PROBLEMS IN THE FINANCIAL SERVICES INDUSTRY AND THE IMPORTANCE OF PROFESSIONALISM

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Introduction:

1. At the SPAA Conference in Sydney in 2007, I stressed the need for professionalism, that is, strict compliance with professional and ethical standards and the pursuit of professional ideals. To-day, I repeat that message with even greater emphasis, an emphasis which is dictated by the catastrophic economic events which unfolded so relentlessly in the last 18 months with devastating consequences for superannuation funds.

2. Some say these events represent the triumph of greed. Greed has been our constant companion throughout human history. But it is only in recent times that we have let him off his leash. His recent triumph has many causes. They include excessive reliance on debt and leverage, extravagant remuneration rewards for writing risky business, lack of transparency, departure from prudential financial standards, inadequate supervision by regulators, and non-compliance with professional and ethical standards.

The need for improved regulatory protection

3. The point of this comment is to highlight to the fact that the major impacts on the security of those who look to superannuation have arisen not so much from their own ignorance or inability to look after their own interests as from the acts and omissions of others, both here and overseas. They include financial institutions, fund managers, regulators and financial advisers. Hence there is a need for tighter regulation.

4. It is said, however, that our first priority is to restore the availability of credit and only then should attention be given to the need for tougher regulation.[1] In terms of structural regulation of the banking system and the shadow banking system this no doubt is correct. But why should not steps be taken immediately to protect investors (who include those who look to superannuation) from unsound, extravagant and unethical business practices that have contributed to the present situation? Why is it that some funds continue to pay distributions in excess of their actual profits out of borrowings on the basis of revaluations of assets of doubtful validity, and continue to pay managers and senior executives extravagant remuneration by way of "performance" or "incentive" fees for services that have substantially devalued the market worth of the assets which they administer? In the United States, the suggestion that there should be a legislative

[1] Ian Macfarlane, "Australia and the International Financial Crisis", 2008 Lowy Lecture.

“clawback” of excessive remuneration paid to senior bank executives who have presided over bank collapses is said to be “gaining traction”.[2] Putting that suggestion to one side, there is a case for imposing some restraints on excessive remuneration in the financial services industry. Designing appropriate restraints will not be easy. Indeed, it may prove not to be feasible. But it is something that should be carefully considered. Taxation of excessive remuneration at penalty rates is one possibility[3].

5. There is certainly a case for insisting on greater transparency and publicity in relation to performance and incentive fees and insisting on appropriate definition of entitlements to them. What justification is there, apart from contractual entitlement (the terms of which are given minimal publicity), for the payment of “incentive” fees to a fund manager, apart from basic management fees? The question has even more force when the “incentive” fee is calculated not, by reference, to the fund’s actual performance but to some other measure, as it was recently in the case of Hastings Diversified Utilities’ Fund, where the payment of the “incentive” fee ($18,356,000 to Hastings, a wholly owned subsidiary of Westpac,) resulted in the Fund sustaining a loss for the 2008 year of $11,767,000, a year in which the market price of the Fund’s units fell from $3.00 to $2.18. Since then the units have fallen to 38.5 cents. Freedom of contract calls for regulation when it is exercised to the detriment of unitholders who are not actual parties to the contract. Entitlements of this kind, if permitted at all, should be related to the actual, rather than some notional or artificial measure of performance of the relevant company or trust, and calculated by reference to actual profits earned after payment of the fees.

6. Surely action to redress these and other ills which I shall mention would not detract from the restoration of the availability of credit. Indeed, you would think that such measures would help to restore confidence in the markets, thereby assisting in the recovery of the credit markets. As it is, we are facing a crisis of confidence in equity markets which may not be dispelled for years.

7. The need for improved regulatory protection extends to investors generally; it is not confined to the superannuation industry. The emphasis in protection should be on preventive monitoring, rather than punitive enforcement. Reliance on enforcement after the horse has bolted results in complex and costly court proceedings frequently yielding substantial professional fees but little in the way of recovery and recompense for the unfortunate individual. Some, at least, of the investment disasters we have seen in recent times have been disasters waiting to happen – Westpoint was an example - disasters which an alert and well-resourced regulator, with its eye on the ball, might well have alleviated by taking prompt action well in advance of the inevitable meltdown, if the emphasis was on prevention monitoring rather than enforcement after the horse bolted. If the regulator has not been sufficiently resourced, the shortfall should be remedied.

