THE REGULATION OF INVESTMENTS

TOM VALENTINE*

"The one great principle of the English law is to make business for itself."

Charles Dickens, ***Bleak House***

1. Introduction

The purpose of this paper is to reconsider the regulation of investment products and markets. This topic has assumed considerable importance of late because of some well publicised failures of investment vehicles and because of rapidly growing retirement savings (including compulsory superannuation). The regulation of financial markets and deposit taking institutions (DTIs) was thoroughly reformed following the release of the Campbell Report in 1981 (Australian Financial System Inquiry (1981)) and the current regulatory structure was formulated in the Final Report of the Wallis Committee (Financial System Inquiry (1997)). However, there remains considerable concern about the regulation of investment markets and products and recent events have made it necessary to re-evaluate the approach that has been taken in this area. The paper does not attempt to develop a comprehensive framework, but rather to indicate some directions which the discussion might take. The objective is to simplify and rationalise regulation rather than to expand it. The current system has twin problems – it is both overly complex and ineffective.

The paper will discuss the following questions:

- the structure of financial and investment regulation arising from the Wallis recommendations and, in particular, the current philosophy adopted in the regulation of investments;

***Adjunct Professor of Finance, MGSM, Macquarie University and joint holder of AFSL Licence No. 225379**

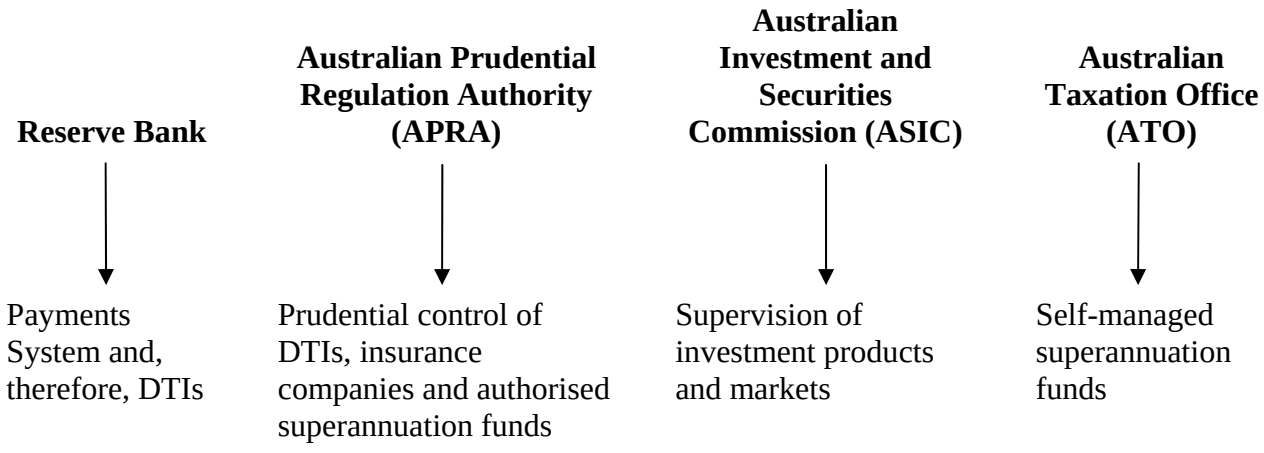
- the role of the Australian Investments and Securities Commission (ASIC) in implementing this philosophy, including the reliance on legal sanctions; and

- the regulation of the investment advice industry in the light of recent extensive criticisms of it.

2. The Wallis Regulatory Structure

Figure 1 indicates the current way in which regulators are allocated over various financial markets and products. Note that ASIC and the ATO have very significant responsibilities outside financial and investment markets.

