

42 Park Road
Kensington Park SA 5068

Tel: (08) 8364 2885
E-mail paul@aptstrat.biz

Mr Ian Johnson
Executive Director- Financial Services Regulation
Australian Securities and Investments Commission
Level 18, No 1 Martin Place
Sydney NSW 2000
GPO Box 9827

By e-mail: ian.johnston@asic.gov.au

Submission in respect of FSRA

Dear Mr Johnston,

I appreciate the opportunity of being able to make a submission directly to you.

My perspective is that of a very small AFS Licencee which was originally issued a dealers licence in 1995. I have also worked as a full-time financial planner since 1986.

Clearly, those who wrote the FSRA and PS 175 have a very different perspective. I suspect that none of these people have ever given financial planning advice and that few of them, if any, have ever sought financial planning advice. I also suspect that their perspective of financial planning is based on a review of a miniscule subset of financial transactions recommended by unscrupulous and/or incompetent financial planners.

From the public's perspective I suggest the following four issues need to be addressed. In each case I suggest the issues are major, but that the action required is very minor.

1. Requirement for SOA in respect of "minor" advice.
2. Procedure is currently more important than the quality of advice.
3. Disclosure of commission.
4. FSRA costs versus FSRA benefits.

Before discussing these issues I offer the following industry data.

Data suggests that small ASF Licencees are not the major source of complaints

- The number of Authorised Representatives in the industry has been estimated to be over 17,000. *Source: Principal Member Survey - Industry Structure prepared by Adjunct Professor Wesley McMaster for the FPA, November 2003)*
 - If each Authorised Representative provided one item of advice every working day (say 200 days per year) there would be 3.4 million items of advice offered every year.
- Membership of FICS includes approximately:
 - 149 members that belong to Category E (>99 Authorised Representatives); and
 - 1,956 members that belong to Category F (<100 Authorised Representatives) *Source: FICS website*
- In 2003 FICS received
 - 361 complaints against Category E members
 - 230 complaints against Category F members. *Source: FICS*

Observations based on the above data

- The total number of complaints to FICS is very small relative to the total number of items of advice that may be expected to have been given. Thus, the subset of advice that has resulted in complaints may not reflect the nature of the industry as a whole.
- Category E members (>99 Authorised Representatives) account for:
 - 149 (i.e. 7%) of the total number of Category E and Category F members; and
 - 361 (i.e. 61%) of the 591 complaints against Category E and Category F members, with 2.4 being the average number of complaints per Category E member.
- Category F members (<100 Authorised Representatives) account for:
 - 1,956 (i.e.93%) of the total number of Category E and Category F members; and
 - 230 (i.e.39%) of the 591 complaints against Category E and Category F members, with 0.1 being the average number of complaints per Category F members.
- The average number of complaints lodged with FICS against each Category E member is 24 times greater than the number of complaints lodged with FICS against each Category F member.
- Given, that over 60% of complaints received by FICS in 2003 related to Category E members (i.e. those with 100 or more Authorised Representatives) it would be naive to believe that the AFS Licensing process has weeded out the “bad” element of the industry unless there is evidence of correlation between those that are no longer licensed and those against whom complaints have been made previously. Any reduction in licensee numbers could be attributed to a restructuring of the industry so as to reduce compliance costs and departure from the industry by those who decided that the expected costs and risks of operating under the FSR regime outweighed the expected benefits.

Issue 1 - Requirement for SOA in respect of “minor” advice

Whereas most items of complaint are likely to involve amounts of money that are large from a client’s perspective there is a great deal of financial product advice (as defined by s766) that is either of advice that is of a very minor nature or is in the way of background information or opinion. This is particularly true in the case of financial planners who have an ongoing relationship with clients. For example, answers to the following questions could all be seen as being:

“intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or could reasonably be regarded as being intended to have such an influence.” (s766)

- What do you think of options?
- Are index funds better than actively managed funds?
- I need \$5,000. From which investment(s) should I take the money?
- The market is at an all time high. Should I sell now and buy back later?
- I have heard that the market is likely to remain flat for the next 12 months. Should I defer investing until it is about to rise?
- The XYZ investment has not performed as well as the ABC investment. Should I move my investment in XYZ to ABC?
- I would like to invest \$1,000 on behalf of each of my grandchildren. What would you suggest?
- I read about an investment offering a guaranteed 8%pa. Do think I should invest in it?
- I have just received notice of a 1 for 10 rights issue by Argo. Should I take it?

