FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

Forestry Managed Investment Schemes

FPA SUBMISSION TO SENATE ECONOMICS REFERENCES COMMITTEE | DATE: 15.12.2014

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

15 December 2014

RE: FORESTRY MANAGED INVESTMENT SCHEMES

Dear Sir/Madam,

The Financial Planning Association of Australia (FPA) [1] welcomes the opportunity to provide a submission to the Senate Economics References Committee inquiry into forestry managed investment schemes (FMIS). We also welcome the broader terms of reference for this inquiry, particularly regarding this inquiry's consumer protection and compensation focus, as well as broader legal reform and policy development.

There have been fundamental changes in the financial services sector, and in the financial planning profession, since the Parliamentary Joint Committee into Corporations and Financial Services inquiry into agribusiness managed investment schemes in 2009. The most important reforms have been the Future of Financial Advice (FOFA) reforms, which directly addressed the Parliamentary Joint Committee's concerns with conflicts of interest in financial advice and conflicted remuneration.

The FOFA reforms are a positive step forward, but should not be the only response to calls for reform in financial planning and the financial services sector. At a fundamental level, the product failures and massive consumer losses associated with FMIS, agribusiness MIS, and many other financial product scandals are the consequence of inadequate leadership in responding to the financialisation of Australian society.

[1] The Financial Planning Association (FPA) represents more than 10,750 members and affiliates of whom 8,055 are practicing financial planners and more than 5,500 CFP professionals. The FPA has taken a leadership role in the financial planning profession in Australia and globally:

- Our first "policy pillar" is to act in the public interest at all times.
- We banned commissions and conflicted remuneration on investments and superannuation for our members in 2009 – years ahead of FOFA.
- We have an independent conduct review panel, Chaired by June Smith, dealing with investigations and complaints against our members for breaches of our professional rules.
- The first financial planning professional body in the world to have a full suite of professional regulations incorporating a set of ethical principles, practice standards and professional conduct rules that explain and underpin professional financial planning practices. This is being exported to 24 member countries and the 150,000 CFP practitioners that make up the FPSB globally.
- We have built a curriculum with 17 Australian Universities for degrees in financial planning. All new members of the FPA are required to hold, as a minimum, an approved undergraduate degree.
- CFP certification is the pre-eminent certification in financial planning globally. The educational requirements and standards to attain CFP standing are equal to other professional bodies, eg CPA Australia.
- We are recognised as a professional body by the Tax Practitioners Board

Forestry Managed Investment Schemes

FPA SUBMISSION TO SENATE ECONOMICS REFERENCES COMMITTEE | DATE: 15.12.2014

The FPA's view is that reforms for FMIS have to be connected to comprehensive law reform and policy development regarding the Australian financial services system. Our submission discusses opportunities for further reforms, many of which are connected to our engagement in other inquiries and consultations, such as the Financial System Inquiry, the Parliamentary Joint Committee's inquiry into the performance of ASIC, and this Committee's inquiry into the scrutiny of financial advice.

The FPA welcomes the opportunity to discuss our submission further. If you have any questions, please contact me on 02 9220 4500 or dante.degori@fpa.asn.au, or Nicholas Melas, Policy and Standards Analyst on nicholas.melas@fpa.asn.au.

Yours sincerely

Dante De Gori
General Manager Policy and Conduct
Financial Planning Association of Australia

Forestry Managed Investment Schemes

General advice and business models

The FPA has consistently argued that the regulation of general advice is insufficient, and that the term 'general advice' should be replaced with 'product sales', 'general information', 'financial product information' or another term which clarifies the distinction between product sales and financial advice. In our second-round submission to the Financial System Inquiry, we wrote:

> "Framing general advice as financial advice plays into the behavioural aspects of financial decision-making by giving the impression that the advice has a reasonable basis or is appropriate for the client, and thereby exposes retail investors to decisions made under uncertainty about the regulatory framework for that advice.
>
> As with many other problems in the Australian financial system, our reliance on a disclosure-based regulatory approach has contributed to this confusion. While a general advice warning is required to be issued when providing general advice, it is the context of the advice which is more influential on many consumers than the warning."

