
# SUBMISSION TO THE PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

## INQUIRY INTO FINANCIAL PRODUCTS AND SERVICES

**JULY 2009**

## SUBMISSION CONTENTS

# EXECUTIVE SUMMARY & RECOMMENDATIONS

**Executive summary**

IFSA does not believe that the recent financial service and product provider collapses are evidence that our regulatory regime has fundamentally failed or that the legislative requirements imposed on financial services providers are grossly inadequate.

We believe that Australia continues to have an enviable financial services regulatory regime and track record. Our system is based on sound architecture which balances the need for structural, conduct and disclosure requirements on financial services and product providers at the same time as providing extensive safeguards for investors.

This is not to say that our financial services regulatory regime cannot be improved. Indeed, many of the recent reforms with respect to consumer credit and margin lending represent important enhancements.

Consequently, our submission outlines a number of areas where we believe there is room for improvement to ensure that Australia's financial services regime and industry continues to be seen as one of the best in the world.

In forming our views we have benefited from in depth analysis of what we understand to be the contributory factors associated with the recent collapses. Our findings have also been informed by detailed discussions with our members as well as information that is publicly available in relation to the collapses in question.

Our analysis has resulted in the identification of a number of key contributory factors and our submission elaborates and provides recommendations to improve the operation of the current system.

Importantly, our submission has sought to distinguish between these factors which we believe were causal and other issues which, while important to the operation of a sound and efficient financial services regime, are not considered to have been contributory factors to the collapses which took place.

With respect to the latter, our submission provides an assessment of the following key features of the current system:

1. Role of Financial Advisory Networks
2. Contribution that quality financial advice makes to the lives of individuals and the economy.
3. Education/qualification requirements for financial advisers.
4. Adequacy and appropriateness of compensation mechanisms.
5. Regulation of financial products and services (other than financial advice)
6. Role of investment platforms

Our submission also provides constructive recommendations which aim to enhance the financial services regime as it applies in these areas, where appropriate.

IFSA trusts that our analysis and recommendations will assist the Committee to reach its own views as to the elements of our system which have contributed to the failures and what measures should be adopted in response.

Our recommendations to the Committee follow.

**Recommendations to address the contributory causes**

1. Licensing standards

*Recommendation: ASIC, in conjunction with industry, to examine the role of the Licensing process in recent collapses and whether improvements can be made which will enable ASIC to better determine that Licensees and their Authorised Representatives are appropriately resourced and sufficiently competent to offer the financial services and products for which they have, or wish to obtain, a licence.*

2. Inappropriate use of leverage

*Recommendations:*

- *The Committee to support the recent inclusion of margin lending activity under the same framework as other financial services in the Corporations Act.*
- *Licensees and ASIC to carefully monitor developments in this area to ensure that client investment strategies involving gearing remain appropriate and that notification practices continue to improve.*

3. Conflicts management

*Recommendation: ASIC to adopt a risk-weighted approach to monitoring and supervision based on improved benchmarking of industry practice to more effectively monitor and assess management of conflicts of interest by Licensees and Licence applicants.*

4. Provision of inappropriate financial advice

*Recommendation: The Committee to consider how "fringe" operators can best be identified and monitored by ASIC. IFSA's suggestion for an improved "risk-weighted" approach to monitoring and surveillance is considered a possible solution (See below '6. Monitoring and enforcement').*

5. Ineffective disclosure

*Recommendation: The Committee to support the work of the Government's Financial Services Working Group which will provide a framework for product providers to develop simpler, more concise and therefore more effective disclosure documents for the benefit of investors.*

6. Financial literacy

*Recommendation: The Committee to endorse closer collaboration between ASIC and the financial services industry on the development and implementation of an appropriate financial literacy strategy and related initiatives.*

7. Monitoring and enforcement

*Recommendation: Industry bodies to work with ASIC to develop criteria which will assist ASIC to take a more informed risk-weighted approach to monitoring and surveillance using its existing powers. This approach will also assist ASIC to develop a better "early warning detection" capability and be better prepared to respond pre-emptively.*

**Recommendations to address other important issues not related to recent collapses**

8. Value of financial advice

*Recommendation: That the Committee recognise the value of financial advice to individuals, families and small business as well as the broader economy, and require that any proposals for reform in this area be subject to economic analysis of the impact on the affordability and accessibility of advice.*

9. Education/qualification requirements for financial advisers

*Recommendation: Should the Committee conclude that the entry level requirements for financial advisers need to be enhanced, an in-depth analysis of the costs and benefits of any proposed enhancements should be undertaken prior to any specific recommendation being included in the Committee's Report.*

10. Adequacy and appropriateness of compensation mechanisms

*Recommendation: Should PI insurance remain the primary mechanism for licensees to meet their obligations in relation to having compensation arrangements in place, ASIC and industry should continue to consult on how to continue to improve the operation of the PI insurance market and the type of coverage that is able to be provided to all licensees.*

11. Regulation of financial products and services

*Recommendation: That the Committee not seek to prescribe financial products that in its view are "appropriate" for retail investors and instead recognise the importance of a holistic approach to assisting retail investors to make better and more informed choices in relation to their financial affairs.*

12. Role of investment platforms

*Recommendation: That the Committee recognise the important role played by platform and wrap service providers in the financial services sector and not seek to introduce regulations which minimise the range of services they provide or the important role they play.*

## INTRODUCTION

IFSA welcomes the opportunity to respond to the inquiry into financial product and service provider collapses being conducted by the Parliamentary Joint Committee on Corporations and Financial Services.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA's membership also includes Financial Advisory Networks (FANs). A FAN is the holder of an Australian Financial Services Licence (AFSL) which enables it and its Authorised Representatives to provide financial advice to the public. Australia's largest 100 FANs provide support and services to more than 15,000 Authorised Representatives.

IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes is actively monitored and ensures the promotion of industry best practice.

Importantly, given our understanding that the inquiry is primarily focussed on the events and causes that gave rise to the recent collapses, our submission is similarly focussed on the regulation of investment products, financial advice and related services. As a result, our submission does not address risk products, such as life insurance, as these have not been a factor in the collapses being considered.

In focussing our comments on investment products, financial advice and related services, it is important to note that our submission will not comment in detail on the specific events or causes that gave rise to the recent collapses which are the genesis of this inquiry.

This reflects the reality that IFSA is not in a position to provide detailed commentary in respect of these collapses as the companies in question are often not associated with IFSA and the activities in question are also often outside of IFSA's scope – for example issues associated with the provision of credit.

IFSA's submission does, however, put forward practical recommendations to improve the effectiveness of Australia's financial services regime, having regard to:

- our general understanding of the causes behind the recent collapses;
- whether the recent collapses are evidence of broader systemic risk;
- whether any gaps in our financial services regime were exposed; and
- how industry participants, industry bodies and ASIC can more effectively work together to reduce the likelihood of future collapses.

In doing so, IFSA's submission focuses on financial service or product provider collapses which have occurred as a result of inappropriate and/or illegal activity.

IFSA does not believe that the Committee should be focussed on collapses in which no financial services laws have been breached or where there does not appear to have been any deficiencies in the current legislative regime. While losses experienced by any investor are unfortunate, these types of collapses are considered

part of the operation of a market economy in which investing involves an inevitable trade-off between risk and return.

Finally, it is IFSA's view that, through the course of its inquiry, the Committee should attempt to answer a fundamental question that goes to the heart of the overall purpose of the inquiry:

> ***Did the collapses represent a failure of the current legislative and regulatory framework or were they a result of participants operating outside or on the fringes of the current framework?***

Careful consideration of this question will assist the Committee in arriving at recommendations that will genuinely reduce the likelihood of future collapses, as opposed to the introduction of additional layers of regulation that may have little or no impact other than to raise the cost of investing for investors.

Moreover, focussing on this key question will also allow the Committee to better target its recommendations to the elements of our system which it considers have contributed to the failures – be it, licensing requirements, disclosure obligations, conduct obligations, compensation mechanisms or monitoring and enforcement.

# CHAPTER 1: OVERVIEW OF AUSTRALIA'S FINANCIAL SERVICES REGIME

**Overview of the Australian financial services regime**

The Corporations Act is the primary source of financial services laws in Australia.

In particular, Chapter 5C which deals with 'Managed Investment Schemes' and Chapter 7 which deals with 'Financial Services and Markets' together outline the key obligations and requirements that any financial service or product provider in Australia must meet.

Australia's regime imposes a combination of structural, conduct and disclosure requirements on financial services and product providers.

For example, in order to offer an investment product (Managed Investment Scheme) to retail investors, the offeror of the product is required to:

- Obtain an Australian Financial Services License by satisfying the necessary capital requirements, demonstrating that they have adequate resources and the necessary competence to provide the financial services.
- Register with ASIC as a Managed Investment Scheme and thus be operated by a 'responsible entity' who has sole responsibility for the operation of the scheme.
- Have a Constitution which outlines the rules of the scheme and a Compliance plan which outlines how the responsible entity will ensure the scheme complies with its Constitution and the Corporations Act.
- On an ongoing basis:
    - issue a Product Disclosure Statement to prospective investors.
    - develop and maintain a Compliance Plan and possibly a Compliance Committee;
    - conduct independent audits of the Scheme and the Responsible Entity and lodge these annually with ASIC;
    - keep the Scheme's property separate from the property of the Responsible Entity and other Schemes;
    - have a procedure for removing the Responsible Entity; and
    - as a holder of an Australian Financial Services License, meet necessary licensing conditions such as being a member of an external dispute resolution body and have adequate compensation arrangements in place in the event of a breach of relevant obligations under the Corporations Act.

This framework provides a range of checks and balances to ensure an appropriate level of investor protection is provided.

Indeed, in many respects, Australia has a world class financial services regulatory regime which continues to be admired by other countries around the world.

We have a consistent framework that covers financial product and service providers, uniform up-front and ongoing disclosure obligations and a range of investor safeguards which, taken together, have served investors, the industry and the economy very well.

**Overseas Experience**

Australia has not been the only country to experience financial service or product provider collapses in recent years. The Global Financial Crisis has impacted almost every country in the world, triggering a wave of collapses in many of them.

By way of example, the collapse of Lehman Brothers in September 2008 triggered significant losses for investors in Hong Kong and elsewhere who had purchased so called "Mini-bonds". The losses are understood to amount to around US$1.8 billion in Hong Kong alone.

While regulatory and legal actions are continuing, it has been alleged that there had been a high degree of miss-selling and that the risk associated with these securities had not been well understood by the investors.

In response, it is interesting to note that a number of the Hong Kong Securities and Futures Commission recommendations following the "Mini-bonds" collapse seek to replicate features of Australia's financial services regime, namely:[1]

- Introducing a "cooling off" regime.
- Considering a "Twin Peaks" model of financial regulation.
- Consistent point of sale disclosure of fees and commissions.
- Creation of an Investor Education Council with a broad remit for educating the public on financial disclosure.

Similarly, the ongoing global debate about financial regulatory reform has also led many to focus on the "Australian model" as one which has performed better than most during the crisis.

Given the extreme market conditions which we have experienced in recent times, the relative health of the financial services system compared to its peers internationally proves the regulatory regime is generally sound and in good order.

This is certainly not to say that it is perfect – indeed, our submission provides a number of recommendations aimed at improving our system. However, in IFSA's view, the overall soundness of our system suggests the importance of the Committee taking a targeted approach to its enquiry which focuses on the key causes of the collapses and addressing those rather than seeking to more broadly redesign the system.

