PJC Inquiry into Financial Services - summary
4 September 2009

Empowering Consumers:

Empowering consumers is one of the most critical aspects of reform of financial services which is required. The critical importance of empowering consumers to get better consumer outcomes is that:

- if the consumer can protect themselves with the tools provided, this takes a massive load off the regulator,
- there are many more consumers – than there are staff at ASIC, so an army of properly empowered consumers can have a much bigger impact than the regulator,
- if the consumer can have any "problem" rectified by themselves, the problem is more quickly rectified – and the rectification process is much less expensive for the community.
- If consumers are properly empowered, many problems with financial planners will not exist because:-
    - Consumers will be able to see more clearly how the game is played – and be in a better position to avoid games that are stacked against the consumer,
    - Consumers will be able to see more clearly who is paid for what, and they will be in a better position to judge whether the service is good value – become receiving a financial planning service,
    - Consumers will be in a better position to identify the total cost of service and be able to compare it to the likely benefit – thus avoiding getting involved in service that leaves the consumer worse off,
    - Consumers will be in a better position to identify if an advice provider is highly conflicted (either by the way he is paid, of because of relationships between himself and one or more product providers, where those relationships are direct relationships or indirect).

Specific reforms required to empower consumers include:

- Empowering consumers to **take control of fees** that are being paid to advisors (and financial planning AFSLs) by:
    - Giving consumers the right to direct the fund manager to rebate any up-front or ongoing commissions to the consumers.
- Empowering consumers by **making it easy for consumers to readily differentiate which AFSL reps are Sales Reps and which are real advisors.** As part of this:
    - **Sales Reps need to be prevented from projecting the image that they are advisors** who put the client needs first – including on stationary, SoAs, signage, FSGs etc.
    - **Any reps who have any form of direct or indirect relationship with a product manufacturer must be required to very clearly identify the product manufacturer** on all letterhead, signage, SoAs, FSGs etc. This would include:
        - Where the financial planner was (directly or indirectly) a rep of a financial planning subsidiary of a product manufacturer – including where the financial planner was a rep of a corporate authorised representative of a financial planning subsidiary of a product manufacturer. This would include financial planners who were reps of AFSLs such as Hillross (AMP) and Garvan. (MLC)
        - where the financial planner was a rep of a financial planning AFSL which white-labelled a fund managers products – eg Count would need to clearly identify that it was white-labelling the BTWrap platform.
        - Where the financial planner was a rep of a financial planning AFSL which had its own product – making the financial planning AFSL a product manufacturer in its own right. This would include IPAC and Professional Investment Services.

