Financial System Enquiry

Submission

1. That the financial services laws be amended to provide for the following changes:

    a. An additional class of persons be created to be known as "Sellers Agents" to distinguish "Financial Advisors" from "Sellers Agents";

    b. An additional class of persons be created to be known as "Principals" to:

        i. Identify the person immediately upstream from the "Sellers Agent" who is contractually engaging the "Sellers Agent" to promote distributed, market and sell the financial product;

        ii. Identify the person who is principally responsible to the consumer for financial products that are misrepresented or fail to meet compliance or other standards ('consumer law obligations");

    c. An additional class or category of persons to be known as "Product Originator" to:

        i. Identify the person upstream from the Principal who is the first issuer of a financial product where the product is a newly issued financial product;

        ii. Identify the person upstream who is liable downstream to the Principal and to the Sellers Agent and to the consumer for financial products that are misrepresented or fail to meet consumer law obligations imposed on a Product Originator;

    d. An additional document be created called an "Express Waiver of Independent Advice" required to be signed by consumers if they buy a financial product from a Principal or a Seller's Agent and not through a Financial Advisor;

    e. Sellers Agents and their Principals and Product Originators to all be subject to substantially the same consumer law obligations requiring full and proper disclosure of all product attributes and characteristics including risks of the financial product and accuracy and completeness of all margin, price and cost inputs and terms and conditions;

    f. Sellers Agents and their Principals and Product Originators to be under and additional obligation to Financial Advisors to the effect that their disclosure in relation to the financial product makes known for the benefit of the consumer all information about the product attributes and characteristics including legal and financial terms that a Financial Advisor would reasonably require or need to know to evaluate and advise a consumer about the financial product;

    g. Principals, Product Originators and Sellers Agents be prohibited from giving or purporting to give ***personal*** financial advice to consumers in relation to suitability of the financial product for the investment purposes or needs of the consumer ***unless*** the consumer is:

    i. Already a customer of the Principal Product Originator or Sellers Agent; and

    ii. Signs the Express Waiver of Independent Advice;

h. Courts be entitled to award punitive or exemplary damages for financial loss if a consumer succeeds in a claim against a Principal, Product Originator or Sellers Agent due to breach of statutory duty of disclosure or care and the customer has signed an Express Waiver of Independent Advice;

i. Sellers Agents be permitted to receive commissions and trailing commissions on the sale of financial products from their Principals provided full and proper disclosure is made in product disclosure document associated with the product, but this is a cost/pricing disclosure of the Principal;

j. Product Originators, Principals and Sellers Agents *not* to be under any fiduciary duty (to act in good faith) to consumers or any obligation to refrain from acting in conflict of interest and duty, it being understood acknowledged that:

    i. Except for consumer law obligations, the limits of the Sellers Agents is its duty to its Principal; and

    ii. The duty of the Product Originators, Principals and Sellers Agent to the customer shall be the consumer law obligations.

k. "Financial Advisors" to be subject to the obligations and liabilities of a fiduciary in the ordinary legal meaning of the term, as has been the situation in general with lawyers or stockbrokers as client advisors;

l. Financial Advisors to comprise a wider class of persons, including lawyers and accountants who hold themselves out to be professionally qualified to advise within their area of expertise in relation to particular financial products, provided that if the persons concerned are not already fiduciaries by virtue of their client/advisor relationship then they will be deemed to be fiduciaries if they provide personal financial advice;

m. Financial Advisors be prohibited absolutely from entering into any contractual relations with Principals, Product Originators or Sellers Agents and from directly or indirectly receiving incentive payments of any kind whether disclosed or undisclosed including commissions for the distribution, marketing or promotion of financial products and such schemes to be treated as a fraud on the client/consumer;

n. Courts be entitled to award punitive or exemplary damages for financial loss if a consumer succeeds in a claim against a Financial Advisor for receiving incentive payments from Principals, Product Originators or Sellers Agents in addition to any fines and penalties;

o. Financial Advisors otherwise be permitted to enter into whatever agreement relating to fees for advice to their client as may be agreed between the Financial Advisor (subject to unconscionable or unfair contracts laws) and the client, including commissions and trailing commissions on income earned, and allowing for the consumer/client to provide a revocable or irrevocable authority and direction to the

Principal or the Sellers Agent to direct and pay such commissions to the Financial Advisor.

Reasons for Submission

In March 2004 following the Wallis Enquiry extensive law reforms were made to restructure the financial services sector. These reforms are now encapsulated in Chapter 7 of the Corporations Act 2001.

