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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Financial products and services in Australia

WEDNESDAY, 24 JUNE 2009

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Wednesday, 24 June 2009

Members: Mr Ripoll *(Chair)*, Senator Mason *(Deputy Chair),* Senators Boyce, Farrell, McLucas and Williams and Ms Grierson, Ms Owens, Mr Pearce and Mr Robert

Members in attendance: Senators Boyce, Farrell, Mason, Williams and Mr Pearce and Mr Ripoll

Terms of reference for the inquiry:

To inquire into and report on:

Issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

WITNESSES

BIRD, Ms Joanna, Senior Executive Specialist, Strategic Policy, Australian Securities and Investments Commission 2

COOPER, Mr Jeremy, Deputy Chairman, Australian Securities and Investments Commission 2

D'ALOISIO, Mr Tony, Chairman, Australian Securities and Investments Commission 2

ERSKINE, Mr Alex, Chief Economist, Australian Securities and Investments Commission 2

RICKARD, Ms Delia, Senior Executive Leader, Consumers and Retail Investors, Australian Securities and Investments Commission 2

Committee met at 5.34 pm

CHAIR (Mr Ripoll)—I declare open this public hearing of the Joint Committee on Corporations and Financial Services, the first in a series of public hearings that the committee will hold to inform its inquiry into financial products and services. The committee is inquiring into issues associated with recent financial products and services provider collapses such as Storm Financial, Opes Prime and other, similar collapses. In conducting its inquiry the committee has made a decision to focus specifically on non-superannuation products and services.

Witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee. The committee prefers to hear evidence in public but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but we would consult the witnesses concerned before doing this.

BIRD, Ms Joanna, Senior Executive Specialist, Strategic Policy, Australian Securities and Investments Commission

COOPER, Mr Jeremy, Deputy Chairman, Australian Securities and Investments Commission

D'ALOISIO, Mr Tony, Chairman, Australian Securities and Investments Commission

ERSKINE, Mr Alex, Chief Economist, Australian Securities and Investments Commission

RICKARD, Ms Delia, Senior Executive Leader, Consumers and Retail Investors, Australian Securities and Investments Commission

CHAIR—Mr D'Aloisio, I understand that in your opening remarks you will provide us with some statements on all 10 of the committee's terms of reference. I ask that you keep your remarks to 15 minutes or less, and then we will be able to revisit each one individually, giving the committee an opportunity to ask questions and explore issues.

Mr D'Aloisio—Thank you, Chair. Your letter of 28 May invited us to appear this evening to cover two subjects: our views on each term of reference and then more specific questioning on Storm and Opes. Can I address those two things and how we would propose to approach them. In relation to the terms of reference, we would like to hand up to you an industry overview and a summary document comprising three columns. After taking you through the industry document we would like to concentrate on column 2 under the heading 'Issues'. It sets out the issues that we think flow out of each term of reference.

We see our role this evening as outlining the policy issues for each term of reference. We will not be expressing a policy position. Our role is essentially to assist the committee with the policy options. We may well express policy options or preferred positions for ASIC in our submission to you which is due on 31 July. As ASIC has not as yet met to formulate policy decisions, we are not in a position to do so this evening.

The third column in that document sets out some legal issues. Again, to assist the committee, in our final submission on 31 July we will cover those legal issues in more detail in an attachment. We would propose to speak briefly on each term of reference and then take questions, with your leave.

Jeremy Cooper, who you know, is our deputy chairman. Alex Erskine is ASIC's chief economist. He will mainly be providing comments on the underlying economic policy settings of our regulatory regime. Joanna Bird will present on the terms of reference to do with licensing financial advisers and remuneration structures. Delia Rickard will present on the terms of reference dealing with consumers and retail investors. At the end of each term of reference we will break and invite questions and comments, with your leave.

On the second matter, the update on Storm Financial and Opes, what we can say about those two matters is limited. These are both significant ongoing investigations. What we propose to do

is, after we have gone through the terms of reference, to give you an update and an outline of where we are and what the next steps are. We are not able to go into a lot more detail because of the investigations. Our responsibility is to investigate this matter fully and assess potential legal actions. We are in a position where we still need to do a lot of work before we can actually express a view. We do want to assist the committee but at the same time we cannot risk prejudicing those investigations, in particular prejudicing retail investor actions or potential parties that could be involved.

We recognise that our own involvement in Storm Financial may be of interest to some of the participants, for a number of reasons, and we also recognise that the committee will have a legitimate interest in assessing ASIC’s role. To balance relevant considerations we are preparing a detailed analysis of our involvement, which we will be prepared to make available to the committee in confidence. We expect to be able to do that by the end of July, when we put our final submission in. I recognise that the issue in confidence will be done with your leave, but that will be an issue that we would take up with you. Our main concern is that, until our investigations are complete, we feel that we need to be careful with documents such as that.

So that is what I wanted to say by way of opening statement, Mr Chair. With your leave, if that is okay with you, we will now move to each term of reference. We will start with term of reference No.1, which Alex will introduce, and then we will open it up to questions.

CHAIR—In terms of dealing with the amount of work that we have tonight, if you could just deal with the 10 terms of reference within that 15-minute timeframe then that would be good. We will then come back to them in a more open environment where we can ask some questions and explore each area.

Mr D’Aloisio—Would you like to take each term of reference separately?

CHAIR—I think it might be helpful for the committee and our hearing tonight if we just do all 10 terms upfront but within 15 minutes—otherwise I think we are going to have run into some time issues—and then we can go back and explore each of those areas.

Mr Erskine—I am going to address the general regulatory environmental and look at the underlying economic philosophy that lies behind the relevant part of the Corporations Act. That philosophy is that markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention. So, in shorthand form, this might be termed the efficient market theory—being a quiet pragmatic reliance on financial markets driving efficiency and with intervention addressing market failures. There is a body of economic and financial thought behind this, and I will not take you through all the ins and outs of the theory. There is: Markowitz’s portfolio theory, Farmer’s efficient markets hypothesis, the capital asset pricing model, the Black-Scholes option pricing model, and Modigliani and Miller’s advances in corporate finance theory. All of these focus on risk and return and build onto what we understand more generally about the behaviour of the economy.

It might help us actually to look briefly at one component of this theoretical base—that is, the efficient markets hypothesis—because it will help to emphasise the vital importance of information in finance and investment markets. The efficient markets hypothesis assumes for simplicity that there are no transaction costs, very many market participants all with similar

information, and a complete range of instruments with different risk and return characteristics so that there is a constant flow of minor transactions. The hypothesis is that such a market takes into account all available information. For economic policymakers one important implication of a market that is efficient in that sense is that the allocation of resources will be optimal provided all other policy settings are right.

Another more practical implication is that investors cannot know whether the next price move is up or down as all of history and what is known about the future is already reflected in the market price. If such conditions apply, it is new news that drives the next price movement and it is very hard to outperform the market. This philosophy has evolved over several decades of learning and reforms and has adapted as circumstances change. It has been the philosophy underlying regulatory policy at least since the Campbell inquiry in 1981 and continuing through to the Wallis inquiry in 1997—inquiries which aimed to improve the efficiency, competitiveness and flexibility of the Australian financial system.

The Wallis report concluded that it is:

... important to ensure minimum distortion of the vital roles of markets themselves in providing competitive, efficient and innovative means of meeting customer's needs.

The Wallis report recognised that there must be regulatory intervention in the market to ensure that market participants act with integrity, not fraudulently, and that consumers are protected in view of the complexity of financial products, the adverse consequences of breaching financial promises and the need for low-cost means to resolve disputes. The way I read that is that the philosophy accepts that regulation is necessary to deal with factors that prevent markets operating efficiently—for instance, fraudulent contact, information asymmetries and anti-competitive conduct—in order to build trust and confidence. But, to the extent possible, that regulation should be the minimum necessary to prevent market failure. The most basic problem in all financial transactions, and therefore the most obvious market failure, is the information asymmetry that exists between the parties to the transaction. They might be an issuer and an investor or a borrower and a lender. They are the parties to financial transactions.

The management of a company may know what it is doing but the investors typically do not or do not know as much. A borrower, whether it is an individual or a complex financial institution, may know what he or she is going to use the borrowed funds for but the person or institution lending the money typically does not know as much. These information gaps are information asymmetries and they undermine trust between the parties. The party lacking the information has to be supplied with the relevant information so that they can have the confidence to make sensible investment and lending decisions. One special case of information asymmetry, which I will come back to later if I can, is moral hazard—the idea, which is very relevant in an insurance business, that a party insulated from a risk may behave quite differently from the way it would behave if it was fully exposed to the risk.

In some circumstances, of course, regulation is not enough. The Wallis report accepted that some areas of the financial system require financial safety regulation in the form of prudential regulation. The intensity of that prudential regulation was to be greatest where the systemic risks and the intensity of financial promises, and hence the risk of market failure, are the greatest. As regulation imposes costs, both directly and on the wider economy, there is a need to balance

prudential and efficiency considerations. In the event the government opted to subject authorised deposit-taking institutions, general and life insurers, and larger superannuation funds to supervision by the Australian Prudential Regulation Authority—but not other financial institutions or products.

In addition two key recommendations of the Wallis inquiry were adopted: that governments should not seek to impose safety regulation across the entire financial system and that the assurance provided even by prudential regulation should not extend to a government guarantee of any financial promises. Consistent with policy embodying this underlying economic philosophy, the financial services regulatory regime is designed to promote market integrity and consumer protection through conduct and disclosure regulation.

Conduct regulation is rules designed to ensure industry participants behave with honesty, fairness, integrity and competence—as well as rules relating to the settlement of disputes between market participants and investors. Disclosure regulation is rules designed to overcome the inherent information asymmetry between industry participants and investors by requiring disclosure of all the information required to facilitate informed decisions by investors and to promote transparency in financial markets. Efficiency, flexibility and innovation in the financial services industry are promoted by ensuring that these rules are focused not only on building trust and disclosing information necessary for financial decisions but also minimising the impediments to carrying on business.

It is important to note that conduct and disclosure regulation does not involve any guarantee that regulated products and institutions will not fail or that promises made to retail investors will be met. Retail investors still face significant risks. There is an important corollary that successful retail investment requires the exercise of judgment in the selection and diversity of investments. The objective, and hopefully the outcome, of this regulatory setting is: an efficient and flexible allocation of risk and resources and a low-cost to capital; a promotion of competition, innovation and flexibility; and retail investors having access to a wide range of financial products. On the other hand, under this regulatory setting retail investors may suffer loss because they have access to all financial products, including the full range of high-risk products; they can choose the extent of diversification for their investments, including an inappropriately undiversified set of investments; and the regime does not aim to prevent failure of these products. So, given that philosophy, what is ASIC's role?

ASIC is an oversight and enforcement body in the conduct and disclosure regime. It is not supposed to intervene in the operation of the market. It is not there to prevent business failure or loss to retail investors. It cannot and does not take action merely on the basis of a flawed business model. A flawed business model has been characteristic of a lot of the business failures recently. Responsibility for flawed business models lies with management and the board of a company.

What are the alternatives to this approach to regulation? Well, the regime could be reformed by moving towards a more prescriptive approach, including greater investor protection and greater intervention in the market. Examples of such reforms might include: APRA-like prudential regulation of some or all investment product providers; product design limitations or prohibitions; allowing only more sophisticated investors to have access to more complex, high-risk products; or a duty of suitability for product manufacturers and intermediaries. It is

understandable that proposals have been put forward that are intended to increase the safety and security of retail investments. There have been significant losses to retail investors and globally the approach to retail investor regulation is being reviewed. Of course there is an economic impact to consider. There are costs and benefits of any change and the balance of costs and benefits has to be assessed. This assessment is a policy matter for government.

Possible benefits of such reform may include an increase in investor protection and, or alternatively, systemic stability. Possible costs of such reform may include a market impact. It may impose burdens on industry, increased regulatory costs, create a risk intolerant culture and impede individual's rights to conduct businesses and make investments of their choice. There are several matters that would have to be considered, including that if there was a more paternalistic approach then it might exacerbate the moral hazard amongst retail investors—for instance, faced by an apparently safer regulatory regime retail investors might decide to take on more leverage and therefore more risk or opt to invest inappropriately in the riskiest of the apparently approved investments. The consideration of issues by Campbell, by Wallis and by other reviews have consistently emphasised the trade-offs between risk and return and between promoting stability and efficiency.

A key point to bear in mind for any assessment is that an efficient market is an objective, not a reality, and depends on a fully informed marketplace with investors having proper regard to risk. Has the existing regime been applied to the maximum? Is there more that ASIC can do? ASIC has been seeking to push the existing conduct and disclosure requirements further following its internal strategic review in 2008. ASIC has been seeking to push the existing regime to the maximum by having a new market focused structure and improving internal capacity to provide a better regulatory response to invest in the market where appropriate. To summarise, the extent to which ASIC can push its existing regulatory tools is limited by its mandate and powers conferred under the Corporations Act and the ASIC Act.

Given the economic policy underlying the FSR regime, ASIC cannot prevent adoption of the sorts of business models that habitually lead to losses. Many proposals that go beyond what ASIC has already done would require an extension of the regulatory framework. It is probably too soon to say whether the losses represent a market failure sufficient to warrant a significant shift in the balance between protecting investors and relying on markets for efficiency or more modest and incremental reforms—for instance, increasing the provision of additional information and education supplemented as necessary by some countercyclical macro prudential measures. The advantages of any regulatory reform need to be balanced against the burdens of continuing change to the regulatory environment for investors and industry and the impact of regulatory reform on market efficiency. I think that is the point I wanted to get to.

