FINANCIAL SYSTEM INQUIRY

An inquiry into the performance of the Australian Financial System.

Focusing on the Interest of the 'Financial Citizen' as Retail Investor and Financial Consumer.

A Submission by

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SUMMARY OF RECOMMENDATIONS

SUBJECT / TOR	RECOMMENDATIONS
Refreshing the philosophy, TOR 2.1	• Review the current philosophy of market intervention based only on 'market failure'; • Extend, from mainly disclosure, the types of 'market failure' that justify intervention eg market concentration and conflicts of interest; • On the basis of practically and legally compelled financial participation by ordinary investors, add fairness, as a justification for intervention; • On the basis of limited capability and behavioural biases in decision-making, add fairness, as a justification for intervention;
Consumer protection and risk allocation, TOR 2.2	• Accept that too much weight has been placed on disclosure in retail financial markets; • On the basis of limited capability and behavioural biases in decision-making and practically and legally compelled financial participation, adopt a more client facing definition of 'investor protection', replacing 'investor confidence' in S1 ASIC Act; • Take a more evidence based approach to expectations and capacities of financial consumers and regulate accordingly; • Accept that in retail markets risk may have to be allocated differently – more a perspective of *caveat vendor*, rather than *caveat emptor*.
Role of financial regulators including international comparison, TOR 2.5	• Retain the 'twin peaks' model of financial regulation, keeping the consumer interest in banking, insurance and investment products with single regulator: do not follow the US separation of consumer function; • Improve ASIC powers to promote co-regulation and professionalization; • Tighten up the existing licensee compensation and supervision arrangements and use licensing powers more vigorously; • Adopt a general last resort compensation scheme adopting the model in the St John Compensation Report (2012);
Changing consumer preferences and demography TOR 3.1	• Universalisation and financialisation of retail participation has changed the nature and calibre of investors, regulation needs to change too; • There is much more 'end user' holding of financial products in funds and regulation should correspond; • Greatly increased use of online information seeking and investing, and

	this should be taken account of in regulation too.
Meet user's needs with appropriate financial products and services TOR 4.3	• In line with international developments address industry concentration and vertical integration with regulation to not merely 'manage' conflicts of interest, but avoid them; • In line with international developments address complex products with new regulator powers for product intervention;

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 independent Chair of the Conduct Review Commission of the Financial Planning Association nor in her role as a member of the New Zealand Financial Markets Authority Code Committee.

The Interest of the 'Financial Citizen' as

Retail Investor and Financial Consumer.

I. Introduction and Terms of Reference

1.1 Terms of Reference (TOR) Addressed

The Financial System Inquiry (FSI) has asked for submissions on the performance of the Australian Financial System, with particular reference to Terms of Reference (TOR) issued in December 2013. This submission concentrates on the consumer interest of the 'financial citizen' as a retail investor and financial consumer. Importantly, this includes the 'financial citizen' as a member of a superannuation fund.

This submission therefore concentrates on the following Terms of Reference:

1. Refreshing the philosophy, TOR 2.1;
2. Consumer protection and risk allocation, TOR 2.2;
3. Role of financial regulators including international comparison, TOR 2.5;
4. Changing consumer preferences and demography TOR 3.1;
5. Meet user's needs with appropriate financial products and services TOR 4.3;

1.2 Background to This Submission

This submission is written against the general background of the Campbell Committee Report (1979-81) and that of the Wallis Committee (1996-97). Both of these reports took what might be described as a classical finance approach to the ability of the ordinary individual to access and use the Australian financial markets.

***1.3 Social Policy and Financial Markets*:** The Campbell Report took the general position that the financial sector was not the place for the delivery of social policy. Any assistance to individuals by way of redistribution of income or assets, should, it concluded, be undertaken through other arms of government and through the Budget. The Wallis Committee recognised that in other countries financial institutions are sometimes enlisted in the delivery of social policy (eg the US *Community Reinvestment*

Act). However, after some consideration of using regulation or other tools of governmental authority to deal with financial services in regional and remote or disadvantaged communities in Australia, it too concluded that imposing 'community service obligations' on financial institutions was inappropriate.

1.4 The Consumer and Investor Interest in Financial Markets*:* The Campbell Committee considered three main approaches in relation to the consumer and investor interest in financial markets. The first was to use the levers of monetary policy and exchange control management to maintain economic stability at a macro-economic level. The second was the use of prudential regulation for the safety and soundness of key banking and insurance institutions in which financial consumers might be depositors or policy holders. These two approaches were designed to provide a stable general economic and institutional environment for consumers. The third approach was the supply, not of more, but of higher quality and more timely financial information, in relation to specific transactions or products.

1.5 The Committee generally took an approach which analysed depositors, policyholders and company and collective investment scheme investors separately. At the level of entry to specific transactions there was however, an acknowledgement that all financial consumers and investors were entitled to the preservation of 'fairness and viability of financial markets' (para 44.2) and there was 'official responsibility for the protection of investors' (para 44.35). It was, the Committee thought, the responsibility of both the private sector and government to discourage 'misinformation' (para 44.36). Consumers and investors were entitled to 'reasonable protection from fraud and malpractice' (para 45.106). They should be able to expect 'fair and well informed markets' though it was accepted that 'disclosure requirements do not always represent a clear alternative to other forms of regulation.' (para 45.106)

1.6 The final conclusion was that many market failures were as a result of government intervention and an over-regulated financial sector. 'Only to a minor extent does [market concentration or absence of information] reflect imperfections or failures in the market process' (para 45.300). Additional competition would sort out many undesirable practices and deregulation and the entry of overseas intermediaries would boost competition. Further, in the retail sector the absence of informed and confident activity (shown for example by high balances in savings accounts) was thought to be 'largely one of apathy' by investors in relation to financial information (para 45.175) as much as it was the failure to supply information by intermediaries or government.

1.7 The Wallis Report concentrated on the philosophy behind and rationalisation of, the regulatory system. The Committee recognised that incoherence of principles for intervention and duplication, gaps and inconsistencies in law and policy were no help to financial consumers and investors. The

Committee observed that: 'financial assets and liabilities are increasing, implying that households now have greater exposure to the financial system than in the past.' (p77). With an aging population, individuals spending longer in education with greater 'variability in timing of income' (p85) the Committee thought that consumers would be looking for greater value and changing channels of distribution, product and supplier choice.

1.8 As household saving was moving 'away from traditional deposit products towards managed investment funds as preferred investment vehicles for these flows' (p 90) the Campbell reforms had been effective in shifting domestic savers out of banking products and into investments. Campbell had suggested improving information for financial consumers and investors, against the background of basic anti-fraud rules. The Wallis report's concentration on the structure of regulation bought a single disclosure regime for financial products to the centre of retail regulation. However, the Committee's fundamental philosophy about regulation bore remarkable similarity to that of its predecessor: market intervention through regulation was to be based on 'market failure' (p 177). While retail investors were deserving of 'protection', this would be delivered through disclosure and rules about 'market integrity'. There would be no 'government guarantee'. (p175). In its subsequent implementation, rules about 'market integrity' were anti-fraud and misleading statements and rules against market misconduct such as insider trading and market manipulation. Both reports assumed that adequate disclosure would result in informationally efficient markets and efficient capital allocation.

