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Will the May 2005 FSRA discussion paper fix the problems BFPPG have raised?

Submission by Boutique Financial Planning Principals Group Inc

as a basis for discussion with Mr David Love, Treasury - 19th May 2005

17 May 2005

The approach we have taken in responding to Chris Pearce's discussion paper, has been to use the last summary of issues that we provided to Chris on 4th March 2005 as a base document – and to annotate this document with comments (in green italics) to indicate whether the issue raised seems to be fixed (or otherwise) by the ideas raised in the discussion paper.

In summary though, we would like to acknowledge that (if we have interpretted this correctly) the ideas proposed in this discussion paper are very constructive large steps in the right direction towards fixing issues and problems that we have identified.

Conclusion

We trust the comments below will be taken into account in your further review of the refinements necessary to make the FSR more practical and workable at the adviser level. We are grateful for the time and effort which both Treasury and ASIC are devoting to this review of FSR and trust that the final outcome will be satisfactory for all stakeholders, including consumers.

Are FSR problems caused by FSR Law or ASIC's implementation?

A Perpective From Regular & Ongoing Advice-focused Small Dealers

1. **The Question Being Posed By Chris Pearce.**

In Chris Pearce's 9th February 2005 address to ASIC's Summer School he *said "The challenge for me as Parliamentary Secretary is to determine the extent to which sub-optimal outcomes are the result of flaws in the legislation and the extent to which they are the result of the way it is being administered by ASIC or interpreted by industry participants."* It is pleasing to see Chris Pearce grappling with this key question. However, while it is pleasing to see growing political awareness around the problems caused by the SoA aspects of FSR, we believe there are much broader issues that need to be dealt with – to ensure that consumers win from FSR and to ensure that tailored regular-and-ongoing advice providers have a reasonable, practical & cost-efficient regulatory environment to work under.

2. **The Fundamental Problem**

2.1 It should not matter how advice is created as long as the advice is good, competent and ethical and provided in the client's interest. Yet Financial Services Reform Act (FSRA) and related Policy Statements focus almost entirely on **how** advice is created. Therein lies the fundamental flaw of FSRA and its related regulatory environment. As it stands, **FSRA is bad law** that solves the wrong problem at immense cost to consumers and good advice providers whilst not preventing unethical operators from staying in business.

The proposed changes will significantly cut back on the costs of preparing SoAs for regular and ongoing advisors. The cost related to the ASIC policy statements eg PS164 is still very high. It seems ASIC seeks to impose a compliance system that:

- *would be appropriate for a large product distributor who provides "standardised advice"*
- *onto small advice-focused, regular and ongoing advice providers who provide tailored advice.*

ASIC policy statements go well beyond what is written in the law and this does impose unreasonable extra cost on small advice-focused dealers.

For large product distributors providing standardised advice, manufacturing-style process control is appropriate to manage quality. For small advice-focused advisors producing highly tailored advice, a culture of ethics and professionalism is the key to quality control.

We think there is more room for negotiation with ASIC in this space. ***This will be our next focus.***

2.2 The regulatory environment needs to be refocused onto the quality of advice produced, not the procedure used by the advisor to manufacture the advice. The law needs to **refocus onto substance rather than form** – and to make tailored quality financial advice more affordable to consumers.

The proposed changes open the way for this to occur, but do not cause this result by itself. This result can only be achieved by refocus and change the priorities within ASIC.

2.3 It seems that Asian countries who were considering drafting law similar to FSRA, now can see FSRA was an Australian mistake. ("FSRA implementation damages reputation" Money Management 3 February 2005.) Australia now needs to be big enough to acknowledge and correct its FSRA mistakes. *In the article Pauline Vamos is attributed as saying that "FSR is not working and it is not helping the consumer."*

3. Who Wins, Who Loses?

3.1 **Consumers are big losers under FSRA.** The only significant benefit that consumers get from FSRA is extra disclosure of any factor which might influence the advice including commission and relationships – and this has been a very positive development. However, most of the new regulatory environment under FSRA creates a major cost imposition on consumers – while providing no net benefit. Further, the new regulatory environment is likely to reduce consumer choice over time. This is a lose-lose outcome for consumers.

