



**AUSTRALIAN  
INVESTORS'  
ASSOCIATION**

## POSITION STATEMENTS: Financial products and services

**Presented to:**

**Delegates to the AIA National Conference July 2009  
and to**

**Mr Bernie Ripoll, Federal Member for Oxley,**

and Chair of the Joint Statutory Committee on Corporations and Financial Services currently inquiring into 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
4. conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
5. the role played by marketing and advertising campaigns;
6. the adequacy of licensing arrangements for those who sold the products and services;
7. the appropriateness of information and advice provided to consumers considering investing in those products
8. and services, and how the interests of consumers can best be served;
9. consumer education and understanding of these financial products and services;
10. the adequacy of professional indemnity insurance arrangements for those who sold the products and services,
11. and the impact on consumers; and
12. the need for any legislative or regulatory change.

## ***POSITION STATEMENTS: financial products and services***

### **Overview**

The Australian Investors Association has already made a submission to the Parliamentary Inquiry into Financial Products and Services. This has stimulated further thinking and we take this opportunity at our 2009 conference to test out our latest thinking among participants.

Our position now encompasses the following topics:

- The inherent conflicts of interest in the industry at present.
- The need to separate sales and advice functions within the industry.
- The low educational level of many (most) financial advisers.
- The illusion of independence of advisory firms connected with banks etc.
- The need to provide simple investment risk signals for consumers.
- The importance of payment for services being initiated by the client.
- The importance of the client being more in control of the investment process.
- The need for investment education for consumers.
- The need to behave like a professional to be treated as such.
- The need for better regulation and increased regulatory enforcement.

## ***SUMMARY OF POSITIONS AND OUR SOLUTIONS***

### **1. Remove the inherent conflicts of interest at present in the industry.**

Because certain uses of disposable income (investment in managed funds, shares, property debentures) attract payments by the investment provider rather than the investor and other uses of disposable income do not (paying off debt including home loans), advisers are exposed to a conflict of interest in providing advice to clients as to the best use of that disposable income.

**Solution:** ban commissions or require that payment for advice be made by the client directly.

### **2. Separate the sales and advice functions within the financial advisory industry.**

The Storm Financial case brought forth many stories that showed quite clearly that selling a financial product (home equity loan + margin lending) was the dominant motivation, since looked as advice the outcome was grossly irresponsible. It was as if the old caveat emptor caution was assumed: let the buyer beware, it's the buyer's responsibility, not ours as (so-called) advisers.

**Solution:** establish much more stringent licensing conditions for advisers who are required to sign off that the client understood what they were investing in. This is already a requirement of a person serving as a guarantor of a loan. So the product seller does his/her job, but an adviser (from a separate firm) signs off that the client understands what they are buying/investing in.

### **3. Raise the low educational level of many (most) financial advisers.**

To become a financial adviser a person has to complete four modules of a diploma course which is equivalent to half a diploma, much less than a university degree. Many go on to complete four more to gain a full diploma. Some complete even higher levels of education. However the entry level is half a diploma. Beyond that it is up to an AFSL licensee to authorise a person to give advice in the many aspects of financial planning and advice. This is an educational level far, far too low for advisers potentially handling the life savings or retirement benefits of clients in a complex and volatile investment environment.

**Solution:** legislate that financial advisers must have degree level qualifications in financial planning and investment advising plus at least two years supervised experience, before they can provide unsupervised services to clients.

#### **4. Address the illusion of independence of advisory firms connected with banks etc.**

Australians have lost trust in banks and insurance companies to quite a degree in the last couple of decades. The result is that they go to financial advisory firms that seem like they are independent i.e. not part of a bank or insurance company. In fact they are in most cases. Retaining the name of the original advisory firm the ownership of the firm is disguised, and clients' trust is misplaced.

**Solution:** require that the ultimate ownership of any financial advisory firm be made quite clear in advertising and in documents provided to clients by the firm.

#### **5. Provide simple investment risk signals for consumers.**

Investing is so complex that it is beyond most investors to understand the level of risk associated with any particular investment. There is an urgent need for a way to signal the relative risk for each investment.

**Solution:** ASIC plans a campaign to warn investors of the risks of some investments compared with others. This is their 'between the flags' idea. This is a worthy initiative but to be really effective it needs to be extended to include 'outside the flags' and well 'outside the flags' (or something equivalent), so that investors have a clear signal of the relative risk associated with an investment.

