FINANCIAL SYSTEM INQUIRY

An inquiry into the performance of the Australian Financial System.

A Submission for the Final Report Focusing on the Retail Investor and Financial Consumer.

by

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GUIDE TO TOR, INTERIM REPORT ISSUES/QUESTIONS & RECOMMENDATIONS

TERMS OF REFERENCE	INTERIM REPORT ISSUES/QUESTIONS	RECOMMENDATIONS
TOR 2.1 Refreshing the philosophy	**Ch 1: Overview** A refreshed approach; Efficiency, stability and fairness	• This submission applauds the addition of fairness, based in mutuality, reciprocal obligation and equality of access, to the philosophy underlying the Australian financial system; • This submission encourages the thorough institutionalisation of stability and efficiency in the Australian financial system. • Stability and fairness should have a higher priority than efficiency in retail investor and financial consumer matters.
TOR 2.2 Consumer protection and risk allocation **TOR 3.1 Changing consumer preferences and demography**	**Ch 6: Consumer Outcomes** Disclosure and alternatives; Access; General Advice; Scaleability; Advisor training and competence; Independence of Providers. **Ch 9: Technology** Technology can promote access; 'Technology neutral' regulation; What are the advantages and pitfalls of technology in consumer financial markets?	• Retail market risk should be allocated fairly: products should be designed to help consumers not take advantage of their short-comings. More a perspective of *caveat vendor*, than *caveat emptor*. • Introduce electronically delivered 'graduated disclosure' supporting both fairness and efficiency; • Introduce product intervention powers and controls on product distribution; • Maintain the existing category of regulated general advice, not 'sales advice'; • Use scaling of advice sparingly; • If general advice is extended it should be for simple and familiar products and have labelling/warnings as to the 'usual purposes' of the product. ASIC product intervention powers and controls on product distribution should apply; • Online consumer finance increases access and should be regulated 'neutrally' along-side other general advice modes; • New online channels should be welcomed subject to careful regulatory development and generally

		applicable disclosure, product intervention and distribution powers. • Higher standards for training and a national examination for financial advisers is required; • An improved national register is supported; • A limited financial services compensation scheme should be introduced.
TOR 3.5 Corporate governance structures in financial system and effect on stakeholders	**Ch 5: Stability** **Ch 6: Consumer outcomes** **Ch 7: Regulatory architecture**	• Financial conglomeration and vertical integration should be addressed by the requirement of a 'financial services holding company' to hold wealth management and superannuation businesses; • The majority of directors should be independent and legislatively required to prioritise the interests of retail investors and financial consumers; • There should be a 're-purposing' of the governance and 'culture' of providers and a professionalisation of their workforces, to prioritise the welfare of consumers and the public interest in stable, fair and efficient markets. Changing training and remuneration practices will be central; • The benefits of the financial services holding company business form also extend to resolution; • Particular steps may be required to make proper provision for compensation arrangements.

The views in this submission are not those of the University of New South Wales or of UNSW Law. They are the views of Professor Kingsford Smith in her personal professional capacity, but not in her capacity as a member of the New Zealand Financial Markets Authority Code Committee.

1. The General Approach of This Submission

1.01 The general approach of this submission is while keeping the Terms of Reference of the Financial System Inquiry (FSI) in mind, to order the submission mostly in response to the layout and issues raised by the FSI's *Interim Report*.[1] It attempts to bring empirical evidence to bear on the questions asked in the *Interim Report* where this is available. It brings reflection and analysis from analogy, like circumstances and logic, where there is little or no evidence. It also takes this approach in relation to questions of philosophy, human agency and legal norms in regulation, which are often not susceptible to the kind of evidence that can be gathered about economic activity.

1.02 As with my earlier submission to the FSI this one addresses the issues and questions raised in the *Interim Report* through the particular interests of the financial consumer and retail investor. It is an observation in line with FSI Term of Reference 1 and a foundational perspective of this submission that since 1997 the 'financialisation' of everyday welfare provision for ordinary individuals (ie the universalisation of the need to provide personal, domestic and household financial needs through the markets rather than say, by government provision) means that everyone can now be thought of as a 'financial citizen'.[2] The government and regulators have been taken the view that ordinary individuals must assume the risks of financialisation and act responsibly in financial decision making as part of this new aspect of citizenship.[3] As well as responsibilising the financial citizen, I assume that one theme the FSI would welcome thoughts on in answering its particular queries is 'what responsibilities do government, financial regulators and financial services providers have to the 'financial citizen'?' given that citizenship of any type is a mutual relation between individuals and between individuals and the state. The institutionalisation of compulsory superannuation in Australia also invites us when answering the FSI's questions to address the theme 'where do the long term interests of the financial citizen lie?'

[1] Financial System Inquiry, *Interim Report*, July 2014 (Commonwealth of Australia 2014).

[2] DA Kingsford Smith and O Dixon, 'The Consumer Interest and the Financial Markets' in N Maloney et al (ed) *The Oxford Handbook of Financial Regulation* (in press, 2014); DA Kingsford Smith 'Regulating Risk: Individuals and the Global Financial Crisis' in *University of New South Wales Law Journal* Vol 32(2), 514-546 (2009).

[3] This was for example, made very clear in the Wallis Report, *Financial System Inquiry: Final Report* (Commonwealth of Australia 1997) (The Wallis Report).

2. TOR 2.1 Refreshing the Philosophy; Chapter 1: Objectives and Principles for Government Intervention.

2.01 ***The Case for Change*** As with the earlier one, the general argument of this submission is that the regulatory philosophy of both the Campbell and Wallis inquiries needs updating in relation to financial consumers, to take account of developments in research and what we know from two decades of experience in Australia with mass markets in retail saving and investment. This is especially true of compulsory superannuation. Too much regulatory weight has been placed on disclosure alone. The behavioural research on financial literacy and biased consumer decision making summarised in my initial submission makes this clear. So does the work of many regulators and other researchers the economic and regulatory significance of which is noted by the FSI in the *Interim Report.*

2.02 The *Interim Report* lists a number of 'market failures' that make the outcomes of financial market participation uncertain: information asymmetry, human psychology, asset values deviating from fundamental values, institutional concentration, networking effects and vertical integration. These together amplify the tendency to anti-competitiveness and even oligopoly, moral hazard and systemic risk. The recent memory of the market failures causing the Global Financial Crisis (GFC) is a presence often felt behind the words of the *Interim Report*.

2.03 ***Refreshing the Regulatory Philosophy*** For the Australian context of a small, mostly privately owned, capital hungry open market economy, the FSI nominates three objectives: 'efficiently allocate resources and risks, be stable and reliable, and be fair and accessible.'[4] These objectives are also described as principles, and it is assumed for the rest of this submission that 'efficiency, stability and fairness' are also intended to be used by the FSI as bench marks or standards for identifying and justifying decisions to intervene (or not) with regulation. Likewise, that these principles are touchstones for deciding how to choose between different tools for regulating departures of the market from desired conditions or outcomes.