Ms Bird—I will now turn to term of reference No. 5 on the adequacy of the licensing regime. I will touch briefly on the role of the regime—what the licensing regime is intended to do and what is not intended to do—and briefly mention some options for change. Looking first at the role of the licensing regime and what it is and is not intended to do, licensing is a gatekeeping mechanism. It seeks to ensure that the people who provide specific financial services have the competence, integrity and resources to do so. The FSR, financial services licensing regime, sets a relatively low-level threshold for entry. ASIC has to grant a license if certain statutory conditions are met and ASIC's ability to remove or suspend a license or ban an individual is likewise restricted. For instance, ASIC could not refuse a license because it did not approve of an

applicant's business model. The role of the licensing regime is not necessarily well understood by retail investors. There may be a perception amongst some retail investors that an Australian financial service license means that the service provider has been approved by ASIC or that the license is in some way an endorsement of quality.

Moving to the options for change, there are always several options to change a regulatory regime but whether or not to adopt them is a policy matter for government. All of the options that we can point to have certain advantages and certain disadvantages. ASIC is simply putting forward options for change for the committee's consideration and not necessarily advocating them. In the licensing area there are probably two key options for change. The first is increasing the threshold for entry and the second is reorienting the settings of the licensing regime to focus more on the individual than on the licensing entity.

Briefly turning to the first one—increasing the threshold for entry—as I have already said, in the existing regime ASIC must grant a license if certain conditions are met. The main ones are if ASIC has no reason not to believe that the applicant is of good character or has no reason to believe that the applicant will not comply going forward. We cannot refuse a license on any other grounds than those. Obviously the regime could be changed so that the threshold for entry is different or higher. You could put the onus more on the applicant rather than on ASIC. You could change the threshold requirements by requiring ASIC to review and approve business models of applicants.

CHAIR—Can I interrupt? Given that it has gone six o'clock—

Ms Bird—I should speed up?

CHAIR—No. There is only 15 minutes, so we are not going to get through it. We might go to some questions in each area of interest for committee members and we will come back at the end when we have some time to go through it so that you can get it on the record. But we really need to get through a whole range of other things as well, so we will do that now. I might begin the process by asking if Mr D'Aloisio could explain the monitoring process that ASIC undertakes in terms of companies such as Storm or Opes Prime and others meeting their obligations for their licensing arrangements. We might just start there. I know the committee has lots of questions.

Mr D'Aloisio—The typical way that ASIC would monitor is that in the act itself there is breach reporting required by the licensees. So if licensees are compliant with their obligations in breach reporting that becomes a mechanism by which ASIC would then look at what is going on. There is also what you would call ongoing compliance and surveillance processes that ASIC would undertake from time to time in industries. They are the principal ways that you would look at license compliance. As Joanna has pointed out, the barriers to entry on licensing are quite low, so the ability to take people out of the market and revoke licenses is quite limited.

CHAIR—Because the entry levels are in themselves low?

Mr D'Aloisio—Yes. The judgment on the entry levels is that if you lift the entry levels on the basis of quality training education it may well lead to better results. The issue is then that you are going to be restricting the group that you are going to select from. In the financial advice area,

for example, that would mean there would probably be fewer advisers than you currently have. So you have this judgment that you would need to make.

CHAIR—I understand that. So the predominant feature here is not delivering a quality service, as it were, in terms of the license. What you are actually saying is that it is a low entry point.

Mr D'Aloisio—The license does not require that you run a particular business model that ASIC approves or that you run your business in a particular way. It is really an entry point, a registration licensing point so that you know the people are there and that they have met the minimum standards that the Corporations Act requires. That is as far as it goes.

CHAIR—So really licensing does not in the end provide much assurance to anybody, apart from that some very low-level, basic requirements have been met?

Mr D'Aloisio—It does provide some assistance. Clearly you know who is in the market and you know with our training schedules and so on that they have gone through a minimum of training. In that sense, yes, it is quite relevant to have. I think the difficulty is that if it is then perceived that, because they hold a license, when dealing with the individual you will always get top-quality service and there can never be any fraud or anything of that nature. That sort of perception of what licensing does can be misread by the market, particularly retail investors who may have a perception that if a company has a license it has gone through ASIC and everything is all right.

CHAIR—There certainly is the impression that if somebody has got a license they have met certain standards and therefore can actually deliver a quality service and quality product through models that are approved. I understand that is obviously not the case. ASIC does not actually approve those. I will just turn to two things you said. You said the way ASIC monitors the companies' licenses is by either breach reporting or ongoing surveillance. I would assume there are certain companies that come to your attention, or are reported to you, and you would—

Mr D'Aloisio—There are a number of ways. There is the breach reporting. There is the complaints system. We get somewhere in the order of 14,000 to 20,000 complaints a year. We have a system to look through them to see if there are smoking guns et cetera. We have the ongoing monitoring surveillance programs that each of the senior leaders in the stakeholder teams would put in place. To put it in context, we have a substantial number of license holders, so we would not be conducting a surveillance program on every licensee. We have also run shadow shopping exercises to monitor the market. It is a risk-wading analysis about what the—

CHAIR—But when certain organisations are brought to your attention what do you do? Let us use Storm as an example. Certainly I have been informed that Storm has been raised a number of times. People either wrote or phoned.

Mr D'Aloisio—What I have said in relation to Storm is that at the end of July when we report we will provide a fuller submission to the committee. We will give you the chronology and the context. I also commented back in February and in June about the contact with Storm. In relation to specific cases, such as Storm and Opes, we will give the committee the actual chronology of what contact occurred within ASIC.

To take it out of the Storm context to more generally, when you simply get one or two complaints about a particular organisation that goes under, with the benefit of hindsight it becomes, ‘You knew. What did you do about it?’ But it depends on what the complaint was and the nature of it when we investigated. You cannot just walk in and decide to look at the whole organisation. You still have to be quite specific. Our obligation is to be quite specific in relation to the particular complaint or issue. The company has to have the opportunity to put its view, and then you handle the complaints. Clearly if you get a series of complaints that is more of a smoking gun and you can go in more aggressively. I think we need to balance when we look at the chronology of some of these things just what the nature of the complaints were with how they were handled. ASIC does as a matter of principle in its approach have a very clear policy which we have refreshed and added resources to and built. The whole organisation has to be alert to what we have termed internally as ‘smoking guns’ on the basis that if we do get complaints and breach reporting we try to analyse them with the benefit of hindsight by saying, ‘Are these issues that could rebound down the track?’ Our people and our senior leaders are certainly very focused on using the material that comes to our attention in that way.

CHAIR—We need to understand how ASIC actually operates in this area. Whether it is Storm or anyone else, it is really a threshold issue. Whether you get one complaint or 100 complaints, it is really about the quality of the complaint. If one person comes to you with a very serious complaint, that should be acted on more so than if 100 people came to you with not so serious complaints. It is not the number; it is the content. If it is the case that people raise very specific issues and they are concerned then I just need to understand what the threshold point is for ASIC to begin a process.

Mr Cooper—It is perhaps a little bit more of an art than a science, but there are three types of complaints. One is anonymous. We get a lot of those. They are quite difficult to deal with. Even if they do raise things that sound quite credible, we do not know who has made the complaint, how to go back to that person and so on.

CHAIR—We get the anonymous stuff.

Mr Cooper—That is one species. The next one often in financial services is what you might call competitor complaints—a rival organisation or someone else in the industry does not like the business model and wants to criticise it or raise issues. Sometimes they are a very good source of information. But they are, again, different from the third type, which is where you have a client saying, ‘I don’t like the service I have received.’ There is sort of a hierarchy. That is one way of slicing it.

Coming back to how many complaints we would have to get before we did something, it really all depends on the circumstances. In my experience, once we see a pattern, in some cases, if the complaint does come from a client and it seems genuine, that will get dealt with immediately. On other occasions, if there is evidence of some sort of pattern, again, that will be elevated. It is very hard to say in advance exactly what the science is, because it involves judgment; it involves weighing up the complaints.

M D’Aloisio—Certainly every complaint that comes in gets actioned and gets actioned at particular levels. There is a series of escalations. The senior leader in the area of complaints will make an assessment of matters that should go to other senior leaders. They will assess that.

There is a process by which they report back to commission members to make sure that complaints that are regarded more seriously have been dealt with. So we can outline to you a series of decision-making processes that we go through so that they are all looked at. And they are looked at from a quality point of view, not from a process point of view.

CHAIR—We will skirt around these issues tonight, but I will come back to you at some later point, very much with some specifics. It appears to me that information we have is that lots of people have made specific complaints that were very specific in a whole range of areas. We want to better understand the process. What are the threshold points? At what stage does the commission decide, 'This is serious and we need to move on this'? What is it that people need to do in relation to organisations that have specific allegations made against them, regardless of where they are from? A competitor's complaint might be the strongest one you have. Sometimes peer scrutiny in an industry is actually the best scrutiny. But I do not think one outweighs the other.

M D'Aloisio—We will go through and outline our resources. There is the call centre—

CHAIR—Just to put you on notice in terms of that particular area, just so you understand, I will allow you in our first public hearing to have some leeway in that area, but certainly I will want some very clear responses in terms of what the process is, particularly in relation to Storm, because that will point to other areas. If there needs to be improvement in that area, so be it.

Senator WILLIAMS—Mr D'Aloisio, in relation to the role of financial advisers, would you agree that many financial advisers do not have the expertise to evaluate the quality of some of the products their licence allows them to sell?

M D'Aloisio—The licence does not actually licence them to sell particular products. They are financial advisers and they meet the initial test and they are in the industry. How they run their business and the products they advise on is then a matter for them. If you are asking me, 'What is our overall view of the financial advice industry?' it is mixed. Overall the industry is providing good service to investors. But clearly it is mixed. We, along with the Financial Planning Association and others, are clearly working towards trying to lift the quality and accessibility of advice because we see it as very important.

Senator WILLIAMS—We have got the problems with Storm. Obviously their whole program was not bullet proof in the way it collapsed as a result of the stock market crash. Storm brokers were selling the product. Various financial institutions were in many cases taking security on homes, giving home loans as deposits into margin loans and then of course we had financial institutions lending money on the margin loan. Have you ever heard of a bloke called Paul Johnston, who is regarded generally as the father of margin loans, who designed the system?

M D'Aloisio—I have not, Senator.

Senator WILLIAMS—I have been informed that Mr Johnston set up a margin loan system and it worked like this. If you had $100,000 cash and you went to the margin lender—CGI or whatever—who was marketing these products, had the facilities, they would lend you $100,000

and buy into shares. So you would have a $200,000 share asset. You owed the financier $100,000 and you had $100,000 cash.

M D'Aloisio—So you put in $100,000 and borrowed $100,000?

Senator WILLIAMS—You put in $100,000 cash and they would lend you another $100,000. So you would end up with $200,000 worth of shares, you owed $100,000 and you have invested $100,000 of your own money.

Mr D'Aloisio—So you had a 50 per cent equity in the share portfolio?

Senator WILLIAMS—Exactly. What would happen? The original plan was that if the market fell 20 per cent that $200.000 worth of shares would then reduce to $160,000. They would sell you up. They would take the $100,000 you owed them and give you $60,000. It was an 80 per cent positive equity. That was how the original plan was instigated by Mr Johnston. So when you lost 20 per cent equity as your $200,000 worth of assets fell to $160,000 you were then sold up and told, 'Goodnight, Irene. You've lost $40,000, but you'll recover from that.' That is what I have been told was the original plan.

Mr D'Aloisio—That is my understanding of the original margin—

Senator WILLIAMS—That is right.

Mr D'Aloisio—I just do not know—

Senator WILLIAMS—Tell me: the way the Storm program worked, instead of being an 80 per cent positive margin they would lend you to an 80 per cent negative margin.

Mr D'Aloisio—Not the negative margin.

Senator WILLIAMS—Okay. If you are worth $200,000, 80 per cent is the positive 80 per cent of your asset, but if you had $200,000 worth of assets and you owed $160,000 and had $40,000 in equity your $40,000 would be the only positive equity. What I am saying is that the original Johnston plan led to a 20 per cent loss factor in the movement of the market whereas the way I see the Storm one it would go to an 80 or 90 per cent loss factor in equity.

Mr D'Aloisio—It could go higher. It actually went to negative.

Senator WILLIAMS—Yes. It went to 143 per cent in one case.

Mr D'Aloisio—We are dealing with the same concept. The loan value ratio in the Johnston model you are talking about was 50 per cent, so that if your equity or value of shares fell below 50 per cent—and you have mentioned 20 per cent—it acted as a floor or ceiling, however you want to look at it, and it led to action being taken. In other models you can have loan value ratios down to 15 per cent. So in fact your equity might be 15. You could set it on the basis of a 20 per cent equity, an 80-20 loan value, and then as the share prices went up you would margin again. In a situation where you might have $1 million of shares and $800,000 of liability, you still have a margin of 20 per cent on your example. The problem is that when the market drops 25 per cent

or 30 per cent the odds are that your equity will be reduced to a point where the loan far exceeds your equity. It is a variation. Those sorts of models in effect instead of being conservative on a 50-50 loan value ratio go to 75, 80, 85, 90. As you know, the greater the debt and less equity the more vulnerable you are in a market downturn. Some of the models worked on 50-50, some of the models might have worked on the basis: 'The stock market only ever fell 25 per cent in 1987, so we'll work on 60-40 or 75-25.' But what we found with the stock market of course is that it went down much further. The margin lending that you are talking about is an unregulated investment product. The government has announced that it will now regulate it. It was essentially left to the bargaining position between the borrower and the lender to determine what was an acceptable loan value ratio. Different margin lender providers adopted different processes.

Senator WILLIAMS—That is right.

Mr D'Aloisio—So you could go to the market and have margin lender providers who might, for example, say, 'Under no circumstance will we go beyond 60-40.' there were those that maintained 50-50. There were those that went to 75-25. And there were those that went to 100 per cent and used other assets as the security or the buffer. Storm—which is the example you have talked about—used both. They used home equity and high leverage and releveraging in a market upturn.