Another reason IFSA believes a targeted approach is appropriate is the reality that imposing further complex regulation on the industry as a result of the practices and behaviour of only a handful of licensees risks placing a further regulatory burden and cost on otherwise compliant licensees – with no net benefit to investors.

[1] Issues raised by the Lehmans Minibonds crisis, Report to the Financial Secretary, December 2008, Securities and Futures Commission.

**Investor safeguards under our financial services regime**

In order to assist the Committee to better understand the scope of investor safeguards under our financial services regime, we have attached a list of relevant provisions (Appendix 2).

The selected provisions are only those which are directly relevant to the operation of a Managed Investment Scheme (managed fund), offer of a financial product or provision of a financial service.

Key investor safeguards under our financial services regime include clear provisions dealing with:

- Obligations on Licensees to do all things necessary to ensure that financial services are provided efficiently, honestly and fairly.
- Prohibitions on unconscionable, misleading or deceptive conduct.
- Surveillance checks by ASIC.
- ASIC powers to suspend or cancel a License or issue a banning order against a Licensee or individual.
- Cooling off rights which allow retail clients to return a financial product and to have the money they paid to acquire the product repaid within 14 days of having acquired the product.
- Mandatory Licensee membership of free to consumer external dispute resolution services (e.g. the industry funded Financial Ombudsman Service).
- Adequate compensation arrangements in the event of a breach of relevant obligations under the Corporations Act.

Despite these considerable safeguards, our view of how the existing financial services regime can be improved is discussed in following Chapters of this submission.

Importantly, IFSA believes that these extensive legislative safeguards demonstrate that *better*, as opposed to *more*, regulation is needed to help prevent future product or service provider collapses.

## CHAPTER 2: GENERAL ANALYSIS OF RECENT FINANCIAL SERVICE AND PRODUCT PROVIDER COLLAPSES

As noted earlier in this submission, IFSA is not in a position to comment on any specific financial service or product provider collapse that is currently under investigation.

However, following are general comments which reflect both discussions we have had with our members as well as information that is publicly available in relation to the collapses in question.

Based on these discussions and this information, we believe there were a number of contributory factors associated with most of the recent collapses.

These contributory factors include:

1. **Gaps in the financial services regulatory regime.**

   These 'gaps' include areas where the current regulatory regime can be improved.

   Chapter 3 provides an analysis of the gaps and in some cases steps that are already being taken to address them.

2. **High levels of leverage, both at a licensee and/or individual level, coupled with a large fall in asset prices.**

   Clearly a number of the recent collapses were associated with business or advice strategies that involved high levels of leverage.

   Chapter 3 provides an analysis of margin lending activity to assist the Committee in determining whether there are high levels of leverage creating systemic risks in the financial system.

3. **Poor management of conflicts of interest.**

   Poorly managed conflicts of interest may have contributed to a number of the collapses in question. These conflicts seem to have been most stark in the way their remuneration models were developed and in the lack of appropriate arrangements put in place to manage those and other conflicts.

   Chapter 3 provides the Committee with an overview of the legislative requirements and what the industry believes amounts to adequate conflicts management.

4. **Inappropriate financial advice.**

   Following consultation with IFSA Financial Advisory Network members, there is strong agreement that a number of the collapses in question appeared to be accompanied by instances of inappropriate financial advice being provided to retail investors.

   Chapter 3 assesses whether the practices of those involved in the recent collapses fell short of legislative and industry standards.

5. **Ineffective disclosure, often overly lengthy and complex, which impacted consumer's ability to understand the risks they were taking.**

   The industry and successive governments have made some progress but more needs to be done if disclosure documents are going to become simpler, more concise and therefore more helpful for investors.

   Chapter 3 will examine what more needs to be done to improve the quality of disclosure made to retail investors.

6. **Low levels of financial literacy among affected retail investors.**

   It is widely acknowledged that there are a large number of investors with low levels of financial literacy.

   Chapter 3 will examine the importance of financial literacy and how more can and should be done to improve levels of financial literacy across all segments of the population.

7. **Shortcomings in monitoring and enforcement of licensees.**

   IFSA believes that the industry has a role to play in alerting and assisting the regulator to what is happening in the marketplace.

   Chapter 3 suggests a new approach where the industry works with ASIC to develop criteria to assist ASIC in taking a more informed risk-weighted approach to monitoring and surveillance using its existing powers.

Each of these contributory factors above is addressed in detail in the following Chapter.

# CHAPTER 3: ADDRESSING THE CONTRIBUTORY FACTORS

This chapter examines the contributory factors above and provides further insight into their systemic significance as well as recommendations to address each where appropriate.

**1. Regulatory gaps**

IFSA believes that a number of the recent collapses have highlighted gaps in Australia's financial services regulatory regime.

Licensing standards

Given the nature of some of the product and service provider collapses which have occurred, IFSA believes that it may be appropriate for ASIC to consider enhancing the financial services licensing process to ensure that Licensees and their Authorised Representatives are appropriately resourced and sufficiently competent to offer the range of financial services and products for which they have, or wish to obtain, a licence.

ASIC may also wish to consider how it assesses the ongoing competence of licensees to ensure they are complying with their licence conditions. This aspect of the regime is discussed in more detail in section '7. Monitoring and enforcement' below.

IFSA would welcome the opportunity to further discuss these matters with ASIC.

*Recommendation: ASIC, in conjunction with industry, to examine the role of the Licensing process in recent collapses and whether improvements can be made which will enable ASIC to better determine that Licensees and their Authorised Representatives are appropriately resourced and sufficiently competent to offer the financial services and products for which they have, or wish to obtain, a licence.*

Consumer credit

Legislation was introduced on 25 June 2009 giving effect to the Government's proposed consumer credit reforms that will bring about greater consistency between the regulation of financial products and services and consumer credit through:

- Extending the powers of the Australian Securities and Investment Commission (ASIC) to be the sole regulator of the new national credit framework with enhanced enforcement powers.
- Requiring licensees to observe a number of general conduct requirements including responsible lending practices.
- Requiring mandatory membership of an external dispute resolution (EDR) body by all providers of consumer credit and credit-related brokering services and advice.

The inclusion of consumer credit under broadly the same framework as other financial services is supported by IFSA.

Margin lending reforms

In addition to these consumer credit reforms, additional reforms are being introduced that will extend the operation of the Corporations Act to margin lending activity.

These reforms will require margin lenders to be licensed and to comply with specific 'responsible lending' rules.

Importantly, under the reforms, unless otherwise agreed with the financial adviser, the margin lender will be responsible for notifying the borrower of a margin call, even where the primary client contact is only with the adviser.

The inclusion of margin lending under broadly the same framework as other financial services is supported by IFSA.

## 2. Leverage

Importantly, IFSA does not believe that a high level of leverage is, in and of itself, inappropriate or that investment strategies involving debt are inappropriate for retail investors.

However, IFSA recognises the additional risks that leverage can introduce both to a financial product and to an investment strategy. For this reason, as indicated above, we support the inclusion of margin lending activity under broadly the same framework as other financial services in the Corporations Act.

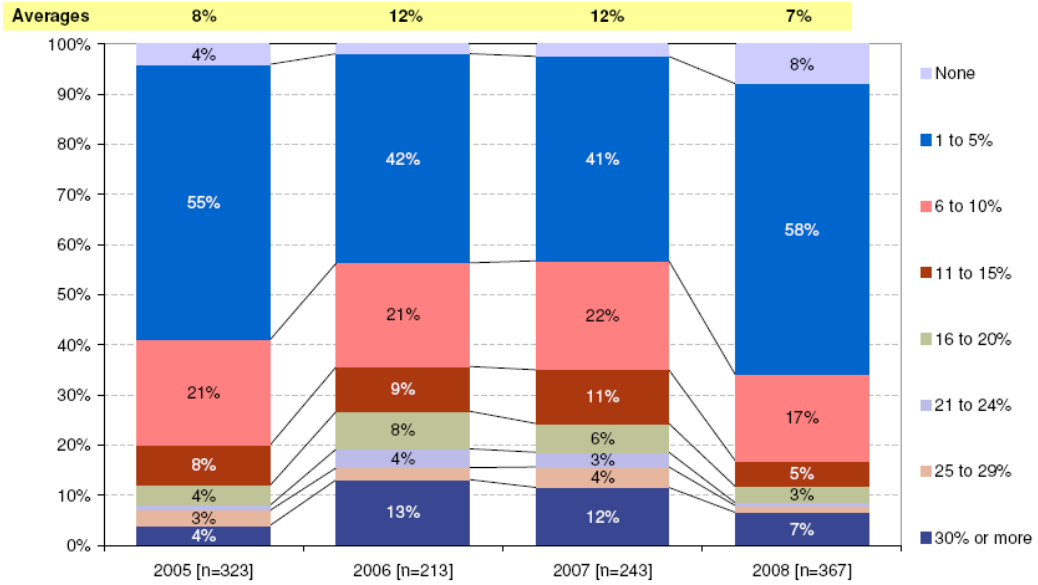
As a result of our views with respect to the additional risks that leverage can introduce, and the role played by margin lending practices in recent collapses, IFSA has sought to better understand the extent to which debt strategies, specifically involving margin lending, have grown over recent years and whether there is any evidence that there are systemic risks building in the financial system that need to be addressed.

Analysis of margin lending activity

The following analysis is conducted on the basis of research obtained from Investment Trends into margin lending activity.[2]

The research found that, of planners who advise on gearing products, up to 12% of their clients on average use margin lending. The chart below shows the proportion of adviser clients that use margin lending in more detail.

Chart 1: Proportion of adviser clients that use margin lending




A key finding from the above Chart is that by the end of 2008, the proportion of clients using margin lending had dropped to below 2005 levels.

[2] Findings based on Investment Trends Dec 2008 Margin Lending Reports: Planner Report, and the Dec 2008 Margin Lending: Investor Report. Investment Trends is the leading specialist market research organisation in the Australian wealth management industry.

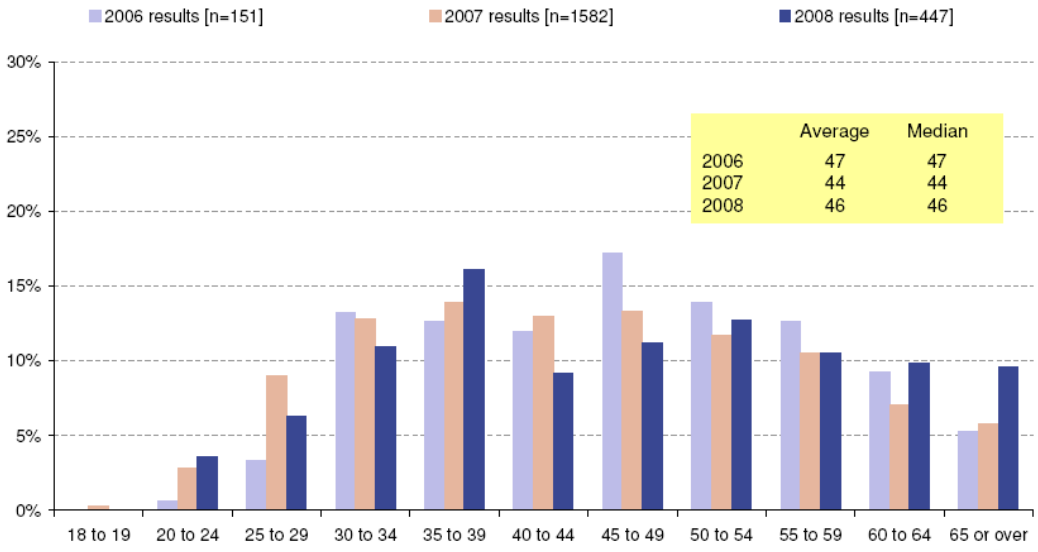
Additionally, the Chart provides an insight into the proportion of advisers who have a tendency to recommend or implement strategies that involve margin lending strategies.

