REGULATING FINANCIAL ADVICE: *Lessons from the United States, the United Kingdom and Canada*

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In November 2014 the Senate disallowed the Corporations Amendment (Streamlining of Future of Financial Advice) Bill. Now is an opportune time to stand back and draw out implications for Australia from how financial advice is regulated in the leading common law countries. We also draw out implications from the debates in those countries about the regulation of advice. An earlier version of this paper was presented to the 2014 Australian Centre for Financial Studies' Melbourne Money and Finance Conference.[1]

At the time of writing (November 2014) the regulation of financial advice in Australia was in a state of flux. The Future of Financial Advice (FoFA) legislation was passed by parliament in 2012. In place of Australia's traditional light-touch regulation of financial advice there was to be a new 'best-interests' duty on financial advisers, a ban on conflicted remuneration, and compulsory 'opt-in' of clients every two years. However, FoFA in its original form was not implemented. The Coalition Government initially sought to weaken the first two provisions and eliminate compulsory opt-in via its Corporations Amendment (Streamlining of Future of Financial Advice) Bill. Subsequently the Senate disallowed the Coalition amendment bill. On 19 November 2014 the Australian Securities and Investments Commission made the following announcement about how it intended to regulate financial advice in the immediate aftermath of the Senate's action:

> ASIC will take a practical and measured approach to administering the law as it now stands following the disallowance of the Corporations Amendment (Streamlining Future of Financial Advice) Regulation 2014. We will take into account that — as a result of the change to the law that applies to the provision of financial advice — many Australian financial services (AFS) licensees will now need to make systems changes. ASIC recognises this issue may arise in particular areas, including fee disclosure statements and remuneration arrangements.
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> We will work with Australian financial services licensees, taking a facilitative approach until 1 July 2015.

In light of this, now is an opportune time to stand back and review how financial advice is regulated in the leading common law countries. We also review the debates in those countries about the regulation of advice. We draw out implications for both the FoFA legislation and the amendment bill.

Australia is not the only common law country to be in the process of changing its regulation of financial advice. In 2013 the United States regulators announced that they were considering changes to the duties of financial advisers, which would not only clarify the meaning of fiduciary duty but bring the duties on US advisers more into line with the corresponding duties in Canada and other common law countries.

There have been significant regulatory changes in the United Kingdom. Implementation of the Retail Distribution Review (RDR) in 2013 streamlined a pre-existing three-way distinction between independent, restricted and tied advice. Now there is a two-way distinction between restricted and independent advice. There is also a comprehensive ban on commissions (conflicted remuneration). Historically, the UK required retired over-75s to annuitise most of their superannuation balances, resulting in the deepest market for life annuities in the world. The 2014 budget announced a radical relaxation of compulsory annuitisation. Identifying good-deal life annuities will no longer be the major task of advisers to people on the cusp of retirement.

Canadian regulation has been comparatively settled. In 2013, however, the Canadian authorities introduced a requirement that a suitability analysis be triggered whenever securities are received into a client's account, the investment adviser changes, or the client's life circumstances change.

In drawing lessons for Australia we do not discuss the market for advice on insurance products. Nor do we address tests and certifications of expertise in advice provision. Also, while there are various reasons for seeking financial advice, we focus on saving for retirement and the subsequent decumulation of retirement savings. The lessons we draw from actual regulations in the US, the UK and Canada are these:

> Following the US example, the Australian authorities should consider an explicit definition of what it means to be acting in the best interests of the client. By contrast, the FoFA legislation is more about promulgating a multi-step process rather than the substance of upholding a best-interests duty. The clauses that define the first six steps of the process use the words 'reasonable' or 'reasonably' four times. In such ways, part of the task of definition effectively is delegated to ASIC and the courts. They would be called upon to issue guidance and set precedents that clarify the substantive duties on advisers, drawing on the Corporations Act. This roundabout approach appears to have worked in Canada (Paglia 2013). Yet, proactive legislation to clarify the duties of advisers might be less haphazard.

> Again following the US, performance fees charged by advisers to unsophisticated investors should be confined to fulcrum fees whereby benefits and costs to advisers are symmetrical around a passive benchmark. This would ameliorate the problems of asymmetric performance fees and chronic index-hugging that beset Australian actively managed funds (Whitelaw et al. 2011a, b).

