Association of Financial Advisers

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Senior Adviser
Consumer and Corporations Policy Division
The Treasury
Langton Crescent
Parkes ACT 2600

*By email:* FSRCconsultations@treasury.gov.au

Dear Treasury,

**AFA Submission: Strengthening Breach Reporting**

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are currently practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

## Introduction

The AFA broadly supports reforms to mandate reference checking and to provide greater objectivity with respect to significant breach reporting. We support arrangements to provide more structure around remediation activity. However, we believe that the current proposals require some significant refinement in order to deliver an outcome that achieves the objectives, without unnecessarily adding to the cost of operating financial advice licensees.

We discuss below our concerns about how this legislation, which has broad application, is being unreasonably focussed on financial advisers and mortgage brokers. Mandatory reference checking could and should apply more broadly. Why is it only being implemented for financial advisers and mortgage brokers? If the reporting of people from another licensee is a good idea, then why has it not been extended to reporting other entities that are suspected of breaching ‘core obligations’? This reflects a common view that the Royal Commission identified issues at the institutional level,

however the regulatory response is focussed at the individual level. There are many expressing the view that this was not the outcome that was expected nor the outcome that should have eventuated from the Royal Commission. We also question some of the penalties that have been proposed for a failure to comply with these new obligations. In our view it seems remarkable that you could go to jail for failing to report a suspected breach by a financial adviser from another licensee.

A self-reporting regime should be designed on a basis where licensees are encouraged to report significant breaches. Getting the balance right between encouragement and penalties is important to facilitate the right culture within licensees.

We have focussed our responses on the issues directly impacting financial advisers and other than some general comments, have not addressed the implications for mortgage brokers.

We have worked with other professional associations in our consideration of this matter and some of our recommendations will reflect those put forward by these other associations.

## AFA's Response on Reference Checking

The AFA strongly supports a mandatory reference checking regime. We agree that the obligation should apply to the party seeking the reference check and the party that is asked to respond to a request for a reference. Often the excuse with respect to giving references, is the fact that a negative response could result in a defamation action. Whilst we have never held the view that this was a likely prospect or the basis to decline a reference check, we still believe that the protections against defamation as offered in this draft legislation are important to provide the confidence for licensees to provide open and honest references.

We are being asked to respond to this proposal when there is a complete lack of detail in terms of exactly how this might work. As a result, we are uncomfortable that we are making this submission, in advance of any understanding of some of the key questions that might emerge as part of the development of the ASIC Protocol. This includes questions like the following:

- How will licensees know who to contact at another licensee to get a reference check?
- Which former licensees must an AFSL contact? Are they required to contact all licensees over the last five years? When should they look beyond five years?
- What should they do if the candidate has only worked/been authorised with one licensee or if they have only worked (or been authorised by) one licensee over the last five years? How do you conduct this reference checking exercise with a current employer/licensee without disadvantaging them with their current employer or licensee?
- What happens if there is no one left at the reference licensee who is familiar with the adviser during the period that they were with that licensee?
- Does the reference check need to be in writing and if it is given over the phone, then what documentation is required by the party giving the reference and the party receiving the reference?
- When a licensee recruits for a role where there is the prospect of the person transitioning to a financial planning role in the short to medium term, in what circumstances should they undertake the reference check?
- How much information should be passed on as a result of a request for a reference, and in what circumstances would a breach emerge if they have failed to adequately respond to the request for a reference? How should they respond to matters involving potential or suspected misconduct that has not been evidenced?

Consistent with the ABA protocol, it will be critical that licensees have access to a central register or point of engagement to identify who the contact point is at a licensee for reference checking. This will be particularly important in the context of this being rolled out to smaller licensees, many of

whom may not even have a website. ASIC currently manages the register of AFSLs, which is accessible via the professional registers section on the ASIC website. Updating this to include a reference checking contact person is presumably the only realistic option in the timeframe that is proposed. This is a critical part of the infrastructure for the entire approach to reference checking and it needs to be resolved before this new regime can commence.