Senator WILLIAMS—As the value of their asset increases—and I also include the increase in their borrowings to purchase more shares.

Mr D'Aloisio—Yes, and as you know the debt remains fixed, because it is a real liability, and as the share price drops the gap between what you have to repay and what you have increases.

Mr Cooper—In the United States, if my memory serves me correctly, there is a mandated 55 per cent maximum LVR. So that bears out what you are saying. What the Chairman is saying is that in this market there was no such limit and nor was there even an industry standard or a code of practice.

Senator WILLIAMS—The margin call buffer with Storm was 80 per cent, wasn't it?

Mr Cooper—The buffer or the LVR?

Mr D'Aloisio—Not 80 per cent equity; 20 per cent equity—25 per cent equity. Because with an 80 per cent buffer we would not have had the issues that we—

Senator WILLIAMS—And I believe that that was actually moved to 92 or 93 per cent.

Mr D'Aloisio—As I said, there are a lot of issues. We want to be helpful but the fact is that there is a major investigation. We have some significant issues still to work through in relation to Storm. From our point of view I think I would prefer not to be getting into the specifics of that because we have got some issues—

Senator WILLIAMS—Just on the specifics of Storm—I do not expect you to go into too much detail—let me just say for the record, Chair, that Mr Erskine, a very capable economist

here, is married to my wife's sister, so we are related through marriage. I want to make that quite clear. I have lost my train of thought.

CHAIR—We will come back to you on the margin lending, because if my understanding is right it is not illegal or a breach of any laws—any LVR.

Mr D'Aloisio—The LVR issue is a contractual matter between the parties. There is law for misleading and deceptive conduct.

Senator MASON—Can I take the committee back to your gatekeeping role, in effect—licensing. I think, Ms Bird, you gave, not evidence, but a very interesting briefing informally the other day about this. I found it to be very helpful. The Chairman and you have both said this evening that there is a low-level threshold for a licence. Correct me if I am wrong, but you said that an applicant has to show that they are of good fame and character—these are the two principal requirements—and that there is no evidence that they will behave inappropriately. Is that right?

Ms Bird—We have no reason to believe that they will not comply with the obligations that will be imposed upon them once they are licensed. It is hard at that initial stage to say how someone is going to behave once they get through the gate.

Senator MASON—I accept that. The Chairman also mentioned that there are certain training obligations. Could you outline what the training obligations are.

Ms Bird—Once you have got through the gate you have to comply with certain obligations. One of those is—

Senator MASON—Sorry to interrupt. 'Through the gate': so you have been given a licence.

Ms Bird—Then there are a whole lot of obligations that are imposed upon you. The licensee has to have the resources to do its job, it has to be competent and it has to ensure that its representatives are competent. For most licensees that is quite a general obligation; it is really up to the licensee to take the responsibility to ensure that the people performing the role are competent. However, in the advice area ASIC does set down minimum standards of training.

Senator MASON—What are they?

Ms Bird—I can tell you what the policy guide is. Essentially they are for financial advisers. I would have to take it on notice because there is a diploma level—we have divided it up between two sorts of products: there are simple products and there are more complex products.

Interjector—Is this an education program?

Ms Bird—No, it is actually a qualification you have to have before you even start, but then there is a continuing education obligation that is—

Mr PEARCE—It is PS146, isn't it?

Ms Bird—Exactly, 146—well done!

Senator WILLIAMS—Can you do that course online over a period of six weeks or so?

Ms Bird—There are different forms of courses. There are two ways to comply. The main way that people comply is by doing a course that is on what is called the ASIC training register.

Senator WILLIAMS—Can you do that online?

Ms Bird—I cannot answer whether any of the courses can be done entirely online, but there is an ASIC register that sets out all the courses that you have to do. They are approved courses.

Mr PEARCE—It is all outlined under PS146.

Ms Bird—Yes, 146 has got the lot of it.

Mr D'Aloisio—We will check the online issue.

Senator MASON—That is fine, if you could take that on notice.

Mr D'Aloisio—We will take it on notice.

Senator MASON—So we have good fame and character and that people will not behave inappropriately. There are some initial training obligations and then there are some continuing professional obligations thereafter. Senator Williams asked an interesting question before about what people understand when they are giving financial advice. For someone who is new to the area, it strikes me as interesting. I think this is where Senator Williams was coming from. It is a low-level threshold, and I think you admit that.

Ms Bird—I should say that there are minimum standards. They set a minimum threshold; they do not set a non-existent threshold. There are certain other advantages attached to a licensing regime. There are not only the obligations but also a whole lot of administrative remedies. So it makes it easier to take action against misconduct. I think I talked previously about how removing people is easier if you have a licensing regime.

Senator MASON—But can I also take note of the chairman's statement before that if you raise the threshold in effect then it can raise the cost of the service. I accept that as well.

Mr D'Aloisio—I raised it as an issue.

Senator MASON—Yes, it is an issue. I do not think anyone here would dispute that. Let me just come to my point. In the case of Storm Financial you have thousands of people who have lost often their life savings. The qualifications for entry to become a financial adviser, on the evidence you just gave, are not great when you compare it. I am a lawyer—and not a very good one; but even then I had to go to university for five years, be admitted to the bar and so forth. It is a long process of mentoring and everything else. I come back to the question that Senator Williams touched on before—and I know the chairman is concerned about this; I think we all. I am wondering, as a policy issue that the committee will no doubt consider further throughout the

course of this inquiry, whether this threshold is sufficient. The advice that financial advisers will be giving in a sense, in many cases, could be more important than the advice the a lawyer, an accountant, a plumber or an electrician ever gives. And yet the training and the requirements involved are so much lower. That is what I, as someone who has no idea about the area, am astounded at. This is a policy issue I know.

Mr D'Aloisio—I think we can comment. The nub of the problem you are getting to is the quality of the service and the fact that you are dealing with financial advisers who are advising, as Senator Williams said earlier, across a range of products with different levels of complexity, different products and different schemes. In that situation clearly, as you do in law and as you do in accounting, you would like to have people with real quality who are providing that serve, because it is so important to the wealth and the future of individuals. The choice for the committee is that you could do it at entry—you could raise the standards at entry in terms of training and development and make it about university courses and experience—

Senator MASON—Like with lawyers or accountants or something like that.

Mr D'Aloisio—I am not getting into the details, but you could do it that way. You could do it with ongoing training and the requirements you impose on a licence holder in terms of lifting standards. You could do it by promoting much more what industry associations do and continuing education and development experiences. So there are a range of tools I guess you could use if you decide—

Senator MASON—And there could be competitive examinations perhaps.

Mr D'Aloisio—You want to lift that quality. From our point of view, at the end of the day ASIC is there to work to implement the policies that are there. At the moment we are working with those policies. I think we see, as others do, that this is an industry where we would like more people to have access to it and more people to have access to better quality advice, if it can be achieved. So all we can really do is reiterate what you are saying and say that the sort of options are at the licence level, the ongoing training level and the standard of the advice—for example, whether you move to a situation where you must always act in the best interests of the client compared to the current test. So there are three or four options there in working through these terms of reference that you could tackle if you wished.

Senator BOYCE—I just want to go back to the licensing requirements. Ms Bird, you mentioned that you did not have to like the business model. Do you have to see the business model?

Ms Bird—Yes, we ask for a statement of what they are going to do; but that is largely because they get an authorisation to conduct a particular type of business so we need to know exactly what their business is. That is often a large part of the licensing process—figuring out whether people have actually asked for the right authorisations for the nature of their business.

Senator BOYCE—So whether it is personal, general or whatever.

Ms Bird—We do actually get as part of the licensing processes a statement on what the business will be doing.

Senator BOYCE—We were taking earlier about complaints. Whilst you may not be able to choose not to allocate a licence because you do not like the model, does that information get fed through to your complaints people as well? I mean do I have a little asterisk against my name if you think my business model is lousy?

Ms Bird—There is a lot of talking between units within ASIC, yes. On the training, I believe it is a diploma-level standard, Senator Mason, that financial planners have to meet. I think it is quite important to realise that the advice industry is very broad—it is not just really what you would think of as a traditional financial planner. It covers a large number of people, even down to basic call centre staff and counter staff. So there are quite a range of training requirements. The Financial Planning Association imposes additional requirements upon its members.

Senator MASON—I know. I suppose the general point is—and I am not having a go at financial planners here—that the threshold where they can practise their profession is much lower than many other professions.

Ms Bird—Yes, it is an not at tertiary level; it is not a degree.

Senator MASON—That is the point. Everything is at stake, potentially people's life savings.

CHAIR—Mr D'Aloisio, just to get a comment from you about all these qualifications, in the end wherever the bar is set it is a very broad industry and there is no differentiation or distinction between those who provide advice on a $1,000 portfolio and those who provide advice on a $100 million portfolio. The entry level, the qualifications and all of the standards are exactly the same regardless of how much money is involved.

Mr D'Aloisio—That is my understanding.

Mr Cooper—It is important to remember though that that is the regulatory landscape. Within the businesses of course—

CHAIR—But you have no control over what happens within the business.

Mr Cooper—No, we do not.

CHAIR—In fact my interpretation of your current answers is that you have no role to play before a company applies for a licence; you have no role to play after a company gains a licence; your role is that you receive a submission for a licence and as long as people tick the box then they gain the licence. It is a low threshold. There are basic minimums of standard in terms of training, which are very basic—and I have had a look at them specifically to see what they are. They are very basic and very simple. In the end your role is to monitor and so forth.

Mr PEARCE—I have a couple of questions about licensing. Mr D'Aloisio, would you agree that the introduction of the AFSL actually lifted the whole bar?

Mr D'Aloisio—I think that would be a fair comment to make. Clearly moving from no regulation to regulation, if it does nothing else, tells you who is actually in the market. It enables ASIC to enforce the requirements around breach disclosure. It actually enables ASIC to then do

surveillance and so on. It brings in the training program. So clearly the system that was introduced has had a positive impact—just what that is is a judgment issue I think, and the committee will form its own view.

Mr PEARCE—How many AFSL licences has ASIC given in total?

Ms Bird—As at 26 May there are 4,811—or around that.

Mr PEARCE—Thankyou.

Ms Bird—Actually I have just noticed that the figure has an extra digit in it, but I am sure it is around 4,000.

Mr PEARCE—How many licences has ASIC terminated through noncompliance?

Ms Bird—Licenses can be cancelled initiated by the licensee for various reasons.

Mr PEARCE—Yes, but how many have you cancelled.

Ms Bird—In this current financial year we have cancelled 21. In the previous financial year there were 20 cancelled.

Mr Cooper—The licence population is a much smaller population than the people underneath them—we ban them in a much greater number than we would actually attack the ultimate licence.

Mr PEARCE—That is right. But in essence you are telling me that you have granted 4,800 licences. Is that for the period since chapter 7 came in?

Ms Bird—I have not got figures for the entire time of bannings.

Mr D'Aloisio—But we do have those figures for the last two years.

Mr PEARCE—So we are talking about 4,800 in the last two years.

Ms Bird—Sorry, around 4,800 licences for the entire time—you are right. That is the current number of licensees. So some people will have come and gone.

Mr PEARCE—I am trying to understand what proportion do not comply. Can you answer that question? It sounds to me like a very low number of the total licences that you allocate require you to ban them, to terminate their licence as a result of noncompliance. Is that right or not?

M D'Aloisio—That is right.

Mr PEARCE—In your experience is it reasonable to conclude that most people that receive an ASL comply and meet the satisfactory requirements that they committed to when you granted the licence?

M D'Aloisio—Yes. They are still allowed to operate and they have not come up as a problem either through our complaints or surveillance or other systems, so the assumption can be that they are operating their businesses in the market.

CHAIR—It is an assumption, not a fact.

Mr D'Aloisio—On the numbers it is a fact.

Mr PEARCE—No, it is just an assumption, in terms of the fact that you have not actually discovered—

M D'Aloisio—We have not looked at every business model for the 4,800.

Mr PEARCE—I understand. I guess the point I am interested in is, given that it is a very low number that you have terminated as a result of non-compliance, and that has generally come about as a result of what you were talking about earlier—your surveillance techniques et cetera—do you feel that the structure of the system works well overall?

M D'Aloisio—That is a big question, Mr Pearce. In terms of what is in the market—and I think the industry is alive to it; we are all alive to it—there is the pressure of trying to improve quality. Certainly the existing system is working; people have got access to advice. We need to be careful that we do not take some of the exceptions, where losses have occurred and are less significant to the investors, as the norm, when overall the industry's working advice is being given. 'Can it be improved?' is the question for you, I guess. We would say that probably there are areas of improvement in trying to get the quality of the advice up. How you do that is really a policy matter.

Mr PEARCE—I have one last question on the licensing issue. Have you any idea of the proportion of AFSL holders who have an affiliation with an FPA, for example, or an AFA or something else that imposes further qualification requirements?

M D'Aloisio—I would like to take that question on notice because it is a significant question and I am aware we have actually looked at that. Rather than try to recollect, I would like to take it on notice, because there are a substantial number of individual licensees, for example, who would be members of the FPA. The corporates are also members of FPA and IFSA and so on. So we can actually get you that information.

Mr PEARCE—Thank you. As you know very well, getting the licence is one thing but having that membership requires further qualifications—and I think it would be very interesting for the committee to understand the proportion of people who have added obligations.

M D'Aloisio—We will get that for you.

Senator MASON—Both Mr Pearce and our chairman have spoken about and asked questions about monitoring activities. I think the chair said that there is often breach reporting by licensees and also ongoing compliance and surveillance. What form does that ongoing compliance and surveillance take? Do you do random audits? How do you do it?