3.2 The **winners** from FSRA are:

3.2.1 **Vendors of compliance services** who believe that they now have a legislated right to force their expensive services onto financial service suppliers and their clients.

3.2.2 The **unethical operators**, because clearly unethical operators will continue to flourish by hiding behind a defence of "good compliance".

3.2.3 **Providers of mass-produced, untailored, "press-the-button" cookie-cutter advice** (typically large institutions) as these service providers are able to tightly control the advice manufacturing process, with highly systematised SoA production processes, designed primarily to support a product distribution operation. This form of AFS licencee has been delivered a huge cost advantage under FSRA, because once they have made the initial capital investment in compliance infrastructure, the marginal cost of producing compliant advice (and in being compliant in general) is much lower than for tailored advice providers. Has this tilting of the playing field really benefited consumers? Of course not.

4. Consumers Already Have Strong Protection

4.1 **How are consumers to be protected if we remove the damaging and unnecessary cost-impositions?** Even without the high-cost and impractical parts of FSRA, consumers are highly protected under Corporations Law, the ASIC Act and under common law. ASIC needs to enforce these laws. Specifically protection provided includes the following:

4.1.1 Common law is well established in terms of negligence, duty of care; etc.

4.1.2 The Corporations Act 2001 already required that:

- there was a reasonable basis for the advice and the advice was reasonable in the circumstances. Section 945A
- the financial services were provided efficiently, honestly and fairly. Section 912(1)A.

4.1.3 The ASIC Act 2001 provides for protection in respect of:

- Misleading or deceptive conduct. Section 12DA.
- False or misleading representations. Section 12DB.
- Requirements to apply "due care and skill", and that advice is "fit for the purpose". Section 12ED.

These are very powerful obligations on advice providers. If ASIC can be persuaded to re-focus their efforts onto enforcing these obligations, consumers will win in spades.

The proposed discussion, clears the way for advice being judged much more heavily on whether it was good advice – based on the above principles – rather than on whether boxes are ticked. This is a big step in the right direction for consumers – and will reduce the ability of bad operators to hide behind the quality illusion of tick-the-box compliance. However, for this change to succeed it does mean that ASIC needs to change its focus onto "good advice" - as compared with its current focus which is on tick-the-box compliance.

5. ASIC Must Meet The Objectives Of Its Charter

5.1 Such a refocus would enable ASIC to comply with its legal obligation as regulator. Specifically the Australian Securities and Investments Commission Act 2001, Section 2 says *"**ASIC must strive to** maintain, facilitate and improve the performance of the financial system and the entities within that system i**n the interests of commercial certainty, reducing business costs."*** Clearly ASIC is currently failing to fulfil this obligation under this law – particularly in respect of small Dealers, who are the primary providers of personalised, tailored advice.

5.2 Small independently-owned Dealers are an important part of consumer choice, yet FSRA threatens their very existence. Independently-owned small Dealers are struggling to survive the immense cost-burden and time-imposition of a regulatory regime more suited to regulating a large product distributor rather than small independently-owned tailored-advice businesses. A regular comment heard from small Dealers is that they are being put in the impossible position of having to choose between staying in business or being compliant at immense additional cost in money and time. Let us be clear, these Dealers are behaving professionally, honestly, ethically and are giving good advice. It is just that the compliance regime imposes immense and unreasonable business risk and an immense and unreasonable time and monetary cost on small independently owned Dealers who handcraft tailored ongoing advice.

6. The Major Weaknesses of FSRA

The most critical weaknesses of FSRA regulatory environment are:

6.1 **The massive cost imposition on consumers without sufficiently compensating consumer benefits** related to compliance with dealer business processes found in (eg Policy Statement PS164) and the advice manufacturing process (SoA in FSR, Policy Statement 175, SoAA Class Order) rather than focusing on whether advice produced is good. The SoA issue is dealt with below. The magnitude of the cost impost relating to dealer business processes is very poorly understood – because of the current poor degree of compliance. However, as compliance is enforced this will be seen as a massive problem. ASIC, through its Policy Statements, has exploded the requirements specified under Section 912A into a massive cost burden, particularly for small regular-and-ongoing tailored-advice providers. **This massive cost imposition clearly is going to be paid for by consumers.** The presumption behind these Policy Statements is clearly that **compliance equates to good advice and non compliance equates to poor advice** – a presumption which is clearly wrong. It is clear that under FSRA that you can deliver quality advice while being found to be non-compliant AND you can deliver compliant "advice" which is poor quality but financially beneficial to the advice provider.