> Following the UK, financial advisers should be required to identify themselves as offering either restricted or independent advice.

> UK endeavours to eliminate commissions have proved problematic. Notably, there are strong arguments that investors seeking advice on modest sums easily become uneconomic to service. Subject to caps on the amount of funds under advice, clear written warnings whenever advice is from a restricted adviser, caps on the remuneration of advisers via commissions, and an exemption for conflicted general advice might be tolerable.

> Following Canada, reviews of financial plans should not take place on a fixed two-year schedule but on a contingent, 'trigger' basis. One such trigger would be when a client's life circumstances change. For example, if the person responsible for managing household finances passes away before their partner, it could take a considerable time before the surviving partner learns about trail fees that have become superfluous to family needs, absent a triggered review. Put another way, the absence of any review smacks of 'inertia selling' of the kind banned by the Corporations Act.

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United States

The US regulations distinguish between broker-dealers, on the one hand, and financial advisers on the other. As in Canada, there appears to be scope for a financial services firm to wear either of these hats. Brokers and dealers in the US are regulated by the Financial Industry Regulatory Authority. Advisers are regulated by the Securities and Exchange Commission (SEC) under the *US Investment Advisers Act 1940*. Unless a specified exclusion applies, investment advisers must register with the SEC. As in Australia, registration is required of the advice-giving firm rather than particular advisers employed by the firm. Exclusions from the Act are available under a long list of headings. Thus US banks and hedge funds are excluded (Staff of the Investment Adviser Regulation Office 2013).

A distinctive feature of US regulation of funds managed on behalf of unsophisticated investors is that fulcrum fees are the only authorised performance fee for mutual funds apart from hedge funds (Cumming et al. 2013). Many leading mutual funds employ fulcrum fees, notwithstanding the carve-out for hedge funds. Performance fees for hedge funds offered in the US tend to be of the asymmetric 2-20 variety. This type of asymmetry tends to encourage risky allocations.

In the wake of the global financial crisis a group of leading US academics in economics and finance produced a series of reports, including one on retirement savings, under the auspices of the Council for Foreign Relations. That report draws an analogy between regulating financial advice and regulating the sale of foodstuffs:

> To be eligible for defined contribution plan investments, a mutual fund should be required to provide a simple standardized disclosure of the costs and risks of investing in the fund. Our model is the nutrition label required for packaged foods in the United States. The investment label should emphasize tangible characteristics that are related to cost and risk (Squam Lake 2009, p. 1).

The Squam Lake group suggests classifying securities into five distinct asset classes: stock, cash, Treasury bonds, corporate bonds, and inflation-protected securities. Stock carries 'investment' or 'equity' or 'market' risk. Cash carries reinvestment risk. Treasury bonds carry inflation risks. Corporate bonds carry inflation and credit risks. Inflation-protected securities protect against inflation risk.

Australian industry practice is different. Take the model holistic plan promulgated in 2008 by the Financial Planning Association (FPA) for a hypothetical 57-year-old couple. Table 1 shows 'investment sectors' along with more specific labels under the heading of 'investment options':

TABLE 1: Asset classification employed by the FPA's model holistic financial plan

Investment sector	Cash	Income	Income	Listed property securities	Australian shares	Australian shares	Australian shares	Australian shares	International shares
Investment options	Cash	Income extra	Income fund	Property securities fund	Australian active equity	Boutique Australian shares	Australian equity long/short	Australian small companies	Global value equity

Source: Financial Planning Association (2008).

Continuing with the nutrition analogy, the FPA's classification system resembles a classification for food groups that allows for seven different categories of carbohydrates but only for two other food categories. Unlike the Squam Lake classification, the FPA's classification does not map well into distinct functional categories (although it does serve to articulate a degree of diversification against equity-manager risk in the model plan). For example, what are the investment and credit risks attached to the 'income' categories? The FPA's system is framed in a way that distracts from its key recommendation of very heavy concentration in growth assets alongside a low weight to safe interest-bearing securities. Judging by the portfolio weights reported by the model plan, stocks and property together appear to account for around 90 per cent of the FPA's model portfolio, whereas safe-interest bearing securities appear to account for around 10 per cent (although the exact percentages are unclear). This is the financial equivalent of a high-carb diet. It could prove unsuitable for the hypothetical household, whose circumstances suggest that they would be unlikely to qualify for much of the Age Pension, yet they are not sufficiently well-off to let their planned estate take the strain of any market crash. Suitable or otherwise, the model portfolio fails to spell out the risks attached to it.