M D'Aloisio—For example, if we were to decide that a particular entity needed a surveillance we would contact that entity and undertake the surveillance. The surveillance would outline, in the first instance, the areas we want to look at. We may want to look at statements of advice, for example. We may want to do a random check of all the statements of advice they may have given over the last two or three years. We would then look at those either randomly or there would be a process by which our people would select that review. They would undertake that. At the end of that process they may well come up with what we would term a statement of concerns. That statement of concerns would then outline what are our concerns in relation to, say, the statements of advice or what we looked at. We would enter into negotiations with that entity to fix those problems. The fixing could take the form of a straight letter from us: they fix it and that is that. It could take the form of an enforceable undertaking, as, for example, we did following the shadow shopping exercise with AMP. It could take the form of institution of proceedings. It could take the form of institution of proceedings coupled with recovering money for investors or advice—

Senator MASON—These are the remedies. I do not want to talk so much about the remedies; rather it is the surveillance. With the surveillance, do you do it randomly? For example, might you just pick a couple of financial planning organisations—one in Brisbane and one in Melbourne? Do you do that sort of thing very much? Do you randomly audit?

M D'Aloisio—It is not random in the sense that you put marbles in a bag and you select one. It is really quite focussed in assessing where, at least from the information we have, there are risk areas. It would be targeted around—

Senator MASON—So complaints?

M D'Aloisio—It would act on complaints, market information. The intelligence may come in different ways. Based on that the team would then form a view about how they will approach that particular organisation. A full surveillance might, for example, look at licence conditions and compliance with that, standard of advice, the statements of advice they give clients, the product disclosure statements they may issue, the way they may run their approved product list, the sort of work they do behind that, the way they manage their conflicts of interest.

Senator MASON—I want to talk about monitoring activities. An option the committee will be considering is whether, if ASIC were to upgrade and make more comprehensive their monitoring activities, that would lead to better advice and companies acting more honestly and appropriately. That is the policy decision we have to come to. Are you happy that your monitoring activities are sufficient?

M D'Aloisio—You are never happy that your monitoring activities are sufficient, because if there are problems in the market you always worry about them. It is not a system that we have an approach where, for example, if there are 4,800 licensees, over a three-year period we would

have carried out a surveillance on each of them. So you necessarily have to be selective in what you do. In being selective you are necessarily making judgments about risk and so on.

I come back to your question about whether we can do more than we are doing. At the moment, in the way we have restructured ASIC and the resources we have put in in terms of stakeholder teams, specifically in the case of financial advisers—leaving other AFSL licence holders out for the moment—we have a dedicated team of about 30 people now that is concentrating on that industry. One of the key priorities of that group, headed by Deborah Koromilas, whom I think you have met, is essentially around surveillance, compliance, quality of advice and so on. They have programs that they will run over each year to carry out that work. We are always glad to receive more resources and to expand, and clearly we are pleased to look at that.

The other side of these surveillances and how you do them is that you do not want to do them for the sake of it, because they are extremely costly to ASIC and they are costly to the organisation that is involved. So you really want to be quite focused and achieve a result. I do not know at this stage—and we can take the question on notice and look at it further. If we are carrying out whatever number of surveillances in this area and we double or triple them, what do we think the net gain will be? I am happy to think about that. Off the top of my head it is hard to give you an answer, because I think that is where you are headed.

CHAIR—It would be fair to say that a good starting point for surveillance would be where you receive complaints?

M D'Aloisio—Absolutely, and you would.

Senator MASON—I just want to make sure I have got this right. Your powers to monitor are sufficient—there is no problem there—and your remedies are sufficient. There is no legislative problem there, is there?

M D'Aloisio—We have not gone to government for policy change around increasing our powers. Certainly we were granted resources to do additional work, which we are doing. In this area of us being able to go in, get access to documents, scurry through all the boxes and all that, that is not an issue—not in the area of surveillance and compliance.

Senator BOYCE—I just wanted to ask a few questions, if I could around understanding the licensing further, and also who uses financial advisers. Am I right in thinking that there is no possibility that a client would take a financial adviser to a court in any action that you would not be aware of?

Mr Cooper—Where a client has a problem with a financial adviser there are a number of steps that are built in. These things come with having a licence. There is what we call internal dispute resolution, where there are formal processes and time limits for a client to make a complaint to the licensee. By dint of having a license it is compulsory to belong to an external scheme like the Financial Ombudsman Service, where the client can go and make a complaint. We have recently made efforts to increase the size of claims that can be dealt with in that situation. We would not know about every single complaint that was working itself through that system. It is quite unusual for normal retail investors to go beyond that and take litigation steps,

particularly without having made a complaint to us, and made us aware of it. So in general terms what you are saying would be correct.

Mr D'Aloisio—But it is also worth making the point that the way the law is drafted it is essentially self executing. It is there; it is black-letter law. You have to comply with it and, if there is a breach, people have rights which they can pursue through the alternative dispute resolutions or, in cases where they feel necessary, go to a court of law. They do not depend on ASIC to pursue their remedy.

Senator BOYCE—No.

Mr D'Aloisio—Our powers to get remedy for them in the compensation area is around companies like Westpoint and Storm Financial, where you are looking at a very large group which is not otherwise able to look after itself.

Senator BOYCE—I just have a few questions about who uses financial advisers. In the case of Storm we have certainly got some sort of picture. Are the majority of funds in investment products in Australia invested via retail investors who are seeing financial advisers?

Ms Bird—The figures on who accesses advice are very hard to get.

Senator BOYCE—Okay.

Ms Bird—The figures vary but between 22 per cent and 34 per cent of people would see a traditional financial planner.

Senator BOYCE—Between 22 per cent and 34 per cent of whom?

Ms Bird—Individual Australians.

Senator BOYCE—All Australians or all adult Australians?

Ms Bird—It would depend on who has done the research. That is always a problem with these sorts of things but we could give you details of the various bits and pieces of research. The use of financial planning increases with age and wealth. So the people who see financial planners tend to be older and have higher levels of assets. I cannot, off the top of my head, tell you what percentage of managed fund investment goes through financial planners, but I think it is about 50 per cent.

Mr Cooper—It is about half and then for shares it is different. The ASX put out its share ownership survey either late yesterday or today—

Senator BOYCE—I have not caught up with that one yet, Mr Cooper.

Mr Cooper—It is a fast-moving world. That gives you a picture of who uses stockbrokers and it does bear out the fact that the older and the wealthier tend to be more active and get more advice. So it does vary according to product. And superannuation is different. It is a matter of

how you slice and dice it but in broad terms the industry tends to talk in terms of between 20 per cent and 30-ish per cent of people are those who have an active relationship with an adviser.

Senator BOYCE—Are there any comparisons you could make between those groups of people you are talking about—the ones who might use financial advisers versus stockbrokers et cetera? Are they different in any way?

Mr D'Aloisio—Well, they should not be, in terms of advice and their obligations.

Senator BOYCE—No, I am talking about the individuals, the investors. I am trying to get a sense of who investors are and if there is anything distinctive we can be saying about retail investors.

Mr D'Aloisio—We can take that on notice and give you a break-up as best we can. But generally speaking people might go to a stockbroker because they feel they want to invest in shares and get advice on funds management and so on, so it will vary, but we will see if we can get you that information, if it is available.

Senator BOYCE—I am just wondering if they are perhaps a less wealthy group, a less sophisticated group—well, I know sophisticated has an actual meaning, but perhaps it is a less sophisticated demographic that we are talking about here.

CHAIR—You will take that on notice, Mr D'Aloisio?

Mr D'Aloisio—Yes, we will.

Senator BOYCE—I have just one other question in that area. Is there anything specific that you might be able to tell us about ethnic or geographic groupings of investors?

Mr D'Aloisio—It will be hard, but we will try. We may be able to with Indigenous Australians. It will be a lot harder for ethnic communities and so on in Australia, but we will have a look and see what is available.

Senator BOYCE—Thank you.

Ms Rickard—There are some gender issues there, too.

Senator BOYCE—And gender, please.

Ms Rickard—It is more likely to be males than female who are using these advisers.

Mr D'Aloisio—Do you want to comment on that a bit more?

Ms Rickard—It is basically that more men will be using them than women. We have the stats, which we can provide you with.

CHAIR—It might be helpful if you provide us with some sort of response on notice. Otherwise, we are not going to get too far with that.

Ms Bird—Yes, who the advisers are and who the clients are.

Senator WILLIAMS—Mr D'Aloisio, are there still financial advisers out there today recommending margin loans? Are they still a popular product and being marketed by financial advisers, do you know?

Mr D'Aloisio—I can only give you my own anecdotal—

Senator WILLIAMS—You do not have any solid evidence they are still being marketed?

Mr D'Aloisio—Margin lending is still a product that is offered. Certainly there has been a rationalisation and consolidation of that industry. A number of lenders have sold those portfolios and have moved out. I think it is fair to say that the heightened awareness of margin lending and its risks, with the concerns that have been expressed, have led to investors coming out of the market and getting rid of their margin loans. A very high proportion of margin lending has also been around employee share schemes and the exercise of options and share entitlements that are then financed through margin loans. So the industry has definitely contracted, but certainly those products are available and I would expect that financial advisers, in giving advice and so on, would still be considering margin loans for their clients. As you know, they have to assess what is appropriate for their client, but I do not have any information that they have stopped giving advice on margin loans.

Senator WILLIAMS—If they do not act in a more conservative way, we are going to have more of the same old, same old, aren't we? Or we could risk having the same old, same old.

Mr D'Aloisio—I think the legislation and the regulation of the margin lending will assist. The heightened awareness in the banks and financial institutions of what has occurred and the reputation damage in relation to margin lending would, we would have thought, act as a means of getting them to do a better assessment of how they lend and what their practices are. So I think there are a number of things now in the market that have heightened that awareness, but that is about as far as I can go.

CHAIR—Can you tell the committee when was the first time that ASIC was made aware, through any means—complaints or otherwise—of problems with Storm Financial?

Mr D'Aloisio—I gave a statement to Senate estimates in February where we had initially gone through our files of where the contacts were, and I can refer to that. What we said we would do and are doing is having all our files looked at and assessed and, as I said earlier, we will provide you with that complete chronology, because we are as anxious as you are to get this off our plate.

CHAIR—Not a problem—that is fine. I accept that. That is why I said 'can you'. If you cannot, that is not a problem.

Mr D'Aloisio—Okay. You will have it. We will discuss the confidentiality issue around it.

CHAIR—Were the people who ran or operated Storm and other companies, people of interest or people who had previously come across your system or under your oversight at any other point in time? Had these people come onto your radar, as it were, previous to their incarnation as Storm, for example?

Mr D'Aloisio—Again, it is not a question that it is appropriate to go into, because we are investigating—

CHAIR—Not a problem. That is fine.

Mr D'Aloisio—I will take it on notice but I cannot answer that.

CHAIR—You have it on notice so that is the point of asking it. Is it fair to say, also—particularly in the case of Storm and perhaps some others—that the directors and the people who operated the organisation, had very much a day-to-day operational involvement? Were they involved, not just in the operation of the overall business, but with individual clients? Is that the impression that you have at this point?

Mr D'Aloisio—It is not uncommon, particularly for smaller groups of advisers, that the directors and those running the companies—as you have in partnerships in law firms and accounting firms—are involved with clients. Indeed, it would be unusual for them not to be involved directly with clients, because it is all about delivering services and doing business.

CHAIR—So, beyond having their employees working under instruction the directors were also involved in the day-to-day operation?

Mr D'Aloisio—Speaking generally, if you want to grow your business the relationships you build with your customers are pretty important and you would expect those people to be actively involved with their customers.

CHAIR—We are very interested also in the corporate structures and the related entities. It is one of our terms of reference. We want to have a particular look at those two areas. Can you give us some idea—it might be for Storm or another organisation—of the importance of the links between the particular organisation providing the advice and the banks, lending institutions and other funds or other advisory firms. How important are those links in terms of the products they provide?

Mr D'Aloisio—In the document that we handed up earlier, in relation to the industry structure, we have sought to talk about the groupings and so on, in the way advice is delivered—platforms and advisor groups: the top 20 and how they work. Perhaps we could refer you to that in the first instance and then we would be more than happy to expand that further. It is a big question that you just asked.

CHAIR—Yes, it is a big question.

Mr D'Aloisio—We understand that it is an industry structure question. In appendix 2 of that document the links and some of the groupings are set out to give you a feel. So I refer you to that but if, after considering that, you have further questions, we are happy to go into it further.

CHAIR—What I am asking in terms of those relationships is: is it normal practice, customary practice or industry standard that there are special relationships that are developed? I think the answer is yes but I am asking you the question. Through those relationships, are special arrangements made in terms of the financial products that are provided, the fees and conditions, and the directing of investors specifically to certain products based on those relationships?

Mr Cooper—The advice industry is around 75 per cent to 80 per cent owned by, in the jargon of the trade, 'product manufacturers'—that means banks, bank-related entities or wealth management companies who create products and manage those products. When you go and see a financial adviser it is typically about superannuation, which is a managed product of a sort, or a managed fund outside super. As I said, in 7½ or eight cases out of 10 that person is going to be in a business that is owned by one of the big brands—one of the big banks or one of the big wealth management companies. That is just a reality. There is no point jumping up and down about that. That is just how our—

CHAIR—My question—you have answered it in part—is leading to the special relationships, be they through subsidiaries or some other link and the issue of who carries the duty of care in terms of the advice, the product or any part of the relationship. When there is more than one entity it is quite easy for them to say, 'Well, it was the other person's fault.' So where does the duty of care rest, ultimately, when it is industry standard or practice to have relationships across organisations and lending institutions?

