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The Solicitor Assisting the Commission
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Dear Commissioner,

AFA Response: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

We refer to the questions raised by Senior Counsel Assisting on 27 April 2018 as part of the concluding submission to the Round Two hearings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

The Association of Financial Advisers acknowledges the important issues raised through these Royal Commission hearings and the appropriate consideration of changes that may be required to address these underlying problems. This is an important process to undertake, as it is clear that without reform and without time to heal, many Australians will have a sub-optimal view of the role of financial advice and the character of financial advisers. In many ways this is a very disappointing outcome for the Australian public and for the overwhelming majority of financial advisers who act in their client's best interest every day and prioritize the interests of their clients above their own. The majority of financial advisers create positive outcomes for many clients on an ongoing basis as part of what they do. The broad community of ethical advisers is viewing what has happened at the Royal Commission with anger and dismay. The AFA is both willing and eager to work with Government and other industry stakeholders to find the best solutions to address these important issues.

It is clear from the Royal Commission's terms of reference that the purpose of this Royal Commission is not to look at good financial advice. It is also apparent, from some of the questions that have been asked, that there is a lack of appreciation of the value of financial advice. We hope that, through this submission, we can seek to more clearly articulate the value of financial advice and the reasons for a client to have an ongoing relationship with a financial adviser.

We would like to draw the Commission's attention to some recent research by Sunsuper that highlights the value of financial advice.

Financial Confidence	• Of those currently advised, 80% believe advice has given them more confidence in making financial decisions. • 80% of advised clients feel more financially secure compared to 47% for those never advised.
Control of the future	• 79% of those currently advised believe advice has given them more control over their financial future. • 69% of those surveyed have a formal retirement plan compared to 18%

	for those never advised.
Retirement Preparedness	• 7% believe they will have to rely on the government age pension compared to 42% for those never advised.
Financial Wellbeing	• 80% of those currently advised believe advice has given them more peace of mind • 75% believe advice is worth more than it costs • 67% feel more secure in their jobs compared to 32% for those never advised • 64% believe they have enough money to do what they want in life compared to 24% for those never advised

These are tangible benefits from good financial advice. The financial advice sector contributes to the overall Australian economy and the Government budget by better ensuring that Australians are protected in the event of injury or illness, that they are better prepared for retirement through self-funding and that more money is available through superannuation and investment products for investment in the corporate sector.

Despite some of the suggestions during the Round 2 Hearings, the financial advice profession does not have a culture of protecting its own. In fact, the financial adviser community want to see those advisers whose advice or ethics does not meet public expectations removed from the industry and therefore ensuring that the community trust prevails and encourages more people to seek financial advice.

This Royal Commission is being undertaken at the same time that the financial advice sector is implementing major reform, in the form of the Life Insurance Framework and the Professional Standards legislation. As an important part of the Professional Standards reforms there will be a new Code of Ethics that will apply across all financial advisers and they will all be subject to the oversight of code monitoring bodies. Both of these important reforms are expected to have a substantial impact upon the provision of quality financial advice. Whilst the benefits of these reforms are only now starting to be identified, it is necessary to take the existing reform agenda into consideration when contemplating what other reforms may be required. These more recent reforms are on top of a series of major reforms that have been introduced since the Global Financial Crisis, including the Future of Financial Advice reforms. It is however apparent that further reforms may be required in areas outside of the recent focus upon remuneration and education.

We believe that culture and risk management systems have emerged as key issues with respect to wrong doing and suggest that reforms should focus upon actions to address poor culture and inadequate risk management systems. The timing of the establishment of code monitoring bodies is extremely tight. We would therefore suggest any recommendations the Commissioner makes that may impact upon the implementation of these important reforms, be highlighted as soon as possible in order to avoid the risk of wasted investment in compliance schemes and code monitoring bodies. Senior Counsel Assisting, Rowena Orr QC has apparently challenged the future of code monitoring bodies and the role that Professional Associations may play.

What has been highlighted through the hearings is examples of advisers who have managed to move from one licensee to another, despite the existence of apparent issues with their conduct and the quality of their advice. Another known issue is advisers moving to a new licensee when their current licensee seeks to increase the requirements, standards and the accountability for advice and conduct. As a sector, the capacity for advisers to move to a lighter touch licensee is a known issue. The complication of this is that to achieve the overall objective of raising the quality of advice, it is important to increase the standards across the sector and remove the possibility for advisers to find a place where lower standards are permitted.

The Royal Commission has already identified the issue of the willingness of consumers to pay for financial advice in Background Paper 8: Key Reforms in the regulation of financial advice, which was prepared by Treasury (published on 13 April 2018). The cost of the provision of financial advice is a very important consideration at present, with a lot of cost increases flowing through as a result of recent regulatory reforms. The direct implication of cost increases is that financial advice may be taken out of the reach of average Australians. We therefore seek to articulate the importance of reforms focusing on cost effective solutions and the avoidance of unnecessary duplication. This is particularly the case with life insurance advice where the remuneration for the adviser is often lower and the client's capacity to afford the cost of advice and the insurance premiums is often in question.

There are no simple or easy solutions for the issues identified by the hearings. The financial advice population is not homogenous, and different issues and solutions apply. It is practical to divide financial advisers into four key groups:

- Salaried advisers employed within vertically integrated groups.
- Self-employed advisers authorized by a vertically integrated group and their employed advisers.
- Self-employed advisers who are authorized by a licensee that is not part of a vertically integrated group and their employed advisers.
- Self-licensed financial advisers and their employed advisers.

An understanding of these different groups is important as the nature of the relationship with the client can be very different. Small financial advice practices are likely to be much more focused upon the servicing of existing clients than may be the case with other groups. New clients typically come as a result of referrals from existing clients or from other professionals. This group of advisers develop long term relationships with their clients and have frequent contact. Remuneration of financial advisers also differs greatly between self-employed and salaried advisers. Restrictions that might be considered in the context of salaried advisers are not practical for a financial adviser who is a business owner.

It is also the case that different issues with the quality of advice emerge in each segment of the market. These issues may emerge as a result of a range of factors including the remuneration model, the breadth of product choice, the level of standards and the quality of the risk management systems. These are all key considerations and it is important that they are all appropriately addressed to ensure the quality of advice is maintained.

One of the key issues with the financial services industry is that it has been driven by sectoral issues, whether that be the banks, the life insurers, platform providers, superannuation funds, financial advisers etc. As a result, the different parties are often in disagreement. This might have held back internally developed solutions and deeper research into identifying and fixing fundamental issues. We therefore propose a role for an umbrella cross financial services industry oversight body that can take a non-partisan view in addressing embedded issues and to drive more consumer-focused outcomes. Such a body could be led by an eminent chair (with secretariat support) and participation by representatives of the sectors that are selected for their big picture thinking, consumer driven perspective and a commitment to industry wide improvement. Such a body could hold the industry more accountable. As an example, it could drive an industry wide reference checking protocol.

Many of the questions raised by the Commission are deep and potentially have significant implications for the financial advice sector. In the context of the short time frame and the recency of the hearings, some of the solutions to the identified problems may take longer to emerge and may require cross industry consultation. Equally, the most appropriate responses to the following questions may evolve over time.

Fees for No Service

Question 1 - Do clients receive any meaningful benefit from ongoing service arrangements?

In answering this question, it is necessary to firstly explain what we believe to be the value that clients obtain from financial advice. It is very much more than receiving a financial plan that is tailored to their specific circumstances. A relationship with a financial adviser is also very much about helping them to make good decisions and to avoid making poor decisions. It is also about financial literacy/education and better understanding the decisions that they are making. Financial advice also has an emotional element, where quality advice and a strong advice relationship leads to increased client happiness. Better understanding your financial position and your financial strategy provides greater confidence, security and peace of mind with respect to the future. Financial stress is a major factor in society and a key contributor to family breakdown. Financial Advice helps people to manage financial stress.

Often a relationship with a financial adviser has a direct influence on changing client behaviours. Better budgeting, cashflow management and savings habits do not come easily and it is important to have someone who will hold you accountable to your plan. The benefits of financial advice are not a one-off outcome, it is an ongoing focus and state of mind.

Clients share more personal information with their financial adviser than any other professional that they deal with. Good client relationships extend for many years and involve advice and support through many major and challenging events in a client's life.

Some of the benefits of an ongoing service arrangement include:

- Tracking progress against client goals (e.g. purchasing homes, preparing for having a family, saving for school fees, planning for major family events and holidays, paying down mortgages, progress to retirement goals).
- Adjusting a current plan in line with altered goals and lifestyle changes (e.g. modifying super contributions due to Government changes to the maximum contribution caps, utilising cash surpluses to contribute more to super or pay more off a home loan or the converse, changing life insurance arrangements as client needs change (e.g. reducing cover once a mortgage is paid off)).
- Reviewing and adjusting of the client's risk profile to ensure the current asset allocation of the investments are appropriate to a client's needs and goals.
- Review of investment asset allocation and performance, including to bring the actual asset allocation back in line with the target asset allocation and the strategy.
- Review and update of beneficiary nominations and ownership structures of assets to ensure a client's estate intentions are adhered to in an appropriate way.
- Identifying other issues such as the need to review wills, powers of attorney, the need for tax planning or helping clients with elderly parents with respect to strategies for Aged Care.
- Ensuring that insurance arrangements continue to reflect client needs and changes in personal circumstances.
- Ongoing service ensures clients understand the discipline of maintaining, reviewing and sticking to a plan in much the same way as a coach.

