ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

SUBMISSIONS OF THE AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION
ROUND 2: FINANCIAL ADVICE

The Australian Securities and Investments Commission (**ASIC**) makes the following submissions in response to the questions identified by Counsel Assisting in closing submissions.

Do clients receive any meaningful benefit from ongoing service arrangements? (Q 1)

1. Based on its experience from its "fee for no service" (**FFNS**) work, ASIC is concerned that many, perhaps even most, clients who are currently paying for ongoing advice may not receive benefit from that advice commensurate with its cost to them. Further in that regard:

    a. Ms Perkovic (CBA) gave evidence as to the nature of the ongoing services provided by CBA's licensees[1]. The core component is an annual review[2] (along with seminars, newsletters, investment monitoring and alerts and liaison with other professionals). According to Ms Perkovic, the mere offer of an annual review was sufficient for the fees to be charged[3]. Further, the benefit to clients of those ongoing services falls to be assessed taking into account that the fees are generally charged as a percentage of "funds under advice" or as a fixed dollar figure[4]. For instance, the maximum ongoing service fee charged by CFPL under its Legacy package was 0.94% of funds under advice[5].

    b. Mr Regan (AMP) gave evidence as to the content of the ongoing services provided by AMP's licensees that was much the same[6]. Fees are generally[7] charged as a percentage of the value of products under advice (e.g. at an annual rate of 0.6% plus GST[8]);

    c. Mr Williams (ANZ) gave evidence about various packages of services offered by ANZ licensees, which were also broadly similar to those identified by Ms Perkovic[9]. Mr Williams also gave evidence about how the fees were calculated for these services[10], with some fees calculated as a percentage of the amount of funds under advice and other fees as a flat dollar amount. The

---

1 Perkovic (CBA); Exhibit 2.73 at [20]-[77] (CFPL); Exhibit 2.75 at [18]-[33] (Count); Exhibit 2.78 at [29]-[44] (BWFA); see also Exhibit 2.77 at [21] and [56].
2 Which was described prior to September 2009 as an annual meeting at which there was a revisiting of "objectives, cashflow management, investment strategy, tax planning and any other issues" – Perkovic; Exhibit 2.73 at [24]. It also appeared that the annual review offered by BWFA prior to the closure of its operations was by telephone - Perkovic (CBA); Exhibit 2.73 at [32(a)].
3 Perkovic (CBA); T1289.34-1290.42.
4 Rather than, for example, an hourly service charge. See Perkovic (CBA); Exhibit 2.73 at [29], [37], [46], [55]; Exhibit 2.75 at [24]; Exhibit 2.78 at [36].
5 Perkovic (CBA); Exhibit 2.73 at [29].
6 Which include access to the adviser, the 'offer' of a full or partial periodic portfolio review, the provision of educational material such as newsletters, receipt and review of investment correspondence etc. – Regan (AMP); Exhibit 2.13 at [75].
7 Regan; Exhibit 2.13 at [79]; T1059.41-47.
8 See AMP.6000.0020.0234 at .0236, referred to in Regan (AMP); Exhibit 2.13 at [76].
9 Williams (ANZ); Exhibit 2.92 at [28]-[44].
10 Williams (ANZ); Exhibit 2.92 at [49]-[53].

precise amounts depended on the scope of the services on offer (e.g. in one case a minimum flat fee of $1,650 p.a.).

2. It is also to be noted that ASIC's FFNS work revealed a widespread failure of the licensees in question to provide ongoing services which were being charged for, which was originally brought to ASIC's attention by licensees, rather than customers. The apparent absence of complaint by customers casts doubt both on the value to the customers of the ongoing services and also the method by which those services were being charged for and paid.

3. ASIC is concerned that a costly, annual review of a client's financial position and investments is likely to be of limited utility to many, whose personal financial circumstances are unlikely to be sufficiently volatile, or investments sufficiently complex, to justify them paying a significant fee[11] for such an annual review[12]. *A fortiori* this is the case if the amount invested is relatively modest.

4. Certainly, in ASIC's opinion, it is hard to see how an arrangement under which the client receives the mere "offer" of an annual review[13] could sensibly, of itself, justify a significant ongoing service fee. Accordingly, ASIC has disagreed with proposals by licensees for FFNS remediation to proceed on the basis that all that was required of the licensee to fulfil its obligation was that it have made reasonable attempts to offer an annual review.