Strictly speaking it would appear that any answer to such questions as above would require a Statement of Advice (SOA) and yet in most cases a client is merely seeking a brief comment.

On the other hand, one should not forget s912A(1)(a) - the very first general obligation of an AFS licensee - requires that a Licensee:

“do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly”.

Clearly, in most cases the preparation of an SOA in respect of such questions is highly inefficient. Also, if clients were to be given an SOA (and an invoice) every time they asked such a question any ongoing relationship would most likely wither leaving the client vulnerable.

It seems appropriate to question whether the FSRA and PS 175 were ever intended to cover minor advice such as illustrated above and whether answers to such questions as listed above have ever been the basis of complaints received by ASIC or FICS.

It should also be recognised that there is a cost involved in preparing an SOA and that this cost will ultimately be passed on to consumers. In any other advisory service industry (medicine, law, architecture, etc.) the provision of written report along the lines of an SOA in respect of trivial and incidental matters would be considered over-servicing the client - a blatant attempt to raise revenue.

Financial planners currently have the option of:

- 100% compliance with the law and going broke due to increased costs and failing to meet client expectations, or
- bending the rules by using discretion as to whether an SOA is warranted. This option may result in the licensee breaching a requirement of their PI policy (e.g. to obey the Corporations Act at all times) and may leave the licensee without cover which creates risk for both the licensee and the client.

This is not a satisfactory situation for anyone.

It has been suggested that SOAs can be scaled in accordance with the level of advice being given. This may be very appropriate in cases where a new client seeks minor advice (e.g. the investment of \$20,000). In such cases a scaled SOA may provide the specific recommendation together with the required disclosure. However, a scaled SOA in respect of minor advice for ongoing clients impedes sensible on-going communication between clients and advisors and achieves no benefit.

Proposed action

Adapt the rules such that an SOA is not required in cases where minor advice is given to an existing client. In particular, a new SOA should be required if and only if the AFS Licencee recommends:

- a significant change to previously recommended strategy, or
- investment in a product not currently held by the client; or
- making a redemption from one investment to re-invest in another investment.

Issue 2 - Procedure is currently more important than the quality of advice

The requirement to provide an SOA in respect of "minor" advice is exacerbated by the:

- requirement to document within the SOA the "basis" for the advice in a "clear, concise and effective manner" (refer s947B);
- civil liability for providing a defective SOA (s953B)

as not only the direct cost of giving advice is being driven up, but the risk of giving advice is increasing. It is to be expected that the increased cost and risk will be transferred to clients one way or another.

It should be noted also that balancing the multiple requirements of being simultaneously

- efficient,
- clear,
- concise, and
- effective

is very difficult and creates potential for litigation. This difficulty is illustrated by the following copies of email that I sent to Bianca Bastion (FSR Industry Coordinator, ASIC) and her reply.

Subject: Re: ASIC Media Release - clear, concise and effective

Hi Bianca,

Thanks for the update.

I understand what is meant by "clear, concise and effective", but I am not confident that my meaning is the same meaning that will be applied by a court or by FICS at some time in the next seven years.

My doubt is increased by the fact that ASIC's solicitors seem to hold different views to those solicitors who recommend SOAs of 80 or 90 pages. How am I (a very small boutique AFS Licencee) meant to interpret the law which appears to impose contradictory requirements when solicitors are unable to agree?

Clearly, neither the legislation nor ASIC's own policy statements are clear, concise and effective.

The fact is the terms "clear", "concise" and "effective" are difficult to define and one must use judgment to determine whether an SOA is sufficiently "clear, concise and effective" in order to be considered "clear, concise and effective" in any particular circumstance.