The release of the Financial System Inquiry's Final Report has shown significant support for our position. The Report recommended that general advice be "re-named", and stated that:

> "The Inquiry believes greater transparency regarding the nature of advice and the ownership of advisers would help to build confidence and trust in the financial advice sector. In particular, 'general advice' should be replaced with a more appropriate, consumer-tested term to help reduce consumer misinterpretation and excessive reliance on this type of information. Consumer testing will generate some costs for Government, and relabelling will generate transitional costs for industry — although these are expected to be small. The Inquiry believes the benefits to consumers from clearer distinction and the reduced need for warnings outweigh these costs."[2]

Our view is that financial products – particularly complex financial products such as interests in FMIS – should not be promoted or sold in circumstances where retail clients may reasonably believe that they are being offered advice that takes into account their personal circumstances. We also believe that financial products should not be promoted or sold in circumstances where the consumer protection framework that applies to the individual is ambiguous.

Another concern is with the role of business models which rely on referral networks providing adequate consumer protection and disclosure of the legal and regulatory framework of the consumer interaction. Referral advice is not regulated by the Corporations Act even where major financial decisions are at stake, as this advice does not of itself constitute a financial product recommendation. Referral networks can play a role in the sale of FMIS financial products, and certainly did play a significant role in the massive consumer losses from Timbercorp, Great Southern, and other widely marketed schemes.

Recommendation 1: The Senate Committee should recommend that the general advice definition be replaced with "product sales", "product information", "general information", or a consumer-tested term that does not pose the risk of misleading retail clients about the service they are being provided.

[2] Financial System Inquiry, Final Report (November 2014), p 272

Forestry Managed Investment Schemes

Recommendation 2: The Senate Committee should investigate the role that referral networks played in the distribution of failed forestry and agribusiness managed investment schemes.

Recommendation 3: The Senate Committee should examine whether consumers are adequately protected from referral strategies intended to transition between legal and regulatory frameworks of varying consumer protection.

Link to Inquiry Terms of Reference: (a), (d), (h)

Gatekeeper failure in FMIS

A systemic failure in the financial system is its lack of a consistent gatekeeper framework in the Australian financial system. The AFS licensing regime introduced by the financial services reform in the early 90's has encouraged a regulatory approach based on fundamentally homogenous regulatory principles for financial intermediaries. The 'gatekeeper' regulatory approach which is preferred by ASIC recognises the different roles which intermediaries play within the system, and adapts the regulatory style for various intermediaries to the features and risks of those roles.

In the case of FMIS collapses and the massive consumer losses associated with them, gatekeeper failures within research houses, AFS licensees, responsible managers, and product issuers have been understated in favour of blaming product distributors and financial planners. Part of this bias towards the distribution end is due to our disclosure-oriented regulatory focus which explicitly excludes financial product quality and research quality from scrutiny.

In our submission to the Senate inquiry into the performance of ASIC, we wrote:

> "It is well established that, rather than all fault lying with the advice provider, there are multiple participants who offer products or services within the financial advice value chain, all of whom influence, directly or indirectly, consumers' decisions on financial matters. However, accountability of these participants to the end consumer is variable, limited and for some practically non-existent, which significantly restricts ASIC's ability to act….
>
> Each of these stakeholders play some part, either directly or indirectly, in influencing a consumers' decision to invest in a financial product and the ongoing stability of that product. Therefore ASIC must have the legislative power to hold each participant accountable for the responsibility they have to the consumer for the 'gatekeeper' role they play, and the consumer's compensation needs"

Key gatekeeper failures of FMIS have concerned the development of managed investment schemes as financial products. The FSI Final Report has stated that product regulation and product issuer regulation need to be more carefully considered in order that those entities bear the appropriate responsibility for a fair, safe, and efficient financial services system.