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[2] Gretchen Morgenson, “After Losses, a Move to Reclaim Executives’ Pay”, The New York Times, 22 February, 2009. www.nytimes.com/2009/02/22/business/22pay.tml?_r=1&hp=&pagewanted=print

[3] See Ross Gittins, “Dirty deeds …….done by chiefs”, Sydney Morning Herald, 4 March 2009, p.15 (“Your behaviour is anti-social and we desire you desist”).

The quality of superannuation advice

8. There is continuing concern about the quality of superannuation advice. In April 2006, ASIC's "Shadow Shopping Survey on Superannuation Advice" (the Survey) revealed that the compliance level in the provision of superannuation advice was well below reasonable expectations. Almost 20% of the advice provided did not have a reasonable basis. The Survey found that conflicts of interest bring a higher risk of inappropriate advice. Regrettably the Survey has not been brought up to date in the intervening three years. Yesterday Jeremy Cooper told us that a fresh survey is to be made next year.

9. Compulsory professional indemnity has been made a requirement for financial planners. But we do not yet know whether the regime is working effectively, particularly with respect to the availability of adequate insurance cover. ASIC is looking into the matter.[4] The issue is of crucial importance; already investors are resorting to litigation through class actions and they are supported by litigation funders.

Conflicts of interest

10. Much consideration and energy has been directed to regulation of some aspects of the financial services industry. Much of it is mis-directed. Our system of regulation does not address in an efficient manner the core problem of conflicts of interest which abound in the industry. One of the regulators, ASX Ltd., suffers from a massive conflict of interest. As to financial advisers, in its 2007 report, the Parliamentary Joint Committee said

" . . . as long as disclosure requirements are met, it is legally permissible for an adviser to recommend a product privately knowing that it is not the best option for the client".

11. The most obvious example of conflict in the industry is the financial adviser who is a product seller deriving remuneration, whether by way of commission or otherwise, related to the product he sells. I stress the words "or otherwise" because commission-based remuneration is not the only form of remuneration which gives rise to a conflict of interest. Our system of regulation proceeds on the footing that the adviser may be a product seller. Indeed, our system enables the product seller to adopt the disguise of a financial adviser and endows that disguise with the aura of legitimacy by calling him a "licensed" financial adviser. As such, he is required to disclose the conflict to the client. But how often is that disclosure meaningful? Often it is made as a small print item in a lengthy document expressed in impenetrable prolix prose to which the client's attention is not directed. Detailed and dense disclosure is often the most effective form of concealment. Three years ago ASIC said that its Survey suggested that

"disclosure . . . can only play a limited role in protecting consumers from inappropriate or conflicted advice."

[4] Report of Parliamentary Joint Committee on Corporations and Financial Services, Feb.2009, para.2.60.

Three years have passed, yet we still rely on disclosure as an answer to the problem. Yesterday Jeremy Cooper said, "it is purely a matter of disclosure".

12. All too often it is thought that disclosure is the answer to a conflict of interest. Disclosure must be full disclosure and it must be of such a kind that it is brought home to the client so that it is meaningful. And it is important to bear in mind that, in some cases, an adviser can come under a duty to advise a client to obtain independent advice. And the only satisfactory answer to some situations of conflict is to avoid them altogether.

13. Another problem is that of the financial adviser who is employed simply on commission-based remuneration. In the last 10 days publicity has been given to a report by Rice Warner Actuaries, commissioned by Industry Super Network (ISN), which concludes that consumers are much better off paying for their advice on a "fee for service" basis than by payment of on-going commissions. According to the report, financial advisers remunerated by commission charge between 2 and 13 times more than financial advisers remunerated on a fee for service basis. There may be, however, a question whether the basis of comparison was entirely fair and accurate.

14. I should point out that the report was made in a context in which ISN is promoting the superior performance of industry super funds over retail funds. Nevertheless the points made appear to have force. It is not easy to see how a financial adviser who seeks to persuade a client that he should pay commission rather than a fee for service could give appropriate advice except by saying "if you pay commission, you will be likely to pay more".

15. Only a fortnight ago one commentator said with reference to ASIC

> "The regulator's emphasis on tick box compliance and disclosure is not enough and is failing investors"[5]. He went on to make the point that ASIC should seek a court ruling on what constitutes "appropriate advice".

What constitutes "appropriate advice" is a fact dependent question. So there can be no guarantee that a single court decision will provide comprehensive guidance. Even so, a court decision can call attention, in an instructive way, to salient factors.