2.04 These objectives or principles differ from those of the Wallis inquiry. In its Final Report it nominated 'competitive neutrality, cost effectiveness, transparency, flexibility and accountability'[5] as the principles of its approach to regulatory intervention. In more particular discussion of financial consumers the inquiry added that they should be 'treated fairly and have adequate avenues for redress.'[6] Summing

[4] *Interim Report* p1-1, 1-2, 1-5 & 1-6.
[5] Wallis note 3 at 176 and Ch5.
[6] Wallis note 3 at 188.

up their principles of regulation the Wallis authors repeated the five items quoted above,[7] without including fairness.

2.05 This submission warmly welcomes the inclusion of fairness as a central objective, analytic and organising principle of Australian financial and regulatory institutions, especially in relation to financial consumers. It also commends the specific inclusion of stability since the welfare of ordinary investors is greatly improved in financial circumstances where market volatility and institutional instability are contained. It is also encouraging that a quick review of many of the final submissions to the FSI, do not object to the adoption of these objects and principles.

2.06 While financial consumers also benefit from efficiency, it is the gravamen of this submission that in regulatory intervention in the consumer interest, values of efficiency should be lower in the hierarchy of justification than either fairness or stability. This author argues that the FSI Final Report should make it clear that in consumer regulation, policy and legislative interpretation, the trinity of 'efficiency, stability and fairness' should be re-prioritised as 'stability, fairness and efficiency'. A good example of this is in relation to disclosure to financial consumers. Disclosure of product and other information promotes information efficiency. However, we know that while this is valuable as a public good to the economy at large, valuable to analysts and professionals and perhaps to sophisticated investors, it is of limited usefulness to financial consumers. Instead, consumers require well capitalised and prudently managed counterparties (stability) who can issue products and give advice from their clients' perspective and put clients' interests first (fairness).

2.07 ***Fairness as a Basis for Investor Protection*** As discussed in the initial submission fairness is the capacity to recognize the circumstances, perceptions or values of another and act accordingly.[8] In financial markets it does not include the redistributive aspirations that fairness sometimes serves in arguments for social or political justice. In financial markets fairness can sometimes be found as impartiality or even as equality of opportunity. Mostly, in financial markets fairness is found as reciprocity or mutuality of conduct or obligations.[9] In general too, fairness is not required to be perfect, but is an approximate notion, a 'rough' or 'good enough' fairness.[10] In practice, fairness is the ability to bring a variety of contextual factors to bear in coming to an understanding of the other party's circumstances and purposes.

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[7] Wallis note 3 at 196ff.
[8] Warren M 'Democracy and the Everyday Meanings of Fairness' in Sarra J ed. *Explorations of Fairness,* Peter Wall Institute for Advanced Studies (Toronto Canada: Carswell Thompson, January 2013)
[9] Kingsford Smith, D 'Can There be a Fair Share? Fairness, Regulation and Financial Markets' in Sarra ed. above note 8.
[10] J Q. Wilson, *The Moral Sense* (Free Press, 1993) 62.

2.08 Until now, regulation justified by market failure alone has not remedied difficulties faced by consumers in relation to asymmetry of information, unequal bargaining power through institutional concentration and standardised product terms in mass markets. Fairness would justify regulation to encourage providers not to 'design and sell products that benefit from consumers not overcoming mistakes, or at times, exacerbating mistakes' because of these market failures.[11] Rather, a fairness justification for investor protection regulation could encourage values of reciprocity and mutuality of conduct. Instead of design to take advantage of the financial citizen's incapacities, it might induce providers to offer products and services which recognise and supply the welfare purposes of the financial citizen, as well as serving the provider's own long term commercial purposes. As detailed in my initial submission, this is an approach being adopted in overseas regulatory regimes. For financial consumers stability is an equal, if not weightier factor, than either fairness or efficiency: it is very difficult to be either fair or efficient when institutions are collapsing, price volatility destroying wealth, payment systems stalled and credit frozen because of instability.

2.09 ***Implementing 'Stability and Fairness'*** Since this particular section of the Inquiry's TOR is concerned with the philosophy of intervention, it seems appropriate to attend to the statement of these principles in the legislative instruments of the *Australian Securities and Investments Act* 2001 and the *Corporations Act* 2001 which empower ASIC. If they are not included in the legislation then it is impossible for ASIC which must act within its legislative mandate, to frame its decision-making according to the FSI' s principles of 'efficiency, stability and fairness', nor for courts and financial services providers to give them proper weight.

Turning first to Section 1(2)(b) *ASIC Act* which now reads:

1(2)(b) promote the confident and informed participation of investors and consumers in the financial system;

This formulation reflects the Wallis panel's emphasis on efficiency often manifested as disclosure, as derived from its principles stated above. To reflect the FSI's principles of 'efficiency, stability and fairness' the provision might be redrafted as follows:

1(2)(b) promote efficiency, stability and fairness in the financial system as a whole giving greater weight to stability and fairness in the protection of retail investors and consumers;

Likewise the objects of Chapter 7 of the *Corporations Act* 2001 which now read:

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[11] Financial Conduct Authority, Applying Behavioural Economics at the Financial Conduct Authority (April 2013) at www.fca.org.au at 21

S760A The main object of this Chapter is to promote:

(a) Confident and informed decision-making by consumers of financial product and services while facilitating efficiency, flexibility and innovation in the provision of those products and services;

might be redrafted to read as follows:

S760A The main object of this Chapter is to promote:

(a) Stability and fairness as first priorities in the protection of retail investors and consumers and then efficiency in dealing with retail investors and consumers;

Other parts of the *Corporations Act* 2001 such as the licensing provision in S912A will require corresponding amendment. Mirror image or similar modifications will be required in other legislation if the FSI's principles of 'efficiency, stability and fairness' are to be effective in changing the legislative, regulatory and legal settings of the Australian financial system.

2.10 Likewise, the rest of this submission while engaging with the issues and questions raised by the *Interim Report,* is also concerned with practical suggestions about how to implement or institutionalise the objectives of 'stability, fairness and efficiency' in a modern financial system with mass markets of financial consumers. For fairness to be a real and practical as opposed to merely aspirational value of the financial system, it has to be made real through legislative directions to regulators and arrangements for its internalisation through governance and human agency by the regulated population.

3. TOR 2.2 How Financial Risk is Allocated and Systemic Risk is Managed. Chapters 6: Consumer Outcomes.

3.01 ***The Case for Change*** The *Interim Report* summarises the main elements of the case for change: failure of disclosure, international examples of alternatives to disclosure, variable quality and accessibility of financial advice. It also mentions difficulties with regulatory approach: insufficient funds for sufficient surveillance or supervision and difficulties in regulating in a 'mass market' when things go wrong: for example recently at Commonwealth Bank Financial Planning and Macquarie Bank and a decade ago at AMP where 35,000 superannuation accounts were improperly switched.[12] Shadow shopping programs by ASIC and overseas regulators consistently show very significant segments of researched groups (usually well over 50%) have received advice (personal or general) which is either misleading and deceptive or lacks a reasonable basis, and for which they have often paid very high fees.