I have no problem with what I believe to be the intent of the legislation, but I have a huge problem with trying to be 100% compliant.

The vast bulk of my communication with clients is caught by the definition of "financial product advice" as it is opinion which is likely to influence a client, but very little of this communication is about a specific investment products. Generally, it is background information about investments which could be historic, case study, risk, investment theory, etc. or perhaps it is merely suggesting a small redemption to top up a client's cash flow. I cannot believe that the SOA was intended to cover such general discussions or trivial advice.

I would really like to see ASIC provide an example of a clear, concise and effective SOA that answers the question: "Do you think I should place the investments now or do you think there is a significant risk that the market will fall further before it starts to rise?"

(I believe the answer to the above question and most other questions asked by clients is financial product advice as defined in s766B.) The basis for any opinion that might be given to such a question is one's education, experience, and exposure to data.

If I were to include such discussion in an SOA I doubt I could contain myself to a mere 80-90 pages. Instead I act in accordance with what I believe is consistent with client expectations and ASIC expectations and in accordance with what I think the law intended, but in so doing I suspect there are occasions when it could be argued that I have breached the law.

On the other hand, if I were to ignore the wishes of my clients and ASIC and I were to follow the strict letter of the law I suspect it could be argued that I had failed to be efficient or fair or concise or clear or effective. My clients would suffer information overload and pay excessive fees for over servicing. Before long my clients would leave me, my business would collapse, and my clients would become vulnerable to lesser advisors.

I look forward to any clarification of what is required.

Regards

Paul Gerrard
Director, APT Strategy

Dear Bianca,

Further to my e-mail of about 15 hours ago I'd just like mention a situation that occurred earlier this morning. A client rang up and asked: *What do you think about options?*

The background to this question was that the accountant of a friend (aged 60+) of my client had recommended options for the friend and my client (also aged 60+) wondered if options might be suitable for her also. (It would be interesting to see the basis for the recommendation contained in the accountant's SOA - if an SOA has been prepared.)

If I offer my opinion that options are inappropriate for my client I am giving financial product advice and I should give an SOA, but to explain the basis of my opinion in a clear, concise and effective manner is not an easy task and the cost would be prohibitive.

Surely, there can be some slack in the FSR regime that allows a realistic degree of freedom to address questions and issues such as the above without the need for an SOA.

Regards

Paul Gerrard

Hi Paul

Thank you for your emails. ASIC has started a project to determine how it can best provide guidance in the SOA and disclosure area. We cannot respond to your specific query at this time, as we need to finalise our internal thinking. It has been passed onto the relevant people.

Kind regards
Bianca Bastian
FSR Industry Coordinator

The financial planner may now be held liable for claims by disgruntled client for:

- failing to adequately describe the basis for the advice; or
- for failing to provide the advice in a clear and concise manner;
irrespective of the quality of advice given.

Similarly, the advisor can also be held liable if an SOA is defective; irrespective of the quality of advice given.

In contrast, in all other advisory service industries (e.g. medicine, law, architecture etc.) participants are judged on quality of their advice and actions; not their description of their basis for the advice. Indeed, in other industries there is no requirement for an SOA and often nothing comparable is given.

ASIC has indicated that AFS Licencees that genuinely try to work within the AFS regime have nothing to fear from ASIC. However, in the event of a severe market downturn clients may be encouraged by the media, solicitors, and personal necessity to make claims against financial planners. Financial planners will be highly vulnerable to claims that they either:

- did not provide adequate basis for their advice; or
- the basis for advice was not "clear, concise and effective"; or
- the SOA was defective in some other manner.

Such claims can be lodged with FICS with no cost or downside risk to the client and compensation may be ordered up to \$100,000. FICS provides a very attractive opportunity for disgruntled clients. Clients may of course also take matters to the courts. In either case the debate with respect to clarity, brevity, and effectiveness may prove to be very expensive for the industry as a whole. The environment that is emerging is one in which we can expect the number of claims of dubious validity to rise. In such an

environment it can also be expected that rational AFS Licencees will respond by attempting to reduce their costs.