Significantly, the latest available data shows that more than 80% of advisers have less than 10% of their clients invested in a strategy that involves a margin loan.

This is clear evidence that the majority of financial advisers do not believe margin lending strategies are appropriate for all investors.

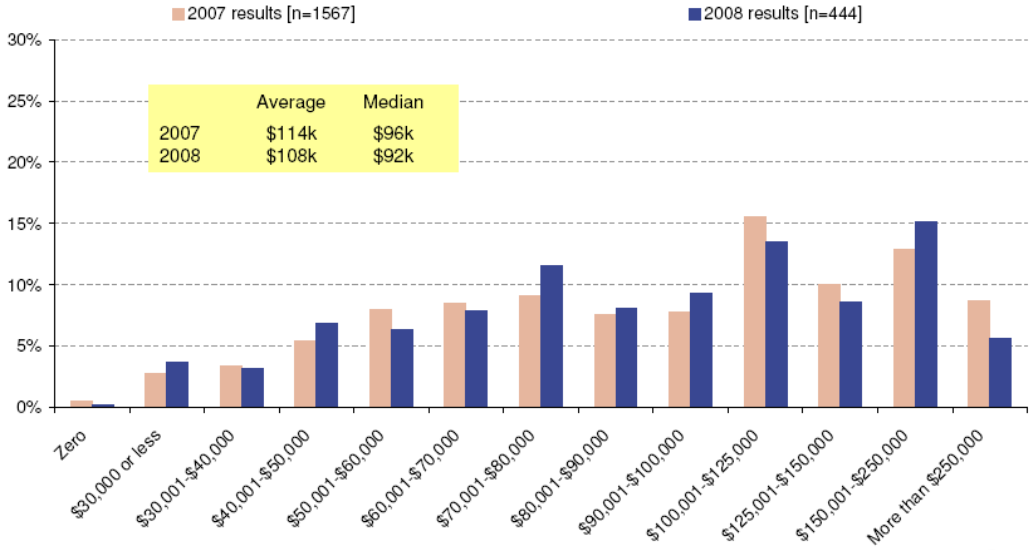
The Chart below illustrates the age demographics behind margin lending activity. It shows that where margin lending strategies are used (currently 7% of clients), it tends to be across all age cohorts, particularly with clients who are above 30 years of age.

Chart 2: Margin lending activity by age segment



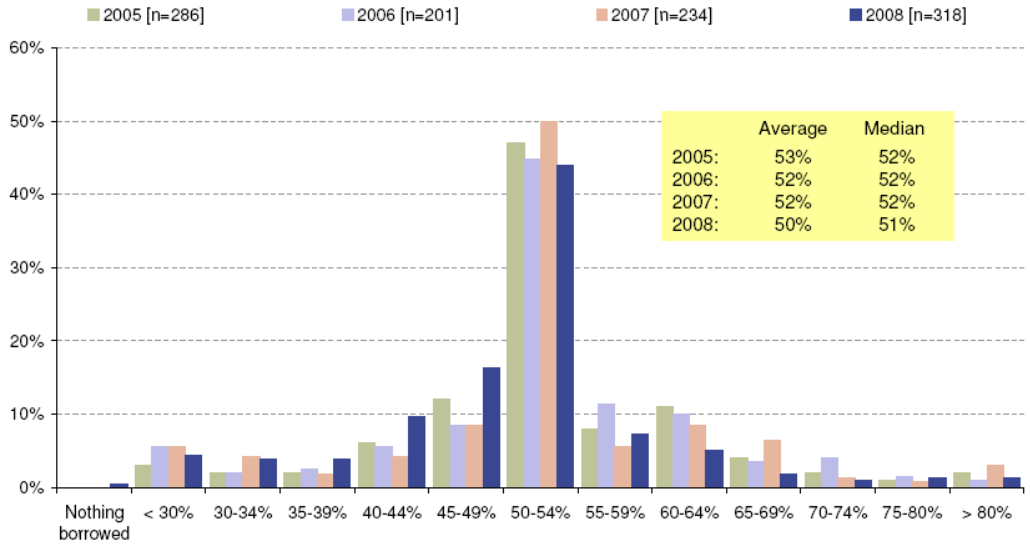

Moreover, the below chart shows that, broadly, there is a positive relationship between a person's income and the likelihood they will have a margin loan.

Chart 3: Margin lending activity by personal income segment




Importantly, the research conducted by Investment Trends shows that loan to value ratios (LVR) have remained fairly constant over the last few years at around 50%. While gearing in excess of these ratios may well be appropriate in certain circumstances, IFSA does not believe that systemic LVRs of around 50% are a matter of concern.

Chart 4: Spread of Loan to Value Ratios across clients




Relevantly, where margin calls were received by investors, assets were sold to meet the call in only a third of cases. The majority (69%) instead added cash to meet the call. While there are a number of possible explanations for this result, a very likely explanation is that the majority of investors were in a position to meet the call and hence do not appear to have been over-exposed.

Interestingly, the work by Investment Trends provides some evidence that financial advisers were themselves concerned about market conditions and the possibility of margin calls as major barriers to margin lending growth as 2007 drew to a close.

It is also instructive to note a number of the other key barriers identified by financial advisers to recommending margin lending strategies to their clients in 2008/09:

- Risk of margin calls/state of the equity market
- Too many retirees in their client base/too risky for their clients
- Lack of client understanding
- Financial Advisory Network imposed restrictions

IFSA posits that the active consideration of these factors by financial advisers again demonstrates that, in the main, advisers are recommending appropriate margin lending strategies to their clients.

Finally, given the nature of margin lending, it is important to analyse the experience of advisers and investors who experienced margin calls.

Interestingly, the research notes that almost half of current margin lending clients had received a margin call within the last 12 months. Half of these margin calls were fully expected and another 30% were suspected by investors. That is, around 80% of investors who received a margin call were sufficiently aware of their facility that they either expected or suspected they would receive a margin call.

This is an important finding as it suggests that the majority of investors are being made properly aware of how margin loans operate.

The research also shows that in the vast majority of cases (96%), where a margin call is received, advisers have discussed the margin call directly with their client. The research found that 72% of investors who had a received a margin call within the last 12 months rated their most recent call as “good” or “very good”.

Importantly for IFSA and its members, the research also highlights areas where lenders and Financial Advisory Networks should look to improve existing practices in this area.

Those investors that indicated that their most recent margin call was either “average” or “lower” (28%), pointed to the following as reasons for their rating:

- Indirect notification
- Poor customer service
- Lack of awareness of client’s situation
- Poor communication
- Delayed notification

On the basis of the above research and discussions with Financial Advisory Network members, IFSA does not believe that systemic risks exist with respect to the use of higher-risk debt strategies by such Licensees. This is not to say that Financial Advisory Networks and ASIC should not carefully monitor developments in this area to ensure that client’s investment strategies remain appropriate.

*Recommendations:*

- *The Committee to support the recent inclusion of margin lending activity under the same framework as other financial services in the Corporations Act.*
- *Licensees and ASIC to carefully monitor developments in this area to ensure that client investment strategies involving gearing remain appropriate and that notification practices continue to improve.*

**3. Poor management of conflicts of interest**

IFSA believes that a number of the collapses in question may have occurred partly as a result of poorly managed conflicts of interest. These conflicts seem to have been most stark in the way their remuneration models were developed and in the lack of appropriate arrangements put in place to manage those and other conflicts.

IFSA does not believe that these examples of poor conflicts management highlight a systemic problem or a structural deficiency in our financial services regime, rather, these are examples of licensed providers not meeting the obligations imposed on them under the Corporations Act.

IFSA believes that the vast majority of Licensees have in place adequate arrangements for the management of conflicts of interest.

Below follows IFSA's assessment of the current conflicts management requirements along with what we consider represents best practice in managing conflicts in accordance with those requirements.

Under Section 912A(1)(aa) of the Corporations Act, Licensees are obligated to have in place adequate arrangements for the management of conflicts of interest that may arise in relation to activities undertaken by the Licensee or their representative in the provision of financial services.

Importantly, the legislative conflict of interest management obligation is predicated on the Licensee being best placed to judge:

- When its interests and those of its customers are not aligned;
- The potential negative results that may arise from any misalignment of interests; and
- How best to prevent any negative results or behaviour occurring.

It is therefore the responsibility of management, on an ongoing basis, to ensure adequate systems and controls are in place to manage conflicts of interest that may arise in relation to activities they undertake in the provision of financial services – failure to do so is a breach of the law.

IFSA acknowledges that potential conflicts of interest can inevitably arise in the provision of financial services, as with the provision of any commercial service.

Examples of conflicts of interest that financial services providers may face include:

- recommending a client replace their existing product with another product which generates a higher ongoing commission;
- maximising trading volumes in order to increase revenue, even though this may be inconsistent with a client's objective to minimise investment costs;
- having an interest in the subject matter of the advice or an association with the product issuer.

The potential existence of these conflicts, and the inability to avoid all conflicts, is in our view exactly why there is a legislative requirement that conflicts be *managed* such that Licensees comply with their obligations under their Licence.

Importantly, IFSA does not believe that all conflicts need to be avoided. In many cases, managing a conflict, as opposed to avoiding it, will actually provide a superior outcome for investors.

For example, while vertical integration in the financial services industry is common, and undoubtedly gives rise to potential conflicts of interest, it is important to also consider the significant benefits that consumers receive from this integration, namely:

- Strong risk management – through imposing standards consistent with those across the group;
- Security – through more substantial capital backing;
- Economies of scale – through a larger organisation with more capital and purchasing power;
- Accessibility – through more efficient processes supported by other parts of the group; and
- Affordability – often vertically integrated businesses are able to cross-subsidise other parts of their business, reducing costs for consumers that access those subsidised services.

These benefits should not be underestimated as they are often key factors underpinning an individual's investment decision.

IFSA therefore supports the current legislative approach to managing conflicts of interest, as opposed to avoiding them, and has supplemented this requirement through IFSA Standards.

Best practice in managing conflicts

What constitutes adequate conflicts management arrangements will depend on the nature, scale and complexity of a Licensee's business.

However, we have provided some information below which we believe will assist the Committee to reach its own views about whether the conflicts management practices of firms associated with the recent product and service provider collapses were adequate.

Under ASIC 'Regulatory Guide 181 – Licensing: Managing conflicts of interest', ASIC outlines the types of issues they will consider in assessing Australian Financial Services Licence applications and when carrying out surveillance with respect to Licensees' compliance with their obligation to have adequate arrangements in place to manage conflicts of interest.

These include:

- What are your procedures for identifying conflicts of interest?
- What are your procedures for assessing and evaluating conflicts of interest?
- How do your conflicts management arrangements enable you to decide how to respond to or deal with particular conflicts?
- When were your conflicts management arrangements last reviewed internally or by a third party (e.g. an auditor)?

- When were your conflicts management arrangements last updated?
- What structural arrangements do you have in place to manage conflicts of interest?
- How does your organisation's structure support your management of conflicts of interest?
- What information barriers do you have within your organisation? How do they help you manage conflicts of interest?
- How do your conflicts management arrangements ensure that conflicts do not affect your compliance with your licensee obligations? How do you test their effectiveness in achieving this?
- How do your conflicts management arrangements ensure that your clients are not treated unfairly? How do you test their effectiveness in achieving this?
- How do your conflicts management arrangements ensure that any personal advice you give is appropriate? How do you test their effectiveness in achieving this?
- How were your conflicts management arrangements formulated and approved?
- How are your conflicts management arrangements communicated to staff and other stakeholders (e.g. clients, customers and the public)?