This is an issue we need to continue to work with ASIC on – and in that regard, the effort required has only just begun. This comes back to the issue raised above, that ASIC (through its policy statements) has sought to impose a compliance system that:

- *would be appropriate for a large product distributor*
- *onto small advice-focused, regular and ongoing advice providers.*

ASIC policy statements go well beyond what is written in the law and this does impose unreasonable extra cost on small advice-focused dealers.

6.2 **FSRA is very poorly focused.** It creates a massive cost imposition on the quality advice providers, while it creates a regulatory environment that protects unethical operators, as long as such unethical operators have sufficient legal advice to achieve compliance. FSRA unfortunately is all about FORM rather than SUBSTANCE: TICKED BOXES rather than GOOD ADVICE. Clearly consumers want cost-effective, quality, tailored advice but FSRA is

effectively denying this to many consumers who will be forced to turn to mass-produced cookie-cutter advice as the only form of compliant advice that they can afford.

This issue has been discussed above – and clearly the discussion paper, is an important step in the right direction, but requires ASIC's priorities to be re-adjusted.

6.3 **Compliance Difficulties with SOA.** FSRA specifies key elements which are required in a Statement of Advice (SoA). While on paper this looked good for consumers, **the SoA requirement has been found to have immense practical difficulties** which has been extensively documented. The problems include:

6.3.1 **Civil Liability.** Despite the intent indicated in the information memorandum, as FSR Law currently reads, a minor technical non-compliance may lead to civil liability for loss even where the advice is good. This defect in the law, may result in many highly professional dealers being bankrupted next time the share market crashes because a lawyer is able to identify a minor technical compliance breach. We have documented this issue in detail.

This problem has not been fixed – and we believe this does require a minor amendment to the law.

Strict reading of s953 Corporations Act 2001 suggests civil liability applies irrespective of whether the defect was material or was related to a loss suffered. In effect this means that if an SOA is "defective" the licencee may be liable even for normal market volatility and normal market downturns.

By contrast, the FSRA explanatory memorandum indicates that civil liability should only apply where there is a demonstrable connection between an SOA defect (or omission) and the loss incurred by the client. This is fair and reasonable, but these words are (unfortunately) not written in the law. Our understanding is that a court will not be bound by the words in the explanatory memorandum.

We ask you therefore to note the (in effect) conflict between FSRA and the intent indicated explanatory memorandum and ask you to amend FSRA to reflect intent indicated in the explanatory memorandum to create greater certainty and reasonableness.

6.3.2 Reasonableness dictates that ***any new piece of advice in a long-term advice relationship, can only reasonably be judged in the context of the entire relationship and the entire communication process***; i.e. in the context of the body of advice, not just selective parts which ASIC says must be date identified or otherwise be treated as technically deficient. Failure by ASIC to accept a more reasonable position on this issue, is severely detrimental to the cost-efficiency and effectiveness of advice to long-term clients. These difficulties result in good, ethical ongoing-advice providers facing unreasonable risk of civil liability even where the advice they have provided was good advice.

"Reasonableness dictates that any new piece of advice in a long-term advice relationship, can only reasonably be judged in the context of the entire relationship and the entire communication process."

In the broad sense, this very important principle has not yet been accepted – but must be, to ensure that FSRA adequately accommodates long-term advice relationships for regular-and-ongoing advice providers.