A regular review is an ideal chance to reinforce the importance of the client's financial strategy and to motivate clients to continue to stay on course, and to providing continuing education in order to make more informed financial decisions. Building the client's financial knowledge is a very important role of financial advisers. This includes awareness of changes in legislation and tax laws that might impact their financial position. This can be facilitated by the adviser through meetings, invitations to seminars and access to other education materials.

Many advisers have been able to prevent clients from making poor financial decisions through regular interactions as part of an ongoing service arrangement, such as avoiding excessive debt or the use of bad debt, avoiding moving investments to cash following a material investment market downturn, but prior to a recovery. Should an ongoing service agreement not be in place then the adviser would need to arrange for the client to pay a one-off fee prior to providing additional advice, which may run the risk of the advice not being provided when it is most needed.

Each adviser needs to ensure that they have the capacity to provide the services that they have committed to providing and that they have an appropriate number of clients and the resources to meet their commitments. The level of service will vary depending upon the complexity of the client's circumstances and their needs. All clients on ongoing fee arrangements receive an annual fee disclosure statement and they need to assess whether the arrangement continues to meet their needs and deliver value. Where it no longer meets their needs, they can renegotiate the arrangement with their adviser or discontinue the ongoing service arrangement. From 1 July 2013, all new clients have the ability to choose every two years whether they want to continue their ongoing fee arrangement with their financial adviser. They can choose to cease the arrangement and if they fail to respond to the opt-in notice, then the ongoing fee arrangement will be automatically terminated.

Importantly, ongoing fee arrangements do not necessarily involve the purchase of a new product, change in investment strategy or recommendations that deviate from the previous year's plan. However, the review by the adviser must take into consideration ongoing needs, changing personal circumstances or the changing macro environment. The adviser still needs to work through the full review process even to decide to recommend no change.

Ongoing service arrangements add a lot of value for clients. We believe that, despite the evidence presented with respect to the failure to provide services by some advisers and licensees, this is not common and should not bring the value of an ongoing financial adviser relationship into doubt.

The AFA strongly believes that any advice business that is not providing contracted services to an ongoing client should contact the client to discuss their needs and where there is no longer a requirement for ongoing financial advice to cancel the ongoing fee arrangement.

Question 2 - To what extent does the continued legislative condoning of grandfathered commissions shape and influence the culture and attitudes of financial advice licensees so as to create a disconnect between community expectations as to the charging of fees and the tolerance of licensees for the charging of fees for no or little service?

Grandfathered investment and superannuation product trail commissions are a declining influence in the financial advice sector. Trail commissions are typically between 0.2% and 0.4% of the account balance, which is at a level well below the typical fee for ongoing service arrangements. For this reason, the relationship with a commission only client is often a different relationship to one with an ongoing fee arrangement client and the level of service is often different. When offered the choice to change to a post-FoFA product, many clients choose to stay where they are.

A trail commission payment for a superannuation or investment product does not constitute an ongoing service contract between the financial adviser and the client. An ongoing fee arrangement is very different as it does require the provision of ongoing service and is an agreement between the adviser and the client.

Whilst we acknowledge that cases of fees for no service do occur, as stated above, we do not believe that the non-provision of services to ongoing fee clients is common across the financial advice sector. It is also important to note that the legislated obligation to provide a fee disclosure statement to an ongoing fee arrangement client along with the fee disclosures in product statements means that clients should be very aware of the fees that they are paying and empowered to take action when they are not receiving those agreed services.

We do not believe that the continuation of grandfathering has a cultural influence on the issue that has been addressed by the Royal Commission with fees for no service.

In the context of life insurance renewal commissions, the situation is somewhat different as this payment might enable the adviser to do a regular review of the client's insurance needs and also may cover their costs when providing support and assistance in the claims management process. The expectation of ongoing service is more explicit as is the expectation that the adviser will be there to assist the client at claim time.

Most financial advisers do not charge extra for support and assistance in the claims process, whereas the involvement of a lawyer in the claims process could cost the client typically in the range of 20% to 40% of any benefit that is paid out. Advisers may charge for particularly complex or drawn out claims, but this would be on an hourly basis or a flat fee, which on a $1m claim would amount to a tiny fraction of what a lawyer would charge. Often the involvement of a lawyer is administrative and simply not required for anything other than a complex or disputed claim.

Question 3 - Should grandfathered commissions cease?

We do not believe that there are grounds to cease grandfathered commissions, although we note that more can be done to ensure that these clients are being serviced.

The grandfathered trail commission is a payment from the product provider to the licensee/adviser and does not come directly from the client's account (although it is built into the overall product cost). When trail commissions are turned off, the payment is generally retained by the product provider, rather than returned to the client or used to reduce the product fee for the client. This would mean that the client gets no benefit through a product fee reduction and would also lose access to the financial adviser unless they agreed to establishing an ongoing fee arrangement, that would involve a material additional cost. Removal of trail commissions through a regulatory means would be a very complex matter and is most unlikely to directly benefit the client in any way.

There are a number of reasons why it may not be in the client's best interests to move from a trail commission paying legacy product to a new post-FoFA product. These reasons include:

- The legacy product may have an exit fee, as was the situation with the case of the client for Mr E in the Royal Commission case study. Thus, forcing the client to move from a trail commission paying product to a post FoFA product could result in the payment of a large exit fee and would not be in the client's best interests.
- The sale of one product and the purchase of another involves other costs. This may include buy/sell margins that exist in most unit linked products.
- The client's existing product may contain significant capital gains that would be crystallised if the client moved to a new product. Recognising the capital gain and paying capital gains tax may not be in the best interests of the client.
- Grandfathered Centrelink treatment of older pension products.
- In the case where the superannuation includes insurance benefits, where the client's health has deteriorated since the current superannuation product was acquired and they may be unable to get insurance in a new product, it may be more appropriate to stay in the old product

When the FoFA legislation was developed, due consideration was given to paragraph 51(xxxi) of the Constitution and the issue of the acquisition of property from a person otherwise than on just terms. As an example, please refer to section 1528(3) of the Corporations Act. The factors relating to this constitutional consideration have not changed and it is therefore important to appreciate that the removal of grandfathered commissions without compensation would be likely to be in breach of the Constitution.

A large number of self-employed financial advisers have purchased financial advice businesses or books of financial advice clients on the basis of a business valuation being applied to trail commission paying clients. Business loans have been arranged on the basis of these valuations. Commission payment rights are often used as security for these business loans. If trail commissions ceased, then these business valuations would be negatively impacted, and these businesses could be in breach of the loan covenants. These businesses were purchased on the clear expectation that grandfathered commissions will continue. The removal of grandfathered commissions would have significant consequences in a number of cases.

We believe that grandfathered products will be a declining factor in the financial advice market and that clients should be made aware of this and encouraged to discuss their options with their adviser to consider whether the move to a modern product would be in their best interest or not. Many advisers are already doing this as part of their review process as they ensure the recommendations that they make continue to meet the ongoing needs of their clients.

We certainly recognize that there will be circumstances where moving from a legacy product to a modern product would be in the best interests of the client and recommend that licensees and advisers implement and operate within licensee standards that address this issue and that licensees are monitoring the activity of their advisers to ensure that this is being addressed.

Investment Platform Fees

Question 4 - Does vertical integration of platform operators with advice licensees serve the interests of clients? If so, how?

Whilst the existence of vertical integration may increase the risk that advice may not be in the best interests of clients, it does not necessarily mean that the advice will not be in the best interests of clients. As is often noted by ASIC, there are positives and negatives for clients in the vertical integration debate. ASIC Report 562 clearly shows that a client is much more likely to end up with the in-house product. This, on its own, does not mean that the advice is not in the client's best interest. On the other hand, the clients of an institutionally owned licensee are much more likely to be quickly compensated for poor advice, whereas sometimes small licensees fail and are unable to pay. Large vertically integrated licensees also typically have access to a greater array of expertise to assist advisers in the provision of advice.

Regulatory Guide 175 clearly sets out that an adviser is not required to recommend the very best product, or to consider every product in the marketplace. Nonetheless an adviser needs to take into consideration not only the best interests duty (Section 961B), but also the obligation that the advice is appropriate (Section 961G) and where there is a conflict between the client's interests and the interests of the adviser (and associates), then the adviser must give priority to the client's interests (Section 961J).

Financial advice can be split into the recommendation of strategies and the recommendation of products. Whilst institutional bias can have an impact upon strategy selection, it is more likely to influence product selection. A failure to meet the best interests duty is often more to do with the strategy recommendation, as opposed to the product recommendation. Aside from this it would be near impossible to give every client the very best product every time and to expect that this product would remain "the best product" for the client.

