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The financial citizen and the market

We're all Warren Buffetts now.

Laws regarding financial services touch on many themes. The financial services market is the domain of many disciplines, including economics, regulatory theory and politics. The Australian financial services market is both sophisticated and global.[1] Its financial services expertise is exported.[2] Australia has the fourth largest funds management industry after the US, the UK and Luxembourg. It has the eighth largest stockmarket.[3] At least 55 per cent of adult Australians either directly or indirectly hold shares through managed funds or self-managed superannuation funds. The Australian Stock Exchange (ASX) believes that this is 'the highest reported level of retail share ownership in the world'.[4] Most importantly, all employed Australians contribute to the market through compulsory superannuation in a unique system with no social security levy and a strictly means-tested old age pension scheme. Superannuation is the largest asset class held by retail investors,[5] who may choose which superannuation fund holds their asset. There has been a shift from readily accessible deposits to 'locked up' superannuation; as

1 For a general account of the financial system, see RBA 'The Structure of the Australian Financial System', *Financial Stability Review*, March 2006.
2 Access Economics 'The Export Potential of Australian Funds Management Services Report by Access Economics for Investment and Financial Services Association', July 2007, www.ifsa.com.au/documents/2007_0726-IFSA%20Access%20Economics%20Report%20July07%20Final.pdf, p. 12.
3 See Axiss Australia 'Australia – A Global Financial Centre', August 2006, www.investaustralia.gov.au. In March 2006, the total funds under management was over $1 trillion, and more than $100 billion flowed in through 2006: Access Economics, 'The Export Potential of Australian Funds Management Services Report by Access Economics for Investment and Financial Services Association', July 2007, p. 13.
4 ASX *Australian Share Ownership Study*, February 2005; Australian Stock Exchange *ASX Share Ownership Study 2003 – Highlights February 2004*, in Grant, R 'Australia's corporate regulators – the ACCC, ASIC and APRA: Research Brief', Parliament of Australia, Parliamentary Library, June 2005, p. 8.
5 See Ryan, C and Thompson, C 'Risk and the Transformation of the Australian Financial System' in Reserve Bank of Australia (RBA) Conference *The Structure and Resilience of the Financial System*, August 2007; D'Alosio, T 'Financial Assets Held by Retail Investors, Growth Over Past Five Years [Table]' in ASIC 'Opening Statement on ASIC's Priorities for the Next Twelve Months to Senate Standing Committee on Economics', May 2007.

a result, households now hold more assets in superannuation than in deposits.[6] In parallel with this development (which has given individuals the freedom to determine their own financial future for retirement) was an earlier freeing up of the paternalistic restraints which Australian governments once imposed on financial institutions lending to individuals There is a corresponding and steady increase in consumer debt,[7] much of it for housing and investment housing,[8] though there are intermittent concerns about credit card debt. A huge proportion of Australian household assets are in the form of unrealised capital gains and this is not picked up in accounts.[9] There was a short-lived crisis in the availability of insurance in Australia, one which has now passed.[10] The greater freedom of individuals to invest and borrow for their future in this market has resulted in the development of a new concept of human being – a financial citizen[11] – and the need for a unique system of financial regulation. This financial citizen is somewhat knowledgeable about market risk; a willing participant in the market for financial services; and dependent on the financial services market for long-term economic security.

6 In the mid-1980s, deposits accounted for about 50% of household assets, but by the end of the 1990s this figure had fallen to below 30%; rights in life insurance policies and superannuation funds have risen from about 30% to nearly 50% of household assets in the same time period. See graph in Battellino, R 'Australian Financial Markets', *Reserve Bank Bulletin*, September 1999, p. 18, www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_sep. 99/bu_0999_2.pdf. In 2004, 15.5 million Australians had a deposit account and 10.2 million held superannuation: see ASIC *Annual Report 2003–04*, 2004, p. 44 in Grant R 'Australia's corporate regulators – the ACCC, ASIC and APRA: Research Brief', 2005, p. 8. The growth in securitisation was partly driven by the reallocation of household savings to superannuation: see Commonwealth of Australia Treasury *Financial System Inquiry Discussion Paper*, 1996, 3.6, p. 46 and p. 66, fsi.treasury.gov.au/content/DiscussionPaper.asp.