16. Indeed, one court decision has already done so, though in a special context. It is the decision of Debelle J. in *Tip Top Dry Cleaners Pty. Ltd. v Mackintosh*[6], to which Chris Wallis refers in his paper "Residency and bringing superannuation to Australia"[7], to be presented at this Conference. In considering the scope of the duty of the accountants and financial advisers in advising Tip Top, Debelle J. said:

> "the scope of the duty depends on the client's need for advice. Thus, the scope of the duty which (the senior partner of the accounting firm and the accounting firm) owed to Tip Top included the duty to give advice which Tip Top appeared to need . . . whether or not it had been specifically requested."

[5] John Collett, "ASIC must stop dodgy advisers", Sydney Morning Herald, Money supplement, 25 February 2009, p.8.
[6] No.SCGRG-95-1295 No.6613.
[7] At pp.41-42.

That duty included "a duty to give comprehensive advice . . . which touched on all relevant matters". Chris Wallace discusses the case in rather more detail as well as the English case of *Hurlingham EstatesLtd. v Wilde & Partners*[8].

17. The ISN Media Release called for two reforms:

- The immediate abolition of sales commissions on superannuation; and
- The extension of the fiduciary obligation required of super fund trustees to act "in the best interests of the client".
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The Media Release said:

> "An obligation for a financial adviser to act in the 'best interests' of their client would require the adviser to scrupulously avoid any actual or perceived self-interest. A best interests obligation would require a financial adviser:
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> - To give advice which is in the client's best interests;
> - To ensure that they do not allow their own interests or the interests of an associate to conflict with the client's interest;
> - To receive fair time-based remuneration for the services provided to the client, which are concisely and clearly disclosed to the client and paid for by the client.

18. The Release went on to claim:

> "Conflicted remuneration practices such as shelf or platform fees, trail commissions, up front commissions, ongoing adviser fees, adviser service fees and asset based adviser fees paid to financial advisers by product issuers ensure that there is always an element of sales in financial advice and are not consistent with a 'best interests' obligation".

19. ISN is not alone in calling for a "client-first" principle of responsibility. The Financial Planning Association of Australia has adopted a new code which operates as a condition of membership. The code incorporates the "client-first" principle. This principle involves a different and higher level of responsibility (described as a "fiduciary responsibility") than the common law duty of care responsibility which, the Association asserts, involves no more than a duty to provide advice "on a reasonable basis".

20. The imposition and adoption of a "client first" principle of responsibility is not only highly commendable; it is essential. Why has it taken us so long to clearly recognise that an adviser should put the client's interest ahead of his own interests?

[8] (1996) 37 ATR 261.

21. Having referred to the claimed superiority of industry over retail super funds, I should refer to the composition of the trustees of industry super funds. They consist at least mainly (and in some cases solely) of employer and union representatives whose interests do not necessarily coincide with those of the members. Indeed, it is possible that the interests of employers and unions, in some situations, may be inconsistent with the interests of members. I can recall more than a decade ago suggestions that a proportion of superannuation funds should be accessed for nation-building projects. Another suggestion was that superannuation funds should be invested in projects to provide low cost accommodation and housing. Proposals of this kind might be attractive to some employers and unions, and to governments, but they might not be in the best interests of those who are and will be dependent on their superannuation. Such proposals might be motivated mainly by a desire to achieve goals other than a desire to protect and maintain the interests of superannuitants. There is a strong argument for saying that industry super funds should be so constituted as to provide for the appointment of some trustees who are selected by the members, many of whom are not union members.

22. One strong objection to superannuation is that it means locking up one's assets in a fund controlled by someone else, particularly when that someone else may have other interests in mind. This objection is all the stronger at a time when superannuation funds have fallen dramatically in value and people are disillusioned with the quality of financial advice they have received. This ground of objection applies to both retail and industry funds. The force of the objection is lessened if the trustees can be seen to reflect, if only partly, the membership of the fund. In SMSFs, the fact that the trustees are members is a central element in their popularity.

23. Measures which encourage individuals to participate in the management and control of their retirement savings are essential features of a sustainable retirement income system. Increased participation in such management and control is likely to lead to increased voluntary savings, in particular by those individuals who take the view that the age pension will or may be inadequate to provide for the retirement lifestyle they have in mind.

24. The announcement on 26 February that there will be a wide-ranging inquiry by the Parliamentary Joint Committee into aspects of the financial services industry is to be welcomed. But it is to be hoped that the inquiry does not become a reason for delaying the design and adoption of obvious reforms that need to be made. As we know only too well, there have been occasions when the holding of an inquiry has been relied upon as an excuse for inaction.