The role of the adviser is often to recommend a platform and also the investment options to utilize on that platform. Whilst the recommendation of the platform is more likely to be influenced by the institutional ownership, the choice of investment options is often much more diversified. The selection of one modern platform in preference to another is not likely to result in a substantial difference in the overall outcome.

It is clear from the hearings that vertically integrated licensees need to do more to ensure that their policies, processes, culture and structures are more aligned to the provision of advice that is in the best interests of the client and that prioritizes the interests of clients.

One obvious challenge with the consideration of a ban on vertical integration is whether it is in any way appropriate to ban a company from selling (through advice) its own products. This would seem to be an unreasonable intervention in the market. In the past, different models have been proposed around the ability of an entity to sell their products through the means of financial advice. It may be the case that this needs to be reconsidered. We would suggest that more work is done to define the minimum standards for vertically integrated groups to ensure that clients are receiving advice that is in their best interests. A tightening of the rules around how vertically integrated businesses operate is likely to include issues such as the breadth of Approved Product Lists, public reporting of product selection information (as recently reported by ASIC in Report 562), clearer requirements around the rules for prioritizing the interests of the client, more prominent disclosure of the relation between the adviser and the product provider, and greater disclosure of product considerations to the client.

In conclusion, vertical integration is one important consideration when it comes to compliance with the best interest duty, however it is only one factor and controls can and should be built to manage the increased exposure to this risk. Equally, there is no simple basis to suggest whether vertical integration is in the interests of clients or not, given there are some advantages and some areas of greater risk.

Question 5 - Why should a platform operator continue to receive a fee or rebate from a fund manager calculated by reference to the value of client funds invested in the fund if that fee or rebate is not wholly passed on to the clients whose funds are the basis for the fee or rebate?

Section 964A of the Corporations Act prohibits a platform operator from accepting volume-based shelf space fees. Section 964A provides two exemptions, with the first reflecting the payment of genuine fees for service and the second relating to the benefits of scales of economy. Section 1529 of the Corporations Act provides for grandfathering of these shelf space fees for pre 1 July 2013 arrangements.

As a point of principle, the AFA would support the passing on of any such rebate to the client other than where it is covered by the grandfathering arrangement.

Question 6 - If platform operators continue to automatically deduct advice fees from clients' investments, why should the platform operator not be required to have controls in place to ensure that subdivision (b) of division (3) of Part 7.7A of the Corporations Act has been complied with? Put another way, why should platform operators not be expected to ascertain that there is a lawful entitlement on the part of fee recipients to the moneys that the operators automatically pay to the fee recipients at the expense of clients?

The FoFA laws place obligations on the adviser and the licensee with respect to the charging of ongoing fee arrangements. These arrangements are between the adviser/licensee and the client and typically form part of a broader arrangement with the client. This is documented as part of a Statement of Advice or other means of documenting the ongoing fee arrangement. The platform provider is typically unaware of these arrangements and it is unreasonable to expect them to be aware or to play a role in oversighting the arrangement.

On this particular question we make two important points:

- The law should not be designed based upon the risk that the responsible party (adviser/licensee) does not comply with their regulatory requirements.
- Any recommendations to make fundamental changes to the operating model for the broader financial services industry should give sensible consideration to the impact on cost of such additional obligations and the fact that these costs would need to be passed on to the end client.

In summary the licensee and adviser are responsible, and it is impractical to expect the platform operator to perform this role, as we have set out below.

The question posed in terms of whether the licensee/adviser has a lawful entitlement to the fees automatically taken from the client's account is a complex matter. There are circumstances that could lead to the automatic cancellation of these ongoing fee arrangements such as the failure of the client to opt-in or the failure of the adviser to provide a fee disclosure statement to a post 1 July 2013 client. A failure to provide a fee disclosure statement to a pre 1 July 2013 client does not result in the automatic cancellation of the ongoing fee arrangement. Whether a client is a pre-1 July 2013 client does not depend upon when the product was commenced but when the client first received personal advice from that licensee or adviser. This could result from the client having a previous or different product with another product provider. The platform operator may not know if the client is classified as a pre or post FoFA client.

Under the FoFA legislation, if the client responds to an opt-in notice and chooses to decline ongoing services, then the ongoing fee needs to cease immediately. If the client does not respond to an opt-in notice, then the ongoing fee arrangement needs to cease by 28 days after the closing date to respond to the opt-in notice. There is significant complexity with the implications of the opt-in requirement and the fee disclosure statement requirement that if the product provider was to police, would mean that they would need to collect a significant amount of information from the adviser and to make decisions on each specific case.

When it comes to whether the adviser is meeting their contractual obligation to provide services to a client, there would need to be some assessment as to whether the services were provided in full or in part and whether the client specifically chose to defer the provision of the service to a later point.

It is also important to note that often the client holds multiple products and fees of different amounts are paid from each product. There is not always a simple one-on-one link between the fees paid on a product and the services that are provided for that payment. Product providers are not going to know what other products that client may hold and what services are being paid by fees that are drawn from other products.

If such an obligation were introduced, then where would the boundary start and finish? Would such a measure be restricted to investment and superannuation products? Would a bank with a client from whose bank account a direct debit for financial advice fees are withdrawn, be responsible for confirming those fees were legitimately taken?

What has been proposed here would involve a significant level of complexity and the duplication of records that would be required to be kept at both the adviser and the product provider level. The additional cost would include the provision of this information by the adviser to the product provider on an ongoing basis and the development of systems for the product provider to collect this information and make decisions with respect to it. It would also open up the issue of administrative delays and the consequences of turning payments off and then turning them back on when the paperwork arrives. Such a requirement would involve significant additional cost that would inevitably need to be passed on to the consumer. Such a change would not be in the best interests of clients.

As stated above, we do not believe that the non-provision of services is of such a scale that would warrant such a fundamental change and even if it was of a material scale, this would not be the best solution. It is more appropriate to ensure that advisers and licensees are doing what they are required to do.

Inappropriate Advice

Question 7 – Do remuneration and incentive policies that reward financial advisers for revenue generated for a licensee or employer create an unacceptable risk that financial advisers will prioritise the generation of revenue over the licensee's obligation to provide financial services in a manner that is efficient, fair and honest over their own obligation to act in the best interests of the customer, and over their own obligation to prioritise the interests of the customer above their own interests and the interests of the licensee?

The obligation to act in the best interest of the client must override any consideration by the adviser of remuneration and incentives. This is a clear legal and ethical obligation.

The simple answer to this question is that incentive schemes aligned to revenue generation do create greater risks of not acting in the client's best interests, however provided that appropriate controls are in place, the risk should not be unacceptable. Incentive schemes are common in many industries and these schemes are often aligned to the performance of the individual and their employer. In the financial advice sector, as a result of the FoFA reforms, there is reduced room for such incentive schemes. We believe that it is difficult to suggest that there should be no ability to incentivise financial advisers for providing more quality financial advice. We certainly assume that lawyers in legal firms are eligible for a greater bonus where they have generated more chargeable time and that this would equally apply in the accounting and medical space.

It is also important to recognise that there are two key types of financial adviser who have fundamentally different remuneration models. Salaried advisers typically are paid a salary plus a variable component and a bonus. Self-employed advisers are remunerated on a totally variable basis, where they receive the income that they generate from clients (less any payment to their licensee).

In terms of legislating restraints on remuneration it is important to appreciate that these laws would apply equally to both salaried and self-employed advisers. How could a model that removed incentive apply in the self-employed section of the market?

The model that has developed in the salaried section of the market is balanced scorecards, which ensures that a range of measures are taken into account in the determination of remuneration. A small percentage that was based upon productivity was always envisaged as an appropriate model during the FoFA debate.

We believe that the solutions in this space should come with better design of remuneration models and improved internal controls to ensure that the advice provided is appropriate. Balanced Scorecards need to include suitable weighting to the quality and compliance of the advice as discussed in the next questions. It is also important to look at the quality of the consequence management systems. Consequence management systems are the policies, processes and structures within a licensee that assess issues at an adviser level that emerge with respect to the quality of advice, breaches or conduct. This is designed to ensure that issues are addressed, and the approach is standardised across the licensee.

Question 8 – How can financial services licensees best incentivise the provision of good-quality financial advice, including in situations where the best advice for a customer is not to change anything at all?

It is appropriate that financial advisers are incentivised to provide as much quality financial advice as is possible. In the design of this, it is important to ensure that the incentive model is balanced, and that early warning systems and other internal controls exist to detect inappropriate advice and poor conduct. Early warning systems assess risks at an adviser level, looking at factors such as exposure to higher risk products, biases to particular client risk profiles or asset allocations, advice activity levels, unusual fees etc. Just as there is in any professional context, the financial adviser has a primary responsibility to act in the best interests of their client. As long as the incentive scheme works to encourage the adviser to provide more compliant advice, then it should not present a problem.