Figure 1: The Structure of Australian Financial and Investment Regulation



A major problem in this structure is the overlapping of jurisdictions. DTIs are supervised by both the Reserve Bank and APRA. This has meant, for example, that the Reserve Bank has been responsible for the regulation of credit and debit cards which form a large part of most peoples' banking experience. The Reserve Bank has been attempting to control the profits earned from credit cards, but it has no influence on the way in which banks reprice their other products in response to its actions. Superannuation funds fall under APRA, ASIC and the ATO. Also, APRA is responsible for DTIs, insurance companies and superannuation funds, each of which are quite different institutions and each of which require quite different approaches to regulation. This structure has led to institutions (e.g. Commercial Nominees, HIH) falling between the cracks. Also, fund managers often run a superannuation fund (regulated by APRA) and a managed fund (regulated by ASIC) from one operation.

The Wallis Committee (Financial System Inquiry (1997, p. 190)) argued for strict prudential regulation of DTIs because:

- the possible impact that a default on their liabilities could have on the stability of the financial system and the economy. It is feared that a failure of one such institution can lead to cumulative failures of others (contagion);

- there is a gap between the knowledge of customers and the knowledge of product providers (information asymmetry). This

viewpoint is examined in Healy and Palepu (2000) and Weil (2002).

The Committee argued (Financial System Inquiry (1997, chapter 8)) that similar regulation of investment vehicles, such as managed funds and superannuation funds, was unnecessary because the value of units in these funds is market linked. If a fund is badly managed, the price of units in it will fall. This fall will impose a market discipline on the management of the fund but generally would not cost investors all of their money. This led the Committee to emphasise **disclosure requirements** as the major way to regulate investment vehicles. Of course, there is always a possibility of a loss from fraud, but it was implicitly assumed that this problem would be handled through the legal system.

An exception to this viewpoint is the Wallis recommendation that superannuation funds with more than four members be placed under APRA. The reason for this is that the Committee believed that the Government had taken on responsibility for these funds as a result of making some superannuation contributions compulsory. There was also a concern about savers losing all of or a large part of their retirement savings. As a result, there is a provision for the compensation of contributors to superannuation funds who lose their money through fraud which can be defined as the diversion of money to personal use by fund managers. There is no provision for compensation for poor investment decisions which produce an unsatisfactory return without benefiting the management. Of course, the borderline between these cases can be quite blurred. Holders of units in managed funds or small self managed superannuation funds can only obtain redress by complaining to ASIC or by going through the courts. The former is likely to come down to the latter.

The Wallis attitude to prudential regulation of investment vehicles has been shown to be unsatisfactory. Its deficiencies are indicated by the following points:

- investors have considerably less knowledge of investment products than they have of deposit products. That is, knowledge asymmetry is greater for investment products than for deposit products;

- loss of significant part of their superannuation funds would have a much greater impact on most investors than the loss of all their bank deposits; and

- failure of large investment vehicles can have systemic effects. This point is illustrated by the effects of the collapse of HIH. A number of governments were forced to introduce schemes to assist policy holders who have suffered losses.

3. ASIC's Performance

As already indicated ASIC adopts an approach which is based on disclosure and skill requirements. It engages in little active enforcement. An exception to this rule is the "secret shopper" technique by which ASIC uses customers of financial advisers to test whether or not the advisers follow the rules. However, this technique mostly tests adherence to disclosure

requirements. ASIC generally takes action only in response to complaints and it is quite selective with respect to its choice of the complaints to be followed up. ASIC decisions can be tested in Court so it always has to give a heavy weight to its potential for success in a legal action. As a result, ASIC is staffed largely by people with legal training. This means that the process is handled by people – ASIC representatives and lawyers in Court – with very little knowledge or experience of financial transactions.

ASIC's approach has been criticised in a number of instances. For example:

- settling with various notable defendants when such settlement did not seem necessary;

- the fact that these settlements were confidential so that investors could not obtain details to be used in evaluating other products; and

- failure to react to information on such vehicles as Westpoint and Fincorp years before they failed.

The disclosure requirements in the investment area include:

- Product Disclosure Statements (PDS) which describe investment vehicles; and

- Financial Services Guides (FSG) which describe the person giving advice, the commissions that will be paid and any conflicts of interest.

