

Consumer financial protection: future directions¹

Dr Richard Sandlant

With governments around the world taking a renewed interest in effective consumer financial protection, this paper focuses on four key pillars: financial literacy, disclosure, advice, and product regulation. Although there is no one 'silver bullet' that will provide effective consumer financial protection on its own, there are potential synergies between these four pillars (and other measures), which can have a multiplier effect on the effectiveness of individual components, enhancing the overall efficiency of the policy framework².

1 The author is from the Retail Investor Division, the Australian Treasury. This article has benefited from the contributions and comments of participants at the 16th Melbourne Money and Finance Conference (2011). The view in this article is the view of the author and not necessarily those of the Australian Treasury.

2 This article was originally published as Sandlant, R 2011, 'Consumer financial protection: future directions' *JASSA – The Finsia Journal of Applied Finance*, issue 4, pp 42-7.

It is widely accepted that consumer financial protection is important not only to protect consumers but also for financial stability.³

Consumers need protection because of the well-known asymmetry between the consumer and the financial services provider. Typically, the consumer has little experience with or understanding of making certain financial decisions, particularly complex financial decisions with long-term considerations. The financial services provider, on the other hand, is usually comprised of a team whose professional specialisation is creating financial products and selling them to consumers.

There is also a view that consumers need protection from themselves, due to their vulnerability to making poor financial decisions, their susceptibility to certain sales messages when framed in a particular way, and their underestimation of their own lack of financial understanding.

Consumer financial protection is also about empowerment and financial stability. The well-being of the Australian people is central to Treasury's mission.⁴ Confident and knowledgeable consumers would also be an enormous asset for well-functioning and efficient financial markets, if only we could figure out how to reliably produce them.

The reality is that few consumers meet such high expectations, and with financial services growing in complexity faster than the capacity of regulators (let alone consumers) to stay 'one step ahead', and with consumers increasingly being given more, not less, responsibility for their own long-term financial security, governments around the world are taking a renewed interest in effective consumer financial protection.⁵

3 'The recent crisis demonstrated the critical importance of financial literacy and good financial decision-making, both for the economic welfare of households and for the soundness and stability of the system as a whole', statement by Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, provided for the record of a hearing held on 12 April 2011 conducted by the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Committee on Homeland Security and Governmental Affairs, US Senate, Washington DC, 20 April 2011.

4 See *Policy advice and Treasury's wellbeing framework*, based on paper presented to the meeting of the Australian Statistics Advisory Council on 25 May 2004.

5 For example, in February 2011 the G20 Finance Ministers and Central Bank Governors asked the Organisation for Economic Co-operation and Development (OECD), the Financial Stability Board (FSB) and other relevant international organisations to develop common principles on consumer protection in the field of financial services by their October 2011 meeting. See FSB, *Progress in the implementation of the G20 recommendations for strengthening financial stability*, 10 April 2011. The author is the Australian representative on the OECD Taskforce on Consumer Financial Protection which led the work related to the development of these principles.

Perhaps the rationale also becomes clearer when confused retail investors making poor financial decisions in complex markets take the world to the brink of global financial meltdown.⁶

Four pillars of Consumer Financial Protection

There are many components to consumer financial protection, but I would like to focus on four key pillars: financial literacy (also known as financial education), disclosure, advice and product regulation. These four are not only important individually, but collectively, as we shall see. By this I mean that the sum of the whole can be greater than the parts.

If we look at what has been going on with respect to these four pillars, we find a number of significant policy initiatives and interesting trends.

Financial literacy

Numerous studies reveal that the level of financial literacy among Australians is depressingly low, but low financial literacy is a worldwide phenomenon.⁷ This reflects the fact that while financial services have been evolving at a rapid pace, individuals' capacity to understand money has been plodding along by comparison.

In Australia, the Australian Securities Investments Commission (ASIC) takes the lead in advancing financial literacy. In March 2011, ASIC launched the government's National Financial Literacy Strategy⁸ and a new consumer financial literacy website: www.MoneySmart.gov.au.

The new financial literacy strategy focuses on four interrelated areas:

- delivering quality financial literacy education to all Australians through schools, workplaces, higher education institutions and in the community;
- providing all Australians with access to the information and tools they need to make good financial choices;
- going beyond education to guidance and other strategies to enhance the financial well-being of Australians, including developing a new consumer website; and

6 Recent economic events have focused attention on the financial decisions made by consumers and the practices of retail financial institutions. Many argue that consumer confusion in the increasingly complex mortgage market contributed to the subprime market meltdown of 2007 which, in turn, triggered the global financial crisis. See Campbell, J Jackson, H Madrian, B and Tufano, P 2010.