3.02 Even where investments are made without advice the steady increase in Australian class actions reveals endemic problems with disclosure. These are generally for misleading and deceptive statements in product disclosure statements, continuous disclosures and (less often) prospectuses. Australian class action litigation funders are a hard-headed crew, and do not take action without a serious prospect of success. Actions often involve thousands of plaintiffs. Likewise at the Financial Ombudsman Service FOS) investors and consumers make tens of thousands of complaints per annum, of which just under 50% are resolved in favour of the complainant. This takes no account of the large number of complaints that are resolved at the internal dispute resolution stage, directly with the provider. Finally, the *Interim Report's* own data reveals that in the investment area, over 30% of FOS determinations in favour of the complainant remain uncompensated.

3.03 ***Disclosure – a Proposal for Graduated or Layered Disclosure***

Part of the case for change is the cheapness, interactivity and immediacy of delivery of electronic disclosure documents. In 2005 this author outlined both the research evidence, that casts doubt on

[12] Pearson G, *Financial Services Law and Compliance in Australia* (CUP, 2009) pp 201-204;
ASIC Media Release 06-251 *ASIC accepts a legally enforceable undertaking from AMP financial planning, Thursday 27 July 2006* at: http://www.asic.gov.au/asic/asic.nsf/byheadline/06-251+ASIC+accepts+a+legally+enforceable+undertaking+from+AMP+financial+planning?openDocument

the degree to which investors read prospectuses, and some suggested solutions using electronic delivery for disclosure.[13]

3.04 One Australian study[14] of the practices of both investors and their professional advisers, found that the vast majority of respondents read a prospectus for over 30 minutes[15] and over half the individual investors who responded 'spent between 30 minutes and an hour reading the prospectus for their most recent investment.'[16] The picture seems to be very similar whether the investor is acquiring shares directly or investing indirectly through a managed fund[17] (a mutual fund in Canada). Only 36% of the respondents thought that prospectuses gave them sufficient information to make an investment decision, and 56% thought that prospectuses are not easy to understand.[18] 'They have most difficulty with legal or technical jargon. They also find prospectuses too detailed and repetitive and also have difficulty with the section dealing with financial matters. 66% of respondents think that prospectuses are too long;[19] 52% of respondents do not find it easy to find the information they want in a prospectus. Suggested improvements are to summarise key points, simplify and clarify the contents, use less jargon, and make the prospectus more concise.'[20] The perceptions of financial advisers on similar questions make an interesting contrast. '85% of respondents found that clients have difficulty understanding prospectuses, finding them too long, too detailed – and too full of legal or technical jargon. Most responses indicated that clients did not want to read or cannot understand, a prospectus, and rely on their advisers to describe and interpret the investment.'[21] The majority of advisers thought that the role of the prospectus in the advisory process is both 'very little' and mostly a back-up to the adviser. Eighty-three percent of advisers believe that simpler prospectuses would be beneficial.[22] This study is in line with the results of similar North American research and research undertaken by the Financial Services Authority in the UK in the same period.

[13] D Kingsford Smith "Importing the E-world into Canadian Securities Regulation" in *Canada Steps Up – Maintaining a Competitive Capital Market in Canada* (October 2006) for the Task Force to Modernise Canadian Securities Legislation (initiated by Investment Dealers Association and Capital Markets Institute, University of Toronto) at http://www.tfmsl.ca/docs/V5(6)%20Kingsford%20Smith.pdf

[14] I Ramsay 'Use of Prospectuses by Investors and Professional Advisers' (Centre for Corporate Law and Securities Regulation, 2003). Available at http://cclsr.law.unimelb.edu.au/research-papers/Monograph%20Series/Australian%20Prospectus%20Survey.pdf

[15] Note 14 at 21.

[16] Note 14 at p2.

[17] Note 14 at 48.

[18] Note 14 at 3.

[19] Note 14 at 3.

[20] Note 14 at 3.

[21] Note 14 at 4.

[22] Note 14 at 4.

3.05 One way of meeting the difficulties of adapting disclosure to its variety of audiences, is to produce it in a variety of interlinked forms. This might be called 'graduated disclosure'[23] or as the *Interim Report* does, 'layered disclosure'. The graduated disclosure documents would be accessible electronically, and could be shaped to adapt to environments such as the MySuper product dashboard or subject to analysis tools such as online comparators or choice engines. The basic format has three components as follows.

3.06 *Foundational Disclosure Document:* A very short (3 pages) foundational document that sets out the basic information about the financial product on offer and the issuer. The document should be 'evergreen'. It should be set out in a standard format, which will promote comparability between investments. It should list URL contacts for all the other sites where the investor may find authorised information about the investment. If it is transmitted electronically, it should contain hyper-links to those other sites. The third page should be an application form which the investor must sign or submit using a PIN. This document should be disseminated to all investors by intermediaries in the selling process, who will not have fulfilled their obligations, if they do not bring it to the investor's attention. The requirement to use the application form should also promote the document being read by self-directed investors. The document is to be bought to the investor's attention before the financial product is sold, as the submission of the application form will require. As the foundational document is very short, it may be passed on by the intermediary in almost any medium – it is not too long to fax, it could easily be emailed, it could be made available on a website, posted or given personally.

The contents of the foundational document should be specified by regulation. There is a clear and strong case for a single document that sets out authorised information, that the regulator considers every investor should know for his or her protection. This avoids the investor being over-loaded with promotional material that they have to sift through to find the essential facts about their investment – that would simply be replicating in another way, the difficulties investors have identified with long prospectuses. The foundational document should not contain hyper-links to other selling material, though all selling material should contain the URLs to all three of the documents described in this proposal, and hyperlinks if selling material is communicated electronically. Above all, the document must be kept short and simple.

3.07 *Document Containing Issuer and Investment Specific Information.* This, like the foundation document, should be very concise, say 10 pages at most. It too, should be set out in a standard format, which will promote comparability between investments. Again too, it should be 'evergreen'. It should contain information about the issuer, its business, its plans and prospects, its management and consequently, the prospects for the investment. It should describe the riskiness of the investment in a fashion that elaborates

[23] Kingsford Smith note 13 *passim*.

on the basic information in the foundational document. Again, the areas to be covered should be specified by regulation.

This document though clearly authored by the issuer, should also be made available by the intermediary, and before the investment decision is made. It should underlie the intermediary's suitability recommendation, and wider explanation to the customer of why the investment in question is being recommended. The proposal anticipates that an intermediary would review this document with a customer, before the investment decision is made. A self directed investor would be alerted to it by the URL or hyperlink on the foundational document, which must be used to apply for financial products.

3.08 *The Full Disclosure Document.* The final graduation in the proposed disclosure scheme, is that the previous two documents described should bear URLs or hyper-links to Internet locations where the issuer's full disclosure document is freely and continuously available. Financial intermediaries should draw the attention of investors to this material, and encourage them to consider it.