7 The ratio of net savings to debt was above 10% in the 1970s: see RBA 'Household Debt: What the Data Shows', *Reserve Bank of Australia Bulletin*, 1 March 2003; RBA *2005 Financial Stability Review*, March 2005, in Consumer Affairs Victoria, *Consumer Credit Review Issues Paper*, May 2005, p. 2. Between 2001 and 2004, the average increase in household debt was 17.5% annually compared with 12.4% in the 1990s: see RBA, *2005 Financial Stability Review,* March 2005. The incidence and level of debt is spread unevenly through the community: 90% of lower-income people report having debts of less than \$5000; 58% of those with higher incomes report debts of less than \$5000. Most of the lower income group do not have a mortgage: see Australian Bureau of Statistics in Consumer Affairs Victoria, *Consumer Credit Review Issues Paper*, May 2005, p. 2.

8 Credit growth for housing has increased by 20% per annum for a number of years: Laker, J, appearing before the House of Representatives Standing Committee on Economics, Finance and Public Administration, House of Representatives Standing Committees Budget Estimates, *Debates*, 10 May 2004 in Grant, R 'Australia's corporate regulators – the ACCC, ASIC and APRA: Research Brief', 2005, p. 8. Bank loans for housing increased from 30% to 55% of all loans between 1990 and 2004: APRA, *APRA Insight*, Third Quarter 2004, p. 18 in Grant, R, ibid. In the 1980s, there were less than 50 home loan products In 2005, there were over 23,000 different products. These products may combine debit and credit features and people may use the equity in their houses for activities such as travel or school fees: Consumer Affairs Victoria, *Consumer Credit Review Issues Paper*, May 2005, p. 1.

9 Battellino, R *Transcript*, 21 February 2007, p. 29 in Parliament of the Commonwealth of Australia, House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of the RBA Annual Report 2006 (First Report)*, March 2007 p. 14.

10 This was attributable to the global reinsurance crisis and the collapse of the Australian insurance body, HIH. General insurers issue more than 41 million insurance policies and process 3.5 million claims each year. Insurers pay out about \$55 million in claims each working day, not all to the household sector: APRA *Quarterly General Insurance Performance*, June 2005; APRA *Selected Statistics on the General Insurance Industry*, Year Ending June 2002; Insurance Council of Australia *Submission to the Australian Government Regulation Task Force*, November 2005.

11 Condon, M and Philipps, L 'Transnational Market Governance and Economic Citizenship: New Frontiers for Feminist Legal Theory' (2005) 28(2) *Thomas Jefferson Law Review* 105 use the term 'economic citizenship'; Gray, J and Hamilton, J *Implementing Financial Regulation: Theory and Practice*, John Wiley & Sons, 2006, use the term 'financial citizen'. I prefer the term 'financial citizen' as it captures engagement with financial markets.

The financial citizen participates in the polity and the market. Just as citizens are expected to vote, they are now expected to participate responsibly in the market. Legislation uses the term 'consumer' or 'retail client' to capture those financial citizens requiring additional support for market participation.[12]

The virtuous citizen is now an informed financial market participant, who makes financial market choices, and embraces market risk, albeit with advice. The financial citizen has both a right and an obligation to participate in the market, particularly through superannuation. This marks a shift from the citizenship of earlier eras that stressed civil rights for individual freedoms such as property, contract and speech, rights and obligations to participation in the political process, and social rights to economic welfare and security provided by the state reconciling inequality with equality.[13] The market-oriented, risk-taking financial citizen of the twenty-first century is in marked contrast with the prudent, diligent, self-denying and thrifty citizen of earlier times.[14]

The focus of this book is on the obligations to support and protect the financial citizen or retail client. To this extent, the book has an interest in market regulation, but it does not examine market regulation per se. Many aspects of regulation are directed at the market and for retail clients. For instance, a safe and stable market protects the assets of consumers through prudential regulation. Other obligations are directed specifically towards retail clients, so that disclosure specifically for consumers complements disclosure to the market. Through the discussion of law, this book sets out the compliance obligations of financial services providers. The compliance obligations of finance services providers do not align perfectly with the rights of retail clients. Many obligations are to preserve the integrity of the market and competitive institutions. In other instances, these obligations do reflect the rights of financial citizens, and in particular rights to information and fair dealing.