1.9 Although more deliberate in terms of philosophy and regulatory detail, the regulatory approach of the Wallis committee very was similar to that of the Campbell report. Both adopted a general bench-mark of 'investor protection' and sought to provide this through classic finance theory analysis of disclosure of financial information and prohibition of fraud and conduct that would mislead the market.

1.10 General Approach of This Submission

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. Too much regulatory weight has been placed on disclosure alone. Likewise, the persistent difficulties faced by all regulators in enforcement, suggest that putting too great a regulatory load on anti-fraud and market misconduct actions, is also an incomplete response. This general approach is elaborated in more detail below in relation to the relevant terms of reference.

2. Refreshing the Philosophy, TOR 2.1;

The general approach of this submission is to argue that by contrast with the prior reports the FSI refresh Australia's financial regulatory philosophy with the *addition* of considerations of fairness in the light of:

***2.1 The presence of market failures other than information failures**:*

Past inquiries have identified information market failures as virtually the sole justification for retail regulation (given that prudential regulation is mostly justified by Campbell and Wallis as supporting systemic stability and incidentally protecting consumers). This is one of the reasons for the heavy use of disclosure.

2.2 The Australian retail market has other important market failures such as high market concentration and related entity transaction links, especially in the advisory portion of the value chain from issuer to client. Australia is not alone in this market feature.[1] This vertical integration results in conflicts of interest, and there is evidence of very high concentration of product recommendations. Recent Australian Securities and Investments Commission, reports review this evidence. [2]

2.3 A related market failure is the variable quality of Australian financial advice: the regular 'shadow shopping' reports by the Australian Securities and Investments Commission make this very plain, especially in crucial areas such as superannuation advice. Some of the largest enforceable undertakings entered by house-hold name financial institutions with the Australian Securities and Investments Commission in the last decade or more make the same point in relation to literally tens of thousands of retail accounts.

2.4 The market failures have been in under investment in training and supervision, and recruitment practices which recycle unsatisfactory authorised representative businesses and individuals from one licensee to another. Narratives and values of individual adviser responsibility for client advice (professionalization) have been undermined by remuneration incentives driving a 'distribution culture' in a concentrated sector with high incidence of related entity transactions.

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[1] A Hung et al, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* (2008 Rand Institute for Civil Justice, sponsored by the SEC) concluded in the US 40% of broker/dealers either directly or indirectly, control, are controlled by or are under common control with a firm involved in securities advisory work – firms reporting such affiliations play a disproportionately large part in the market p xvii.

[2] Australian Securities and Investments Commission, Report 251 *Review of Financial Advice Industry Practice* (2011) 11-13 provides a review of this evidence.

2.5 These market failures clearly require regulatory responses other than disclosure: mandated improvement in training and conduct standards and a national examination would bring Australia into line with comparable countries. The Future of Financial Advice (FOFA) reforms have gone some way to dealing with concentration and conflicts of interest: the 'best interests' and 'client first' tests and curbs on conflicted remuneration, give grounds for optimism. However, unless the values embedded in these rules are internalised by individual advisers through greater professionalization (higher standards for entry, training, supervision, discipline and exit) they will remain 'regulation on the page' and not 'regulation in action'.

2.6 'End – User' Products and Information Efficiency:

Both prior 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'.

2.7 This development means that the philosophies behind disclosure regulation must likewise adjust. While maintaining information efficiency in secondary markets is central, the disclosure to individuals at point of sale of many 'end-user' financial products has other purposes and justifications, as well as price discovery. Markets in 'end-user' products are characterised as much by 'supply side' decisions where product disclosure is irrelevant to price, as 'demand side' price setting. 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, 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).

2.8 The evidence of incapacity in financial consumer/retail investor decision-making:

This evidence has emerged in the last 20 years, demonstrating deep deficiencies (50% of the population cannot calculate a percentage accurately) in financial literacy in large portions of the population. The research demonstrates particular illiteracy in response to disclosure, especially in relation to risk disclosures[3] and fees and charges.[4] There is further evidence about biases and short cuts adopted in financial decision-making revealed by research in behavioural finance. These biases and short cuts can distort investor decision-making and also the judgment of advisers. A very short survey of the evidence of this financial consumer/retail investor behaviour is set out below in response to TOR 2.2.

2.9 Here it is sufficient to say that the more recent research shows that the deficiencies in decision-making go beyond the apathy remarked on by the Campbell Committee and the diagnosis of information based market failure: further or better presented disclosure is unlikely to remedy these cognitive deficiencies. While it may be the case over a long period that financial illiteracy rates can be improved, there is much less optimism about reversing the inherent distortions most people suffer in making decisions under uncertainty. Accordingly, the FSI will need to find other justifications for regulatory interventions in mass markets showing these difficulties. More fundamentally, the FSI might develop additional philosophies for retail regulatory intervention if as the FSI might reasonably conclude, it is not useful to call inherent human biases 'market failures.'

2.10 The legal and practical compulsion of 'financialisation' of every day welfare needs*:*

As noted above both Campbell and Wallis rejected justifications for regulatory intervention, other than market failure. The Campbell Committee was most direct: it dismissed markets as appropriate for providing financial assistance (welfare transfers through discounts or cross-subsidised services) to the poor and disadvantaged (para 41.31).

2.11 By the time of the Wallis report, there had begun a major change in approach to the provision of retirement income to citizens, being the Superannuation Guarantee legislation of 1992, and the extension of retirement investment accounts to all employed Australians. In contrast to the circumstances in which the Campbell Committee reported, from 1992 there was massive engagement

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[3] See Hamilton, Jenny and Gillies, Lorna E. (2003) 'The impact of e-commerce developments on consumer welfare - Information disclosure regimes' *Journal of Financial Regulation and Compliance*, 11 (4). pp. 329-348, at 332

[4] A Hung et al, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* (2008 Rand Institute for Civil Justice, sponsored by the SEC) at xix and 87; I Ramsay, *Disclosure of Fees and Charges in Managed Investments* (ASIC commissioned report, September 2002) at 47 and passim.

of the private sector financial markets in the 'financialisation'[5] of welfare transfers (foregone taxation revenue) from government. There was also recruitment of the financial sector into the management of retirement income through mandated superannuation savings. This 'financialisation' (use of the financial system to supply welfare for everyday life) extended (for some) to insurances for health and disability, saving and investment for education. As Wallis pointed out, another aspect of 'financialisation' was the increased use of house-hold debt in the smoothing of income over a life cycle (p85). Overall the Wallis Committee concluded:

> 'As a consequence of these trends, Australian households now rely more on the financial system and have greater exposures to particular financial service providers and to the financial system generally. This trend heightens the importance of the overall efficiency and safety of the financial system. A further important implication is that, with greater financial wealth, households will tend to shift their preferences towards the higher end of the risk-return spectrum, with a consequent shift towards managed funds and holdings of market linked investments and away from holdings of deposits and other low-risk products.' (p186)

