Network for Sustainable Financial Markets

Wealth management in a post-GFC world

Promoting best practice, innovation & sustainable outcomes
for industry, consumers & society

Network for Sustainable Financial Markets
Wealth Management Working Group

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About the Network

The Network for Sustainable Financial Markets ("NSFM") is an international, non-partisan network of finance sector professionals, academics and others who have an active interest in long-term investing. We believe that the recurring crises recently experienced in our financial markets are not isolated incidents. Rather, this instability is evidence that the financial market system is in need of well thought-out reform so that it can better serve its core purpose of creating long-term sustainable value.

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"Few wealth advisors understand the extent to which client dissatisfaction has developed. 80% of wealth managers thought their performance was good or very good during the financial crisis. Only 30% of clients agreed and a further 30% thought it was poor or very poor…" (Dow Jones Wealth Bulletin Report, 15 June 2009)

"Families and small businesses are still reeling from the effects of the financial collapse that occurred a year and a half ago. These unacceptable allegations [against Goldman Sachs] highlight the need to move to fundamentally reform the way Wall Street does business. If we don't use this opportunity to create safeguards for consumers and protect American taxpayers from having to prop up banks that are 'too big to fail,' we will continue to run the risk of another financial crisis." (Colorado Senator Michael Bennet, 16 April 2010)

"Investors rarely research recommendations they receive from trusted advisers, and may not realize the so-called advice is tainted, or that there are better alternatives." (B Roper, CFA (US), 28 February 2010)

"The wealth management model is broken, but who will fix it? What little trust people had in wealth managers has all but evaporated, dissatisfaction is such that some ultra wealthy individuals are looking to set up their own banking institutions, going a step beyond the family investment offices that are mushrooming in Europe and elsewhere. It seems Chief Executives of wealth managers and private banks recognise the existing model is broken but are powerless to change it." (J Rutter, 26 March 2009)

"The wealth management world is badly in need of an early warning system to help detect bad advice and products…there are obvious holes in regulatory enforcement and in puny professional standards, the educational standards required to become a financial planner are minimal … It's time for regulatory and policymakers to do more to protect people from blatantly poor advice and high pressure sales tactics. It's also time for the planning industry to banish unprofessional members instead of closing ranks around vague principles that profess to be in the public interest, only to allow conflicts of interest within the sector to flourish…the sales first culture that pervades the financial advisory industry as well as the institutions whose products it flogs is inimical to the interests of many investors."(Australian Financial Review Editorial, 7-8 February 2009)

"This crisis has prompted governments to be more outspoken about specific market instruments and asset classes than ever before … All industry practitioners can ask of the new laws is they are well thought out and implemented accordingly. Because if they are not, they could harm the very markets they are trying to protect." (Global Investor magazine, April 2010)

"The definition of fiduciary is actually fairly straightforward. It's putting the interests of the clients ahead of your own. It arises from a relationship of trust, and Lord knows that dealing with other people's money is a very personal matter that definitely involves trustworthiness." (D Tittsworth, 1 March 2010, Executive Director, Investment Adviser Association, US)

"Our suspicion of the inaction to this point is that many institutions believe they are satisfying their current client base so they question the need to invest. To an extent they were right although the recent litigations I referred to at the start of the article suggest this stance may need to be reviewed. Notably regulators in several markets including Australia, India, Singapore and Hong Kong are all now taking a closer look at the capabilities of financial salesmen – in whatever market segment they operate including wealth management."
(S Dovey, 16 March 2010)

"Perhaps a more interesting development that could arise from the new regulations is the advent of new business models, or at least ways of working, thus bringing a refreshing level of innovation in how end clients are being serviced … the traditional approach to investment research does not demonstrate enough value to end investors, despite the fact that research is key to the investment process and client outreach." (Y Mathieu, S&P Equity Research Europe, 12 April 2010)

As long as we keep investor protection at the core of [the] debate, I think we have an opportunity to really affect better and smarter regulation and legislation." (L Roth, 1 March 2010, Keystone Capital, Monahan & Roth)

"What we're seeing today in the post-Madoff world is a regulatory community so afraid it might miss something that there seems to be analysis by paralysis. Regulators are not making any subjective decisions as to what's a risk, what's important and what's material because they're afraid they might miss something. They're just getting overwhelmed with the minutiae." (Tracy DeWald, General Counsel for Securities America, 1 March 2010)

Introduction

The global wealth management industry has seldom found itself the subject of such intense regulatory, political, media and consumer scrutiny. This focus is multi-jurisdictional, spanning both developed and emerging markets and reflects the continuing globalisation of the industry and its consumer base.

We stress that there are high quality industry participants[i] in many jurisdictions. Nevertheless, high profile corporate failures, investment scandals, tax avoidance and "age old", systemic problems continue to plague efforts to improve industry quality, integrity and efficiency. This has eroded consumer trust, confidence and prospects for optimal industry growth. It is also fundamentally at odds with economic, social and broader public policy goals that seek long term savings and wealth creation to help fund investment, retirement, GDP and employment objectives.

There are high quality industry participants in a number of jurisdictions. However, significant improvement is required in a number of key areas if industry growth is to be underpinned by sustainable and best practice approaches moving forward

International policymakers, regulators and industry are currently re-appraising financial services architecture in a post-GFC world. Accordingly, now is the time for the global wealth management industry to be remodeled in a fashion better aligned with generating sustainable, best practice outcomes for industry, consumers and society.

Relevance for industry

It is important to stress that the recommendations below are designed to assist industry and the market to move to a naturally self-regulating and more sustainable model.

Whilst recommendations necessarily focus on what policies and regulatory practices should be adopted to address systemic industry issues, industry participants in particular are encouraged to view these recommendations in the context of how they might drive their own business models towards global best practice and competitive advantage.

Scalable, profitable and higher quality business models are achievable, but this requires leadership, new thought, innovation and know-how. Enduring value and market share advantages exist for those players prepared to undertake the necessary transformations.

International (jurisdiction agnostic) focus

Given the international focus of this paper, we have sought to develop a set of recommendations that is global in focus and jurisdiction agnostic. Whilst it is obviously essential that issues be addressed having

regard to local market conditions and industry constructs, this report does not critique specific solutions being developed or implemented in any one jurisdiction, although the principles outlined are timely and highly relevant to current debate and deliberations in many countries.

Further, policymakers in emerging markets must continue to develop regulatory frameworks with regard to global best practice (i.e. not only by reference to the current state of sophistication of the wealth management industry in their jurisdiction). Clearly, the high relative growth in wealth in emerging markets and rapid globalisation of the industry create unique challenges, which require an approach to regulation and industry development that accommodates the pace of change, consumer demand and competitive dynamics introduced by the presence of domestic and foreign players.

In this regard, emerging markets have the benefit of learning from mistakes made in more mature wealth management jurisdictions.

Background

Some systemic & structural impediments

Simply stated, a number of interrelated themes explain the failures of the wealth management industry[ii] and associated policy and regulatory frameworks:

- A predominantly sales-driven industry culture that creates conflicts of interest between providers and consumers of wealth management services and a devaluation of advice (framing the advisor-consumer relationship as product sales and transaction, rather than advice, driven)
- An inadequate focus on the quality of advice and the technical competence of financial advisors (and other key service providers)
- Bundled pricing, commission-driven remuneration and business valuation models that have entrenched conflicts of interest, a primary focus on accumulating funds under management ("FUM / AUM / AUA" etc), product distribution and transactional revenue at the expense of quality consumer service and advisory outcomes
- High rates of portfolio turnover, misaligned remuneration, pricing and executive compensation schemes, inappropriate leverage practices and an entrenched concentration on short-term performance, effectively perpetuating a negative "feedback loop" between corporations, institutional investors, asset managers, financial advisors and other intermediaries (including analysts, research houses, credit rating agencies, asset consultants etc), promoting short term risk-taking at the expense of long term wealth creation
- Overreliance of policymakers and regulators on flawed assumptions regarding both the aptitude of consumers to make decisions in their own best interests and the ability to manage conflicts of interest via disclosure and related measures. Such issues being compounded by the limited focus of traditional conduct and disclosure based regimes, a lack of regulator resources and specialist

industry knowledge – creating a "box ticking" as opposed to proactive, inquiry driven supervisory culture

- Lack of service innovation leading to highly scalable but simplistic and reactive business models at odds with consumer expectations and needs. This may be contrasted with exponential product growth from both an investment and lending perspective which, whilst welcome from an innovation standpoint, has tended to reinforce sales and product distribution driven cultures, risk and complexity, opaqueness, short-termism and the inadequacies of disclosure based regulatory regimes
- Fragmented and ineffective industry self-regulation
- A lack of consumer financial literacy (i.e. consumers typically don't have the skills, knowledge or experience to know whether advice is good or bad, creating disincentives for industry to improve business models beyond the status quo – particularly where prevailing models are both highly scalable and profitable)

Efforts to date & international position

These impediments have been considered (to a certain extent) in past regulatory reviews and in the development of numerous standards and codes of conduct by professional and industry bodies. Having said this, it is clear that current regulatory approaches have failed to meet their stated objectives (including the maintenance of fair and efficient markets, the promotion of informed consumer decision-making and the protection of consumers from business practices inconsistent with their interests).