IFSA believes that any conflicts management policy should address these matters and welcomes ASIC monitoring of Licensees in this area – both at the time of issuing a new Licence and on an ongoing basis.

In addition to the legislative requirements, IFSA Standards specify that a member must not allow conflicts of interest or bias to influence their actions. Specifically, IFSA members are required to:

- assess existing and potential areas of conflicts arising from internal or external interests by identifying:
    - (i) types of behaviour that may cause a conflict of interest at an individual, business or entity level; and
    - (ii) behaviour that may impact on decisions at an individual, business, entity, product or service level; and
- manage the potential behaviour or decisions in contemplation of the ethical standards expected of members.[3]

Additionally, in certain areas, IFSA Standards require that certain conflicts of interest be avoided, namely entering into or accepting certain alternative forms of remuneration provided by a third party to the Licensee/client relationship.[4]

---

[3] See IFSA Standard No.1 'Code of ethics and Code of conduct'. These Standards impose obligations on IFSA members to ensure that:

- client and investor interests are paramount in all decisions and transactions;
- the execution of client requirements come before those of the member; and
- their conduct contributes to markets operating in an efficient and informed manner.

[4] See IFSA Standard No.14 'Alternative Forms of Remuneration', also known as the IFSA/FPA Industry Code of Practice on Alternative Forms of Remuneration in the Wealth Management Industry. The

The IFSA/FPA Industry Code of Practice on Alternative Forms of Remuneration prohibits alternative forms of remuneration that are based on the volume of business placed. The Code also requires that other alternative forms of remuneration be disclosed on a Public Register that is available for any party (including clients or potential clients) to view.

Addressing poor conflicts management arrangements

IFSA believes improved benchmarking by ASIC, with the industry's assistance, could lead to more effective monitoring of Licensees and improved practices in this area.

By way of example, in relation to the potential conflicts created by remuneration models, if ASIC were to adopt a risk-weighted approach to monitoring and supervision (as discussed in more detail below in section 7), the payment of fees to Licensees and their representatives that are obviously high compared to a reasonable industry range, could provoke closer scrutiny by ASIC, with the opportunity to conduct a subsequent audit of whether appropriate advice is being provided to clients.

IFSA therefore supports the existing conflicts management obligations, as supplemented by industry Standards, which together ensure that financial services licensees are conducting themselves in a manner consistent with their legal, industry and professional obligations.

*Recommendation: ASIC to adopt a risk-weighted approach to monitoring and supervision based on improved benchmarking of industry practice to more effectively monitor and assess management of conflicts of interest by Licensees and Licence applicants.*

Code sets the industry benchmark for IFSA and FPA members on how alternative forms of remuneration paid by third parties should be managed and disclosed.

**4. Inappropriate financial advice**

IFSA strongly believes that the majority of participants in the advice industry in Australia, particularly those that operate as Financial Advisory Networks that comply with industry standards in addition to the legislative obligations imposed on them, provide an important and valued service to their clients.

As with any industry, there will always be service providers whose practices are not considered consistent with those of the majority and who unfortunately fall short of legislative and industry standards.

IFSA believes that the Committee should focus on how these "fringe" operators can best be monitored and identified as early as possible. IFSA's suggestion for an improved "risk-weighted" approach to monitoring and surveillance is an example of a measure which could address this challenge (See '7. Monitoring and enforcement').

Following consultation with IFSA Financial Advisory Network members, there is strong agreement that a number of the collapses in question appeared to be accompanied by instances of inappropriate financial advice being provided to retail investors.

This is demonstrated by a number of factors including:

- use of inappropriate strategies – such as higher risk strategies for older age investors;
- unusually high concentration of an individual's portfolio in a single financial product; and
- "one size fits all" investment strategy (whether high risk or not) being consistently recommended to many clients irrespective of its appropriateness.

Advice demonstrating these attributes will in most cases amount to a contravention of the current legal requirements which impose an obligation that personal financial advice must be appropriate with regard to the person's relevant objectives, financial situation and needs.[5]

IFSA believes that this inappropriate advice was largely driven by a combination of poor conflict management processes, poor client risk assessments and a lack of effective oversight on behalf of the Licensee as well the regulator.

Importantly, IFSA does not believe that the poor quality of advice provided in connection with a number of the recent product and service provider collapses is symptomatic of broader malpractice in the industry.

However, in order to assist the Committee to reach its own views about whether the risk assessment practices of firms associated with the recent product and service provider collapses were adequate, we have developed a guide below to what we believe amounts to best practice risk assessment in the industry.

[5] See Section 945A of the Corporations Act 2001.

*Best practice risk assessment*

There are a variety of sound risk assessment models which advisers and Financial Advisory Networks apply to assess the risk profile of their clients. These models assist the adviser in determining what advice will be appropriate for their client.

The central objective of conducting a risk assessment is reaching a clear understanding about how much risk of financial loss a client is willing to accept to achieve their financial goals.

Appropriate advice therefore involves calibrating an individual's financial goals against their risk profile.

Risk assessment models are typically based on an in-depth survey or guided discussion between the financial adviser and their client.

Below is a summary of the key information and issues typically discussed and recorded during a client risk assessment:

- Familiarity with investment markets.
- Attitude to investment markets.
- Level of risk the client is prepared to take in arranging their financial affairs.
- Comfort with volatility and the possibility of losses.
- Level of experience in investing.
- Investment priorities. For example, whether the client is primarily seeking preservation of capital, income returns versus capital growth or a combination.
- Investor psychology, for example, understanding the client's likely response to rapid rises or falls in the value of their investments.

The outcome of the risk assessment is usually a statement and categorisation of the individual's risk tolerance, such as:

| | |
|---|---|
| **Conservative (very low risk taker)** | Investor's main objective is stability of income and capital protection. They are very prepared to accept lower returns to protect their capital. A low level of volatility can be expected from time to time and overall long term returns are likely to be relatively low. |
| **Moderately conservative (low risk taker)** | Investor's main objective is to maintain stable returns. Capital protection is still a priority however they are willing to accept some risk and low levels of volatility to achieve these returns. |
| **Balanced (average risk taker)** | Investor's main objective is to achieve balanced returns to meet their medium to long-term financial goals. The aim is to achieve some capital growth and investors are willing to accept a moderate level of volatility to achieve these returns. |
| **Moderately aggressive (high risk taker)** | Investor's main objective is to accumulate assets by targeting capital growth over the medium to long term. They are prepared to accept higher volatility and moderate risks to achieve these returns. |
| **Aggressive (very high risk taker)** | Investor's main objective is to achieve high long-term growth. Capital protection is not a concern as they are prepared to accept high portfolio volatility to pursue potentially greater long-term returns. Investment choices are diverse but carry with them a high level of risk. |

In summary, licensees and their representatives that fully comply with their legal and professional obligations are required to provide financial advice that has taken account of a client's needs and circumstances, including their risk tolerance.

In IFSA's view, the current regulatory framework along with professional and industry standards simply does not permit some of the practices and behaviours that appear to have led to the provision of inappropriate advice in connection with the collapses which the Committee is examining.

Given this, IFSA suggests that if the Committee concludes that there is no evidence of inappropriate advice being delivered broadly across the industry, the Committee should seek to adopt a targeted approach which addresses the specific causes of the recent collapses.

IFSA is concerned that the introduction of broad reforms could place an unnecessary and costly regulatory burden on the majority of licensees and representatives that already comply with their legal and professional obligations, and in doing so deliver a a valuable service to their clients.

*Recommendation: The Committee to consider how "fringe" operators can best be identified and monitored by ASIC. IFSA's suggestion for an improved "risk-weighted" approach to monitoring and surveillance is considered a possible solution (See below '7. Monitoring and enforcement').*

**5. Ineffective disclosure**

IFSA strongly supports the intent behind our present disclosure regime which provides comprehensive "point of sale" disclosure to investors to enable them to make an informed investment decision.

Our system has three main disclosure documents:

- Financial Services Guide – outlines relevant information about the provider of the financial service or product, including about any conflicts of interest and how the provider is remunerated. This may be provided even where the individual has not received any financial advice or purchased any financial product.
- Product Disclosure Statement – outlines the key characteristics of the financial product being provided, including any fees and costs, benefits and risks. This is provided where an individual is considering purchasing a particular financial product.
- Statement of Advice – outlines the information needed by an investor to make an informed decision about whether to act on the personal advice received.

While IFSA supports the above disclosure framework, we recognise that the industry has found it difficult to find a balance between managing "regulatory risk" – the risk of not providing sufficient information to satisfy ASIC that the legislative content obligations have been met – and providing simpler and more concise disclosure which is likely to be of most benefit to investors.

Since the introduction of the financial services regime, there have been numerous refinements and attempts to address this issue and "get the balance right".

The industry and successive governments have made some progress but more needs to be done if disclosure documents are going to become simpler, more concise and therefore more helpful for investors.

Disclosure will always be a feature of any financial services regime, and it is therefore our combined responsibility with ASIC and policy makers to ensure that the regime delivers on its objective – ensuring that investors are sufficiently informed about, and able to understand in general terms the investments they are making, including the benefits, risks and costs of doing so.

Consequently, IFSA is a member of the Financial Services Working Group which was jointly established by the Finance Minister and the Minister for Financial Services in February 2008 to determine the best possible approach to delivering short, comparable Product Disclosure Documents.

IFSA is hopeful that this group will be able to deliver significant improvements to the financial services disclosure regime which will allow product providers to develop simpler, more concise and therefore more effective disclosure documents for the benefit of investors.

*Recommendation: The Committee to support the work of the Government's Financial Services Working Group which will provide a framework for product providers to develop simpler, more concise and therefore more effective disclosure documents for the benefit of investors.*

**6. Financial literacy**

Improving financial literacy is crucial if Australians are to feel confident in making financial decisions and in supporting good quality financial decision making.

However, it is well recognised that this is a complex and generational challenge which requires the coordinated support of multiple stakeholders, working on a range of initiatives on an ongoing basis.

In their 2004 report *Australian Consumers and Money,* the Financial Literacy Taskforce identified that:

> '*many good initiatives exist and that organisations are actively engaged in delivering consumer information. However it is also clear that the spread of information is uneven across different topics and target audiences. For example there appears to be more information available to consumers on credit and loan products and how to manage borrowing, and less on insurance and superannuation*'.

IFSA and its members have long supported the Government and its agencies in coordinating, developing and delivering initiatives to improve financial understanding. As a result, in respect of the findings of the Financial Literacy Taskforce report, IFSA set about developing materials of its own and supporting member companies in doing the same.

The focus of IFSA's activity has been specifically on educating consumers regarding investing, superannuation and life insurance and providing support for the objectives of the Financial Literacy Foundation (the successor to the Financial Literacy Taskforce).