- One method by which AFS Licencees can reduce their expected costs is to negotiate a settlement in cases where the expected cost of defending their innocence before FICS or the court is greater than the cost of the settlement. From the public's point of view this is unfair as it means that honest clients will ultimately pay the cost of the settlements made to dishonest clients.
- Another method by which AFS Licencees can reduce their expected costs is to create legal impediments to claims. This is also unfair from the public's point of view in that it may result in this is unfair as may prevent action being taken against AFS Licencees even when the advice has been poor.

Such responses may be unfair to the public, but the legislative environment virtually compels AFS Licencees to take such action.

Finally, it is worth considering how rational profit oriented businesses are likely to respond to a regulatory environment in which "process" is considered most important and quality is considered "irrelevant". My guess is that resources will be focused on process at the expense of quality:

- personalised and ongoing advice will become prohibitively expensive for most people;
- large AFS Licencees will dominate the industry by marketing their products/services via staff who are trained to sell using standardised SOAs, check lists, client sign-offs etc. designed by solicitors to give clients little scope to take action against the AFS Licencee irrespective of the quality of advice given;
- the legislation has now created a situation where AFS Licencees that peddle generic poor advice can be more easily protected from litigation than AFS Licencees that give advice that is tailored to a client's circumstances.

Thus, from the public's perspective there may be less protection, less choice, and increased costs.

There is an abundance of evidence that large companies have for some years been implementing procedures to make it very difficult for the public to take action against them. For example:

- Many PDSs will require that investors declare that: they have read and understood the PDS, have had opportunity to read the Constitution and agree to be bound by it, and have had opportunity to seek legal advice. What do you suppose is the purpose of such declarations? Who is being protected most by these declarations? The product manufacturer or the public?
- Banks frequently send "important notices" to their customers to provide updates to terms and conditions. What proportion of people do you suppose read them? Why do you suppose the banks send them? Who is being protected most by these important notices? The banks or the public?

Clearly, it is much easier to define a generic set of procedures than to define what is meant by "good" advice and "bad" advice. However, the industry does not need a definition of good or bad advice in order to judge the quality of advice. This is because the "smell" of bad advice is easily recognised despite the fact that:

- the specifics of advice may vary considerably from one AFS Licencee to another; and
- some naive members of the public may fail to recognise bad advice when it is being sold to them by a skilled salesperson.

The smell is often accompanied by high commissions, heavy exposure to a narrow range of risks, and an investment that is not commonly recommended by other AFS Licencees.

From a client's perspective the relevant question must surely be whether the advice was reasonable at the time it was given.

Proposed action

Adapt the rules such that AFS Licencees are held responsible for the quality of the advice they give, not the procedure by which advice is given.

Issue 3 - Disclosure of commission

There has been some debate with respect to disclosure of commissions in respect of insurance. This may be because the level of commissions in some cases is sufficiently substantial that public disclosure would lead to embarrassment of the insurers and negative attitudes by consumers the combined effect of which would be a decline in insurance sales and less people being insured. Thus, it could be argued that from a public perspective there is a downside to disclosure - at least in the short term.

However, in the longer term, if the marketing costs, and in particular sales commissions were reduced substantially and insurance became better value for money the economic law of supply and demand suggests that more people would buy insurance products. Thus, in the longer term more people may be insured at a lower cost.

The potential embarrassment to insurers and the potential to bring down the cost of insurance is illustrated by the promotional literature of one well-known, major insurer which offers Licencees the choice of either:

- commission equal to over 115% of premium in the first years premium plus around 10% on subsequent premiums, or
- slightly more than 30% of all premiums paid.

Also, currently a very large proportion of the cost to the public of insurance goes in commissions and other marketing expenses, legal and administrative expenses, and corporate profits. If the marketing of insurance became less reliant on such commissions to provide incentive to salespeople perhaps the insurance products may be re-packaged so as to be more easily understood by the public. If this were to occur insurance could be marketed more simply - perhaps over the internet - and people would choose to "buy" it rather than needing salesman to "sell" it to them.

