OFFICE OF
REGULATION REVIEW

Review of the licensing regime for securities advisers

Submission to the Australian Securities Commission Review of the Licensing Regime for Securities Advisers

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Preface

As part of a review of the current licensing regime applicable to securities advisers, who provide investment advice to individual and institutional investors, the Australian Securities Commission (ASC) has sought public comment on an Issues Paper.

The Office of Regulation Review (ORR) — located within the Industry Commission — provides advice on the Commonwealth Government's regulation review policy: it reviews new regulation; and monitors progress and participates in programs for the reform of existing regulations. The ORR also advises Cabinet on regulatory proposals affecting business, liaises with departments and agencies in the development of regulation, and comments publicly on regulatory issues.

1 REVIEW OF LICENSING REGIME FOR SECURITIES ADVISERS

The Australian Securities Commission (ASC) regulates corporations and other financial markets, which includes the issuing of licences for securities advisers. This licensing regime is currently under review by the ASC. In this submission the Office of Regulation Review (ORR) offers some observations and suggestions about the regulation of securities advisers. These comments cover the process which the Commonwealth Government requires any regulatory authority to use when amending regulations, as well as the ORR views on some particular issues for consideration flagged by the ASC in its Issues Paper (ASC 1995).[1]

2 GENERAL ISSUES FOR CONSIDERATION

The following general observations are based on the ASC issues paper and on Commonwealth Government endorsed 'Guidelines for Regulation Impact Statements' (attached). Whilst these guidelines to date have applied only when agencies seek Cabinet approval for new or amended regulations, their essential elements will apply more broadly in the future. For example, the Legislative Instrument Bill currently before Parliament provides similar tests which agencies must apply to a wide range of legislation and subordinate regulation. Such guidelines and tests also provide useful indicators of 'best practice' for all public sector organisations seeking to introduce new or amended regulations.

2.1 Identification of objectives and necessity of regulation

There is a clear need to regulate securities advisers, in particular to ensure that consumers are protected from misleading or poor quality advice, and to ensure public confidence in the financial system. For persons seeking investment advice, the amounts of money involved are often a relatively large proportion of their wealth and its misappropriation or poor allocation can have a large impact on individual investors.

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[1] Licensing Review Task Force 1995, 'Review of the Licensing Regime for Securities Advisers', *Issues Paper*, Australian Securities Commission, Melbourne, February.

Current regulation of securities advisers

- Securities advisers are currently regulated under the corporations law and are required to have a licence issued by the ASC.
- The aim of regulations is to protect investors and enhance public confidence in the integrity and efficiency of markets.
- Criteria for the allocation of licences include level of education, integrity and experience of advisers.
- Various conditions and minimum standards are attached to such licences, including a requirement that a $20,000 bond be maintained, training and supervision of advisers be provided, and details of the standard of conduct of businesses be maintained. The ASC monitor compliance with licence requirements and can revoke or vary licences.

Source: **ASC 1995**

The ORR supports in broad terms the approach of the ASC Issues Paper in outlining objectives of the review, which include promotion of high quality advice, increased investor protection, minimisation of risks, and promotion of the 'integrity and efficiency of the markets'. However, the minimisation of risks can impose considerable costs on regulators, service providers and consumers. Thus, in reducing risks it is always important to compare the *benefits* **derived from risk reduction with the** *costs* **incurred in reducing such risks.**

The ORR notes that the Issues Paper analyses in detail a licensing regime and self regulation. The ORR supports the approach of the Task Force of analysing in detail these alternative ways of regulating securities advisers, including consideration of self-regulation. However, the Issues Paper does not identify and analyse other alternatives to regulation. Nor does it explain or justify why a 'licensing regime', which seems to be regarded by the ASC as an objective, is the best method of regulating securities advisers (see page 6 of the Issues Paper). The same goals being sought via a licensing regime might be attained by alternative approaches, including:

- **no specific action, whereby the market and existing laws, including the** *Trade Practices Act 1974*, **and where applicable relevant State Government legislation, would be relied upon to regulate the conduct of market participants;**

- **enhanced information strategies for consumers, especially for poorly informed consumers (in addition to existing information strategies such as joint publication of a pamphlet by the ASC and the Financial Planning Association of Australia Limited (FPAA) which is titled 'Don't Kiss Your Money Goodbye');**
- **restrictions on advertising, including voluntary or mandatory warnings to consumers of the potential dangers and risks of using securities advisers; and**
- **other mechanisms such as the listing of securities advisers (ie. provision of information such as name, address, business organisation and qualifications etc), mandatory audits, certification and/or quality assurance schemes and co-regulation.**

These options are not mutually exclusive and a number of approaches could be employed simultaneously. The ORR believes that such alternatives to regulation of securities advisers should be considered by the ASC.