Reflecting this, an unprecedented number of reviews considering regulation of wealth management products and services are currently underway in many jurisdictions. These include for example:

An unprecedented number of reviews considering the regulation of wealth management products and services are underway around the world

- The European Commission's ongoing work and consultation on Packaged Retail Investment Products (PRIPs) looking at pre-contractual disclosure and selling practices as they relate to retail investment products (draft legislative proposals are expected to be released in 2010 and may ultimately involve consequential changes to the cornerstone Markets in Financial Instruments Directive (MiFID) and Insurance Markets Directive (IMD) regimes currently applying to European securities and insurance markets)
- The UK Financial Services Authority's ongoing Retail Distribution Review (RDR) which commenced in 2006 and continues to develop and implement widespread changes to retail wealth management regulation (recent consultation on, inter alia, professional standards for financial advisors was released in December 2009)

- US Senator Christopher Dodd's ''Restoring American Financial Stability Act of 2010" draft bill released in March 2010 canvassing a range of proposals for improved regulation of financial markets and providers of financial and investment products in addition to improved consumer protection frameworks

- The Australian Parliamentary Inquiry into Financial Products and Services (the Ripoll Inquiry) which in November 2009 released a list of broad recommendations (which are being responded to by the Australian Government with key reforms to be implemented from 1 July 2012). Concurrent reviews relating to Australia's taxation and superannuation frameworks (Henry and Cooper reviews) will also have substantial ramifications for the wealth management industry

- The Monetary Authority of Singapore's (MAS) consultation on the regulation of the sale of investment products and strengthening of consumer protection measures (a consultation paper on the "Proposed Regulatory Regime for Listed and Unlisted Investment Products" was released in January 2010)

- The Hong Kong Securities and Futures Commission (SFC) current consultation on "Proposals to Enhance Protection for the Investing Public" which is seeking to strengthen and codify multiple regulatory mechanisms governing the marketing and sale of unlisted investment products to retail investors

- Ongoing work by the New Zealand Government in relation to strengthening the regulation of financial advisors including the draft Code of Professional Conduct released on 31 March 2010

- Broader inter-governmental reviews of offshore tax havens and banking secrecy

Whilst there is widespread acknowledgement of the need for action (and there has been recent progress on a number of fronts), global policymakers and regulators have much work to do to address systemic issues and deliver a genuinely sustainable framework for the international wealth management industry.

Building an effective pathway to best practice

Policy and regulatory solutions need to be driven by the long-term interests of all consumers and the implementation of "best practice" business models that support scalable, profitable and sustainable outcomes for industry participants. These are not mutually exclusive outcomes, but do require innovation and a fresh approach to regulation, industry development and consumer engagement.

The recommendations ultimately seek to stimulate industry growth by enhancing the quality of wealth management services thereby improving consumer outcomes and increasing market demand

In essence, policy and regulatory responses require:

- A focus on ensuring the best interests of end-consumers drive the business practices of all players in the "wealth management value

chain" (from financial advisors, brokers and bankers to analysts, research houses, credit rating agencies, asset consultants, asset managers and institutional investors whose decisions all ultimately impact the quality and sustainability of wealth outcomes for consumers)

- Recognition of the value of advice to sustainable wealth outcomes. This includes the importance of focussing on improving the quality of – and access to – financial advice which meets the needs of consumers, unimpeded by conflicts of interest
- Specific targeting of "short-termism" and sub-optimal remuneration, pricing, valuation and other industry practices which perpetuate conflicts of interest and continue to diminish the value of advice (notwithstanding disclosure and related measures aimed at "informing" consumers of these constraints)
- Greater attention to the technical competency of financial advisors and others throughout the industry whose decisions and business practices influence the sustainability and quality of wealth outcomes for consumers
- Increased focus on addressing what industry participants specifically need to have in place (from a business process, risk management, supporting infrastructure and human capital perspective), in order to genuinely drive best practice outcomes. This does not extend to "picking winners", but does require the evaluation of structural impediments (including at a micro business level) that inhibit the market's ability to naturally evolve to a best practice state
- Benchmarking of industry participants against best practice guidelines and the use of results to inform and recalibrate existing approaches to disclosure
- Enhanced regulatory capacity leading to improved industry intelligence, greater proactivity and effective supervisory and consumer education activities
- Practical assistance for business to implement best practice operational processes, systems and product and service delivery models

There needs to be an overarching focus on the development of regulatory solutions which assist industry to implement "best practice" business models

The recommendations made in Part 1 of this report seek to address these imperatives in "nuts and bolts" terms, focussing on the identification of practical solutions which need to be considered by policymakers, regulators and other industry stakeholders.

Managing risks & sustainable investment

The delivery of sustainable, best practice outcomes by the global wealth management industry requires the abovementioned issues to be addressed.

These outcomes also depend on industry architecture supporting investment in activities that produce long term, sustainable wealth creation. The global financial crisis has starkly demonstrated the consequences for investors of ignoring "hidden", long term risks – a position which threatens to be repeated with respect to climate change and broader environmental, social and governance ("ESG") issues that remain outside mainstream (and mandated) approaches to:

- Investment decision making
- Company and investor disclosure and reporting frameworks
- Financial product and service design and delivery

The limitations of traditional fundamental analysis and accounting driven methodologies to support investment decision making are well understood in today's global economy. In this regard, momentum towards effective ESG integration (created by a plethora of international voluntary initiatives[iii]), needs to be supplemented by mandated legal requirements which also encompass key stakeholders in the international wealth management industry. This is essential if:

- Fiduciary duties to consumers are to be discharged and material ESG risks and opportunities are to be properly mitigated / capitalised on
- The pool of investment capital controlled by the global wealth management industry is to be appropriately allocated to sustainable economic pursuits (including mitigation and adaptation activities contemplated under the Copenhagen Accord)

Recommendations made in Part 2 of this report seek to provide practical measures to achieve these objectives.

A way forward

As noted, there are high quality industry participants in a number of jurisdictions. However, it is equally clear that significant improvement is required in a number of key areas if industry growth is to be underpinned by sustainable, best practice approaches moving forward. We call on global policymakers and regulators to recognise the importance of these issues and the positives flowing from a consistent approach to international resolution.

Part 1 - Realigning the wealth management industry

Recommendations

#1 – Redressing the value & quality of advice

The traditional focus of wealth management models on distribution and the accumulation of funds under management - elevating and rewarding "salesmanship" over and above technical competence and client service - has impacted the capacity of providers to deliver quality advice to consumers.

Whilst investment planning, securities trading and product placement are critical components of wealth management, the overarching link between pricing, advisor remuneration, the purchase or sale of a security, acquisition of FUM / AUM / AUA and business valuation methodologies has meant that these activities have typically (and inappropriately) trumped consumer-centric, "advisory" activities.

By way of example, a predominant focus on investment product distribution can too often overshadow the most basic of advisory considerations, including:

- Is the investment a good one (why / why not / is it consistent with maximising risk adjusted, after tax outcomes)?
- What is the optimum way to finance the investment (e.g. via surplus funds, debt, sale of existing assets etc and why)?
- What is the best way to structure the ownership of the investment?
- How do you protect wealth associated with that investment?
- When should wealth or losses associated with the investment be crystallised and why?
- How is wealth associated with that investment best transferred to intended beneficiaries?