Dividend imputation

25. Recent reports highlight the fact that the Henry Committee review of the taxation system will be looking at dividend imputation. The suggestion seems to be that the

benefits of dividend imputation could be modified, but not eliminated. The fact that dividend imputation is the subject of scrutiny in a comprehensive taxation review is not surprising, particularly at a time when the Federal Government's tax revenue base has been eroded and it has been forced to embrace deficit budgets, at least as a temporary measure. Obviously there is a need to consider new or increased taxes as a *possible* means of meeting the economic crisis and its consequences.

26. But there are powerful arguments which should sound a stern warning against interfering with dividend imputation. First, there is the principle of equity. The one revenue stream should not be taxed twice, as it is in the absence of dividend imputation, initially in the hands of the company's profits and then on the shareholder's dividends paid out of the company's profits after tax has been paid on those profits.

27. Then there are the untoward consequences of any significant interference with imputation. Investors, particularly those who rely and will rely on superannuation, have been heavily hit by the economic crisis. The value of their investments and superannuation has fallen sharply. The elimination of dividend imputation, or a significant lessening in the tax advantage which it confers, would have a detrimental effect on the market price of shares, thereby further devaluing the assets of investors and those relying on superannuation. In that event, the impact on companies which regularly pay substantial dividends, such as banks, would be considerable. If so, it would or may have a detrimental effect on the capacity of the banks to raise further capital, a capacity which should be fully protected to meet the unknown dangers which still lie ahead.

28. Any significant impairment of the existing tax advantages relating to superannuation is likely to further damage public confidence in the régime. The history of government policy changes on superannuation, to say the least of it, does not inspire confidence. It is a history of chopping and changing, of granting tax advantages and then imposing tax burdens. Subject to the correction of inequities and distortions in the system, there are obvious advantages in acting consistently and sticking to policies which have generated expectations at a time when other expectations have been bitterly disappointed.

29. There is a notion abroad that tax advantages are not an important motivating reason for making contributions to superannuation. The notion is certainly counter-intuitive. Tax advantages, when available, are always drivers of investment advice and decisions, as informed investment advisers and commercial people will tell you. And as we all know, tax advantages are reflected in the market price of the assets to which they relate. It is, of course, likely that people would make provision for their superannuation in any event but it is very probable that they are more likely to do so and to a greater extent if they know that superannuation will attract substantial tax advantages. So much seems to be glaringly obvious.

SMSFs

30. Because self managed funds are managed and controlled by the member trustees, they reflect concepts of autonomy and choice. The popularity of these funds is demonstrated by the continuing increase in their number. Their return on assets has been up to 6.5% better than APRA funds for a period of 7-9 years and their expense ratio has been consistently lower than that of industry and retail funds in recent years.

31. Compliance with statutory and regulatory requirements has been a matter of concern in the administration of SMSFs, particularly in relation to audits. Although the investment knowledge of a percentage of trustees and the professionalism of auditors is open to criticism, there is reason to believe, as Michael D'Ascenzo said yesterday, that the compliance rate of SMSFs will improve, thanks to various steps which have been taken and continue to be taken to educate and alert participants in the industry to their responsibilities. Trustees and auditors must realise that the very future of SMSFs depends upon compliance with regulatory requirements and professional standards.

32. The ATO initiatives in this area have been particularly helpful. Michael D'Ascenzo referred to them in his paper. They include publications, educational programs, rulings, determinations, taxpayer alerts and interpretive decisions relating to SMSFs. In addition, the ATO provides advice to SMSF trustees who seek it.

33. The Institute of Chartered Accountants, in combination with other leading accountancy bodies, has developed, as a joint initiative, a set of competency requirements for SMSF auditors, after consultation with the ATO. The three accounting bodies will review members' compliance with the competency requirements and will take appropriate action if breaches are noted. The three bodies have committed themselves to implement the requirements and to continue to liaise with the Auditing and Assurance Standards Board and the ATO.

34. SPAA, the organiser of this Conference, is active in promoting and maintaining professional standards in the industry. It provides independent accredited certification of SMSF specialist skills held by professional advisers in addition to their other professional qualifications and affiliations. SPAA also publishes on a regular basis information, including regulatory rulings, to industry members. At least two universities, UNSW (Atax) and the University of Adelaide have courses which give detailed attention to SMSF issues.

Conclusion

35. There is reason to believe that with the increasing focus on education and the increased availability of relevant information, the standard of literacy of SMSF trustees and auditors will improve. It is also to be hoped that the quality of advice given to participants in the superannuation industry by financial planners and advisers will improve. But it is impossible to believe that existing problems in the industry and the wider investment industry will be resolved in the absence of substantial reforms and a

greater insistence on higher professional and ethical standards by all those who participate in the corporate world and the financial services industry.