2.12 It is the argument of this submission that this mandated 'financialisation' of the relationship of the citizen and government in welfare provision, combined with what we know about the capabilities of the financial consumer, justifies regulatory intervention on grounds other than market failure. In many respects, particularly with mandated superannuation, ordinary Australians have now become 'financial citizens'. The restructuring of their relationship with the state to include participation in financial markets has now become part of their identity as a citizen. Those who cannot or do not participate,[6] or for some reason do not succeed in financialised self-provision, risk being seen as lesser citizens, or non-citizens.[7]

2.13 Investor Protection as Fairness

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[5] Palley T 'Financialisation: What it is and Why it Matters' (2007) Working papers The Levy Economics Institute, No. 525; Palley T, *Financialisation and the Financial Sector* (2013) *passim.*

[6] The Centre for Social Impact for National Australia Bank, *Financial Exclusion in Australia* (June 2013) at http://www.financialliteracy.gov.au/media/465159/nab_csi_measuring_financial_exclusion_in_australia_2013.pdf reports that 17.7% of the Australian population was completely or severely financially excluded in 2012. This figure comprises 1.1% of adults who were fully excluded (they had no financial services products) and 16.6% of adults who were severely excluded (they only had one financial services product). This represents an increase from the previous report, which identified 17.2% of the population as being either fully excluded or severely excluded in the 2011 data:

[7] Hohnen, P and Hjort,T 'Citizens as Consumers: A Discussion of New Emergent Forms of Marginalisation in Nordic Welfare States' (2009) 11(3) *European Journal of Social Security* 271-290.

In essence, fairness is the capacity to recognize the circumstances, perceptions or values of another. [8] It has many meanings from the everyday and prosaic, to overarching norms which reflect humanity in its finest aspirations. So, fairness has been the foundation of theories of justice which argue for keeping in mind the least well off, and adjusting economy and society, consistent with liberty for all, to operate for their benefit.[9]

2.14 In financial markets fairness tends to be writ smaller, and does not have the redistributive purpose of theories of 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.[10] In general too, fairness is not required to be perfect, but is an approximate notion, a 'rough' or 'good enough' fairness.[11] 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.

2.15 This submission argues for a philosophy of fairness as one important foundation of investor protection. Behavioural and literacy research demonstrates that the financial citizen is at a disadvantage in using the financial markets for financial self provision, against a civic background of being compelled to be a financial consumer. This disadvantage is particularly marked when there is heavy reliance on disclosure, unequal bargaining power through institutional concentration and standardised product terms in mass markets. Until now, regulation justified by market failure alone has not remedied these difficulties. 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'.[12] 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.

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[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] J Rawls, *A Theory of Justice* (HUP, 1971; rev. edn, 1999) *passim*.
[10] Kingsford Smith, D 'Can There be a Fair Share? Fairness, Regulation and Financial Markets' in Sarra ed. above note 8.
[11] J Q. Wilson, *The Moral Sense* (Free Press, 1993) 62.
[12] Financial Conduct Authority, Applying Behavioural Economics at the Financial Conduct Authority (April 2013) at www.fca.org.au at 21

2.16 Although the philosophy of fairness as a justification for investor protection is not as well recognised as market failure, it is gaining support in overseas regulatory regimes, particularly since the GFC. For example in the US the new Consumer Finance Protection Bureau established under the Dodd-Frank Act has as one of its objects that consumer markets are 'fair, transparent, and competitive'.[13] In the UK the Financial Conduct Authority administers a program of six cross-cutting principles aimed at all aspects of financial consumer business treating customers fairly.[14] The expectation that providers treat customers fairly is not an optional consideration: it has come to the heart of investor protection regulation of retail customers, particularly in times of financial austerity.

2.17 The rest of this submission makes some concrete suggestions for changes to regulatory approach and use of regulatory tools in retail markets for the protection of the 'financial citizen'. Some of these can rightly be made on the basis of market failure. Some however, cannot be so justified. So, this submission argues for those changes on the basis of philosophies of fairness and mutual obligation which should also underlie investor protection. It does so deliberately, based on a contemporary understanding of what it means to be a citizen in an age of financialised welfare provision.

[13] 12 U.S.C. § 5511 (Dodd-Frank Act § 1021).

[14] The Financial Conduct Authority has recently renewed its commitment to the program of 'Treating Customers Fairly' initiated by its predecessor, see FSA, 'Treating Customers Fairly: Towards Fair Outcomes for Consumers' (July 2006) at: http://www.fca.org.uk/static/fca/documents/fsa-tcf-towards.pdf

3. Consumer Protection and Risk Allocation, TOR 2.2;

3.1 The 'financial citizen' as investor and allocation of risk:

As the authors of the Wallis report observed in the quote above, 'with greater financial wealth, households will tend to shift their preferences towards the higher end of the risk-return spectrum, with a consequent shift towards managed funds and holdings of market linked investments and away from holdings of deposits and other low-risk products.' Indeed, as we have observed, all employed Australians now must become superannuation investors, and so by comparison with simple financial products such as bank accounts, have seen their financial portfolio shift towards the higher end of the risk-return spectrum.

3.2 The variety of retail investment products has increased greatly, and so has their complexity and risk.[15] Many retail investors rely on 'packaged products' managed by intermediaries, for they do not have the resources to invest directly. These are particularly opaque investments where even advisers have not understood exactly the terms of the product and its behaviour in differing market conditions. Disclosure is a disappointment as a regulatory constraint on unprofessional conduct in the marketing of 'packaged products' because of their complexity and opacity. 'Structured products' have the same difficulties and are even riskier, as they commonly use derivatives in the underlying interests that make up the product. As was the case in Storm Financial margin lending is another technique that ordinary investors may not understand fully because of its relative complexity of operation. It too, adds significant risk to an investor's position.

3.3 The Wallis report was unequivocal that prudential regulation should not extend across the entire financial sector, and should not amount to a government guarantee (p175). Accordingly, while some bank deposits are guaranteed, investments in superannuation are not, and neither are the myriad of other investments offered to the financial citizen. The restructuring of citizenship through financialisation has the effect of 'pushing down' risk to the individual,[16] because that is where the final loss is allocated. The allocation of risk to individuals is of both alpha and beta risk, the latter being market risk about which even the most well informed and diligent financial citizen can do virtually nothing, and which can be devastating as the GFC demonstrated.[17] In Australia there is no general financial compensation scheme to alleviate the allocation any of this risk. The question then becomes, what response should there be to the allocation of significantly greater risk to ordinary individuals, some of it compulsorily?

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[15] ASIC '*Regulating Complex Products'* Report 384 (January 2014).
[16] Gray, J & Hamilton, J *Implementing Financial Regulation* (Wiley 2006) *passim*.
[17] ASIC , Report 240 *Compensation for Retail Investors: the Social Impact of Monetary Loss* (May 2011).

The answer argued for in this submission is a wider group of regulatory techniques than disclosure, and in some contexts, resort to an investors' compensation scheme.

3.4 Consumer and Investor Protection

Since 'financialisaton', the allocation of risk to households and the preservation of 'investor protection' are generally bi-partisan political policies in Australia, it is important to understand to what degree consumer and investor protection provides a constraint on the risks allocated to households.