2.2 Benefits and costs of proposed regulations

A licensing regime for securities advisers is likely to yield various benefits to markets and consumers, whilst also imposing various costs on consumers and service providers. The ORR suggests that such benefits and costs should be identified and analysed by the ASC in a systematic manner.

There are a number of benefits that could be attained through licensing. For example, some of the potential benefits of a licensing regime might include:

- **excluding the entry of persons who are unqualified or have a previous serious criminal history and thus, reducing the risk that consumers — particularly those with little information about the quality of advisers — will receive poor quality advice; and**
- **enhancing consumer confidence in the securities advisers market.**

Against these benefits licensing may also involve various costs, including:

- **restrictions on entry, imposition of licensing fees and charges (such as a $20,000 security deposit) and other administrative costs etc, that can increase prices charged by licensed securities advisers. Excessive and costly licensing regulation in Australia could impede growth of this sector of the economy and reduce the efficiency of the allocation of funds to markets;**

- **reduced incentives for consumers to inform themselves about the quality of advisers, because they believe that licensing provides a guarantee of high quality advice. But licensing will not screen out all agents likely to engage in criminal or fraudulent activity. Nor does it guarantee that the quality of advice will be above the minimum required by regulation; and**
- **reducing consumer choice. By ensuring that only high price advisers that provide a wide range of services are able to operate, advisers that provide limited and low price services might be excluded.**

Under a licensing regime, better informed consumers could be made worse-off, because they may pay higher prices with no improvement in the quality of advice they receive. By contrast, poorly informed consumers will be better-off, because the benefits of higher quality advice and service is likely to exceed any increased prices charged by advisers. In summary, it is possible that only a subset of consumers will be made better-off by licensing.

The ORR suggests that the benefits derived from licensing, in terms of protecting some consumers, should be compared with any costs to advisers and all consumers generated by a licensing regime. It may be that many of these costs and benefits are not amenable to quantitative measurement. Nevertheless, a listing of a qualitative nature — if systematic and comprehensive — may be sufficient to gain a good appreciation of whether the benefits exceed the costs.

2.3 Consistency of proposals with other rules and regulations

Under the Corporations Law the ASC has the power to regulate persons and organisations operating businesses that provide investment and securities advice. In reviewing the regulatory regime for securities advisers, the ORR suggests that the ASC needs to give some consideration to consistency with the way some other occupations are regulated.

There are some occupations and areas that are specifically excluded from ASC regulation, such as life insurance. In addition, it is unclear whether the ASC can and should regulate some areas at the margin where securities advice may be provided, including incidental advice from solicitors and accountants, asset allocation advice, computer software, Australian and overseas publications containing general investment advice, information pertaining to investments provided by educational institutions and investment advice sourced from outside Australia.

The ORR notes that consumers can obtain investment advice from any of these sources. In addition, with the increased use of new low cost communication technology, such as ‘Internet’ etc, some consumers can readily seek advice both throughout Australia and overseas.

These factors raise several important questions regarding:

- **the scope of regulations in this area — which occupations should be covered, which should not be covered, and which might not for legal/jurisdiction reasons come under the ambit of regulations, such as overseas advisers. Since securities advice is increasingly easy to obtain from overseas sources, a costly regulatory burden on Australian securities advisers could impede growth of this important sector of the Australian economy;**
- **whether substantially similar occupations, (such as stock brokers, asset allocation advisers, ratings services and securities advisers), might come under different regulatory regimes, resulting in different regulatory outcomes such as different reporting requirements and cost structures etc. This could arbitrarily affect the relative competitiveness of different occupations and sectors of the economy; and**
- **whether the ambit and content of regulations pertaining to security advisers will be sufficiently flexible to cope with rapid institutional, economic and technological change in this area, including rapid growth in information based technologies such as ‘Internet’ and the evolving integration of Australia in the world financial system.**

Given the unclear boundaries between security advisers and similar but related occupations, and rapid change in technology and products, the ORR has doubts about the effectiveness of mandatory licensing of securities advisers.

In addition, the ORR brings to the attention of the ASC changes to the regulation of occupations arising from Government’s response to recommendations of the Hilmer Report. These changes include the agreement by all governments to review anti-competitive regulation, with consideration to be given to non-legislative approaches which do not unnecessarily restrict competition. In addition, all governments have agreed to review anti-competitive legislation which may have implications for licensing arrangements for certain occupations and professions. These agreements cover activities of all Commonwealth and State Government departments and agencies.