These documents are meant to provide investors with potentially important and relevant information. However, in their present form they are usually excessively long and opaque with the effect that many investors cannot understand them and do not bother to read them. They do not always include information that would be regarded as significant; for example, the success of previous investment projects of the promoters of the present vehicle. On the other hand, some of the information included is of questionable use to potential investors. For example, it is well accepted in the investment area that the past performances of investments or asset classes give limited information on their future prospects. A great deal of work needs to be done before these documents become useful to investors and this work must include significant simplification. The documents should include information which is important for an investor's decision. This would include the projected return and the security provided by the investment. Many lenders to property companies do not understand that their investment is not necessarily secured on property. Also, Australian managed investment funds are not required to provide useful information on their performance such as their alphas and betas. They tend to do so only when the performance measures are favourable.

One unnecessary aspect of the requirements imposed on investment advisers is the need to establish a risk profile (or tolerance) for a client. This requirement is extremely vaguely defined (see Valentine (2003b)), but, more importantly, it is irrelevant. Investment advisers should educate clients to understand that if they have a long investment horizon, as is the case with all

superannuation funds, they should invest in growth portfolios. Such a portfolio would include the long term highest yielding asset classes – shares and property.

Financial advisers are required to have specific training. These requirements ensure that investors are dealing with an adviser who has some knowledge of the field and provides a partial solution to investors' lack of information. However, the requirements focus on the acquisition of facts and do not provide advisers with an integrated view of the investment process. Also, no amount of tests passed will ensure that an adviser behaves in an ethical fashion.

The reliance on Courts to resolve complaints in investment markets is likely to lead to unsatisfactory outcomes. The participants in this process have little or no financial knowledge and the chance of a silly decision coming out is quite high. Some examples of such decisions are:

- the Federal Court of Australia (2002) ruling in Firth –v- Commissioner of Taxation that the interest paid on a protected capital product does not include an implicit option premium and is fully tax deductible (see Brown and Davis (2005));

- the Newman –v- Financial Wisdom case which found that "dealers are liable for the actions of their authorised representatives even if those representatives have knowingly acted dishonestly and outside

their authorisation" (**Asset**, October, 2006, p.18). The funder of this litigation received more than $10m;

- the Queensland Federal Court case in which three applicants are to be compensated for negative investment returns in 2002 by Vision Super (**Australian Financial Review**, 7 July, 2006, p. 3). This was a year in which the market fell and if the principle behind this decision was applied generally it would wreck the investment industry; and

- the IG Index v New South Wales case in which it was held that a spread betting operation was not subject to various gambling legislation because it held an FSR licence. The licence was based on the idea that spread betting is a derivative product.

Another example of the perverse results produced by the legal approach is the recent success by a group of litigation lawyers in inducing shareholders in AWB to sue the company, i.e. themselves. Some shareholders may gain but others will lose, depending on the timing of their transactions. However, the net outcome will be a loss, equal to the legal costs.

A further example of the weaknesses of the legalistic approach is the prohibition on borrowing by superannuation funds (see Valentine (2003a)). In fact, there are numerous ways in which these

funds can acquire leveraged investments. The legalistic approach means that these instruments are acceptable so long as the word loan is not mentioned.

Legal cases take a great deal of time and are often decided on minor and irrelevant legal points. In addition, much of the effort in legal cases is directed towards finding a target who can be blamed for the problem (even if it is not the obvious candidate) and who has the resources to pay compensation (for example, who has insurance). Legg (2006) points out that "securities class action settlements were greater when defendants had deep pockets. In addition, when a case included an accounting firm co-defendant settlements increased by more than three quarters." Legal action is expensive and the costs of running a case often far exceed the amount in dispute. As a result, many investors do not proceed with complaints. It would be more useful if potential investments could be scrutinised more carefully before they are released to the public. As part of this, promoters of investments could be required to contribute a minimum amount of capital or to have appropriate insurance.

