

JULY 2016

Consultation paper 260: Further measures to
facilitate innovation in financial services

Submission to the Australian Securities and
Investments Commission

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

To find out more about CHOICE's campaign work visit www.choice.com.au/campaigns

CHOICE welcomes the opportunity to provide comment on *Consultation paper 260: Further measures to facilitate innovation in financial services* (the consultation paper).

The consultation paper gives detailed consideration to the barriers to entry that financial start-ups face. It fails to give equivalent consideration to the risks consumers will face should some proposed measures be implemented.

Innovation can produce significant benefits for markets and for consumers. But the term 'innovation' is sometimes used so loosely as to refer to any kind of new business model, positive or negative. Used this way, a new business model promoted as 'innovation' may effectively represent a step backwards for consumer welfare, eroding important protections and posing unacceptable risks. Financial services are complex and can pose significant risk to retail consumers. Recently, small and large financial service providers have demonstrated appalling low regard for consumer needs and protections. For this reason, new businesses must meet minimum standards to protect consumers.

CHOICE does not oppose recommendations that ASIC provide additional guidance about the assessment of responsible manager skills (option one) or for businesses to rely, in part, on sign-off from an appropriate third-party to meet organisational competence obligations (option two).

We have significant concerns about the impact on consumers should an industry-wide exemption to allow new Australian businesses to test certain financial services for six months without holding an Australian Financial Services (AFS) licence proceed in the proposed form (option three, or the regulatory sandbox exemption).

CHOICE strongly opposes any AFS licence exemption for financial advice services. Our opposition is based on the risks these services have posed to consumers in the past and the inability of the sector to provide adequate compensation arrangements for consumers without a last resort compensation scheme.

Should ASIC proceed with option three, CHOICE recommends that:

- No service providing consumers with personal financial advice should be allowed to operate without an AFS licence.
- Should financial advice services be considered for an AFS licence exemption, that no financial advice business should be able to receive an exemption until consumers are able to access a last resort compensation scheme for financial services.
- That the maximum exposure limit is set at \$10,000 for retail clients but that businesses must assess clients' assets to set individual limits based on risk appetite and financial capacity.
- That all financial advice services have to meet basic consumer protections (including s961H of the Corporations Act).

Unlicensed advice services will put consumers at risk

The consultation paper proposes to allow new Australian businesses to test certain financial services for up to six months without obtaining an AFS licence.

The consultation paper proposes to only apply the regulatory sandbox exemption to businesses which:

- a) Give financial advice in relation to listed or quoted Australian securities, simple managed investment schemes and deposit products; or
- b) Arrange for other persons to deal in the above products; or
- c) Provide other services where exemptions are assessed on an individual basis by ASIC.¹

CHOICE does not support the proposal to allow new Australian businesses providing financial advice services to operate for up to six months without an AFS licence.

We agree with the consultation paper's assessment that some financial products are unsuitable for a regulatory sandbox exemption, particularly products like superannuation, life insurance, illiquid products and complex products. These products can be difficult for consumers to understand and there are long-term and irreversible consequences if they are mis-sold.

However, we are concerned that the regulatory sandbox exemption would apply to financial advice, a service that has caused significant consumer detriment in recent years. The effects of major financial advice scandals in the last decade have been catastrophic, resulting in consumers losing more than \$5.7 billion in funds as well as their homes and life savings due to financial adviser or service provider misconduct.² Certain scandals have highlighted the risk that consumers face when they are mis-sold products through advice, particularly the risks posed by managed investment schemes.

By removing the obligation for new financial advice businesses to apply for and hold an AFSL, ASIC would be lowering the bar for an industry that has yet to show it can meet basic public expectations. A financial advice company without a licence will not have to meet current legal obligations. For example, they will not need to:

1. Have adequate arrangements in place to manage conflicts of interest.

¹ Consultation paper, p 25.

² Losses from Opes Prime, Storm Financial, Timbercorp/Great Southern, Bridgecorp, Fincorp, Trio/Astarrar, Westpoint and Commonwealth Financial Planning sourced from figures in ASIC (2014), Submission to the Financial System Inquiry, pp. 192-193 and Industry Super Australia (2014), Exposure Draft: Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014, ISA Submission, pp. 37-38.

2. Take reasonable steps to ensure that people working for the company comply with financial services law.
3. Maintain the competence to provide the financial services.
4. Adequately train the people working for the company to ensure they are competent to provide the financial service.
5. Have adequate risk management systems.³

The financial advice industry has only recently been required to meet basic consumer protections, like the requirement to operate in the best interests of clients.⁴ In addition, there is ongoing work being done to lift the ethical, educational and professional standards of financial advisers. This is an industry that has left too many consumers out of pocket and has yet to prove that it can deliver services in a way that protects clients' interests. It is not appropriate to grant new businesses in this sector a regulatory holiday given the risks posed to consumers.