Mr Cooper—The legislation is very clear about that because the architects who built the provisions were acutely aware of it. So the ultimate buck stops with the licensee and the authoriser of that person—the linkage between the person giving the advice, which is typically the authorised representative and the licensee that is responsible for that representative. That is the end of the story. While there might be all sorts of other players around—

CHAIR—But I am asking about duty of care between two organisations. I am specifically referring here to an organisation that gives advice and an institution, like a bank, that provides the finance. There are two separate organisations and both have duty of care. Ultimately, who carries the duty of care for the investor?

Mr D'Aloisio—You have now broadened the issue.

CHAIR—Well, that was my original question.

Mr D'Aloisio—As Jeremy says, the duty of care is on the licensee and the duty that is in the legislation and at common law. But the Corporations Act does not stop there. The Corporations Act also talks about being knowingly involved or concerned—aided and abetted, involved et cetera—in relation to a potential contravention of the act. So if, in fact, in a given facts situation the nature and the circumstances are such that it was not only the advisor but others who were knowingly involved, such as financiers, then the duty of care extends that far. But it is not the duty that is extended; it is extended in the way that the Corporations Act works in relation to those who are knowingly involved.

Mr Cooper—Might I add, if I can have a bit of a go here, that there is also the ASIC Act. Where credit is involved there is a whole different set of specific statutory obligations that relate

to credit. So it does depend on the specific scenario. And then there are duties outside both of those acts that also apply.

CHAIR—Is there a specific duty of care in relation to one of either of those parties—the advisory party or the lending party—in relation to what the other is doing? I will give you an example if you need it.

Mr Cooper—That might be helpful.

CHAIR—The advisor recommends a very high-risk product which involves a massive loan from the financial institution which provides that loan. Does the financial institution, for example, have a duty to say, 'This is outside the scope of your capacity as an investment; we can't lend you that amount of money because it just does not fit.' So, have they got a duty of care back the other way?

I will give you a ridiculous example, to make my point. An advisor advises someone with zero income to borrow $10 million, and the financial institution says, 'Yes, not a problem, because your advisor recommended that to us.' Do you understand my question? I hope so.

Mr Cooper—I do understand the question. That is why your government is rolling out a credit regime which includes a responsible lending obligation—because the strict black-letter answer is that credit is not a financial product that is regulated under the act or, in strict terms, under the advice regime.

Mr PEARCE—It is regulated at state level.

Mr D'Aloisio—Not a responsible lending.

Mr PEARCE—A credit case.

Mr Cooper—Yes. Credit has been regulated with disclosure obligations and so on, but that core question of the duty of care and responsibility in making a loan and that person's capacity to repay that loan is the subject of the current reforms that are going to be implemented later in the year. But it is more complicated than that, of course, because the question is: can you so cleanly separate what is a financial product, when it is known that that product is going to be financed? That is a very difficult question.

CHAIR—But it did still come under advice provided, which is covered by the act. So it did not absolve a financial adviser from their responsibilities under the act just because they recommended something which was not—

Mr D'Aloisio—To give appropriate advice, yes.

CHAIR—It is still covered—any product, any advice.

Mr Cooper—Well, it is more complicated. It is not a financial product under those advice provisions.

Mr PEARCE—I want to be clear on that. Isn't this where you need to separate the issue of advice versus products?

Mr Cooper—Yes.

Mr PEARCE—It is very important to keep that distinction, in my view. In my understanding of the act, if you take the chairman's scenario, if an adviser were to advise a client of a product and that product required the client to obtain a loan to fund it, that client would be required to apply to an institution for that loan. That arrangement is then between the client and the institution, because that is the product. The adviser has given the advice on the product, but the transaction that takes place as a result of that advice is between the client and the financial institution, isn't it?

Mr Cooper—That is certainly one way of looking at it.

Mr D'Aloisio—Yes, that is correct.

Mr PEARCE—No, Mr Cooper. That is the way the act works, isn't it?

Mr Cooper—That is the black-letter view of how it might work.

Mr D'Aloisio—Where you get confusion is that it is not as clear cut as that. In other words, the relationship between the financier and the adviser is such that a whole lot of services and arrangements are in place. Is the adviser then acting as an agent of the financier? Is it acting in its own right? That is where you get some complicated situations.

Mr PEARCE—Yes, I understand that, but whether or not the credit is provided is the decision of the financial institution, isn't it?

Mr D'Aloisio—It can be. It depends on the structure, and it is an interesting result where the subject matter of the advice is margin lending. It does put pressure on your analysis of it being so easily separated. So that is a difficult question. Clearly, the architecture of the act is that a credit product is not a financial product under the Corporations Act. Interestingly, it is under the ASIC Act for the purposes of unconscionable conduct, misleading or deceptive conduct and so on. That is the regulatory landscape. We cannot forget, of course, duties and obligations that sit outside both of those acts, about equitable conduct and so on.

Senator WILLIAMS—Looking at the Storm fiasco, surely you would agree that it was a close working partnership between the Commonwealth Bank and Storm?

Mr D'Aloisio—We are getting into areas which are exceptionally important for the ongoing investigation.

Senator WILLIAMS—Right, and you will be investigating. Will you be looking at things like—

Mr D'Aloisio—We are happy to go into the update on Storm, but we have said we would look at the broad range—

Senator WILLIAMS—Okay, I will move on to another issue. Will you be looking at the loan applications relating to Storm and the financial applications that were put forward to the banks?

Mr D'Aloisio—I have said on a previous occasion that you can rest assured that the investigation, whatever investigation we undertake, whether it is into Storm or any other party, will be full. You can rest assured that we will look as broadly as we need to.

Senator WILLIAMS—Have you got access to some of those applications?

Mr D'Aloisio—We have powers to get access to that sort of information.

Senator WILLIAMS—Will you exercise those powers?

Mr D'Aloisio—Those powers are being exercised. I can assure you that at the moment we are in the process of working through some nine million documents.

Senator WILLIAMS—Then you will obviously contact some clients to confirm whether things are correct or not in your investigations?

Mr D'Aloisio—Our investigations will, as I said, be across a range. We are working to keep investors informed of what we are doing to the extent we can, either through their association or individually. We will have a database that will have all of the investors so that we know their circumstances and we can contact them, and we will be exploring fully the issues I spoke about earlier. They are in relation to advice, the quality of advice and whether or not others were involved in any breaches, if there are breaches of the Corporations Act.

Proceedings suspended from 7.10 pm to 7.25 pm

CHAIR—I believe Senator Williams wants to continue where we had left off before the break.

Senator WILLIAMS—I just need to clarify the holiday, if we can call it that, on bank interest that the CBA has put out. It is a little confusing. Perhaps for the record you might state it how you see it, Mr D'Aloisio.

Mr D'Aloisio—My understanding from the release that the Commonwealth Bank put out today is that there is a suspension, which I understand to mean that interest is not chargeable or payable in the period between the start of the suspension and the end of the suspension. My further understanding would be that, if interest were for some reason to recommence, that would not be retrospective to the start of the suspension. I am more than happy to clarify that and ask the bank to issue a clarifying statement if that is what is needed.

Senator WILLIAMS—In your opinion, from now to 31 August there is an interest holiday for those Storm victims in relation to the CBA?

Mr D'Aloisio—That is how I have read the statement.

Senator WILLIAMS—I just needed that clarified, because it is confusing. We can say without doubt that our reading of it is that there is no interest being charged to Storm customers related to the CBA from now until 31 August?

Mr D'Aloisio—It says: 'We will ensure no customer will pay additional interest as a result of this payment suspension in any—

Senator WILLIAMS—Can I stop you there. The additional interest may be confusing. Is there any extra interest on the normal rate for not making payments?

Mr D'Aloisio—My understanding is the form of what you describe as a rent holiday, and we will clarify that with the bank.

Senator WILLIAMS—It would be good if you could do that; thank you.

Senator MASON—If that is the case, Mr D'Aloisio, I commend the Commonwealth Bank for what they are doing. I go back to the surveillance role of ASIC. As part of that monitoring role, does ASIC monitor advertising by financial planners?

Ms Rickard—We have a commercial monitoring service and at different times we monitor different types of advertising very completely depending upon what we are focusing on. For instance, when we were focusing very heavily on superannuation advertising, that included advertising by planners in relation to superannuation and switching. So it depends upon what work is going on and what the priorities are of different teams as to what advertising is being monitored in terms of every ad that comes out in that area.

Senator MASON—So you do not monitor every advertisement that comes out within the industry?

Ms Rickard—At certain times that may happen, but not in perpetuity, no.

Senator MASON—Not each one all the time?

Ms Rickard—Not each one all the time; that is right.

Senator MASON—Did you ever monitor Storm Financial's advertising?

Mr D'Aloisio—We would have to take that on notice.

Senator MASON—Can you remember?

Mr D'Aloisio—I can't, no.

Senator MASON—I understand that there were offers of overseas trips and so forth. Would that have caught your attention if that was the case?

Mr D'Aloisio—I think the publicity around those trips was really after the collapse, as you will recall.

Senator MASON—But I think the offers were made before the collapse.

Mr D'Aloisio—We will investigate it for you.

Senator MASON—So you are not sure?

CHAIR—That is what they are saying.

Mr D'Aloisio—We are not sure it was even advertised. We just don't know if there were advertisements and what the nature was. We will look into it.

Mr Cooper—It would be odd if it were advertised, if you think about it.

Senator MASON—Well, we know there is advertising within the industry and we know that you monitor certain aspects at certain times; I understand that. I think the evidence was in relation to superannuation. The committee is concerned about whether you monitor it all the time, but you don't; I understand that. Is that a resource issue?

Ms Rickard—I asked a question around Storm advertising recently—and I do not know that this is a complete answer—and I was told that Storm was primarily promoted not through advertising but through word of mouth plus through seminars. I would assume that there were some ads promoting those seminars and I am not aware of anything that leapt off the page in terms of being misleading and deceptive that would cause us concern. But I cannot answer beyond that.

Senator MASON—You are not sure?

Ms Rickard—I can't answer beyond that, no.

Mr Cooper—Senator, also, by far the bulk of advertising is in fact at the other end of the production pipeline by the people who make the products. Typically speaking, very generally here, financial advice is not one of the great profit centres of the distribution system. So for financial advisers to dip into their own pockets and advertise is generally not the norm—certainly not on the scale that large-scale products are advertised. That is where the bulk of our activities go. So it is the advertisements put in about products by the people who make those products that we concentrate on, because they are the bulk of the ads.

Senator MASON—But I just want to make sure this is clear. You do not monitor all advertisements?

Ms Rickard—No, we don't.

Senator MASON—And that is a resource issue rather than an issue of integrity. So ASIC would not have asked Storm in that case to correct or rectify—you have the powers to do this with advertising. That clearly never happened?

Mr D'Aloisio—I am not aware that we have taken any—we have powers for corrective advertising.

Senator MASON—I know that, but did you use those?

Mr D'Aloisio—I am not aware. We will look at it, but I do not think so. I do not recollect that we took action—as I say, we are struggling here to actually remember whether there were any ads to start with.

Senator MASON—Sure. Can you take that on notice?

Mr D'Aloisio—I will, absolutely, Senator.

Senator MASON—Again, this reflects questions I asked earlier about surveillance. Do you investigate potential cases of misleading or deceptive advertising only after receiving complaints or, again, do you go out and search for them?

Ms Rickard—We proactively go out and search. As I said though, it depends upon what issues we are focusing on at the time. One example of something we focused on recently was high-yield online savings accounts, where we would go and look at every ad that was out there in the marketplace. In that case we looked for a six-week period. We identified problems and we raised them with the industry and the firms concerned. That has resulted in correction of all those problems and the disappearance of those concerns from the advertising that we continue to monitor.

Senator MASON—Ms Rickard, do you ever play, perhaps, the sleuth here? Do you ever appear at some marketing seminar—just turn up unannounced—and monitor what is going on?

Ms Rickard—We do.

Senator MASON—Have you ever taken any remedial action as a result of that?

Ms Rickard—We do.

Senator MASON—What is an example? Because, again, you think there is unconscionable or misleading conduct—that is the legal principle.

Ms Rickard—I could think of one at the moment; however, we are taking action right now and I am not sure that I can actually say anything about it, so I will check that out.

Senator MASON—You don't need to mention any names; I am just interested in the principle.

Ms Rickard—I can think of an example in the last couple of months where we attended a seminar that was being widely publicised in the *Financial Review* and elsewhere and we are currently looking into taking action in relation to that.

Senator MASON—Why? What happened?

Ms Rickard—Look, it's an active investigation, so I would prefer not to say more at this stage and take it on notice.

Senator MASON—You cannot even give the facts without mentioning any names—that would be inappropriate too?

Ms Rickard—It was around share-trading software and we had concerns around claims that were being made, but I can't say any more around that.

Senator MASON—All right. But there are, in a sense, for want of a better word, spot checks taken at times in various areas?

Ms Rickard—Yes.

Senator MASON—In an undercover role, Ms Rickard?

Ms Rickard—That is right.

Mr Cooper—Do not forget, of course, our shadow shopping campaigns, which are extensive and not exactly popular among the industry. We are about to do another one in the forthcoming financial year. They are substantial pieces of work and all advisers are aware that we do them on a reasonably regular basis and on a pretty large scale.

CHAIR—How seriously do you take the issue of misleading or deceptive advertising in terms of the claims made? Is it just a case of rectifying the ad or taking the ad off air or going deeper and looking at the company and saying, 'Well, if you are doing this, you really are drawing people into a scheme which is based on a falsehood'?

Mr D'Aloisio—It is very serious. Again, I will ask Delia to expand. She heads the retail investor part of the organisation and a lot of her work, and also Greg Kirk's work, is around the misleading and deceptive conduct provisions of the ASIC Act and the Corporations Act. There is a lot of work. It is very serious. Perhaps Delia can expand on that and go through a few of the things that we do.