Reforms to occupational regulation to date include the mutual recognition agreement, which includes occupations. In essence, this

agreement allows those meeting the regulatory requirements of any Australian jurisdiction to be entitled to provide services in any other jurisdiction. The ORR notes that New Zealand might participate in this agreement from 1997. Accordingly, the ASC should give some attention to relevant New Zealand regulations in this area.

2.4 Review of regulations

All regulations should be reviewed periodically to ensure that they continue to attain objectives in a manner that minimises costs and maximises benefits. The ORR suggests that the ASC should give serious consideration to 'sunset' clauses which automatically limit the life of particular regulations, on-going arrangements for consultation with interested parties, provision for regular review and for reporting to the public on the impact of such regulations.

3 COMMENTS ON SPECIFIC ISSUES AND MATTERS FOR CONSIDERATION

This Section comments on five of the wide range of issues and matters for consideration raised in the ASC Issues Paper. A common theme in this Section is that there is a clear need for the ASC to highlight the costs, benefits and direct and indirect impact of specific proposals. In addition, the issues raised in this Section raise doubts about whether regulation of securities advisers through mandatory licensing is likely to be effective in attaining the goals that are sought, including minimisation of investor risks and promotion of an efficient market.

3.1 Matter for consideration: How should high quality advisory services be measured? (page 10)

Markets already provide information about the quality of advisory services, including the reputation of individuals/firms, fees charged, qualifications of advisers, and history of returns derived from recommended investments of particular advisers etc. Thus, there is already a considerable amount of information about the quality of advisory services. Such information is currently provided to consumers through the media, professional associations and by word of mouth.

There are other non-market methods of measuring quality that are sometimes used by public sector organisations, in particular benchmarking through the use of performance indicators. However, it is unclear whether such measuring techniques yield sufficient information to allow an informed judgment regarding quality.

For example, specific performance indicators can provide misleading information about total quality. In addition, their use can generate incentives for individuals and firms to modify their behaviour to meet such indicators, which in turn can be detrimental to total service quality.[2] Whilst such risks can be mitigated to some extent by the use of several indicators, that can increase transaction and compliance costs to regulators and firms respectively. Such costs need to be compared with the benefits of enhanced information likely to flow from such indicators.

The ORR suggests that rather than focusing on the development of additional measures of quality — which are likely to be imperfect and costly to administer — the ASC should first seek to develop an appropriate framework that enhances the flow of existing information between regulators, consumers and service providers. As previously noted in Section 2.1, the joint ASC and FPAA publication 'Don't Kiss Your Money Goodbye' is an example of useful information being transmitted to consumers. Additional information could be provided to consumers by the ASC, securities advisers, consumer groups or government departments dealing with consumer affairs. Such information could provide a list of registered securities advisers, their qualifications, history etc, which if transmitted widely would enhance consumers decision making.

Only if existing information is shown to be clearly deficient (ie. there is clear market failure in the provision of information about adviser and service quality) should additional measures of quality be developed and used by the ASC.

2 For example, the demise of the Victorian Economic Development Corporation (VEDC) in the 1980s has been attributed, in part, to the use of performance indicators to assess the efficiency of staff. In short, staff were assessed by the amount of loans they approved to target firms (ie. the more loan money approved the better the performance of the officer). This led to powerful incentives for loan officers to maximise the amount of money lent to borrowers, with subsequent increases in commercial risk (Ryan, F. 1988, *Report of Inquiry into the VEDC*, Victorian Government Printer, Melbourne, 21 December).

3.2 Matter for consideration: How important is it for investors to know the focus of the advisory services they obtain? (page 26)

Securities advisers can have different focuses. For example, independent financial advisers can focus on objective needs of their customers. By contrast, sales advisers may focus primarily on promotion of their own or associated products.

Two key questions arise when considering this issue, including:

- **does the focus of an adviser impact on the quality of advice? and**
- **can regulations ensure that the focus of advisers is made known to consumers?**

Enhancing and maintaining the quality of information provided by advisers is a key goal of regulations. If information provided is accurate and of a high quality, then the focus of an adviser is not a relevant or important consideration for regulators. Only where it can be clearly shown that the focus of advisers can lead to provision of inferior or misleading advice should regulations seek to distinguish between the focus of advisers.

However, even where there is a clear case for regulations to ensure that consumers be informed of the focus of advisers, it is unclear whether any regulations will be effective in ensuring that the focus of an adviser is transparent and made known to consumers. This important point is acknowledged in the Issues Paper which states that 'In practice, there may be difficulties in making a clear distinction between the two types of focus' (page 15).

The ORR notes that in the United States regulations do not distinguish between the focus of securities advisers, whilst in the United Kingdom such distinctions are made (page 26). Both approaches appear to work effectively and there is no presumption that one works better than the other.