These reforms represent an application of theories, concepts and behavioural models derived from an economist's view of the world of business and the transactional drivers of business behaviour from an industry or supply side perspective.

In many areas the reforms "got it right" in simplifying the whole industry and its administration with a licensing and regulatory scheme that operates across industry sectors and by reducing administrative complexity (arising from the prior duplication of regulatory regimes) and achieving consistency in the rules regulating conduct by having consistent mechanisms for enforcing the law and remedies for default.

However, this approach of grouping industry sectors or different product value chains and calling them one industry results in an assumption that the same legal rules or governance regimes can be applied across a range of different business activities and industry practices, despite differences in the value chains and difference in the characteristics of the products and contractual nature of relationships within a sector value chain.

The essence of this submission is that the economists designing the reforms also "got it wrong" when they applied in effect what was a "one size fits all" regime to the retailing of and advising in relation to all financial products and services. What follows is an explanation for why they got it wrong. The submissions above reflect the writer's views on the substantive changes required to correct what is wrong.

Why did they get it wrong?

The reason the economists got it wrong is because of the mainstream view in economics that markets are efficient and that "intermediaries" represent added and un-necessary transaction costs. In essence, if one believes in the efficient markets hypothesis, there are only "buyers" and "sellers" in a market, and there is no need for or utility delivered by "intermediaries".

In the real world that is nonsense and wrong in fact. Economics is a theory about choice and efficient markets theory is a view of that theory of choice that says if buyers have all the relevant information they will make rational choices.

To work in practice as it is postulated in theory an efficient market does not need intermediaries or overarching governance arrangements to facilitate transactions. In fact the market does not need anything more than very basic laws to protect property rights and their transfer.

That is the "idealistic" position of liberal free market economics. In the real world, choice decisions are more complex and "intermediation" takes a range of forms to ameliorate the transaction risk and uncertainty involved in making choices.

For example, this intermediation may include laws and regulations that make rules that constrain sellers from being misleading or deceptive conduct to buyers; or it may include hiring advisors with expertise who can analyse and advise to help the buyer make the choice about what they buy from amongst a range of options.

The Wallis reforms were a form of legislative intervention to simplify an industry or supply side structure and set industry or supply side constraints or governance arrangements on how a market would operate. A key feature was to bring into the regulatory framework activities that were previously either not regulated or were subject to minimal regulation. Another key feature is that the reforms set rules directed around the delivery of financial services and products through licensing providers, regulating their conduct and providing for product information disclosure.

That was all well and good but the main deficiency in the thinking behind these reforms was the assumption in mainstream economics that efficient markets only consist of buyers and sellers and that in such a market there is no need or place of "intermediaries".

The second deficiency in these reforms was to think that my making sufficiently comprehensive rules about information disclosure, the law or regulations would solve all the problems that intermediation otherwise attempts to solve.

The third deficiency – and this is the "fatal flaw" in the regulatory design – was the failure to understand the conceptual distinction between the legal relationship of "principal" and "agent" and the problem economists call "agency". What the designers of the legislative scheme appear not to have grasped is that there is (or should be) a distinction preserved between on the one hand:

- a "seller" of a product who in the public interest may be made subject to consumer protection laws (such as merchantable quality and fitness for purpose, prohibition on false advertising, etc.) and product disclosure laws for the benefit of a "buyer" and due to the need in those circumstances to reduce "agency" costs of inadequate information disclosure;

- an "advisor" to the "buyer" who may be retained by a "buyer" to assist the "buyer" to investigate and analyse the financial product to assist the buyer in making an informed choice who may then owe a duty of care to avoid conflict of interest and perhaps duty of good faith to the "buyer" given those circumstances.

The reason the economists got it wrong is simple.

- In economics, the "agency" problem says that as between two parties two parties negotiating a transaction there is the problem that either side of the transaction may not disclose all information the other side needs to know to do the transaction and price it appropriately, i.e. the "information asymmetry" problem. In economics, the agent is the one who does not fully disclose to the principal. However, the principal/agency problem is symmetric. That is to say, whoever is being "deceived" is the "principal" and whoever is doing the deceiving is the "agent" and the world being contemplated is a world consisting only of buyers and sellers.

- In law however, an "agent" is the agent of the "principal" and owes its duty to the principal including as a fiduciary not as a party to a buy/sell transaction in its own right but only as representative of one of the parties. In that conception of "agency" there is a clear line of duty and relationship and no confusion between where the third person or intermediary sits in the transaction. An agent in most cases can only be a representative of one party whether the seller or the buyer and in any case the person to whom they owe a duty and usually that is the person by whom they are retained.