Also, we should revisit the earlier decision to collapse the trustee and management of a managed investment into a single responsible entity (SRE). This change removed any independent check on the management and promoters of a managed investment and this change cannot be regarded as beneficial.

A major problem is that when an investment vehicle fails, the promoters, who are primarily responsible, often have no resources. Their assets have been transferred to family members, trusts or superannuation funds and cannot be touched. The Richstar, 2006, case has created more

stringent conditions for money placed in this way to be protected, but the basic situation is unchanged. This is an area where fundamental reform is required.

The Financial Industry Complaints Service (FICs) represents an alternative way of resolving disputes in the investment area without litigation. However, FICs suffers from some weaknesses. First, it cannot handle claims of more than $100,000. This problem could be dealt with simply by removing the limit. Secondly, FICs deals only with licensees and not with other possibly involved parties, e.g. promoters of investment vehicles. Thirdly, licensees are forced to pay a fee for any complaint to be considered, but complainants do not pay even if their complaint is found to be mischievous.

There are other proposals for regulating investment markets and products that merit some attention. First, an insurance scheme could be created to compensate investors for losses. As already noted, there is some possibility of contributors to superannuation funds obtaining compensation for losses due to fraud. This process could be formalised in terms of a fund to compensate these investors created from a levy on investment managers. However, there is little argument for setting up a fund to compensate investors for poor investment performance. First, it would be very difficult to establish a sensible definition of "poor investment performance". Secondly, such a development would create moral hazard removing the commercial discipline on investment managers. They would have an incentive to take excessive risks because if they fail, the insurance fund would bail the investors out.

Secondly, Sykes (2006) has suggested that unsophisticated investors should be able to invest in a narrow range of safe investments and have these investments protected. The problem with this

proposal is that investors with a long time horizon, even if unsophisticated, should not restrict themselves to conservative investments. Growth investments are likely to give them a much better result at the end of the process. However, such investors could be offered or required to hold an indexed portfolio which would mimic the performance of the market. Such a portfolio would be highly diversified and, therefore, insulated from default risk.

4. ASIC, Westpoint and Financial Advisers

The failure of the property development group Westpoint has focussed attention on many aspects of the prudential regulation of the investment industry. The investors who lost money in the Westpoint debacle included many individuals who provided mezzanine finance in return for high returns. At this stage, it is not clear why such high losses could have occurred because the Group had substantial property holdings.

ASIC has been criticised because it did not act until it was too late to retrieve any of the investors' money. This weakness reflects ASIC's need to hold its hand until it has sufficient evidence to convince a Court. As usual, this meant that it had to wait until a loss had crystallised.

At the time the loss became public, litigation lawyers, with the connivance of their friends in the media, launched a vicious campaign against the financial advisers who had put investors into this project. This campaign was an exercise in prejudgement. It noted that some advisers had not followed the required procedure (for example, they had not provided FSGs) and that they received 10% commissions. It was suggested that they deliberately put their clients into a

shonky investment in order to obtain this commission. Many of these comments reiterated the arguments of Kohler (summarised in Kohler (2005)) and Kohler (2007). However, Kohler (2007) also argues that the more recent Fincorp debacle cannot be attributed to financial planners but rather to the weak position that ASIC finds itself in with respect to its regulatory powers.

If investment advisers have failed to follow the required procedures, they should be penalised for this behaviour. However, it is not plausible to argue that advisers would deliberately put clients into an investment which they know is likely to fail. The ramifications of such a failure overwhelm the 10% commission. Also, attempting to attribute the loss to advisers has the paradoxical outcome that investors will not obtain compensation if their advisers have behaved correctly but only if their advisers have contravened the rules.

Why are the litigation lawyers focussing on investment advisers rather than the promoters of the investment who actually lost the money? The answer is – because advisers have money (via their Professional Indemnity (PI) insurance if in no other way) whereas promoters can be assumed to have protected their assets (for example, by putting them in the name of their spouse or in a trust). This approach is not only morally questionable, but it suffers from the weaknesses that:

- the investors may lose because the actual guilty parties are not the ones targeted; and

- it provides no incentive for promoters of investments to behave properly.