#### **6. Require the payment for services to be initiated by the client.**

Payments for many (most?) cases of investment advice comes from the provider of the investment product to the adviser (via the licensee), rather than the client. This gives the illusion of a free service or an inexpensive service. But the client pays fully for this commission, both up-front and as a trail. One other consequence is that clients keep paying well beyond the period for which services are provided to them by the adviser.

**Solution:** Require that investment product providers do not pay advisers, but that any investment advice charges be made direct to the client.

#### **7. Encourage the client to be more in control of the investment process.**

Because the client is not directly involved in payment for services, this matter is hardly discussed. Payment is 'by someone else'. A result is that the services that are to be provided by the adviser aren't high on the agenda for discussion and so the adviser proceeds in (almost) total control of the discussion. Contrast this with the client talking with a builder about building a home (an activity that makes use of similar amounts of money). Here a detailed quote is provided, and the client knows exactly what they are getting for their money.

**Solution:** Require not just a Statement of Advice at the end of the discussions between adviser and client, but a Terms of Engagement (functions plus

costs) very early in the discussions, so that the client begins to get some control over where the discussions are going.

#### **8. Promote investment education for consumers.**

Investment is a complex matter not easily understood by consumers. As well as providing signals of risk to investors and requiring advisers to be more open with them about risk and other characteristics of the investment, it is important that a culture of consumer education in investing be generated and maintained.

**Solution:** Empower non-government agencies to create educational opportunities for investors and potential investors. As well government agencies should be funded and tasked to gradually raise the level of consumer knowledge of investment.

#### **9. Facilitate the emergence of a professional service provided by advisers.**

What constitutes a profession is a matter of much debate. But we all recognise what's not professional: when the actions taken are in the interests of the provider rather than the client. This situation appears to prevail within financial planning at present as cases such as Storm Financial dominate the news.

**Solution:** Separate advice from sales. Empower the professional bodies to establish strongly professional codes of conduct and the right to enforce these. Regulate the use of the term 'financial adviser' or 'investment adviser'.

#### **10. Provide for better regulation and increased regulatory enforcement.**

The current requirements of the Corporations Law that legislate the requirement within the financial services industry focus on financial products rather than advice, and emphasize documentation of advice rather than the substance of that advice. Further no government agencies seem to have sufficient power and/or funding to enforce these (inadequate) regulations.

**Solution:** Regulation needs to address the quality and appropriateness of advice rather than its documentation, and some 'teeth' given to enforcement.

## **Topic 1: The inherent conflicts of interest in the financial services industry at present.**

Because certain uses of disposable income (investment in managed funds, shares, property debentures) attract payments by the investment provider rather than the investor and other uses of disposable income do not (paying off debt including home loans), advisers are exposed to a conflict of interest in providing advice to clients as to the best use of that disposable income.

To illustrate:

Consider the case of Greg and Joan who are middle-aged with a couple of children, a mortgage of \$180,000 and school fees totalling \$18,000 pa. Both are working and their employers are contributing 9% to industrial superannuation funds. Unexpectedly they receive an inheritance from a distant relative of one of them of \$200,000. So they visit a financial adviser to ascertain their options.

The following are some of the most commonly accepted options:

1. pay off the mortgage completely
2. pay off part (say \$150,000) and contribute (say) \$25,000 each to their super funds
3. place the \$200,000 in term deposits to pay for the school fees each year (gradually depleting the capital)
4. invest the \$200,000 in a portfolio of shares (if the adviser is a stockbroker) or in a series of managed funds in a master fund (if the adviser isn't a stockbroker)
5. pay off the home loan completely and re-borrow (say \$100,000) against the equity in their home for investment purposes
6. place the \$200,000 in a margin lending facility with another \$200,000 provided by the lender, thereby investing \$400,000. (Not all that commonly accepted really, particularly since Storm Financial showed what could go wrong with this strategy).

Many choices possible, most with good points and some with risk (some very high) attached. The virtue of each option isn't the point. Rather the point is the options that probably won't even be mentioned because there's nothing in it for the adviser who charges by commission. The first three options fall into this category. Most independent advisers would support the first and/or second as key first steps. This reflects the best interests of Greg and Joan. (Competent and ethical advisers might move on to suggest option five, probably not six – but the fourth option would be a no-no.)

Experience of our members suggests that option four would be the first suggestion of commission-paid advisers. This reflects the best interests not of Greg and Joan, but of the adviser.

Clearly commissions give rise to conflicts of interest. No amount of protestations otherwise can get away from this inherent conflict.

