INSIGHTS FROM
CFA SOCIETY SINGAPORE

By Mary Leung

Safeguarding investor outcomes

This is best done through a balance of new regulations, more rigorous enforcement, and heightened attention to culture

FINANCIAL industries around the world thrive on an incentives-driven model, sometimes to the detriment of investors. What are countries doing to raise the level of investor protection?

A commission model may be the best way to incentivise a sales force and drive profitability, but it also could encourage the recommendation of products that pay higher commissions rather than doing what's best for the client. Full disclosure of sales commissions helps investors understand potential conflicts of interest, but how do you disclose them in a meaningful way?

In Australia, seventy public enquiries and the Hayne Royal Commission down, still it seems the sales- and commission-driven culture, which has proven to be so frequently inconsistent with good investor outcomes, persists. The financial industry in Australia is highly developed and heavily regulated, and significant expectations exist for the industry to deliver real, tangible value to its customers.

The Future of Financial Advice (FOFA) reforms of 2012 went some way towards promoting outcome-oriented models, by banning conflicted remuneration structures and imposing a best interest duty, but grandfathering arrangements and weak enforcement undermined many of the potential benefits.

The "widespread sense of complacency and overly collegial culture", which the Australia Prudential Regulatory Authority found characterised the Commonwealth Bank in 2018, appears to have changed very little.

During the Royal Commission investigation, unsurprisingly, banks were once again in the spotlight, along with AMP Ltd, a financial services company in Australia.

Together, they dominate financial services in a highly concentrated and vertically integrated market. Nevertheless, there is some optimism that the 76 recommendations made by Commissioner Kenneth Hayne, combined with new powers given to the Australian Securities and Investments Commission, may go some way towards addressing these problems.

In CFA Societies Australia and CFA Institute's response to the Hayne Royal Commission – "Professionalising Financial Advice" – we made a number of policy recommendations, acknowledging that a genuine, long-lasting impact could not be achieved with a single solution. In our view, grandfathering of commissions, which undermined attempts at meaningful change post-FOFA, should be outlawed within 12 months.

In addition, we recommend changes aimed at better aligning the interests of customers with those of investment managers, better disclosure of fees and charges as well as ownership structures, and last but not least, strong deterrents in the form of serious consequences for breaches.

Australia clearly has some way to go, but how does it compare with other markets?

North America

In Canada and the United States, both fees and commissions are allowed. In the US, mutual funds are sold through brokers, dealers, and registered investment advisers (RIAs). They have different standards of care for clients and are regulated separately. RIAs work toward a fiduciary standard, whereas broker-/dealers only have to observe a suitability standard. Both broker/dealers and RIAs interact with the same clients and call themselves advisers, however, creating huge confusion in investors' minds.

Earlier this year, the US Securities and Exchange Commission approved a package of reform called Regulation Best Interest (Reg BI). The hope was that Reg BI would improve investor protection.

Unfortunately, much remains the same – brokers and RIAs continue to be regulated separately, and although labelled "best interest," this rule does not define what best interest is and requires only that broker/dealers not put their interests ahead of their clients.

United Kingdom

The mis-selling scandals before the global financial crisis led to a Retail Distribution Review (RDR), which recommended structural changes to the financial advisory market. Implementation of the RDR rules fundamentally changed the financial advisory industry in the United Kingdom, and it became the first jurisdiction to ban commissions.

Advisers were no longer able to receive commissions from product providers for selling or recommending their products and could be paid only by their clients. Minimum qualifications for advisers also were raised. There were concerns that the reforms would create an "advice gap" as the barriers to entry were raised.

During initial post-implementation reviews, some evidence showed that investors' portfolios had shifted towards lower-cost products and no conclusive evidence revealed an advice gap. Both were positive outcomes, but it also was acknowledged that it was still too early to understand the full effects of the new regime. Further review is expected in 2020.

Hong Kong

In Hong Kong, the fallout from the Global Financial Crisis (GFC) first prompted a real change. Regulators tightened standards and introduced new regulation and guidelines covering product suitability, fee disclosure, and the selling process.

A commissions ban was considered, but rejected, as a consensus developed that the market was not ready for a fee-for-service model.

Hence, a regulatory focus has been placed on reducing and managing conflicts of interest by enhancing transparency, driving down investor costs, and promoting competition.

Another focus has been on customer protection through policies that support a client's understanding of what he/she is buying. These protections impose on licensed intermediaries a duty to adhere to a suitability standard – they can recommend only a product whose risk-and-return profile is commensurate with that of the client.

The focus on minimising conflicts of interest has prompted regulators to emphasise disclosure – intermediaries must disclose the fees they stand to receive, how these will be paid, and whether they will receive any benefit from product issuers.

This is a welcome change on its face, but the debate is ongoing as to how much attention investors pay to such disclosures and how effective they are in enabling investors to make informed choices.

Singapore

As in Hong Kong, the GFC had a significant impact on the market in Singapore, because of the wide selling of Lehman mini-bonds and other structured products.

Following that crisis, in 2009, Singapore introduced the "Fair Dealing Guidelines" for the board and senior management of financial institutions, emphasising their responsibility to deal fairly; offer suitable products; ensure competency of representatives; offer clear, relevant, and timely information; and handle complaints in an independent manner.

Despite some improvement, a mystery shopper exercise in 2011 found that 30 per cent of products recommended were "clearly unsuitable" and that representatives were not upfront about fees and charges.

As a result, a panel was created to recommend changes aimed at raising the standard of financial advisers and financial advice through education and ongoing professional development.

Conclusion

Serious challenges remain for governments and regulators, but the good news is that post-GFC, most markets have made material improvements in their regulatory frameworks.

Most have tried, where possible, to ask industry to include other nonfinancial criteria when determining remuneration; to increase disclosure and transparency, particularly with respect to costs and conflicts of interest; and to increase the levels professionalism. All efforts represent positive improvements.

It is our strong view that a healthy, well-functioning market should be able to support a range of different business models, while at the same time protecting investors and managing conflicts of interest. A balance of new regulations, more rigorous enforcement, and heightened attention to culture offers the best chance of creating ideal investor outcomes over the long term.

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