Where the adviser charges an ongoing adviser service fee on the basis of assets under management or as a flat fee and they have committed to a range of services, then it does not matter whether the advice is to make changes or not. This is on the basis that a comprehensive client review has been undertaken and any change in the client's needs, objectives and personal circumstances has been taken into account. The adviser is providing advice and continuing with the current strategy and recommending continuing to hold the current financial products is financial advice. Under these remuneration models, recommending no change will not impact the fees paid to the adviser.

Once again, we make the point as we did above that the tools available to the licensee vary greatly between salaried advisers and self-employed advisers.

Incentive schemes need to be designed to avoid an incentive to do the wrong thing. It also needs to be appreciated that an incentive system might generate the right behaviour in 9 out of 10 employees, or even 99 out of 100. The fact that it resulted in inappropriate conduct by the remaining one employee, does not mean that there is something fundamentally wrong with the incentive system. Certain individuals are more pre-disposed to doing the wrong thing. This needs to be addressed by other measures such as recruitment practices, supervision, audit, early warning systems, complaint systems and whistleblowing arrangements.

We believe that there should be no constraints on an adviser where no change to the current arrangements is the most suitable option and that a balance of measures needs to be in place to ensure that this happens. As much as anything, culture is a key determinant of doing the right thing. Building the right culture can have a very big impact on the presence or absence of inappropriate conduct. It is, however very difficult to legislate for the right culture.

Of course, incentive schemes are not limited just to advisers. There must be a distinct correlation between the incentive to provide quality advice by the adviser and the incentives and KPIs of the layers of management overseeing these advisers. Balanced scorecards and quality of advice KPIS must filter through the entire management structure, not just at adviser level. Management needs to take more responsibility so that the penalty at a senior level is not limited to just a reduced or no bonus. There needs to be a strong message in terms of the corporate culture and what is acceptable and what is not acceptable. Too often we have seen executives and senior managers allowed to move on, leaving a trail of non-compliance to be cleaned up.

We do not believe that remuneration should be the predominant or only focus of the overall control model. It does not make sense to totally remove incentive and this will not necessarily result in better outcomes for clients.

Question 9 - How can financial services licensees best ensure that the results of routine compliance measures, such as compliance audits, are appropriately escalated so that potential risks to customers are identified and managed in a timely manner?

Since the Global Financial Crisis, the larger licensees have increasingly invested in early warning systems. These systems are designed to leverage all the available information to identify higher risk conduct and the indicators of inappropriate advice. Alongside these systems is the need for the right culture. The right culture is one where all members of the firm are risk aware, looking for warning signs and that indicators of poor quality advice and unacceptable conduct are thoroughly investigated in a timely manner. In very small practices, such as a one-person practice, it is ethical values that are critical.

In terms of responding to warning signs, the response needs to take into account the severity of the matter so that material issues are addressed as quickly as possible. The initial assessment needs to take into consideration whether the issue is competency, conscientiousness or ethics. It is often easier to address a competency issue by further training. A lack of conscientiousness can be addressed by warnings or sanctions and the utilisation of additional resources. Where the matter is an ethical matter it is more challenging as this is likely to be a pointer to the issue of character, which is more difficult to modify. One of the issues in the past has been that warning signs have not been adequately responded to and issues have been allowed to become bigger, when they should have been investigated and remediated much sooner.

Other critical element to this question are the risk management framework, policies around the management of issues and the organisational structures to deal with advice and conduct issues. These structures should include committees such as:

- A breach committee,
- A risk management and compliance committee, and
- A consequence management committee.

Depending upon the scale of the licensee, some of these committees may be merged into a single committee, however the three different roles need to be separately addressed during the course of the committee meeting. Another key structural factor is reporting of these matters to the licensee's board and consideration of matters at the licensee's board meeting.

The timeframe for responding to a significant breach is defined in the legislation (Section 912D - 10 business days). The maximum timeframe for responding to a complaint is set at 45 days. These limits are both indicators to how quickly a licensee must respond to emerging issues.

As mentioned in Question 8, there also needs to be a consistency of KPIs and incentives in place so that all layers of management are both duty bound and financially accountable for compliance and the management of risks.

Improper Conduct

Question 10 - Is it possible for financial services licensees to adequately monitor the quality of advice provided by employees and authorised representatives where that advice is provided in a manual environment?

In answering this question, we have assumed that "manual environment" refers to the situation where the licensee has no direct visibility of the client file, such as might arise where the use of a centralised financial planning and CRM systems is not mandated. We note this was the case in some of the specific adviser matters addressed at the Hearings.

Whilst this scenario of a lack of visibility was historically the model in financial advice, we acknowledge that it is now expected that the licensee will have access to the client files and records of financial advice.

In terms of the licensee's ability to oversee the adviser, in what has been described as a manual environment, there are other controls that are available to the licensee including supervision visits, audits, pre-vet of advice and careful oversight of fees and commission records.

Having an integrated system solution does present a significant advantage, enabling the licensee to employ other forms of technology to supervise the adviser. Most recently we have seen the emergence of artificial intelligence solutions for the assessment of Statements of Advice. We consider this to be a huge leap forward, and one that would enable real-time assessment of the quality of advice.

In the absence of system support for adviser oversight, other controls would need to be enhanced. This might include a reduced span of control for supervision resources and a more frequent audit. As has been the case historically, any warning signs should be a trigger for increased supervision visits, more frequent audits, suspension and even potentially termination.

The utilisation of increased technology in the financial advice space is a development that we strongly support. We note however that other controls can be used to effectively monitor the quality of advice.

Question 11 – Are improvements in technology the only way to ensure that financial advisers provide quality advice?

Quality financial advice has been provided for many years by many advisers before technology was a key element of the sector. Technology is just one of many components and factors in the current framework for the delivery of quality financial advice. There are many human skills that are equally, if not more important, in the delivery of quality financial advice.

Technology can be employed at multiple levels in the financial advice process. To provide consistent high-quality advice has become more expensive for advisers, so automation and technological efficiency is vital in providing high quality but affordable advice. Technology can be used for business efficiency and to lower the cost of implementation such as the preparation of Statements of Advice, capturing and monitoring accurate client data, completing adequate research and calculations, communication and education of clients, tracking portfolio performance, documenting and record keeping including file notes etc. It is also important in the supervision and monitoring of advisers. Even before technology becomes a part of the process, the most important step is that achieved in a one-on-one manner when the adviser takes the time to genuinely understand the client's needs and objectives and personal circumstances. These personal relationship and emotional intelligence skills are central to getting the financial advice process off to the right start. From that point, other key elements of the adviser's capability kick in, such as the education, commitment and conscientiousness of the adviser. Equally important is the ethics of the adviser and their dedication to placing the best interest of their client above all else.

Technology enhancements in the area of data collection on clients including real time information on client portfolios and product holdings can streamline the fact find process and enable advisers to spend more time understanding the client's needs and objectives.

Access to an appropriate range of product options via the approved product list and an efficient non-approved product process, alongside access to product research tools improves the product selection process and the quality of the recommendations.

Technology enhancements are an increasingly important option for licensees to ensure that their representatives are providing quality advice as part of the supervision and monitoring exercise as discussed above. The recent development in artificial intelligence tools that enable an automated review of adviser websites and advice documents provides an important new tool in the endeavour to detect and eliminate poor quality advice.

Licensees can have a range of options in terms of activity to promote the quality of advice such as education and training programs, ethics training, clearer guidelines and expectations. Education and training of advisers needs to emphasise relationship and emotional intelligence skills as they are the cornerstone of quality financial advice.

Through the Professional Standards legislation, the education level of all advisers will be lifted to the minimum standard of degree equivalence. Advisers will also need to undertake a registration exam to confirm their competency. Continuing professional development standards will also be increased. All of these changes will contribute to an increase in the quality of advice.

As discussed above, working on a quality advice culture and early warning systems and intervention models are also effective tools to enable licensee management to respond to issues and to seek to modify behaviour.

Question 12 - How should financial services licensees ensure that customers of their authorised representatives are adequately protected while the licensee investigates the conduct of the authorised representative?

This question specifically refers to authorised representatives, which by definition excludes employee advisers and directors. We have assumed that this is unintentional and that the question applies to all representatives.

We have discussed above the importance of early warning systems and the timely response to the emergence of risk indicators. We have also discussed an issues management protocol so that a quick assessment is done on any emerging issue to understand the severity and the likely consequences. It is also important to quickly determine the probable cause of the issue to see if the matter can be resolved or whether the licensee needs to take more drastic action in terms of disciplining or terminating the adviser.

The response will also depend upon the licensee's knowledge of the adviser and their business. The issue might be related to the loss of a key staff member within the advice practice that can be more quickly addressed. It also might depend upon the licensee's access to resources who could be put into the business to help address any issues.

Any response to such an issue needs to also depend upon the adviser's performance history including their previous track record with audit results, remediation plans and in following the directions of the licensee. A licensee cannot rely upon a control, where there is any evidence to suggest that the adviser might circumvent the control.

Where the matter is of a level of severity that suggests further risks to the clients, then the licensee might need to take action to prevent the adviser from providing further advice to clients and placing alternative advisers in the role of remediating the clients.