Unfortunately, ASIC has connived in trying to shift the blame for the Westpoint debacle onto financial planners. Perhaps it feels guilty because it allowed the investment onto the market in the first place. If a drug had been allowed onto the market which subsequently proved to have undesirable side effects, the makers of the drug and the regulator who approved it would be pursued rather than doctors who prescribed it in good faith.

ASIC released a website telling Westpoint investors how to complain about their adviser. Originally this website included a draft letter of complaint which implied that any fall in the value of a recommended investment was sufficient reason to make a claim against advisers. When representations were made about this absurd letter, ASIC defended it. However, it quickly replaced it with a meaningless but harmless alternative.

The lack of financial expertise in ASIC has led to other errors. For example:

- the National Share Purchasing Corporation Pty Ltd has been offering to buy AMP shares in return for an annuity due of 20 payments over 19 years. The return on the annuity is well below the market return. This annuity is clearly a financial product which according to ASIC rules should not be issued without an FSR licence and a PDS indicating the return on the security and its

risks. Representations to ASIC requesting it to enforce its rules have been met with blank incomprehension and recitation of the irrelevant rubric "it is not illegal to make unsolicited offers to buy"; and

- when financial planning associations complained about ASIC using industry funds as their sole examples on their FIDO website, ASIC replied:

> "… taken across the whole market, the 'law of large numbers' has the effect that the 'universe' of investment fund returns revert to the market mean. Therefore, from our 'whole of system' viewpoint, there is no such thing as one fund having a better return than another.
>
> …
>
> Therefore, in trying to help consumers, we look at what other factors could affect returns over the long term (assuming, as we do, that all funds have the same returns). The answer to this is fees."

ASIC does not seem to realise that it is arguing that the investment market is efficient and that the implication of this argument is that investors should invest in indexed (not industry) funds. There is considerable evidence in support of this argument (see, for

example, Drew and Stanford (2001)), but it is hardly the role of a regulator to engage in this debate.

Recently, the government has moved to make Professional Indemnity (PI) insurance compulsory for licensees. One could ask why this had not been done before. Not requiring PI insurance was very advantageous to large institutionally owned dealerships who could afford to self-insure themselves. Is this another example of regulators preferring to deal with a few large organisations than many smaller ones? However, it appears that the major motivation for this change is to ensure that advisers can be made responsible for any losses suffered by their clients. This will drive up the cost of PI insurance and in the end clients will bear these higher costs. Some potential clients may find it impossible to obtain advice. In addition, PI policies are full of "weasel clauses" which allow insurance companies to deny responsibility for a loss. As a result, they provide only limited protection for investors.

5. PAYMENT OF FINANCIAL ADVISERS

The Westpoint case and the results of a recent shadow shopping survey based on superannuation choice have generated a discussion of the way in which advisers receive their fees for advice. They often receive a percentage commission on investments made (supplemented by "trailing commissions" paid in later years). It is argued that this system leads to conflicts of interest because advisers have an interest in recommending the investments which pay the highest commissions. If all investments paid the same commission, there would be no problem. This is roughly the case for most financial investments, but the major problem is that there are many investments (e.g. Australian banknotes which have done very well) which do not earn an adviser

any commission. It could be argued that advisers have an incentive to have clients from such investments to commission generating ones. Actually, there is a larger conflict of interest in that many investment advice organisations are affiliated with large product providers and their employees recommend the products of the parent institution. Kohler (2007) points out that these organisations are distribution networks rather than sources of investment advice. This conflict of interest has received some comment, but the authorities appear to have dropped it in the "too hard" box.

A reasonable response to these criticisms would be that so long as the commissions are disclosed to clients, they should be left to choose amongst advisers on the basis of their preferences. The investment advising industry is a highly competitive one with freedom of entry. Many investors prefer the commission approach because it does not require them to pay an upfront fee. Abolition of the commission approach would probably mean that many of those investors would not receive financial advice. In the end, competition will force advisers to adopt the approach with which the majority of clients feel comfortable.