The market now reflects earlier changes discerned in the financial system inquiry that initiated the current regulatory structure and which continue to reshape the market.[15] These include the forces of technological change, convergence, consolidation and globalisation. They have driven the massive increase in the value of the financial services market and its importance to the Australian economy and people. New technologies have impacted on the creation and management of risk in the market and for individuals. Two of the biggest technology-driven innovations have been securitisation in lending and insurance, and platforms for managed funds. Financial product 'manufacturing' or 'engineering' has

12 See Chapter 3 of this book.
13 See Marshall, TH *Citizenship and Social Class*, Cambridge University Press, 1949, on the three forms of citizenship – civil, political and social – associated with the eighteenth, nineteenth and twentieth centuries.
14 On the characterisation of the responsibilities of the nineteenth-century citizen, see O'Malley, P *Risk, Uncertainty and Government*, The Glass House Press, 2004, p. 33; on changes in attitudes to debt from a vice to a risk, see Braucher, J 'Theories of Overindebtedness: Interaction of Structure and Culture' (2006) 7(2) *Theoretical Inquiries in Law* 323.
15 Commonwealth of Australia Treasury, *Financial System Inquiry Discussion Paper*, 1996; Commonwealth of Australia Treasury, *Financial System Inquiry Final Report*, (Wallis Report), 1997, <http://fsi.treasury.gov.au/content/FinalReport.asp>.

become a specialist field. The full characteristics of many products are opaque, barely knowable, and may produce operational risk.[16] Convergence,[17] where institutions in one sector offered their customers products traditionally sourced from a different sector, led to attrition of previously discrete product sectors and the creation of new products bundling, for example, banking with insurance. Consolidation of financial institutions resulted in mergers of banks and building societies, widespread bank ownership of financial planning groups, potential mergers between large banks and insurance firms, further dissolution of product boundaries and cross-selling.[18] The impact of globalisation is felt in different ways in the market and in regulation. Examples include the global re-insurance and subprime crises and Basle 1 and 2. Globalisation also means greater opportunity and increased risk of financial instability, particularly in a country with a highly traded dollar such as Australia.[19]

At the beginning of 2006, financial intermediaries, institutions such as banks, non-bank deposit takers, life offices, general insurance companies, superannuation funds and other managed funds, managed assets of about $2.3 trillion. This is equivalent to more than 250 per cent of Australia's gross domestic product (GDP).[20] The banks as institutions still dominate the financial services sector of the Australian economy, even though the distinction between different types of financial institution has blurred.[21] They were successful in cross-selling, insurance for example, as the boundaries between types of institution dissolved, and they have been successful in consolidating their institutional position through mergers, and through acquisitions of firms such as financial planning groups. They are big players in wealth management through cash management trusts and funds management. The managed funds sector of the financial system is worth over $1 trillion,[22] due to the significant flow of superannuation investments, and the banks control about one-quarter of managed funds.[23] The banks'

16 On the funds management supply chain, see Access Economics 'The Export Potential of Australian Funds Management Services: Report by Access Economics for Investment and Financial Services Association', July 2007, www.ifsa.com.au/documents/2007_0726-IFSA%20Access%20Economics%20Report%20July07%20Final.pdf, p. 12; PWC Australian Investment Management Survey 2007, www.ifsa.com.au/documents/2007%20PWC%20investment%20survey.pdf, p. 7.
17 See Commonwealth of Australia Treasury *Financial System Inquiry Discussion Paper*, 1996, 3.70–3.72, p. 73.
18 On bank mergers and the four or six pillars policy, see Valentine, T and Ford, G 'Bank Mergers in the Australian Financial System – Should the Pillars be Pulled Down?' (2001) 20 *Australian Economic Papers* 4; Goddard, G and Walker, G 'Competition Analysis of Bank Mergers in Australia' (2002) *Journal of Law and Financial Management* 2.
19 Laker, J 'The Reserve Bank of Australia Post-Wallis', RBA, October 1999, www.rba.gov.au/Speeches/1999/sp_ag_281099.pdf.
20 RBA Financial Stability Department 'The Structure of the Australian Financial System', *Financial Stability Review*, March 2006, www.rba.gov.au/PublicationsAndResearch/FinancialStabilityReview/Mar2006/Html/s.
21 Previously, life offices and superannuation funds held about one-third of the assets held by banks: see Wallis Report, 1997, Chapter 2. The top four Australian banks rank among the top 80 in the world. Banks account for about one-third of the capitalisation of the Australian stockmarket. They hold about 50% of assets in the system, an increase of 10% since 1985: see RBA Financial Stability Department, 'The Structure of the Australian Financial System', March 2006.
22 See fn3 above.
23 Banks control about one-quarter of managed funds: see RBA Financial Stability Department, 'The Structure of the Australian Financial System', March 2006.

