

Are FSR problems caused by FSR Law or ASIC's implementation?
A Perspective From Regular & Ongoing Advice-focused Small Dealers

8 March, 2005

1. The Question Being Posed By Chris Pearce.

In Chris Pearce's 9th February 2005 address to ASIC's Summer School he *said* "*The challenge for me as Parliamentary Secretary is to determine the extent to which sub-optimal outcomes are the result of flaws in the legislation and the extent to which they are the result of the way it is being administered by ASIC or interpreted by industry participants.*" It is pleasing to see Chris Pearce grappling with this key question. However, while it is pleasing to see growing political awareness around the problems caused by the SoA aspects of FSR, we believe there are much broader issues that need to be dealt with – to ensure that consumers win from FSR and to ensure that tailored regular-and-ongoing advice providers have a reasonable, practical & cost-efficient regulatory environment to work under.

2. The Fundamental Problem

2.1 It should not matter how advice is created as long as the advice is good, competent and ethical and provided in the client's interest. Yet Financial Services Reform Act (FSRA) and related Policy Statements focus almost entirely on **how** advice is created. Therein lies the fundamental flaw of FSRA and its related regulatory environment. As it stands, **FSRA is bad law** that solves the wrong problem at immense cost to consumers and good advice providers whilst not preventing unethical operators from staying in business.

The proposed changes will significantly cut back on the costs of preparing SoAs for regular and ongoing advisors. The cost related to the ASIC policy statements eg PS164 is still very high. It seems ASIC seeks to impose a compliance system that:

- would be appropriate for a large product distributor*
- onto small advice-focused, regular and ongoing advice providers.*

ASIC policy statements go well beyond what is written in the law and this does impose unreasonable extra cost on small advice-focused dealers.

For large product distributors providing standardised advice, manufacturing-style process control is appropriate to manage quality. For small advice-focused advisors producing highly tailored advice, a culture of ethics and professionalism is the key to quality control.

*We think there is more for negotiation with ASIC in this space. **This will be our next focus.***

2.2 The regulatory environment needs to be refocused onto the quality of advice produced, not the procedure used by the advisor to manufacture the advice. The law needs to **refocus onto substance rather than form** – and to make tailored quality financial advice more affordable to consumers.

The proposed changes open the way for this to occur, but do not cause this result by itself. This result can only be achieved by refocus and change the priorities within ASIC.

2.3 It seems that Asian countries who were considering drafting law similar to FSRA, now can see FSRA was an Australian mistake. ("FSRA implementation damages reputation" Money Management 3 February 2005.) Australia now needs to be big enough to acknowledge and correct its FSRA mistakes. *In the article Pauline Vamos is attributed as saying that "FSR is not working and it is not helping the consumer."*

3. Who Wins, Who Loses?

3.1 **Consumers are big losers under FSRA.** The only significant benefit that consumers get from FSRA is extra disclosure of any factor which might influence the advice including commission and relationships – and this has been a very positive development. However, most of the new regulatory environment under FSRA creates a major cost imposition on consumers – while providing no net benefit. Further, the new regulatory environment is likely to reduce consumer choice over time. This is a lose-lose outcome for consumers.

3.2 The **winners** from FSRA are:

3.2.1 **Vendors of compliance services** who believe that they now have a legislated right to force their expensive services onto financial service suppliers and their clients.

3.2.2 The **unethical operators**, because clearly unethical operators will continue to flourish by hiding behind a defence of “good compliance”.

3.2.3 **Providers of mass-produced, untailored, “press-the-button” cookie-cutter advice** (typically large institutions) as these service providers are able to tightly control the advice manufacturing process, with highly systematised SoA production processes, designed primarily to support a product distribution operation. This form of AFS licensee has been delivered a huge cost advantage under FSRA, because once they have made the initial capital investment in compliance infrastructure, the marginal cost of producing compliant advice (and in being compliant in general) is much lower than for tailored advice providers. Has this tilting of the playing field really benefited consumers? Of course not.