Whilst we support a mandatory reference checking regime, we also recognised that it could be misused by someone seeking to prevent an adviser moving to a new licensee or a licensee with a grudge against a former adviser. It is recognised that there could be a range of factors that could lead to that outcome and it would be important to consider what protections can be provided for an adviser who is the subject of a dishonest or inaccurate reference check.

As discussed above, we do not agree that this measure should be focussed exclusively upon financial advisers and mortgage brokers. If it is going to apply to financial advisers, then it should apply more broadly in the financial services sector.

**Recommendation**
The AFA believes that it is appropriate to extend mandatory reference checking to other roles in the financial services sector, including within product providers, super fund trustees and also management roles in financial advice licensees.

Whilst overall we support a mandatory reference checking regime, we believe that it is inappropriate to put this proposal forward without any detail of how it would work in practice, in order to provide confidence that the expectations on licensees would be reasonable and that individuals would be treated fairly. We also believe that a 1 April 2021 commencement date is impractical given that the ASIC protocol has not been developed and the solution to provide access to a register of reference checking contacts has not been resolved.

**Recommendation**
Our suggestion is that the commencement should not be until at least six months after the release of the ASIC Protocol, however preferably 12 months, to allow the infrastructure to be built.

## AFA's Response on Breach Reporting

The AFA supports an objective test of significance for the purposes of significant breach reporting to ASIC. We are conscious that there are legitimate concerns that this obligation has not been applied consistently in the past and that some licensees have failed to comply with the timeframe requirements.

We note Recommendation 1 of the ASIC Enforcement Review Taskforce (AERT):

> "The 'significance test' in section 912D of the Corporations Act 2001 be retained but clarified to ensure that the significance of breaches is determined objectively."

The task force talked in terms of serious misconduct and material loss to clients. They also suggested that changes to the significance test should be supplemented by new, specific, regulatory guidance from ASIC that takes into account different businesses, products and distribution channels.

It is our interpretation of the AERT recommendation, that the obligation to report significant breaches should remain based upon a test of significance that is similar to the current level of severity, however a solution should be found to ensure that it can be applied on an objective basis. We did not consider that this recommendation involved a suggestion that the level of significance should be significantly reduced.

We favour an environment where licensees are encouraged to report significant breaches and believe that there should be no factors that discourage them from reporting. We are very concerned that a combination of factors could discourage licensees from reporting breaches under the new definition. This is in part, due to the fact that they would be required to report many totally immaterial breaches and that with each breach, there is a risk that ASIC could apply an infringement notice. In our view, this would be a counterproductive environment and may actually serve to cause more inconsistency with breach reporting.

**Understanding Breach Reporting in a Financial Advice Context**

Financial advice presents a very different context to other financial services environments. Whereas most financial services entities operate very standardised processes that operate in a consistent manner and deal with very similar issues, for a self-employed financial advice licensee, each adviser often operates a very different set of processes and they each deal with very different and complex situations. Therefore, a licensee who operates 200 self-employed financial advisers typically has 200 advisers who each operate in very different ways. The reality of this is that the prospect of a mistake is much higher, however as opposed to a product provider operation, it is much less likely to impact a large number of clients. Financial advice is inherently much more likely to result in breaches.

Financial advice licensees also have structured compliance processes that are proactively looking for breaches of obligations. This includes the adviser audit process, where a file auditor will, on a regular basis (at least every year), review four to six files containing recent advice and assess the quality of the advice and the client file against each of the obligations. Often these audits will find issues with the file, although in most cases the matter is minor and does not need to be reported to ASIC. Licensees also run other processes, such as supervision reviews by Practice Development Managers, Issues self-reporting systems and complaints systems, which each contribute to the identification of breaches. Licensees also run remediation processes that respond to each of these issues that arise through these different processes. The reality is that any licensee, that is well run, will discover a number of breaches during the course of the year, and will address each of these issues.

We conservatively estimate that the proposed change in the definition of a significant breach to include each civil penalty provision will result in a 25 to 50 fold increase in the number of significant breaches reported by the financial advice sector. This is simply a reality of a higher risk process and the number of different people operating these processes.