5. A difficulty with the present "ongoing service" practice is that the fees are mostly deducted from the customer's investment funds and simply remitted to the licensee[14]. Although customers are notified of the fees deducted in their fee disclosure statements (and are subject to the 'opt-in' requirements of the Future of Financial Advice (FOFA) reforms), ASIC is concerned that this may not suffice to bring the fact that they are being charged significant ongoing fees for service sufficiently to the attention of the customer.

6. In ASIC's view, it would be more likely that any ongoing service would provide meaningful value to a customer if the fee for that service were required to be invoiced to the customer and that payment specifically authorised, as and when the service was provided, rather than being deducted automatically from a client's investment funds and only notified subsequently as a line in a fee disclosure statement or a periodic product statement.

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

---

[11] Bearing in mind that ASIC's experience was that the annual service fee charged by the financial advisers in its FFNS work was around $500 per annum at the lower end of the scale and was commonly around $2,000 per annum – Kell; T1032.37. Note also that the proposed ongoing service fee in one of the case studies considered in the hearings was $14,642 per annum (Henderson; T1762.34-45) and, in another case, ranged between approximately $3,300 to $5,200 per annum; for an offer of an annual review which the customer believed he would have declined more often than not, because he was able to "*see how things are tracking by looking online or by reading the annual reports received from BT*" – Perkovic (CBA); Exhibit 2.77 at [66]-[68]. It was not established in the latter case whether the customer knew that he was being charged even where the annual review was not conducted.

[12] This concern was not alleviated by the evidence of Wright (Westpac) that customers do not typically ask for ongoing advice – T1451.1

[13] As to which see Kell; Exhibit 2.1 at [38(g)], [39]; Perkovic (CBA); T1286.35-T1287.10; T1291-T1292.12.

[14] Perkovic (CBA); Exhibit 2.73 at [45] and [54]; Exhibit 2.75 at [25]-[26]; Exhibit 2.78 at [38]; Regan (AMP); Exhibit 2.13 at [79](a)]; Kwa (ANZ); Exhibit 2.93 at [32], [86]-[88], [132]-[133]; Britt (AMP); Exhibit 2.94 at [27(f)], [28(f)], [52(f)], [53(f)], [89(f)], [90(f)], [91(f)]; Williams (ANZ); Exhibit 2.92 at [45], [54], [57(a)], [58].

the charging of fees, and the tolerance of licensees for the charging of fees for no or little service? (Q 2)

7. Ongoing service fees, at least in the context of the FFNS conduct exposed by ASIC's work in ASIC Report 499[15], have some similarities to commissions, in that they are recurring, are practically "invisible" to the customer and may bear no relation to the work actually done[16].

8. In ASIC's view, it is plausible that a continuing culture among licensees and advisers of receiving ongoing commissions which bear no direct relationship to the provision by them of service to the customer (a culture condoned to at least some extent by the grandfathering of commissions) may have contributed to those licensees and advisers paying insufficient regard to the need to charge ongoing service fees only where the service was provided.

Should grandfathered commissions cease? (Q 3)

9. In principle, any exception to the ban on conflicted remuneration has the ability to create misaligned incentives, which can lead to inappropriate advice[17].

10. When grandfathering of commissions was included as an element in the FOFA reforms, ASIC's position was that those arrangements should not continue in perpetuity (as do the current arrangements), ought not to extend to new clients or new arrangements (which occurs in some circumstances under the current provisions) and ought to treat all products and platforms equally in order to ensure competitive neutrality (which is not the case under the current provisions). ASIC's position was also that grandfathered commissions should not be passed on to individuals who provide the financial advice in relation to those products or platforms (which is permitted in certain circumstances under the current provisions).

11. ASIC is concerned that:

    a. almost five years after the implementation of the FOFA reforms, grandfathered commissions continue to form a significant proportion of licensee/adviser remuneration[18]; and

    b. grandfathered commissions operate to incentivise advisers to keep clients in legacy products with a continuing commission structure, even where there may be better products available to meet the client's needs[19].

12. Accordingly, ASIC believes that the grandfathering of commissions should cease as soon as reasonably practicable and to the maximum possible extent[20], although

---

15 Kell; Exhibit 2.1.1.

16 Kell; Exhibit 2.1 at [33]; T1032.25.

17 Kell; Exhibit 2.1 at [96].

18 For instance, it appears that the majority of revenue that is being paid to financial planners within the AMP network is derived from grandfathered commissions – Regan; T1150.32. See also Kotsopolous; Exhibit 2.11 at [13]-[14].