3.5 The first modern version of 'investor protection' appeared in the Securities Exchange Act legislation in the US, after the great depression. It was a regulatory policy to protect ordinary investors from conmen and sharpers, and mostly reliant on disclosure. In the US states investor protection also had a 'merit regulation' element. This gave state regulators what we would now recognise as something between a 'stop order' power[18] and 'product intervention' powers[19] to require that products being offered were appropriate in a general way for target investors.

3.6 In Australia this general approach to investor protection was adopted in the post-WWII years. Disclosure was central though some disclosure such as prospectuses were vetted by the regulator (until the late 1990s). In the area of prescribed interests issued by unit trusts, there were also powers to refuse to register constituting documents, if the product was not generally appropriate to those it was being marketed to.

3.7 The two decades before the GFC saw a toughening stance on the meaning of 'investor protection'. In Australia the legislation was changed so that instead of promoting 'investor protection' ASIC was mandated to promote 'investor confidence' (on the basis of disclosure and market integrity).[20] In the US[21] and the EU[22] there was a parallel shift in meaning as market facing approaches of financialisation became more common and devolved risk to households.

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[18] Regulator's power to order a stop on distribution of a prospectus – see s739 *Corporations Act*.

[19] See below paragraph 6. 4

[20] S3(2) Australian Securities Act 1989 provided at para (b) for the regulator 'to maintain the confidence of investors…by ensuring adequate protection for such investors.' In 2001 this aim was altered to read regulator should 'promote the confident and informed participation of investors and consumers in the financial system.' Note new inclusion of financial 'consumers' along with investors.

[21] Black, B 'Behavioural Economics and Investor Protection: Reasonable Investors and Efficient Markets" (2012-2013) *Loyola University Chicago Law Journal* 44, 1493 at 1494-5 who writes: 'Thus courts tell us that reasonable investors 'can do the math' to figure out the financial bottom line ...courts expect reasonable investors to have an awareness of general economic conditions, and to understand the principle of diversification, the time-value of money, the nature of margin accounts and the security industry's compensation structure.'

[22] Maloney, N, *How to Protect Investors* (2010) 92 and Ch 2; Maloney argues that before the GFC, the identification of the typical retail investor was as a consumer of financial services but a 'consumer' who was empowered and confident.

3.8 Eventually however Maloney reports that in the EU a more consumer facing interpretation of investor protection was adopted, which did not make such robust demands of the ordinary investor.[23] In the US since the GFC there has been greater concentration on 'financial consumer protection' with the establishment of the Consumer Financial Protection Bureau.[24] However, this Bureau does not regulate 'investors' who are still within the scope of the Securities Exchange Commission. In Australia since the GFC there have been a few superior court judgments that seem to confirm a more investor leaning interpretation of 'investor confidence'[25] though the conduct of the defendants is so egregious, it is difficult to be definitive.

3.9 At this point in the argument, it is appropriate to turn to what we know about investor and financial consumer literacy and behaviour in financial decision-making under uncertainty in financial matters, or behavioural finance as this area of psychological research has become known.

3.10 Investor and Financial Consumer Literacy and Decision-making Behaviour

The OECD defines financial literacy as 'a combination of financial awareness, knowledge, skills, attitude and behaviours necessary to make sound financial decisions and ultimately achieve individual financial wellbeing.'[26] The financial citizen who is literate will be confident and empowered to use disclosure in an orderly market bringing quite advanced decision-making skills to bear in rational analysis of a variety of financial information and taking into account their personal preferences. While this is the ideal, the reality is that most individuals have few if any of the skills and basic knowledge for good financial decisions: this is a global finding.[27] The problems range from basic budgeting through to advanced decision-making and if the average financial citizen learns at all from financial experience, it is very slowly.[28] Education programs at all levels of the population have failed to give a clear answer to

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[23] Maloney above note 22 at 70ff.

[24] The bureau's main functions include conducting financial education programs; collecting, investigating and responding to consumer complaints, and researching and monitoring areas of the financial markets that affect consumers: Dodd-Frank Act § 1021(b).

[25] *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq) [2012] FCA 1028 (21 September 2012); Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200;*

[26] Atkinson, A. and Messy, F-A., 'Measuring Financial Literacy: Results of the OECD INFE Pilot Study', OECD Working Papers on Finance, Insurance and Private Pensions No. 15 (2012).

[27] See, e.g. Lusardi, A. and Mitchell, O. S. 'Financial Literacy around the World: An Overview' (2011) 10(4) *Journal of Pension Economics and Finance* 497; Australia and New Zealand Banking Group Limited, 'Adult Financial Literacy in Australia (2011); Australian Securities and Investments Commission, Report 230: Financial Literacy and Behavioural Change (2011); Atkinson, A. et. al., Levels of Financial Capability in the UK: Results of a Baseline Survey, Financial Services Authority (2006)

[28] Gervais, S. and Odean, T. (2001), 'Learning to Be Overconfident' (2001) 14 *Review of Financial Studies* 1.
Glaser, M. and Weber, M. 'Why Inexperienced Investors Do Not Learn: They Do Not Know Their Past Portfolio Performance' (2007) 4(4) *Finance Research Letters* 203).

the question of whether they improve financial skills:[29] whether financial literacy programs help is something we will only discover on a generational basis.

3.11 Some argue that the equivocal results of literacy education are due to the virtually indelible effects of biases and heuristics (short cuts) that behavioural psychology research has revealed. The clutch of behaviours most identified in this research, when translated to the investing context, has become known as behavioural finance. Theoretically, the strongest learning of the research is that the 'rational' decision-maker model of classical finance is just that: a model. The empirical research does not support the model, instead it reveals a population of financial consumers and investors who make decisions in ways that bear little relation to the information they receive in disclosure. There is an array of these biases and heuristics that have been identified in research in differing contexts, but the three path-breaking and enduring heuristics (short cuts) used by consumers are the availability, salience and the anchoring heuristics.[30] The most prominent biases are those of over-confidence, risk tolerance, social influence and framing effects.[31] Online trading tends to augment the effects of at least some of these behavioural tendencies.[32]

3.12 The recognition of this research professionally and by regulators has taken three decades, and still there is limited understanding of exactly how it might be used to improve the position of financial consumers and investors.[33] Although at present behaviouralism gives only some insights as to how to regulate better, rather than a single or set of policy directions, there is one clear message: the expectations of the financial citizen in the 20 years prior to the GFC have been pitched too high. Particularly in relation to investment risk (as opposed to financial products with no investment element) the financial citizen who is compelled to be in the financial market deserves greater support from law makers and regulators.