Any step towards making insurance more affordable and more easily understood would seem to be beneficial for the public.

Finally, how is this industry every going to be accepted by the public as being reputable while some participants refuses to disclose what is true?

Proposed action

Require full disclosure of all fees, commissions, etc. with respect to insurance without delay.

Issue 4 - FSRA costs versus FSRA benefits

It was reported in the Financial Review (10/3/2004) that:

"The major banks have spent at least \$100million on training, paperwork, systems and legal fees to comply with the wide-ranging Financial Service Reform Act. And it is not over."

Goodness knows what the cost to the industry as a whole has been. However, as one of the smallest AFS Licencees I can say that the drain on my time has been very great.

Interpolating between my little company and the banks it seems reasonable to suggest that the cost to date for the industry has been in the vicinity of several hundred million dollars. This cost will ultimately be borne by the public - just as ASIC's own costs are passed on to the public.

The really interesting question is whether the FSRA will lead to a commensurate improvement in protection for the public.

The theory behind the FSRA appears to be that the public will be protected if they are provided with information that enables them to make an informed decision. While this may seem a reasonable proposition it fails to account for the fact that:

- Many people lack the time, energy, interest, cognitive power, training and experience to properly assess the information provided to them.
- Many people recognise their inability to assess the information and instead rely upon assessing the advisor (i.e. the written information may not even be read).
- Many people are swayed more by verbal communication, non verbal communication such as the charisma of the advisor and the corporate image created by marketers, than by the written word.
- Many financial product manufacturers have proven with prospectuses that by employing the specialist talents of marketers, graphic artists, solicitors, and accountants they can package financial products that meet all disclosure requirements and which are marketable irrespective of the quality of the product. (I have recently attended a pre-prospectus briefing in respect of a product to be released by a major producer around the end of April 2004 and from its description I suspect it will need to be packaged very skillfully so as to provide protection for the institution while remaining compliant and marketable. The entity involved expects to raise at least \$30m over a 10 week period. Such products are often accompanied by “independent research” paid for by the product manufacturer which together with the professionally crafted PDS creates a powerful sales aid.)
- Many large organizations intentionally create environments in which incentives are given which are inconsistent with good practice. Recent evidence of this is NAB’s loss of \$360m and the results of ASIC’s own surveillance project into payments of preferential remuneration by institutions to their financial advisers. Within such environments it is reasonable to expect that investors may be provided with selected information (subject to legislative requirements) which may be presented in an arguably “clear, concise, and effective manner”, but which has been carefully crafted to lead the investor to make a purchase decision that they would not normally make if the investment had been presented more openly. That is, no lies, just premeditated manipulative behaviour.

Given the above opportunities for taking advantage of clients the relatively small number of complaints to FICS indicates that the financial planning industry may not be as corrupt and advice may not be as bad as some people suggest and that the relationship between many advisors and their clients may be very satisfactory.

Also, given the above opportunities for taking advantage of investors I doubt that FSRA will provide the intended benefit to the public.

Sadly, we may never be able to quantify the benefits - if any - of the hundreds of millions of dollars spent in respect of FSRA. This is due to the quality of statistics collected in respect of complaints by investors. Treasury, in their Position Paper, *Compensation for loss in the Financial Services Sector* refer to the “paucity of hard data”.

While I fully support the underlying objectives of ASIC I am concerned that perhaps sometimes the basis for its decisions is flimsy. This is not meant as a direct criticism of ASIC as I understand that sometimes action is better than no action. However, I am strongly critical of the level of data that exists in our industry. The lack of suitable data leaves the industry vulnerable to unwarranted criticism and makes it very difficult for ASIC, Treasury, FPA, etc. to clearly identify the nature and magnitude of problems within the industry which in turn makes it virtually impossible to either design remedies that are focused or to assess the effectiveness of such remedies.

For example, there are many factors that could lead to client dissatisfaction. These factors include, but are not limited to:

- poor advice resulting from negligence;
- poor advice resulting from lack of training;
- poor advice resulting from lack of experience;
- poor advice resulting from lack of intellect;
- poor advice resulting from commission driven bias;
- fees being excessive;
- fees being different to expected;
- service being less than expected;
- investments having being different to expected;

- information provided being misleading; and
- advisor being fraudulent.