For Australian holistic plans we suggest as a minimum requirement a simple two-part classification: growth assets (stocks and property), and safe assets (AA, i.e. interest-bearing securities rated 'high quality' by one of the major credit rating agencies). The growth-assets class could be subdivided, but not at the expense of the safe interest-bearing securities class. If the portfolio is geared up by means of secured loans, as often occurs with wealth accumulation plans outside superannuation, disclosure of an explicit net figure — presumably negative — could be mandated for the overall exposure of the recommended portfolio to safe-interest-bearing securities.

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United Kingdom

Following the *Financial Services Act 2012*, UK supervisory responsibilities that had been vested in the Financial Services Authority have been allocated to two new organisations: the Prudential Regulation Authority and the Financial Conduct Authority. The PRA supervises financial businesses that are systemically important: banks, building societies, credit unions, insurers and major investment firms. The FCA supervises the rest of the market for financial advice, including specialist financial planners.

There are two distinctive features of the UK's regulations. First is a longstanding insistence on distinguishing between 'independent' advice (not confined to a particular list of 'solutions' to a retail client's problems) and 'restricted' advice (limited to the products of a particular provider). Enforcing this distinction extends to an unusually rigorous insistence on accurate self-labelling by firms. Second, the RDR involves an unusually determined effort to stamp out commissions (Financial Services Authority 2012).

Andrew Clare (2013) provides a leading contribution to the UK debate on financial advice. On the basis of a survey of 2,062 adults he concludes that only 7 million people are likely to be willing to pay for financial advice. Two things follow. First, there is a 'guidance gap' whereby a majority of the population remains unable to access the advice it needs. Second, the RDR regulatory regime is likely to make this situation worse: 'both the demand for and the supply of financial advice are likely to shrink' (Clare 2013, p. 2). He flags the possibility that an expansion of the sales force of 'restricted' advisers might be needed to reduce the guidance gap, even though RDR means these direct sales teams would have to be paid on a fixed-salary basis, and not as some proportion of sales. Notably, people with a relatively small involvement in saving for retirement might benefit. He says that services on the internet might also help to fill the guidance gap.

This type of problem is familiar to economic theory. The so-called 'market for lemons', i.e. the market for used cars, is a leading instance of the problem. If it is hard for consumers to distinguish between high-quality goods and low-quality ones, and if sellers avoid the market unless rewards exceed a threshold, then the market for high-quality goods will disappear. Volumes shrink, and transactions that do take place will price the product or service as if it were invariably a lemon. In this way, ignorance about quality can drive out high-quality goods and services.

There are standard ways of mitigating the lemons problem. First, society mandates standards and certifications to prevent opportunism by sellers, and this is obviously the intention of FoFA. Second, buyers can screen suppliers by, for example, seeking out expert third-party comparisons of products and brands. Numerous advice businesses offer this type of service. Third, sellers of high-quality services can signal their superiority. For example, Product Disclosure Statements and related documents often include a chart aiming to show how an initial $10,000 invested in the fund has subsequently outstripped the relevant passive benchmark. In principle, the Corporations Act empowers the authorities to punish sellers who disseminate deceptive or misleading charts. Overall, though, the notion of a guidance gap is no less relevant here than in the UK.

Canada

Canada has a distinctive system of Self-Regulatory Organisations (SROs) that supervise transactions in the market for financial advice (Avocis 2012). The Investment Industry Regulatory Organisation of Canada supervises dealings in securities. The Mutual Fund Dealers Association of Canada supervises mutual funds. Managing General Agencies look after insurance. The Canadian Securities Administrators organisation serves as an umbrella over the others.

A leading contribution to the Canadian legal debate on regulating financial advice is due to Laura Paglia (2013). She argues forcefully that the totality of Canadian law, regulation and case law is in good shape compared to the corresponding totalities in the US, the UK and, especially, Australia.