dominant position has been buoyed by the drop in the percentage of overall financial assets held by general insurance companies along with a significant reduction in the number of insurance companies[24] and the decline of other deposit takers, such as credit unions and building societies.[25] Despite product neutral regulation and the convergence of products offered by firms, industry is still organised along sectoral lines (as discussed in Chapter 2). Peak bodies (such as the Australian Bankers' Association, the Insurance Council of Australia and the Investment and Financial Services Association) reflect this division. However, the Financial Industry Council of Australia works to draw the different parts together.

Notably in the area of consumer credit, some financial institutions stand outside the perceived mainstream, and there has been an increase in non-bank lenders.[26] New finance companies engaged in 'micro' lending or 'fringe' lending have entered the scene.[27] Australia has not been immune to low-doc loans and subprime lending, although this is not widespread.

The adviser is the new financial services intermediary, who is cast as a key to successful engagement of financial citizens in the market.[28] This intermediary is not an institution standing between savings and loans. Rather, it is an individual or firm interpreting market risk for the financial citizen who is morphing from a saver to an investor. The trend from deposits towards managed funds is explained as consumers 'increasingly taking on risk in financial transactions',[29] yet this risk is increasingly on the advice of specialist advisers. The role of the adviser or planner in distributing products is crucial for financial services providers. The adviser influences the financial citizen in their choice of class of asset, managed investment platform, or superannuation fund. The growth in the advice industry was initially linked with decline in the life insurance sales force and growth in the equities market[30] and has continued, despite grave concerns as to the

24 APRA *Quarterly General Insurance Performance*, June 2005. Insurance Council of Australia *Human Resources Standing Committee Research*, October 2005. Insurance Council of Australia *Submission to the Australian Government Regulation Task Force*, November 2005. RNA Financial Stability Department 'The Structure of the Australian Financial System', March 2006.

25 Credit unions and building societies hold about 2% of domestic financial system assets. Their numbers grew in the 1980s because they were less regulated than banks. There were 60 building societies and 400 credit unions in 1985. However, by the end of 2005, there were 14 building societies and 157 credit unions On the evolution of banking regulation, see www.bankers.asn.au/Default.aspx?ArticleID=619. The banks were at a regulatory disadvantage because of licensing requirements and having to hold funds in reserve and in government securities. Banks were also disadvantaged by lending guidelines. They were also subject to a rule to hold 30% of their assets in government securities: see RBA Financial Stability Department 'The Structure of the Australian Financial System', March 2006.

26 GE Money was the sixth biggest lender in 2005: Consumer Affairs Victoria, *Consumer Credit Review Issues Paper*, May 2005, p. 1.

27 They may provide small loans periods, ranging from two weeks to two years, for amounts ranging from $200 to $2000: Consumer Affairs Victoria, ibid.

28 For a critique of the role of advisers and the FSA, see Gray, J and Hamilton, J *Implementing Financial Regulation: Theory and Practice*, 2006, Chapter 6.

29 Commonwealth of Australia Treasury *Financial System Inquiry Discussion Paper*, 1996, 2.48, p. 28.

30 Previously, life offices sold their products through a 'tied' agency sales force. In a little over 10 years to 1995, the number of agents declined by 75%. Life offices began selling through investment advisers, securities dealers, people who operated as agents for more than one company, and bank branches. Life insurance was also packaged with superannuation. In line with this trend, there was a growth in the investment advice industry and an increase in the number of authorised representatives of securities dealers and advisers: see Commonwealth of Australia Treasury, *Financial System Inquiry Discussion Paper*, 1996.

quality of advice.[31] The collapse of high-return, high-risk investments sold by financial planners receiving above-market returns places the spotlight on the advice industry and its remuneration practices.[32]

The specialist financial planner or adviser is joined by the broker. The roles of the insurance broker and the stockbroker are well established. The mortgage broker distributes housing loans. The importance of this role in the financial system is a consequence of the trend to mortgage origination independent of banks. This in turn resulted from securitisation, with its bundling and keener pricing of mortgage or collateral debt obligations.[33] The proportion of non-bank mortgage originators doubled in a decade, so that by 2005 they issued one-third of asset-backed securities and nearly half of all housing loans, promoting easy availability of credit for housing. The adviser, planner and broker typically conflate the conflicting roles of sales promotion and advice.