These and a host of other planning, structuring and advisory needs which are chiefly responsible for consumers seeking to engage with financial advisors (a fact that is acknowledged by industry and professional bodies around the world) are often rendered of secondary importance by a prevailing business model driven by fundamentally different objectives.

In many respects, this is simply a reflection of how the global wealth management (and many other financial services industries) have evolved.

In this regard, financial institutions have commonly:

- Developed and acquired wealth management businesses (e.g. financial planning, private banking, insurance and broking operations etc) as a distribution base for a wide range of financial products including loans, mutual funds, bonds, shares, insurance and platforms on which transactional and ongoing product based revenue streams may be derived
- Valued these businesses with reference to these same recurring revenue streams (i.e. % of FUM / AUM / AUA, ongoing trail commissions, transactional revenue flows etc)
- Developed highly scalable and simplistic service delivery processes delivering cost and time efficient client profiling, template-based risk assessment and model portfolio solutions supported by recommended product lists driving investment and other product selection (allowing for maximum client-per-advisor ratios and minimising the time required to be spent on client service)
- Treated advice as a "loss leader" and "bundled" the cost of advice in with recurring product or portfolio based fees, effectively obscuring / diminishing the true cost and value of advice from the consumer, whilst maximising product / portfolio based income streams for the provider
- Rewarded financial advisors utilising sales, transaction and portfolio / volume based remuneration mechanisms

Not only have these factors resulted in a flawed consumer service model, they have:

- Introduced structural disincentives for industry to seek out and transition to more customer-centric advisory models
- Adversely shaped consumer expectations (both with respect to what they should be receiving from their wealth management service providers and their attitudes to the value of financial advice)
- Notwithstanding rhetoric, created a pervasive sales culture, resulting in the "devaluation" of quality advice as a key business outcome

Poor consumer financial literacy levels, in addition to a generally low understanding of the technical requirements that must be addressed in developing optimal wealth management outcomes, have compounded these outcomes and allowed this market failure to evolve.

As surveys by regulators in a number of markets have found, consumers often do not have the skills to differentiate good advice from bad advice or even to understand where no advice has in substance been provided. Further, consumers will often expect they have received advice when obtaining products or services from a financial advisor (particularly where services have been delivered by a human face be it a broker, a financial planner, a sales representative, a bank teller etc) – even in cases where the provider has not taken their personal circumstances into account and disclaimed liability for any "advice" provided.

With respect to these concerns, industry, policymakers and regulators must address the following imperatives:

- Business operating models must be realigned to prioritise the delivery of quality advice such that market forces (and consumers) come to better value those organisations that meet this objective and penalise those that don't. In addition to the measures outlined below, this requires regulators to proactively assess business and operating models against a raft of criteria that are consistent with this objective (as opposed to just employing fiduciary and advisor charging / remuneration remedies). This necessitates a substantively different focus to traditional conduct and disclosure based regulatory systems (which typically rely on self execution and do not seek to identify business processes and supporting infrastructure which must be present to consistently deliver quality consumer outcomes)
- Consumer financial literacy levels must be improved and consumer awareness of the value of advice heightened
- Straightforward and cost-effective advice must be made accessible to consumers in a way which is suitable to consumer needs and is transparent (i.e. the consumer knows what to expect from a service, quality and risk perspective and is aware of any advice limitations)

Different tiers of advice & service

Consumers should be able to choose how they obtain wealth management products and services and whether they get advice or not (advice here being distinguished from appropriate risk management, and control procedures, that need to apply for instance in the context of responsible lending activities etc).

The fact that investment, risk, lending and other products are sold in the absence of advice is not of itself a threat to consumer protection objectives and indeed, market innovations have improved direct access to various product and trading / transaction capabilities.

However, an issue clearly arises for consumers when services based on "no advice", "limited advice" or "execution only" are delivered in an "advisory context" (i.e. where either advice is purported to be provided or where the relationship or setting could create consumer expectations that some form of advice has been provided).

In other words, key objectives of the reform process need to be:

- The clear distinction between advisory and non-advisory services (and those providing services under each scenario)
- A much improved consumer and industry understanding of the ramifications of alternative modes of service delivery (in terms of risks, fiduciary duties, service obligations, business processes and supporting infrastructure requirements etc)

- Consumer agreement to upfront and ongoing advice (which needs to be framed with reference to appropriate service standards and the actions required to discharge an advisor's fiduciary duty where applicable – see below)

In practical terms, regulatory frameworks need to be developed for different modes of advice and service delivery – acknowledging the often simple needs of some consumers, the more complex needs of others and the legitimacy of (appropriately regulated) execution only, investor self-directed and product, sales-based services.

Affordability for consumers

From a policy perspective, the desirability of consumers receiving good quality advice is well established (particularly where advice facilitates wealth creation, GDP and employment growth, self funded retirement etc). In this regard, measures to correct the market value of advice should be complemented by reforms addressing affordability, including:

- Flexible alternatives for funding advice including from preserved assets (taking account of revenue, liquidity and capital / compounding implications)
- Fee caps for standardised "low cost" and simple advice services
- Tax deductibility

#2 – Establishing clear fiduciary duties

The need for a codified fiduciary standard is widely acknowledged. However, detailed guidance as to what such standards require is paramount if they are to have practical meaning

Whilst a number of regulatory frameworks impose or are considering a fiduciary or fiduciary-like standard on financial advisors (e.g. Europe, US, Canada, Hong Kong, Australia etc), explicit legislative recognition of the primacy of consumer interests is not universal.

Critically, even where a fiduciary standard has been established at law, it is uncommon for laws or regulatory guidance to address in the requisite detail what such a duty entails from a "nuts and bolts" technical, service and product delivery perspective. Equally, guidance as to what risk management and broader operational processes, human capital and business infrastructure needs to be present in order to give effect to these duties is also lacking.

Regulatory frameworks must establish:

- A codified fiduciary standard governing the relationship between financial advisors and consumers (addressing all scenarios where financial advisors can reasonably be inferred to stand in an "advisory" relationship with their clients)

- The range of circumstances where the fiduciary standard can be circumvented should be specifically restricted and clearly defined (e.g. "execution only" transactions should be excluded)
- Financial advisors acting in an advisory capacity should be prohibited from contracting out of the fiduciary duty. That is, a provider of financial advisory services should not be able to deliver products on a non-fiduciary basis where the rest of the relationship has an "advisory character" or could be objectively construed as such (e.g. a financial planner or broker-dealer charging ongoing commissions or an annual % of a client's portfolio - as opposed to transaction fees – may create expectations of an "advisory relationship" which consumers believe will result in products and services being delivered taking account of their personal circumstances and in their best interests)
- Where a service provider sits outside of the prescribed fiduciary standard (e.g. by acting in a non-advisory capacity), that provider should be restricted in how they represent their role to the consumer. For example terms such as financial advice, financial advisor and financial planner etc should not be used by service providers in non-fiduciary scenarios
- Where certain groups are excluded from the fiduciary standard by virtue of their providing execution-only services (e.g. broker-dealers or insurance professionals), members of those groups should have the ability to "opt in" to a fiduciary standard (allowing firms or individuals to differentiate themselves from competitors based on their higher professional obligations and consumer focus etc), providing supporting business processes and infrastructure are in place
- Acknowledging insurance, legal and market impacts, mechanisms should be explored for ensuring that breaches of fiduciary standards create mutual obligations for licensees (e.g. the bank, financial planning firm, the IFA, the brokerage, the family office etc) and individual advisors, including restitution of a client's financial position (if negatively impacted), refund of fees, opportunity cost provisions and/or expulsion or suspension from industry. Bulked-up compensation and complaints resolution schemes need to be evaluated and implemented
- The prescribed fiduciary standard should explicitly address the nature of the obligation owed to the consumer in addition to any limitations. For example, the standards should:
  - Ensure transparency regarding what potential issues the advisor should at a minimum consider in addressing client needs (ultimately there should be consistency between fiduciary standards and suitability rules – in a number of jurisdictions suitability or KYC rules impose inappropriately low standards whilst providing the veneer of advisory, fiduciary-like relationships)
  - Provide clarity regarding what advisory issues cannot be taken into account (due to an advisor's lack of knowledge or accreditation, information or resource limitations etc). As noted above, the practice of financial advisors providing advice or commentary on matters which could easily be relied on by the client on investment, banking, tax or legal issues whilst at the same time disclaiming legal responsibility should be reviewed (particularly given the materiality of such issues in many instances to risk and after-tax outcomes). The fiduciary standard should require advisors to be transparent with the client as to qualifications and what services and information

are not able to be provided (together with an explanation as to why it is important that independent advice in relevant areas be obtained)