Ms Rickard—I think it depends upon the areas and the products concerned and the entities that are involved. If you look at the advertising monitoring we did around unlisted, unrated debentures, that led to a very close examination of companies. It led to very detailed guidance coming out from us in terms of what we expect in relation to—

CHAIR—Does it lead to real action?

Ms Rickard—That led to multiple stop actions and—

CHAIR—Stop actions in the sense of what—the ad or the funds themselves?

Ms Rickard—The ads were pulled and they were corrected. Often what we find most effective is simply publicising through a media release what we are doing. If I think about the work we did around superannuation choice, where there was very active monitoring of all

advertising that went on, we took a policy stand from the beginning that wherever we had concerns we would publicise those concerns. We put out media releases, and that has as strong a deterrent effect as almost anything.

CHAIR—Is it going far enough or is it adequate? If an organisation obviously deliberately—because it would be hard to do it by accident—goes out and misrepresents what it can provide, there needs to be very serious action taken in terms of their licence or conditions being placed upon them, beyond just the ad itself, warnings or anything else. I would see that that is an area of great concern, because obviously that leads people into making investment decisions based on a falsehood.

Mr Cooper—There are a range of examples. I can think of one within the last two years where we intervened in relation to advice given about switching people out of one type of superannuation product into another. We stopped that by a court order and then imposed the requirement that the adviser effectively reinstate the people back to where they were. So it depends on the circumstances. Because we regulate it—

CHAIR—Does it affect their standing within their licensing obligations? Is it more than just correcting what they have done, moving on and hoping?

Mr D'Aloisio—All these things would have a matter of degree. One ad, depending on what it is, could be so serious that it could warrant not only action under the act for misleading and deceptive conduct or corrective advertising but looking at the licence conditions. You really have to look at the nature of the misrepresentation.

Senator MASON—How many times in, let's say, the last 12 months have you used coercive powers to remedy misleading advertising?

Mr D'Aloisio—When you say coercive powers, are you saying—

Senator MASON—How many times have used your powers? There may just be a friendly reminder or they may be coercive.

Mr D'Aloisio—We will take that on notice and give you a list, from really tough down to just a warning or something.

Senator MASON—Fair enough.

Mr D'Aloisio—We can go back and look at the work that that unit has been doing and give you that.

Senator MASON—That would be useful. Thank you.

CHAIR—Do you take false advertising—we will just call it that to generalise—in the sense of what is printed or some other hard form of media as seriously as verbal advice in terms of misrepresentations?

Mr D'Aloisio—If you mean to separate that, giving bad advice—

CHAIR—No, I mean giving people specific verbal advertisements, verbal advice such as, 'Our fund does XYZ'—marketing promotion in a verbal sense. At a seminar, for example, you do not provide advice through any written form but you say: 'Our product is 100 per cent safe. Our product is absolutely secure. Our product never loses.' All I am asking is: do you take that as seriously—

Mr D'Aloisio—Of course we take it seriously. The issue is: how do you come to know about it? For example, if you are playing golf—

CHAIR—I am not asking you how you come to know about it. I am saying: once you do know about it, lots of people already know about it. I know about it, others know about it and others go to seminars where they hear about it. Do you then take action against those people who provide that verbal promotion, advertising, marketing—whatever you want to call it?

Ms Rickard—I think the answer to that is yes. We would need to go back and check but I am fairly confident that there are a number of issues, particularly in the seminar area, where we have. But we would need to confirm that and provide you with details.

CHAIR—The main source, or the only source, of this type of verbal promotion would be through seminars. There are a number of seminars across the country but I assume that at all of these seminars there would be claims sometimes made.

Mr D'Aloisio—You need to be careful, Chair, when you use the word 'seminar'—

CHAIR—Or any other form.

Mr D'Aloisio—No, I do not mean to correct you.

CHAIR—I am not trying be specific or pedantic.

Mr D'Aloisio—What I am saying is that if you use the word 'seminars', there are public seminars and there are some seminars that are advertised which you could have a look at. As Delia has said, we have a program of going to those seminars and having a look and taking action. We can give you more detail. There are seminars that financial advisers or groups actually organise for their clients on an invitation-only basis. They invite them: 'Come and have lunch with us.' 'Come to the afternoon session from five o'clock to eight; there's dinner and we'll do this.' They promote and give advice et cetera. We cannot say, in answer to your question, that we monitor those. It is not an issue of resources; it is an issue of getting access to that. Indeed, they are private meetings.

CHAIR—That is fine.

Mr D'Aloisio—These happen all over the place. Indeed, that is a way, from the advisers' point of view, of creating a network for the adviser but also for those that attend—in terms of knowing each other and relying on—

CHAIR—I am not trying to be tricky. All I was asking is: do you take that as seriously? Is that an area of interest and concern?

Mr D'Aloisio—Yes.

Mr Cooper—It is.

CHAIR—If it is I am pleased that it is. I encourage you to continue doing that. I am more than happy with that.

Senator BOYCE—Ms Rickard, in terms of industry awareness about their responsibilities in advertising, do you think you are winning?

Ms Rickard—Overall I would say yes. We do not find huge numbers of examples of clearly misleading and deceptive advertising. A lot of it is at the edges. Standards, on the whole, are not that bad.

Senator BOYCE—Have they improved or have they always been good?

Ms Rickard—You would need to take it sector by sector, but where we find there are problems we go in and send some very strong messages about what we expect. Then we continue to monitor. In each of the instances that I am aware of where we have done that we have seen very clear improvements.

Mr D'Aloisio—A lot of credit in this area should also go to the ACCC, because the misleading and deceptive provisions really go back to 1974 with the Trade Practices Act. Certainly, over many years the ACCC has made the misleading and deceptive provisions a very significant part of its work. ASIC has picked up the consumer finance part of that. I think that, as a cultural thing within Australia, the misleading and deceptive provisions are very well known.

CHAIR—I might just move on to the role of commissions and certain arrangements relating to products and sales and how that all works. Do you find, as a general rule, that in the sector there is a difference in standards and quality of products and advice, depending on how that advice is provided? Is there any indication at all that says to you that a particular remuneration model works better than some other model?

Mr Cooper—The shadow shopping work that we do shows that where there is a conflict in the way that the adviser is remunerated or otherwise connected with the product there is a fairly strong correlation between that and advice that does not have a reasonable basis or is otherwise not up to par. So there is data that shows there is a correlation there.

CHAIR—Which areas are those? Is it commissions, particularly, that show up as a problem? Is it upfront fees?

Mr Cooper—Yes. Typically it is when you look at commission related advice and find that it is noncompliant in the sense that it does not have a reasonable basis or perhaps the product is not necessarily appropriate for the client or you cannot see on the face of the advice why it is appropriate for the client.

CHAIR—Is it difficult for investors to make those distinctions about the way they pay for a particular service—be it commission fees or hourly rates—and who markets, owns and distributes the product and what is in their best interests? Is that difficult for people?

Mr Cooper—It is a multilevel question. I think, in general terms, yes. There are disclosure obligations around fees but, speaking in very general terms about retail investors, they are complicated in the way that they work. Addressing the last question, it is a little bit like going to the dentist. You go along to seek advice because you do not know, you are seeking answers to things. It is very difficult in the short term for retail clients to walk away from an adviser knowing whether in fact they have been given good advice or not. It is often down the track that—

CHAIR—Are there any limits to what someone can be paid for providing that advice?

Mr Cooper—No.

CHAIR—None at all?

Mr Cooper—No.

Mr D'Aloisio—Its limits would only be imposed through competition. In other words, it is a market mechanism; it is not a regulatory mechanism.

CHAIR—So it is completely open and really anyone can charge anything they like in pretty well any form they like?

Mr D'Aloisio—Subject to disclosure.

CHAIR—But on the issue of disclosure, the complexity obviously is that that can be varied in quite a lengthy and complex document.

Mr Cooper—I would not say 'varied'. It is just that—

CHAIR—It can be contained within a lengthy document, which could make it very difficult for someone who is not—

Mr D'Aloisio—Yes, there would be situations—

CHAIR—experienced enough or who does not have the time.

Mr Cooper—Yes.

Mr D'Aloisio—But at the nub of this is the issue of conflict of interest and how the legislation manages it. If you do have a potential conflict, as you may in an example you have given where you get an upfront commission if you recommend product A but you do not get an upfront commission if you recommend product B, the conflict being that the remuneration may influence the recommendation of the adviser, the statutory solution to that is disclosure. By disclosing that and being upfront, the investor would then make the judgment and say, 'You may be pushing me

to that product because you are getting a commission. You have disclosed it, so I am comfortable.’ The question you then get to is: if that is the broad regulatory framework that is there, will retail investors actually have the ability and the wherewithal to question that and sit back and say, ‘Actually, I won’t stay with you as an adviser because you are getting this three, five or seven per cent. I am going to go to someone who will recommend me products where they do not get that.’ We are not seeing strong evidence in the market of those sorts of choices being made by investors.

CHAIR—Given that most advisers work to an approved product list, would it then be the case that all the products on their list attract similar or the same commissions, so it does not matter which one they recommend? The problem there is that there is no point having disclosure about getting a commission on product X but not on product Y when all your products attract commission.

Mr D’Aloisio—But I think all those products will still have other alternatives and you would still need to make that disclosure.

CHAIR—What other alternatives?

Mr D’Aloisio—There might be products that are offered that are similar products to those that are on the approved list—

CHAIR—But how would you know that they exist if they are not on the approved list?

Mr D’Aloisio—There is not just one supplier of products. You would ring around and—

CHAIR—But once you arrive at a financial adviser and you have decided—

Mr D’Aloisio—I thought that was obvious—sorry.

CHAIR—That is all right. Once you are at the table with the adviser of choice by whatever means you have come there—which is why you are getting a disclosure document; you would not get one from X number of how many people who provide this information—how do you distinguish which product is the best if all the products they provide and that are on heir approved list are all pretty much the same products which pretty much attract the same fees? If you do not like X, you can have X plus one—but it is the same product.

Mr Cooper—I am not sure what you are driving at. Are you driving at fee comparability?

CHAIR—Mr Cooper, if you are not sure what I am driving at, let me explain it in a different way. You are saying that people get a choice and that choice is provided through disclosure. If you do not like the fees, you can go to a product which does not attract fees. But the problem for an investor is, when they are at the table with their adviser, the only products that are presented to you, no matter how many different ones you ask for on an unlimited list, are all pretty much the same products which attract the same fees. So thereby you have no real choice. But you wouldn’t know. So the disclosure document discloses a whole range of things but will never disclose to you an option or any real information that, ‘Yes, you could get a similar product that attracted no fees,’ because all the ones they are offering do attract fees.

Mr D'Aloisio—I do not think I can argue with that proposition, Chair.

CHAIR—Again, I am not trying to be clever; I am just trying to—

Mr D'Aloisio—If you have got an industry that is selling cars and all cars have a surcharge of five per cent, whatever make or model, you do not have choice.

CHAIR—No, but in this case it is not all cars that have a surcharge of five per cent. In this case, there are tens of thousands of products which can be remunerated in a variety of ways. If we are talking about disclosure and the links between commissions and the problems that exist with those, once a person has made a decision, by whatever means, once they are at that table with that adviser, their choices have ended. Their choices then are limited to what that person provides, no matter how much disclosure there is. I just needed to understand that. If that is right, that presents a problem.

Mr D'Aloisio—The only choice that would exist at that point is if the investor then went to some other adviser—

CHAIR—Which would give you the same outcome in a different form.

Mr D'Aloisio—But your view would be that it is going to be pretty difficult for an investor to leave, because you are charged commissions on all these products and you will go to someone who has an approved list that does not have commissions. That would be extremely difficult to do.

CHAIR—If they do not have commissions they attract some other fee. If they go to the next adviser and they have an approved list, you are caught in the same conundrum. How do you get a choice in an environment where your choice is limited by what is presented to you? You turn up at a buffet and there is a lot to choose from but it is all the same. As long as we have some clarity about that being an issue, because that leads directly into disclosure. Disclosure in terms of what is actually disclosed is limited to what is offered. It is not disclosure about the total market. It is not disclosure to the investor that, 'Yes, sure, we will disclose to you that there is a conflict of interest.' In fact, if you went down the road you could get the very same product—in fact, a better product—and get it with few fees or no fees or completely different. That is not disclosed.

Mr D'Aloisio—That is not competitive disclosure; that is correct.

CHAIR—It is only disclosure in terms of what you are offered. If you are only offered one product you will get disclosure in terms of that one. You have got nothing to compare it to. Disclosure is highly limited in its capacity to, in the first place, offer you any choice. Even if you are very good and in fact you are a financial planner yourself being offered this, you may not learn anything from the disclosure. Often disclosure can be a form of protection more for the people providing the product rather than for providing information.

Mr D'Aloisio—The disclosure is designed in the legislation to deal with the way you manage a conflict between your personal interest and getting a commission and giving the advice that is appropriate to me. It is not designed to regulate that the adviser must disclose that there are other

products that may not attract a five per cent commission, which is I think the point you are heading to. That is correct: the legislation does not do that, and ASIC does not require that. That is a competitive issue for the market.

Ms Rickard—If I could quickly say something there, and this is far from a perfect solution, but it is certainly one of the things we actively try to educate consumers and investors about. If they are looking for an adviser, there are questions to ask before you settle on one. How are they remunerated? What products do they sell? We also try to educate about the sorts of products you will never be able to purchase through a financial adviser. It will not cure the problems you are referring to but it is one of the things we focus on in our education.

CHAIR—What that leads to, then, is differentiating between those who provide a truly independent advisory service and those who just sell a product, regardless of how many different products they sell, because they are just selling what they are permitted to sell, not what they would like to sell you or what is most appropriate for or what you should buy or anything else. There are really only two types: those who sell advice on what may be most appropriate to the most and those who sell according to a list—you can pick anything on the list, but that is all that you are able to order. Is that—

Mr Cooper—It is. That must sound unattractive—in other words, it does not sound—

CHAIR—I am not making any judgment as to whether it is attractive or not; I am just trying to establish the facts.