7 See, for example, Australian Government Financial Literacy Foundation 2007.

8 ASIC, Report 229, March 2011, *National financial literacy strategy*; see also ASIC Report 230, March 2011, *Financial literacy and behavioural change*.

- developing partnerships between the various sectors involved in financial literacy work and better means of measuring the impact of what we do.

It's a long-term strategy, because improvements in financial literacy require generational change (think 'slip-slop-slap' and suntans). The new consumer website leverages the unique strengths of the internet to deliver financial literacy services to consumers.⁹

Research across a number of fields has shown that people learn something best from actually doing it. Not surprisingly, few want to curl up in front of the fireplace with a good financial literacy book. With this in mind, the new MoneySmart website offers tools and functionality that are designed to be interactive, useful, fun and engaging over time.

The idea is that MoneySmart can become a trusted source of personalised money guidance for financial decisions, even more complicated decisions such as those relating to superannuation contributions, margin loans and income tax.

If we step back and look at the big picture, this website represents the 'first rung' on the ladder of financial advice, providing what is otherwise known as free 'generic advice' to every Australian with access to the internet.¹⁰

A similar innovation is underway in the United Kingdom where their consumer website, Money Made Clear, became 'The Money Advice Service', a free, independent financial advice service funded by financial services companies. It provides free telephone and face-to-face advice, in addition to website functionality.

The United Kingdom took this further step, they tell us, because 'we found that if you offer people money advice for free, then most of those people will do something as a result of that advice'.¹¹

This brings us to the next pillar of consumer financial protection: financial advice.

Financial advice

From a consumer protection perspective, a financial adviser should be a trusted professional who acts in their best interests. The financial adviser should be someone consumers can rely on to navigate complex financial issues and help them to make the

9 See Bottrill, C 'Internet-based tools for behavioural change', paper presented at European Council for Energy Efficient Economies (ECEEE) Summer Study 2007, *Dynamics of consumption*, session 9, paper 211; Stout, P A Villegas, J Kim, H 2001.

10 'A key plank of this strategy is the development by ASIC of a generic guidance service – 'personalised money guidance' – for a mass market. 'Generic' means the guidance does not recommend specific brands of products'. ASIC, *op cit*, p 42.

11 Lemos, G 2011.

right decisions, and someone who is financially literate, highly trained, competent and ethical.

The fundamental challenge with advice has been that advice is also a distribution channel for product providers. Product providers need to invest in their distribution and, for an advice business, this represents a revenue stream that is difficult to ignore.

In 2009, ASIC estimated that around 85 per cent of the 18,000+ advisers in Australia were associated with a product manufacturer (including many independently owned dealer groups that had ‘white label’ arrangements).¹² The Independent Financial Advisers Association of Australia (IFAAA), by comparison, had seven members in April 2011.¹³

In 2009, in the wake of the collapses of Storm Financial and Opes Prime, the Parliamentary Joint Committee (PJC) on Corporations and Financial Services conducted an Inquiry into financial products and services in Australia examining, among other things, the role of financial advisers and commission arrangements.¹⁴ In its recommendations, the PJC called for a fiduciary duty requiring advisers to ‘place their clients’ interests ahead of their own’ and action to develop ‘the most appropriate mechanism by which to cease payments from financial product manufacturers to financial advisers’.

The government responded with the Future of Financial Advice (FoFA) reforms, which include a ban on product commissions and volume payments, and introduce a statutory duty requiring advisers to act in the ‘best interests’ of consumers. Perhaps the key to understanding FoFA is that the reforms aim to change the source of adviser remuneration from the product provider to the consumer.¹⁵

In 2010, ASIC reported that up to 80 per cent of adult Australians had never used a financial adviser, and that many Australians want piece-by-piece simple advice rather than holistic financial planning (which can cost upwards of \$2,500).¹⁶ The FoFA

12 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia*, submission by the Australian Securities and Investments Commission, August 2009, p 4.

13 The IFAAA has a ‘Gold Standard of Independence’ that few advisers can meet – they can’t be affiliated with a product provider, receive commissions or charge asset-based fees. See Power, T 29 April 2011.