- Extend to the engagement of 3rd parties introduced into the client relationship by financial advisors (e.g. robust performance and due diligence checks for investment managers, custodians, accountants, lawyers etc) – see also Recommendation #7 below

- Regulators need to provide detailed guidance to financial advisors to ensure they are aware of and can manage the practical, business implications of their fiduciary obligations (e.g. policy and best practice guidelines should provide practical, "straw man" style examples and assist providers to develop appropriate risk management standards and supporting operational and ongoing client service, advice and review processes)

- These standards need to be reflected in compliance, marketing and advice documents as well as supporting operational processes and infrastructure

The rationale for classifying consumers as "sophisticated" on the basis of wealth levels alone is flawed (and has failed many consumers who have fallen victim to negligent advice and high profile market scandals e.g. Madoff) – all consumers seeking advice should be protected

Protecting all investors seeking advice[iv]

It is common for existing frameworks to exclude wealthy or sophisticated consumers (*variously described as wholesale, sophisticated, professional, qualified investors etc*) from consumer protection measures typically aimed at the "retail" investor (based on the assumption that sophisticated investors possess adequate knowledge and/or resources to warrant "relief").

Whilst a common sense carve-out for sophisticated investors can improve the efficiency and costs of providing complex product solutions to these consumers (in addition to restricting access to certain kinds of products), it is clear that wealthy investors can be just as susceptible to the risks facing retail investors.

Indeed, flawed assumptions regarding the heightened capacity of "sophisticated" investors to make sound decisions have failed many consumers who have fallen victim to negligent advice, including some of the more high profile market scandals (e.g. Madoff).

Consequently, to the extent that any investor seeks advice (rather than execution-only style services), the fiduciary standard should not be diluted by virtue of the client's wealth or the level of assets involved (*see also comments below relating to product restrictions*).

#3 – A balanced approach to disclosure

A key feature of regulatory frameworks (and policy proposals emerging from reform processes) has been a heavy reliance on disclosure mechanisms to improve the quality of consumer decision making.

As experience has shown, disclosure measures which assume that consumers are sufficiently knowledgeable to be able to understand industry structures, conflicts of interest, advice limitations and to consistently make decisions in their own best interests have proven to be flawed. In this regard, reform initiatives based on addressing information asymmetries between advisors, product providers and consumers need to be placed in an appropriate policy context, taking into account:

- Empirical data regarding consumer behaviours (incorporating advances in consumer psychology and behavioural finance)
- Industry complexity and conflicts, levels of financial literacy and the technical skills required of consumers to independently assess whether advice, products and services are "good", "bad" or otherwise
- A recognition that wealth management involves more than "investment management" (at which disclosure is essentially aimed) and requires a broad range of potential issues including tax, estate planning, asset protection, remuneration and retirement planning, business structuring and succession planning, insurance, banking, finance, cash-flow management etc to be addressed if risks are to be properly assessed and after-tax wealth is to be maximised

Whilst the sheer length and complexity of disclosure documents has become a problem, improving the usefulness of information presented to consumers is more important than seeking brevity and simplicity at all costs

This is not to suggest that disclosure is unimportant – to the contrary.

Measures aimed at providing transparency for consumers through adequate disclosure remain critical, however significant focus must be redirected towards improving the usefulness of disclosure mechanisms particularly regarding industry standards, benchmarks, averages and facilitation of meaningful competitor comparisons – allowing consumers to genuinely "vote with their feet".

In a number of jurisdictions, considerable efforts have been undertaken to restrict the length of product disclosure documents (measures which are to be encouraged). Whilst the sheer length and complexity of such documents has become a problem in a number of jurisdictions, improving the usefulness of information presented to consumers is a high order priority (and should not be sacrificed in the interests of brevity or simplicity). Current efforts in this regard (in all jurisdictions) have failed to deliver meaningful, comparative data to consumers.

#4 – Product provider prohibitions and fiduciary / suitability obligations

As a general proposition, regulatory frameworks should encourage industry innovation. In this regard, whilst a number of jurisdictions impose some design constraints on product providers (e.g. HK, Singapore, UK etc), such arrangements are in the main sub-optimal.

Equally, initiatives to promote or embed advice in products (including via the licensing of product providers to give limited advice to consumers), are both counterintuitive and potentially misleading. Whilst typically aimed at reducing the "cost of advice", such measures diminish the value of advice and often do not consider a range of factors that are necessary to adequately frame "good" advice.

Analogously, moves to impose fiduciary or suitability rules on product providers are often poorly designed and can ignore a number of issues relevant to determining whether a product is in fact suitable. This is not the domain of asset managers or institutional investors but of financial advisors (operating in accordance with well designed fiduciary standards).

Having said this, products are typically "sold not bought" and in light of both financial literacy levels and distribution pressures (including with respect to derivative, structured and a host of other exotic products), there is merit in regulators:

- Determining objective measures to assess product risk (whether in terms of complexity, liquidity, volatility, gearing, underlying asset backing, structure, tax, capital loss or other factors) and classifying such products, where appropriate as "sophisticated"

- Limiting the distribution of such products (in the absence of personal advice governed by fiduciary standards) to "sophisticated investors" (such investors being required to explicitly "opt in" to this defined classification and provide objective evidence as to their professional and practical experience). "Sophisticated investor" status should not be governed (as is the case in a number of jurisdictions) by reference to wealth or asset levels – which as noted can be a poor predictor of financial literacy and competence

- Allowing product providers to distribute "sophisticated" products to the broader market where personal advice is provided and is governed by fiduciary standards. Application forms should confirm that the consumer is making the investment as a "sophisticated investor" or following personal advice from a financial advisor acting in a fiduciary capacity

- Establishing a regularly updated register of "sophisticated investors" and "sophisticated products" to facilitate the above

The basic requirements for obtaining a licence to provide financial advisory services have been relatively easy to satisfy and provide little or no guarantee of advisor proficiency

#5 – Addressing technical competence

The establishment of rigorous competency-based hurdles for entry into, and ongoing entitlement to practice in, the wealth management industry must be a central aspiration of all policymakers in the current reform process.

Technical competency standards for financial advisors are critical, not only to the delivery of quality advice but also to improving professionalism, consumer confidence and reducing the risk of market failures (particularly as they relate to misselling of investment products, loans, derivative instruments etc and the delivery of risk-adjusted, after-tax outcomes).

Various jurisdictions have undertaken reviews of advisor technical competencies and professional bodies around the world continue to advance their educational and professional development standards.

Notwithstanding broad acceptance of the issues, various jurisdictions are yet to embark on similar formal processes or, in a number of cases, are confronted with the need to balance the competing objectives of improving consumer access to financial advisory services (through growing advisor numbers) and ensuring that appropriately rigorous standards apply for market participants.

Additionally, the unfortunate reality is that in most if not all jurisdictions, the basic requirements for obtaining a licence to provide wealth management services is relatively easy to satisfy and provides little or no guarantee of advisor proficiency in a range of technical issues relevant to the delivery of financial advice.