19 Kell; Exhibit 2.1 at [89(b)]; T1042.28; T1042.28-32.

20 ASIC notes that a number of witnesses who gave evidence appeared to accept, at least in principle, that a move to replace grandfathered commissions with fee for service arrangements would be a positive move in reducing conflicted remuneration in the industry – Regan (AMP); T1153.14; Perkovic (CBA); T1345.32; Wright (Westpac); T1445.35-1446.29; T1452.32-1454.40. ASIC also notes that, when the grandfathering of commissions was originally discussed in the context of the proposed FOFA reforms, there were concerns that the abolition of commissions might breach s 51(xxxi) of the Constitution.

it accepts that consideration may need to be given to a short transition period to allow licensees and advisers to adjust their businesses[21].

Does vertical integration of platform operators with advice licensees serve the interests of clients? If so, how? (Q 4)

13. ASIC identified the potential benefits of vertical integration in the financial advice industry more generally in ASIC Report 562[22] as follows:

    a. the creation of economies of scale, which potentially improve cost efficiencies in the provision of services and produce savings that may then be passed on to the customer and improve access to advice;[23]

    b. some customers may benefit from the convenience of dealing with a single financial institution;[24] and

    c. some customers may value the perceived safety of dealing with a large institution.[25]

14. In ASIC's view, however, while some customers may derive benefit from dealing with a vertically integrated financial institution, it may be important to assess whether these benefits are being realised in any given case; for instance, to consider whether:

    a. cost efficiencies produced by economies of scale are, in fact, being passed on to customers;

    b. the arrangements within vertically integrated financial institutions are sufficiently transparent to permit clients to make a fully informed choice to prefer convenience over countervailing considerations[26]; and

    c. large financial institutions are acting in a manner that vindicates the trust and reliance that clients may place in them.

15. Further, as highlighted by ASIC Report 562[27], a vertically integrated business model gives rise to an inherent conflict of interest, which needs to be carefully managed by a licensee to ensure that advice given to the client complies with the best interests duty and related obligations and is not tainted by that conflict.

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? (Q 5)

16. Evidence in relation to the AMP case study on Topic Two of the hearings revealed, for instance, that, pursuant to pre-FOFA arrangements, some fund managers pay ongoing fees to the AMP platform manager (NMMT Limited), calculated as a percentage of the funds invested in the fund by a client[28]. The evidence did not reveal that the platform manager provided anything in return for these fees and it appears from the evidence that this sort of arrangement continues only as a result of grandfathering provisions in the FOFA reforms.

[21] See the concerns expressed in that regard by Wright (Westpac) at T1446.19.
[22] *Financial Advice: Vertically integrated institutions and conflicts of interest;* Exhibit 2.1.7.
[23] Ibid at [8], [56]-[57].
[24] Ibid.
[25] Ibid.
[26] So, for example, in ASIC Report 562: *Financial Advice: Vertically integrated institutions and conflicts of interest*; Exhibit 2.1.7 at [183], ASIC proposed the introduction of public reporting on approved product lists and where client funds are invested.
[27] Ibid; see also Kell; Exhibit 2.1 at [51(a)].
[28] Keating; Exhibit 2.69 at [88]-[93].

17. Where the fund manager is paying a fee to the platform operator, it is to be expected that the manager will have priced that fee into the fee charged to the client. Where the platform operator is not providing anything in return for the fee, it is difficult to understand what would justify the customer in having to bear the burden of it.

18. There is in ASIC's view much to be said for the proposition that such a fee or rebate should be passed on to the client.

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? (Q 6)

19. It is a significant step to deduct money from a client's investments[29]. It is to be expected that all persons involved in processes that have that result should take all reasonable steps available to them to ensure that the client has properly authorised that deduction and, in ASIC's view, platform operators should be expected to have controls in place to ensure that fee recipients are legally entitled to the funds removed from client funds.

20. Further, no evidence was adduced in the hearings which raised any issue as to the technological capacity for platform operators to implement such controls[30].

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 obligations to provide financial services in a manner that is efficient, honest and fair, their obligation to act in the best interests of the customer and to prioritise the interests of the customer above their own interests and the interests of the licensee? (Q 7)

21. A remuneration or incentive arrangement which rewards a financial adviser for generating revenue from customers creates a conflict of interest[31]. Where the revenue varies according to the advice given, the adviser may be influenced to give advice by reference to that revenue objective, rather than the best interests of the customer. The more the remuneration of the adviser depends upon revenue generation, the greater the risk that that arrangement will influence the advice given and the less acceptable will be that risk.