4. Consumers Already Have Strong Protection

4.1 **How are consumers to be protected if we remove the damaging and unnecessary cost-impositions?** Even without the high-cost and impractical parts of FSRA, consumers are highly protected under Corporations Law, the ASIC Act and under common law. ASIC needs to enforce these laws. Specifically protection provided includes the following:

4.1.1 Common law is well established in terms of negligence, duty of care; etc.

4.1.2 The Corporations Act 2001 already required that:

- there was a reasonable basis for the advice and the advice was reasonable in the circumstances. Section 945A
- the financial services were provided efficiently, honestly and fairly. Section 912(1)A.

4.1.3 The ASIC Act 2001 provides for protection in respect of:

- Misleading or deceptive conduct. Section 12DA.
- False or misleading representations. Section 12DB.
- Requirements to apply “due care and skill”, and that advice is “fit for the purpose”. Section 12ED.

These are very powerful obligations on advice providers. If ASIC can be persuaded to re-focus their efforts onto enforcing these obligations, consumers will win in spades.

He proposed discussion, clears the way for advice being judged much more heavily on whether it was good advice – based on the above principles – rather than on whether boxes are ticked. This is a big step in the right direction for consumers – and will reduce the ability of bad operators to hide behind the quality illusion of compliance. However, for this change to succeed it does mean that ASIC needs to change its focus onto “good advice” - as compared with its current focus which is on tick-the-box compliance.

5. ASIC Must Meet The Objectives Of Its Charter

5.1 Such a refocus would enable ASIC to comply with its legal obligation as regulator. Specifically the Australian Securities and Investments Commission Act 2001, Section 2 says “**ASIC must strive to maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs.**” Clearly ASIC is currently failing to fulfil this obligation under this law – particularly in respect of small Dealers, who are the primary providers of personalised, tailored advice.

5.2 Small independently-owned Dealers are an important part of consumer choice, yet FSRA threatens their very existence. Independently-owned small Dealers are struggling to survive the immense cost-burden and time-imposition of a regulatory regime more suited to regulating a large product distributor rather than small independently-owned tailored-advice businesses. A regular comment heard from small Dealers is that they are being put in the impossible position of having to choose between staying in business or being compliant at immense additional cost in money and time. Let us be clear, these Dealers are behaving professionally, honestly, ethically and are giving good advice. It is just that the compliance regime imposes immense and unreasonable business risk and an immense and unreasonable time and monetary cost on small independently owned Dealers who handcraft tailored ongoing advice.

6. The Major Weaknesses of FSRA

The most critical weaknesses of FSRA regulatory environment are:

- 6.1 **The massive cost imposition on consumers without sufficiently compensating consumer benefits** related to compliance with dealer business processes found in (eg Policy Statement PS164) and the advice manufacturing process (SoA in FSR, Policy Statement 175, SoAA Class Order) rather than focusing on whether advice produced is good. The SoA issue is dealt with below. The magnitude of the cost impost relating to dealer business processes is very poorly understood – because of the current poor degree of compliance. However, as compliance is enforced this will be seen as a massive problem. ASIC, through its Policy Statements, has exploded the requirements specified under Section 912A into a massive cost burden, particularly for small regular-and-ongoing tailored-advice providers. **This massive cost imposition clearly is going to be paid for by consumers.** The presumption behind these Policy Statements is clearly that **compliance equates to good advice and non compliance equates to poor advice** – a presumption which is clearly wrong. It is clear that under FSRA that you can deliver quality advice while being found to be non-compliant AND you can deliver compliant “advice” which is poor quality but financially beneficial to the advice provider.

This is an issue we need to continue to work with ASIC on – an din that regard, the effort required has only just begun. This comes back to the issue raise above, that ASIC (through its policy statements) has sought to impose a compliance system that:

- *would be appropriate for a large product distributor*
- *onto small advice-focused, regular and ongoing advice providers.*

ASIC policy statements go well beyond what is written in the law and this does impose unreasonable extra cost on small advice-focused dealers.