Some alternative methods of charging for investment advice, the costs which might justify the approach and the possible negative effects of forcing advisers to adopt them are as follows:

- A fixed fee for specified services. The difficulty with this approach is that it may lead advisers to reject customers who have particularly complex situations. Also, some costs (for example, PI) vary with the size of the portfolio rather than the nature of the report provided.

- A fixed fee for putting investors into an approved market portfolio as discussed in section 3.

- A fee based on the hours worked. This approach is open to advisers' "padding out" their costs.

- A fee based on the amount invested whose weaknesses have been noted above.

- A fixed fee supplemented with an incentive payment for outperformance. In this case we must find an appropriate definition of out-performance. For example, if the measure does not take account of the risk of the investments chosen, there will be an incentive for advisers to adopt riskier investments which are unsuitable for the clients.

- Kohler (2007) suggests that the requirement that investment advice should be put in the context of the client's full portfolio be dropped so that advisers can offer one-off (and, therefore, cheap) consultations on single products. However, there are very good reasons for the requirement. The risk of an investment product depends significantly on the other assets held.

In view of this complexity, it is probably most efficient to allow the market to sort the process out. A more important problem is the high level of costs created by various regulatory pressures. The first is the costs created by the overly elaborate disclosure requirements imposed on advisers. Another is the cost of PI. These costs could result in smaller investors being unable to obtain professional advice. Indeed, many investment advisers already restrict their services to relatively wealthy people.

It is impossible to resist noting that the same lawyers who so freely criticise investment advisers adopt a system of charging based on the hours (allegedly) worked and have vigorously resisted any attempt to make them liable for the quality of their work.

6. Who Should We Licence?

According to the **Financial Services Reform Act**, an FSR licence is required when a financial investment is being considered. A financial investment is created if an investor gives another person money or moneys' worth with the intention that the second person will manage the investment so as to generate a return for the investor. The investor must have no day-to-day control over the management of the funds. This definition excludes many transactions which most observers would regard as an investment. In 763B, for example, the Act indicates that purchasing real property is not classified as a financial investment and, therefore, advice on such transactions does not require an FSR licence. The Wallis Committee (Financial System Inquiry (1997)) recommended that the regulation of real estate agents providing financial advice should

be reviewed (recommendation 16) but that nothing should be done about professionals such as lawyers and accountants providing incidental financial advice (recommendation 17).

This means that many participants in the financial sector who appear to be providing financial advice are not covered, or are only partially covered by the regime.

Such people include:

- insurance brokers
- mortgage brokers
- real estate agents
- art dealers
- coin and stamp dealers
- antique dealers
- jewellers
- sellers of sporting memorabilia

All of these people provide advice on the acquisition or sale of assets or liabilities which are not consumed immediately but which have a defined (perhaps infinite) life. These are products which would properly appear in the investor's balance sheet. What are the arguments for putting all of these people under a single financial services regime? First, they often represent the product in which they are dealing as an "investment".

Secondly, they are seeking to induce investors to spend comparatively large amounts of money and it could be argued that the investors should have some protection in such circumstances. They should be able to rely on the knowledge and honesty of their advisers.

Thirdly, ASIC has made much of the argument that advisers should consider the total position of an investor (including the risk of his/her portfolio) in deciding whether advice is appropriate. It is difficult to see how they can do this without knowing the full composition of clients' portfolios.

Fourthly, if some parts of the investment advice industry are heavily regulated and other parts are lightly regulated, there is a tendency for business to shift into the less regulated area. Practitioners in the latter are likely to be less knowledgeable, less ethical and less efficient. Uniformity of regulatory burdens (what is known as a "level playing field") is necessary for the effective functioning of investment markets. A problem that has recently emerged in the financial system is that of lenders who do not fall within the existing regulatory framework. This appears to be the case for lenders who offer housing loans with no deposit or who offer to lend 105% of the value of a house. These lenders should be drawn into the regulatory system. In this case, APRA would be the appropriate regulator.