14 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2009.

15 ‘I strongly believe that financial planners should only have one master – the consumer. Yet, for years, product providers have called the tune because they are the ones paying the planners through sales commissions and other kick-backs like expensive conferences. Any industry that survives on these kinds of practices will not be trusted by consumers. This lack of trust is one reason why up to 80 per cent of Australians have never used a financial adviser. It’s time that the regulatory framework governing the provision of financial advice shifted the focus back to the consumer’, the Shorten, B (then-Assistant Treasurer and Minister for Financial Services and Superannuation), 2011.

16 ASIC 2010, Report 224 *Access to financial advice in Australia*.

reforms also seek to ensure that financial advice will be more widely available and within the reach of more Australians, by facilitating the expansion of more affordable 'scaled' or limited advice.

Striking the right balance between enabling lower-cost, 'simple advice', while at the same time protecting consumers from 'product flogging', is something of a 'holy grail' in advice reform. A 'best interests' duty is one way to address this issue; another is disclosure, to which we now turn.

Financial product disclosure

The Financial Services Reform Act 2001 enshrined disclosure as a key consumer financial protection measure in Australia. The thinking was based on 'efficient markets theory', and relied on disclosure and conduct regulation to manage conflicts of interest, with the expectation that consumers would use disclosure to make informed decisions and that efficient markets would thereby drive competition and innovation.

The legislation was drafted using a principles-based approach, to provide financial service providers with maximum flexibility. This sounds good but the outcome, as is now well known, was that disclosure turned into a liability-management tool for product providers. Disclosure ratcheted up in size and complexity until it became virtually unreadable. Ever since, the entire reliance on disclosure has come into question.¹⁷

As ASIC commented to the 2009 PJC Inquiry:

[ASIC is] querying whether it has gone far enough in protecting retail investors, given the important role, which was not foreseen by the Wallis inquiry, that retail investors would play in the market. They had not foreseen and could not have foreseen the impact that the superannuation levy has had on investment in our markets. In that situation, you have a much broader range of retail investors and retirees. You have groups of people who lose money at the wrong time in their life and it is no answer to them to say: 'Well, it was a risk, you know. There was disclosure. You should have read the disclosure statement'. The fact is that they cannot easily come back into the workforce.¹⁸

The government has responded with a number of measures designed to improve and simplify disclosure. Product disclosure statements (PDSs) for margin loans, superannuation and simple collective investment schemes have been shortened and

¹⁷ See, for example, Kingsford Smith, D 2010, 'Beyond disclosure: how did retail investors and financial consumers fare in the crisis? Is there a need to improve outcomes for consumers and retail investors?' paper presented at the ASIC Summer School.

¹⁸ Parliamentary Joint Committee on Corporations and Financial Services 2009, *Inquiry into financial products and services in Australia*, November, p 74.

provide only the key information, in summary form, that a consumer needs to know in order to make their financial decision. Everything additional to this core information is ‘incorporated by reference’, which means it is provided online or upon request.

Disclosure is important, but the question is now how it can be used more effectively to communicate the key information consumers need to know. One of the key lessons of recent years is that this is very hard to get right.¹⁹ It’s not just that we need ‘plain English’, we need ‘stark language’ because sometimes the message needs to be really clear and unambiguous.²⁰ At the 2010 ASIC Summer School, for example, Paul Clitheroe suggested that PDSs should feature a photo of a family standing on the street next to their belongings along with a warning that ‘this could happen to you’.²¹

The future of disclosure, I suggest, is to keep working on improving it, and also to look at new ways of using disclosure to assist consumers to make better financial decisions. Assuming that consumers have access to advisers and that advisers are acting in the consumer’s best interests, one obvious way is to design disclosure to be more helpful to advisers in comparing products and making their recommendations.

Another, less obvious way is to design disclosure for computers (and even journalists), not consumers. The idea here is that the information consumers need to know can reach them through indirect channels.²² Complex data that is very difficult for consumers (and even some advisers) to compare meaningfully could be designed for computers to compare. The results could be made publicly available not so much for consumers but for advisers and financial journalists, who could then publish their analysis in a way that consumers actually might understand and care about.