- 6.2 **FSRA is very poorly focused.** It creates a massive cost imposition on the quality advice providers, while it creates a regulatory environment that protects unethical operators, as long as such unethical operators have sufficient legal advice to achieve compliance. FSRA unfortunately is all about FORM rather than SUBSTANCE: TICKED BOXES rather than GOOD ADVICE. Clearly consumers want cost-effective, quality, tailored advice but FSRA is

effectively denying this to many consumers who will be forced to turn to mass-produced cookie-cutter advice as the only form of compliant advice that they can afford.

This issue has been discussed above – and clearly the discussion paper, is an important step in the right direction, but requires ASIC's priorities to be re-adjusted.

6.3 Compliance Difficulties with SOA FSRA specifies key elements which are required in a Statement of Advice (SoA). While on paper this looked good for consumers, **the SoA requirement has been found to have immense practical difficulties** which has been extensively documented. The problems include:

6.3.1 **Civil Liability.** Despite the intent indicated in the information memorandum, as FSR Law currently reads, a minor technical non-compliance may lead to civil liability for loss even where the advice is good. This defect in the law, may result in many highly professional dealers being bankrupted next time the share market crashes because a lawyer is able to identify a minor technical compliance breach. We have documented this issue in detail.

This problem has not been fix – and we believe does requires amendment to the law.

6.3.2 Reasonableness dictates that **any new piece of advice in a long-term advice relationship, can only reasonably be judged in the context of the entire relationship and the entire communication process**; i.e. in the context of the body of advice, not just selective parts which ASIC says must be date identified or otherwise be treated as technically deficient. Failure by ASIC to accept a more reasonable position on this issue, is severely detrimental to the cost-efficiency and effectiveness of advice to long-term clients. These difficulties result in good, ethical ongoing-advice providers facing unreasonable risk of civil liability even where the advice they have provided was good advice.

“Reasonableness dictates that any new piece of advice in a long-term advice relationship, can only reasonably be judged in the context of the entire relationship and the entire communication process.”

*In the broad sense, this very important principle has not yet been accepted – but must be, to ensure that FSRA adequately accommodates long-term advice relationships for regular-and-ongoing advice providers. **Further discussion of this topic is provided separately.***

The problem that continues to exist under proposed refinement 2.1 is that this document assumes an advice process which involves a big piece of initial advice followed by many minor pieces of advice. While this covers the advice process of some advisors, it does not cover many forms of good regular-and-ongoing advice. The best way to illustrate the issue is with the old riddle “What is the best way to eat an elephant?” Answer: One bite at a time. And so it is with financial advice.

- In an attempt to tackle this problem, ASIC has introduced the concept of **Statements of Additional Advice (SoAA)**. While SoAA might be of some value in limited circumstances, it is a very long way from being a total solution. Where long-term regular and ongoing advice is provided, SoAA has made compliance rules even more complex because of the requirement to list every other relevant advice document by date and to identify in each of those documents any information which may no longer be relevant. Clearly this makes tailored long-term regular-and-ongoing advice very expensive – because of the many interactions and documents which would need to be cross-referenced and qualified.

The discussion paper solves the bulk of problems related to Statements of Additional Advice – as for regular-and-ongoing advice providers, any possible role for SoAAs seems to have gone away.

- **Better Solution:** The rules-based partial solution of SoAA would never have been required if a simpler solution had been adopted, namely **a principles-based**

interpretation of FSRA, where the total body of advice would always be judged as a whole rather than individual documents or subsets of documents. The advantage of this solution is that it addresses a broader set of compliance problems, reduces the cost of providing advice and makes it easier to provide “clear concise and effective advice” without weakening the strength of the law – in short it is a much much better solution, and is much more in line with the objectives of FSR and the obligations of ASIC.

In effect, the discussion paper adopts a strategy which is consistent with the comment above in that it allows for a refocus onto “a principles-based interpretation of FSRA”.