It should be noted that it is essential that licensees have adequate contractual rights in authorised representative agreements to intervene where clients are at risk.

Question 13 - Taking into account that it may never be possible to reduce the risk to zero, what is an acceptable level of risk that customers will be provided with inappropriate advice?

The concept of risk is used in different ways. One version refers to risk profiling and the adviser genuinely understanding the client's tolerance to movements in investment markets. Risk in a risk management context is the risk of non-compliance with policies and processes resulting in the client receiving advice that is not in their best interests. This can happen as a result of a number of different failings in the process or conduct, such as failing to genuinely know the client, recommending the wrong strategy or recommending the wrong products. Each of these failings can arise as a result of a range of different causes, including inadequate skills, failure to correctly listen to the client, failure to investigate key issues, flawed information or logic, failure to fully consider all the consequences etc.

Financial advice is inevitably a higher risk business as it typically takes the form of a single adviser meeting and working with clients in a one-on-one fashion, where the financial adviser has all the knowledge of the client's situation and the instructions of the client. There is less capacity to put internal controls in place to fully mitigate all the risks. It is also important to note that in self-employed licensees, advisers have greater flexibility as to how they run their business and therefore processes are not as standardised as may be the case in salaried businesses.

It is certainly never possible to reduce the risk of a financial advice business to zero. To do so would involve a level of duplication and costs that clients simply could not afford. The culture and control environment are critical elements of the overall risk framework in order to ensure that the level of risk is within acceptable tolerances. The business risk needs to be regularly reviewed to ensure that it remains acceptable.

A commitment to the financial education of clients is an important element of running a financial advice practice. Where clients are more financially literate, they better understand the financial decisions and can provide genuine informed consent. They can also more readily identify any concerns with the advice. A commitment to financial education is an important element in running a good financial advice business.

Since the Global Financial Crisis, there have been a number of cases of financial product failures. These product failures do not necessarily mean that the advice was inappropriate. Financial advisers rely upon research reports in recommending these products. Unethical conduct within the product provider or major economic upheaval can cause these products to fail. With the failure of products where there is an inability to pursue the product provider, clients and lawyers have often turned to the financial advisers for compensation. Whilst some of this advice may have been inappropriate, it is certainly not universally the case.

It is also important to appreciate that there will always be the risk of rogue advisers who take extensive steps to cover their steps and defraud clients. This risk can be carefully managed, but never completely avoided.

It is not possible to simply state what is an acceptable level of risk of inappropriate advice and this is likely to vary from one business to the next. The risk will also vary based upon the size of the entity, the level of discretion provided to the advisers and the strategies and products utilised. What is important is that the risk is understood and carefully monitored and managed. Where mistakes are made they need to be identified quickly and remediated promptly.

It might be that in the future we need to think about a financial advice profession target for complaints, which could be expressed in terms of the number of complaints per 1,000 clients (per year or maybe per 5 years). More work would need to be done to progress the thinking about such a measure of overall sector client risk.

Question 14 – What is an acceptable period of time after identifying that a client has been or may have been provided with inappropriate financial advice to inform the client of that fact?

The answer to that questions is dependent upon some key determinants, including the following:

- Whether the matter has the potential to further deteriorate or there is a time constraint on fixing the issue, then a timely response is more important.
- The likelihood for secondary consequences.
- Whether the matter can be fixed or alternatively just needs to be compensated.
- The number of other clients impacted by the same matter.

Where the client loss has not been isolated and the matter is material, notification should happen as soon as possible and certainly within a matter of days.

As noted above, there are other critical timeframes such as the significant breach reporting deadline of 10 business days and the complaints maximum time of 45 days.

In most other circumstances that does not involve a significant breach or a complaint, we would expect this to have occurred within 3 months.

When it comes to potential inappropriate advice the consideration becomes more complex and will depend upon the grounds for considering whether it is inappropriate advice, whether it is part of a broader remediation program and the availability of resources to address the matter.

As discussed above it is important to have the right policies, processes and structures in place. The utilisation of breach committees and risk and compliance committees should help to ensure that there is a focus on the timeliness of responding to these matters.

Question 15 - What is an acceptable period of time after identifying that a client has been or may have been provided with inappropriate financial advice to remediate the client for any losses suffered?

As discussed above the response to this question will depend upon a number of factors. In our view it is only appropriate to consider this question from the perspective of confirmed inappropriate advice. If it has not been confirmed, then remediation is not necessarily the required outcome.

Where inappropriate advice has been confirmed then in most circumstances we would expect remediation to have occurred within 6 months. It should be noted that where Professional Indemnity insurers are involved, the licensee may not have total control of this process and is generally unable to acknowledge liability until approval is obtained from the PI insurer.

Where a remediation project is required then it is important to allocate the required level of resources and to put the most appropriate management arrangements in place.

As discussed above it is important to have the right policies, processes and structures in place. The utilisation of breach committees and risk and compliance committees should help to ensure that there is a focus on the timeliness of responding to these matters.

Question 16 - How should financial services licensees balance the need to ensure that employees are held responsible for misconduct against the risk that punishing poor behaviour will encourage employees to conceal that behaviour?

Misconduct is misconduct and it needs to be appropriately dealt with in all circumstances.

We do not accept that the risk of concealing misconduct should be treated as a material factor when it comes to holding advisers responsible for misconduct. Where the incentive system is appropriate, and the culture is right, then confronting misconduct should be the expected approach. When the control environment means that concealing misconduct is not achievable on anything other than a short terms basis, then this risk of concealment can be effectively mitigated. Improvements in technology and risk management systems have reduced the likelihood of long term concealment of misconduct.

Advisers should be encouraged to report advice issues and misconduct. Licensees should take a reasonable approach when it comes to honest and accidental mistakes. If the penalties for not reporting matters are material, then this will also assist in encourage reporting.

Large licensees implement this through the utilisation of a consequence management policy and a consequence management committee. Having an objective model and having multiple parties involved in the assessment of the conduct better ensures that the process is employed appropriately. As most things emerge eventually, this committee would need to actively consider whether the right balance in the consequence management policy has been achieved and whether it runs the risk that issues are being concealed in order to avoid punishment.

Smaller licensees and self-licensed businesses need to employ similar policies and arrangements to ensure that misconduct is appropriately managed and dealt with.

Again, it must be emphasised that particularly in large and possibly vertically integrated institutions that the incentives and KPI's must be consistent through all levels of management to ensure that the entire culture is one of encouraging the right behaviour and calling out the wrong behaviour.

Question 17 - How should financial services licensees recognise and reward ethical conduct by financial advisers?

All advisers are expected to be ethical and by being ethical they are rewarded by keeping their job or being able to continue practicing. Ethical advisers are recognised by their clients for the good ethical services that they provide and sometimes by their licensees in the form of acknowledging those advisers who received a clean audit result.

Ethical conduct is expected. Unethical conduct is what needs to be managed. The recognition and reward tools available to licensees typically differ between salaried advisers and self-employed advisers. The options available to licensees with respect to self-employed advisers are typically limited to consequence management options available via the authorised representative agreement, which includes the option of termination. Unethical conduct should be addressed in this and should be considered in any consequence management response.

Specific examples of highly ethical conduct could be addressed through inclusion and recognition as part of a licensee's adviser award program.

For salaried advisers where an incentive system includes access to variable remuneration or a bonus, eligibility should be subject to the achievement of certain gates, including a compliance score and a customer satisfaction score. The occurrence of unethical conduct should result in automatic ineligibility for such remuneration or recognition.

Equally examples of highly ethical behaviour could be addressed through inclusion and recognition as part of an adviser award program.

Rewarding for the demonstration of ethical conduct can be more difficult, however it might emerge in terms of feedback that licensees receive from clients and other practices that are observed through supervision and monitoring.

The other critical mechanism is the intrinsic reward that advisers get when they have delivered quality advice to their clients and they receive positive feedback from their clients. The importance of this should not be underestimated.

Question 18 - Are there particular characteristics of the financial advice industry that lead to there being a higher incidence of improper, unethical or dishonest conduct than in other industries? If so, what should be done to address that issue?

The prevalence of misconduct in the financial advice sector seems to have been put forward as an accepted fact. Analysis of FOS statistics in the 2016/17 financial year indicates that 524 complaints were received against financial advisers. It is likely that some advisers will have received multiple complaints, however 524 complaints across 25,400 financial advisers is only approximately 2%. Misconduct also occurs in other professions and examples are demonstrated on a regular basis.

It may be that the risks of misconduct in financial advice is subject to a higher focus as a result of the role that financial adviser play in managing money for clients. We have not seen any evidence to suggest that improper, unethical or dishonest conduct is higher than other industries. We do appreciate that it often takes a long time for misconduct to be brought to light, which was a message that came from the ASIC hearing, and that this makes it look worse.