In seeking to address advisor competency standards, we recommend:

- The required standard of technical proficiency should be universally rigorous for all financial professionals (however described) who intend to act in an “advisory” capacity – requiring the individual to demonstrate (e.g. in a regulator approved examination setting) applied understanding of technical concepts, including to a range of practical factual situations relevant to their designated areas of practice

- Licensing frameworks should be structured to recognise (as is often the case in other professions) different stages of technical proficiency in particular areas (e.g. basic, intermediate, advanced) requiring advisors to satisfy technical and experience based criteria for admission to a particular stage

- A licensing system based on tiered competency levels would facilitate clearer disclosure to consumers of the level of expertise which they might expect from their financial advisor (and a meaningful reference point for comparing advisors) - assisting consumers to begin to understand what technical competency entails from a knowledge and ongoing training perspective

- A review of the continuing professional development (CPD) requirements for retention of advisor accreditation should be undertaken (to address the problem in a number of jurisdictions of advisors treating CPD as a “tick the box” exercise)

- A review of advisor qualification and CPD courses should be undertaken in each jurisdiction, examining the technical rigour, currency and practical elements of content (addressing commonly encountered factual situations), the competency of training providers and the quality and sophistication of assessment procedures

- Regulators should have active involvement in the development of substantive technical content of curriculum in all areas relevant to the licensee’s approved areas of practice. Regulators should work closely with industry and professional bodies, universities and other educational institutions to ensure appropriate technical competency frameworks are reflected in curricula and no unnecessary duplication occurs

- Training and professional development programs developed and operated by industry participants (e.g. internal “universities” and “business schools”, “advisor academies” and the like operated by financial institutions for their employees and in some cases, for external advisors) should be considered for accreditation within the framework developed (encouraging industry initiative and allowing market participants to use technical competency and training support as a differentiator in the employment market)

- Minimum standards should also be met by existing practitioners within clearly defined timeframes if licenses are to be maintained (as is the case in jurisdictions such as the UK with respect to recent reforms). Whilst experience in a number of jurisdictions has shown that this may result in advisor attrition (and in certain instances the early retirement of experienced and entirely competent practitioners), we believe the broader industry benefits from such measures to outweigh the costs. Alternative measures of competency assessment for existing practitioners (e.g. viva voce examination etc) should also be considered to mitigate any attrition

- The establishment of a multi-stakeholder body (representing a cross-section of industry and professionals, regulators, consumers and industry focussed academics) to oversee training, education and competency standards for all financial advisors, middle and back office staff. In addition, best practice training for executives of wealth management operations should be mandatory. This body should oversee the adequacy of curriculum, accreditation of training programs and the development of ongoing standards having regard to emerging trends, legislative changes and market conditions etc

#6 – Benchmarking industry practices

The abovementioned recommendations rely on regulator proactivity, combined with detailed industry guidance, which in turn necessitates acquisition of industry data and development of a "useful" fact base to support better industry analysis and comparison.

Meaningful industry benchmarking has been difficult to achieve around the world (due in no small way to the challenges regulators have faced in obtaining the "right" and comparable data on industry practices and standards).

Whilst it is difficult to expect "real time" data (both quantitative and qualitative) to be collected and made publicly available on an industry wide basis, we see considerable merit in the development of a disclosure framework which collects and makes available to consumers selected information to facilitate meaningful comparisons between market competitors.

It is essential that ratings agencies, research houses, analysts and others (whose activities impact wealth management decisions) operate with the end consumer in mind

In this regard, policymakers and regulators should:

- Establish an information gathering and related disclosure framework which is integrated into compulsory licensing and compliance requirements (via a streamlined annual reporting process)
- Focus on important aspects of an organisation's structure, operational processes, product and service offering, infrastructure etc (having regard to best practice metrics that are consistent with delivering optimal consumer service and advisory outcomes) and where appropriate highlight variances with key industry averages and benchmarks
- Disclose information online (e.g. via a regulator managed website) which would provide selected details in relation to quantitative industry data, service and product offering information, organisational structure, operational processes, human capital approaches and other critical business infrastructure

#7 – Regulating market participants consistently

Given the impact that service providers such as ratings agencies, research houses, analysts and other industry participants can have on investment and other wealth management decisions, it is essential that they operate with the end consumer in mind and effectively assist financial advisors to discharge their fiduciary duties.

In seeking to address these issues, regulators should ensure:

- Service providers whose recommendations are used to determine approved product lists, asset class weightings for model and bespoke portfolios, security selection, risk products etc are required to be licensed
- In the case of research houses and ratings agencies, minimum research standards and processes should be established which must be satisfied before a “rating” or “view” can be provided
- Clear disclosure requirements should be developed to enable consumers to understand conflicts of interest and other factors with the potential to influence the robustness of the views expressed - e.g. sell-side analysts and others whose research may be used should be required to disclose potential conflicts of interest to the end-consumer in addition to their overall range of recommendations (both with respect to covered securities and with respect to securities which are potentially affected by conflicts - whether because the organisation provides services to the covered company, or otherwise)
- A standardised framework should be established requiring ratings to be issued by all providers in a comparable way (i.e. enabling consumers and other users to make meaningful comparisons between such ratings)
- Research houses, ratings agencies and analysts should be required to “flag” material capital, liquidity, gearing and other risks where they are aware that their views will be used in a wealth management context (rather than merely expressing a view as to product rating or classification)
- Where financial advisors utilise approved product lists or prescribed menus of approved investment product and securities, consumers must be made aware of the basis on which these lists have been developed, (e.g. sources of research, other inputs etc) and any underlying conflicts of interest or potential conflicts

Whilst progress has been made in a number of jurisdictions, the regulation of insurance, credit, margin lending, portfolio and broader consumer lending also needs to be integrated into wealth management regulatory frameworks. As recent experience has shown, excessive gearing and irresponsible lending practices that magnify risks remain significant consumer protection issues – fiduciary duties must extend to risk, lending and other “liability side” products.

#8 – Addressing sub-optimal remuneration, pricing & short termism

Whilst the introduction of a codified fiduciary standard for financial advisors should promote the adoption of higher integrity remuneration and pricing structures (free of conflicts of interest), policymakers and regulators should (for advice, disclosure and financial literacy reasons) prescribe standards governing:

- The remuneration of financial advisors
- The pricing of financial advisory services (in particular, addressing commissions and other sales based, "bundled" pricing structures)

Where advisors are paid via upfront and trailing commissions for selling product - or via a % of assets the client places with the advisor – global industry experience points to a natural tendency for the advisor to focus on FUM / AUM / AUA attraction (including via inappropriate use of gearing to increase portfolio volumes on which fees can be charged) and/or product sales rather than on the actual quality of the overall advisory process.

Anecdotally, such mechanisms are also often blamed for increasing the risk profile of portfolios (and late actions of advisors to change the asset allocation or product mix to more defensive weightings where required, because of fee differentials between defensive versus more aggressive portfolio settings).

Intuitive difficulties with portfolio related charges also exist (i.e. Why is somebody charged extra for making further investment contributions to their portfolio? Why does somebody receiving the same advice via the same process get charged more than somebody receiving precisely the same services in respect of a smaller sized portfolio? If advice is so important, why are fees and advisor livelihood ultimately dependant on the investment of funds, the sale of loans, the placement of product etc?).

Accordingly, in all scenarios involving the provision of financial advice to consumers we recommend that commissions and other sales or volume based payments from investment, insurance and other financial products (including platform providers) should be prohibited.

In such situations, financial advisor fees should be directly negotiated with clients and be backed by engagement and service level agreements that address both upfront and ongoing advice.

Sales based remuneration mechanisms (including surrogate sales-based mechanisms embedded into bonus structures etc) should also be prohibited for employed financial advisors operating in an advisory context.

In concept, the working group considers that product commissions, other sales incentives and brokerage payments should remain permissible in execution-only scenarios provided that measures are instituted to ensure that consumers understand the nature of the transaction and the limited obligations of the provider of the product or service. Clearly, prohibitions in relation to churning and negative short term transaction behaviour should remain.

The detrimental impacts of “short-termism” on the behaviour of institutional investors, asset managers and other service providers are well documented (see also other NSFM papers) – these issues extend to financial advisors and other intermediaries. See Recommendation #12 below for further detail.

Accordingly we recommend:

- Mandating that fees relating to financial advice are clearly disclosed to the consumer (separately from product and other service fees charged)
- Requiring that consumers be offered a flat or capped fee alternative (i.e. utilising transparent methodologies which are unrelated to portfolio size etc) for financial advisory services in addition to any other pricing options which might be provided (e.g. % of assets approach, performance bonuses etc). Whilst there have been calls to prohibit pricing options based on % of assets (which like other commission models have a number of “counter-advice” characteristics), to the extent such mechanisms and commission based pricing structures are retained, comparative disclosure highlighting industry best practice should also be required
- Providing consumers with useful comparative information regarding how fees are determined and, if appropriate, the different after-fee return impacts of alternative pricing mechanisms should be a priority

In all instances (advisory and execution-only), we support mandatory disclosure of pricing and remuneration structures to consumers (including the $ value of fees or estimates).

#9 –Enhancing consumer awareness & engagement

Financial literacy

Throughout this report, we draw attention to the limitations of disclosure based regulatory regimes (see above).