Through many transactions, financial citizens participate directly in the market without the aid of an intermediary providing advice or broking services. Technology transformed payments systems, enabling the use of credit and debit cards, EFTPOS, ATMs, telephone and internet banking. The associated decline in over-the-counter interaction with bank tellers changed the relationship between individuals and banks, though banks still dominate the payments system.[34] Contactless payment chips in mobile phones promise further changes in mobile payment systems.[35] Technology also made online trading and investment possible and the 'day-trader' has become a stock figure. These innovations have revolutionised the way people access the market.

Easier access to credit and a debtor culture, direct access to ways of investing, enforced savings for retirement and mobile payments systems all offer and secure the ready participation of citizens in the financial services market. Financial services have been democratised. They are widely available to the people

31 See Chapter 6 of this book.
32 See, for example, the collapse of Westpoint (discussed in Chapter 6).
33 Lending was undertaken by deposit-taking institutions prior to the mid-1990s. The advent of securitisation meant that smaller deposit takers and specialised mortgage originators could obtain loan funds through pooling mortgages. In 2005, non-bank mortgage originators issued one-third of the asset-backed securities – more than double that in 1995: RBA Financial Stability Department, 'The Structure of the Australian Financial System', March 2006. In 1992, foreshadowing one of the biggest changes in home loan products, Aussie Home Loans, a mortgage originator whose business was predicated on securitisation, was established. In 1997, there were 382 members of the Mortgage Industry Association of Australia. By 2004, there were over 8000 members. The growth of the mortgage industry is a result of non-bank lenders offering home loan products, low interest rates and the boom in property prices. In 2004, 45% of all home loans were provided by intermediaries and non-bank lenders: *Mortgage Industry Association of Australia Media Information Update*, 1 September 2004.
34 In 2002, about 25% of all household spending was made using credit cards and credit card debt was estimated at about $24 billion: *Visa International Service Association v Reserve Bank of Australia* [2003] FCA 977. A small group of financial institutions process over 90% of all debit and credit card transactions. The four major banks processed over 93% of credit card transactions: *Visa International Service Association v Reserve Bank of Australia* [2003] FCA 977 at [88]. Banks drove the use of credit cards for small-scale lending, but new competition in that market means that credit cards can now be obtained from new entrants to this market such as Virgin Money, Aussie and Wizard. Credit cards are an example of a 'bundled' product, as they may come with additional features such as travel rewards and insurance. Consumer Affairs Victoria *Consumer Credit Review Issues Paper*, May 2005, p. 1.
35 www.visa-asia.com/ap/au/mediacenter/pressrelease/NR-300807_telstra_nab_visa.shtml.

on an egalitarian basis. Financial citizens have the freedom to choose from an extensive array of different products. Indeed, they must choose.

1.1 Risk and responsibility

Making a choice involves both risk and responsibility. The twinning of risk and responsibility is now a well-established theme in explaining social and political developments stemming from the late twentieth century.[36] Our societies have manufactured risk by expanding the areas of life in which decisions are required and attributing value to the uncertain outcome of a probable event. Risk has a social and political content and is intimately linked to the expansion of choice.

As financial citizens must make more choices, there are more risks and also more responsibilities. Risk has both a negative and positive side, as it may limit consequences and energies. Responsibility may involve causing an event, acting ethically and accountably or accepting an obligation or liability. For society, the value placed on individual choice-making and risk-taking is about collective risk and responsibility and the allocation of these. For the financial citizen, making a choice involves dealing with risk, taking on the responsibility to limit consequences and creating opportunities. Consumers are said to have been 'responsibilised',[37] no longer protected to the same extent by the state.

The risks to consumers in the financial services market include performance risk, prudential risk, bad faith risk and complexity and suitability risk.[38] It is the nature of the financial services market that most investment products cannot guarantee returns and that investors may not receive hoped-for returns. Because market prosperity is based on consumer participation in the financial services market and the large inflows of 'locked-up' household savings, we need a better articulation of the nature of risks to consumers in a financial products market.[39] The global credit crisis has made this clear.