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[29] Financial Services Authority, *Evidence of Impact: An Overview of Financial Education Evaluations*, Consumer Research Report 68 (2008).
[30] Kahneman, D. and Tversky, A., 'Judgment under Uncertainty: Heuristics and Biases' (1973) 185 (4157) *Science* 1124.
[31] Kahneman, D. and Tversky, A, note 22 above, though there is a wealth of other research since this path-breaking publication. For a more detailed account of this literature, see Kingsford Smith, D and Dixon, O 'The Consumer Interest in Financial Markets' (Ch 25) in Maloney et al, *The Oxford Handbook of Financial Regulation* (2014) forthcoming.
[32] Barber, B. M. and Odean, T., (2001), *The Internet and the Investor*, 15 JOURNAL OF ECONOMIC PERSPECTIVES 41.
[33] Financial Conduct Authority, Applying Behavioural Economics at the Financial Conduct Authority (April 2013) at www.fca.org.au;

4. Role of Financial Regulators Including International Comparison, TOR 2.5;

4.1 Regulatory Structure, Financial Consumers and Investors

The 'twin-peaks' regulatory structure introduced on the recommendation of the Wallis Committee has served Australia well. The division between 'prudential' and 'market conduct' regulatory styles institutionalised in APRA and ASIC, has been more resilient than either the extreme fragmentation of regulatory structure seen in the US, or the single regulator approach exemplified by the now disbanded Financial Services Authority in the UK.

4.2 In both the US and the UK, and increasingly else-where there is beginning to be an understanding that the consumer interest in financial markets needs regulation on different principles or regulatory philosophy, to that of the wholesale markets. This point is made above in response to TOR 2.1. This different philosophical approach has been in terms of regulatory structure, institutionalised in the US by the establishment of the Financial Consumer Protection Bureau and in Canada, through the creation of the Financial Consumer Agency of Canada.[34]

4.3 The market conduct function that the UK Financial Conduct Authority regulates is more in line with the legislative mandate of ASIC. The Financial Conduct Authority regulates both the wholesale and consumer markets in relation to market conduct – its sibling the Prudential Regulatory Authority, regulates the prudential function, much like APRA. The Financial Conduct Authority's mandate is also more like ASIC's because both regulate the financial consumer interest not only in banking, credit and insurance products, but also in investment products. The new US Bureau and the Canadian Buraeu by contrast regulate consumer credit including home mortgages, student loans, credit cards, and services provided by other financial corporations. Unlike the Financial Conduct Authority and ASIC, neither jurisdiction in relation to investment products, including shares. These, including in their consumer aspects, remain regulated by the SEC and the Canadian provincial securities regulators.

4.4 As already discussed in relation to TOR 2.1, a leading characteristic of consumer financial markets is that many of the products are sold to an end-user, who keeps them for their term, or they are redeemed by or on behalf of their issuer. Although having an investment component, interests in managed investment schemes, 'packaged products' or 'structured products' are often not traded and

[34] Financial Consumer Agency of Canada regulates the consumer interest in relation to banks, credit unions, insurers, retail outlet credit providers see: http://www.fcac-acfc.gc.ca/eng/pages/home-accueil.aspx

there is usually no secondary market, by contrast with shares or bonds.[35] More retail investors hold these funds based products than ever before, instead of holding shares directly. The point is that this 'end-user' characteristic gives many retail investment products consumer aspects like banking, credit and insurance products.

4.5 This growing assimilation of the end-user aspect between financial products, including those with an investment component, argues against the separation of the consumer banking, credit and insurance interest, from the consumer investment interest, in terms of regulatory structure. It makes more sense to retain the functional approach to the regulation of market conduct, which is a legacy of the Wallis regulatory architecture. This approach which has been adopted in the UK, has much to recommend it in terms of regulatory consistency, coverage and co-ordination. The US institutional approach of splitting the regulation of the consumer interest in investment products (SEC) from banking and credit (FCPB) fragments the regulatory effort and is likely driven by political obstacles to changing historical arrangements. For these reasons too, and given that there is increasing convergence between various consumer investment products, it is desirable to keep the regulation of directly held securities with the regulator of the general consumer interest.

4.6 Co-regulation, Self-regulation and Professionalisation

A particular aspect of regulatory structure, is the presence of self-regulatory organisations (SROs) in co-regulatory strategies with the state regulator. As Carson points out,[36] while securities exchanges are the most frequently appearing form of SRO, there is a spectrum of SROs. Internationally, these range from SROs with a purely regulatory mandate[37] through exchange-related SROs,[38] to professional or industry associations which may conduct private regulatory functions[39] while remaining lobbyists for the industry sector it represents.

4.7 Co-regulation is where a state regulator works closely with an SRO, often within a legislative framework, giving the state regulator powers to approve SRO rule changes, conduct and publish

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[35] As with everything there are exceptions: some managed investment schemes are listed, there are 'exchange traded funds' and exotic interests such as 'stapled securities' which are interests both in a fund and a share, the latter of which is traded.

[36] Carson J, *Self-Regulation in Securities Markets* (World Bank, 2010)

[37] Eg Financial Industry Regulatory Authority (FINRA) in the US which has no exchange operation responsibilities, and is closely supervised by the SEC.

[38] Eg Australian Securities Exchange, which conducts the exchange, and also regulates authorised market participants of the exchange, though its prior responsibilities in relation to insider trading and market manipulation have now moved to ASIC.

[39] Eg Financial Planning Association of Australia: it has a code of conduct, some supervisory capacity, an investigation function and a disciplinary tribunal which publishes its determinations.

periodic reviews of SRO effectiveness, and even direct aspects of SRO governance[40] and action. The ASX is in a co-regulatory arrangement with ASIC. Co-regulation may be established through legislation or through the authorisation of codes of conduct which meet particular standards,[41] though in the Australian financial services regulation no codes have as yet been authorised by ASIC.[42]

4.8 An alternative is for state regulators such as ASIC to encourage closer co-ordination with professional or industry associations: a more informal version of co-regulation. This can be promoted through the use of a Memorandum of Understanding between the regulator and association specifying the ways in which they would co-operate and share regulatory functions and information.

4.9 The benefits of co-regulation include increase in the level of regulatory resources that can be applied to the work of regulation; having the SRO on the 'front line' of regulatory tasks allowing the regulator to concentrate on more systemic and strategic matters; bringing industry knowledge to bear on 'front line' tasks, and having trends and developments of 'systemic significance' reported to the regulator; improving the training and continuing professional development of association members and devolving to the SRO the conduct of entry level/registration examinations as most associations already have a considerable education function. Checks and balances on the over-centralisation of state regulatory power can be an advantage, especially if new, fresh regulatory ideas come from associations. A good example of this is the regulatory foresight and courage shown by the leadership of the Financial Planning Association of Australia in having rules to ban commissions and require their members to 'put clients first' years before this was legislated for by the Commonwealth Parliament in the Future of Financial Advice (FOFA) reforms. Indeed, it might be argued that the FPA changed the 'norms' of at least some financial advisors, and showed that businesses could still thrive, making the FOFA reforms politically possible.

4.10 The drawbacks of co-regulation include fragmentation of the regulatory structure as evidenced in the US and Canada where SROs are used most. European regulatory arrangements have largely retreated to state regulators, though this may be a response to the fragmentation which exists at the European Union level. Conflicts of interest between the public interest and the industry interest, and between the members themselves, are an endemic difficulty of SROs, particularly in relation to supervision and enforcement. 'Competitive destruction' in a 'race to the bottom' in conduct standards and laxity of enforcement can be a problem if an SRO does not have a regulatory monopoly of the area

[40] Government Accountability Office, *Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority* (GAO-12-625: May 2012).
[41] Section 1101A *Corporations Act*.
[42] No codes have been registered despite the Wallis report's optimism, Wallis report, 259

it is regulating, and membership is voluntary. Volatility of revenues and unpredictable increases in expenses, can unsettle or even debilitate associations or SROs in a fashion that reliance on public taxes generally avoids for state regulators.