Accordingly, IFSA has undertaken a range of initiatives in this area, including:

a. Developing investment seminars which were delivered to audiences in Melbourne and Sydney, as well as providing scripts for use by financial advisers and other third parties within their own communities.

b. Developing a range of investment and insurance fact sheets which are available online for use directly by the public or, as is often the case, made available via financial advisers and member companies. These fact sheets are also often used by the media.

c. Working in partnership with a range of other organisations in the development of financial literacy material, including the following:

   - Smarter Insurance Booklet: A joint publication between the Australian Bankers Association, IFSA and the Insurance Council of Australia.
   - Smarter Super Booklet: A joint publication between the Australian Bankers Association, IFSA and the Financial Planning Association.
   - Superannuation in the context of the global financial crisis: A joint communiqué prepared by Australian Bankers' Association, Association of Financial Advisors, Australian Institute of Superannuation Trustees, Association of Superannuation Funds of Australia, Australian Securities Exchange, CPA Australia, Financial Planning Association, Industry Funds Forum, Industry Super Network and IFSA.

d. Actively contributing to the development of materials by Government agencies including ASIC, the Financial Literacy Foundation and the Australian Tax Office.

e. Recently launching 'Lifewise' – a long-term awareness campaign that aims to educate Australians and to arm them with the knowledge they need to make conscious and informed decisions to protect themselves and their families.[6]

At a Federal Government funded level, on 1 July 2008 the functions of the Financial Literacy Foundation were transferred to ASIC including the Understanding Money website.

Over the course of the last year, we understand that ASIC has been considering its strategies for delivering on its dual objectives of financial literacy and consumer protection. To date a formal announcement is yet to be made.

We believe that it is important to recognise that while improving financial literacy will almost certainly assist with consumer protection, initiatives focused on consumer protection are unlikely to address the complex and generational challenges associated with improving financial literacy.

We are also aware of international approaches which, while well intentioned, have been costly and poorly executed. An over-reliance on protecting consumers will not achieve the end goal of "giving all Australians the opportunity to increase their financial knowledge and better manage their money."[7]

*Recommendation: The Committee to endorse closer collaboration between ASIC and the financial services industry on the development and implementation of an appropriate financial literacy strategy and related initiatives.*

[6] See: http://www.lifewise.org.au/.
[7] See: http://www.understandingmoney.gov.au/content/media/about.aspx.

## 7. Monitoring and enforcement

IFSA recognises that the regulator's role is not to completely remove the risk of failure and corporate collapse. Naturally, this is not to say that the regulator should not be in a position to effectively monitor and supervise Licensees and their representatives.

In this regard, IFSA believes that the industry has an important role to play in alerting and assisting the regulator to what is happening in the marketplace. A strong feedback loop between industry and regulators has the potential to improve the operation of the financial services system for the benefit of all stakeholders.

ASIC presently has broad supervisory and compliance monitoring powers under Part 3 'Investigations and Information Gathering' of the ASIC Act. For example, ASIC may use its general powers of investigation to investigate licensees "as it thinks expedient for the administration of the corporations legislation".[8] It may also use its audit information gathering powers to inspect a Licensee's financial accounts "for the purpose of ensuring compliance with the Corporations legislation".[9]

More broadly, IFSA understands that ASIC's current powers can be used to:

- Test organisational competence.
- Gather information regarding organisational structure, compliance processes, complaints processes, remuneration structures, training, etc.
- Search for more specific information relating to specific transactions or products.
- Better understand industry practice to inform regulatory guidance such as through analysis of Statements of Advice relating to specific types of financial advice.

These are extensive powers which in our view provide considerable scope for the regulator to monitor Licensees' compliance with their legal obligations under the Corporations Act – including in circumstances where the regulator has not yet formed a view as to whether a Licensee has breached the Act.

Should the Committee conclude, on the basis of contrary evidence or advice, that ASIC does not have the powers to conduct monitoring activities as described above, then IFSA suggests that the Committee consider recommending that such powers be provided.

Given the importance of these pre-emptive powers, IFSA believes there is a significant opportunity for industry bodies such as IFSA to work with ASIC to develop criteria which will assist ASIC to take a more informed risk-weighted approach to monitoring and surveillance using its existing powers.

Industry bodies are in a good position to provide ASIC with practical insights into industry norms and best practice standards which can assist ASIC to develop a risk-weighted strategic view of licensees.

Importantly, in adopting a risk-weighted approach, ASIC would not be seeking to assess the likelihood of a financial services provider becoming insolvent or having insufficient capital to operate its business, rather ASIC would be seeking to better

[8] See ASIC Act, section 13.
[9] See ASIC Act, section 28.

understand the risk of non-compliance with the Corporations Act and the potential impact of any non-compliance.

Thus, in relation to Licensees that provide financial advisory services, the type of information which ASIC could consider to better assess this risk includes:

- Extent to which ASIC has had prior constructive dealings with the Licensee
- Prevalence of leverage across clients
- Membership of professional or industry associations and their compliance history with such bodies
- Details of management qualifications/experience
- List of approved products and the basis for approval
- Products most frequently recommended
- Internal processes for the delivery of complex or high-risk advice strategies
- Number of complaints lodged against the Licensee and their type
- Number of advisers/authorised representatives
- Number of Certified Financial Planners
- Number of SoAs produced
- Amount of funds under advice

Should the Committee and ASIC see merit in this approach, IFSA would be pleased to work closely with ASIC to ensure that the relevant information is able to be collected in an appropriate manner, having regard to confidentiality, commercial sensitivity, the difficulty and cost of providing the information and the frequency with which it is proposed to be collected.

IFSA notes that as part of the 2009/10 Federal Budget, the Government provided a funding increase of $63.2 million over 4 years to "enable ASIC to engage additional 'front line' resources to perform a range of new and existing enforcement and monitoring activities."[10]

This additional funding is welcome and IFSA looks forward to assisting ASIC in the possible development of any new enforcement and monitoring strategies which are more risk-weighted as suggested above.

*Recommendation: Industry bodies to work with ASIC to develop criteria which will assist ASIC to take a more informed risk-weighted approach to monitoring and surveillance using its existing powers. This approach will also assist ASIC to develop a better "early warning detection" capability and be better prepared to respond pre-emptively.*

[10] Media release, Senator the Hon Nick Sherry, Minister for Superannuation and Corporate Law, 12 May 2009.

# CHAPTER 4: IMPORTANT ISSUES NOT RELATED TO THE RECENT COLLAPSES

Below follows an examination of issues which IFSA does not believe were causes or drivers behind the recent collapses but which this inquiry nevertheless provides an opportunity to address.

These issues will also no doubt be considered by the Committee and IFSA has therefore sought to provide the Committee with our considered views, including constructive recommendations to enhance the financial services regime where appropriate.

Important issues addressed in this section include:

1. Role of Financial Advisory Networks
2. Contribution that quality financial advice makes to the lives of individuals and the economy.
3. Education/qualification requirements for financial advisers.
4. Adequacy and appropriateness of compensation mechanisms.
5. Regulation of financial products and services (other than financial advice)
6. Role of investment platforms

**1. Role of Financial Advisory Networks**

IFSA's membership includes Financial Advisory Networks (FANs) in Australia. A FAN is the holder of an Australian Financial Services Licence which enables it and its Authorised Representatives to provide financial advice to the public. Australia's largest 100 FANs provide support and services to more than 15,000 Authorised Representatives.[11]

The main function of FANs is the provision of services to advisers operating under the FAN's Licence, or to those advisers operating under their own Licence who do not have the resources or infrastructure to maintain the relevant services.

IFSA believes that the capital strength, resources, research capabilities, compliance and quality assurance frameworks offered by larger FANs provide significant value and support for Australian consumers.

While a number of the FANs that are members of IFSA are institutionally owned, this institutional ownership does not prohibit the provision of appropriate, objective and impartial advice to consumers.

Indeed, the resources offered by larger FANs permit a range of key services to be offered to advisers that underpin the provision of professional financial advice, namely:

- the development of well researched financial product lists that can act as a means of monitoring and controlling advice provided, and which can prevent a client being placed in products which may not be suitable, or are outside the accepted risk parameters;

[11] For detailed background concerning the Structure and Operation of Financial Advisory Networks (FANs), please refer to Appendix 1 of this submission.

- ongoing professional development programs for advisers;
- compliance frameworks that assist advisers to meet their legal and professional obligations, including audit and pre-vetting programs;
- well resourced internal dispute resolution mechanisms; and
- capital resources that can be relied upon in cases of consumer compensation claims, if the cover available under a professional indemnity policy is insufficient to meet the claims.

IFSA therefore seeks the Committee's recognition of the important role played by FAN's in supporting the provision of quality financial advice under our financial services regime.

**2. Value of financial advice**

The comments that follow are informed by our understanding of our FAN members' activities, policies and procedures.

Many Australians are currently benefiting from the financial advice they are receiving during volatile markets. The advice delivered by most financial advisers is assisting clients to respond appropriately to the crisis, and to avoid crystallising unnecessary losses as a result of taking rash and uninformed decisions.

More broadly, good financial advisers add tremendous value for individuals and their families – in both good and bad economic times. They carefully assess a person's financial circumstances and provide guidance, savings discipline and planning strategies to build and protect wealth.

In many respects, the key to successful investing in the long term is discipline. Just as some individuals need a fitness coach to motivate them and get them into a tailored training regime, a financial adviser can help individuals and their families get into a savings regime that will allow them to reach their financial and retirement goals.

The value of financial advice has been clearly demonstrated in the Value of Advice Report (February 2008) prepared for the Financial Planning Association by Michael Rice of RiceWarner Actuaries.

The report sets out an evidence-based quantification of the value of advice for individuals at various life stages, and identifies both financial and wellbeing benefits for individuals and families. This Report also identifies the societal benefits of financial advice as:

- reduced debt that increases disposable income for more productive purposes;
- higher rates of return on investments over long periods build wealth in real terms;
- insurance protection keeps people from falling back on welfare; and
- higher levels of savings reduce calls on government benefits.[12]

In addition to these benefits, individuals that receive financial advice typically make higher voluntary superannuation contributions – ensuring that their standard of living in retirement is higher as well as minimising their reliance on the old age pension.

[12] "Value of Advice", Report prepared for the FPA by Michael Rice, February 2008, p 25.

By way of providing a practical illustration of the actual benefits of financial advice for individuals and families, IFSA has received a number of real life case studies which we would be pleased to share with the Committee.

Repeatedly, these case studies demonstrate how appropriate financial advice helps people to improve their financial situation, achieve a much greater level of security in retirement and manage traumatic events.

By way of example, in one real life situation, the main breadwinner in a family suffered a massive stroke that left him unable to ever work again. The family had already gained the benefit of financial advice, and as such he had a good level of income protection cover prior to the stroke. With the benefit of further ongoing financial advice, he was able to build his super and at the same time minimise his tax, resulting in longer term financial security for him and his family.

Consequently, given the clear financial and wellbeing benefits that arise from the provision of financial advice for both individuals and the wider economy, IFSA requests that the Committee not seek to recommend reforms that may dramatically increase the cost of financial advice and thereby reduce access to financial advice to even more Australians.

*Recommendation: That the Committee recognise the value of financial advice to individuals, families and small business as well as the broader economy, and require that any proposals for reform in this area be subject to economic analysis of the impact on the affordability and accessibility of advice.*

**3. Education/qualification requirements for financial advisers**

We note that the Committee has discussed in recent hearings the adequacy of current education and qualification requirements for financial advisers. Importantly, in our opinion, the recent collapses that have occurred have not been caused as a result of the level of education or qualifications obtained by the financial advisers involved.

This is not to say that the financial services industry does not take improving the level of professionalism in the industry very seriously.

Indeed, improving the entry level and ongoing qualifications of financial advisers over time is supported by IFSA. Importantly, a large number of financial advisers already have educational qualifications that go well beyond the requirements under the Corporations Act and those imposed by ASIC under Regulatory Guide 146.