There may need to be changes to the law to make it clear that in this level of disclosure, as well as that outlined in the previous two documents, investors and financial consumers should have rights should there be any misstatement or material error contained in them. There is obviously a lot of work with focus groups, legal and IT technical detail needed to develop 'graduated disclosure' along these lines. However, Australians have shown themselves to be adept in using the Internet, over 80% of them have access to a computer, and many electronic disclosure documents are already delivered or accessible to consumers already. Although development costs might be substantial, the longer term cost saving implications of this scheme may recommend it to industry. Its greatest virtue is that of providing a 'mass customisation' of disclosure for different audiences.

3.09 ***Supplements (Alternatives) to Disclosure***

Previous financial system reports assumed that efficiency in securities information and price formation was a high value in market operation, and that mandated disclosure was cardinal for market function and capital allocation. This conception of efficiency and the importance of information to maintain it, is derived from and mostly relevant to research in secondary markets in tradeable securities. Since the earlier reports, retail markets have shifted substantially from directly held tradeable securities to interests in funds which are generally not traded, with no liquid market in the interests involved. Financial consumers of interests in funds are not traders they are 'end-users'.

3.10 This development means that the philosophies behind disclosure regulation must likewise adjust. While the disclosure scheme proposed above would maintain information efficiency, disclosure to individuals at point of sale of 'end-user' financial products has other purposes and justifications, as well as price discovery. Disclosure in 'end-user' markets is about helping consumers understand the product, whether it is suitable or fit for purpose, disclosing terms and conditions, and for avoidance of fraud. In 'end-user' products justifications of investor or financial consumer protection, and fair treatment, are at least as relevant to disclosure as information efficiency for price discovery. The justifications of investor protection do not end with disclosure: they may well justify other regulatory strategies, which information or market failures would not. As the Campbell Report acknowledged, 'disclosure requirements do not always represent a clear alternative to other forms of regulation.' (para 45.106).

3.11 The *Interim Report* asks us to consider a number of alternatives to disclosure and to make the case for them. In my initial submission I drew attention to a lot of research on financial literacy and behavioural finance which together with the failings of disclosure, make the case for alternatives to disclosure. Indeed, this submission argues not that they be considered alternatives but supplements to disclosure. There are many audiences for and purposes of disclosure,[24] and disclosure which is informationally efficient as well as helpful and fair for consumers is the rationale for the graduated disclosure above. The question then is, in what ways would it promote the FSI's principles, particularly 'fairness', to introduce supplements to disclosure and what form should they take?

3.12 A standard response to the inadequacies of disclosure, is to argue that consumers should seek financial advice. Advice is considered further below, but as with the long term aims of improving financial literacy, we need to accept that professionalizing and improving the quality of advice will take time too. In the meantime, what supplementary interventions would encourage fairer treatment of consumers? What regulation would dissuade providers from 'design and sell products that benefit from consumers not overcoming mistakes, or at times, exacerbating mistakes?'[25] Consistent with a philosophy of fairness as mutual obligation, regulation should induce providers to offer products and services which recognise and supply the welfare purposes of the financial citizen, as well as serving the provider's own long term commercial purposes.

3.13 This submission argues on grounds of fairness and practicality for arming ASIC with product intervention powers, *and* subjecting product issuers to distribution requirements to promote provision of suitable products to consumers. The first is necessary to support the second. Encouraging default product designs probably does not require new powers and could easily be encouraged by issuing regulatory guidance about the features and pitfalls of default products and ASIC law and policy. Regulating product features is the most interventionist of the alternatives

[24] Kingsford Smith note 13 passim.
[25] Financial Conduct Authority, Applying Behavioural Economics at the Financial Conduct Authority (April 2013) at www.fca.org.au at 21

raised in the *Interim Report.* This would require a significant step change in ASIC powers and resources. ASIC would need powers and resources to identify the required product features and the client segments to which they were permitted or not, to be sold. It would likely need some sort of pre-approval power, at least for unusual products or product features. It would need resources for surveillance to enforce the proper matching of product features with target consumers. It might even need some supervision powers of provider business form or resources in order to confidently approve certain products or features. It would need the intervention powers mentioned above, to enforce those features. This submission argues that in the absence of significant new powers, resources and skilled personnel, it would be impractical to give ASIC new powers to regulate product features.

3.14 Turning back to product intervention powers, the following thoughts might assist the FSI. If ASIC were given product intervention powers (in addition to the disclosure stop order power it currently has) good regulatory guidance would be crucial as to what ASIC considered appropriate and what would trigger use of the power. ASIC may wish to divide that guidance into types of products (eg complex, high risk, superannuation, simple and familiar) or the types of investor where it might intervene in a variety of circumstances. It might wish to provide guidance on the internal development and approval processes it thought would result in financial products that 'should be designed to meet the needs of identified consumer groups and targeted accordingly'.[26] It could give particular attention to features which it thought indicated complexity: leverage, riskiness especially of liability that exceeds the cost of the product, use of derivatives other than for hedging, complexity of terms and conditions (eg whether a capital guarantee applies, product lock conditions etc) and set out its intervention policy. It should include temporary product banning powers. The due process of exercise of the product intervention power could be modelled on existing disclosure stop order powers.

3.15 Distribution arrangements which match the product and the typical investor type are central. It should be an express responsibility of the issuer to identify the product/investor match, and educate those involved in distribution about the purposes, terms and characteristics of the product. The issuer should identify the investment purposes and class of investors for which the purposes are fit. Clearly product distribution must be considered during product development: it may be that an issuer without the appropriate distribution channels, cannot develop and distribute a product. Those

[26] Joint Forum of Financial Market Regulators, *Financial Product Development Standards and Practices*, (2013), 5 at: http://www.jointforum.ca/en/init/Product_Disclosure/Fin_Product_Dev_Stds.pdf

involved in distribution must be able to clearly describe and explain the product, and the ways in which it will fulfill the investing needs of the class of individuals to which it is directed. The distribution process would be assisted if the product disclosure bore labels stating the kind of investment purposes the product is intended to meet, and a warning that it should not be acquired by investors not seeking those purposes. The practical significance of the risks to the target investor class (not merely a generic description of the risks) and any costs attached to the product, should be clearly, concisely and effectively set out. The product should not be sold in any channel, advisory or not, without these brief statements. This is using a labeling/warning approach to disclosure of financial products. ASIC should develop a standard set of labels/warnings that issuers can use with appropriate variations for their particular product. ASIC would need augmented resources for surveillance of mandatory distribution requirements, and product intervention powers should be drafted to include contraventions in distribution as well as inappropriate product features.

3.16 *Accessibility of Advice*

Changes to general advice and scaling: This submission agrees with the position of the *Interim Report* that general advice should continue to be regulated as such, given it is the only form of advice generally received by the majority of consumers acquiring a financial product. The policy aim of increasing access to advice, one technique being to widen or remove regulation of general advice, is noted. So is the proposal to rename general advice as 'sales advice' or 'sales information'. However, research shows financial consumers have great difficulty recognising and understanding the differences between brokers and advisers,[27] tied or 'aligned' and independent advisers[28] and understanding fees they are charged even after years of paying them.[29] It seems very unlikely that Australian consumers will understand that 'sales information' does not contain advice, and 'sales advice' does not take a consumer's needs and purposes into account. Instead a consumer protective approach to any changes to general advice is warranted, and not one which relies only on disclosure to get the right result. The research just mentioned shows this is an area where disclosure has been particularly disappointing as a regulatory tool. Removing, as the FOFA rules do, the worst of the conflicted remuneration practices except for very simple banking and insurance products sold with general advice is an encouraging first step. However, more is needed.