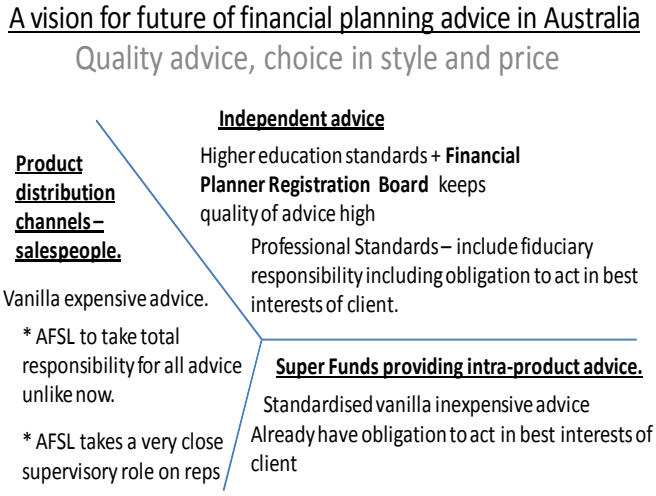
        - Where the financial planner was a rep of a financial planning AFSL that was partly owned by a product manufacturer of related party. Eg Professional Investment Services is 24% owned by Aviva.
        - Where the financial planners was a rep of a corporate authorised rep, which was partly owned by (or otherwise an associate of) a product manufacturer or related party.
- Empower consumers by **making it easier to find an independent financial planner.**
    - If all financial products were required to allow the financial planner to rebate all up-front and ongoing commission to the consumer plus any volume over-rides, this would make it much easier for many for "independently-minded" financial planners to comply with ASIC requirements to use the term "independent".
    - Remove the Corporation Law bias that incentivises planners to build a product distribution businesses over building an advice business. If this is done, there will be many more independent planners.
    - Banning product manufacturers from owning financial planners, would free large numbers of "tied agents" to become independent financial planners.
- Empower consumers to **demand advice in a form which is usable to the consumer** – not 140 pages of pro-forma filler of standardised text that might be good for compliance but of no value to the consumer – because it is too long and often unreadable to many consumers.
- Empower consumers to **demand short advice where any statutory disclosure was in an intelligible form that consumers can readily understand** – and where all conflicts of interest are fully and clearly disclosed – no vague references and no maybes (eg I might get paid something if ...). Preferably though, all conflicts of interest should be banned for all advisors – because it is very clear that disclosing conflicts of interest does not protect consumers.
- Empower consumers by **creating a regulatory system where conflict-free advice was readily available.** The current regulatory system is biased against conflict-free advice because it has created an environment where there are huge financial incentives for financial planners to build product distribution businesses rather than advice businesses.
- Empower consumers to **be aware that any advisor that they are dealing with, clearly disclose if they have been given sales targets or other directives and incentives that might result in the consumers needs being subservient** to the needs of the advisor or the needs of the AFSL that the advisor represents.
- Empower consumers by **ensuring that consumers have access to a web site run by independent professional advisors, where the web site educates consumers about the very high risks of very risk investment strategies and investment products.**
    - High risk strategies would include gearing strategies pursued by Storm Financial.
    - High risk products would include credit risk products such as Nexus Bonds or structured products where complexity makes it difficult to understand fees or risks.
- Empower consumers by **helping consumers find more experienced, more highly-educated planners** – thus reducing the incidence of consumers putting their retirement future and their life savings into the hands of an inexperienced advisor with only 2 weeks training. Financial planner registration board – run by professional advisors (not compliance people and not product manufacturers) – where dodgy planners are expelled and dodgy planning practices identified as being dangerous (eg by web site).
- Empower consumers by **making cheaper advice and cheaper products more readily available to consumers. Also remove barriers to switching to cheaper products.**
    - Cheaper advice.
        - Recent introduction of intra-fund advice was a good start.
        - Removing the focus on FORM onto SUBSTANCE to enable shorter SoAs would help.
        - Introduction of Fiduciary Duty for planners would help – because rather than focusing on the FORM of the advice, the planner could be judged simply on whether the advice was in the best interests of the consumer.

- Cheaper products.
  - Promote cheaper index/passive funds and Exchange Traded Funds (ETFs).
  - Make US-listed ETFs much more accessible to Australian consumers.
  - Break down entrenched product distribution channels. Force competition between large Australian fund managers who are currently not competing on price or product – but rather are using their high margins to develop and support existing distribution channels using a range of financial incentives.
  - Develop a single Australia-wide "exchange" where managed funds can be bought or sold in a similar manner to buy & selling listed securities. There is no reason why it should cost any more to buy or sell a managed fund than it costs or sell a listed security eg on Commsec or E-trade. (Buy/Sell margins excepted). This "exchange" could also enable buying and selling of super products.
  - Make it simple between platforms and Wraps. Currently it is expensive in time and often expensive in money to move platforms – resulting in many consumers being locked into un-necessarily high ongoing costs.
    - Currently you can switch stock brokers – taking your whole portfolio of listed stocks with you – very simply by filling out one form – and at not cost – simply by transferring your HIN (Holder Identification Number) from one broker to another. With $1.3trillion in superannuation, we need to be able to do the same for managed funds. Eg have a singled HIN for all managed funds. So one solution if that you switch from one platform to another platform with a simple mechanism like switching HINs from one broker to another.
    - Alternately, all platforms could be required to use one common engine – a transaction exchange for platforms, so that when you switch from one platform to another, you are still using the underlying engine. Again a bit like switching your HIN from one platform to another.
- ATO to develop an **e-tax**-system-like Internet application to provide simple super services. Eg switches, death benefit, redemptions, setting pension payment amounts. ATO to become a Superannuation Clearing House.