22. In ASIC's view, it is very far from clear why there is a need for this risk to be embedded, to any extent, in the remuneration or incentive arrangements for financial advisers. In the second round of hearings, for instance:

    a. Westpac gave evidence that, from 1 October 2018, it would abolish its share of revenue scheme, no longer pay bonuses monthly, and move to a balanced scorecard that would be 80% comprised of non-financial criteria and 20% revenue-based[32]. When pressed on why any revenue component

[29] As was accepted by Ms Elkins (CBA) at T1254.13.
[30] To the contrary, see Elkins (CBA) at T1254.35.
[31] This issue is discussed, in relation to the conflicted remuneration provisions, in ASIC Regulatory Guide 246 - *Conflicted and other banned remuneration*; Kell; Exhibit 2.1.14; Part D.
[32] Wright (Westpac); T1451.26 – revenue in this context being total customer revenue generated by the adviser, including fees and life insurance commissions – T1478.42.

was required, the answer given was, in ASIC's submission, unpersuasive[33]; and

b. ANZ gave evidence that it had amended the balanced scorecard for its financial planners to remove altogether the two revenue measures which had previously comprised 15% of that scorecard[34].

This evidence, in ASIC's submission, tends to suggest that there is no good reason why the remuneration of employed financial advisers should be structured so as to incentivise them, to any degree, to maximise the revenue generated from their clients.

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? (Q 8)

23. If the financial advice industry had a true professional ethos then, in ASIC's view, it ought not to be necessary to incentivise financial advisers to provide good quality advice.

24. That said, a precondition to incentivising the provision of good quality financial advice must be to identify when an adviser is giving such advice.

25. In ASIC's experience:

a. this would probably need to involve an expert, objective review of the advice being given by a financial adviser, which could be done in conjunction with a routine compliance audit; and

b. the use of "customer satisfaction" as a measure of the quality of advice given is likely to be deficient in this regard[35]. This is because financial advice consumers are typically not good judges of whether the advice they receive is actually good quality advice, given in their best interests, and may assess advice on other subjective criteria, such as the rapport they have with an adviser[36].

26. Once objectively good quality advice is identified, it can be rewarded by the licensee. On the other hand, remuneration which operates to incentivise advisers to recommend any particular advice outcome, or any particular product, or to "switch" clients between products, will tend to work against advice in the client's best interests. ASIC's position is that there should be no difference in the remuneration for advice that is in the client's best interests, whether it be to recommend change or no change to an existing investment strategy.

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 in a timely manner? (Q 9)

---

[33] Wright (Westpac); T1452.4

[34] Rixon (ANZ); T1556.25; Exhibit 2.151.

[35] Contrast Rixon (ANZ); T1562.32.

[36] This was illustrated in ASIC Report 279: *Shadow shopping study of retirement advice* (Exhibit 2.1.10). In that study, 86% of participants felt that they had received good quality advice, and 81% of participants said that they trusted their advisers 'a lot' (at [22]). In contrast, ASIC found that only 3% of the advice provided represented good quality advice (with 58% being adequate and 39% being poor) (at [18]). ASIC also conducted in depth interviews with 11 customers and found that, in many instances where customers had received poor or adequate advice, they still reported feeling quite satisfied with the adviser and the advice experience (at [24]). The interviews suggested that participants' sense of comfort with their adviser was informed by a range of factors relating to a generic notion of the adviser providing a 'professional service', such as organisation and preparation and interpersonal skills and manner (at [25]).

27. Licensees are required by s 912A of the *Corporations Act 2001* to implement adequate monitoring and supervision processes to provide financial services efficiently, honestly and fairly, and to ensure their representatives provide financial services that comply with the financial services laws.

28. In ASIC Report 515: *Financial advice: Review of how large institutions oversee their* advisers[37]*,* ASIC reviewed the way the large institutions monitored and supervised their advisers, including their advice audit process. In particular, ASIC assessed 160 sample files from a range of licensees, which files had been subject to the licensee's business-as-usual audit, and found that the recommendations made for adviser consequence management were often inadequate to address the compliance issues identified by ASIC. Thus, of the 131 audit outcomes assessed by ASIC as being ineffective or partially effective, it found 48 cases where corrective action should have been recommended by the licensee's auditor but was not.

29. This experience was mirrored in some of the case studies undertaken in the current round of hearings[38].

30. ASIC Report 515 contained a number of recommendations about how to improve the advice audit process, including the use of key risk indicators (KRIs) to target audit work, the importance of adequate record keeping of advice files and appropriate consequence management recommendations by auditors. Ultimately, however, the appropriate monitoring and supervision of advisers comes back to whether the licensee has the commitment to do so, has devoted sufficient and appropriate human, technological and financial resources to the task and is appropriately incentivising the auditors and managers involved in the task.