Whatever the level of improper, unethical or dishonest conduct, it is essential that the financial advice sector is working hard to reduce this. As we have discussed above, historically the sector has not been as effective at removing the wrong advisers from the industry that we should have been. There are many reasons for this, including the existence of light touch licensees, advisers being allowed to move before their conduct is fully examined, ineffective reference checking and even the ability for some advisers to get their own licence even after being terminated by a licensee.

To address this, we recommend the following:

- Increased education standards, as addressed by the Professional Standards legislation.
- Further training on compliance with the Best Interests duty.
- Uniform application of minimum licensee and compliance standards across the sector.

- Improved policies, controls and structures to deal with the risks involved with vertical integration
- The implementation of specific guidelines for licensees on the management of improper, unethical or dishonest conduct.
- Mandated reference checking guidelines across the industry, including where ASIC is granting an AFSL.
- Enhanced whistleblowing measures.
- Enhanced communication between the stakeholders when an issue of misconduct emerges.
- Increased use of technology to better identify improper, unethical or dishonest conduct.

Disciplinary Regime

Question 19 - Are the steps required by the ABA reference checking and information sharing protocol adequate to protect the public when financial advisers transfer between licensees?

The ABA Protocol is an important step forward to better ensure that the wrong people are removed from the financial advice sector. As discussed below, we believe that there is room to enhance the questions, however the biggest issue is to achieve an outcome where a standard reference check is a mandatory requirement for all parts of the sector. At present it is largely limited to the banking sector and some of the current users are not willing to provide the ABA reference check reports to parties outside the current signatories.

The next important step with this reference checking framework is to extend the application of a standardised minimum reference checking framework across the entire financial advice licensee population. Without some form of regulatory intervention this is more challenging than it may appear, as there are well over 1,500 AFSL's who have financial advisers who are registered on the Financial Adviser Register and they don't all belong to one of the existing professional associations.

The ABA protocol addresses the needs of the new licensee to understand the history of the financial advice candidate. It is fact based, which is what the intention is. It does not provide for questions that might be forward looking or indicators of problems for the future. Some of the questions that we would propose being included are as follows:

- What is your experience with the adviser? Did they require a high degree of support?
- How would you describe their approach to compliance and commitment to complying with licensee standards?
- What is your understanding of the adviser's practice/business model?
- Were there any ongoing training issues? Were they up to date with training?
- Do you know why the adviser is looking to change licensees? Are they resigning or were they terminated?
- Would you want to have the adviser come back to your licensee in the future?

Questions that address the attitude of the adviser and their level of compliance with licensee standards are important to determine whether the candidate would be a good fit with the new licensee. Some of these judgement-based questions may be more difficult to answer and may raise concerns about the risk of defamation. Some regulatory protection for licensees may be desirable.

We are conscious that advisers who have been terminated for misconduct are either managing to re-emerge at another licensee or getting their own licence. There is a view that some licensees have lower standards and will take advisers on when they have a problematic track record. Such licensees are referred to as licensees of last resort. There needs to be a minimum standard across all licensees.

We receive feedback from time to time suggesting that an adviser who was terminated by a large licensee has been able to go and get their own licence. This would suggest that ASIC, in the process of considering the approval of an AFSL application, are not undertaking reference checks on the licence applicants with their former licensee. This would seem to be an important gap that needs to be filled.

More needs to be done across the industry to prevent the wrong advisers from continuing their career in another entity, without the application of adequate consequences for their previous conduct.

Question 20 - Should licensees be required to maintain a minimum degree of satisfaction as to the competence and integrity of applicants to become authorised representatives before authorising? If so, what form should that requirement take, and what minimum levels should be set?

Yes - licensees should have minimum levels of competency and integrity. These steps should be completed before a new adviser starts and not afterwards. It is more complicated to terminate an adviser after they start, rather than not appoint them in the first place. Neither is it particularly fair to appoint them on the basis of the lack of adequate due diligence and then terminate them after due diligence has been completed.

In terms of competency requirements, this has been addressed under the professional standards legislation and financial advisers will need to complete an exam and be required to achieve degree equivalence. New advisers will also need to complete a professional year. Licensees should be required to confirm that the qualifications are genuine. Where an adviser has been appointed to perform a specialist role, they would need to confirm that they have achieved the specialist training required to operate in that role. Ongoing professional development obligations will also apply under the Professional Standards legislation.

When it comes to the matter of integrity, the criteria need to include matters such as:

- A police check.
- Reference checks.
- Bankruptcy checks.
- A review of previous audit reports.
- Knowledge of any investigations undertaken by a regulator.
- A review of any complaints history.
- Current membership status of a professional association.
- A review of any disciplinary matters or judgements by a professional association.
- An annual declaration of ongoing compliance with the minimum standard.

It may also be possible that the financial advice sector should more broadly implement psychological testing to assess the suitability of candidates.

Where any of these checks present a warning indicator, the licensee should be very careful about appointing the adviser. Additional levels of due diligence would be required before a warning indicator could be dismissed.

As previously stated, it is important that all licensees take their responsibilities very seriously and that everyone is working hard to identify those advisers who are doing the wrong thing and providing inappropriate advice or acting improperly and working to remove them from the sector as soon as possible. The management of licensees should be held accountable for doing this and there should be greater consequences for the management of those licensees who fail to do this.

Question 21 - Are the general obligations set out in section 912A of the Corporations Act expressed at too high a level of generality to be capable of being effectively enforced? What alternative obligations would be more appropriate?

It is important to note that Section 912A applies to all Australian Financial Services Licensees and not just those that include financial advisers who provide personal advice to retail clients. As it applies to all licensees it cannot be tailored specifically to financial advice.

It is appreciated that these obligations are expressed at a high level, however they are also supported by ASIC Regulatory Guides that provide much more detail in terms of what ASIC expects.

Having said this, we would support more guidance on the general obligations and how they should be applied specifically to the financial advice sector. Areas where greater clarity would be beneficial include the requirement for adequate resources (Section 912A(1)(d)) and adequate risk management systems (Section 912A(1)(h)).

One important point that we note is that the ASIC Regulatory Guides are all issue specific documents. Many of them are applicable to the financial advice space. The problem is that there is not a single document that sets out the obligations of advice licensees. Given that the vast bulk of small licensees are in the financial advice space, specific tailored guidance would be of great value. We have recently asked ASIC to run a half day briefing for our licensee partners to succinctly brief them on their obligations as a licensee. We have received a positive response to this idea from the licensees and are committed to working with ASIC to deliver this training. We believe that more can be done on a collective basis to raise the standard of licensee activity.

Question 22 - Is the current division of responsibility for professional discipline of financial advisers between employers, ASIC and professional associations operating effectively to ensure that financial advisers face appropriate consequences for breaching their statutory and professional obligations?

At a high level the current division of responsibility is not operating effectively. One important part of the problem has been an inability or disinclination to share information between each of the key stakeholders.

In answering this question, we have viewed the reference to employer to mean licensee, given that in the self-employed model, they may not have an employer, or they themselves are the representative of the employer.

It is important to note that historically the key players in this arrangement have been the licensee and ASIC. Through Section 912D, licensees have had an obligation to report misconduct to ASIC, and ASIC has had an obligation to consider this misconduct.

Other key parties in the framework, such as the professional associations and the external dispute resolution schemes have had a lesser role and influence in the disciplinary regime. The EDR scheme is an important part of the overall framework as they receive complaints which might provide an early indication of systemic issues with an adviser's advice and may also reveal where the licensee is not responding adequately to complaints. This information would be an important indicator for further action by ASIC. EDR schemes do not report adviser concerns to professional associations and privacy matters currently impact how they share information with ASIC.

We openly acknowledge the fact that not all advisers are members of a professional association and that being expelled from one professional association does not prevent them from joining another or prevent them from operating as an adviser without being a member of a professional association. In our view this is a key obstacle in the overall disciplinary regime.

This flaw has in part been addressed in the professional Standards legislation through the development of a single sector wide Code of Ethics and the requirement that all advisers belong to a compliance scheme and are subject to oversight and disciplining by a code monitoring body. Whilst it had been expected that the professional bodies would develop the compliance schemes and be the code monitoring bodies, it is also recognised that there are many different elements to the financial advice market and many different associations. For context, the sector includes financial advisers, accountants who are operating as financial advisers, stock brokers, insurance brokers and timeshare scheme sales persons.

As has been effectively identified by the Royal Commission the possibility of having multiple code monitoring bodies potentially opens the sector up to the risk that the worst advisers will migrate to both the lowest touch licensees and the lightest touch compliance scheme and code monitoring body. We acknowledge that this presents a risk to the effectiveness of the model and therefore a concern as to whether this will meet community expectations. In our answer to the next two questions, we have identified a potential solution to address this problem.

Question 23 - Does that division of responsibility create gaps in the disciplinary system? If so, what are they?

Where there are multiple parts in a structure there will always be the risk of gaps. An assessment of the financial advice sector indicates that there are many stakeholders (other than the client), including the following:

- The financial adviser.
- The licensee.
- Associates of the licensee, including potentially product providers.
- The External Dispute Resolution scheme that the licensee belongs to.
- The professional association that the adviser belongs to.
- ASIC.