The Report made the recommendation that a principles-based product design and distribution obligation be implemented for product issuers, and stated that::

> **"During product design**, product issuers should identify target and non-target markets, taking into account the product's intended risk/return profile and other characteristics. Where the nature of the product warrants it, issuers should stress-test the product to assess how consumers may be affected in different circumstances. They should also consumer-test products to make key features clear and easy to understand.
>
> **During the product distribution process**, issuers should agree with distributors on how a product should be distributed to consumers. Where applicable, distributors should have controls in place to act in accordance with the issuer's expectations for distribution to target markets.
>
> **After the sale of a product**, the issuer and distributor should periodically review whether the product still meets the needs of the target market and whether its risk profile is consistent with its distribution. The results of this review should inform future product design and distribution processes. This kind of review would not be required for closed products."[3]

The FPA has consistently called for greater product issuer accountability, and we fully support this recommendation. We urge the Senate Committee to consider the FSI's discussion of product issuer regulation in the Final Report, particularly in the context of comprehensive gatekeeper regulation of the financial services sector.

Notwithstanding that Report's emphasis on product issuers, we maintain that may other gatekeepers, such as research houses and AFS licensees, have also failed their obligations. Many retail investors have suffered as a result of faulty research regarding fundamentally flawed forestry MIS. We urge the Senate Committee to examine the involvement of these critical gatekeepers.

Recommendation 4: The Senate Committee should recommend a review of the obligations of key gatekeepers in the creation, operation, marketing, and distribution of forestry and agribusiness managed investment schemes, including research houses, licensees, and product issuers.

Link to Inquiry Terms of Reference: (a), (b), (c), (d), (e), (g), (h)

Professional indemnity insurance

Following from the failure of Timbercorp, MFS/Octavia, Great Southern, and other schemes, professional indemnity insurers have increasingly excluded cover for forestry and agribusiness managed investment schemes.

This has several consequences for existing investors in forestry and agribusiness MIS and for product issuers and distributors. Financial planners often take on clients who have made poor investment decisions and need advice to return to financial health. For clients who had invested in forestry and agribusiness MIS, there is significant compulsion from a PI perspective to advise defensively on existing investments in forestry and agribusiness MIS, or to exclude any advice on those existing products altogether. There is a risk that a financial planner who provides advice relating to a new client's existing MIS investment, will not be covered by PI, even though they did not recommend the

[3] Financial System Inquiry, Final Report (November 2014), p 198

investment in the first place. Clients who consult with a financial planner to try to mend their financial situation should be able to expect full and frank advice on every aspect of their circumstances.

Furthermore, the existing market for PI insurers is quite limited, and the market is not very competitive as a result. It is possible that, as PI insurers tighten their coverage, existing investors who have not sought redress may find it more difficult to access the PI cover of the entity which originally distributed the financial product.

Lastly, financial advice firms are required to have adequate PI arrangements in place, and that the present legal and regulatory environment poses significant litigation risks to licensees who authorise their representatives to provide personal financial advice. If product distributors are not able to secure distribution through licensees offering professional financial advice as a result of the licensee's PI arrangements, they may rely on general advice business models and/or targeting wholesale and sophisticated investors.

Recommendation 5: The Senate Committee should investigate the risks to consumers and financial planners of professional indemnity insurers excluding forestry and agribusiness managed investment schemes from their policies.

Recommendation 6: The Senate Committee should recommend that product issuers and responsible managers maintain adequate levels of PI insurance and/or assets to meet the risk of product and/or management failure in forestry and agribusiness managed investment schemes.

Recommendation 7: The Senate Committee should recommend that Treasury review the existing provisions for scaled advice, to determine whether financial planners are legally capable of scoping existing investments in managed investment schemes out of their advice to clients.