1.2 Regulating for the financial citizen

Financial services reform or financial services regulation (often referred to as FSR) derives from the Wallis Report into the financial system,[40] national

36 Beck, U *Risk Society: Towards a New Modernity* (trans Mark Ritter, 1992), Sage, 1996; Douglas, M *Risk and Blame: Essays in Cultural Theory*, Routledge, 1992; Giddens, A 'Risk and Responsibility', (1999) 62 *Modern Law Review* 1.
37 O'Malley, P *Risk, Uncertainty and Government*, 2004, Ramsay, I 'Consumer Law, Regulatory Capitalism and the 'New Learning' (2006) 28 *Sydney Law Review* 9.
38 Financial Services Authority *A New Regulator for the New Millennium*, January 2000, www.fsa.gov.uk/pubs/policy/p. 29.pdf at 8–9.
39 Pearson, G 'Risk and the Consumer in Australian Financial Services Reform' (2006) 28 *Sydney Law Review*.
40 Wallis Report, 1997.

competition policy[41] and the Corporations Law Economics Reform Program (CLERP).[42] The central plank is Chapter 7 of the *Corporations Act 2001* (Cth).[43]

FSR is directed to complementary goals – creating the financial citizen who is a risk-taking active participant in the financial market and an innovative, efficient and honest market that increases wealth and delivers prosperity for the whole community. It is no accident that in the list of regulatory objectives 'confident and informed decision-making by consumers' is given pride of place.[44] This co-dependence of market and retail client objectives is fundamental. The aim of regulation is a safe, efficient and competitive market for a strong economy underpinned by the aggregate savings of financial citizens. Yet regulation of the financial citizen is not directed solely towards participation. It is also concerned with supporting and enhancing the capacity of the financial citizen to participate in the market. The model of supported decision-making is evident in a number of regulatory strategies, including disclosure of risk, the role envisaged for advisers and the promotion of financial literacy (discussed below). Thus regulation aims to reduce some risks, encourage others and enable financial citizens to make choices.

The key innovation of Chapter 7 of the Corporations Act is product neutral regulation. This is directed at both an efficient market and a supposed reduction of complexity for financial citizens. A distinguishing feature of FSR is that to promote efficiency, a whole range of different activities have been made subject to single sets of standards. There are product neutral rules that apply across the sector so that insurance and deposits, for example, are regulated in like fashion. For instance, it does not matter if you are selling general insurance or loans, taking deposits, issuing securities, or giving financial advice. To sell any of these products you still need an Australian Financial Services Licence (AFSL). The general rules for providing information to retail clients and standards of conduct when dealing with consumers are the same irrespective of the product.

Product innovation, driven by technological developments in IT, is characteristic of financial services markets. Specific regulation based on existing product categories may be a roadblock to innovation. Thus, a further purpose of product neutral regulation is to drive innovation in products and processes and further global competitiveness. The Australian approach is generic law and regulation

41 National Competition Council *Compendium of National Competition Policy Agreements* (2nd edn), 1998, at 19–20 (Competition Principles Agreement, 11 April 1995, Clause 5, Legislation Review), www/ncc.gov.au/pdf/PIAg-001.pdf.

42 CLERP 1 Proposals For Reform: Accounting Standards; CLERP 2 Proposals For Reform: Fundraising; CLERP 3 Proposals For Reform: Directors' Duties and Corporate Governance; CLERP 4 Proposals For Reform: Takeovers; CLERP 5 Proposals For Reform: Electronic Commerce; CLERP 6 Proposals For Reform: Financial Markets and Investment Products; CLERP 7 Proposals For Reform: Simplified Lodgments and Compliance; CLERP 8 Proposals For Reform: Cross Border Insolvency; CLERP 9 CLERP (Audit Reform and Disclosure) Bill 2003. See www.treasury.gov.au.

43 This is complemented by the ASIC Act. This and further complementary legislation are discussed in relevant chapters in this book.

44 Corporations Act, s 760A(a); ASIC Act, s 1(2)(b).

complemented by product-specific laws in the expectation that this will contribute to economic growth. For this reason, there are two new product neutral legal concepts: the 'financial product' and the 'financial service.' The general definition of a financial product rests on three generic concepts: making an investment, managing risk and making non-cash payments.[45] Chapter 3 of this book analyses these conceptual building blocks.

Product specific regulation has been retained to supplement product neutral regulation. Prudential regulation, detailed statutory rules and prescriptive regulations to Chapter 7 of the Corporations Act, and the self-regulatory rules in codes of practice, all remain product specific. The regulation of specific sectors is discussed here in Chapters 7–11.