There is no question that the various stakeholders mentioned above have not worked together as constructively as they could have to ensure a more effective disciplinary regime. One obvious issue is information sharing. The hearings have shown that licensees have not historically shared information with professional associations. Neither has the EDR schemes or ASIC. Information sharing between ASIC and EDR schemes has also been problematic. Privacy and confidentiality is often raised as a reason that prevents timely information sharing. Legislation can address this obstacle to information sharing.

Information provided by ASIC indicates that it could be two years from the point that issues are identified with the conduct of an adviser through to the point where they are finally banned by ASIC. This is too long and where the wrong advisers are able to continue to operate, when the professional associations and the general public are unaware, there is an unacceptable risk of further client detriment.

Whether the regime creates gaps is possibly a point of debate. The serious consequences in the system result from action by ASIC, which could lead to a banning or an enforceable undertaking. What happens as a result of an investigation by a professional association is somewhat less serious or important as membership of a professional association is not mandatory and there is more than one to choose from.

Under the proposed model set down in the Professional Standards legislation, code monitoring bodies will only be responsible for breaches of the Code of Ethics. All breaches of the law will still rest with ASIC. Code monitoring bodies will be able to terminate advisers as punishment for a serious breach of the Code of Ethics. Without being a member of a code monitoring body, they will not be able to practice as a financial adviser, however they will still be able to move to another compliance scheme and code monitoring body.

Question 24 - Is it possible to implement a single system for professional discipline of financial advisers? Would structural changes to the financial advice industry be required to bring that about? Would a system of licensing at both an individual and an entity level be more appropriate than the existing system of licensing only at the entity level?

The current model is already scheduled for a significant restructuring from 1 July 2020. The Professional Standards legislation envisages two levels of oversight of advisers – ASIC and code monitoring bodies. Code monitoring bodies would be responsible for the monitoring of compliance with the FASEA Code of Ethics. This model will place a greater level of power with the code monitoring bodies, which had been assumed to be the professional bodies, although open to other organisations (except licensees) who might choose to apply. As discussed above, there is provision for multiple code monitoring bodies. In this model, code monitoring bodies will also be required to report breaches of the Code of Ethics to ASIC and these breaches will be recorded on the Financial Adviser Register. Importantly, however, ASIC will remain responsible for industry oversight and breaches of the law and serious misconduct matters. They would also remain responsible for breach reporting and bannings/enforceable undertakings.

If the question is referring to a single disciplinary body, where breaches of the law and breaches of the Code of Ethics were all considered by the same body then this would involve significant regulatory and structural reform.

In the context of the questions raised by the Royal Commission and the current scepticism with respect to the capacity for self-regulation of the financial advice sector, we recognise the concerns expressed about multiple code monitoring bodies and the ability for advisers to move between these bodies to avoid penalty. In this context we recognise that arguments exist for the establishment of a single code monitoring body that applies across the entire financial advice sector. In this manner there would be one set of standards for advisers and the single code monitoring body could be set up in a manner where it was not controlled or influenced by any one association and was therefore more independent. It would also be more efficient to have a single body rather than have duplication of resources. It is likely that the achievement of this model would require regulatory intervention. With the process of preparing for code monitoring bodies already underway, we believe that it is important that such a change of direction be addressed by government as a priority.

However, we do not believe that this necessitates having only one professional association. The current environment provides choice and the cultural and philosophical difference that exist, promotes competition. Accounting is another profession where multiple professional associations exist.

The AFA is willing to engage in negotiations to achieve this outcome, however clarity is required in the short term to ensure that a solution can be found well in advance of the commencement of compliance schemes and code monitoring bodies from 1 January 2020. Otherwise we would be seeking a delay in the commencement of code monitoring arrangements, so that we all have the time to get this important part of the framework right.

We don't see the benefit of having licensing operate at both a licensee and adviser level. This would seem to add duplication with limited benefit. Over the longer term it is possible that the option of individual licensing should be considered, however it would be necessary to consider how these individually licensed advisers would get the support that they currently get from their licensees. Such a change would involve a fundamental revision to the Corporations Act.

Although the role of licensees has been subject to criticism as part of the hearings, it is important to recognise the value that they provide. Some of the key elements are as follows:

- Provision of licensee standards dictating required obligations.
- Delivery of training and compliance with training and education standards.
- Provision of support infrastructure including financial planning software.
- Supervision and monitoring of advisers.
- Intervention to facilitate remediation where required.
- The separation of licensee and financial advice practice, results in a level of oversight that may not apply in a self-licensed business where it can only be achieved by outsourcing functions to other parties.

Whilst we acknowledge the weaknesses demonstrated in the licensee model, we also recognise the value that they provide and the potential consequences if they did not exist in their current form. Small self-licensed practices do not have the same capacity or scale to provide the resources that are made available by larger licensees.

Question 25 - Is there a particular regulatory culture that has developed in relation to the regulation of the financial advice industry? What is that culture? And what has contributed to its development?

In answering this question, we must express our view that the majority of financial advisers act in the best interests of their clients. The research that we have undertaken in the past reveals that the clients of financial advisers trust their adviser as much or more than they do with many other professionals. As an example, an AFA white paper from July 2010, shortly after the Global Financial Crisis, presented research by CoreData that showed that the clients of advisers rated them 7.5 out of 10 on trust, which was only just behind doctors and dentist. Yet those people who did not have a financial adviser rated financial advisers as 4.5 out of 10.

Financial advice is a new profession and has in part emerged out of the origins of the life agent model. The Financial Services Reform Act fundamentally changed the regime and established the role of licensees following the commencement in 2003/4. The culture of an industry is formed over time and changes as it experiences change and reforms. We make the point that culture has evolved significantly since the early days and continues to evolve. It is simplistic to assume that there is one culture, and in fact each different segment of the market has its own culture, just as every individual entity does.

We have seen a notable change in the regulatory culture within the financial advice sector following the Global Financial Crisis and the Future of Financial Advice reforms. As recently as three or four years ago it was relatively easy for an adviser who was under investigation or subject to termination by a large licensee, to move to a new licensee. This might be another large institutionally owned licensee or a privately-owned licensee. This culture was reflected in a lack of urgency to investigate adviser conduct matters and a willingness to give advisers a second chance at a different licensee. Reference checking was not as thorough as it should have been and there was a reluctance to give comprehensive reference checking feedback due to the perceived risk of defamation action by the adviser.

This culture has changed fundamentally. Reference checking is now much more comprehensive across the majority of the market. Advisers who are terminated or under investigation or for whom client books are subject to remediation are likely to have a great deal of difficulty finding a new licensee.

Such a change in the culture will have long terms benefits with a number of advisers forced out of the industry over time. It will however also cause complications for their clients who will not have access to financial advice whilst these matters are subject to investigation and resolution.

Financial advice has become a very politicalized area over recent years and this has led to continuing media attention and demands for regulatory reform. There is a perception amongst some observers that the financial advice sector does not want to move forward and become more professional. This is not the case for the majority of advisers. Most are small business operators, who are working hard to deliver quality services to their clients, yet at the same time being subject to constant change, some of what appears to drive inefficiency rather than improved service to clients. There is also a level of resentment amongst some advisers that this demand for change is the result of failings within the larger organisations. There is also a continuing belief that the failings of a minority are causing extensive complications for the majority. Despite all of this, there is a continuing commitment to seek the changes that will deliver recognition as a profession and regain the trust of consumers.

ASIC are also an important part of the culture of the financial advice sector. How they interact with the industry has been the subject of some discussion. The AFA meets regularly with ASIC and we have recently been discussing ways to have ASIC provide more guidance to licensee and advisers. We believe that ASIC can be more vocal in assisting licensees and advisers to avoid getting into trouble in the first place, which will reduce the need for disciplinary and remediation action after something goes wrong.

The experience of the Royal Commission has had a significant impact as all elements of the financial advice sector are forced to consider the weaknesses in the current model and the issues with the culture.

Question 26 - Has the existing regulatory culture in the financial advice industry contributed to the occurrence of misconduct in the financial advice industry? What changes in regulatory culture might assist in reducing the incidence of misconduct in the financial advice industry?

Yes, elements of the historical culture have led to occurrences of misconduct. As discussed above, we are already seeing changes in the culture and these changes are likely to see these issues better addressed in the future. It is possible that licensees have not acted on the basis of a full appreciation of the significant risks of operating a financial advice business, where the licensee is responsible for the conduct of its representatives. These messages are getting through and we have no doubt that the Royal Commission has done a lot to reinforce this message.

It is also necessary to recognise that changes that will influence the culture are already underway in terms of the changes to life insurance advice remuneration and education standards and a code of ethics through the Professional Standards Legislation.

ASIC has recently made the point that some financial advisers are still not seeming to understand the Best Interests Duty or at least failing to demonstrate or articulate that they have met the duty in their advice. We believe that further training of financial advisers on understanding this duty is critical.

One thing that will need to be considered as part of this process is the business model employed by licensees and advice practices and whether the business model influences the culture and behaviours. At all levels more questions need to be asked and the voice of the customer needs to be central in the consideration of issues. Equally importantly, the advice sector needs to do more to facilitate the removal of the wrong people from the industry.