The existence of a much higher level of breaches is demonstrated by ASIC reports on advice quality, such as ASIC report 413 on life insurance advice, 562 on superannuation switching in vertically integrated groups, 575 on SMSF advice and 639 on advice from superannuation funds. In addition, ASIC report 636 on compliance with the FDS and Opt-in obligations also revealed a high level of breaches.

The vast majority of these civil penalty breaches are immaterial. We are talking about issues like the failure to provide the current version of the Financial Services Guide, or a Product Disclosure Statement, or being a bit late in the issue of a Fee Disclosure Statement. Each of these issues, on a once-off basis do not deserve to be treated as a significant breach and reported to ASIC. Equally, many of the breaches of the best interest duty, whilst being more material, are unlikely to influence the client outcome and are therefore not likely to be material or worthy of significant breach reporting.

The proposed definition of a significant breach would result in a substantial increase in the level of breach reporting activity within licensees, which would equally increase the cost of operating these licensees. We are talking about a substantial increase in activity that would lead to a need to materially increase resources across the financial advice sector. It would also lead to a significant increase in the

amount of work that would be assigned to compliance consultants and external lawyers. The consequence of this additional workload is that breach reporting processes would get overloaded and breach reporting committees and licensee risk management committees would be unable to focus on the most important matters. This would also lead to a significant increase in delays in responding to significant breaches. Ultimately this would be a poor outcome for all stakeholders.

**Recommendation**
The AFA recommends that the breach reporting threshold is set at a much higher level, in order to avoid significant additional work at the licensee level and a loss of focus on material issues.

**Reporting Advisers from Another Licensee**

Whilst the AFA supports a proactive approach to the removal of unsuitable financial advisers from the financial advice sector, we have serious reservations about the proposal to introduce mandatory reporting of financial advisers from another licensees. We have questioned above, why this measure is solely focussed upon the reporting of individuals (financial advisers and mortgage brokers). If it is appropriate for one product provider to report a financial adviser that they think is doing the wrong thing, then why shouldn't they similarly have an obligation to report other product providers who they believe are doing the wrong thing. This lack of consistency undermines the whole regime.

The obligation to report advisers from other licensees, seemingly fails to consider the implications for Authorised Representatives' business models. Is a licensee responsible for reporting any suspected breaches that their adviser may identify with respect to other financial advisers from another licensee? For example, if an adviser has a new client come into their office who expresses a complaint about the advice that they received from a previous adviser, what is the new adviser expected to do and what is the licensee expected to do? If the new adviser receives a verbal statement to this effect, then what further steps are they expected to take to investigate the matter? The cost impact of this is something that needs to be taken into account.

Whilst a licensee may from time to time come across issues where they might suspect the risk of mis-conduct, often they do not have sufficient information to make a meaningful assessment. Even if they have a Statement of Advice, they are less likely to have the fact-find or any of the file notes in order to undertake a reasonable assessment. Neither do they have any powers to request these documents.

Licensees will be stuck between the reality that they have an obligation (an offence provision) to report significant breaches by advisers from other licensees and also the consequences of reporting another licensee and notifying the other licensee that they have made a significant breach report. This might attract retaliation.

We also envisage that when it comes to a breach by an individual licensee that reporting the breach to them might actually serve as a trigger to hide the breach or to act to avoid any risk of prosecution. Inevitably there will be situations where the notification to the licensee could put a prosecution in jeopardy.

Whilst we acknowledge that the implications of this obligation will be significantly reduced if a genuine higher level significant breach definition is the ultimate outcome, however important issues will remain.

**Recommendation**
The AFA recommends that licensees should have the ability, on a voluntary basis, to report advisers from another licensee through a direct contact line to ASIC. We believe that this should work as a feedback loop and that any report is followed up by ASIC and on an annual basis subject to aggregate level public reporting.

Section 912DAC(6) provides an exemption where there are reasonable grounds to believe that ASIC is aware of the existence of the matter and all the information with respect to that matter. How can a licensee make this assessment? If they see a matter reported in the media or if they are aware that another licensee reported the matter, then what evidence do they need to actually take advantage of this exemption provision?