Link to Inquiry Terms of Reference: (c), (e), (g)

Retail, wholesale, and sophisticated investor definitions

One of the causes of regulatory failure in the case of FMIS collapses is the inadequate legal and conceptual framing of the end user of the financial system. The FPA does not believe that the current regulatory structure appropriately identifies and addresses the needs of various end users of the financial system. This is particularly true of the way that the Corporations Act defines categories of end users and regulates financial services differently depending on the end user of the service. In our first-round submission to the FSI, we pointed out these weaknesses in the current way that the law defines and categorises investors:

- the distinction is based on the wealth of the investor, rather than a measure of their financial literacy;
- the distinction does not incorporate behavioural elements into the categorisation or basic understanding of how these participants will operate;
- the distinction functions to remove judgement and discretion from financial intermediaries regarding their conduct towards clients with differing degrees of financial capability, and;

- the distinction, when paired with a disclosure-based system of regulation, encourages documentary compliance with little consumer protection benefit or improvement in financial capability or opportunity.

The investment case for forestry and agribusiness projects, as well as for the underlying MIS structure, is very complex. Many of our members have related to us that forestry and agribusiness MIS are so difficult to understand and justify as an investment option over alternative products that their licensees do not include them on their approved product lists and financial planners avoid them. Professional indemnity insurers likewise have begun to exclude such products from their policies, as a response to the perceived risk and opacity of the investment case for MIS recommendations.

This response from the industry begs the question of whether we can reasonably expect retail investors to understand these structures. It also begs the question of whether a regulatory strategy which categorises end users of the system based on wealth rather than sophistication is appropriate. Our submission to the Financial System Inquiry proposed alternative regulatory schemes which better address the realities of the end user's engagement with the Australian financial system;

- Investor/consumer: Market participants could be categorised with respect to the purpose they have engaged with the financial system. In particular, users who rely on carrying risk for profit as the basis of their use of the financial system should have different regulatory rights and obligations to users who purchase financial products as a consumer.[4]
- Suitability regulation: Suitability regulation may also be appropriate outside of recommending complex products. If financial intermediaries are required to form a judgement about the financial capability of the clients they serve, it will help them to tailor their disclosure obligations to the needs of the client and to reasonably adjust the scope of their professional obligations to those needs as well.
- Institutional/individual: This distinction relies on the institutional checks and balances available to the client in order to mitigate behavioural, capability, and exclusion-based inefficiencies. Where suitability regulation is intended to respond to the unique financial capability of the client, regulation which focuses on the ability of the investor to access financial intermediaries to help that investor make better financial decisions.

Our view is that the exercise of professional judgment and the fair treatment of consumers should be the guiding principles for how any categorisation of users of the financial system should operate.

Recommendation 8: The Senate Committee should recommend a review of the definitions of 'retail', 'wholesale', and 'sophisticated' investors in the Corporations Act, with a view to proposing alternative regulatory structures which consider more circumstances of the individual in question.

Link to Inquiry Terms of Reference: (d), (g), (h)

[4]For more detail on the investor/consumer distinction, see Niamh Moloney, 'The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?' (2012) *European Business Organization Law Review* 13, 169-193; Dimity Kingsford-Smith and Olivia Dixon, 'The Consumer Interest and the Financial Markets', in Eilis Ferran, Niamh Moloney and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (2014 - forthcoming).

Product regulation

Another part of the problem with regulating forestry MIS is that the ideological underpinnings of the FSR regime in the Wallis Report were rooted in product agnosticism – in that neither the regulator or the Government are responsible for regulating financial products themselves. The result is that the law does not permit regulators to intervene in forestry MIS and other products and schemes which were/are directed at tax efficiency as opposed to their business case.