Bottom line – what changes are required from this PJC Inquiry into Financial Services?

1. **Financial Planners to be held to Fiduciary responsibility – Financial planner to act in the best interests of client.** (http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15h.pdf)Financial planner registration board (FPRB) (a group of professional practising ethical independent planners) to define what "acting in the client's best interest" should require of the planner – and what sort of things are examples of not acting in the client's best interest.
   1. This will simply reflect the reality of the nature of the relationship between most planners and their clients.
   2. Treasury fear that this will increase costs.
      - Why might this occur?
        1. Possible extra documentation for the file of how the advice was in the client's best interests? Issue for FPRB.
        2. Possible extra professional Indemnity Insurance.
      - But costs might also fall.
        1. Because planners could rely on their fiduciary responsibility, they could act in good faith, and issue a short appropriate advice document rather than a long and useless document that a client won't read – because the focus would need to shift onto SUBSTANCE and away from FORM.
2. **Executives who control financial planners (and their superiors) must also be held fully to account for the actions of their financial planners.** http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15i.pdf
   1. Chan-Serafin's research (4/8/2009 AFR article "Liars need others to lie too") into corporate behaviour and finds 41 percent would act immorally or lie to keep their jobs. She found that in the Prudential Securities case she studied, "the sales were so lucrative for the brokers that they shrugged off ethical concerns." She also found that "brokers and staff were intimidated into doing things they knew were wrong and whistle blowers were fired." The systemic weaknesses identified by Chan-Serafin needs to be taken into account when refining Financial Services regulations in Australian.
   2. However, a much better solution would be that financial planners be regulated in a somewhat similar manner to accountants (individually-licensed) – where financial planners are free from the control of large corporations – and where planners primary accountability is to their client rather than to a corporate master.

3. (Supplementary Submission 7) **To help protect consumers from Storm Financial or West-point style losses, we need to create a Financial Planner Registration Board (FPRB)** http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15h.pdf – requiring higher education standards and a requirement that advisor acts in the best interests of the client. The goal would be to register only quality financial planners delivering "acceptable" advice. Tasks of the FPRB would include:-
   1. defining what advice is bad advice and what is risky advice.
      1. Eg The style of investment strategies (including gearing) recommended by Storm Financial is exceptionally high risk and was "a disaster waiting to happen." Views along these lines could be published on a FPRB web site to help raise awareness among the public of what ethical professional advisors regard as



excessively risky strategies.
    2. Investments like the agricultural schemes that have failed, may be reasonable in small portions in a much bigger portfolio, but it would be excessively risky. Views along these lines could be published on a FPRB web site to help raise awareness among the public of what ethical professional advisors regard as excessively risky strategies.
2. defining what "acting in the client's best interest" should require of the planner – and what sort of things are examples of not acting in the client's best interest.