[27] A Hung et al, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* (2008 Rand Institute for Civil Justice, sponsored by the SEC);
[28] FSA, *Polarisation and Financial Services Intermediary Regulation*, (July 2000) 30-32.
[29] Hung et al note 27 passim.

3.17 At the moment 'general advice' is defined in two steps as 'a recommendation, or a statement of opinion, or a report of either of those things ...that is intended to influence a person in making a decision in relation to a particular financial product or class of financial products...'[30] and further 'general advice is financial product advice that is not personal advice.'[31] 'Personal advice' is given where the adviser considers one or more of the client's personal circumstances.[32] Further, merely letting a client know the costs, rate of return on a product (or similar information specified by regulation) is not a 'financial recommendation',[33] and hence not financial advice. It is financial information. Likewise, general advice may be given if an adviser is licensed to give general advice, and provides only advice prepared by an issuer who itself has no financial services licence,[34] or is advice for which the giver receives no compensation over and above what would be received on the sale of the product without the advice.[35]

3.18 Returning to the issue of access to advice, another technique for navigating the Scylla and Charybdis between general advice and more expensive and inaccessible personal advice, has been to legislatively endorse 'scaled advice'. This permits personal advice to be given in a very limited area of the client's financial affairs, as agreed with the provider. The central difficulty with scaled advice is that even a well intentioned adviser may give narrow advice which, as with the uncoordinated drug inter-actions of polypharmacy in the medical field, has a damaging effect on the overall financial health of the client. However, it is the recommendation of this submission that scaling be used sparingly, for relatively small amounts, or for advice about 'closed systems' of investment such as superannuation: if so limited it may be that consumer detriment is outweighed by the benefits of access to advice, even if scaled.

3.19 Turning back to general advice, it should now be clear that the ambit of general advice in Australian law is quite narrow. The question is what standards might we require the issuers and distributors of products sold with general advice to maintain, if we were to extend the ambit of general advice to improve accessibility? It is already the case that prohibitions on 'misleading and deceptive' conduct apply to general advice. A duty of care also applies when giving general advice. Given that with general advice more of the decision to acquire a financial product is left with the

[30] S766B(1) *Corporations Act.*
[31] S766B(4) *Corporations Act.*
[32] S766B(3) *Corporations Act.*
[33] S766B(6), (7) *Corporations Act.*
[34] *Corporations Regulations* Reg 7.1.33A
[35] *Corporations Regulations* Reg 7.1.33G

client (because the adviser does not match client purpose with suitable product), what can be done to help the client bridge the 'purpose to product' gap?

3.20 Pearson's thoughtful piece on suitability and 'fitness for purpose' in the consumer credit market, may show us a direction.[36] Generally the requirement for a seller to provide goods that are 'fit for purpose' requires the buyer to inform the seller of their purpose. However, there are other versions of the rule that could operate to provide a contractual implied term that the goods supplied are fit for their 'usual purpose' (eg a Ferrari must be fit for the usual purpose of driving even if the buyer's own purpose is an attempt on the sound barrier). Such a usual purpose will most easily be identified when goods are of 'a well known and ascertained kind'. Since any extension would presumably limit the kinds of products and services available with general advice to the simple and familiar, the 'usual purpose(s)' should not be difficult to ascertain.

3.21 Indeed it is the recommendation of this submission that where financial products are being sold with general advice that those 'usual purposes' are listed and their significance explained in a prominent position on the Product Disclosure Statement. Those usual purposes and any main product features should also be explained orally to the client at point of sale. Further, every client sold a product using general advice, should be given a warning under Section 949B *Corporations Act*, both on the Product Disclosure Statement and orally at point of sale. Not only should a warning to get personal advice be given, but the practical significance of not doing so should be explained in terms the client is likely to understand and recorded in a prominent position on the Product Disclosure Statement. Obviously, the client should be warned that if their financial purposes do not fit within the list of 'usual purposes' for the product, personal advice is necessary or they should not acquire the product.

3.22 Accordingly, this submission suggests that the *ASIC Act*[37] is amended to provide that:

S12ED(1) In every contract for the supply of financial services by a person to a consumer in the course of business, there is an implied warranty that...

(b) any financial products supplied in connection with those services will be fit for the usual purposes for which they are supplied;

(c) in the event the only contract between the person and the consumer is for the provision of a financial product that product will be fit for the usual purposes for which such products are supplied.

[36] G Pearson 'Reading Suitability Against Fitness for Purpose – the Evolution of a Rule' 32 *Sydney Law Review* 273 (2010) at http://sydney.edu.au/law/slr/slr_32/slr32_2/Pearson.pdf

[37] Section 12ED(1)(b).

3.23 In addition to the implied term (giving inter-party contract remedies only), there should be a corresponding provision which gives ASIC power to take action on behalf of investors: this could be included in the product intervention powers already discussed. There would also need to be consequential changes to the requirements for Product Disclosure Statements.

3.24 *Advice Delivery Using Technology – Advice Engines and Calculators.* As the *Interim Report* observes technology, automation of advice and 'mass customisation' offers opportunity for increasing access to advice. It asks submitters for improvements or pitfalls for regulators to watch in the development of a technological approach to financial services. The general approach to the online mode by financial regulators has been to say that they intend to regulate in a 'technology neutral' way, so that the mode of market participation confers neither an advantage nor any disadvantage on users. That seems a practical and competition friendly policy starting point.

3.25 Another important characteristic of the online mode is that it is (generally) non-advisory. In terms of the above discussion of changes to advice, the online mode operates in a general advice environment. So if electronic modes of consumer financial participation are to be encouraged, regulators must be ready to determine which products might be safely sold this way, to which types of investors or consumers. If regulation is truly to be medium neutral, then it may be that some products now sold online (eg complex products like Contracts for Differences) should not be sold there, if more regulation of intervention in or distribution of complex products in future means they are not able to be sold off-line without personal advice. The reverse insight also applies. So, if regulatory neutrality as to mode of delivery is central, it may be that online investing systems have to build in referrals to a personal advisor for some aspects of the investing process for some products or investors: this might be thought of as a 'mixed modes' approach to the provision of online services.

3.26 As mentioned in my initial submission research that is now of some 10 years standing makes it clear that the online mode does induce different behaviour in investors. Barber and Odean have found that the behavioural traits identified in the behavioural finance literature are amplified online: over-confidence leads to over-trading and online investors earn lower returns as a result.[38] Bradley has argued that greater 'immediacy, interactivity and inter-jurisdictionality' in the online investing context demand some different approaches to regulation by comparison with advisory modes.[39]

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[38] B.M. Barber and T. Odean 'Online Investors: Do the Slow Die First?' (2002) *The Review of Financial Studies* 15(2) 455, 455-487; Barber and Odean (2000) 'Trading is Hazardous to your Wealth: The Common Stock Performance of Individual Investors', 55 *Journal of Finance* 773.
[39] C Bradley, 'Online Financial Information: Law and Technological Change' (2004) *Law & Policy, 375 passim*.