4.11 A professional or industry association or SRO needs institutional co-ordination with the regulator (however formal) to be successful in contributing to the regulatory load. To be fit to address the drawbacks, and take advantage of the benefits of co-regulation, associations need to attend to a number of matters internal and external. They need to adopt public interest objects so they can act in the public interest as well as their members' professional interest. Ideally they should adopt a corporate business form so that the decisions of their board and management are independent from the membership. They need to appoint independent members to their board, ideally including members from consumer peak bodies. They should have an independent, expert, professional staff, answerable to the board. There should be transparency of governance and management of conflicts of interest. Revenue sources should be diverse so as not to be concentrated on a few large members. In relation to discipline and enforcement there should be arms length arrangements to ensure independence and confidentiality of process and publication of final determinations.

4.12 The GFC has demonstrated that state regulatory rules and enforcement alone, have failed to instil in significant numbers of individuals in the financial services sector, an ethic of client service and care. So long as norms of state regulation set the underlying principles, co-regulation with an SRO promoting professionalism, can help individuals (say, financial advisers) to 'internalise' professional client facing norms. The professional association may provide a personal ethic of service combined with peer legitimacy that a state regulator cannot. An SRO may also be freer to do what Braithwaite and Drahos call 'regulatory entrepreneurialism':[43] advocate for new or higher standards that can give the SRO members comparative advantage in client fidelity, and eventually commercial advantage because of it.

4.13 This submission argues that FSI should investigate ways in which the benefits of co-regulation in the Australian financial sector could be promoted and regulatory structures arranged to reduce the drawbacks. It should recommend that regulators put in place arrangements to promote co-regulation such as Memoranda of Understanding. Regulators may need to be given additional powers to implement this co-regulation.

[43] Braithwaite J and Drahos P, *Global Business Regulation* (CUP 2000) Ch 2&4.

4.14 Dispute Resolution and Compensation

An important part of the regulatory structure is dispute resolution and compensation for financial consumers. In all leading jurisdictions there are alternatives to the courts for the resolution of retail financial services disputes.[44]

4.15 The current position in Australia is that most disputes against financial services providers not satisfied internally go to the Financial Ombudsman Service. Over half of these are resolved in favour of the provider. The question considered in this part, is what happens to the determinations made in favour of the client when they are not paid by the provider? The further question is: what should happen if a determination is not paid by the provider?

4.16 In all comparable jurisdictions and Australia there is a combination of techniques used in an attempt to ensure that providers can pay compensation when ordered or agreed. Capital requirements for prudential institutions, insurance for providers with few capital requirements (eg financial advisers) and in some places sector wide compensation funds,[45] combine to provide some coverage. More usually compensation funds are limited to losses between particular parties, for example Australian Securities Exchange members and their clients.[46] In Australia there is also The Financial Claims Scheme (FCS) for depositors and policyholders, [47] and a scheme for compensating superannuation fund members where there is fraud or theft.[48] There is no general compensation fund that covers products with an investment component, such as managed investment schemes, 'packaged' or 'structured' products or directly held securities. As a result there is unevenness in compensation coverage: if a 'packaged' product is acquired from a prudentially regulated provider (eg a bank subsidiary) it is more likely that a compensation order will be paid than if it is obtained against an adviser with limited insurance, or a share in a non-financial issuer, where there is no requirement for prudential capital at all.

4.17 The practical position is that the financial citizen may, through no fault of theirs, find that fraud or mis-selling[49] or the failure of the product[50] remains uncompensated because either the issuer or the adviser is

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[44] Financial Industry Regulatory Authority (FINRA) in the US; Financial Services Ombudsman (FSO) in the UK. Since the 2012 amendments to the Financial Services Act in the UK, determinations are routinely published by FSO on its website. FINRA publishes arbitral awards, without reasons or appeal, also on its website. However, there is no capacity to browse FINRA awards, unless one has the matter number, which usually only the parties and their advisers, would have.

[45] The Financial Services Compensation Scheme, in the UK.

[46] In Australia, the National Guarantee Fund (NGF) http://www.segc.com.au/>; In U.S., the Securities Investor Protection Corporation (SIPC) http://www.sipc.org/who/who.cfm

[47] FCS is a last resort scheme for depositors or policy holders losing money on the insolvency of an Australian authorised deposit taker or insurer regulated by APRA.

[48] Under the *Superannuation Industry (Supervision) Act*, 1993, Part 23.

[49] Mis-selling is a compendious description of a bundle of legal wrongs that occur at point of sale: misleading statements, unsuitable recommendations, conflicts of interest and over-charging in fees and charges. These may be by the issuer or its agents, or by advisers.

[50] Failure of the product occurs for a number of reasons, but can be because of changes in tax laws, changes in credit availability, a run on redemptions, freezing of redemptions and the like. Not always, but regularly, the product provider fails as a consequence.

insolvent, or has disappeared. In these circumstances the loss is not due to the investment risk the financial citizen has agreed to take on, but risks outside that scope, or risks that they have been misled about, or have not properly understood. The latter may be because the product features or risks involved are too complex for a like investor to understand, or they have not been explained in a fashion that an investor of that capacity is likely to understand. Given that the financialisation of personal household provision is practically and in some cases legally compulsory, and given what we now know about ordinary investor capacity and the biases and heuristics of decision-making, this seems a harsh outcome.

4.18 This submission agrees with the Richard St John report into financial compensation written in 2012, that much more should be done to strengthen insurance as a compensation mechanism, and its tie to the maintenance of a licence-holder in the financial sector.[51] It is also important to recognise the importance of the current policy discussion by APRA about increasing the prudential requirements of superannuation providers, and that the vulnerable and compelled position of the financial citizen is given proper consideration in the development of that policy. These two points make the argument, that other techniques should also be used and the expensive tool of compensation schemes should be a last resort.

4.19 Eventually however, the financial citizen is investing in a mass retail market. One of the leading difficulties of compensation in such a context, is that mis-selling or product failure usually occurs at scale: unlike in the past where only a few persons were generally effected, now hundreds or even thousands of financial consumers can lose funds through a virtually identical product or advisory strategy. As insurance has claim limits and excesses, such a mass occurrence can easily exhaust insurance provision. Then, in the absence of other resources, a provider may become insolvent. This is one of the consequences of the deliberate policy of financialisation.

4.20 It is noted by St John in his 2012 report, that some determinations of the Financial Ombudsman Scheme, remain unpaid in large amounts.[52] This is seems to be largely where licensees have become insolvent and there are no assets to meet the determinations. The Report notes FOS estimates of $12 million per annum of the amount that a compensation scheme might pay out.[53] This figure does not account for extra claims that might be made if claimants thought actions more worthwhile pursuing because there were funds to meet them. Nor does it account for fewer claims that might be made, if ASIC tightened up the administration of compensation arrangements across the board, and used its licensing powers more vigorously, as the Report also advocates.

