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All aboard the PDS Titanic

This paper questions the current heavy reliance on disclosure as a regulatory instrument within the context of compulsory superannuation, particularly in relation to product disclosure statements (PDSs). It highlights a number of reasons why such disclosures are problematic, and questions the logic of disclosure in a system where participation is compulsory. It also suggests a need for reforms that rebalance the emphasis in the regulatory scheme shaping superannuation away from disclosure and in favour of other regulatory instruments and strategies.

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ALL IS NOT WELL ON THE PDS TITANIC. In 2007 the Parliamentary Joint Committee on Corporations and Financial Services came to the conclusion that:

> it [is] widely acknowledged through the inquiry that product disclosure statements (PDS) are often not suitable for general consumption … Although they may be legally compliant, PDSs that are long, complex, difficult to compare and have key information lacking prominence, do not serve the purpose of communicating effectively with consumers. The public is overwhelmingly put off by such material and anecdotal evidence conveyed to the committee suggested that they ordinarily do not read it.[1]

These comments are a sad indictment of the centrepiece of the disclosure regime aimed at informing Australia's superannuation fund members. They point to a regime choking on detail, which is compiled and communicated at great expense but, seemingly, has little practical impact.

The real tragedy is that, as the title of this paper suggests, the Committee's comments are only the 'tip of the iceberg'. The literature is littered with theoretical and practical findings that raise questions about specific aspects of both the PDS regime and disclosure as a regulatory strategy, more generally. This paper suggests that the cumulative effect of these findings should create considerable unease about the central role currently accorded to disclosure in the regulatory scheme shaping superannuation in Australia.[2] Taken together, the findings suggest that the PDS regime applying to compulsory superannuation is analogous to the Titanic, which was also highly expensive and elaborate to the point of over-engineering but which ultimately sank under the weight of its own ornamentation.

Anatomy of the problem

The problem with the disclosure regime applying to compulsory superannuation in Australia runs much deeper than the report of the Parliamentary Joint Committee identified. It goes first to the logic of disclosure as a regulatory strategy in a compulsory superannuation system. The fundamental problem is that (with one qualification that is discussed below), disclosure implies that individuals can act on the information to protect their own interests, a freedom that is greatly curtailed when participation in the system is mandatory, as is the case with compulsory superannuation. In addition to this fundamental problem, there are at least five other problems that can (with some rhetorical licence) be summarised as follows:

- The information provided to super fund members is unreliable and potentially misleading.

Taken together, the findings suggest that the PDS regime applying to compulsory superannuation is analogous to the Titanic, which was also highly expensive and elaborate to the point of over-engineering but which ultimately sank under the weight of its own ornamentation.

- Even if the information was reliable and relevant, individuals couldn't understand it.
- Even if the information was reliable and relevant, and individuals could understand it, they wouldn't necessarily use it to act rationally.
- Even if the information was reliable and relevant, and individuals understood it and acted rationally, it might not be in their interests to receive it.
- Even if all those concerns were addressed, industry incentive structures would probably still get in the way.

These problems compound the more fundamental problem that heavy reliance on disclosure is potentially inconsistent with a compulsory system. They pose serious challenges to those who rely on disclosure as a lynchpin of member protection in the superannuation environment. Perhaps, more importantly, they also cast doubts over the value of current tinkering with the information content required in PDS disclosures.

Each of the problems is discussed briefly below. But before that, it is necessary to review briefly how disclosure earned such a central role in the regulatory strategy designed to protect Australia's superannuation fund members, and to assess the logic of that reliance.

The rise of disclosure in the regulatory tapestry

Disclosure has always been an important component in the regulation of superannuation since at least the mid-1980s. Its importance was reiterated by then-Treasurer, the Hon. John Dawkins MP, in his statement introducing the measures that led to the Superannuation Industry Supervision (SIS) Act, but it only reached its current pre-eminence as a result of the Financial System Inquiry of 1996, (commonly known as the 'Wallis Committee' after its chairman, Stan Wallis AO). The Wallis Committee pursued an avowedly economic agenda, tasked to identify:

> the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.[3]

In pursuit of a 'level playing field' that would promote efficiency, the Committee sought to remove the distinctions between the regulation of superannuation and the regulation of other forms of collective investment. The Committee recognised the 'implications of compulsory contributions and tax assistance for superannuation' in intensifying the level of regulatory 'assurance', but it did not consider that superannuation required full 'financial safety' regulation (such as was to be imposed on the payments system).[4] Essentially, members and prospective members of superannuation funds were to be regarded as consumers of financial products and, as such, the principle of caveat emptor ('buyer beware') applied.[5] This was notwithstanding the fact that the 'product' was inextricably linked to the uncertainties of investment markets. That is, members were seen as 'investors'.