3.27 There is also evidence that decision-making using online information may rely more on impressions than logic.[40] Bradley argues that regulators should concentrate more on educating investors on how to recognise unreliable online financial information and trading sites, and provide them, where possible, with 'cooling off' rights on product purchases. 'Cooling off' rights are difficult to manage where financial products are acquired in a secondary market, but as we have observed the majority of retail and consumer products are of an 'end-user' nature where 'cooling off' rights can be implemented.

3.28 A visitor to sites such as the US Vanguard Investments portal at: https://investor.vanguard.com/etf/investment-options gazes into the future of consumer investing interfaces. This is a sophisticated algorithmic and inter-active system, which provides great immediacy of communication with the client and action by the provider. 'Advice engines' like this can also link to calculators which help clients to see possible long term costs, or returns, and variations in capital growth if certain levels of continuing contributions are made. For the FSI's philosophies of 'stability and fairness' to be realised in this setting, regulatory guidance will have to be very alert to the assumptions that are embedded in the programs which support these advice engines and calculators. Regulators will also need to create guidance for the kinds of online advising practices that given the legislative definitions can be considered 'general' and those which in substance are 'personal' despite the mode in which it is being delivered. This is a complex and subtle area of regulation, obviously influenced by access to advice policy, and more work is required.[41] Further, surveillance resources and expert personnel will be required to ensure that biases in favour of particular products or results are not programmed into the operation of these interfaces and missed because they are offered online and not through personal broking or advising.

3.29 In the likely event that we see only more online consumer participation over time, regulators will have to 'beef up' their online enforcement capacity dramatically. Forensic capacity to identify and analyse illegal or non-compliant behaviour is crucial, as well as to feed this analysis back to policy makers. Capacity to act swiftly, including internationally is also important. Much of the law of evidence has been bought up to date in Australia to allow both civil and criminal action in a digital environment. However, it is not clear that a 'technology audit' of the readiness of other areas of financial regulation is in as good a shape. A review of licensing for technology issues might be

[40] C Bradley note 39 at 384.

[41] D Kingsford Smith 'The Same Yet Different: Australian and US Online Investing Regulation' University of Toledo Law Review, (2006) 37(2) 461-95; N Liblin & J Wrona 'The Securities Industry and the Internet: A Suitable Match?' 2001 *Colum.Bus. L.Rev* 601-681.

useful, similarly for disclosure and ASIC surveillance or APRA supervision: experts will nominate other areas too. General and on-going training of regulatory staff to bring them up to date enough to recognise technology issues in their work so specialist back-up can be requested, is important. A greater awareness of the effects of digital modes in dispute resolution and compensation is also necessary and barely being realised.

3.30 In conclusion this submission is in favour of the extension of digital modes to consumer financial markets. Overall, issues of accessibility, access to advice and financial information, order timing benefits, cost effectiveness, competition and variety and innovation of products will all be served by extension of the online mode. However, there is a significant dark side, which will need regulation with a long term perspective in mind. Uptake of the online mode leading to potential benefits will only be realised if stability and fairness are the leading philosophies for policy, rulemaking and enforcement. Regulators must work with providers and self regulatory bodies on regulatory strategies that may take years before technological changes can be made available safely and fairly. Patience, resourcefulness, a tolerance for 'pilot schemes', consumer 'focus group' testing and continuous review will be required, guided always by the basic principles of regulation.

3.31 ***Quality of Advice and Advisor Competence***

The *Interim Report* has raised a number of issues about quality of advice and advisor competence. This submission squarely supports higher standards for training and a national examination for financial advisers. There is research evidence that it is advisors both early and late in their careers in relation to whom the greatest volume and most serious complaints are received.[42] As in New Zealand where half a decade ago such changes were introduced, a period of years should be allowed for existing advisers to qualify or leave the industry. All new entrants should begin at the higher standard.

3.32 This submission also supports an enhanced national register. It has the benefit of making individual, not merely corporate, reputation and conduct evident. This (along with some 2012-2013 legal changes in the FOFA rules) would be an important catalyst to changing an advisor's perception of their own responsibility for conduct towards their clients. As Smith[43] points out, ethics must be internalised personally, not merely promoted organisationally, for conduct towards clients to change for the better. To this end, the FSI may like to consider whether the national register

[42] J Smith *Professionalism and Ethics in Financial Planning* a thesis submitted for the degree of Doctor of Philosophy 2009 at: http://vuir.vu.edu.au/15535/1/june_smith.pdf
[43]Note 42 *passim*.

should include details of serious disciplinary sanctions by either professional associations or ASIC. This submission also supports banning individuals from the management of financial services firms, not just from advising clients. It also supports a greater emphasis on professionalization and 'regulation of the self' along with self regulation that is in co-regulatory connection with governmental regulators. Likewise a limited Financial Consumer Compensation Scheme is supported. Details of these views can be found in my initial submission to this Inquiry, and in my submission 154 to the Committee of the Australian Senate which investigated the Performance of ASIC in 2013 here: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC

4. TOR 3.5 Corporate Governance Across the Financial System; Chapters 5, 6 & 7: Stability, Consumer Outcomes and Regulatory Architecture.

4.01 This submission has argued in relation to the principles of 'efficiency, stability and fairness' which the FSI has adopted, that in the area of retail investors and financial consumers, the values of stability and fairness should be weightier than efficiency. It has suggested that legislative amendments are needed and justified, to effect this change from the philosophy of the Wallis Committee.

4.02 This part of the submission responds to the characteristics of the Australian financial system that reflect the intense concentration of ownership and control in consumer product issuance and distribution: high levels of vertical integration, related party service and product providers and endemic conflicts of interest. The *Interim Report* has found that overall the Australian financial system remains competitive as between major participants. However, there is considerable evidence that in the consumer area ties between related party providers provide incentives to distort advice, over-service clients, introduce over-concentration in the products and services of a single provider stable and blunt price competition and innovation because clients are so tied in to one provider or brand. This has serious implications for all of the contestability of the Australian consumer financial sector, the stability of the system should a large consumer provider fail, and most importantly the welfare of individuals whose personal and domestic welfare has been financialised in a highly concentrated fashion. The following provides analysis and recommendations about how this situation might be improved.