Other Questions

Question 27 - Can financial advisers effectively manage the conflicts of interest associated with providing advice as a representative of an institution that also manufactures financial products? Is it necessary to enforce the separation of products and advice?

As discussed above, whilst we note the increased risk of inappropriate advice that might occur as a result of vertically integrated business models, we believe that this can be managed by sensible controls and the right culture. Evidence presented to the Royal Commission indicates that these controls may not be in place or may not be working effectively.

The hearings have clearly demonstrated the need for change in the vertically integrated section of the financial advice sector. As discussed above there are a number of things that could be done to improve the controls to better ensure that advice is in the best interests of clients.

It is also important to note that a large number of advisers (approximately 40%), are currently authorised by vertically integrated institutions. The consequences of this percentage of the market, being required to move to a new licensee in a short time frame would be drastic, impacting the advice relationship for a very large number of clients and the livelihood of numerous financial advisers and the many staff who work in their businesses. We believe that more should be done, such as broadening Approved Product Lists and enhancing the advice quality frameworks before vertically integrated business models were banned. What has often been discussed is more steps to ensure that the clients of a financial adviser who operates under a different brand, genuinely understands who the ultimate owner of the licensee is.

The separation of product and advice can be achieved through the application of policies and structures, without the need for divestment of advice businesses.

Vertically integrated licensees need to do more to better enable their advisers to meet their obligations to act in the best interests of their clients. We have discussed previously some of these recommended changes, however improved management of the conflicts of interest implicit in this model need to be better addressed.

When we talk about vertical integration in the financial advice sector, it is much broader than just the large institutions. It also should be noted that there are a number of financial advisers on the Financial Adviser Register that are directly appointed by product providers (i.e. timeshare schemes) and within superannuation funds. Adviser numbers have been growing in recent years across the larger superannuation funds. One of the primary services that the superannuation funds provide is intra-fund advice, which includes advice such as the selection of investment options, modifying insurance arrangements and the maximising of contributions. The banning of vertical integration would equally impact this group of superannuation fund advisers.

Question 28 - Should the statutory carve-outs to the ban on remuneration, including the recent carve-out in relation to insurance commissions, be maintained. If so why?

As discussed above we do not support the removal of grandfathering for conflicted remuneration for the reasons raised above. As set out below, we strongly oppose any move to make further changes to the treatment of commissions on Life Insurance. These Life Insurance Framework changes only commenced on 1 January 2018 and further reductions are scheduled over the next two years. To the extent that these changes were felt necessary by the Government, we certainly see no need to make further changes until there has been the opportunity to assess their effectiveness. We have not seen any recent evidence that would support a ban of commissions on insurance and would suggest that in the absence of this evidence and a comprehensive review of the consequences, that this should not be proposed.

One exemption that is available under Section 963B(1)(c) is for execution only services where a product is being acquired by a client without advice and where no advice has been provided to that client within the last 12 months. Since this law was established, the direct sale of life insurance is now caught under the Life Insurance Framework, and we therefore question the need for the continuation of this execution only exemption.

In terms of the exemptions included in the regulations, we do not support the removal of the exemption for training and education non-monetary benefits which is beneficial in terms of the delivery of training for financial advisers which they may not otherwise obtain. The exemption for the provision of financial services software is also a sensible exemption that supports the efficient running of financial advice businesses.

We believe that the modified exemption for Life Insurance, by the means of caps on both upfront and ongoing commissions under the Life Insurance Framework should stay unchanged for the following reasons:

- International experience does not suggest that banning commissions on life insurance is a viable model. There is only one nation (The Netherlands) in the world where commissions are banned. A very limited number of countries have introduced caps, however notable leading economies such as the USA, New Zealand and the UK have no limitations.
- Extensive research by leading actuarial and accounting firms (e.g. Rice Warner and KPMG) indicates that there is a high level of underinsurance in Australia. This reflects people who don't have any insurance and those who don't have enough. This will only get worse if commissions on life insurance were banned. An impact on underinsurance is already expected as a result of the Life Insurance Framework.
- Life insurance is a very different product to investments and superannuation. Superannuation is effectively mandatory in Australia. Life insurance is not mandatory and whilst it is often available through group superannuation, this typically is at a level well below the needs of the client. Consumers do not fully appreciate the need for insurance and advice is often necessary before they really appreciate the importance of it. The typical client for insurance is different to that for investments and superannuation clients, in that insurance clients are often younger, have higher debt and have less disposable income or available assets. They simply don't have the willingness or capacity to pay anything more than a notional fee for advice.
- The Royal Commission has previously referred to a lack of willingness to pay for financial advice, which in the current climate is likely to get worse, not better. Research undertaken by Zurich in 2011 revealed that 57% of clients would leave the market altogether if they were forced to pay any amount for life insurance advice. The cost of providing life insurance advice is estimated to be at least $2,500. This cost covers the initial meeting, client fact find, product research, SoA preparation and implementation including dealing with medical

assessments and potential consequences. If advisers had to recover this cost via a fee for service in year one, then the impact on the client is set out in the following table. The client ends out paying substantially more in year one ($4,000 versus $2,000). In this respect commissions work for the benefit of clients as the insurer bring forward future year premiums to pay the financial adviser for the advice.

TOTAL COSTS	Commission Model	Fee for Service Model
Clients Fees for Service	-	$2,500
Total Premium	$2,000	$1,500
Total Cost to Client	**$2,000**	**$4,000**
Total Year 1 Revenue to Planner	**Hybrid Commission- $1,600** **Level Commission - $600 (per annum)**	**$2,500**

- The reluctance of consumers to pay on the basis of a fee for service for life insurance advice has the risk of working against consumers in ensuring that their cover continues to be appropriate. Unless the client already has an ongoing contractual relationship with the adviser they may be reluctant to pay a one-off fee for a risk review. The danger of this is that they do not get advice on how best to make changes to their policies if needed. Another risk is that they might cancel a policy that they still need, without understanding the consequences. Most importantly they may not get claims support or be aware that they could make a claim for example on income protection or a specific trauma policy benefit. Typically, most fee for service life insurance arrangements are made when there are other professional services being provided and the client pays for a bundled more holistic service. In most cases these clients are high net worth, who can afford higher ongoing fee arrangements, where the insurance is included as part of the package.
- On top of all the factors above, there is one other important reason why commissions remain the preferred remuneration model for life insurance advice. Unlike investment and superannuation clients, for whom there will always be a suitable product, in a percentage of cases, it is not possible to find an insurance solution for some clients. People who have health issues may be subject to premium loadings, exclusions or even straight out rejection. The adviser may need to try a number of insurers, however in the end there may not be a viable solution. These are often the people who need insurance the most. The more health issues, the more work that is involved for the adviser. Financial advisers do not feel that it is right to charge a large up-front adviser service fee, where they may be unable to obtain insurance for the clients. Clients would not accept this either. Under the commission model, advisers accept this risk, on the basis that they will be paid for clients where policies can be implemented.
- There are three key channels for the sale of life insurance, being retail advised, direct and group super. The retail advised option is one where the recommendation is tailored to meet the needs of the client, where the product is more comprehensive and where cover is guaranteed on a going forward basis. The cost of the retail advised product is less than that of direct insurance, despite the product being of a higher quality. The retail advised channel also is the only one where the client gets genuine support in the event of a claim.

To the extent that past work by ASIC (Report 413) has indicated that there was an issue with inappropriate product replacement, it needs to be noted that this report revealed that the current

Hybrid form of upfront commission model (80% and being reduced to 60%) delivered a 93% compliant advice outcome. Rather than making further changes to commission rates, we strongly encourage regulatory action to be taken against those who are identified as inappropriately replacing product. ASIC is now collecting information on lapses from life insurers and are investigating advisers who are highlighted as part of this process. Generally, the insurers know which advisers are inappropriately replacing insurance and therefore direct action can be taken against them rather than looking at further reforms to commissions that will unnecessarily impact client access to insurance advice and the viability of insurance specialist advice businesses.

In conclusion, we believe that a banning of commissions on insurance would decimate the market for retail advised life insurance resulting in a significant decline in the levels of insurance that Australians have and also a decline in the number of financial advisers. This would lead to much greater stress being placed on the welfare system and Australian families. Research has been done to show the implications of underinsurance on the cost of Government funded social security benefits (KPMG Report – Underinsurance – Disability Protection Gap in Australia – 2014).

To appreciate the importance of life insurance to the Australian community, it is important to appreciate the numbers. In 2016, a total of $9.2 billion in life claims was paid to Australian families. The statistics from 2015 indicate that 70% of life insurance claims were paid from retail advised policies (source - the Risk Store).

Concluding Remarks

Should the Royal Commission require clarification of anything in this submission then please contact us on (02) 9267 4003 or via email at philip.kewin@afa.asn.au.

Yours Sincerely,

Philip Kewin
Chief Executive Officer
Association of Financial Advisers Ltd