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[51] St John R, *Compensation Arrangements for Consumers of Financial Services* (Australian Government 2012); the recommendations in this respect, can be found in the final chapter of the report. The matters which need to be addressed, and read as a 'laundry list' of deficiencies are set out in the report at p27-29. See also Kingsford Smith, D 'Financial Services Regulation and the Investor as Consumer' in Ramsay, Howells et al (ed) *The International Handbook of Consumer Law & Policy* (2010) Ch 27.

[52] St John, *Compensation Arrangements*, note 51 above, 40ff.

[53] St John, *Compensation Arrangements*, note 51 above, 41-44.

4.21 Finally, the St John Compensation Report does not discuss the possibility that fewer claims for compensation would be made if there were changes to the law to give the regulators product intervention powers. These are powers to require product providers to amend the features or terms of products or withdraw them, if they are not generally suitable (eg too complex, or too risky) for the class of investor to whom they are to be offered. The Financial Conduct Authority in the UK has such powers, and they are in line with the research and policy discussions we have canvassed above, about the capabilities of retail investors. They are one of the developments in regulatory policy the FSI might consider, and the idea is considered further in relation to TOR 4.3 below.

4.22 The Powers and Performance of ASIC

The author of this submission made a comprehensive submission to the Commonwealth Senate, Economic References Committee, on the performance of the Australian Securities and Investments Commission. It is submission 154 and can be viewed here:
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC Many of the suggestions for change made in that submission, are also relevant to the FSI inquiry.

5. Changing Consumer Preferences and Demography TOR 3.1;

There are many ways in which the retail investor market has changed since the Campbell and Wallis inquiries. The most obvious and the most significant in every dimension – personal welfare, social, political, regulatory and financial – is the universalisation of ordinary citizen participation that is discussed above and described as 'financialisation'. While this is most obvious in compulsory superannuation it is more ubiquitous than super (eg a bank account is required welfare recipients to receive payments) and is lifelong. This means that retail markets are 'mass markets', investors vary greatly in their needs and capabilities – while at the same time providers wish to 'industrialise' provision of financial products to reap economies of scale. This is a constant tension in the development of regulation for financial consumers.

5.1 At the time of both the prior inquiries, the population of financial citizens was thought about in terms of the different financial institutions they dealt with. Hence those reports speak of depositors, policy holders, superannuation members and investors, each regulated under a different regime. They did not speak of 'financial consumers' - some holding more intense promises (eg with banks) than others (eg direct shareholders in a non-financial company). Now we tend to see the mass of retail participants more holistically. This has benefits, such as having a single regulator, licensing, disclosure and conduct regime. It also has drawbacks such as assuming that the protective tone of the term 'consumer' means the elimination of risk (as it tends to do with non-financial goods) when the essence of financial products is that holders are remunerated for retaining risk – especially those with an investment element.[54]

5.2 The retail population has grown so quickly in the last 20 years, that there have been insufficient time and resources for proper study of the cohorts in the population as a whole. While we know that the bulk of the retail population is not very capable in financial matters, there is also a lot we do not know about the differences within that population. The financial literacy research tells us that older people for example are better at budgeting and saving, while women are more risk averse than men. There are other traits in segments of the financial consumer population that we understand better than we did in the past. There has however, been less use of this information for changing the approach to and content of regulation than is ideal. Because of the adoption by Campbell and Wallis of the classical finance framework for justifying market intervention in the retail as well as the wholesale market, regulatory responses to this knowledge that all financial consumers are not alike, has been

[54] Kingsford Smith D, note 51 above *passim*.

circumscribed. Suggestions for regulatory responses, some of them now adopted in retail markets overseas, are set out in relation to TOR 4.3 below.

5.3 As already observed, retail preferences in the last 20 years have shown a reduction in direct investment in company shares, and an increase in holdings of interests in funds: superannuation, managed investment schemes, structured products and so on. As we have also already observed, this means there is less participation in secondary markets in financial products, and much more of an 'end-user' approach to the acquisition and holding of retail interests. The implications of this for regulation and the protection of financial consumers is that markets in the interests they hold are less liquid increasing risk. Further, that liquidity risk is compounded by 'provider' risk, since the interests if they are transferable or redeemable at all, depend very much on the provider continuing to offer redemptions, or to make an OTC market in the product. This development underscores the importance of increasing the vigour of regulation of fund providers, intensifying the scrutiny of their operational compliance and particularly their insurance arrangements. It also provides further justification for the creation and conduct of a final resort general compensation scheme.

5.4 One of the most significant developments in the retail markets has been the adoption of online means for financial information seeking and online trading: this is the subject of the next paragraphs.

5.6 Who are Online Investors?

There is beginning to be some empirical research about Australian online investors and who they are. One study including the author of this submission looked at this question some years ago. The results of the study are summarised below and the results in full can be found here: http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2004_2/kingsford-smithandwilliamson/ [55]

5.7 Financial consumers use the online mode for two main purposes: online information seeking and online trading. Although most of them use the online mode virtually constantly to seek and keep up to date with information, many only actually trade relatively infrequently. Day traders who commonly close out by the end of the market day, are not the common type of online investor. Some online investing users who do not currently have cash for trading see the mode also as a leisure occupation: they do 'dummy trades' in competition with their friends, to see who makes the most on pretend-trades in investments.

[55] Kingsford Smith D and Williamson K, 'How do Online Investors Seek Information, and What Does This Means for Regulation?' *Journal of Information Law and Technology* (2004:2) at http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2004_2/kingsford-smithandwilliamson/

5.8 Most online investors have a finance or information technology background. They have a surprising range of age, with retirees managing their own investments being prominent users, especially in information seeking. More males and younger people use online modes, but some very successful older women and women at home with young children, use it too.

5.9 The research suggests that to be successful at running an online portfolio, a lot of time needs to be spent – mostly on information seeking, analysis and record keeping. Some interviewees who were not retired (retirees sometimes spend many hours per day) said they spent up to 7 hours per week managing their investments online. Much of this was in information seeking and analysis. Some interviewees said they had given up online investing in certain periods (new job, more travel, new domestic responsibilities) when they could not give the attention to it that was needed for the portfolio to be managed successfully.

5.10 Unlike the mass of financial consumers who the financial literacy research tells us are rather disengaged from financial matters, online investors are very interested in their own investments and in investing matters generally. Some of them use very sophisticated programs to analyse financial information and make investment decisions, often following a stock for weeks or even months before trading. This is necessary because the online trading mode is non-advisory: it is presented as a 'DIY' service by online brokers. In these ways, many online investors are amongst the few retail investors who actually seem to behave like the rational investor of classical finance. Of course not all onliners seek and analyse information in an entirely rational way: the behavioural finance research warns us that even the most skilled investors can make decisions distorted by biases and heuristics. Further, as we have mentioned, some online investors enjoy a 'ludic' or playful element to investing in this mode!!

5.11 What Significance Should the Online Mode Have for Financial Regulation?

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.

5.12 However, 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.[56] Bradley has argued that greater

[56] 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.