4.03 Philosophical and legislative statements (see above) set expectations, but they require operationalisation to be effective in day to day transactions with financial consumers. This is a matter of governance. Effective governance of institutions requires firstly that appropriate structures and practices are adopted. It is now accepted that these are unlikely to be effective in changing attitudes, conduct and outcomes, unless accompanied by changes in what the human actors in the organisation believe to be the purpose of their work in participating in the organisation's mission.[44] This set of personal beliefs and organisational purposes needs to be held by individuals from the board, through management below board level to employees and agents carrying on transactions with clients. Sometimes this combination of governance structures, processes or practices, beliefs and human

[44] J Webber 'Legal Pluralism and Human Agency', 44(1) *Osgoode Hall Law Journal* 167at 171-173 (2006) at http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1316&context=ohlj; H Becker 'Culture: a Sociological View' (1982) 71(4) *Yale Review* 513; E Meidinger 'Regulatory Culture: A Theoretical Outline' (1989) 9 *Law & Society* 355; Parliamentary Banking Standards Commission, *Changing Banking for Good* (HM Parlt 2013) Vol 2 para 634.

agency is called ‘culture’ or ‘organisational culture’.[45] There have been many calls for a change in ‘culture’ in financial organisations since the GFC.

4.04 One reason for the demands for change in culture has been the leaching into the treatment of consumers of attitudes and practices developed for and appropriate to, other market segments such as professional and sophisticated investors. Financial practices such as high leverage, margined loans, share lending and derivatives or packaged products with risk levels determined by derivatives, have been recommended to ordinary investors. This ‘democratisation of the techniques of high finance’ combined with commissions or ‘assets under management’ fees where borrowed assets are included, has driven unsuitable investment recommendations to financial consumers. The prioritisation of disclosure (efficiency) in tandem with high expectations of consumer literacy and ability to make rational investor financial decisions, has meant providers have failed to establish appropriate governance or ‘culture’ in those parts of their organisations that deal with financial consumers. Instead, they have promoted narratives of client profit (rather than retirement income provision), ‘innovation’ when the innovations often benefit providers more than clients (eg over-servicing through expensive platform services initially developed for high wealth clients) and encouraged risk taking through products that appear safe but have embedded risk (eg structured products containing derivatives).

4.05 If the FSI wishes its emphasis on principles of stability and fairness to be taken seriously then providers must abandon this narrative of risky wealth generation for *both* provider and client in the consumer segment. Instead of the ordinary retail client being encouraged by providers to think of themselves as high rollers on a ‘journey to capitalism’[46] they should be supported to make prudent choices against longevity risk and other personal domestic and household welfare purposes that most seek (or are required) to manage through the financial system. Correspondingly, providers to consumers must alter their side of the narrative from profit taking to professionalism, seeing their organisations as having a ‘public utility’ role[47] and a service ethic, before being profit takers. These

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[45] Culture ranges from facts about (financial) institutions or various practices to ‘more nebulous aspects of ideas, values, aspirations and mentalities’. Culture is a set of social understandings through which we make meaning about what we do, personally and within institutions. It ‘is about who we are, not just what we do’. D Nelken, ‘Using the Concept of Legal Culture’ 29 *Aust J of Legal Philosophy* (2004) 1-26 at 1. Westbrook observes that while we speak of ‘organisational culture’ or the culture of a profession or sector (eg ‘legal culture’) it is also the case that various cultures, including ‘financial culture’ are ‘absolutely central to the wider way we as people conduct ourselves and understand our lives. Financialisation makes this ever clearer as ‘many social goods - including much education, health care, and retirement – are provided through institutions directly dependent on portfolio investment.’ D Westbrook ‘The Culture of Financial Institutions’ in O’Brien and Gilligan *Regulating Culture* (Hart 2013) 1-20 at 5.

[46] The narrative expressly invoked by Storm Financial in their Statements of Advice.

[47] Both before and since the GFC it has been recognised in commentary on the financial and social position of banks and other financial providers, that they have a ‘utility like’ role. That is one reason for the intensity of regulation of banks by comparison with non-bank providers. This was made clear by the British Report of the Parliamentary Commission on

more aggressive supply side rationalisations for treating clients as professional counterparties or as sophisticated may be appropriate in investment banking or capital markets arms of banks and financial institutions.[48] Fair treatment of consumers requires other approaches. Accordingly, the next part of this submission argues for governance changes to quarantine parts of an organisation which deal with wealth management for individuals and superannuation trustees from the more aggressive assumptions, attitudes and practices which may apply elsewhere in a conglomerate financial organisation. The following arguments are for the practical priority of 'stability and fairness' over 'efficiency' in the governance (and culture) of providers serving retail investors and financial consumers.

4.06 There is an important body of research about the absence of good governance and the failure of corporations. Since the GFC this insight has been applied to financial institutions, particularly to banks.[49] The lesson is that corporate governance – structures, processes, practices, purposes, expectations and beliefs – really matters to the stable continuation of an organisation. While evidence of the relationship between good governance and higher share price varies between studies, where institutional instability or financial failure is found, so virtually always is poor governance.[50] In a financialised consumer sector it is institutional stability and continuance and not share price which matters.

4.07 It is a common place governance requirement in the US financial sector for the holding company structure to be employed to separate banking from other business of financial groups.[51] In Australia this technique has been employed by Macquarie Bank since 2007 to separate its riskier investment banking and capital markets business from the banking business of Macquarie Bank Limited. Macquarie Bank is regulated by APRA as a bank under the Banking Act and other prudential regulation. That legislation prioritises prudence and stability because of the payments system and the systemic importance of banks. It regulates for a different risk profile from that of Macquarie Group's investment banking and

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Banking Standards *Changing Banks for Good* (12 June 2013) at: http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf especially at 22-23.This is also the gravamen of academic and regulatory opinion: H Mehran & L Mollineaux 'Corporate Governance of Financial Institutions' *Annual Review of Financial Economics* Vol. 4: 215-232 (October 2012) also at: http://www.annualreviews.org/doi/abs/10.1146/annurev-financial-110311-101821

[48] *ASIC v. Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963.
[49] Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis' Vol 2009/1 *Financial Market Trends* 1-30 (OECD 2009).
[50] Kirkpatrick, ibid; A Valukas *Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report.* New York, 2010: United States Bankruptcy Court Southern District of New York; HIH Royal Commission *The Failure of HIH Insurance* (April 2003) Vol 1, full report available at www.hihroyalcom.gov.au/finalreport/index.htm; J Coffee 'Financial Crises 101: What Can we Learn from Scandals and Meltdowns – From Enron to Subprime' *The Credit Crunch and the Law* (Ross Parsons Centre, University of Sydney, 2008) 36-56; H Davies, *The Financial Crisis: Who is to Blame?* (Polity, 2010) *passim;* R Tomasic 'Corporate Rescue, Governance and Risk-Taking in Northern Rock-Parts I and II' (2009) *The Company Lawyer* Vol 29:10 297 and Vol 29:11 330.
[51] R Jennings et al *Securities Regulation* (8th Ed, Foundation Press) 76-86.

capital markets activities. The holding company structure adopted in 2007[52] was adopted to manage the capital charges of banking which would otherwise have been applied to those aspects of Macquarie's activities that were particularly profitable but not considered part of the traditional business of banking.[53] The holding company structure addresses difficulties of using a bank conglomerate to undertake financial activities with differing purposes and risk profiles.