ASIC has recently developed a novel approach to disclosure by setting new disclosure benchmarks for complex products. These benchmarks require issuers to clearly identify the key risks consumers should understand before making a decision to invest. At the same time, ASIC has set benchmarks for how product manufacturers should address these risks in establishing their business model and compliance procedures. The issuer is then required to state in the PDS (and other disclosure) whether they meet these benchmarks, and if not, why not.²³

19 ‘Disclosure policy is tricky. If you remember nothing else from what we say today, that’s our bottom line. Getting information policy right and disclosure policy right is tricky indeed. We say this based on our experience as staff economists working on cases and analysing broader regulations’, Mulholland, J 2007.

20 For ‘stark language’, see Godwin, A 2009.

21 ‘Words are done by lawyers and they are very poor disclosure tools. What I would like on the cover is a group of retirees with their furniture in the street outside their house. Then I’m happy for the words to say: “This may not happen to you but guess what, mate”. That would get their attention.’

22 See Thaler, R H and Sunstein, C R 2009.

23 ASIC is proposing to introduce disclosure benchmarks for contracts for difference (CFDs): in July 2010 ASIC published a detailed report on the retail CFD market in Australia (Report 205 *Contracts for difference*

The question arises, however, whether it is necessary to go even further for consumer financial protection than all of this, and regulate financial products themselves, which brings us to the final pillar: product regulation.

Financial product regulation

The recent global financial crisis (GFC) has led to a reassessment of the effectiveness of traditional conduct and disclosure regulation. Regulators are now asking how much we can expect from disclosure reform and financial literacy when financial products themselves are becoming excessively complex. In some overseas jurisdictions, thoughts are turning to the possibilities for financial product regulation.

For example, Martin Wheatley, then CEO-designate of the new UK Financial Conduct Authority (FCA), recently asked whether it was time for regulators to consider direct product intervention which, he acknowledged, was a fundamentally different approach from the way most regulatory regimes have operated in the past.²⁴ The concern here is that it may be inherently difficult for competition in retail financial services to prevent consistently poor consumer outcomes.²⁵

If this argument is right then, perhaps, logically the regulator should look upstream and consider measures that might influence the design and construction of products. While still a work-in-progress, the new rules being floated would mandate certain requirements on products and product features and potentially restrict sales of complex and risky products to certain classes of consumers.²⁶

and retail investors). Following this ASIC released an investor guide, *Thinking of trading contracts for difference (CFDs)?*, to help retail investors understand the risks of investing in CFDs and a consultation paper on disclosure benchmarks for over-the-counter (OTC) CFDs (Consultation Paper 146 *Over-the-counter contracts for difference: improving disclosure for retail investors*). A regulatory guide with final benchmarks for OTC CFDs is likely to be released later this year. ASIC has also recently published a consultation paper on financial requirements for issuers of retail OTC derivatives (Consultation Paper 156 *Retail OTC derivatives: financial requirements*).

24 'Many investment products have become excessively complex, and doubts are cast as to whether they make any meaningful economic sense. In some cases, due diligence is not only beyond investors; it is probably safe to assume that intermediaries selling these products or advising their clients on these products find it impossible to grasp the structure of these products ... Before the advent of complex structured products, regulatory attention was appropriately targeted at conduct issues, mainly in the selling process. But with investment banks continuing to recruit droves of mathematicians and financial engineers each year, we can expect more complex products to come on stream'. Wheatley, M 2011.

25 See Financial Services Authority 2011, DP 11/1, *Product Intervention*; HM Treasury 2010, *A new approach to financial regulation: judgement, focus and stability*; HM Treasury 2011, *A new approach to financial regulation: building a stronger system*.

26 There is a wide range of policy tools that might be used to achieve such ambitious aims, from requiring product providers to have appropriate product governance processes in place to more prescriptive measures, such as requiring product pre-approval, mandating or banning some products, mandating appropriate charging structures, requiring product benchmarking, and mandating risk warnings. In Australia, Dimity Kingsford-Smith has been an advocate of merit regulation. See Kingsford-Smith, D 2009.

In all of this the UK authorities explicitly recognise that excessive regulation inhibits innovation and competition, which might otherwise be to the benefit of consumers. However, they argue that perhaps this is acceptable where the resulting benefits to a majority of consumers (from not being miss-sold a product) outweigh the costs to a minority who might benefit from being able to access it.