Mr Cooper—It is how a large part of the industry is structured. Nonetheless, because of the perimeter around that list, what it often means is that—although the products might be all relatively the same—they are relatively safe and the advisor understands what those products are and that there has been a sorting or weeding process. Those products might be a little bit vanilla and some people might say that the price competition around accessing those products is not as vigorous as it might be, but often what you will find is that they are reasonably appropriate for the client and that they do not have catastrophic problems. I call the problems that they have incremental problems, so the market can—

CHAIR—If that is the case, how genuine is it to make the claim that you are providing advice? You are not.

Mr D'Aloisio—That is another big issue to with the notion of distribution versus advice. You used the phrase 'independent adviser'. Clearly, you can use the analogy of a solicitor or an accountant or some other profession that you use on a fee-for-service basis. You can conclude in those cases that the advice that you are given is free of bias, if you like, towards one product list or another. That is a model that is in the market and it needs to be evaluated. Working out whether that is the best or only model that can work would need a lot of other consideration. As Jeremy has just said, when you look at these product lists and how they work and you look at the reputation of the brand that might be behind them and the organisation that is doing it, there is also a lot of comfort to be drawn from the fact that those organisations, given their reputation, have put those products on a product list, have developed them and will stand behind them. It means that the financial planner or adviser who is recommending those products is probably in a reasonably good position from the consumer's point of view.

CHAIR—So this is a case—

Mr D'Aloisio—I am not making a judgment about this. These are things to be debated.

CHAIR—No, I get that. But it is more a case of asking how we define that they do. My interpretation, and let us say the interpretation of the person on the street, of someone who provides financial planning advice is different then somebody who just sells you a product from a list of products, be they similar, the same or slightly different. That is highly limited, because they cannot step outside of that, no matter how inappropriate any of those products are to the individual.

Mr D'Aloisio—The assumption that you are making there is about how inappropriate they are. Say, for example, you have a brand reputation around a group of products and you have your licensee standing behind those and putting the effort and research into them and providing that information to the adviser. That could work as a means of ensuring that the retail investors are getting good service and good products. It has the problems we have just talked about, but what is happening there is that the brand and the reputation is working to distribute those products. Indeed, when you look at the big distributors or the big product manufacturers in Australia—the major players—they are generally connected to a major bank and the reputation issues are extremely important to them. When you look at some of the areas where we have had problems—great problems—they have tended to be outside those. We in assisting you need to point out both scenarios. I am not taking away anything from your point, but I am just saying that there are other considerations that you might want to look at.

Mr Cooper—If I may help the committee on this, you should not overestimate the role that advice plays. You can look at this as having three pillars. You have advice, which we have talked about a lot. There is then disclosure and comparability, which goes to your observation about how a retail investor compares price. The third pillar is the product: what the product is, how it works and how risky it is. You have those three pillars. Sometimes in our system we overemphasise the advice bit and sometimes overlook the other two elements—and particularly the product one.

CHAIR—But the problem exists that there is no distinction, as it currently exists.

Senator MASON—Mr Cooper, you mentioned before that you were the architect of the legislation. The chairman raises a very good point. Again, I am someone who is a layman in this area of law; I know nothing about it. It strikes me that there is an inherent tension—if not conflict—between being an adviser on the one hand and being a salesman on the other. I understand, Mr D'Aloisio, your argument that disclosure to some degree makes that more transparent, and I accept that. But a fee-for-service lawyer also has to make disclosures. The chairman's question really goes even before that. That is right, but the conflict seems nearly inherent in the relationship and that is what is concerning. That goes to things like what the legal test should be, the legislative duty of care and the common law duty of care. It is all linked.

Mr D'Aloisio—Are you saying the conflict between selling and advising is inherent?

Senator MASON—Yes. It is inherent. I accept that disclosure somewhat ameliorates that. I accept that. But anyone with any conflict—whether they are a fee-for-service lawyer—has to, in a sense—

Mr D'Aloisio—Disclose.

Senator MASON—disclose. Yet this predates that. We do not have a fee-for-service lawyer. We have someone who actually makes their living from commissions. I think the chair makes a very good point about this inherent tension. I would say 'tension' but you could say 'conflict'. It would depend on how far you wanted to go. I know, Mr Cooper, you are trying to not salvage but explain it. I accept you are right, that products have their own marketability, that Macquarie Bank has marketability and so forth. But you have to admit there is an inherent tension right at the beginning of the relationship, which worries me.

Mr Cooper—There certainly is. As we explained, 75 to 80 per cent of the industry is wired up in that way. So it absolutely is there. But you do need to go to the next step and ask: 'Okay. What are the outcomes? What are the results of that conflict?' We all agree it is there. The legislation seeks to present three opportunities. One is disclosure, one is management and the other one is avoidance. Let us go to that next step. What is the actual outcome of the conflict?

CHAIR—Can I suggest to you that people pay too much in fees?

Mr Cooper—All right. You may well be right.

Senator MASON—You are using the word 'conflict', Mr Cooper. I was not game to use 'conflict'. I used 'tension'. But you are using 'conflict', which is a stronger term.

Mr Cooper—Let's accept that that is the case. I am not necessarily accepting that that is the case. It is still an incremental problem. If the product is reasonably appropriate for them and it is safe, that is a lesser problem than a system that delivers a product that is cheaper but then loses their life savings for them. There are two dimensions to the problem.

Senator MASON—I accept that in theory. Someone being paid fee for service, as an accountant or a lawyer might be, does not mean in any sense that their advice is going to be lesser. In fact, I understand the financial planners are thinking of moving towards a fee-for-service operation. That has been mooted.

Mr Cooper—It is very common to have three different types of remuneration, all in the one.

Senator MASON—Sure. But you see my point. It is a bit hard to argue that a commission basis leads to more satisfactory financial outcomes for investors. Can you empirically show that?

Mr Cooper—No. What I am suggesting is that there is reasonable empirical data that shows that institutionally the sorts of big distribution channels that we are talking about may well throw up incremental outcomes. They may not be the cheapest outcome for the retail investor, but because of the risk management controls, the approved product lists and the additional training and vetting that you find going on, you will come back to the safety question: are the retail investors, the consumers, getting products that are so inappropriate and so dangerous that they

are losing their life savings? If you look at some of the catastrophes we have seen in recent times—like your Westpoints, and you know the list as well as I do—in nearly all cases they are not in the big conglomerate, institutionally owned sectors where there are conflicts and there are possibly higher fees being paid. But you do have to balance that—

Senator MASON—I accept that. But that is to do with the quality of the product, not the means of selling.

Mr Cooper—Exactly. That is exactly right.

Senator MASON—That is a different issue.

Mr Cooper—I am urging you—

Senator MASON—Mr Ripoll is talking about the means of the sale rather than the quality of the product. They are not necessarily connected, are they?

Mr Cooper—Just do not look too much at the advice and think about the impact that a good or a safe product, a well-manufactured product which is appropriate for the consumer plays in this mix.

CHAIR—We are looking at the advice very closely because it would seem to me that any model, no matter how risky, at either end of the spectrum, from least risk to most at risk, is all legitimate and legal. There are no rules, laws or otherwise that prevent any particular model. So it does not come down so much as to whether the model is good or bad. Even the riskiest novel can be very good for someone who is making money from it. The real question which comes in is the advice. It is the responsibility of the person providing the advice, but if that advice is provided on the basis that it is limited to the products that are available for them to advise on, there exists a conflict. I could go one step further and say that the conflict that exists is that the responsibility of anyone selling any product is to the person who pays them not to the person they sold the product to necessarily. Therefore, if you are obtaining advice from someone who is paid to sell you a particular piece of advice or a product, their responsibility, unless it is different otherwise, is to the person providing their income, not to you, the client. This is a real problem in terms of conflicts of interest and disclosure but also in the way that very poor advice is provided regardless of the models or systems are used.

Mr D'Aloisio—I think it is a major policy issue for you and your committee. In all these things, it is a matter of assessing it with the benefit of some hindsight. There is no question, if indeed the changes you were talking about had been in place, that you would have to ask the question: would a Storm occur, would an Opus Prime occur, would a Timber Corps or a Great Southern occur? That is the difficult judgment the committee will need to make. If you take the front-end commissions and the ongoing commissions out, would those investors have received different advice?

CHAIR—I am not suggesting that that becomes the panacea for what happens in the sector, and collapses or otherwise commercial failure, but certainly it would appear at this stage that there is a strong link between poor advice, inappropriate advice and commission or fee structures, at least at the outset. It may be that, if you got rid of commissions altogether,

obviously that would not prevent commercial failure and corporate collapses. Sometimes corporate structures are wrong, the people running the organisations may be the wrong, there may be a range of reasons. It would at least go some way to making it clear that, if you are buying a particular financial product, it is a product that may be best suited. There is no other connection apart from that it is the product which suits the individual.

Mr D'Aloisio—Yes.

Senator BOYCE—I am looking at the evidence on page 14 of your submission. Can you tell us about the forms of remuneration other than commissions which financial planners receive?

Ms Bird—A financial planner may be remunerated by commission or by a fee for service. There are different types of fee for service—it could be an hourly rate or a flat fee or it could be a percentage of funds under advice, which does itself raise perceptions of conflict. Some advisers are also remunerated by salary.

Senator BOYCE—Platform fees would be considered a type of commission, would they?

Ms Bird—If there is a platform provider who will take a fee for their services, yes. They will probably pay commissions to advisers out of that.

Senator BOYCE—Would financial advisers who use a fee for service normally get trailing commissions or management fees from platform providers?

Ms Bird—Because the commissions are built into the product, a commission is an arrangement set by the product issuer. A fee-for-service provider would have to get the commissions and rebate them to the client.

Senator BOYCE—To the client. Thank you.

CHAIR—Is there a distinction to be made when advice goes beyond purchasing any particular product under any particular scheme; it goes beyond that with the current assets that you hold and goes to the extent of saying, 'I now advise you to actually go into debt—to borrow money'? Is there any distinction at all so that if you were to draw a line and say, 'You can give advice to anyone on any product,' but if that advice then extended to saying, again on any product, 'Now I actually advise you that you should borrow money in any form'?

Mr D'Aloisio—You can envisage situations where it would be appropriate, as part of the advice, to recommend that a client go into leverage or go into debt. It is not uncommon, for example, to recommend to the client: 'Forget all this funds management stuff. Go and buy a supermarket and rely on the yield and finance it 60-40—60 per cent equity and 40 per cent debt.' That could be appropriate advice in a particular situation. The consequence of that would be that you would also be recommending going into debt. Indeed, in the Australian system, as you know, negative gearing is a very fundamental part of the tax laws. I have not been able to check this—we could look at it—but I would expect that going into debt would be part and parcel of appropriate advice depending on the particular situation.

CHAIR—So you do not see any real distinction between the advice being: 'These are my assets and this is what I hold in my bank account or super or whatever it might be. I am prepared to invest and take advice on those but I am not prepared to borrow.' So there is no real distinction—

Mr D'Aloisio—In think that, for example, if you are looking at a recent retiree or retail investor who is nearing retirement, I am sure the average retiree would say: 'I am at a stage in life where I cannot go back into the workforce. I have paid off all my debts. I really do not want any additional debt so I would like to invest in a way that I do not have to have debt or, if I have debt, it is just a small percentage.' So a lot will turn on the circumstances of the individual. In the recent boom, where negative gearing or margin lending and negative gearing went high, I think there was also a sense of a false understanding, or at least it emerged that as the markets kept going up the appetite for risk got greater and greater—or the understanding that the bubble could stop, and the impact of that. Probably a lot of people found themselves to be more leveraged than they otherwise would have liked and have taken steps to de-leverage and have taken steps to sell assets and get back into balance. Going into the next wave and the next change of circumstances I think you will see probably initially quite an aversion to debt. But I would expect that the markets, as they have done before, as they will do again and as they will do for our children, will be back there in 10 years time; there will be very high leverage and issues. It is a generational issue.

Senator WILLIAMS—Perhaps we could get an answer on that forecast from Mr Erskine!

Senator BOYCE—When an investor who has used a financial planner to invest in an entity receives a margin call, how is that call made.

Mr D'Aloisio—Let's talk about a vanilla arrangement. Let's take a simple case where I have got a margined portfolio of, say, $1 million of shares which I have margined to 50 per cent and I have got 50 per cent equity—just a basic vanilla arrangement. Let's assume that I did that in October 2008 at the height of the market and then copped the fall since so that my 50 per cent equity got diluted to 25 per cent and that led to a margin call. Typically the margin call would be made by the lender, not the adviser.

Senator BOYCE—The bank or whoever?

Mr D'Aloisio—The bank would say: 'Tony, you took out a margin loan with us; it has got to the limit now. Either put up cash or in three days time we will sell your shares. Give us your instructions.' It also can be common in that vanilla arrangement that sometimes the lender can make the decision to sell a part of the shares to get you back into balance. That is the vanilla arrangement.

Senator BOYCE—What would the financial adviser's role be in that?

Mr D'Aloisio—In the vanilla arrangement the financial adviser stands aside. In a sense they are not advising on that product; that product is provided. What may happen is that the relationship between the financial adviser and the lender may be such that the lender acts as a bit of a wholesaler of the finance and a lot of the legwork around the margin loan itself is done by the adviser. So it may be the adviser that could contact me and say, 'Tony, in the relationship I

have got with lender X, you are in margin call territory. Put in some money,' or, 'Don't you worry. I will organise the selling of so many of your shares and I will fix it up.' I would say, 'Senator, that is fine, get it done.' In that situation the legal implication of that is, is the financial adviser giving me advice or is the financial adviser acting as agent of the financier? Has the financier allowed the financial adviser to be its agent so that whatever the financial adviser does or does not do is attributable back to the financier?