**Investigations and Understanding the Impact**

We note the new obligation to report investigations and the outcome of investigations to ASIC, yet there is no definition of what an investigation actually is. If this is a matter that is being considered by local management and has not yet been elevated to a central risk and compliance team, then does that qualify as an investigation?

We do not support the requirement to report an investigation, where there are insufficient grounds to consider the possibility of a breach. This could be a regular thematic review that is undertaken, without any basis to assume that there are any matters that could require reporting. It also seems unnecessary to have an obligation to report the commencement of an investigation and then shortly afterwards need to go back and report that no reasonable grounds exist to believe that there has been a reportable breach. We understand that this is being put in place to address the risk that a licensee will take a long time to investigate a matter before reporting the breach. We would suggest that the best solution is to fix the breach reporting obligations, without introducing a new obligation that will, in large part, add no additional value, but rather involve a material additional cost for licensees.

Another important consideration in the investigation of a matter is a licensee's engagement with their professional indemnity insurer as part of an investigation into a matter where there may be liability and where remediation may be required. Licensees will need to notify their PI insurer, who will then often appoint a lawyer to consider the matter. This all takes time and will impact the timeframe for reporting. Consideration needs to be given to inevitable delays in the investigation process.

**Understanding the Impact on the Financial Advice Sector**

The proposal needs to be assessed from the perspective of both large licensees and small licensees. Whereas large licensees will typically have internal resources to assess the significance of the breach, often small to medium licensee will need to seek external compliance or legal support on each occasion. For a small licensee, they are unlikely to understand the test of significance, and would not be aware of which obligations are civil penalty provisions and which offences relate to dishonesty involving a jail term of 3 months or more and which other cases involve a jail term of 12 months or more. Simply making this assessment would require access to external compliance or legal resources and this would automatically involve a significant cost. Where potential issues arise on a regular basis, this would amount to a significant cost over the course of a year.

We believe that it is necessary to provide a definition of 'gross negligence'.

**Other Questions and Concerns**

In addition to the issues that we have raised above, we also have the following questions:

- If a licensee breaches the obligation to report significant breaches, then who within that licensee will go to jail? Why does this need to be an offence rather than a civil penalty provision? Yes it appears to be consistent with the new approach of being tough and litigating, however, is it really necessary or appropriate?
- We are somewhat uncertain about what the obligations are with respect to licensee level public reporting by ASIC, and we seek confirmation that this reporting will not involve

information that would specifically identify an individual breach report. The public reporting also needs to address how ASIC has responded to these matters. We also have some concerns with respect to the reporting of suspected breaches and whether it is appropriate for this to be publicly reported.

- Paragraph 2.63 of the draft Explanatory Memorandum includes the following statement – "The use of an infringement notice is appropriate as it is expected that there will be a high volume of contraventions of the reporting provisions. The Guide highlights failing to comply with the reporting obligations as an example of a case where infringement notices are generally used." Why is it expected that there will be a high volume of contraventions? Is it then seen as a revenue raising proposition and has the threshold been reduced so significantly in order to increase the number of infringement notices issued?
- We note with amazement that at the same time, this proposal will significantly increase the number of breaches that will be reported by financial advice licensees that the legislation is drafted in a way to minimise the requirements for an APRA registered entity to report to ASIC if they have already reported to APRA. Once again, this seems to be an inconsistency that is favouring large institutions over small businesses.

**What the AFA Recommends for the Definition of a Significant Breach**

It is the AFA's view that it is not possible to find a legalistic solution within the Corporations Act to easily define what should be classified as a significant breach, and what should not be. We therefore believe that the most sensible way forward is to define the test of significant breach on a sector by sector basis and set this through either a regulation, or through an ASIC legislative instrument.