'immediacy, interactivity and inter-jurisdictionality' in the online investing context demand some different approaches to regulation by comparison with advisory modes.[57] There is also evidence that decision-making using online information may rely more on impressions than logic.[58] 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 are of an 'end-user' nature where 'cooling off' rights can be implemented.

[57] Bradley, 'Online Financial Information: Law and Technological Change' (2004) *Law & Policy, 375 passim*.
[58] Bradley note 57 above 384.

6. Meet user's needs with appropriate financial products and services TOR 4.3;

This submission has already drawn attention to the drawbacks in a heavy reliance on disclosure in regulation for the financial citizen. That is not to say that regulators and the issuers of disclosure should give up on its use or on improving it for financial consumer use. It is also not the argument of this submission that regulators and financial consumers should give up on improving the level of financial literacy and consumer understanding of the biases, which can distort their decision-making. All these disclosure related strategies will help, especially over the long term. Information is important in financial markets, and much valuable research analysis which is used in the provision of services to consumers, such as financial advice, depends heavily on timely and high quality disclosure. Rather, the point is that disclosure in retail markets is significantly limited, and should not be relied on alone, or to such a considerable extent as it is in Australia.

6.1 Regulating for Conflicts of Interest in Retail Markets.

This submission has also considered the concentrated and vertically integrated condition of Australian retail consumer finance and investment markets. It has argued that such an industry structure provides justification for regulatory intervention on the basis of both market failure, and fairness. This intervention must principally address conflicts of interest, particularly between advisers and their clients. As it is unlikely that the systemic conflicts of interest born of the conglomeration of financial institutions in the 1980s and early 1990s will be reversed, the regulatory strategy must be to mitigate the effects by other techniques.

6.2 One of these is the package of reforms known as the Future of Financial Advice reforms. These reforms ban financial advisers from taking commissions from third parties, and other forms of conflicted remuneration. They introduce a statutory obligation on advisers to act in the 'best interests' of the client and generally to place the client first when dealing with a retail client. This combination of reforms has the effect of requiring advisers to avoid conflicts of interest in retail client transactions, rather than merely 'managing conflicts of interest' as is required more generally of providers licensed by ASIC.[59] In short, the Future of Financial Advice Reforms are in line with post-GFC developments which, world-wide, are more demanding of providers dealing with financial consumers.

6.3 The banning of commissions has been operating in the UK since January 2013,[60] and in the European Union.[61] European firms must also disclose to clients whether they are acting independently (of a product issuer) or giving advice on a more restricted basis because of issuer ties. In the US the Dodds-Frank Act mandated a

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[59] Corporations Act S912A(1)(aa) and ASIC *'Managing Conflicts of Interest'* RG 181 (August 2004).
[60] Financial Services Authority 'Distribution of Retail Investments: Delivering the RDR – feedback to CP 18/09 and final rules' (March 2010) http://www.fsa.gov.uk/pubs/policy/ps10_06.pdf; and further guidance on those rules Financial Services Authority 'Retail Distribution Review: Independent and Restricted Advice – Finalised Guidance' (June 2012) at: http://www.fsa.gov.uk/static/pubs/guidance/fg12-15.pdf
[61] Article 24(5) and (5) MiFID II

study by the SEC of the imposition of a uniform fiduciary duty on broker-dealers and investment advisers.[62] Although there has been no rule-making yet, and a further study of the economic effects of the rule change is currently underway,[63] the SEC staff has recommended a uniform requirement to 'place the client first' should be adopted for broker-dealers and investment advisers.[64] There has however, been no proposal to ban commissions and conflicted remuneration.

6.4 Product Intervention

The Ripoll Committee concluded that in Australia regulators should not have powers to intervene in product design or distribution, unless a stop order is required because of misleading and deceptive statements in the disclosure for a product.[65] However, this submission has argued for a change in regulatory philosophy from the classic finance settings of the Campbell and Wallis Committees, which Ripoll seemed to accept. Instead it argues for amendment to the disclosure oriented objects and powers of ASIC, and addition of fairness as a justification for investor protection. One regulatory strategy being developed for retail markets in line with these arguments, is to give regulators powers for retail product intervention.

6.5 Product intervention is not only in relation to marketing and distribution conduct, but may require approval of product features and conditions or extend to the development of principles or rules for the creation of products which are suitable for particular retail investors. Examples of the last two types of intervention are the requirement of authorisation and the regulation of the features of 'My Super' default funds targeted to fund members who do not exercise choice in relation to their superannuation investments.[66] The authorisation and product features requirements respond to an express policy of providing simple, low cost and balanced investment options for compulsory superannuation contributions. The MySuper product is an example of a regulatory response to what we have learned about ordinary investors from behavioural and financial literacy research and a philosophy of fairness.

6.6 In the UK the Financial Conduct Authority has powers to restrict the marketing and distribution of unregistered collective investment schemes (UCIS) to certain types of (more sophisticated) investors.[67] Under these powers the FCA may temporarily ban or remove a product from the market without prior notification. Likewise in the EU, there is provision for regulators to intervene in the marketing and distribution of a financial

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[62] Section 913

[63] See SEC request for data and other information, at: http://www.sec.gov/rules/other/2013/34-69013.pdf

[64] Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011) ("Study"), *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf.

[65] Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia*, (November 2009), 143

[66] *Superannuation Legislation Amendment (MySuper Core Provisions) Act* 2012, SS29T & 29S deal with authorisation by APRA and SS29R and 29TC deal with required product characteristics.

[67] Financial Conduct Authority, *Policy Statement 13/3: The FCA's use of Temporary Product Intervention Rules* (PS13/3) (2013).

product or service.[68] This power may be exercised if the product or service has certain features or price that would give rise to significant concerns about investor protection or impairs market integrity or orderliness or market stability. Although in the US additional consumer protection powers[69] are not called product intervention powers as such, the new Bureau has been given very significant powers in relation to fees and charges on credit and debit card.[70]

6.7 In its report on complex investments[71] ASIC argued that there is room for greater regulatory intervention at various stages in the life cycle of a complex product. It is considering providing guidance to the market about product development so that poorly designed products which may be difficult for ordinary investors to understand and which are unsupported by good financial advice, don't cause damage. The difficulty at present is that ASIC does not have the powers to insist that guidance is acted on. It has no powers to direct providers about products, their features and the customers to whom they are marketed: ASIC can take no action unless there is mis-selling or misleading and deceptive conduct, and this may not be obvious until well into an investigation.[72] This submission strongly argues for the development and legislation of powers, parallel with those in use in the EU and UK, for the regulator to intervene in relation to a product in the interests of investor protection. One of the strengths of this approach is that the product intervention principles are developed in advance, making both compliance easier and departures from compliance more obvious.

[68] MiFIR, Articles 31 and 32
[69] Of the Financial Consumer Protection Bureau.
[70] The CARD Act 2009.
[71] ASIC *Complex Investments Report* 343 (February 2014)
[72] ASIC had great difficulty taking action in relation to structured products offered by Westpoint see: *ASIC v Emu Brewery Mezzanine Ltd* [2004] WASC 241 upheld on appeal in *Emu Brewery Mezzanine Ltd (in liq) v ASIC* [2006] WASCA 105