Whilst recommendations seek to address this anomaly (as a complement to the reforms necessary to address conflicts and other impediments for which disclosure measures have traditionally been employed), improved financial literacy and measures to help redress consumer apathy levels are important elements supporting the long term effectiveness of regulatory measures.

Whilst government, regulator and industry-led financial literacy initiatives are developed (and increasingly widespread) in many jurisdictions, it is well recognised that they are typically focussed on the long term (e.g. programs aimed at school children etc) and to a large extent also continue to rely on consumers seeking out information to improve understanding (e.g. even sophisticated and comprehensive online reference sources being developed around the world still require the consumer to be proactive in seeking out and utilising these resources).

From a long term perspective, we consider the continued investment in consumer education (and indeed the creation of well resourced consumer information hubs bringing together financial literacy, industry benchmarking and licensing data as discussed above) to be essential to consumer interests.

However, in the short term, we also recommend:

- Government and industry embarking on both mass media and more targeted campaigns drawing attention to regulatory and industry reforms and what they mean for consumers (*which can be modelled on effective campaigns in various jurisdictions which have brought issues such as the long term value impacts of advisor sales commissions to the attention of consumers*)
- These programs should focus heavily on the nature and value of financial advice and the ways in which it can be obtained by consumers (drawing attention also to a message that "*there has never been such a thing as free advice*" and that current measures seek to improve transparency, improve cost effectiveness, access and quality of advice)
- These kinds of campaigns should also draw attention to the availability of consumer financial literacy resources (such as online sources etc)
- Financial literacy programs and campaigns should also focus on educating consumers as to the structure of the financial services industry (information should be available as to the different kinds of service providers and what functions they perform, data regarding ownership structures, business practices and related parties of licensees etc) – the adoption of earlier suggestions regarding industry benchmarking and disclosure should frame these activities

Industry terminology

A related issue for policymakers, regulators, industry and consumers is the complexity and lack of uniformity / comparability of industry language. In particular, language commonly used to connote professionalism, expertise or quality (*e.g. terms such as independent, financial advisor, financial planner, holistic, fee for service, open architecture, best in class, highly rated, award winning etc*) can misrepresent the qualifications or suitability of the service provider and can mislead consumers regarding the level of expertise and service they can expect to receive.

In a number of jurisdictions the use of specific terms (including some of the words and phrases above) is restricted by law or is otherwise subject to industry initiatives to improve comparability standards. However, even where this is the case, consumers are typically unaware of the conditions which must be met for these terms to be used or indeed what they mean in practice.

Further, the meaning of restricted terms (such as "independent" etc), which has a defined meaning in certain jurisdictions) remains fluid notwithstanding such restrictions (typically because the terminology has both a defined legal meaning and a common commercial, legacy or colloquial usage which doesn't necessarily accord with legal definitions).

We recommend that policymakers produce a “glossary” of industry terminology for use in the representations and communications of all licensed wealth management operators – focussing particularly on the appropriate use of language denoting professionalism, expertise and qualifications.

There is obviously a deal of precedent for this kind of approach in other consumer protection regimes around the world (e.g. relating to food and drug regulations etc). Consultation with industry, professional and consumer bodies (as has been the case with market testing undertaken in some jurisdictions) should guide effective design and implementation.

Critical assessment of whether the nomenclature used in current licensing and regulatory frameworks for information provided in a “no advice” or “execution-only” setting is potentially misleading (for example, in Australia the term “general advice” is used to describe information which is provided to consumers but which does not take into account the consumer’s personal circumstances – the issue being whether the term “general advice” still connotes to the consumer that advice is being provided and as such can be relied on notwithstanding the presence of legal disclaimers etc and whether better terms such as “no personal advice” would better reflect the nature of the service provided).

#10 – Improving regulatory capacity & effectiveness

Sector specialisation

Development of specialist “wealth management” expertise is key to informing proactive industry engagement, strategic intelligence gathering and compliance activities and is critical for regulators charged with governing the industry.

Even in more mature jurisdictions, the absence of dedicated, specialist expertise (at a “nuts and bolts” operational level) can be a significant regulatory constraint, particularly given the complexities associated with the wealth management sector and the difficulties for inexperienced staff to rapidly grasp issues facing multiple industry stakeholders. Most importantly, such constraints operate to thwart proactive work with industry that could increase the effectiveness of supervision activities and take up of best practice standards.

Wherever possible, focus and resources need to be directed to the ongoing development of specialist expertise across the wealth management value chain including via secondment arrangements etc.

Industry & market intelligence

As noted, whilst there has been a trend to increased audit and information gathering activities in a number of jurisdictions (together with often extensive industry consultation / engagement practices), the quality of industry intelligence particularly in relation to the intricacies of wealth management business models and the potential for alternative business practices needs to be improved.

In designing data collection programs, regulators must focus on the quality and substance of their enquiries of industry - informed by detailed ex-ante analysis and the specific utility of the data to promote regulatory objectives, including with respect to industry benchmarking and disclosure goals.

Consumer intelligence & engagement

In addition to market and industry intelligence, the capture of meaningful consumer behavioural data is an area which requires continuing focus.

Regulators need up to date primary data regarding consumer financial literacy and other factors driving investment behaviour, if they are to appropriately calibrate policy and regulatory initiatives and ultimately promote a market position that can support self regulation with reference to best practice. In this regard, we recommend:

- Mandated independent research programs conducted at regular intervals (ideally no less frequently than every 2 years) covering consumer attitudes, expectations, experience with service providers, financial literacy levels and other relevant data
- Standardised consumer surveys which are conducted by financial services providers as part of their client service cycle (with findings provided via an independent, annual reporting process)

Independent consumer representative body

Establishment of a specialist independent body to represent consumers and provide guidance and advice to policymakers, regulators and industry has merit particularly given the corresponding level of representation enjoyed by industry.

Depending on the local regulatory framework, this body could be charged with the coordination and rationalisation of the consumer protection functions of multiple agencies and regulatory bodies (where relevant), development and management of consumer financial literacy programs, consumer complaint and dispute resolution, research on consumer attitudes and thought leadership, particularly in relation to the analysis of emerging trends and practices.

An independent consumer representative body should be considered

The early identification of potential market failures, significant risks and the provision of strategic intelligence and advice to policymakers and regulators should be key objectives.

Risk driven surveillance & enforcement

By extension, we support the development and execution of targeted, risk-based market surveillance and compliance programs based on ex ante analysis (rather than comprehensive, “scatter-gun” style audit or industry information gathering activities)

We advocate that ongoing market surveillance and intelligence gathering exercises be informed by:

- Extensive analysis of the potential risks / sources of current or future market failure
- Considered targeting of the industry sectors and/or identity of the participants most likely to be contributing to market failure
- Limiting as far as possible the compliance and business costs for industry participants
- Proportionality of the intended actions to the risks involved
- Where appropriate, consultation with external specialists and advisory panels etc who are able to provide independent views regarding appropriate approaches

Where they do not already do so, statutory powers provided to the regulator should facilitate pre-emptive orders and powers of investigation and discovery to assist proactivity and increase the likelihood of prevention of market failure.

Commitment to industry self-regulation

Where appropriate industry structures exist, policy proposals should affirm and strengthen the effectiveness of industry self regulation as a critical component of the regulatory framework. In particular, recommendations should explicitly address the central role of industry bodies in aligning professional and regulatory standards and driving the implementation of necessary changes to business practices.

Whilst the merits or otherwise of industry self-regulation are subject to much current debate (and are to a large extent informed by local industry dynamics including the extent to which bodies are actually representative of or “captives to” their constituencies), we see formal empowerment of industry and professional bodies to develop and enforce suitable professional standards for all financial advisors as an important measure to build consumer confidence in the financial advisory process and create additional capacity for regulators to focus on proactive, value-add activities.

To achieve these objectives, recommendations include:

- Controls for approval of industry and professional bodies (having regard to governance structures, ethical and professional standards, technical capabilities, membership base, global connectivity and other key attributes)
- Incentives for industry and professional bodies to consolidate (reducing fragmentation and expanding reach and coverage of interrelated disciplines within the wealth management value chain)

- Integration of industry and professional body disciplinary mechanisms with regulator approved consumer complaint and dispute resolution programs

- Other initiatives designed to provide industry and professional bodies with the “teeth” (and if necessary, the compulsion) to regulate their member’s conduct and add to consumer confidence

Alternative measures such as the creation of a multi-stakeholder professional standards body should also be considered (particularly where existing professional and industry bodies are not well established, are fragmented, uncoordinated or underdeveloped in terms of their membership, governance, technical, professional and disciplinary capacity etc).