The impact of this logic can be traced from the Committee's Report, through CLERP 6 to a series of legislative initiatives, including the *Corporations Act (Cwth)* 2001, *Financial Services Review Act 2002* and *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act (Cwth) 2005*.

The logic of disclosure: caveat emptor

Few would argue that providing information to super fund members is not important. It is their money, after all. Transparency inspires confidence. In a system with as many complexities as superannuation, and which inexorably assumes even greater priority in an individual's financial balance sheet, features that inspire confidence are enormously valuable. Moreover, in theory at least, disclosure provides information that can empower individuals to exercise greater control over their personal financial position.

It is the logic of this latter assertion that deserves close attention. Consumers, including most types of investors, can use information about the products or investments they are considering. In extreme cases, where they are unable to satisfy themselves, either because the information is inadequate or because the information, though adequate, deters them from buying, they can walk away. That course of action is not available in a compulsory superannuation system. The Superannuation Guarantee, for all its virtues, forces individuals to participate. This means that where a problem is systemic, there is no escape route. If, as the Joint Committee seems to have concluded, Product Disclosure Statements are consistently deficient across the entire system, would-be members cannot simply walk away. Disclosure may be an effective instrument in consumer protection situations where the decision can be characterised as discretionary and where the dictum caveat emptor (buyer beware) applies. Arguably, this extends to the intra-fund choices members make between different investment options (so-called 'Member Investment Choice'). However, relying on disclosure seems much less defensible when individuals have no discretion but rather are required to participate. Disclosure may therefore be much less effective in supporting the inter-fund choices (so-called 'Fund Choice') individuals can make.

It is now time to assess the other problems listed above.

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Problem 1: Unreliable and misleading information

The form and content of the items of statutory disclosure required of superannuation funds are regulated at a number of levels. Most obviously, the Corporations Act and the SIS regulations set out what is expected. Both ASIC and APRA have supplemented the legislation with guidance notes that articulate the regulators' interpretation of what is required. More subtly, the accounting conventions define how certain types of data are to be presented, especially in relation to the financial statements of the fund.

So far so good, except that over the past decade researchers, including most notably Gallery and Gallery, have repeatedly identified pervasive and material problems in the way key financial measures are calculated and disclosed.[6] More worryingly, they have come to the conclusion that the accounting principles and standards present 'scope for trustees to manipulate disclosures, thus potentially misleading fund members and adversely affecting their decisions'.[7]

Problem 2: Financial literacy

It has become fashionable to argue that poor decision-making on the part of superannuation fund members reflects inadequate financial literacy.[8] The Wallis Committee recognised this problem. It noted:

> In a market economy, consumers are assumed, for the most part, to be the best judges of their own interests. In such cases, disclosure requirements play an important role in assisting consumers to make informed judgments. However, disclosure is not always sufficient. For many financial products, consumers lack (and cannot efficiently obtain) the knowledge, experience or judgment required to make informed decisions …[9]

The solution *de jure* is financial literacy education which, if it were costless and well-defined, would be unexceptionable. It is, of course, neither of these things. Recent research suggests mixed results, with most success accruing to programs with a focused objective, such as helping individuals to manage a mortgage or enrol in an employer-sponsored pension plan (in circumstances where participation is not mandatory).[10] Gauging the impact of broader-based education initiatives has proved harder. This suggests that, at the very least, education is no panacea and specific initiatives should be justified after an unbiased weighing of both cost and benefit.[11] Perhaps of more concern, common sense suggests that the curriculum necessary to gain mastery over the decisions required to participate actively in superannuation would be challenging. It would need to include specialised factual knowledge as well as numeracy and literacy skills, which might attract some concerns in some quarters. However, the greater challenge will surely arise from the need to master abstract concepts like uncertainty and longevity. Realism therefore demands that education should be seen as a way to narrow the financial literacy gap (and hence reduce the risks that regulation seeks to contain), but it also suggests that disclosure should not be relied upon to eliminate the gap.

Problem 3: 'Behavioural' biases in decision-making

Even if individuals are presented with all relevant information in a timely manner, and have the education and intelligence to assimilate it effectively, there is no guarantee that they will make a 'rational' decision. Indeed there are both psychologists[12] and experienced market practitioners[13] who argue that investors' decisions inevitably reflect 'irrational' biases innate to human decision-making. The implication is that the biases may be somewhat resistant (perhaps even substantially resistant) to education. Indeed, some have argued that the provision of more information may exacerbate the problem, either by feeding such irrational biases as 'overconfidence' or by encouraging marketing tactics on the part of product providers that are designed to exploit such biases.[14]

Problem 4: Window-dressing

It is commonly assumed in economic theory that the transparency that results from disclosure assists principals to reduce agency costs. Judge Brandeis' famous analogy in support of disclosure that 'Sunlight is the best disinfectant' expresses a slightly different aspect of this. The sense of Brandeis' aphorism is that the transparency provides an incentive for the disclosing entity (the agent) to clean up its act.