Paglia gives a concise summary of what it means for financial advisers and dealers in the US and other common law jurisdictions to uphold a fiduciary standard or best-interests duty towards a retail client. The key words are care and loyalty: ‘A duty of care is comprised of know your product and suitability obligations along with fair and reasonable compensation. A duty of loyalty requires disclosure of the aspects of the retail client relationship and material conflicts of interest.’

Paglia says the US falls short relative to Canada in ensuring that loyalty to the client extends to relationship questions whereby an adviser or dealer responds to issues arising after the initial sale of a product or service. Moreover, adviser duties fall short of actually being fiduciary; the term itself is ‘abstract and unclear’ in US practice. In the Canadian industry, by contrast, SROs have succeeded in promulgating a clear definition of fiduciary duties.

Similarly, the UK lacks a statute that imposes a best-interest duty on clients. Its authorities have shied away from defining a best-interests duty although Paglia indicates that the problem has been acknowledged and is being considered by the authorities.

Canada appears to have evolved a distinctive solution to the lemons problem in the market for financial advice. Part of that problem is particular instances of well-publicised bad advice generating negative externalities for the industry as a whole. Lax regulation may help the industry in the short run but not the long run. In Canada, SROs (rather than governments) have made the running on standards and certifications to curb opportunism by sellers.

Paglia paints an unflattering picture of our market for financial advice. ‘Australia suffered from various corporate collapses.’ She identifies Storm Financial and Opes Prime as cases in point. ‘Similar collapses did not occur in Canada.’ Moreover, ‘the meaning of their best interest duty … is not readily apparent through statute’. She also suggests that Australia’s industry associations do not measure up to their Canadian counterparts (SROs): ‘Canada benefits from significant compliance and cooperation from the industry.’

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In fairness to the Australian industry, there have recently been comparable developments here. For example, the FPA has backed FoFA's tougher stand on commissions, and has also sought to raise the ethical and educational standards of its members, who number about half of our financial planners. The FPA's website acknowledges that all has not been well in the past: 'We recognise it will take a collective effort to transform the financial planning industry into a universally respected profession' (Mark Rantall, CEO, FPA).

Concluding comments

The US, the UK and Canada all have first-cum-second pillars of retirement income that include defined-benefit schemes, both public and private ones. The resulting link between wages and total income in retirement ensures that these schemes perform an income-replacement function for people of middle means. Australia's distinctive problems in regulating financial advice arise from our policy of a first pillar consisting of a means-tested public pension, along with a second-cum-third pillar consisting mainly of privately managed defined contributions, which are supposed to perform the income-replacement role. High allocations to growth assets go hand-in-hand with high fees to advisers and managers (Kingston and Weng 2014, Table 1). This tempts adviser-managers to overweight growth assets in portfolios for people of middle means who are on the cusp of retirement, a time of life when funds under advice and management tend to peak.

Means testing of the pension creates moral hazard on the demand side. The problem is compounded by compulsion, leading to unengaged investors who place undue reliance on default options in superannuation funds.

The upshot has been superannuation portfolios in Australia that have the riskiest asset allocations of any OECD country (OECD 2012). The income-replacement function of the second-cum-third pillar is vulnerable to market crashes.

There may be lessons for Australia from countries other than the major common law ones. An OECD report notes that Australia imposes no limits on pension fund investments by asset class, although investments involving 'self-investments/conflicts of interest' are capped at 5 per cent of the portfolio. More generally, OECD countries outside the common law ones tend to regulate pension fund investments more heavily. For example, Switzerland caps equity investments at 50 per cent and real estate investments at 30 per cent (OECD 2011).

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Our 2012 paper on FoFA proposed mandatory target-dating (or glide paths) for MySuper accounts. These accounts are intended for disengaged superannuation contributors. We suggested a simple two-step mandatory glide path: a 60 per cent weight to growth assets workers under 55 years of age, and a 40 per cent weight for workers over 55 years. We would not object if these caps were revised up to (say) 70 per cent for the under 55s and 50 per cent for the over-55s. Engaged investors would remain free to choose their preferred allocations.

Note

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