- 6.3.3 What is sufficient documentation of basis for investment advice? This is not at all clear for other than simplistic investment advice. At a superficial level, SoA requirement to include basis for investment advice sounds very reasonable. At a practical level for non-simplistic ongoing advice, compliance with this requirement is a nightmare – creating immense compliance uncertainty, excessive cost and unnecessary replication.

The discussion paper does not solve this major problem. A minor technical amendment to FSRA changing the obligation for an SoA to provide “basis for advice” to an obligation to provide “reasons for advice” would help address the compliance uncertainty. Consumer are best protected by the obligations such as:

- *the obligation to have reasonable basis for advice*
- *to take due care*
- *to behave efficiently, honestly and fairly*
- *to disclose commissions and relationships*

rather than the potentially very costly obligation to provide hug quantities of “basis for advice” - in a bid to minimise compliance risk – when providing highly tailored, non-simplistic advice.

- 6.3.4 ASIC seem be requiring that not only should **adequate inquiry** occur as required in FSRA, but also that evidence of this adequate inquiry be included in each SoA. This adds unnecessary cost to tailored ongoing advice and it irritates a lot of clients – making it much more difficult to meet the “clear concise and effective” requirement.

This problem has not been addressed – needs to be rectified at the regulator (ASIC) level.

- 6.3.5 When it comes to **immaterial or minor advice** in a regular-and-ongoing advice relationship, it is impossible to be compliant at a half-reasonable cost to the client, given the current way the law is being interpreted. And with regular-and-ongoing advice, the advice generally is liberally sprinkled with exchanges of immaterial and minor advice – a key reason why regular-and-ongoing advice is severely challenged by FSRA.

The discussion paper provides an approach which solves this problem for providers of regular and ongoing advice.

- 6.3.6 **General SoAs.** There are often circumstances where an advisor wishes to make a specific recommendation to all clients – regardless of their circumstances. This form of advice also needs to be acknowledged as being acceptable.

The discussion paper provides an approach which may solve or partially solve this problem – this is still to be ascertained.

- 6.3.7 The requirement **by law** (taking sections 766 and 944A together) that an SoA is required *every time* an advisor could reasonably be regarded as seeking to influence a retail consumer regarding a financial product or class of product. No other profession has been lumbered with this draconian requirement. Clearly the industry and ASIC are ignoring what is written in the law here, because the requirements of the law are impractical. In practice what is happening, is that an SoA is being written only where a recommendation has been made that the advisor intends the

client to implement as this is the only viable and practical thing to do – and the law needs to be changed to reflect this reality otherwise licencees will remain at unreasonable risk.

The discussion paper provides an approach which solves this problem in most cases for providers of regular and ongoing advice.

However, there is one special case which should also be given exemption under 2.1 of the proposed refinements. Many financial planners give potential clients one free initial interview – to give the potential client the opportunity to determine whether they should use this advisor. After the interview, many of these consumers would choose not to proceed – i.e. Not to use this advisor.

*However, as the law stands, this advisor still has an obligation to provide an SoA, even though the advisor will not be paid – and even though the consumer is not looking for advice (or SoA). This obligation comes from the fact that during this initial interview, it would be normal that the advisor would make comments that **“could reasonably be regarded as seeking to influence a retail consumer regarding a financial product or class of product.”***

It is pleasing that the Parliamentary Secretary to the Treasurer, Chris Pearce seems to be coming to understand this SoA issue. However, this is only one of many problems that needs to be fixed.

7. The Solution

- 7.1 **So what is the solution to this problem?** The solution is that regulatory measures need to be focused on quality of advice rather than procedural compliance. **It should not matter how the advice is created as long as the advice is good, competent, ethical advice, provided in the client’s interest.** That is, a regulatory environment needs to be created in which it is the quality of advice that is judged, not the procedure used by the advisor to manufacture the advice.
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Attachments:

1. Our paper “Legislative Changes Required on SoA” dated 15 December 2004
2. Our 25 August 2004 paper on civil liability issues.