4. (Supplementary submission 6) **Remove the bias in Corporations Law that creates huge incentives for financial planners to pursue product distribution businesses rather than independent advice businesses.** http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15g.pdf
    1. License individual advisors rather than businesses.
    2. Ban all factors which can bias financial planners to recommend expensive investments over inexpensive investments. To be completely effective, this would require:
        1. Banning commissions. Commissions (and all similar payments from product manufacturers) reward the wrong/undesirable behaviour for consumers seeking advice & punish good/desirable behaviour.
        2. Banning volume over-rides
        3. Banning all other payments (or financial benefits) from product manufacturers to financial planning AFSLs except where the payment is directed by a client and that the payment is to reduce the account balance of the client by the same amount.
        4. Banning product manufacturers owning financial planners.
            1. When a product manufacturer owns a financial planner, the margin from the product can be (and is) used to provide financial incentives to the financial planner to bias advice.
            2. When a product manufacturer owns a financial planner, non-financial penalties can be held over the financial planner to bias advice. Eg "meet your sales quota for selling the parent companies product or you are sacked."
            3. Note: If there is not the political will to ban product manufacturers from having financial planning reps (directly or indirectly) THEN all these product manufacturer reps need to be labelled very clearly as financial product SALES REPS – so that consumers can clearly see what their role is AND so that they cannot readily pass themselves off as an advisor.
                1. Where a product manufacturer is associated in any way with any financial planner then:
                    1. The financial planner's business cards, letter head, FSG, SoA's, signage, advertising and all other similar or related means of identification must clearly disclose that this is a financial product SALES REP.
                    2. The name of all related product manufacturers must clearly be displayed in the same manner.
    3. Adopt the UK FSA's proposal from the June 2009 consultation paper section 4.15 that "where firms access lower prices they will have to pass these on completely to their consumers, without retaining a margin." This would ensure more complete and clearer disclosure of fees.

5. (supplementary 2). **The regulatory focus needs to be shifted from FORM and onto SUBSTANCE.** http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15b.pdf
    1. Remove the requirement to document the basis for advice – and require that the advice be in the client's best interests.
        1. Removing the requirement to document the basis for the advice:-
            1. simply acknowledges that other than for simplistic investment advice, the basis

for advice is huge and cannot be adequately documented in a short enough form to be useful to the client or costs effective – so this currently creates immense compliance uncertainty.

2. Simply acknowledges that the investment risks for non-simplistic investment advice would fill volumes – and (as we have seen over the last 18 months), there are many remote risks that may in some situations cause immense damage to the capital of investors – but documenting all these risks will not help the client because:-
    1. the client would not read it all.
    2. The client typically would not afford to pay for this in many situations.
    3. It is not cost-effective or of good value to consumers.
    4. It is better that advisors be required to act in consumer's best interests.

2. The consumer will be well-protected if ASIC adequately enforces the following aspects of law:
    1. The well established common law obligations in terms of negligence, duty of care; etc.
    2. The Corporations Act 2001 requirement that:
        1. there was a reasonable basis for the advice and the advice was reasonable in the circumstances. Section 945A
        2. a licensee must "do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly" s912A(1)(a)
        3. disclosure of all factors which might taint advice – currently not adequately policed.
    3. The ASIC Act 2001 provision for protection in respect of:
        1. Misleading or deceptive conduct. Section 12DA.
        2. False or misleading representations. Section 12DB.
        3. Requirements to apply "due care and skill", and that advice is "fit for the purpose". Section 12ED
    4. The proposed new obligation that advisors act in clients best interest – fiduciary responsibility.

6. (Initial submission by Puzzle) **Adopt many of the recommendations of the UK FSA.**
http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15-2.pdf
http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15a.pdf
    1. Separate product sales from advice – but go much further than the UK FSA.
        1. **Remuneration for advisors.** Product providers should not be allowed to set remuneration terms for advisors, and should require advisors to set their own charges. Also any payment for advisory services made through the customer's product or investment must be funded directly by a matching deduction from that product or investment made at the same time as that payment.
            - **Empower investors.** Further to FSA's recommendations, we recommend that investors be empowered to direct any product provider that any commission be rebated to investor. This helps to address the imbalance in the relationship between investors and advisors and helps investors ensure advisors deliver a valuable service.
            - **Regulate to change products so that independent advisors can use term "independent".** We recommend making it easier for an Australian advisor to comply with requirements to use the word "independent" - without weakening the spirit of the law. Specifically, we note that the lack of being able to direct all fund managers to rebate trailing brokerage (and volume bonuses) is a major impediment in Australia, to many advisors complying with ASIC's current interpretation of FSR's requirements regarding use of the term "independent". All products need to be required to be able to accommodate the rebating of all commissions to the benefit of the client.
        2. **Use of the term "independent advice".**
            - Those wishing to provide "independent advice" "be required to provide unbiased, unrestricted advice based on a comprehensive and fair analysis of relevant markets." We support this recommendation of the FSA proposal.
            - We recommend that Australia go further than FSA's recommendations. Specifically:-
                - ***We recommend that if an advisor is to claim they provide "independent advice", that the advisor must be working towards conflict-free advice.*** Disclosure of conflicts of interest would not be sufficient.