In the move towards improving the qualifications of financial advisors, it is important to recognise that they are also being supported by the development of professional standards by associations such as the FPA and professional accounting bodies, as well as by the significant commitment of resources from Financial Advisory Networks to improve compliance, research, quality assurance processes and professional development for their representatives.

Nevertheless, IFSA notes that, as with all professions, there will always be varying levels of qualifications, quality and experience. Any minimum entry level should not be set so high that it dramatically impacts on the cost of advice or the number of individuals that are able to provide financial advice – especially where the majority of

advisers are trained to an appropriate level and operate within a robust structure that supports the advice they provide.

These factors should be explicitly recognised should any enhanced minimum legislative qualifications be deemed necessary.

Given this, should the Committee conclude that the entry level requirements for financial advisers need to be enhanced, IFSA recommends that an in-depth analysis of the costs and benefits of any proposed enhancements should be undertaken.

The analyses should include consideration of:

- Levels of educational competency amongst existing financial advisers.
- Adviser demographics – including the qualifications of new advisers entering the industry versus existing advisers.
- The support provided by Financial Advisory Networks.
- Role of professional bodies in supporting advisers and providing appropriate ongoing training and accreditation.
- Impact on the supply of financial advisers.
- Impact on the cost of providing financial advice.
- Impact on competition in the industry.
- Length of any transition period that will be required.

IFSA believes that only through a holistic assessment of these factors will the Committee be in a position to make an appropriate recommendation in this area.

*Recommendation: Should the Committee conclude that the entry level requirements for financial advisers need to be enhanced, an in-depth analysis of the costs and benefits of any proposed enhancements should be undertaken prior to any specific recommendation being included in the Committee's Report.*

**4. Adequacy and appropriateness of compensation mechanisms**

The Corporations Act requires licensees to have in place arrangements to compensate retail clients for losses they suffer as a result of a breach by the licensee or its representatives of their obligations under Chapter 7 of the Corporations Act.

This framework seeks to reduce the risk that retail clients will go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients.

The primary way for Licensees to comply with their legal obligation is to have an adequate level of Professional Indemnity (PI) insurance cover.

Given uncertainty about the availability of appropriate PI insurance cover in the market, the requirements were introduced with a two year implementation period. During that period, which expires 31 December 2009, ASIC provides greater flexibility as to what it considers "adequate" cover in recognition of what policies are available in the market.

ASIC has, nevertheless, specified what it believes to be minimum levels of cover Licensees need to obtain in order to comply with their legal obligations:

> **Minimum requirement:** We consider that, to be adequate, a PI insurance policy must have a limit of at least $2 million for any one claim and in the aggregate for licensees with total revenue from financial services provided to retail clients of $2 million or less. For licensees with total revenue from financial services provided to retail clients greater than $2 million, minimum cover should be approximately equal to actual or expected revenue from financial services provided to retail clients (up to a maximum limit of $20 million).[13]

Importantly, however, under the current regime, ASIC does not approve a Licensee's PI insurance arrangements.

Significantly, ASIC recently announced that it would delay raising the minimum level of PI insurance cover required until 1 January 2012, noting that the cost-effective availability of appropriate PI insurance cover has been adversely affected by the global financial crisis and still has some way to improve.[14]

In addition to cost, IFSA understands that there remains a broad range of other challenges which continue to affect the ability of Licensees to obtain appropriate PI insurance cover, including:

- Lack of alignment between policy terms and cover required under the Corporations Act – that is cover against civil liability but not necessarily breaches of Chapter 7.
- Common exclusions under policies which relate to standard financial advice services such as "super switching advice".
- Unwillingness of PI insurance providers to cover recommendations outside of an "approved product list".
- Increasing "deductibles" resulting in more Licensees effectively self-insuring for the majority of likely claims.

Finally, IFSA believes that more needs to be done to align the underwriting processes of PI insurers with the risk management and compliance practices of Licensees. This approach will ensure premiums more closely reflect the strength of internal compliance practices of Licensees.

Given the issues raised above, IFSA would be pleased to arrange roundtable discussions between relevant participants with the aim of continuing to improve the operation of the PI insurance market for financial services providers.

*Recommendation: Should PI insurance remain the primary mechanism for licensees to meet their obligations in relation to having compensation arrangements in place, ASIC and industry should continue to consult on how to continue to improve the operation of the PI insurance market and the type of coverage that is able to be provided to all licensees.*

[13] Regulatory Guide 126 'Compensation and insurance arrangements for AFS licensees', March 2008.
[14] See: Insurance Council of Australia submission to the Committee, 6 July 2009. Financial Ombudsman Service 2009 National Conference, An ASIC Update, Jeremy Cooper, Deputy Chairman.

## 5. Regulation of financial products and services

This section provides the Committee with the industry's view on the regulation of financial products and services (excluding the provision of financial advice) and more information about how the retail financial services industry is structured and operates.

One of the strengths of Australia's financial services regime is that rather than adopt a prescriptive approach to the types of financial products retail investors are permitted to invest in, the regime relies on a combination of structural and disclosure based requirements to reach an appropriate balance.

Broadly, a financial product is permitted to be offered to a retail client provided:

- It is offered by a licensed provider or their authorised representative.
- In the case of a Managed Investment Scheme (managed fund), the Scheme is registered with ASIC.
- Regulated disclosure is provided to the investor prior to them applying for the product.
- The Licensee is a member of an external dispute resolution scheme and has an adequate compensation mechanism in place in the event of breaching its obligations under Chapter 7 of the Corporations Act.

IFSA strongly believes that, in the main, investors have been well served by this approach.

Indeed, it is a testament to the Australian system that while there are no prescriptive rules prohibiting retail investors from investing in more sophisticated products or implementing higher risk strategies, such investments and strategies have overwhelmingly not been adopted by the majority of retail investors.

We believe this is strong evidence that there have not been systemic levels of misconduct in the system and that in the absence more prescriptive rules, financial services providers have nevertheless acted appropriately with respect to the investment strategies they have recommended to retail investors.

Moreover, we are not aware of any evidence that suggests adopting a more prescriptive approach is likely to result in better outcomes for investors. Indeed, we refer to our earlier comments with respect to Hong Kong, for example, which show that even seemingly "conservative" investment products can fail.

This is consistent with the Australian experience where many of the investment product "failures" over the years have not necessarily occurred in what might be regarded as "high risk" products.

IFSA therefore does not believe that the regulatory regime should seek to protect investors by imposing a dividing line between financial products that are suitable for retail investors and those that are not.

Any such dividing line would be fraught with compromises and inconsistencies. Such an approach would also seek to treat all retail investors as a homogenous group – with the same preferences, risk tolerance and investment horizon.

By way of example, every investor faces at least one, if not a combination, of the following risks when investing in a financial product:

- **Market risk:** Investment returns are influenced by the performance of the market as a whole, which itself is affected by factors such as political events, economic events, global events, changes in interest rates, investor sentiment, etc.
- **Investment risk:** Each financial product will have its own unique product risks depending on the risks that are specific to that investment or product. For example, the value of a company's shares can be influenced by changes in company management, its business environment or profitability.
- **Product/provider risk**: Each financial product will have a risk that the provider of the product will be unable to meet the promise it makes to investors. This could arise, for example, as a result of poor management.
- **Liquidity risk:** Liquidity risk refers to the difficulty in selling an asset for cash quickly without an adverse impact on the price received.
- **Currency risk:** Investments in overseas markets or securities which are denominated in foreign currencies give rise to foreign currency exposure, which means the value of these investments will vary depending on changes in the exchange rate as well as the underlying value of the investments.
- **Credit risk:** Credit risk refers to the risk that a party to a credit transaction fails to meet its obligations.
- **Regulatory risk:** Arises where regulatory intervention prevents a financial product from behaving as promised. A recent example was the inability to utilise short selling strategies due to the Government ban on short selling in financial companies listed on the ASX.

Clearly, no regulatory regime can fully safeguard investors from all of the above risks.

By way of example, an Australian share index fund could be considered a relatively simple product that is appropriate for retail investors. However, as we have seen with the impact of the global financial crisis on the Australian share market, the value of an investment in such a fund could have fallen in excess of 50% had the investment been made at the top of the market.

Moreover, no regulatory regime or intervention would be able to prevent an individual from investing their entire life savings in a single product.

This highlights the importance of a holistic approach based on improving levels of financial literacy, more effective disclosure and appropriate advice to assisting retail investors to make better and more informed choices in relation to their financial affairs.

*Recommendation: That the Committee not seek to prescribe financial products that in its view are "appropriate" for retail investors and instead recognise the importance of a holistic approach to assisting retail investors to make better and more informed choices in relation to their financial affairs.*

## 6. Role of investment platforms

Investment platform services have been in operation in Australia for over 10 years.

Over that period, these services have significantly increased the efficiencies faced by investors and advisors in managing investment portfolios.

Platform services are essentially administration facilities that allow investors to hold and manage a diversified portfolio of investments. Through the use of sophisticated information technology, they simplify administration, management and reporting in relation to multiple investment portfolios.

The development of platform services has allowed advisers and Financial Advisory Networks to focus more on servicing their clients and providing them with quality advice rather than diverting resources to back-office administration.

In doing so, IFSA believes platform services have provided overall cost reductions for investors due to the economies of scale achieved by these service providers.

If every adviser and/or Financial Advisory Network instead had to invest and develop its own technology to provide the services currently delivered by platform providers, the cost of managing a large number of diverse investment portfolios would undoubtedly rise.

To illustrate this point, IFSA understands there are approximately 16,000 active financial advisers in Australia, providing advice and related services to some 5 million Australians. This amounts to over 300 clients per financial planner, with around 140 client meetings every year.[15]

Given the shortage of financial advisers[16] and their already large workload, increasing their administrative burden will not only increase the cost of advice, it will also reduce the number of clients they are effectively able to service. This will also result in an increase in the cost of advice.

Platforms therefore not only increase efficiencies in the delivery of financial advice they also enable financial advisors to advise a larger number of clients – partially offsetting supply constraints in the advice industry and putting downward pressure on fees in the advice industry.

A related benefit provided by the development of platform services is the lower barriers to entry they provide to non-institutionally owned Financial Advisory Networks.

This ensures that smaller Financial Advisory Networks are able to more effectively compete against larger Financial Advisory Networks (aligned or otherwise) – both on a cost and service basis.

Importantly, platforms have also allowed institutionally owned Financial Advisory Networks to evolve from offering primarily related financial products to moving towards a more open market model whereby it is now common practice for investments to be made in funds offered by competitor groups/firms.

[15] Financial Advice 2013 - White Paper: An assessment of the financial advice industry for the next five years, CoreData 2008.
[16] There are presently more than 400 financial planning roles advertised on Seek.

Benefits of platform services for investors

The benefits of platform services for investors can be summarised as:

- Increased efficiency in portfolio management
- Enhanced reporting
- Increased choice, flexibility and control
- Fund manager selection

*Increased efficiency in portfolio management*

A platform service allows investors to consolidate the management of their financial and non-financial investments as well as better manage their investments in a way that minimises tax and other transaction costs.

For example, investors are often able to nominate specific tax parcels of shares or managed funds to be sold – allowing them to manage their investments in a tax efficient manner.

Investors also get the benefit of consolidated reporting over their entire investment portfolio rather than relying on multiple statements from each managed fund.

Finally, through the platform, investors are able to access a broader range of managed funds with lower investment management costs than they would otherwise face if they invested directly.

*Enhanced reporting*

As mentioned above, platforms provide investors with consolidated reports covering all the transactions from different investment managers and listed entities within their portfolio. Platforms also often prepare portfolio reports at regular intervals as well as detailed annual tax statements to assist investors in completing their tax return.