The problem that continues to exist under proposed refinement 2.1 is that the discussion paper seems to assume (in refinement 2.1) an advice process which involves a big piece of initial advice followed by many minor pieces of advice. While this covers the advice process of some advisors, it does not cover many forms of good regular-and-ongoing advice. The best way to illustrate the issue is with the

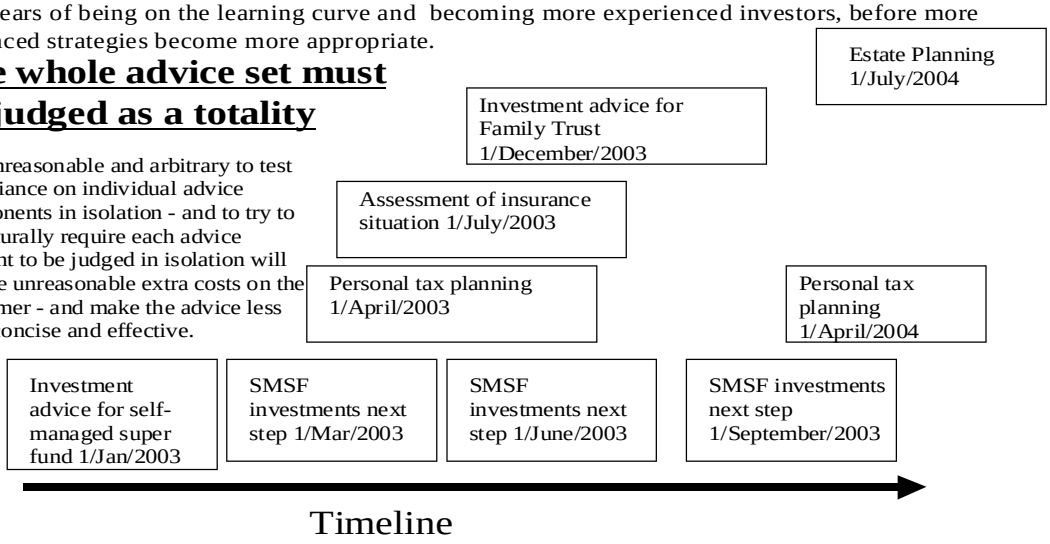
old riddle "What is the best way to eat an elephant?" Answer: One bite at a time. And so it is with financial advice.

Why does the investment process advice process often take a sequence of steps over a number of years before it is anything like a "complete plan"?

Eg With experienced investors, they often has a set of beliefs about investing which they wish to hold onto - at least initially. So the first couple of years, are often a fairly intense period of education. As time goes on, client is more ready to proceed with a more refined strategy as client comes to understand the logic of an alternate approach to past strategies. Likewise, with any new client, over a few years of being on the learning curve and becoming more experienced investors, before more advanced strategies become more appropriate.

The whole advice set must be judged as a totality

It is unreasonable and arbitrary to test compliance on individual advice components in isolation - and to try to un-naturally require each advice element to be judged in isolation will impose unreasonable extra costs on the consumer - and make the advice less clear concise and effective.



Over the first few years of advising a client, you get to know a client a lot better than you can over the first few meetings – so necessarily the advice and strategy becomes a better fit over time – and therefore necessarily a big first-off financial plan is unlikely to be the perfect plan. With regular-and-ongoing advice, the "financial plan" is an evolving, living and growing concept that should not be expected to be captured in any one document.

It is possible that FSRA requires a technical amendment to allow the SoA concept to be used to mean a set of advice documents – allowing later advice documents to readily "assume" (or simply incorporate by implication) the set of advice documents that have gone before.

- In an attempt to tackle this problem, ASIC has introduced the concept of **Statements of Additional Advice** (SoAA). While SoAA might be of some value in limited circumstances, it is a very long way from being a total solution. Where long-term regular and ongoing advice is provided, SoAA has made compliance rules even more complex because of the requirement to list every other relevant advice document by date and to identify in each of those documents any information which may no longer be relevant. Clearly this makes tailored long-term regular-and-ongoing advice very expensive – because of the many interactions and documents which would need to be cross-referenced and qualified.

Section 2.1 of the discussion paper solves the bulk of problems related to Statements of Additional Advice – as for regular-and-ongoing advice providers, any possible role for SoAAs seems to have gone away.