More recently, theory has caught up with reality. Researchers have long been aware that fund managers are prone to window-dressing: altering the structure of their portfolios immediately before reporting season to avoid uncomfortable questions. Lakonishok et al[15] have even speculated that the close monitoring of delegated portfolio managers by pension plans in the United States has harmed their performance. Theorists, operating in the sterile and sometimes arcane laboratory of mathematics, have now developed formal proofs that demonstrate the conditions under which transparency has a perverse effect.[16] When agents act in the knowledge that they can be judged by their principals not just on the outcome (e.g. the investment return they earned) but by the actions they took in pursuit of this outcome (e.g. the stocks they held or the transactions they made), they will adjust their actions to reflect their understanding of the principal's preferences. In lay terms, they will window-dress.

How does this affect the disclosures present in a PDS? Quite simply, it suggests that it may be far harder for super fund trustees to act independently. The herd behaviour described by Myners in the United Kingdom and observed anecdotally in the Australian market, and the persistence of 'peer group' comparisons across many markets, may be reinforced by the institutional structure imposed on fiduciaries in modern financial markets. If so, then policy makers and regulators need to be very careful about what types and frequency of disclosure they require from super fund trustees. Transparency may not be such a panacea after all.

Problem 5: Incentives in the industry

The last of the problems arises from the very nature of superannuation itself. The availability of expert, independent financial advice ought to be a powerful complement to disclosure, assisting those less familiar with superannuation's myriad complexities to assimilate the information contained in product PDSs and make a well-considered decision. However, the long-term, incremental nature of superannuation makes it difficult to design appropriate incentive structures for those who act as agents in the system, such as advisers and investment managers. Stated simply, there is a pressing need for advice at the start of an individual's savings career. Advice at that time can help the individual get 'on track' early and also gives the advice most time to have an impact. Unfortunately it is also the time when the individual has least ability to pay for the advice, irrespective of whether the advice is separately identified as a fee-for-service or is bundled into a commission payment. This means that those who have small superannuation balances, including the young and the relatively less well-paid, who are arguably most in need of the assistance, are the most vulnerable.

The crux of the problem is that advice entails an upfront cost to the provider of the advice but the benefits to the consumer accrue only when the investments are realised at some point in the distant future. That temporal mismatch between the cost of relevant, customised advice and the benefit that will accrue at retirement limits the extent to which financial advice, as currently delivered in the Australian superannuation environment, can act as a complement to the disclosure regime.

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Directions for the future

As fundamental as these criticisms of PDS disclosures in the superannuation context are, they do not constitute a conclusive argument to abandon disclosure as a regulatory strategy entirely. Much of what is currently required is just good, common sense. Indeed it is hard to find fault with ASIC's 'Good Disclosure Principles'. Instead of providing formal rules of inclusion, definition, presentation or exclusion, ASIC requires that information be presented in a clear, concise and effective manner and that it be timely, relevant and complete, promote product understanding and comparison, highlight important information and have regard to consumer's needs.[17]

On paper, this approach gives trustees considerable scope to assess the needs of their members and to tailor the content and form of their PDS appropriately. The fact that PDSs contain much information that is 'boilerplate' and mis-specified (see problem 1 above) has more to do with risk management by the funds' legal and accounting advisers than with the regulations per se.

The argument here, then, has to do with the overreliance on disclosure as a regulatory strategy in the compulsory superannuation context. Disclosure is a vital element in any regulatory framework, but the weight currently accorded to it in the compulsory superannuation context is inappropriate.

The corollary of that conclusion is that change is needed. Recommending regulatory change in any industry typically attracts a hostile response from key stakeholders. The financial services industry is no exception, though the current climate is more amenable to recommendations for reform than some. What the form of the change may be is an open question. The change in government in

2007 seems to have brought about renewed recognition that compulsory superannuation is not simply a financial product, and that the consequence of a failure of the superannuation system, whether on an individual or systemic basis, would be fundamentally different from the failure of other types of investment. It remains to be seen whether this points to a return to some form of merit-based regulation in superannuation, to closer regulation by government instrumentalities, to facilitation of low-cost advisory models, to review of the remedial avenues open to aggrieved members, or to some other strategy. It would be disappointing, however, if the Government's current plans to review the content and form of PDSs, and the AASBs project to review the relevant accounting standards, marked the limit of the reform agenda. As important as those specific items are, that would seem to be simply 'moving the deckchairs'. Something more fundamental is surely required, and perhaps the recent announcement that the government will conduct a review into the structure, operation and efficiency of the Australian superannuation system is the opportunity for that discussion to take place.[18]

Concluding comments

No one would deny that members of superannuation funds deserve to receive relevant information about their fund in a timely manner. Similarly, those considering investing in a new fund or a new investment option within a fund should be able to collect and assess information relevant to that decision. But, from a public policy perspective, should we rely so heavily on disclosure as a regulatory instrument in the context of compulsory superannuation?