Part 2 - Facilitating sustainable investment outcomes

The delivery of sustainable, best practice outcomes by the global wealth management industry requires the abovementioned issues to be addressed.

Such outcomes are also dependant on industry architecture supporting investment in activities that produce long term, sustainable wealth creation. The global financial crisis has starkly demonstrated the consequences for investors of ignoring "hidden", long term risks – a position which threatens to be repeated with respect to climate change and broader environmental, social and governance ("ESG") issues that remain outside mainstream (and mandated) approaches to:

- Investment decision making
- Company and investor disclosure and reporting frameworks
- Financial product and service design and delivery

The limitations of traditional fundamental analysis and accounting driven methodologies to support investment decision making are well understood in today's global economy.

In this regard, momentum towards effective ESG integration (created by a plethora of international voluntary initiatives targeted at the institutional investor, asset manager, broker, company and broader service provider level – PRI / EAI, GRI, CDP, HRH Prince Of Wales Accounting for Sustainability Forum etc to name but a few), need to be supplemented by mandated legal requirements that also encompass key stakeholders in the international wealth management industry. Such a position is essential if:

- Fiduciary duties to consumers are to be discharged and material ESG risks and opportunities are to be properly mitigated / capitalised on
- The pool of investment capital controlled by the global wealth management industry is to be appropriately allocated to sustainable economic pursuits (including mitigation and adaptation activities contemplated under the Copenhagen Accord – *see Figure 1*)

Policy and regulatory initiatives could potentially be enhanced by the extension of relevant voluntary initiatives (e.g. PRI) to the international wealth management industry.

In seeking to adopt a consistent approach to ESG integration by all key players in the global financial services industry, it is not being suggested that issues in the institutional or wholesale market mirror those in the broader investment or retail wealth management market. This is clearly not the case as there are unique challenges faced by different market segments that must be addressed. However, by pursuing reform activities in a co-ordinated fashion, that acknowledges critical links between different market participants, policy objectives are more likely to be achieved.

Figure 1 - The role of private capital in addressing climate change

Notwithstanding incremental progress made in Copenhagen[1], the unfortunate reality 15 years on from the Rio Earth Summit is that global emissions have risen beyond the IPCC's most pessimistic scenarios, necessitating low carbon industries grow at 25-30% per annum within a five year window.

Economic modelling estimates that the scale of low carbon reindustrialization required (to avoid global warming of greater than 2 degrees Celsius, explicitly recognised by global leaders under the Copenhagen Accord) will be three times larger than the industrial revolution and must begin by 2014 in order for the 450ppm pathway to be achieved[2]. This is because empirical evidence suggests that 30% annual, low-carbon industry growth is a real-world upper limit[3].

Whilst the costs associated with reducing GHG emissions are significantly lower than the economic costs of not acting[4], the quantum of investment capital and hence financial services industry mobilization required is significant.

The UNFCCC secretariat estimates that more than $200 billion in total additional investment capital for mitigation is required each year by 2030 just to return GHG's to their current levels[5], while the International Energy Agency estimates that additional investment of $10.5 trillion is needed globally in the energy sector from 2010- 2030 to stabilize GHG emissions at around 450ppm[6]. In developing countries, the World Bank estimates that $140-175 billion annually is needed by 2030 to mitigate climate change on a 2 degree Celsius trajectory and $75-100 billion is needed annually for adaptation through to 2050[7].

With respect to these projections, escalating international Government deficits precipitated by the global financial crisis are forecast to limit public funding to one sixth to one fifth of what is required from 2013 onwards to deliver adaptation and mitigation goals outlined under the Copenhagen Accord.

This serves to highlight not only the "white knight" role capital and investment markets (and hence the global financial services industry) must play in addressing public sector funding and multilateral negotiation limitations, but also the potential for such goals to be met particularly when viewed in the context of an estimated $178 trillion of global financial assets, including $85 trillion of debt and equity securities.[8]

Removing obstacles (including various structural flaws in the wealth management industry) is essential if the private sector is to play the fullest role possible in assisting (and benefitting from) the transition to a more robust global financial system, the transition to a low-carbon economy and the resolution of other social and humanitarian imperatives.

[1] *See Copenhagen Accord.*

[2] *Kidney, S, Mallon, K, Silver N, Williams C, "Network for Sustainable Financial Markets ("NSFM") Draft Paper for the London Investors Roundtable on Climate Change", June 2009. These figures are based on international modelling performed by Climate Risk Ltd, commissioned by the WWF.*

[3] *ibid.*

[4] *"Stern Review, The Economics of Climate Change", 2006 at vi*

[5] *United Nations Framework Convention on Climate Change (UNFCCC) Secretariat, "Investment and Financial Flows to Address Climate Change", August 2007*

[6] *International Energy Agency, "World Energy Outlook 2009", November 2009*

[7] *World Bank, "World Development Report 2010: Development and Climate Change", September 2009*

[8] *See McKinsey Global Institute, "Global Capital markets: Entering a new era", September 2009 and 2010 Investor Statement, "Catalysing Investment in a Low-Carbon Economy – Investors Urge Policymakers to Act Quickly", January 2010*

Recommendations

#11 –Inclusion of ESG issues in fiduciary duties

As noted above, fiduciary standards applying to the provision of financial advice should ensure transparency regarding what potential issues the advisor should consider in addressing client needs (with consistency existing between fiduciary standards and KYC, "suitability" rules). These standards should include the obligation to consider material investment risks and opportunities deriving from ESG factors.

Seminal reports[v] produced by Freshfields Bruckhaus Deringer ("Freshfields") and the Asset Management Working Group of the United Nations Environment Programme Finance Initiative ("Fiduciary II"), equate fiduciary responsibilities with the active consideration and integration of material ESG issues in the investment process.

In particular, Fiduciary II notes the role of investment advisors, investment consultants and asset managers as parties who operate under a contract for services and, as professional advisors to their clients, must consider ESG issues on a proactive rather than reactive basis if their fiduciary obligations are to be discharged.

Whilst these reports were commissioned with institutional investors in mind, their findings are directly applicable to financial advisors providing personal advice and should be explicitly recognised in fiduciary standards and KYC, "suitability rules".

It should be noted that whilst international initiatives and guidance on this front (including in Canada, US, Europe and Australia) have tended to focus on the incorporation of consumer attitudes regarding ESG factors into KYC / suitability rules, this is insufficient. Indeed, the integration of material ESG considerations into investment decision making and supporting operational processes is consistent with the fundamental premise of a fiduciary obligation and (as recommended for institutional investors) should be mandatory for all financial advisors providing investment advice to consumers.

Fiduciary standards for financial advisors should include the obligation to consider material investment risks and opportunities deriving from ESG factors

In specific terms:

- Fiduciary standards for financial advisors should adequately reflect the need to consider and incorporate material ESG factors (that can influence portfolio valuation, risk, opportunities and broader planning and structuring activities)
- Supplementary "values based" enquiries regarding consumer attitudes to ESG issues (as contemplated by KYC / suitability rules) are also required, promoting product and service delivery which is consistent with client desires and expectations

Operational processes

By extension, fiduciary standards for financial advisors should ultimately reflect:

- The incorporation of ESG considerations into operational and disclosure guidelines for "account opening", "fact find", "risk assessment", "marketing and financial services guides", "investment policy statements", "approved product lists", "statements of advice", "ongoing advice procedures" and other core client service instruments (supplementing existing suitability practices which may be in place at an organisational level)
- The way in which climate (and other ESG) risks are dealt with by financial advisors (these processes should be specifically disclosed in compliance, marketing and advice documents and be reflected in wealth management operating models and supporting infrastructure (*see comments on disclosure below*)

Service providers

ESG considerations are also relevant to decisions regarding the use of product provider, research house, credit ratings, asset consultant and/or analyst recommendations in the course of formulating investment recommendations (including the development of portfolios and approved product lists etc). In this regard:

- Where service providers are used to assist with the formulation of portfolios and product recommendations, financial advisors (and their research units, investment teams etc) should be required to assess how these providers address ESG factors at both an individual security and product level
- The extent to which this analysis has been performed should be disclosed in compliance, marketing and advice documents (*see comments on disclosure below*)
- Contractual arrangements between wealth managers and service providers (as well as business processes and supporting infrastructure) should reflect these considerations

#12– Short-termism

As noted, the detrimental impacts of short-termism on the behaviour of institutional investors, asset managers and other service providers are well documented (see also other NSFM papers addressing these issues).