What could happen? The consumer risk

Mr X wants to start a new financial advice business. He sets up a company but does not need to get an Australian Financial Services Licence for six months. He is not required to manage or disclose his conflicts of interest. He also isn't required to prove that the financial advisers he hires know what they're doing, comply with the law or manage risks. Mr X hires his brother-in-law that he believes was unfairly let go from another financial advice firm because he didn't pass a test about adviser obligations under the Corporations Act. Mr X encourages his brother-in-law to advise clients to invest in his cousin's new managed investment scheme. Mr X finds clients for his new business from his local community – he advertises his service as something to help retirees use their savings to pay for their grandchildren's education.

Mr X's business gives the same advice to 100 clients – invest \$10,000 in his cousin's scheme. The scheme collapses, but the people running it were paid very well before it did. Clients are accusing Mr X's business of not acting in their best interest as they were all provided the same advice and personal circumstances were never considered. This is against the law but by the time clients realise their money is gone, Mr X's business has gone bankrupt and the limited professional indemnity insurance Mr X held won't cover anything. The hundred clients who received a service from Mr X's business have each lost \$10,000, or \$1 million dollars total.

³ These are all current requirements of AFSL holders providing financial advice. These obligations are set out in ASIC (2016) *Regulatory Guide 36: Licensing: Financial Product Advice and Dealing*, page 32-33. <http://download.asic.gov.au/media/3889417/rg36-published-8-june-2016.pdf>

⁴ While the Future of Financial Advice (FoFA) protections were established some years ago, they have only been fully in effect and enforced since July 2015.

Comments on other aspects of the proposal

If the regulatory sandbox proposal proceeds, much stronger consumer protections are needed.

It is not possible for financial advice start-ups to provide adequate compensation arrangements without a last resort compensation scheme

The consultation paper proposes that the regulatory sandbox exemptions should only apply if a business is able to maintain adequate compensation arrangements. It is assumed that this can be achieved by a business obtaining professional indemnity insurance.

Professional indemnity insurance is typically used to meet compensation requirements but this product was not designed to function as a compensation mechanism, creating instances where insurance doesn't cover all cases of consumer loss. For example, professional indemnity insurance will never cover instances of adviser or service provider fraud.

There remain a number of instances where consumers have received a positive outcome through the Financial Ombudsman Scheme (FOS), an External Dispute Resolution (EDR) scheme, but compensation has been not paid.

As at 31 March 2016, the FOS had 137 unpaid determinations. The total value of these is \$12.61 million. With interest and adjustments for inflation this comes to \$16.63 million. 56 per cent of the unpaid determinations relate to disputes in the financial planning and advice sector.⁵ There are a number of other consumers with substantial loss who have not gone through the FOS determination process after being informed they have no hope of a determination being paid.

Consumers sorely need a compensation scheme of last resort in the financial services industry. Until a scheme is established, high-risk ventures for consumers, particularly regulatory exemptions for financial advice services, should not proceed.

CHOICE expects that new start-up services would be more likely to draw on any future last resort compensation scheme. Consideration should be given to how these new services should contribute to a scheme that their customers are more likely to draw upon.

Recommendation:

- No financial advice business should be able to receive an AFS licensing exemption until consumers are able to access a last resort compensation scheme for financial services.

⁵ FOS, May 2016, FOS circular 25, <http://fos.org.au/fos-circular-25-home/fos-news/unpaid-determinations-update.jsp>

Proposed test limits must protect individual consumers

The consultation paper proposes to place limits on the number of clients that can participate in any activity conducted by an unlicensed business. An unlicensed business could provide services to as many as 100 clients and invest as much as \$10,000. This proposal does not address the risks individuals would face. \$10,000 is a significant sum for some consumers and relatively minor for others.

Recommendation:

- That the maximum exposure limit is set at \$10,000 for retail clients but that businesses must assess clients' assets to set individual limits based on risk appetite and financial capacity.

If financial advice services are able to operate without an AFS they must meet all basic consumer protection requirements

The consultation paper proposes that businesses operating as part of the regulatory sandbox exemption should still meet the best interests duty and conflicted remuneration provisions set out in the Corporations Act (the Act).

Specifically, the consultation paper says that businesses will need to

- Provide advice in the best interests of a client (meeting s961B of the Act)
- Ensure that advice is appropriate to the client (meeting s961G of the Act)
- Ensure that client interests are prioritised over the interests of the advice provider or their associates (meeting s961J of the Act)
- Not accept remuneration that could reasonably be expected to influence the advice as per ASIC's Regulatory Guide 246.⁶

This list misses the crucial protections in section 961H of the Act.

Recommendation:

- Any financial advice service operating without an AFS licence must warn a client if advice is based on incomplete or inaccurate information (meeting s961H of the Act)

⁶ Consultation Paper, p. 32.