4.08 The conglomeration of a superannuation or wealth management business into a large provider, even if conducted in wholly owned subsidiaries, also raises differences of purpose and risk profile. While the Macquarie Bank example involved financial ventures riskier than the bank, operating a wealth management business for consumers *should* involve a business with a particular focus on stability, fair treatment of clients and placing their interests first. A thorough-going application of 'stability and fairness' along with 'efficiency' means this focus should apply from product design, through issue terms, to advice giving and distribution and onward to dispute resolution and compensation.

4.09 This submission argues for a holding company structure to separate wealth management and superannuation business from other activities of financial conglomerates. There is evidence that boards of engaged, expert and even independent directors may

'consider that his or her sole responsibility is to the shareholder. Supervisors are interested in other stakeholders like creditors, depositors, and the public. How do they ensure that boards and senior management consider the interests of other stakeholders? How do they align their interests—at least to some extent—with the goal of containing downside risk?'[54] Further, 'Opacity and complexity play a role in governance in both the interaction between the board and management and the relationship between the bank and its regulators'.[55] If the conglomerate shareholder has a high appetite for risk and commensurate return, then fair treatment of other stakeholders such as financial consumers who have no voice on the board, nor as influential block-holders or in the general meeting, may be disregarded.

4.10 The policy response suggested in this submission is to interpose a 'financial services holding company' in a conglomerate financial group. The financial services holding company would hold the equity in wealth management and superannuation entities operated by the group. Its directors would be

[52] See Macquarie Bank Limited *Explanatory Memorandum* (2007) at: https://www.macquarie.com/dafiles/Internet/mgl/shared/au-com/about/profile/docs/explanatorymemorandum.pdf for detailed explanation of reasons for and steps to be taken to restructure Macquarie Bank Limited to a holding company structure.
[53] Note 52 at 17.
[54] H Mehran, Alan Morrison & Joel Shapiro 'Corporate Governance and Banks: What Have We Learned from the Financial Crisis?' Federal Reserve Bank of New York, Staff Reports no. 502 June 2011 at 12: at http://www.newyorkfed.org/research/staff_reports/sr502.pdf .
[55] Note 54 at 5.

a majority of independent directors and not executives from the wider financial group.[56] The directors should discharge their fiduciary duty to the company they direct, and not give an overwhelming weight to the interests of the wider group. Section 187 of the *Corporations Act* would require amendment to make clear that the board of the financial services holding company and its operating subsidiaries should prioritise the interests of its immediate stakeholders not the financial conglomerate. An alternative to the amendment of Section 187 would be a legislative requirement that financial services holding companies and their subsidiaries include a clause in their corporate constitutions requiring them to prioritise the interests of retail investors and financial consumers over the interests of shareholders and creditors, especially if the latter are related party creditors. Superannuation, life insurance and managed investment scheme legislation already includes provisions to this effect in relation to super members, policyholders and scheme members.

4.11 Some submissions argue[57] that the multi-fiduciary decision-making imposed on directors by these types of obligations is too difficult. However the empirical evidence is clear that directors and trustees are constantly balancing interests.[58] 'Multi-fiduciary' is simply a fine-grained description of the central task of decision-making 'in the best interests of the beneficiaries' or 'in the interests of the company' which is what trustees and directors are already required by law to do. What the legislative prioritisation of financial investors and consumers or other 'APRA beneficiaries' does is to require directors to put those interests before those of the group shareholders. Given the concentration of ownership and vertical integration of the Australian financial sector, and the financial dependence of the wider conglomerate on the related party services and products supplied to 'APRA beneficiaries' and financial consumers,[59] it is difficult to see how 'stability and fairness' can be prioritised other than by a holding company structure and a legislative imperative to prioritise stakeholders. The fact of only one judicial decision concerning these provisions is not evidence of their ineffectiveness.[60] It is equally likely to be a testament to board compliance or to the endemic difficulties of enforcement in all regulatory systems, or both.

[56] The research cited above suggests that 'banks with busy bank executives serving as directors of other companies also do poorly.' Note 54 at 9.

[57] Eg the very thoughtful second round submission to this inquiry of the partners of Allens Linklaters.

[58] S Marshall & I Ramsay 'Stakeholders and Director's Duties: Law, Theory and Evidence' (2012) Vol 18 (No1) *UNSW LJ* (Director's Duties Forum) 29.

[59] Australian Securities and Investments Commission, Report 251 *Review of Financial Advice Industry Practice* (2011) 11-13.

[60] Allens Linklaters submission note 57 above.

4.12 Supposing a holding company structure and legislation to put the interests of stakeholders first were introduced: in what specific ways would this benefit investors and consumers? There is evidence that financial incentives in remuneration practices lead to over-risky decision-making undermining risk management controls.[61] Board and staff recruitment could prioritise purposes of service to retail investors, financial consumers and the public interest. A financial services holding company empowered to give more weight to client welfare could remunerate differently so as not to undermine a service ethic. Risk management settings and practices could likewise be more conservative.[62]

4.13 There are other benefits. The financial group business form is not only 'too big to fail' it is also often 'too complex to govern'.[63] A holding company structure addresses some of the opacity of size and complexity bought on by conglomerate business form. In the unhappy event of financial failure, resolution or insolvent administration of a holding company structure is more straightforward. Perhaps most importantly given the intense vertical integration of Australian financial groups, it makes more transparent the related party contracts and services to clients supplied by other companies in the group, and the distortions they may introduce. It is often pointed out for example that Australian retail funds have some of the highest fees in the world: if boards were freed to put super members, retail investors and financial consumers first this may improve. A structure which frees directors to discharge their individual duties solely to the company they direct and to put other stakeholders before shareholders, would allow the FSI's principle of 'stability and fairness' to be properly institutionalised in the governance, professional standards and the organisational 'culture' of financial services providers serving the financial citizen.

4.14 Eventually, the successful and confident participation of financial consumers and retail investors in financial markets requires a re-purposing of why financial services providers are involved. This has the ethic of fairness at its centre. There needs to be better developed and expressed the idea that the providers' role is a professional one: that they serve the interests of the financial consumer first, the public interest in stable, fair and efficient markets second, and their own interests in remuneration thereafter. The essence of the professional idea is the individual providing the financial service, authorised and supported by their licensee, has ultimate personal responsibility for seeing that this hierarchy of interests is discharged in the delivery of every transaction involving financial services and products. Their authority, their qualifications and training, but most importantly their personal belief in

[61] Note 57.
[62] Note 57.
[63] Mehan, note 54.

their professional purpose must be supported by the governance of the organisation through which they deliver products and services.

4.15 Finally, as a matter of both regulatory architecture and corporate governance, this submission supports the introduction of a limited financial services compensation scheme as mentioned above. It is acknowledged that the promotion of the adoption of a financial services holding company business form may require particular arrangements (such as cross-guarantees) to ensure that there is sufficient capital available for mass market consumer compensation if required. Between proper provision for the capital of such a holding company by the conglomerate, and a limited compensation scheme, compensation arrangements which do not rely only on insurance, should be introduced as an established feature of financial services business in the retail investment and financial consumer market in Australia.