For example, platforms generally provide a comprehensive capital gains tax statement with details of any investments sold during the year.

In addition to these reporting benefits, most platforms have online systems that allows and investor to see:

- current valuations of their overall portfolio;
- list of transactions for each of their investments and cash holdings; and
- breakdown of their investments held in various asset classes.

*Increased choice, flexibility and control*

The wide investment choice available through platforms services makes them an ideal service for investors seeking to diversify their portfolio while still having it centrally managed.

Additionally, the pooling advantages of investment platforms often means retail investors can access managed funds that they otherwise would not be able to invest in directly due to high minimum investment amount requirements.

*Fund manager selection*

Platform service providers typically apply a range of vetting processes in determining the composition of investments that can be accessed through the platform. These processes are not intended to replace, rather complement, the role of a financial adviser. Importantly, the vast majority of investors using an investment platform do so with the assistance of an adviser.

Many platforms also employ dedicated teams of investment professionals to construct multi-manager portfolios based on the advice of asset consultants and research houses.

These processes can include assessing investment managers across a range of criteria including, organisational stability, capability and their performance track record.

Additionally, while not abrogating the role of the adviser, many platforms also regularly monitor and review their investment menu and, as necessary, make changes aimed at delivering improved performance and/or risk management.

IFSA notes the evidence provided to the Committee on 24 June by ASIC which explicitly recognises the important role played by platform service providers in this area. In its evidence, ASIC makes specific reference to the absence of "Westpoint" on almost all platform product lists.[17]

Competition

As in practically every area of the financial services value chain in Australia, there is a high level of competition in the provision of platform services between a number of providers in the market. This competition takes place between both larger, well resourced, market participants as well as between smaller boutique operators.

The table below, sourced from Morningstar's Q1 2009 Market Share Report, shows the largest platform service providers by 'Retail Funds Under Administration'.

[17] See Committee Hansard, pages 40-42.

| Rank | | | $M | | | | |
|---|---|---|---|---|---|---|---|
| Mar 2009 | Dec 2008 | Manager | Mar 2009 | Dec 2008 | Mar 2008 | Mar 2007 | Mar 2006 |
| 1 | 1 | BT Financial Group | 67,279 | 72,763 | 48,201 | 46,347 | 37,196 |
| 2 | 2 | National/MLC Group | 46,299 | 52,928 | 64,816 | 66,593 | 58,173 |
| 3 | 3 | AMP Group | 36,174 | 37,322 | 44,300 | 45,269 | 37,375 |
| 4 | 4 | Commonwealth/Colonial Group | 28,069 | 28,674 | 34,427 | 34,058 | 32,824 |
| 5 | 5 | ING/ANZ Group | 27,815 | 28,519 | 34,492 | 33,975 | 26,592 |
| 6 | 6 | AXA Group | 22,491 | 23,218 | 25,801 | 26,330 | 22,762 |
| 7 | 7 | Macquarie Bank Group | 20,469 | 21,150 | 26,065 | 26,588 | 19,588 |
| 8 | 8 | AVIVA/Navigator | 13,881 | 14,376 | 17,450 | 17,317 | 14,418 |
| 9 | 9 | Mercer Investment Nominees | 11,565 | 11,825 | 12,441 | 12,787 | 10,490 |
| 10 | 10 | Australian Wealth Management Ltd | 10,682 | 11,027 | 13,808 | 13,926 | 8,183 |
| | | **Top 10 Total** | **284,723** | **301,803** | **321,801** | **323,189** | **267,601** |
| | | **Industry Total** | **299,688** | **317,520** | **382,787** | **387,788** | **320,301** |

While ASIC has identified that there is a higher concentration of platform providers compared to wholesale fund managers, this does not of itself mean that there is a lack of competition in the market.[18] Indeed, the higher concentration can partly be explained as a function of the significant investment that is required to maintain an innovative and, at the same time, cost-competitive investment platform.

Additionally, when comparing the level of concentration in the platform market to that found in other non-financial services markets, the platform market would likely be considered highly competitive.

In reality, platform providers face strong competitive pressures with respect to costs, functionality, manager selection and choice. Platforms compete directly on:

- their menu of investment options;
- the direct costs of using the platform service;
- the cost of accessing underlying managed funds;
- the scope and timing of reporting capabilities; and
- the functionality they offer investors and advisers.

Additionally, Financial Advisory Networks are increasingly offering investors the option to select the platform service through which they wish to invest and have their investments administered. This is imposing further competitive pressures on platform service providers.

[18] Sale and distribution of investment products to retail investors, ASIC, June 2009.

Payments related to the use of investment platforms

As discussed above, investment platforms provide significant benefits to investors and advisers including greatly simplified administration, management and reporting in relation to diversified investment portfolios.

Naturally, these services come at a cost. Investment platform service providers primarily seek to recoup these costs through a combination of fees levied on:

- investors for use of the platform;
- investment funds for placement on the platform; and
- Financial Advisory Networks for use of the platform.

These fees effectively provide a cost-sharing arrangement between the users of platforms.

Importantly, as indicated above, platform providers operate in a competitive market where investors, investment managers and, increasingly, Financial Advisory Networks are all able to freely choose with which platform they wish to transact. This has implications on the extent to which platform providers are able to charge for their services.

Should any of the above payments be proscribed, this could affect the underlying economics of platform providers and Financial Advisory Networks that rely on a range of revenue sources to operate their businesses. This, in turn, could adversely affect the cost and provision of advice.

Additionally, as noted above, given the fees outlined above effectively provide a cost-sharing arrangement between the users of platforms – if an element of the cost sharing were removed, it would likely result in an increase in the fees levied on the remaining users of the service.

Importantly, in order to address any perceived conflicts or related concerns associated with these payments, in 2004, IFSA and the FPA collaborated to develop a joint industry guide on rebates and related payments within the wealth management industry.

The Guide, which is compulsory for IFSA and FPA members, requires the use of standard definitions and terminology in disclosing payments within the wealth management industry that may impact the return or the financial advice provided to the client.[19] These disclosures are required to be made in the Financial Services Guide, Product Disclosure Statement and Statement of Advice, as appropriate.

The Guide was developed to ensure payments, such as those related to the use of platforms outlined above, were being disclosed in a consistent manner across the industry to improve understanding and comparability.

More specifically, the Guide requires that:

1. Clients know what payments or discounts they are receiving when paying for advice and/or investments and which service they relate to.

[19] See IFSA Standard No.15 'Rebates & Related Payments in the Wealth Management Industry', November 2004.

2. Clients be aware of the remuneration received by a licensee or their representatives in relation to any recommendation that the client use a particular investment platform or invest in a particular financial product. This includes any payment which is received by a licensee or their representatives from an investment platform provider or a fund manager, which is not passed straight through to the client, should be disclosed to the client as remuneration of the licensee or their representatives.

3. Clients know if fees are paid by the fund manager to a platform provider and what the payment is for.

4. Clients know if fees are paid by the platform provider to a Financial Advisory Network or its representatives and what the payment is for.

*Recommendation: That the Committee recognise the important role played by platform and wrap service providers in the financial services sector and not seek to introduce regulations which minimise the range of services they provide or the important role they play.*

# APPENDIX 1 – STRUCTURE AND OPERATION OF FINANCIAL ADVISORY NETWORKS

## 1 Introduction

The development of FANs has come as a result of both the increased regulatory complexity imposed upon the financial services industry and the significant increase in the number of products available to retail investors.

Initially, investment products (particularly unit trusts, cash management trusts) were sold directly by the product manufacturer, through their sales network if they were a large institution, or through a number of stock brokers who were expanding into financial planning. By the early 1980s, financial planners were required to be licensed by the state Corporate Affairs Commissions, although there were still only several hundred licensed financial planners then operating. The introduction of the *Managed Investments Act 1998* and then the various CLERP reforms culminating in the Financial Services Reforms in 2002 has resulted in a tightly regulated industry.

Given the cost and complexity of the regulatory regime (including licensing and compliance costs), the need for an entity that was able to provide these services and support the financial adviser or planner, became necessary.

The whole concept of advice had also broadened to encompass not only financial product advice, but also strategies for retirement planning, superannuation, life and risk insurance, estate planning, debt management and wealth creation – which all required a much greater depth of support and training within the financial planning practice.

It is against this background that FANs have developed and expanded.

## 2 The different FAN structures

Whilst a considerable number of financial planners have formed themselves into financial planning practices they have generally found it to be uneconomical and practically impossible to operate as stand alone businesses which have to provide their own IT systems, client management platforms, compliance processes and product research. Outsourcing these processes, particularly IT and platform systems is also generally uneconomic for smaller businesses, given their limited bargaining power. The development and growth of FANs has essentially occurred in order to meet the needs of planners and their clients.

In broad terms it could be suggested that FANs are similar in structure to any grouping of professionals. A law or accounting firm provides back office, IT systems, and technical research to enable the professionals working within the firm to deliver their services to the consumer. The larger the law firm or accountancy practice the larger its economies of scale are to provide these services to its professionals in a cost effective manner.

It is estimated that the top 100 FANs had approximately 15,000 advisers. The largest FANs had more than 1,500 advisers while the second and third largest had approximately 1,300 and 850 advisers respectively.[20]

Whilst the basic structure of FANs are similar, there are many variations of the basic model. A FAN will be the holder of an Australian Financial Services Licence (AFSL) which will enable it and its authorised representatives to provide financial advice to the public. There are three main variations to the basic FAN:

(a) the one which is part of a larger institutional group;
(b) the franchise structure with authorised representatives of all operating under the FAN's brand although essentially operating their own businesses subject to any restrictions imposed by the FAN; and
(c) the non-aligned model where the FAN provides support for independent financial planning practices which operate under their own brand.

Institutional structure

The institutional group FAN initially existed as a distribution arm for the products of the institution although recent regulatory reforms have cast obligations on advisers to ensure that clients have access to broad product options which will meet their individual needs. This has resulted in the expansion of the product lists of these organisations to include products other than those of the institution. The institutional FAN is able to call upon the resources of the institution to provide the necessary platforms and software in order to manage their clients' investments and trades on the brand of the institution.

Franchise structure

The franchise structure may be a significantly capitalised entity listed on the stock exchange or a smaller privately owned business which will either own or have access to operating platforms (IDPSs or WRAPs) through a licence agreement or a referral arrangement. It will have a product list that it will have established to meet its own particular philosophy or charter and which will be managed and monitored by its internal research resources. This structure may employ a number of planners operating out of its own branch network as well as franchise its brand to other financial planning practices who will operate under its AFS licence and use its client management and back office systems.

Non-aligned model

The non-aligned model similar to the franchise structure may be a stock exchange listed entity or a smaller privately owned entity. It will provide services and licensing requirements to independent financial planning practices that will operate under their own brand whilst utilising the FAN's back office systems, platforms, research and compliance resources. Only where it is legally required will the name of the FAN appear on material issued by the planning practice. This model tends to be favoured by accounting practices wishing to provide financial planning services to their clients whilst continuing to use their own name.

[20] IFA Dealer Group Survey, October 2008.

## 3 Legal framework for FANs

Before he or she can begin providing advice to clients, a financial planner must either hold an AFS licence or be an authorised representative of an AFS licence holder. Whilst there is no restriction on a natural person applying for an AFS licence, the application requirements and the ongoing licence conditions imposed by the Australian Securities and Investments Commission (ASIC) mean that, for all practical purposes, the applicant will almost always be a body corporate.