Please note that there is a quite critical adjustment to the wording of Section 2.1 of the discussion paper which is required to ensure that it conveys the intended meaning clearly. Specifically, the word "information" needs to be replaced by the word "advice". The sentence would then read as follows:

"2.1. Amend regulations to exempt advice providers from the requirement to provide a Statement of Advice for ADVICE subsequent to the initial Statement of Advice, where:

• there is an ongoing relationship between a retail client and a provider; and

• there are no significant changes in the client's personal circumstances or the basis of the advice since the last Statement of Advice was given. The provider would instead be required to keep a record of the subsequent advice for seven years and provide it to the client, if requested."

This change is necessary to more precisely reflect the intent. Clearly there never has been an obligation to provide an SoA when providing information – and a paper has been prepared by ASIC to compare and contrast the differences between information and advice.

- **Better Solution:** The rules-based partial solution of SoAA would never have been required if a simpler solution had been adopted, namely ***a principles-based interpretation of FSRA***, where the total body of advice would always be judged as a whole rather than individual documents or subsets of documents. The advantage of this solution is that it addresses a broader set of compliance problems, reduces the cost of providing advice and makes it easier to provide "clear concise and effective advice" without weakening the strength of the law – in short it is a much much better solution, and is much more in line with the objectives of FSR and the obligations of ASIC.

In effect, the discussion paper adopts a strategy which is consistent with the comment above in that it allows for a refocus onto "a principles-based interpretation of FSRA".

6.3.3 What is sufficient documentation of basis for investment advice? This is not at all clear for other than simplistic investment advice. At a superficial level, SoA requirement to include basis for investment advice sounds very reasonable. At a practical level for non-simplistic ongoing advice, compliance with this requirement is a nightmare – creating immense compliance uncertainty, excessive cost and unnecessary replication.

This issue has not been resolved by the ideas proposed in the discussion paper.

With investment advice, for anything other than simplistic or simple advice, the requirement to document "basis for advice" remains problematic. While superficially the FSRA requirement to document basis for advice is such motherhood that it seems a reasonable and important requirement for a Statement of Advice. Unfortunately, in practice this requirement causes perhaps the most important short-coming of FSRA – namely a focus on FORM over SUBSTANCE, leading to serious consumer detriment.

The "basis for (investment) advice" is huge including:
- *the immense volumes of modern portfolio theory,*
- *the merits of a given approach to portfolio construction,*
- *the merits of each individual investment,*
- *why this set of investments work together as a whole,*
- *why this set of investments are appropriate for the times,*
- *why this particular portfolio is appropriate for this client.*

These issues rightly need to be considered as part of preparing investment advice – and an advisor/dealer needs to be prepared and able to defend the advice (in court if necessary) as having a reasonable basis – but ***to document this full basis will create excessive poundage*** *(defeating the "clear concise and effective" objective) and creating excessive cost to the client at no additional benefit to the client (from which no-one wins).*

However, under FSRA as it stands, to not document the full basis creates immense compliance uncertainty – and unreasonable business risk for small tailored advice providers like ourselves.

The discussion paper does not solve this major problem. *A minor technical amendment to FSRA changing the obligation for an SoA to provide "basis for advice" to an obligation to provide "reasons*

for advice" would probably help address the compliance uncertainty. However, since there is such immense scope for arguement about whether there is adequate documentation of basis for advice (or reasons for advice), it may well be that the only good solution is that "basis for advice" be regarded as "best practice" rather than being a compliance obligation – and this woudl require a technical amendment of FSRA.

The focus of consumer protection in this area needs to be addressed by obligations such as:
- *the obligation to have reasonable basis for advice*
- *to take due care*
- *to behave efficiently, honestly and fairly*
- *to disclose commissions and relationships*

rather than the potentially very costly obligation to provide huge quantities of "basis for advice" - in a bid to minimise compliance risk – when providing highly tailored, non-simplistic advice.

6.3.4 ASIC seem be requiring that not only should **adequate inquiry** occur as required in FSRA, but also that evidence of this adequate inquiry be included in each SoA. This adds unnecessary cost to tailored ongoing advice and it irritates a lot of clients – making it much more difficult to meet the "clear concise and effective" requirement.

This problem has not been addressed – needs to be rectified at the regulator (ASIC) level.