Senator BOYCE—Is there any situation in which it would be legally possible for an investor not to know that a margin call had been made?

Mr D'Aloisio—The only way it would be legally possible, again speaking generally, would be if you had an agreement with the financier that said—

Senator BOYCE—Keep me in the black, please.

Mr D'Aloisio—Yes. 'We can keep you in the dark' principle or clause which said, 'Your margin loan with us is such that if at any time we feel you are a risk we will sell it up and tell you later.' Highly, highly unusual. In my own experience I have not come across that. I have come across where they can act pretty quickly, sometimes on notice without notice on some parcels of shares but not that they could keep you in the dark about your affairs.

Senator BOYCE—Is it illegal to activate a margin call without the investor's knowledge and approval, whether that has been a blanket approval or an individual approval?

Mr D'Aloisio—It depends on the agreement that would exist between the lender and the borrower.

Senator BOYCE—That would have been covered, what, in their initial negotiations. So if an investor is not understanding some parts of it, they may not understand that part.

Mr D'Aloisio—Absolutely. I think this is why as a matter of policy you are now seeing the issue of responsible lending. You are also seeing why the government has decided to take margin lending under chapter 7. I think that is designed to deal with issues, as you said, where you may not have fully been aware of what your obligations were—

Senator BOYCE—What you were signing away.

Mr D'Aloisio—What you were signing away and what the terms were; that is correct.

Senator MASON—Senator Boyce asked general questions. I have a specific question in relation to Storm Financial. Was the loan to value ratios and the behaviour of the banks in accordance with normal commercial practice at the time, or was there something different about those relationships?

Mr D'Aloisio—Are you talking generally about loan-value ratios?

Senator MASON—Yes, but specifically in relation to Storm.

Mr D'Aloisio—Again, because of the investigation I really do not want to go into that.

Senator MASON—Okay. It is clearly something that is close to the committee's heart.

CHAIR—We do not have a lot of time left tonight. We are doing okay, we are getting through it all.

Mr D'Aloisio—I am glad to hear that, Mr Chair. We are holding up well.

CHAIR—I thank the commissioner and the committee members. There are two more areas I want to cover before we might go to some general questions to finish. One is the issue of consumer education and understanding of financial products and services. It is pretty obvious at least from our conversation here tonight that it is a pretty complex world, a pretty complex market and pretty complex products, that there is not a great deal of agreement by anyone anywhere as to just what everything can potentially mean and choice is a highly subjective matter. How much can any of us really expect to be able to deliver in terms of trying to further educate ordinary consumers and investors? While I do at the same time support it and think it is a very important thing that we must continue to do, how much can we expect out of that in the end?

Ms Rickard—I do not think we can ever hope to educate everyone or even the majority about the complexities of a whole range of things out there, but I think there are some very basic messages that we can get across. I think we can get across messages around the fundamentals of investing, just simple things like diversification, asset allocation, even a bit around risk, which when we look at the victims in ACR, Fincorp et cetera, Westpoint, the fact that they were not diversified is one of the reasons why the consequences were so catastrophic. I think we could get across basic messages: if you don't understand it, don't buy it. And the importance of understanding which you are investing in—

CHAIR—That would leave very little buying!

Ms Rickard—We are doing some work at the moment which Jeremy might want to elaborate on around investing between the flags, where we want to use some simple visual Australian metaphors to help people think about risk and to ask the right questions. I suspect in a lot of cases the best we can do is to have in people's minds what questions to ask, where to go to look for further information. I do not think we are going to get all that information—

CHAIR—I agree with you and I think that is a step in the right direction in terms of trying to provide some core messages in education, but obviously the complexities are quite difficult. Is there the possibility or option that they could go one step further and that, when making certain types of investments or buying into certain types of products, people are required to actually take that one step further and almost have a cooling-off period or some other form that they have to really go to which is done aside from at the point where they sign. They sign, go away, have to do something else and come back, to give them the opportunity to better understand exactly what it is, even if it is just the core messages.

Ms Rickard—There is a cooling-off period in existence under the legislation at the moment, but that is another thing we need to educate people about because I do not think they are

generally told about it and a lot of people are not aware of their rights in respect of the cooling-off period.

Mr Cooper—Going back to my dentist analogy, in the short term if they would like the adviser they are probably reasonably happy with the whole experience.

Senator WILLIAMS—In relation to the investing et cetera, when we look back at the last 12 months and what has happened and the subprime in America and 'Lend the money, she'll be right, the price of the house will be worth an extra $50,000 in six months time,' when we go through the period we have been through up till the end of 2007, when the market started to dip down after that bull run for so long, do you think financial planners and potential advisers may get a little lackadaisical saying, 'We've had such a good run, it is going to continue?' Is that a thought that may be in the minds of some? I know it is a difficult question.

Mr D'Aloisio—It clearly is—

Senator WILLIAMS—What I am saying is because of that bull run does that delete caution.

Mr D'Aloisio—That was in the mind of all the institutions and was in the mind of the financial planners and was in the mind of the politicians and consumers. I do not need to go through it. We had a situation where what happens, and Alex will explain this in economic terms but I will do it in layman's terms, is that basically you get a situation with the risk-reward premium where the chase for yield is such that the risk is greater and greater and it gets to the point where the bubble bursts. But I do not think that is peculiar to any particular sector. Alex could explain it far better than I.

Mr Erskine—I think it is a case of confidence breeding more confidence until it reverses.

Senator WILLIAMS—Until we hit the wall.

Mr Erskine—It makes clear the desirability of counter-cyclical economic policies.

Mr D'Aloisio—Going back to the issue of the cooling off, in this tension that exists between the efficient markets and protecting retail investors there are other options you may want to consider, this notion that the product manufacturer has to actually have a greater obligation of ensuring that the product is suitable for a retail investor and so on. So there are other concepts similar to swimming between the flags. So there is a tension between the efficient markets and getting retail investors back into the market with protecting them. I think options such as better retail investor education, greater understanding of the risks associated with investment, plus potentially looking at issues around the way that products are delivered and greater obligations on those who are manufacturing the products, are other options to look at.

Senator MASON—I do not in any sense want to criticise your approach to educating the public, but if I could just point out an inherent problem. Sure, you want people to be educated about financial matters, but the psyche of the public, surely, is something like this: they go to a lawyer to seek legal advice, they go to an accountant to get accounting advice, they go to an electrician to fix the wires or whatever and a plumber as well. You do not ask in any of those areas that people should have prior education—not really. You do not ask people to be educated

in plumbing to be an electrician, or even the law. People think in their minds when they go to a financial adviser that that financial adviser will give them the independent advice. This is not a criticism of what you are doing, but you can see that mindset. The mindset will be, 'This person will be giving me that independent advice.' So you have quite a challenge before you.

Ms Rickard—We do have quite a challenge. It is also interesting that, if you look at the research about what consumers and investors feel in relation to planning, there is a real trust issue there. The population as a whole does go along with some question marks there.

Mr D'Aloisio—In other words, I think what Delia is saying is that they may not form that view—as you say they do—that, 'If I go along and get my advice it is independent advice.' In other words, they would scrutinise that proposition a bit more.

Senator MASON—They might, but the difficulty is whether it is sufficient to counteract that.

CHAIR—Could we draw from what Senator Mason is saying that there is an issue of professionalism within the sector given that on the sector's own reading or surveys only three out of 10 Australians actually get any financial planning advice? I would hazard a guess that the other seven just ask their mates down at the pub on a Friday night—and the quality of advice could be the same. So there really is a massive issue within the sector in terms of professionalism, the standards that are applied and also the way they are viewed by the public.

Mr D'Aloisio—Our observation would be that the financial planners are really, through industry associations and so on, alive to these issues. Certainly they are improving in the way they are approaching client service and so on. Whether it has gone far enough quickly enough is a judgment for you and the committee. It would be unfair for us to leave you with any impression that we need to start again with this whole industry. When we look at the issues that have occurred and how they have been caused, fundamentally a lot of the losses and so on that have occurred in Australia have been due to flawed business models in terms of leverage and operation, and they have not been designed by the advisers. The advisers have advised, but they have not designed those products. So I think we need to bear that in mind. Having said that, we have been clear that—and we have said this, and we say this, to the industry—we want to see a lift in standards, improved training, greater professionalism, as you say, and a much greater focus around looking after the interests of the client ahead of anything else. So we would be pushing those issues and then through consumer and investment education really saying to the investors and consumers as well: 'You've got a responsibility here too. We all have a responsibility. There are basic things you need to know about risk.'

Mr Cooper—The committee should also be aware just how our settings in Australia differ from comparable jurisdictions and present great challenges for all of the things we have been talking about—advice, investor education and our work. I will give you an example: in the United Kingdom there is no retail margin lending. It just does not exist. You could say that is partly cultural, but we and the UK regulators believe that merely the suitability obligation they have there means that the general consensus is that the product is not suitable for retail hands. We have very generous settings in Australia as part of our architecture. We allow products; we give an enormous amount of choice to our retail investors. I think the general consensus has been that we are outliers in that respect. In general terms that has been a successful setting, but a committee like this would, I think, have to have a look and see how that is working.

Senator WILLIAMS—Looking forward, we know that the Storm model, Opes Prime and things have gone sour. We have many financial products on the market and obviously new ones will probably be invented in years to come. How can there be a system to stress test those current or new model systems to see that they do not go wrong, as we have recently? Is there any way they could be stress tested? In other words, what I am saying to you is: if you are going to make a car, what standards are there to see that the brakes are right and the suspension is right and everything else? If you put that analogy to a financial product, what can we do in the future to see that this sort of thing does not happen again?

Mr D'Aloisio—It is a big issue that goes right back to the start of this discussion, as Alex was pointing out, about the underlying policy of what we have. If you take the area that APRA regulates—the prudential regulation of the banks, for example—that is a greater intervention in regulating the banks and their capital and so on. Why? Because they are regarded as potentially systemic problems for the markets. Therefore the balance between efficient markets and competition against protecting systemic risk has warranted a greater intervention. When you come into the retail investor area, which is at the moment regulated in the way that we have talked about, you have the benefit of having retail investors coming in and investing on the stock market. Indeed, when they saw the statistics today that stock market investment by retail investors had gone from 55 per cent to 41 per cent, people got concerned because they could see that it means there is less liquidity in the market, and if there is less liquidity in the market the cost of capital could go up for companies.

In the debenture area—in market linked investments, mortgage trusts and so on—a significant amount of money that has gone in is used to invest in real estate et cetera. By bringing in a prudential type of regulation or greater regulation in those areas you may well reduce the level of investment that comes in. So you have protected the investors because you have created a system where you are minimising failures but at the same time you have restricted the flow of capital. It is a judgment that you need to make. The way that things have been unfolding at the retail level the mood is that our system will probably get some tightening in the way we protect retail investors, having regard to what has occurred. The difficult judgment is in putting that setting in in a way that means we still have efficient and effective capital markets, because the cost of capital in these markets, when they were operating well for our companies, was low. It enabled them to create jobs and it enabled them to compete internationally.

Mr Cooper—Could I just add very quickly that what you were talking about is very similar to what President Obama has just put on the table. They talk in the US about a thing—call it the 'financial safety commission' if you like. They are specifically proposing the creation of a regulator that would look at—this is where they have had problems in the US—mortgages and other credit products and behaviour. As I understand it, the role of that agency would be to challenge and test and put some controls around those specific types of products. I think that is very similar to what you were raising—

CHAIR—Finally, Mr D'Aloisio, can I just ask you for your comments in relation to professional indemnity insurance, specifically around the issues of adequacy. I think adequacy is the central issue, given what has happened.

Mr D'Aloisio—In good chairman style I will delegate that to my colleague.

Ms Bird—With regard to adequacy or efficacy, there are some limits to PI as a compensation mechanism. It is not a perfect mechanism. Essentially, PI insurance is not really designed to compensate retail investors. And it is not going to be a guarantee that compensation will be paid. It is a contractual arrangement between the insurer and the insured—the licensee. So it is going to be limited by the contract between those two people. And it would be limited by what the market is able to provide at certain times.

CHAIR—Is it also time limited and dollar limited?

Ms Bird—Yes. There is a maximum—

CHAIR—Which is?

Ms Bird—The law requires that licensees have adequate insurance, taking into account the size of their business and the likelihood of claims. It is up to the licensee to decide what is adequate. ASIC has given guidance as to what we think the minimum is, in terms of conditions and quantum. What you want to know is what that guidance is. It is really a sliding scale between $2 million and $20 million, taking into account revenue of the licensees. I can give you the details in writing if you would like.

Mr D'Aloisio—Sure. But, again, the issue for the committee is that certainly having PI in place, having the rules that are in place at the moment, is better than where we were three or four years ago—

CHAIR—Absolutely.

Mr D'Aloisio—There is no question that it is better, but it has, as Jo says, a lot of limitations. The more difficult issue then becomes what you replace it with if you do, and that brings in issues of statutory schemes and raises issues of funding. So, again, it is a policy matter of some significance. On the one hand, you would give better protection to retail investors if they got into a problem; on the other hand, there is a cost to that that the community would need to bear, similar to the government guarantees on deposits and so on. So there are obvious issues, but that is really where we would leave it. Overall, we would say having a PI insurance system in place, with all its limitations, is better than not having one, but obviously there are better schemes, and they would be statutory forms of compensation.

CHAIR—I thank the Australian Securities and Investments Commission very much for appearing tonight before the committee in its public hearing. I also thank the committee members, Hansard, and the public gallery for their patience and cooperation.

Committee adjourned at 8.36 pm