However, does anyone in the industry have data that indicates the relative significance of these factors?

Also, it seems likely that client dissatisfaction may tend to be associated with factors such as: certain characteristics of licencees, products, and investment strategies. For example:

- Size of AFS Licencee (e.g. number of authorised representatives).
- Ownership of AFS Licencee (e.g. subsidiary of financial product producer, more than 50% owned by of financial product producer, minority ownership by financial product producer, zero ownership by financial product producer)
- Experience of AFS Licencees (e.g. years of that licence has been held)
- Qualifications of advisor (e.g. CFP/non CFP, Tertiary, Industry Diploma)
- Type of product recommended (e.g. mainstream managed funds, direct shares, tax driven, agricultural schemes, non-mainstream investment (e.g. Wattle), life insurance, trauma insurance, income insurance)
- Type of strategy recommended (geared/ungeared, superannuation/rollover driven, tax reduction, etc.)

However, does anyone in the industry have data that indicates the extent to the above factors may be correlated with client dissatisfaction?

Finally, it is possible that either:

- the bulk of client dissatisfaction can be attributed to a minority of repeat offenders which would indicate systemic circumstances within a Licencee not being addressed, or
- client dissatisfaction is spread relatively evenly across the industry participants which would indicate that appropriate action is taken.

However, does anyone in the industry have data that indicates the extent to which client dissatisfaction can be traced to repeat offenders?

I respectfully suggest that until such time as the industry has data such as outlined above we really do not have a good understanding of the problem we are trying to fix and that any remedy proposed is unlikely to be very cost-effective.

Also, apart from FSRA and ASIC's own PS 175 the financial planning industry supports colonies of "holier than thou" parasites who press for "increased professionalism", "raising the bar", "higher standards", "on-going training", "professional development", etc. while promoting their training courses, seminars, etc. which are in my opinion often:

- over-priced;
- of dubious quality and relevance;
- bought for use as a marketing tool; and
- provide minimal benefit to clients.

I believe there is no value to the public in requiring those AFS Licencees who already satisfy their clients to adopt higher and higher standards. Such relentless pursuit of "excellence" is not professionalism; it is nonsense; it is a mindless waste of resources, and it is a cost to consumers.

If we are to help this industry evolve to the point where consumers can seek advice with confidence I suggest we must first focus attention on those factors that have led to dissatisfaction. Then we can develop strategies and ongoing basis we can review the effectiveness of these strategies.

Perhaps the richest and most easily mined source of data in respect of client dissatisfaction are the complaints lodged with FICS.

I understand that PS 139.83 requires FICS to collect and record certain information in respect of complaints, but from their published data and from personal enquiry it seems the level of data collected by FICS is of minimal practical value, but as someone who was formerly employed as a senior systems

analyst by a major corporation and who has built and maintained for over a decade a relational database for his own business I suggest that the cost of upgrading the FICS complaints database such that it would be useful would be somewhat less than the cost of a very small dealer applying for an AFS Licence!

Some months ago the Boutique Financial Planning Principals Group wrote to FICS with suggestions as to the type of information that may be valuable and easily collected, but FICS has shown no interest. (A copy of correspondence with FICS on this matter can be supplied.)

Proposed action

- Review data collected by FICS to ensure its adequacy in terms of meeting PS 139.83(f) and determine whether there may be value in collecting additional information.
- Make data collected by FICS publicly available so that it can analysed not only by ASIC, but by FPA, industry participants, consumer groups, and individuals.

I apologize for what has turned out to be a much longer letter than I had originally intended. As with my SOAs I have tried to write in a clear, concise and effective manner. It may be of interest to note that this letter contains considerably less words than I would expect to provide in an SOA to a client who is retiring.

Yours sincerely,

Paul Gerrard BEc, MBA, CFP, FAICD, DipFinAdvising (Sec Inst)
Director, APT Strategy