6.3.5 When it comes to **immaterial or minor advice** in a regular-and-ongoing advice relationship, it is impossible to be compliant at a half-reasonable cost to the client, given the current way the law is being interpreted. And with regular-and-ongoing advice, the advice generally is liberally sprinkled with exchanges of immaterial and minor advice – a key reason why regular-and-ongoing advice is severely challenged by FSRA.

In regular-and-ongoing advice, many statements of opinion are intended to be educational, but which may ultimately influence a decision, but to record each and every opinion given and to hold it for 7 years is very onerous.

The discussion paper provides an approach which helps alleviate the magnitude of this problem for providers of regular and ongoing advice. In an effort to ensure cost-effectiveness, the practical reality is that in many situations involving immaterial or minor advice, a judgement will need to be made as to whether there is sufficient materiality in a minor piece of advice to warrant its documentation. However, this would then place the advisor and dealer in a position of technical breach of the law – which is a far from desirable result.

6.3.6 **General SoAs.** There are often circumstances where an advisor wishes to make a specific recommendation to all clients – regardless of their circumstances. This form of advice also needs to be acknowledged as being acceptable.

The discussion paper seems to provides an approach which may solve or partially solve this problem. We are lead to this conclusion based on the following sentence "Concerns about whether any advice provided to a person becomes personal advice merely because the provider has personal information about the recipient." on page 25. However, we would need to see more detail to see if this problem has been addressed or not.

6.3.7 The requirement **by law** (taking sections 766 and 944A together) that an SoA is required *every time* an advisor could reasonably be regarded as seeking to influence a retail consumer regarding a financial product or class of product. No other profession has been lumbered with this draconian requirement. Clearly the industry and ASIC are ignoring what is written in the law here, because the requirements of the law are impractical. In practice what is happening, is that an SoA is being written only where a recommendation has been made that the advisor intends the

client to implement as this is the only viable and practical thing to do – and the law needs to be changed to reflect this reality otherwise licencees will remain at unreasonable risk.

The discussion paper provides an approach which solves this problem in most cases for providers of regular and ongoing advice.

*However, **there is one additional special case which should also be given exemption** under refinement 2.1. Many financial planners give potential clients one free initial interview – to give the potential client the opportunity to determine whether they should use this advisor. After the interview, many of these consumers would choose not to proceed – i.e. Not to use this advisor. However, as the law stands, this advisor still has an obligation to provide an SoA, even though the advisor will not be paid – and even though the consumer is not looking for advice (or SoA). This obligation comes from the fact that during this initial interview, it would be normal that the advisor would make comments that **"could reasonably be regarded as seeking to influence a retail consumer regarding a financial product or class of product."***

It is pleasing that the Parliamentary Secretary to the Treasurer, Chris Pearce seems to be coming to understand this SoA issue. However, this is only one of many problems that needs to be fixed.

7. The Solution

7.1 **So what is the solution to this problem?** The solution is that regulatory measures need to be focused on quality of advice rather than procedural compliance. **It should not matter how the advice is created as long as the advice is good, competent, ethical advice, provided in the client's interest.** That is, a regulatory environment needs to be created in which it is the quality of advice that is judged, not the procedure used by the advisor to manufacture the advice.

Attachments:

1. Our paper "Legislative Changes Required on SoA" dated 15 December 2004
2. Our 25 August 2004 paper on civil liability issues.

Further discussion of whether Refinement 2.1 will solve regular-and-ongoing advisor issues?

Further, to determine the extent to which refinement 2.1 has addressed the concerns of regular-and-ongoing advisors here needs to be some discussion of the details of how this idea might be implemented. Issues include:

- *If an additional product recommendation is made, but where "there are no significant changes in the client's personal circumstances or the basis of the advice since the last Statement of Advice was given", what disclosure of commission is required? In this context, there seems to be a range of different possible implementations of refinement 2.1 including:*
  - *→No additional disclosure of brokerage as long as it is consistent with previous disclosures. This would be consistent with obligations on stock-brokers under the Further Market Related Advice (FMRA) rules.*
- *The issue above that the advice set needs to be seen in totality.*