It is clear from this discussion that the question of licensing different participants in investment markets is one that should be considered in a general context and not in a piecemeal manner. There has been a tendency to consider whether and how individual classes of market participants should be licensed (e.g. accountants, mortgage brokers). The only way to come out with a comprehensive and consistent framework is to consider all candidates together.

It could be argued that brokers are simply performing a search function for their clients. The latter have decided to borrow a certain amount of money or take a certain amount of insurance cover on the advice of their investment advisers and their qualifications for the loan or insurance cover will be assessed by a properly regulated financial institution or insurance company. However, many borrowers consult mortgage or insurance brokers without obtaining other advice. Also, it is necessary to have full knowledge of a client's asset/liability position in order to assess whether a given loan or insurance policy is appropriate for that client.

In spite of these general considerations, it is not sensible to extend the full regime to all activities that have some investment advice aspects in them. Some principles that may allow us to eliminate some players who appear to offer forms of investment advice:

- materiality – if the assets/liabilities in question represent only a small percentage of investors' portfolios, they can be ignored. This criterion is difficult to apply because a few investors may have large holdings of a particular asset (e.g. art). Perhaps we can regard these people as "sophisticated investors" in this area and leave them to their own devices; and

- consumption expenditure – when the assets are purchased largely for personal enjoyment, they can be ignored. Hopefully, this is true of sporting memorabilia.

These principles would allow us to eliminate art dealers, coin and stamp dealers, antique dealers, jewellers and sellers of sporting memorabilia. However, these areas should be subject to normal business regulations, some additional regulations requiring that the dealers possess a satisfactory level of knowledge and dealers should not be permitted to advertise their wares as "investments" unless clients are referred to a holder of an FSR licence. They should be required to:

- indicate that they have not undertaken a full evaluation of the client's position and where their product fits into it;

- indicate that it is desirable for the client to see an FSR licensee to go through such a process.

There should be a separate licensing regime for such agents and the acquisition of one of these limited licences should require good character, adequate financial resources and appropriate knowledge in the specialised area.

7. Conclusion

The regulation of investment markets and products clearly needs reconsideration. The discussion of this paper indicates that the following questions could be considered, along with many others.

First, the process for introducing investment vehicles needs to be revised so that investors are only presented with substantial investments. For example, promoters could be required to contribute a minimum level of capital or to have satisfactory insurance cover. Reform is needed to prevent promoters from "hiding" their assets so that investors in a failed vehicle cannot obtain redress from them. A short-form PDS which provides investors with the information they need in a concise form should be introduced.

Secondly, ASIC should be given powers to intervene in investment vehicles similar to those held by APRA with respect to DTIs. These powers should include the ability to impose an administrator on an investment vehicle whose brief includes a responsibility to make the investment work if that is possible. Intervention should occur at the first sign of problems and not be deferred until the vehicle is insolvent.

Thirdly, resolution of investment disputes should be taken out of the legal system. For example, disagreements could be resolved by expert tribunals rather than inexpert Courts. This change would mean that ASIC could change from a legally based organisation to one based on financial expertise, from litigation to enforcement. This view is supported by Norman (2007) in another context:

> *"It is time to open the debate whether law courts without much economic input are the proper places to resolve issues like this. It can be noted that even the summary description of what bracket creep is ranges in this judgement between quite wrong to badly described".*

Fourthly, there is no reason to introduce schemes to protect or compensate investors for losses from investments arising from market movements. Such schemes create moral hazard and could lead investors to restrict their portfolios to protected assets.

Fifthly, steps should be taken to simplify documentation and to make disclosure more concise and effective. However, there is no reason for the authorities to interfere in fee structures in investing advising. Competition should ensure that they take the form desired by clients. It is also desirable that clients have a choice in this area.

Sixthly, the extent of the licensing regime needs reconsideration. It should cover all entities who in effect give significant amounts of investment advice.

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