It might be that for financial advice, four cases of inappropriate advice or breaches of the best interests duty across an adviser audit, would be the trigger to classify the matter as a significant breach. What is applied to other sectors may be driven by issues specific to that segment.

| **Recommendation**<br>We recommend that ASIC set up a panel of large licensees and compliance consultants and legal advisers that work with small licensees to work through a definition for a significant breach that results in roughly the same level of significance and as a result the number of breaches for a licensee that is currently complying with their obligations remains broadly the same. |
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**Commencement and Transition**

We note with concern the fact that a licensee could be subject to consideration at the same time of some breaches under the old rules and some under the new rules. We do not believe that this is appropriate and it is more likely to cause problems.

| **Recommendation**<br>We recommend that a delayed commencement date is utilised and that all breaches beyond the commencement date are processed under the new rules. We recommend a 1 July 2021 commencement date. |
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## AFA's Response on Notifying and Remediating Clients

An Important consideration in responding to this proposal is the establishment of a more sensible definition of a reportable situation, to ensure that it does not involve a focus upon immaterial matters.

We are once again surprised to find that these obligations would only apply to financial advice clients. If these requirements are considered to be appropriate for financial advice clients, then they should also be appropriate for other financial services clients. Once again, this has the appearance of singling

out financial advisers for special attention.

We strongly disagree with a requirement (Section 912EA) to notify clients where it is only at a stage of having reasonable grounds to believe that a reportable situation has arisen, and that the client has suffered a loss. In our view, in the vast majority of cases, such contact with clients should only happen after the matter has been finalised and the loss has been confirmed. Reporting to the client on the basis of reasonable grounds, runs the risk of significantly damaging the reputation of the financial adviser and unnecessarily alarming the client. You only need to consider how a client might respond to the receipt of such communication to realise the potential ramifications. This would have the appearance of a judgement by the licensee that the adviser has done the wrong thing, even before the matter had been properly investigated. This will alarm the client and force them to consider whether they should move to an alternative adviser. Equally important, the financial adviser would need to devote their attention to responding to questions from clients, rather than working to fix the issue.

Section 912EB refers to obligations with respect to investigating a reportable situation that may affect clients. As this is an investigation, we assume that it would require notification to ASIC as discussed above under the breach reporting section. We question this need to report all investigations into suspected matters. For small licensees who need to contract resources (e.g. compliance consultants or lawyers), it may be difficult to properly commence the investigation within 30 days.

The requirement to notify the client within 10 days of the completion of an investigation will most likely result in investigations being held open until all considerations have been addressed. Once again, we make the point that this will be particularly difficult for small licensees who are caught up in a matter of this nature.

It is our view that a failure to keep records of compliance should not be an offence provision. Where records have partially been maintained, this is a subjective test, and is therefore going to come down to a judgement call. For a financial advice licensee, potentially some of the records would be maintained by the Authorised Representative business and this might open up additional challenges.

There is no discussion on the definition of a loss. There is an important difference between a confirmed loss and a potential future loss. In some cases, the loss may not have been confirmed, however may arise in the future. One example of this would be switching a client from one insurance product to another, however, having exclusions for some conditions in the new product. Where that was considered to be inappropriate advice, then the client loss would only arise as a result of those excluded health conditions arising in the future and the insurance not covering those conditions. In such cases, what remediation is required? How can the loss be quantified at the time of identification? There will be other cases where the client was not provided with some information that may have influenced their decision to proceed with the advice. Does this constitute a loss, and if so, then how would this be calculated?

| **Recommendation**<br>We believe that a definition of a loss should be clearly outlined in the legislation and the Explanatory Memorandum should include a number of examples. |
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## Concluding Remarks

The AFA supports the intent of this legislation, however we are particularly concerned about a number of elements as discussed above, particularly with respect to the proposed definition of a significant breach. Sensibly addressing this issue will go a long way towards making this more appropriate and to avoid what would otherwise be a significant increase in workload and cost for financial advice licensees. We have also questioned why many of these measures have been focussed solely on individual financial advisers and mortgage brokers.

We believe that it would be beneficial to have a further round of consultation once Treasury has considered the feedback to this version of the draft legislation.

The AFA welcomes further consultation with Treasury, should it require clarification of anything in this submission. If required, please contact us on (02) 9267 4003.

Yours faithfully,

**Philip Kewin**
Chief Executive Officer
Association of Financial Advisers Ltd