### ***What to do about it?***

***There's only one way: require payment to be made by the client for investment advice and related services. Proscribe payment by the investment product provider i.e. ban commissions.***

## **Topic 2: The need to separate sales and advice functions within the industry.**

The Storm Financial case brought forth many stories that showed quite clearly that selling a financial product (home equity loan + margin lending) was the dominant motivation, since looked at as advice the outcome was grossly irresponsible. It was as if the old caveat emptor caution was assumed: let the buyer beware, it's the buyer's responsibility, not ours as (so-called) advisers.

A case based on experiences of other clients of Storm Financial and reported in *Money Management* demonstrates that giving appropriate advice wasn't the driving motivation within that group but rather product selling.

This client was a self-funded retiree who owned not only his own home but four other properties, and had other assets totalling over \$300,000. As a direct result of a double gearing strategy this couple are now unemployed, have a \$1,500,000 debt after selling all the properties except the family home. Some shares and superannuation remain. But their indebtedness exceeds their assets by some hundreds of thousands of dollars.

The 'selling' was so good that not only was this couple enticed into a regrettable arrangement, but so were the parents of one of them (aged 72 and 68). They now have a debt in excess of \$300,000, the pension to live on, and face the prospect also of losing their family home.

It is in our view unarguable that a culture of selling underpinned the financial service being provided in cases such as these. Admittedly these are the extreme examples. But it is clear that at root the fault lies in the remuneration being directly connected with the dollar value of investment being sold to people. Commissions beget salespeople – it's human nature.

We need to find a way of separating the two functions: providing advice and selling investment products. The adviser would be paid for advice just as so many other professionals are – taking account of the complexity of the advice and the time it takes to assemble and present it. Thereafter, if investment products are called for, the client moves on to the salesman (who might well be paid by commission). Alternatively the adviser might well organise the investment products but charge a fee-for-service not commission.

We need to establish much more stringent licensing conditions for advisers who are required to sign off that the client understood what they were investing in. This is already a requirement of a person serving as a guarantor of a loan. Such a person is required to seek independent advice from an adviser or lawyer who signs off that the client understands what they are guaranteeing. This model could be adapted to a financial adviser/investment broker situation.

Another simple analogy is doctor and chemist. The doctor gives the advice (a prescription) and the chemist supplies the product.

***There must be a way of separating the functions of advice-giving and product-selling; this has become such a problem that the solution will only be found by legislation and regulation. The industry itself has been shown to be toothless in confronting this problem.***

### **Topic 3: Low educational levels of many (most) advisers**

To become a financial adviser a person has to complete four modules of a diploma course which is equivalent to half a diploma, much less than a university degree. Many advisers go on to complete four more to gain a full diploma. Some complete even higher levels of education. However the entry level is half a diploma. Beyond that it is up to an AFSL licensee to authorise a person to give advice in the many aspects of financial planning and advice. This is an educational level far, far too low for advisers potentially handling the life savings or retirement benefits of clients in a complex and volatile investment environment.

Some advisers with low educational levels sell specific investment products or insurance products and are often quite skilled in these limited areas. But apart from the restrictions their employers place upon them (which assumes that the employer can supervise this) such advisers are in a position to offer advice or sell products that are quite unsuitable for clients. And they are called financial planners or advisers – they are not – they are salesmen. The wide variation in educational levels within the financial planning industry further adds to the argument for the separation of sales and advice.

There is a vast difference between a family man asking an insurance salesman for \$400,000 life cover and a retiree seeking advice for the investment of his \$400,000 superannuation payout. The former is a mere matching of an appropriate product (of which there are many) with the individual's circumstances. The latter involves a complex array of matters that will determine whether the individual's payout will last the rest of his/her life or not. Matters such as taxation, estate planning, asset allocation, specific investments, appropriate income payments not to mention anticipating financial market conditions all have to be taken into account. This is not a task for someone with half a diploma.

First aid workers do a great job; but they don't do brain surgery or prescribe pharmaceuticals. They work at the level of their qualifications. So it ought to be with financial advisers.

The industry will argue that that's the way it works, with licensees ensuring that advisers operate only to their level of competence. But there have been plenty of cases that give the lie to this protestation: Westpoint, Storm Financial, Opes Prime to name but a few.