The combined and systemic impact of high rates of portfolio turnover, misaligned remuneration, pricing and executive compensation schemes (including at the corporation level), inappropriate leverage and the concentration on quarterly earnings and other short-term performance metrics, have effectively entrenched a negative "feedback loop" between corporations, institutional investors and asset

managers (promoting risk taking and the prioritisation of short-term financial objectives at the expense of long term wealth creation for end-consumers).

This short-termism extends to financial advisors and other intermediaries, and has also operated to embed practical impediments to integrating ESG issues in investment decision-making.

In this regard, the following recommendations should be considered:

- Alignment of fiduciary duties with mandatory consideration of material ESG risks in the investment decision-making process (including disclosure of how ESG risks are reflected in approaches to the development of investment policy statements, portfolio construction and approved product lists etc)
- Tax laws (both incentives and disincentives) which promote longer-term holdings of investment capital
- Ensuring pricing and financial advisor remuneration mechanisms are not inconsistent with medium to long term performance measures
- Disclosure of after-tax, after-fee investment performance relative to medium / long-term benchmarks (where possible, combined with fiduciary requirements to pursue returns on this basis)
- Disclosure of portfolio turnover data (where personal advice is being provided, along with industry averages, including for long term oriented investments)

#13 – Sustainability disclosure & reporting

A number of the suggested reforms focus on additional areas for mandatory disclosure to the end consumer. These suggestions are made fully cognisant of both:

- The limitations of disclosure based regulatory regimes to promote consumer protection outcomes, the desire of end-consumers for more succinct and useful information (rather than more information), often high levels of consumer apathy and low levels of financial literacy
- The costs and inconvenience to industry of implementing additional disclosure requirements (which must, as far as possible be mitigated including via practical guidance as to best practice template design, the use of online media and integration of disclosure obligations with existing processes, documents, compliance and licensing requirements)

Notwithstanding these issues, the benefits to be derived from “shining the light” on industry practices should outweigh concerns regarding “information overload”, or industry objections regarding additional compliance obligations.

It is also important to note that practical implementation of a number of the measures outlined above, particularly as they relate to consideration and integration of ESG factors, necessarily rely on a host of issues including improved corporate disclosure (which in many jurisdictions remains governed by voluntary frameworks).

Effective ESG integration relies on a host of factors including improved (mandatory) corporate disclosure

In this regard, mandatory ESG disclosure by corporations is essential (e.g. as has been or is being considered for various sectors in France, The Netherlands, Spain and Denmark and currently by the European Commission more broadly - the US, China and India have also made important steps forward in this regard).

Currently, of 82,000 multinational enterprises globally, some 3,000 issue sustainability reports[vi]. KPMG research conducted in 2008 shows that 79% of the Global 250 largest companies disclose ESG data and of the 100 largest companies in 22 countries surveyed, 45% disclose ESG data[vii].

Whilst this represents a vast improvement on 2005[viii] numbers and reflects the significant achievement of a number of international voluntary mechanisms targeting the institutional investor and corporate markets, such levels remain inconsistent with research, legal and commercial opinion highlighting the need for ESG factors to be considered in investment decision-making.

Accordingly, additional measures required include:

- Large and medium size corporations to disclose and report material ESG impacts on a mandatory basis and in a fashion which facilitates genuine financial risk, opportunity and governance assessment. Ongoing guidance is required regarding best practice disclosure approaches (this may include the use of "objective triggers" but needs to ensure that risk assessment and quality of investment decision making are not adversely impacted by artificial constraints placed on the universe of potentially material ESG issues considered)

- Ideally, ESG disclosure by corporations should be consistent with GRI (G3 reporting guidelines) and integrated into annual reports

#14 – Mandatory education & training

Revised licensing, competency and CPD frameworks (discussed in detail at Recommendation #5) also need to incorporate:

- Mandatory ESG related education and training for financial advisors. Clearly, such training is also relevant for broader financial services industry participants as well as corporate executives who are required to understand ESG business impacts

- Mandatory ESG related education and training for senior executives of wealth management businesses (i.e. not just front and middle office staff) in order to promote "hard wiring" of sustainability objectives and embed appropriate cultural change

#15 – Broader impetus for sustainable outcomes

Promotion of sustainable outcomes requires a multitude of other public and private sector inputs. Whilst beyond the scope of this report, additional impetus for the abovementioned reforms will be provided by:

- International coordination of ESG disclosure, reporting, accounting, stock exchange (and listing rules) frameworks
- Short and long term GHG emission reduction targets for both developed and developing countries consistent with Copenhagen Accord targets
- Global carbon pricing and well designed carbon markets that provide appropriate signals regarding lower yielding returns of carbon intensive projects
- Incentives and targets to support clean technology, renewable energy and "green" infrastructure, including via innovative financing mechanisms (e.g. climate bonds etc)
- Carbon reduction programs for existing energy sources (e.g. CCS), assets (e.g. buildings), transportation frameworks (e.g. public transit and low-carbon fuel standards) and land (e.g. REDD+)
- Implementation of debt and credit risk guarantees and other risk sharing instruments to facilitate low carbon investments
- Financial infrastructure to support microfinance, disadvantaged communities and achievement of other humanitarian and social objectives under the Millennium Development Goals
- Public finance mechanisms in respect of the above that leverage private investment capital to the maximum extent possible

Endnotes

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[i] "Industry participants" includes all forms of financial intermediaries providing financial advice to consumers (e.g. financial planners, brokers, retail, priority and private bankers, private client advisors, family offices, wealth managers, risk advisors and others), asset managers (including at a retail, wholesale and institutional investor level), financial institutions and a host of other organisations delivering these services to consumers, representative industry bodies, professional services providers (e.g. asset consultants, analysts, research houses, credit ratings agencies, IT providers, administrators etc) and a range of other industry stakeholders

[ii] The authors acknowledge that existing regulatory approaches and industry terminology vary considerably between countries and therefore it has been necessary to utilise generic, jurisdiction agnostic terminology. In this regard, unless otherwise stated, the term "regulatory framework" denotes the complex of legislation, regulations, administrative rules, industry supervisory and prudential agencies and other bureaucratic structures which comprise the overall governance environment of the wealth management industry; the term "regulatory reform" and analogous terms are used broadly to connote all formal and informal reviews and inquiries, policy proposals and related discussion papers and documents in addition to debates at all levels regarding the effectiveness of the regulatory framework etc; the terms "retail investors", "consumers", "retail wealth management" and like terms are used broadly to connote private investors and consumers of wealth management products and services and, unless otherwise stated, make no distinction between mass market, high net worth, sophisticated or professional investors etc; the terms "financial advisor" and "advisor" are used to connote all individuals (regulated or otherwise) who hold themselves out to provide advice to consumers

[iii] For instance, initiatives targeted at the institutional investor, asset manager, broker, company and broader service provider level – e.g. PRI / EAI, GRI, CDP, HRH Prince Of Wales Accounting for Sustainability Forum etc to name but a few

[iv] As noted, terminology differs among jurisdictions – the term sophisticated investor is used in this paper generically and refers generally to investors excluded from "retail" consumer protection legislation however described (common terms in addition to "sophisticated" include "wholesale investors", "professional investors", "qualified investors" etc)

[v] See Freshfields Bruckhaus Deringer, "A legal framework for the integration of environmental, social and governance issues into institutional investment" produced for the Asset Management Banking Group of the UNEP Finance Initiative, October 2005 and A report by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative, "Fiduciary Responsibility – Legal and Practical aspects of integrating environmental, social and governance issues into institutional investment", a follow up to the AWMG's 2005 Freshfield's Report, July 2009

[vi] Global Reporting Initiative, "Beyond Voluntary Laissez-Faire Reporting: Towards a European ESG Disclosure Framework", February 2010

[vii] KPMG, "International Survey of Corporate Social Responsibility Reporting" 2008

[viii] ibid.