Regulation of the market is premised on the efficient capital market in which participants make rational choices, and which left to itself will find the optimum situation. Here, regulation is justified only by the possibility of market failure through sub-optimal choice within the market based on information asymmetry or through fraud and dishonest behaviour. The regulatory objects reveal this. Markets for financial products are to be 'fair, orderly and transparent'; systemic risk is to be reduced; financial services providers are to be fair, honest and professional; and consumers should be able to decide on financial services and products in a way that still delivers efficient, flexible and innovative products and services.[46] To these market-oriented objectives are added maintaining, facilitating and improving the performance of the financial system and its entities. Performance is judged against commercial certainty, reduced business costs and an efficient and developing economy.[47] This classic view of the market is challenged by behavioural economics and theories of irrational choice that feed into adjustment of regulation through questioning the effectiveness of prescriptive disclosure[48] and justify supported choice of financial products.

It is not the aim of regulating for the financial citizen within an efficient market to eliminate the risk of market performance. This is a risk and a responsibility that the financial citizen takes. Nor is regulation directed at prescribing financial products for consumers. This would fetter innovation in the market and limit the choices available to the financial citizen. Instead, regulation is aimed at ensuring that providers are able to meet their promises, that the retail client is an informed consumer, and that the conduct of market actors is fair. Returns are linked to overall market performance and the strategy is to regulate for a stable, safe and fair market in the expectation that this will secure returns. It is in this context that financial citizens are steered into accepting market risk and choosing the degree of risk they will accept.

45 Corporations Act, s 763A.
46 Corporations Act, s 760A(a)(d).
47 ASIC Act, s 2(a).
48 This is currently the case in the regulation of consumer credit. On the insights of behavioural economics on financial decision-making, see (for instance) Stabile, J 'The Behavior of Defined Contribution Plan Participants', *NYUL Review*, vol. 77, no. 71, 2002.

The Wallis Report characterised a financial system as an exchange of financial promises.[49] When promises are exchanged on the basis of perfect information, there will be an alignment of price and value according to the efficient market hypothesis. The freedom to choose on this basis should result in optimum allocation of resources and thus community prosperity.

The possibility that an entity will fail to meet its financial promises due to capital or management problems is part of a competitive market. Financial citizens take the risk that this may occur. Prudential regulation and licensing obligations are aimed at preventing this (licensing will be discussed in Chapter 4). Prudential regulation is a key strategy to minimise risk to deposits, insurance and superannuation and is explored in Chapters 7, 9 and 12.

The big issue for financial citizens is knowledge of the risks in financial products. It is a challenge to regulate financial products in any system. Australia is not alone in this. Financial products are based on financial promises. It is the promise that is the product. Some promises, such as contingent promises to pay relatively set amounts as in insurance (managing risk) or deposit taking (making an investment or making non-cash payments), are reasonably clear and definite. The outcome of other promises that involve a market return, as with investment products, is less certain. In this sense, financial products are credence goods, dependent on factors extrinsic to the product that evolve over time and whose characteristics cannot be fully evaluated until after purchase.[50] The acquirer needs to rely on and have confidence in the seller and the market to assess their potential qualities. This is also why financial product and service regulation is directed towards processes and there is virtually no product regulation in the sense of regulating the safety, quality, characteristics, kind or suitability of the financial product itself.[51]

It follows that the primary risk to the financial citizen is lack of perfect information. Information about the products and their providers is a key to the market in which they are traded and to the products themselves. Information asymmetry and overcoming this through disclosure is at the heart of both market regulation and supporting the choices of financial citizens. This model does not recognise limitations on perfectability of information, or the insights of behavioural economics that individuals do not make rational choices. Nevertheless, the approach is the basis for laws to guard who can offer financial promises to citizens (discussed in Chapter 4) and what information the financial citizen must receive before making a decision (discussed in Chapter 5), and underpins conduct rules (discussed in Chapter 6). Separately regulated consumer credit (discussed in Chapter 10) also relies on disclosure.

The risks of fraud, misrepresentation, mis-selling, failure to disclose information and bad, tainted or incompetent advice go to the heart of financial citizen

49 Wallis Report, 1997.
50 See Sah, M and Cameron, G 'Controlling the Quality of Financial Advice' (1997) *JBL* 143.
51 Although licensees must have a reasonable basis for advice and the advice must be appropriate (Corporations Act, s 945A), there is no obligation to supply a suitable product.