***Deciding who can give comprehensive financial advice is too important to be left to licensees: it need to be legislated.***

***We need legislation that financial advisers must have degree level qualifications in financial planning and investment advising plus at least two years supervised experience, before they can provide unsupervised services to clients. Anything less is unacceptable.***

#### **Topic 4: The need to provide simple investment risk signals for consumers.**

Investing is so complex that it is beyond most investors to understand the level of risk associated with many investments and investment strategies. The problems with Westpoint debentures, Storm Financial margin lending and the many Australians who have 'negatively geared' investment properties indicate this clearly. There is an urgent need for a way to signal the relative risk for each investment.

We have health warnings on cigarette packets, flags to indicate safe areas on our beaches and regularly see warning signs "caution: wet floors".

The time has come for us to find ways that signal simply to investors the potential for adverse outcomes associated with various investments and investment strategies.

ASIC has floated the idea of 'invest between the flags' suggesting that bank deposits, superannuation funds, diversified blue-chip shares, vanilla managed funds are all 'between the flags.'

This is an excellent idea, signalling to the investor to be cautious. We suggest another category however than the 'outside the flags' implied by ASIC. Certainly use the idea but add another: 'way outside the flags' and use this for some of the more preposterous investments and investment strategies we have seen recently eg. some of the property debentures in which there is a direct connection between the fund manager and the property developer, and margin lending practices that use a home equity loan as the client's 'own funds' thus giving gearing on gearing.

These strategies aren't illegal – they are just very unwise. Swim out there if you are good at detecting sharks and ocean rips!

Human beings have taken risks for the whole of our history, many of us quite enjoying the risk while contemplating the rewards. However unless we know enough to understand the nature of the risk and the possible outcomes it's like being thrown to the lions.

***We desperately need a system that signals the magnitude of the risk of investing and of specific investments.***

#### **Topic 5: The need to behave like a professional to be treated as such.**

What constitutes a profession is a matter of much debate. But we all recognise what's not professional: when the actions taken are in the interests of the provider rather than the client. This situation appears to prevail within financial planning at present as cases such as Storm Financial dominate the news. No one who guides a retiree into doubly-geared situations is driven by the desire to provide for the best interests of their client; this is a clear case of self-interest.

A recent case might be considered even more disturbing. Corrina Jack reported in *Money Management* on 9 July of conflict within Suncorp where financial advisers whose 'sales' of managed funds to clients who went seeking advice, were considered to be below the sales targets given them. So here we have a situation in which advisers who spent their time giving advice – what the clients came seeking – were at risk of losing their jobs because their sales of investment products weren't high enough.

This makes the notion of professional behaviour a joke.

It adds weight to the argument that people paid by commissions on sales cannot claim professional status: working towards sales targets is the final straw.

Our solution is to separate advice from sales. Empower the professional bodies to establish strongly professional codes of conduct and the right to enforce these. Regulate the use of the term 'financial adviser' or 'investment adviser'.

***Given the significance of advising people of how to invest their life savings there is a strong case for a registration process in which entry qualifications are established, standards for performance are set and the behaviour of registrants monitored and individuals held to account.***

We might then see a smaller number of practitioners, Registered Financial Advisers, who would operate in a similar manner to mother professional: medical practitioners, engineers, lawyers.

### **Topic 6: The need for investment education for consumers.**

Investment is a complex matter not easily understood by consumers. As well as providing signals of risk to investors and requiring advisers to be more open with them about risk and other characteristics of the investment, it is important that a culture of consumer education in investing be generated and maintained.

Consider the case of Fred and June, retired with superannuation accounts of \$500,000 and a home they own outright worth \$750,000. Fred and June were attracted by the amazing claims made by Storm Financial. It is reported that they borrowed \$600,000 using equity in their home, and then placed this in a margin loan with an additional \$680,000 of borrowed money. This cost them \$128,000 in upfront fees. When the market fell 50% the investment reduced to \$560,000, which the bank retrieved by selling the portfolio, leaving the investor with a \$600,000 debt on his home. Clearly, living on account-based pensions, they were unable to make loan repayments and had to sell their home to pay off the loans.

Undoubtedly Fred and June wondered from time to time about the risk they were taking. But reassurances by an adviser settled their concerns. They didn't know enough to ask:

1. By how much might the Australian share-market fall?  
Answer: it fell by almost 50% in 1987.
2. What affect would that have on us?  
Answer: you'd be bankrupt.
3. How likely is that to happen to us?  
Answer: not very, but it could as it has in the past.

An adviser would not only answer such questions, but would pose them for Fred and June; a salesman would not do the latter, and would skirt around the former.