It is generally accepted that an adviser or a group of advisors need to have at least $60-80 million[21] under advice to justify the cost of holding a separate AFS licence.

The AFS licence holder will be responsible for the actions of their proper authority holders. It is a requirement as part of its licence conditions to have appropriate processes in place to monitor and support its proper authority holders.

There is no specific mandate or legal requirement calling for the establishment of a FAN, but given the responsibilities imposed on both AFS licensees and their proper authority holders, it makes good sense for planners to be attached to a FAN.

Nonetheless, the ownership of FANs varies and they may be part of a larger institutional group, an ASX listed entity or a privately owned business. In a number of cases FANs are owned or partially owned by the financial planners who operate under them.

## 4 FANs and the benefits of scale

The main aspects or functions of FANs are the provision of services to advisers operating under the FANs AFS licence or advisers operating under their own licence but who do not have the resources or infrastructure to maintain these services. These services can be varied but generally consist of compliance services in the form of compliance monitoring software, internal audit and compliance resources, client asset management platforms such as WRAPS, front end software systems and technical support, and product lists and investment research.

As an AFSL holder a FAN is responsible for the actions of its authorised representatives in meeting their obligations under the FAN's licence. FANs are therefore required to have compliance systems in place to ensure that these obligations are met. As most FANS and/or their proper authority holders are members of a professional industry body such as the Financial Planning Association (FPA), any compliance systems will generally need to be sufficiently detailed to enable monitoring of Professional Standards and Codes of Ethics imposed by a professional industry body such as the FPA, in addition to the general legal responsibilities imposed under the Corporations Act.

Access to both asset management systems and front-end client management systems are an integral part of a financial planner's practice, however such systems can be prohibitively expensive. It has been suggested that one of the bank owned financial services groups has in recent times spent in excess of $200 million replacing its front and back office systems, whilst a larger independent FAN spent $10 million building a front end client management system.

[21] The costs of holding a license include personal indemnity insurance, compliance, software, research, legal and accounting costs. In addition to these, there are the costs of developing the business, including practice development, staff training and recruitment.

One of the more critical services provided by FANs is therefore the ability to provide access to client management systems and asset management platforms.

In order to provide clients with up to date advice on investment products and broad economic trends, planners need to be able to access independent reviews and comment on the products offered by the FAN and performance trends of both products and asset classes. A major function of FANs is therefore their product and investment research which may be provided by in house resources or provided externally from specialist organisations.

A FAN, and particularly a larger one, may be able to negotiate Professional Indemnity insurance cover for itself and its planners over and above that which an individual or small planning practice could ever obtain. The result of this is that consumers have the benefit of greater and broader cover which is obtained at a cost which is affordable for the planner.

## 5 Role of FANs in the development of product lists

The development of product lists is an important function of any FAN, as the product list will reflect the particular philosophy of the FAN and any degree of specialisation it may use to distinguish itself from other groups.

The development of product lists also acts as a means of monitoring and controlling the advice provided by a FAN's proper authority holders and avoiding clients being placed in products which may not be suitable or are outside the accepted risk parameters.

The past decade has seen an increase in the number and variety of investment products available within the Australian market which now number conservatively several thousand. It is beyond the capacity of the individual planner or small planning practices to effectively research and select a preferred product list from such a broad selection and yet it is incumbent upon the planner to recommend appropriate products for the client.

A FAN may select a range of products to reflect its own views through the use of external asset specialists, research houses, or through its own internal research resources. A number of FANs utilise a manager of manager process whereby specialist funds are structured using a combination of underlying externally managed funds.

Research provided by FANs includes managed funds, property and direct equities. Different research processes, such as qualitative or quantitative, are used to review products and provide a rating that the FAN can then use as a guide when compiling or reviewing their product lists.

These product lists generally comprise a minimum of 50 different products, although the product lists of the larger organisations run into hundreds. An individual planner or small planning practice is not in a position to maintain such a range of investment products without the resources of a FAN.

## 6 Raising standards

### The role of FANs in Professional Development

Financial Services regulation imposes an obligation on licensees to ensure that their representatives are adequately trained, that they are competent to provide financial services and that they maintain that competence.[22]

In support of these regulations ASIC has issued Regulatory Guide 146 which sets out its requirements for licensees' training obligations. Licensees are required to implement policies and procedures to ensure that their representatives undertake continuing training to maintain and update the knowledge and skills that are appropriate for their advice activities. Whilst the level and detail of training is not prescribed, the licensee must be able to demonstrate that it is appropriate for the type of advice and products which the representative is providing.

In addition, financial planners who are members of the Financial Planning Association (FPA) are required to undertake a minimum amount of professional development each year in order to retain membership. The FPA provides planner education and professional development programs. FANs also operate professional development programs which will enable their Authorised Representatives to meet their obligations under the AFS licence.

The generally accepted minimum amount of Continuous Professional Development (CPD) training is around 30-40 hours per annum and this may be accumulated by attendance at relevant conferences, external training courses and internal professional development programs. A number of larger FANs provide structured training programs utilising on-line training with inbuilt monitoring to ensure that representatives undertake the minimum amount of training prescribed by the organisation.

### The role of FANs in compliance

FANs play an important role in assisting financial planners to meet their regulatory and professional obligations. In addition to their obligations under their AFS licences and under the Corporations Act 2001 (and other key legislation such as the Trade Practices Act), most FANs are Principal members of the Financial Planning Association and are thereby governed by the FPA's professional standards and Code of Ethics. All FANs will operate compliance programs which are generally IT rather than paper based systems which allow easier oversight and control by the FAN as AFS licence holder. Programs will cover such matters as:

- Overseeing planner adherence to licensee standards and legislation;
- Managing complaints and disputes;
- Coordinating all reporting; and
- Manage and control planner risk.

Often the internal audits provided by the FAN will include a total review of the financial planner's business as well as an educational process to ensure that the planners understand their responsibilities and obligations. Many FANs have in place a system of selectively reviewing financial plans prepared by their authorised

[22] See Section 912A(1) Corporations Act 2001.

representatives prior to them being issued to the client to ensure that they meet with the standards imposed by both regulation and the FANs internal standards.

## 7 Dispute resolution

All AFS licence holders are required to be members of an ASIC approved, industry funded, External Disputes Resolution scheme (EDR) as well as maintain internal complaints resolution processes.[23] FANs as AFS licence holders are responsible for the actions of their authorised representatives and it is in their interests to ensure that where complaints or disputes arise between planners and clients they are dealt with in a fair and expeditious manner and where possible do not escalate to the External Dispute Resolution scheme or become the subject of a legal claim. A FAN's success is very much tied to its reputation and it is therefore in their best business interests to avoid the bad publicity that can accompany complaints. A successful business can be destroyed very quickly by consumer complaints.

[23] See Section 912A(2) Corporations Act 2001.

# APPENDIX 2 – INVESTOR SAFEGUARDS UNDER OUR FINANCIAL SERVICES REGIME

**Corporations Act: Chapter 5C Managed Investment Schemes**

*Section 601FC (1) – Duties of a Responsible Entity*

This provision outlines a series of duties owed by a Responsible Entity in exercising its powers. Among other obligations, the Responsible Entity must act honestly and in the best interests of the members. If there is a conflict between the members' interests and its own interests, it must give priority to the members' interests.

*Sec 601FD (1) – Duty of Officers of Responsible Entity*

Similarly, officers of a Responsible Entity must also act honestly and in the best interests of the members. If there is a conflict between the members' interests and the officer's own interests, they must give priority to the members' interests. Officers must also not make improper use of their position to gain, directly or indirectly, an advantage for themselves or for any other person or to cause detriment to the members of the scheme.

*Sec 601FE (1) – Duties of Employees of Responsible Entities*

An employee of a Responsible Entity must not make improper use of their position as an employee to gain, directly or indirectly, an advantage for themselves or for any other person or to cause detriment to the members of the scheme

*Sec 601FF (1) – Surveillance Checks by ASIC*

ASIC can check whether the Responsible Entity of a Registered Scheme is complying with the Scheme's Constitution and Compliance Plan and with the Corporations Act.

*Sec 601MA (1) – Civil Liability of Responsible Entity to Members*

A member of a registered scheme who suffers loss or damage because of conduct of the Responsible Entity that contravenes a provision of Chapter 5C of the Corporations Act may recover the amount of this loss or damage by action against the Responsible Entity whether or not the Responsible Entity has been convicted of an offence in respect of the contravention.

**Corporations Act: Chapter 7 Financial Services and Markets**

*Section 911C – Prohibition on Holding Out*

A person must not hold out that they have an Australian financial services license or that a financial service provided by the person or by someone else is exempt from the requirement to hold an Australian financial services license if that is not the case.

*Section 912A – General Licensee obligations*

A Licensee must do all things necessary to ensure that financial services are provided efficiently, honestly and fairly.

Additionally, it must have in place adequate arrangements for the management of conflicts of interest, take reasonable steps to ensure that its representatives comply with the financial services laws and ensure that its representatives are adequately trained, and are competent, to provide those financial services.

*Section 912B – Compensation arrangements if financial services provided to persons as retail clients*

If a licensee provides a financial service to retail clients, the Licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under Chapter 7 by the Licensee or its representatives.

*Section 912D – Obligation to notify ASIC of certain matters*

If a Licensee significantly breaches, or is likely to significantly breach, a financial services law, they must notify ASIC in writing within 5 business days after becoming aware of the breach or likely breach.

*Section 912E – Surveillance checks by ASIC*

A Licensee and its representatives must give such assistance to ASIC as ASIC reasonably requests in relation to whether the Licensee and its representatives are complying with the financial services laws, and in relation to the performance of ASIC's other functions.

*Section 915C – Suspension or cancellation after offering a hearing*

ASIC has the power to suspend or cancel an Australian financial services license where, among other matters, the Licensee has not complied with their obligations or ASIC has reason to believe they will not comply or where the application for the license contained a material omission.

*Division 6 – Liability of financial services licensees for representatives*

Licensees are responsible for the conduct of their representatives.

*Section 920A – ASIC's power to make a banning order*

ASIC may make a banning order against a person where, among other matters, they have not complied with financial services laws or have been convicted of fraud. A banning order is a written order that prohibits a person from providing a financial service or product.

*Section 1019B – Cooling-Off Period for return of Financial Product*

Retail clients have the right to return a financial product and to have the money they paid to acquire the product repaid within 14 days of having acquired the product.

*Section 1041G – Dishonest Conduct*

Prohibits a person from engaging in dishonest conduct in relation to a financial product or service.

*Section 1041H – Misleading or Deceptive Conduct*

Prohibits a person from engaging in conduct that is misleading or deceptive or likely to mislead or deceive in relation to a financial product or service.

**ASIC Act 2001**

*Section 12 CC – Unconscionable Conduct*

Prohibits unconscionable conduct in the supply or acquisition of financial services. In ascertaining whether the conduct was unconscionable, Courts may have regard to matters including:

a) the relative strengths of the bargaining positions of supplier and service recipient;
b) ability of recipient to understand the related documents;
c) undue pressure or unfair tactics;
d) circumstances under which the service recipient could have acquired similar/ identical services from a different supplier;
e) the extent to which the supplier and service provider acted in good faith.

*Section 12DA – Misleading or Deceptive Conduct*

Prohibits conduct that is misleading or deceptive or likely to mislead or deceive in relation to financial services.

*Section 12 DB – False or Misleading Representations*

Prohibits the making or false or misleading representations with respect to the standard, quality, value, price, affiliation or need for financial services.

*Section 12ED - Warranties in relation to the supply of financial services*

It is an offence to supply financial services without taking due care and skill.