This is a very tricky policy issue, because if we want informed and empowered consumers to stimulate innovation and competition, this might be harder to achieve if governments intervene too much in product design. On the other hand, the potential risk to consumers (and to financial stability) of complex products being miss-sold, particularly when all the other reform elements are still a work in progress, is significant. For this reason, the idea of product intervention in the United Kingdom is no longer 'out of bounds'.

The 2009 PJC Inquiry considered whether there should be limitations placed on certain complex and risky financial products so that they were not available to retail investors. It decided that 'it is not for the parliament or the government to determine for whom particular investment products are appropriate. This is a decision for individual investors, in consultation with a financial adviser bound by a fiduciary duty to put their clients' interests ahead of their own'.²⁷

In Australia there have been a number of product interventions with consumer financial protection objectives in mind. For example, we see an example of 'libertarian paternalism' in the compulsory superannuation system and recently in the introduction of MySuper.²⁸

The United Kingdom has also recently experimented with 'simple' or 'vanilla products', however, some of their experiences illustrate the challenges. For example, the Stakeholder product initiative struggled to appeal to its target market (less experienced, less knowledgeable consumers). Partly, this was due to mandated requirements for low fees, free movement in and out of the products without penalty, and the low balances invested. Product providers simply preferred to sell other products that delivered greater profitability, while the target market itself had little enthusiasm to seek the 'simple products' on their own initiative. Moreover, to keep costs low, distribution had to be through a 'Basic Advice' model which proved difficult to achieve in practice.²⁹

²⁷ Parliamentary Joint Committee on Corporations and Financial Services, November 2009, *Inquiry into financial products and services in Australia*, p 143.

²⁸ The idea behind 'libertarian paternalism' is that, if real people don't always make rational choices why not give them a little 'nudge' in the right direction by designing a 'choice architecture' so that if they end up making a choice by default it is actually a good choice. See for example Camerer, C Issacharoff, S Lowenstein, G O'Donoghue, T and Rabin, M 2003; Sunstein, C and Thaler, R 2003.

²⁹ Devlin J 2011.

An alternative to various forms of intervention in product design or creating ‘vanilla products’ is to tighten the regulation around consumer access to more complex and risky products. In Australia, the government is currently reviewing the retail/wholesale investor classification as part of the FoFA reforms. A number of countries are also exploring requirements for consumer knowledge to be tested before they can access complex and risky products.³⁰

Synergy in consumer financial protection

There is no one ‘silver bullet’ that will provide effective consumer financial protection on its own but there are potential synergies between these four pillars (and other measures) which can have a multiplier effect on the effectiveness of individual components, enhancing the overall efficiency of the policy framework.

For example, an integrated approach can entail using financial education to teach consumers not only financial concepts, but also how to use disclosure more effectively (it should not be assumed that consumers understand how to use disclosure to compare products and services). Financial education could be used to build this capability using relevant ‘real life’ examples. Feedback from this process could perhaps even lead to improvements in product design.

Similarly, one of the challenges in making ‘generic advice’ more effective is how to inform consumers that it exists and encourage them to actually use it. Again, financial education can be used to establish awareness about generic advice and give consumers hands-on experience in using the tools and resources that are available. Disclosure can be used to further market the availability of such publicly available resources, especially at the point of sale. Could product design even make ‘generic advice’ a built-in component of the product’s own features?

In all of this, where the rubber really hits the road is the moment when a consumer makes a financial decision. Everything that we have been talking about, from financial literacy to advice, from disclosure to product design, impacts on how effectively the consumer makes that decision.

Consumer financial protection is not just about protecting consumers, we want financial markets to become more efficient as a result of consumers making more

³⁰ For example, Hong Kong recently introduced a derivatives knowledge test requiring distributors to assess consumer knowledge of derivatives and rate them based on that knowledge. The *Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011* was passed by the Legislative Council on 4 May 2011. Singapore is also reviewing whether advisers need to obtain from consumers ‘information that is necessary to ascertain the customer’s investment knowledge or experience before selling an investment product’. See, for example, Monetary Authority of Singapore 2010.

informed financial decisions, and we need efficient markets to ultimately improve well-being.

Governments promote competition in financial services because that, in turn, leads to better social and economic outcomes, in the form of lower prices and a better match between financial needs and the products and services provided.

Because of the linkages between all of these elements, it is in our collective interest to get consumer financial protection right. And, as this paper has argued, there are real benefits in thinking through how each of the four pillars can be used to strengthen the other three, to ultimately contribute to well-being and financial stability over the long term.

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