- ***We believe that some conflicts of interest are simply not consistent with "independent advice".*** For example, it needs to be recognised that an advisor who is hired to sell product, has an irreconcilable conflict which puts the representative's employment obligations ahead of the best interest of the client. This is not consistent with the concept of *"independent advice."*
- We believe that advice should not be deemed to be independent if a product provider holds any form of financial interest (eg ***ownership***) in the advisor.

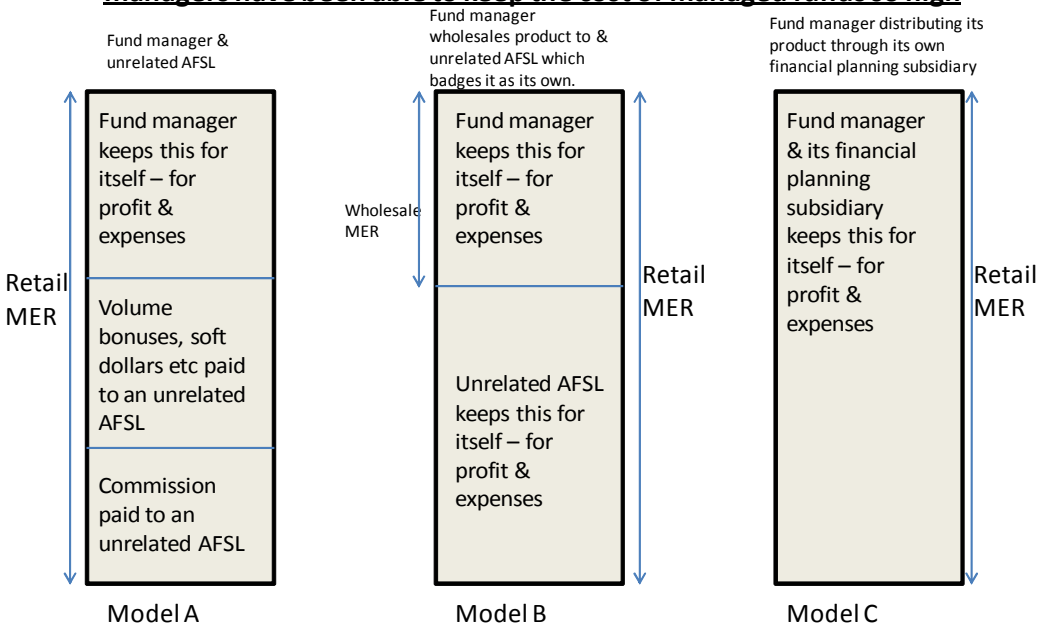
7. Create positive incentives for independent advice.

8. Reduce the costs of funds management. (supplementary submission 4)

http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15d.pdf

- managed funds and super costs too much because:-
  - of lack of competition in price or product because
  - the big fund managers who get 80%+ of the business, compete through control of distribution channels – not on price or product – and the high margins are used to maintain status quo eg
    - by owning their own financial planners whose advice they can control, to direct business into their own product – despite high prices and
    - and for planners that they do not own, by "paying-off" financial planners & financial planning AFSLs with commissions & volume over-rides, and with an additional share of MERs where a product is white labelled.