So in law, the conception of complex transactions has always been to allow for the role of “intermediaries” as understood by economists, performing roles on one side or other of the transaction. But for economists working under an completely different conception of what “agency” means and without knowledge of that conception agency in its legal sense and working under efficient markets theory where there are only buyers and sellers it is logical to “think” it is possible to get rid of intermediaries by simply fixing the problem of asymmetric information.

In the real world, it has proved almost impossible to get rid of intermediation entirely even in efficient markets. It was ambitious to think that financial services reforms would establish efficient markets between buyers and sellers without advisors as intermediaries. Perhaps since the GFC market economists have a better understanding of the role of governance arrangements and intermediation.

As may be understood from the above, I contend the main problem with the reforms now encapsulated in Chapter 7 of the Corporations Act 2001 is that the economists view of the market for financial products as one operating between “buyers” and “sellers” without “intermediaries” and the only problem to overcome being to ensure that “buyers” have proper information on which to make their choices.

However, treating “sellers” as if they are “advisers” has conflated and confused a number of different pre-existing concepts and principles well understood as different in law with similar terms used to express ideas in economics that do not operate in the same understanding in law as in economics: In particular, the idea of principal and agent and the idea of agency theory in economics.

This conflation of concepts has led to the serious risk of undermining the distinction between fiduciary duties and consumer protection or contractual obligations. This may not seem important from the perspective of finance or economics but from a legal perspective if fiduciary duties do not imply some higher level differentiated or special duty that is different from the sellers contractual duty in negotiating a contract then either all sellers and their sellers’ agents have become fiduciaries to buyers or all consumer protection has been elevated to a fiduciary standard and the distinction has ceased to have meaning.

Life would have been easier for consumers as “buyers”, “sellers” and “advisors” so called and for the financial services industry as a whole if the natural and hitherto well understood distinction between a “seller” and “sellers agent” and a “buyer or “consumer” and a consumer’s “advisor” or “agent” had been preserved in the Wallis reforms. If that had been the case, there would have been less chance of “sellers’ agent” ever being placed in any actual or notional or perceived conflict of interest and duty to his principal (namely the “seller”) and the consumer or “buyer”. Advisors would be subject to fiduciary obligations and sellers and sellers’ agents would be subject to consumer law obligations.

This governance structure would also have allowed for the development of a professional and independent financial advisory sector whose duties as “agents” and “advisors” of “buyers” or “clients” and as fiduciaries would have been clear and unequivocal and in accordance with well-established and accepted legal conventions and principles. At the same time, consumer law obligations could have played the more conventional and normal role of establishing standards that apply to “sellers” within an industry context on which the market generally could rely.

Limiting Consumer's source of Advice

One of the other effects of the financial services reforms is to "remove" advisors like lawyers and accountants from giving advice in relation to financial products. In many cases this does not matter; but it matters in the case of complex financial products where the risks are not only in the financial performance under market conditions but relate to the terms and conditions of the product or its design characteristics.

That is to say, for every financial product with an economic or financial dimension it also has a legal or contractual structure the importance of which, through the prevalence of finance discipline perspectives, has been belittled and minimised resulting in substantial financial and economic costs to markets and consumers who have suffered loss of investment. For example, the sub-prime mortgages and CFDs and share lending agreements with margin loan features or debentures or reverse mortgages to name a few are all financial products with complex contractual arrangements where "buyers" and even many financial advisors might not fully understand the nature and character of risk associated with ownership of or exposure to the financial products.

It seems reasonable to hypothesise in relation to such complex contractual products that if "buyers" had a better understanding of the terms and conditions of contracts and the totality of the transaction arrangements they would have better understood the risk of the investment and its returns beyond the financial metrics and may not have proceeded with acquisition. It is also reasonable to hypothesise that if financial advisors were buyers' agents as opposed to highly incentivised sellers' agents then they may have been more circumspect in putting their clients into these financial products. Or, at least buyers who suffered loss would have had less to complain about.

It is also reasonable to hypothesise that even experienced financial advisors in those product areas were not necessarily well equipped to give advice on the risk associated with such complex contractual arrangements. It would seem incontrovertible that financial advisers who are "sellers agents" as I have termed them and who are incentivised by their principals to distribute, market and promote such products should be absolutely barred from providing personal financial advice in relation to such products.

It would be reasonable to argue that independent financial advisors, lawyers or accountants who clearly owe a fiduciary duty of loyalty to a client as a professional obligation and who are contractually incentivised by fees for services rendered and or by commissions agreed to by the buyer are likely to be "independent" and less likely to be susceptible to influences that might colour their advice.

Yours sincerely

Robert B. Turnbull

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