3.3 Issue: How should the ASC regulate journalists and other media advisers? (page 30). Matters for consideration: Have the issues relating to media advice been correctly identified? Which, if any, of the above options are appropriate to regulate media advice? (page 31)

It is important for the ASC to take note of the growing internationalisation of the media and new technologies, such as Internet etc. Consumers can now readily obtain advice from various media sources, both in Australia and overseas, which are subject to different regulations.

Even assuming — for arguments sake — that regulations could be effective in modifying the behaviour of Australian media, information could still be sourced from less-regulated or unregulated overseas sources. Regulation is thus unlikely to be effective in protecting consumers.

In addition, new technologies are being developed and implemented that provide consumers with a growing choice of communication. Therefore, it is doubtful — and will become increasingly so — that the ASC would be able to effectively regulate the media in this area.

3.4 Issue: Is adequacy of resources an appropriate test of business competence and, if so, how should it be evaluated? (page 69)

The level of resources of competent financial advisers can vary from a personal computer/modem and appropriate computer packages to substantial human, informational and legal resources of larger firms. The level of resources provides an indicator of success in business, which may — or may not — be a reliable indicator of service quality. For example, a given firm might be small because it provides low quality services, or because it has recently entered the security adviser market, or because of the preference of its management.

So long as persons providing advice have an adequate level of professional indemnity insurance, there is no clear reason why the level of resources of advisers should be used as a criterion for assessing competence, and thus for awarding licences. In addition, use of this criterion could create a barrier to entry into this occupation, potentially reducing competition and driving up prices to the detriment of consumers. As discussed in Section 2.2, such barriers to entry could also have a detrimental impact on growth of a competitive securities adviser sector in Australia.

3.5 Issue: What is the purpose of the security bond requirement and can this objective be achieved by alternative means? (page 74)

Corporations regulations currently allow the ASC to require licensees to lodge and maintain with the ASC an approved security of $20,000. Such security allows investors to obtain compensation — for improper or inadequate advice — through an administrative process rather than through the courts. There are some exceptions to this requirement, such as stockbrokers, where licensees are subject to other regulations resulting in additional investor access to compensation mechanisms.

The main advantage of the existing approved security system is that it provides access to consumers for up to $20,000 in compensation.[3] However, there are also several important disadvantages. These include:

- **the deposit is not related to the level of risk. Risk taking advisers pay the same amount as low risk advisers. Such fixed deposits increase the costs of all securities advisers. Hence, the prices charged by advisers will not reflect the level of risk associated with using the services of different advisers;**
- **this approach discriminates against small advisers, who might have difficulty obtaining the required deposit. It can also deter entry of small advisers to the securities market, reducing price and quality;**
- **consumers need to be aware of existing ASC compensation mechanisms so that they can claim for their losses. Thus, many eligible consumers might not obtain compensation, simply because they are not aware of the process available to make a claim; and**
- **the security deposit is unlikely to provide adequate compensation to consumers, especially when large financial advisers provide inadequate or misleading advice to a large number of consumers.**

In short, the existing system is inequitable (especially to low risk and smaller service providers), it reduces competition and provides inadequate protection for consumers.

By contrast, a requirement for advisers to have professional indemnity insurance is likely to provide a superior outcome to the existing system. Insurance companies are best placed to assess the level of commercial risk associated with individual advisers. Differing levels of risk will be reflected in the size of the insurance premium. This in turn will be reflected in the differing cost structures of different service providers. For example, high risk providers would have larger premiums, hence higher costs and therefore would be less price competitive than low risk advisers. Indemnity insurance would therefore assist the operation of the market by helping to drive out high risk advisers.

This approach would not arbitrarily discriminate against smaller organisations, making entry into the security advisers markets easier, thus increasing price and quality competition.

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3 The amount that can be obtained depends on: whether the consumer is aware that he or she can make a claim; the size of the loss incurred by the consumer; and the number of consumers able to claim a loss. For example, if 40 consumers who made claims lost $1,000 each, each consumer would be able to obtain only $500 in compensation. This is because total claims from one licensee cannot exceed the size of the security deposit, which is currently $20,000.

The level of indemnity insurance would also reflect, in part, the organisational size and level of liabilities of security advisers. Thus, large firms — who are likely to have larger liabilities — would have larger policies. Therefore, all consumers would be likely to be fully compensated for failure or inappropriate advice.

A simple requirement that securities advisers have fully paid professional indemnity insurance to cover future contingencies — perhaps for one or two years in advance — would ensure that policies would not lapse following business failure. This would allow consumers to make claims after a business failure and receive full compensation.

The ASC acknowledges that 'significant resources' are needed to administer the security deposit scheme (page 74). The use of professional indemnity insurance would also reduce regulatory costs, since the ASC would no longer have to administer every component of a security deposit scheme.