Non-price competition by controlling distribution channels is how fund managers have been able to keep the cost of managed funds so high



These are just different packaging of the same product distribution business model.

To be consistent, if Model A is banned by banning commissions, then you must ban Model B & Model C.

Model A, Model B and Model C each have the same conflicts of interest that can taint advice and keep costs high.

- Therefore to reduce costs of super and managed funds you must:-
  - break down non-price competition – i.e break down distribution channels by
    - stopping payments from product manufacturers to financial planners and financial planning AFSLs eg commissions & volume over-rides
    - banning product manufacturers from owning financial planners – where a product manufacturer includes a financial planning AFSL that white-labels a product.
  - Introduce more competition – and make it easier to switch between providers
    - make it as easy (and inexpensive) to buy a managed fund (or super fund) as it is to buy a listed security – by developing a platform for managed funds similar to the Australian Stock Exchange's trading platform for listed securities (Integrated Trading System – ITS).
      - So where an investor has a single HIN (Holder Identification Number) for all their listed securities, their would have a single HIN for all their unlisted managed funds and superannuation.
      - So just like you can inexpensively and simply move between one stock broker and another by transferring your HIN between brokers, an investor needs to be able to move between platforms (Wraps and mastertrusts) as inexpensively and easily. This might require platforms and Wrap to comply with common interface standards – but may require all platforms and wraps to use the same transaction engine.
        - This helps remove the lock-in that platform and wraps create.
    - introduce more Exchange Traded Funds (ETFs) – ETFs provide a simple, low-cost alternative to managed funds. In the USA, a very large number of ETFs are traded while in Australia, there are currently only a few. Therefore, if we can make it even easier for Australians to traded on US stock exchanges, many more Australians will have ready access to to a much wider range of inexpensive ETFs.
  - ATO to become a Superannuation Clearing House. ATO to develop an **e-tax**-system-like Internet application to provide simple super services.

9. Ban all conflicts of interest for advice – including product manufacturers owning planners. References:

1. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15-2.pdf
2. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15a.pdf
3. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15c.pdf
4. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15d.pdf
5. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15f.pdf
6. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15g.pdf
7. http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15i.pdf

- All payments from product manufacturers to financial planning AFSLs need to be banned apart from payments out of client account balances – with the approval/consent of consumers. i.e. Ban Commissions, volume over-rides, shelf-space fees, marketing support, soft dollars and all other payments and financial benefits/incentives provided by fund managers to advisors and financial planning AFSLs.
- No point banning commissions if you don't also ban product manufacturers owning planners. A fund manager owning planners is one of the biggest conflicts of interest of all. This is because the financial planning AFSL has a massive incentive to influence its advisors using carrot and stick – as can be seen from studies such as describe in the 4/8/09 Financial Review article "Liars need others to lie too". (http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/supsub15i.pdf) The key principle here is that to remove the conflicts of interests, consumer's need to be able to pay for advice clearly separated from their payment for funds management (i.e. Costs of

advice must be clearly identifiable to the client and any financial benefits received by the financial planning AFSL that is in any way connected to that advice must be clearly identifiable to the client) – and because of complexity of financial arrangements, the only way this can be achieved in a clear and transparent manner is to separate advice businesses from product manufacturing – i.e no organisation (or its associates) should be able to do both. If product manufacturers are not prevented from owning financial planners, then consumers can never be sure whether they are distributing a product (to earn management fees on the product) or providing advice in the client's best interest. Disclosure DOES NOT remove this conflict or fix this problem. This ban needs to include:-

- banning white-labelling of products. White-labelling transforms a financial planning AFSL into a product manufacturer, with the same incentives (using carrot and stick) to influence their advisors.
- Banning financial planning AFSL's from creating their own products.

Note: Banning product manufacturers from owning financial planners will force product manufacturers to compete on price. It will also free the planners currently owned by product manufacturers to advise independently – thus increasing dramatically the consumer availability of independent advice.