The issues raised in this paper suggest that the current heavy reliance on PDSs, in particular, is misguided. The paper highlights a number of reasons why such disclosures are problematic in the real world, and questions the logic of disclosure in a system where participation is compulsory. While this analysis does not suggest that the PDS system is irretrievably flawed, it does suggest a need for reforms that rebalance the emphasis in the regulation scheme shaping superannuation away from disclosure and in favour of other regulatory instruments and strategies.[19]

Notes

1 Parliamentary Joint Committee on Corporations and Financial Services, *The structure and operation of the superannuation industry*, 2007, at section 6.119–6.120.

2 Many of the specific criticisms contained in this paper apply to the use of PDSs in other contexts, and to disclosure generally. See, for example, Emilios Avgouleas, 'What future for disclosure as a regulatory technique? Lessons from the global financial crisis and beyond', presentation to the University of Glasgow and ESRC World Economy and Finance Conference: The Future of Financial Regulation, 30–31 March 2009. Available at SSRN: http://ssrn.com/abstract=1369004. Notably though, the cumulative effect of the findings has greatest force in the context of compulsory superannuation.

3 Financial Systems Inquiry, *Terms of reference*, (Wallis Committee Report, 'Wallis') found at http://fsi.treasury.gov.au/content/terms.asp

4 See Wallis, above at note 3, p.193.

5 For a more detailed discussion, see M.S. Donald 2008, 'Beneficiary, investor, citizen', presentation to Law Council of Australia, Superannuation 2008 Conference, Brisbane, February.

6 For a summary, see Gerry Gallery and Natalie Gallery 2004, 'Applying conceptual framework principles to superannuation fund accounting', *Abacus*, vol. 40, no. 1, p. 117. See also, Gerry Gallery and Natalie Gallery 2003, 'Inadequacies and inconsistencies in superannuation fund financial disclosure: the need for a principles-based approach', *Australian Economic Review*, vol. 36, no. 1, p. 89.

7 Gerry Gallery and Natalie Gallery 2006, 'Accounting impediments to better superannuation fund governance', *Accounting, Accountability & Performance*, vol. 12, no. 2, p. 33.

8 See, for example, Kerry Brown, Gerry Gallery, and Natalie Gallery 2002, 'Informed superannuation choice: constraints and policy resolutions', *Economic Analysis & Policy*, vol. 32, no. 71. See also, Robert Clark et al. 2006, 'Retirement plans and saving decisions: the role of information and education', *Pensions Economics and Finance*, vol. 5, no. 1, p. 45; and Maria Teresa Garcia 2005, 'Individual responsibility for the adequacy of retirement income', *Pensions – an International Journal*, vol. 11, no. 3, p. 192.

9 See Wallis Committee Report above at note 3, p. 192.

10 See Sandra Braunstein and Carolyn Welch 2002, 'Financial literacy: an overview of practice, research and policy', *Federal Reserve Bulletin*, vol. 88, p. 445; and OECD 2005, *Improving financial literacy, analysis of issues and policies*.

11 Edward Zelinksy 2004, 'The Defined Contribution Paradigm', *Yale Law Journal*, vol. 114, no. 451, p. 526.

12 Most notably, recent Nobel Laureate, Daniel Kahneman. See, for example, Daniel Kahneman 2002, 'Maps of bounded rationality: a perspective on intuitive judgment and choice', Nobel Prize Lecture, available at http://nobelprize.org/nobel_prizes/economics/laureates/2002/kahnemann-lecture.pdf

13 See, for example, Arun Abey and Andrew Ford 2007, *How much is enough?*, A&B, Sydney, and the research cited therein.

14 See, for example, Jeffrey Rachlinski 2003, 'The uncertain psychological case for paternalism', *Northwestern University Law Review*, vol. 97, no. 1165, p. 1177.

15 Josef Lakonishok, Andrei Shleifer and Robert W. Vishny, 'The structure and performance of the money management industry', in Martin N. Baily and Clifford Winston 1990, *Brookings Papers on Economic Activity: Microeconomics*, Brookings Institution Press, Washington, DC, p. 199.

16 Andrea Prat 2005, 'The wrong kind of transparency', *The American Economic Review*, vol. 95, no. 3, p. 862.

17 ASIC 2007, *Regulatory Guide 168: Disclosure: Product Disclosure Statements (and other disclosure obligations)*.

18 Available at http://minscl.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/041.htm&pageID=003&min=njs&Year=&DocType, viewed 29 April 2009.

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