***We acknowledge that Australians should individually take responsibility for their own lives, making their own decisions, but believe that there is an urgent need for government assistance to raise their levels of understanding about financial and investing matters. This is a task for both government and non-government agencies. We believe that the AIA has much to offer in this regard.***

## **Topic 7: The importance of the client being more in control of the investment process.**

Because the client is often not directly involved in payment for services, this matter is hardly discussed by advisers and clients. It is as if payment is 'by someone else'. In fact it is, but it is still the client's money that changes hands from product provider to adviser. A result is that the services that are to be provided by the adviser aren't high on the agenda for discussion and so the adviser proceeds in (almost) total control of the discussion.

Contrast this with the client talking with a builder about building a home (an activity that makes use of similar amounts of money in many cases). Here a detailed quote is provided, and the client knows exactly what they are getting for their money.

By their nature commissions take the spotlight off the cost of services, and to an extent the services themselves. It is all too human to take less interest in a service that seems to be 'free'. Which of course it isn't.

What often happens in practice is that the adviser collects a large amount of pertinent information from the client at a first interview. This is considered and turned into a Statement of Advice or financial plan that is presented to the client, generally with the assumption that it will be agreed to and implemented. Not much involvement in thinking through this planning is allowed to the client.

Throughout the adviser has had 100% control, of the process.

***Our solution: We must find ways to empower the client more in this process. One way would be to require the preparation of a Terms of Engagement (functions plus costs) very early in the discussions, so that the client begins to get some control over where the discussions are going. This serves in a similar way to a quote for some other service.***

Follow this with the Statement of Advice by all means for now the client has had some say in what it will include/exclude.

## **Topic 8: The importance of payment for services being initiated by the client.**

Payments for many (most?) cases of investment advice comes from the provider of the investment product to the adviser (via the licensee), rather than the client. This gives the illusion of a free service or an inexpensive service. But the client pays fully for this commission, both up-front and as a trail. One other consequence is that clients keep paying well beyond the period for which services are provided to them by the adviser.

Upfront commissions of 7% were reported in the Storm Financial case. Some advisers involved in this argued that it wasn't a commission - that the client paid from the loan amount paid by the bank. When paid it wasn't in any REAL sense the client's money, it was the banks. It didn't have the same effect on the client as if they'd taken out a cheque book and paid \$128,000 for the service, as in an earlier case above.

Quite often there is the illusion of payment for services by the client, but the reality is different.

## **Topic 9: The illusion of independence of advisory firms connected with banks etc.**

Australians have lost trust in banks and insurance companies to quite a degree in the last couple of decades. The result is that they go to financial advisory firms that seem like they are independent i.e. not part of a bank or insurance company. In fact they are in most cases. Retaining the name of the original advisory firm the ownership of the firm is disguised, and clients' trust is misplaced.

Whether or not the mistrust of many Australians in banks and insurance companies is warranted it is not unreasonable that people know who ultimately owns the financial advisory business that they are intending to deal with.

Most financial advisers or planners work for AFSL licensees that are owned by a bank or an insurance company. Most Australians do not realize this.

***Our solution is to require that the ultimate ownership of any financial advisory firm be made quite clear in advertising and in documents provided to clients by the firm.***

## **Topic 10: The need for better regulation and increased regulatory enforcement**

The current requirements of the Corporations Law that legislate the requirement within the financial services industry focus on financial products rather than advice, and emphasize documentation of advice rather than consideration of the substance of that advice. Further no government agencies seem to have sufficient power and/or funding to enforce these (inadequate) regulations.

In this position statement we have argued that there needs to be regulation that:

1. addresses conflicts of interest that are endemic within financial advisory service provision
2. bans commissions
3. requires the client to pay for advisory services rather than a financial product provider
4. raises the educational levels of financial advisers
5. requires advisory firms to disclose the ultimate ownership of the business
6. provides clients with simple to understand risk signals, something akin to health warnings
7. affords the client more control in the client-adviser relationship
8. separates the selling of investment products from the provision of advice.

We believe that as a consequence clients will receive advice and place funds in investments that is in their interests, and that a profession 'financial adviser' will emerge.

It is time to recognise that the emergence of financial planning and investment advising has arisen out of a long history of insurance selling and stockbroking. Both are and remain worthy activities. However their foundation in selling is quite clear. In the last couple of decades a new service has emerged – financial advising/financial planning – that does not sit well on this selling foundation.

***It's time to start again – regulate the emergence of a new profession.***

**Solution:** Regulation needs to address the quality and appropriateness of advice rather than its documentation, and some 'teeth' given to enforcement.