CIS) is a method by which money from a number of different investors is pooled together**
- **A 1993 Australian Law Reform Commission report noted that there was “a lack of clear focus of responsibility for operations of CISs”. This was because there was a fundamental flaw in attempting to divide the responsibility for the operation of the scheme between the trustee and the manager**
- **The proposed reform amongst other things**
 - **requires the identification of a single responsible entity**
 - **requires a custodian to hold scheme assets**
 - **requires responsible entities to have an “in house” system to ensure compliance with the law, e.g. independent Board members, compliance plan, compliance committee**
- **The proposed reform brings CISs into line with other forms of investment, e.g. life insurance and superannuation funds.**

The general distinction between the wholesale and retail market should be retained

- **A distinction between wholesale and retail markets should be preserved**
- **Retail disclosure and other operating and licensing restrictions are not appropriate in a wholesale environment because**
 - **they are costly**
 - **these investors are better able to look after themselves**
- **The existing definition of the wholesale market should be retained unless a better option is available.**

The Government should review certain taxes which distort the market. In particular -

- ***Foreign Investment Fund*** - A highly complex regime that affects the ability of a domestic investor to invest internationally and creates a barrier to entry to the Australian funds management industry
- ***Barriers to Fund Mergers*** - Because of the inability to carry forward or transfer tax, stamp duty, capital gains, or tax losses, tax rules are a disincentive to merge trusts. Mergers would potentially result in substantial benefits to current holders. The current taxation consequences appear to be unintended
- ***Tax Losses*** - Unit trusts are required to carry forward their capital losses. This is contrary to the tax transparent nature of investment trusts
- ***Taxation of Unit Trusts*** - The current taxation regime for unit trusts is designed for discrete family or personal trusts. A more flexible regime is required that recognises the trust as an investment vehicle e.g.
 - a unit trust should be able to elect to pay tax on retained income and be taxed at the company rate. Adaptation of the dividend imputation system would be required
 - introduction of a tax transparent investment company.

Any financial services business should be able to take deposits as long as they meet appropriate capital and other prudential requirements

- **The banks/deposit taking institutions currently hold significant liquidity risk on their balance sheets that necessitates an extensive prudential supervisory regime**
- **For the same level of security to the customer less supervision should be required if assets backing the deposits are marketable securities that more closely match the liabilities and are marked to market**
- **Less supervision should lead to lower expenses and therefore a more efficient product for the consumer**
- **In future deposit taking institutions should not have to take on the same liquidity risks as banks currently do**
- **Deposit taking institutions should have the flexibility to structure their business (and hence degree of prudential supervision) in the most efficient way**

The ASC model of supervision (commercially oriented, less prescriptive) is the preferred approach for the regulation of advice across the whole financial services industry

- **Advice is not to be obligatory**
- **Individuals who give financial advice need to be suitably competent**
- **If advice is given it should be appropriate under the circumstances**
- **Individual advisers are authorised by organisations who have a licence from the Financial Services Regulator**
- **There should be no restriction on the way licence holders are remunerated**
- **Regulation should not discourage advisers from working for more than one licence holder**
- **The Agents and Brokers Act should be repealed and the ordinary laws of agent and principal should apply,**

There needs to be a clear distinction between accountability for advisers for advice and suppliers for product performance

- **Advisers need to clearly disclose the capacity in which they are advising**
- **Licensed Principal advisers are responsible for the behaviour of, and advice provided by, their authorised advisers. Both will be liable for misconduct**
- **A transition plan will need to be developed to enable multi-agents to operate under the new arrangements**
- **The customer needs to be aware of the distinction between product information and financial advice.**

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Summary of
International Experience

AIMA, IFA and LISA
joint submission to Wallis Inquiry
on the Financial System

AIMA

Australian Investment Managers' Association



LISA

Prepared with the assistance of

TROWBRIDGE
CONSULTING