Product regulation is a distinctly different style of regulation to product issuer regulation. Where product issuer regulation attempts to influence the features of financial products by adjusting the behaviours of financial intermediaries who are responsible for issuing these products, product regulation examines the particulars of the product itself. In our first-round submission to the Financial System Inquiry, we discussed three forms of product regulation:

- Suitability requirements: These requirements are intended to ensure that the end user of complex financial products is sophisticated enough to understand the product, and/or the intermediary has formed a judgement about the suitability of that product for the client. For example, the IOSCO final report on the *Suitability Requirements With Respect To the Distribution of Complex Financial Products* recommends a series of principles, such as duties, warnings, disclosure, and judgement with respect to the 'classification' of a customer, the information required to make a reasonable recommendation, and conflicts of interest.[5]

- Merits regulation: Merits regulation involves the regulator, and/or the financial intermediaries who distribute, advise, or issue complex products, to form a judgement about the value of a complex product. This value judgement will inform the basis on which the financial product can be distributed, or if the product can be sold or advised on at all. For example the European Securities and Markets Authority has recently published a legal opinion indicating that,[6] if the internal controls of a financial intermediary indicate that "a particular complex product will never meet the best interests of their clients, or there is a lack of sufficient information available to ascertain the main features and risks of a product", that product should not be sold or advised on.

- Disclosure obligations: Enhanced disclosure obligations are another way to approach complex products, which provide clear and easily accessible information about the particular features of complex products which make them so difficult to understand. However, the FPA do not believe disclosure obligations alone are sufficient regulation for complex products.

As these regulations are directed at the financial product itself, this style of regulation offers a highly targeted (albeit intrusive) method of regulating financial services in Australia. This approach to regulation has found some support in the Financial System Inquiry's Final Report. The Report recommended that a product intervention power be introduced for ASIC, which would include powers to:

- Amend marketing and disclosure materials.
- Warnings for consumers, and require labelling or terminology changes.

[5] IOSCO, *Suitability Requirements With Respect To the Distribution of Complex Financial Products* (January 2013); see also ESMA, 'MiFID practices for firms selling complex products' above n 16 at [15]
[6] ESMA, 'MiFID practices for firms selling complex products' above n 16 at [14]

- Restrict distribution of the product, and;
- Ban financial products[7]

This approach is a significant departure from the principles in the Wallis Report, but may be warranted in the case of risky and complex financial products – especially if these products continue to be available to retail clients without providing personal financial advice.

Recommendation 9: The Senate Committee should recommend that Treasury review the Corporations Act and/or the ASIC Act to consider how product intervention powers could be implemented for ASIC.

Link to Inquiry Terms of Reference: (d), (g), (h)

[7] Financial System Inquiry, Final Report (November 2014), p 206

Appendix A – List of Recommendations

Recommendation 1: The Senate Committee should recommend that the general advice definition be replaced with “product sales”, “product information”, “general information”, or a consumer-tested term that does not pose the risk of misleading retail clients about the service they are being provided.

Recommendation 2: The Senate Committee should investigate the role that referral networks played in the distribution of failed forestry and agribusiness managed investment schemes.

Recommendation 3: The Senate Committee should examine whether consumers are adequately protected from referral strategies intended to transition between legal and regulatory frameworks of varying consumer protection.

Recommendation 4: The Senate Committee should recommend a review of the obligations of key gatekeepers in the creation, operation, marketing, and distribution of forestry and agribusiness managed investment schemes, including research houses, licensees, and product issuers.

Recommendation 5: The Senate Committee should investigate the risks of professional indemnity insurers excluding forestry and agribusiness managed investment schemes from their policies.

Recommendation 6: The Senate Committee should recommend that product issuers and responsible managers maintain adequate levels of PI insurance and/or assets to meet the risk of product and/or management failure in forestry and agribusiness managed investment schemes.

Recommendation 7: The Senate Committee should recommend that Treasury review the existing provisions for scaled advice, to determine whether financial planners are legally capable of scoping existing investments in managed investment schemes out of their advice to clients.

Recommendation 8: The Senate Committee should recommend a review of the definitions of ‘retail’, ‘wholesale’, and ‘sophisticated’ investors in the Corporations Act, with a view to proposing alternative regulatory structures which consider more circumstances of the individual in question.

Recommendation 9: The Senate Committee should recommend that Treasury review the Corporations Act and/or the ASIC Act to consider how product intervention powers could be implemented for ASIC.