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? (Q 10)

31. In ASIC's view, it is possible for licensees to adequately monitor the quality of advice provided by employees and authorised representatives where that advice is provided in a manual environment, provided they dedicate adequate resources to the task.

Are improvements in technology the only way to ensure that financial advisers provide quality advice? (Q 11)

32. In ASIC's view, the appropriate use of technology can enhance the monitoring and supervision of advisers to detect poor advice and facilitate good advice, but improvements in technology are neither a prerequisite for quality advice, nor a substitute for other forms of monitoring and supervision.

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? (Q 12)

33. ASIC understands that the question is directed to a situation in which a licensee has identified a risk that an adviser has provided non-compliant advice leading to client loss and is undertaking an investigation to establish if this is so. In that scenario, in ASIC's submission, the licensee should:

    a. Immediately inform clients that inappropriate advice may have been, or has been, provided, take steps to review the advice provided and remediate

[37] Exhibit 2.1.9.

[38] See, for example, Wright (Westpac) at T1421.37-47; Whereat (ANZ) at T1543.1-26 and Forde (ANZ) at T1711.31-1712.8.

clients as appropriate. *ASIC Regulatory Guidance 256: Client review and remediation conducted by advice licensees* provides guidance to licensees on review and remediation; and

b. Immediately take appropriate measures to ensure that no further non-compliant advice is provided. Depending on the degree of risk and the potential seriousness of the misconduct involved, this might range from suspending the adviser pending the outcome of the investigation (in a serious case) to imposing pre-vetting and close management supervision of the adviser (in a less serious case).

Taking into account that it may never be possible to reduce the risk to zero, what is an acceptable risk that customers will be provided with inappropriate advice? (Q 13)

34. In ASIC's view, the aim of licensees should at all times be to keep inappropriate advice to the minimum level that is reasonably practicable[39]. What level of risk is "acceptable" in this context should depend on the cause of the inappropriate advice in question. For instance:

    a. although there will always be some risk of inappropriate advice due to human or technological error, a licensee's systems ought to be adequate to minimise such errors and to detect them quickly when they occur;

    b. there ought to be almost no inappropriate advice given which is attributable to lack of training or competence on the part of the adviser or which results from identified but un-managed conflicts of interest; and

    c. the risk of inappropriate advice flowing from dishonesty or fraud ought to be minimised by systems and controls calculated to make it as difficult as possible to accomplish and to quickly detect it when it occurs.

35. In any event, licensees should have systems in place to speedily investigate and remediate inappropriate advice once it is identified.

36. Given that some level of non-compliant advice leading to client loss is inevitable, consumer protection would be enhanced in ASIC's view by the creation of a last resort compensation scheme[40].

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? (Q 14)

37. In ASIC's view, when a licensee becomes aware that a client has been, or may have been, provided with inappropriate advice it should immediately inform the client that:

    a. the client has been, or may have been, provided with inappropriate advice;

    b. the licensee has reviewed or is reviewing the advice and what this means for the client;

    c. the time frame for review of the advice (if applicable);

[39] Further, as discussed in ASIC's response to Question 18 below, it should be borne in mind that the prospect of inappropriate advice (and, potentially, its consequences) increase with the complexity and risk of the financial products being recommended for investment and would consequently be reduced if access to complex, riskier products by retail investors was restricted and more basic, simple financial products that are suitable for most Australian consumers were made available.

[40] Kell; Exhibit 2.1 at [232]-[241].

d. the client's rights and a contact point if the client wishes to discuss the matter further.[41]

38. It is not acceptable in ASIC's view for licensees to fail to undertake any investigation or otherwise to make a concerted effort to determine whether inappropriate advice has been or is likely to have been provided, so that clients are not informed for months or even years[42].

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? (Q 15)

39. Where a licensee determines that a client *has been* provided with inappropriate advice, the client should, in principle, not only be informed, but be remediated immediately. ASIC recognises, however, that practical considerations may mean that this is not feasible. For example, it may take some time for the licensee to reconstruct circumstances from a client's file to enable the preparation of a reasonable counterfactual in order to determine the amount of remediation payable[43]. In such cases, remediation should occur as soon as is reasonably practicable.

40. Where a licensee determines that a client *may have been* provided with inappropriate advice, it will be necessary for the licensee to determine whether inappropriate advice has in fact been provided. In some cases of larger, systemic failures, this may be a complex exercise[44]. In ASIC's view, however, there is an onus on licensees to dedicate sufficient resources to this task to allow compensation to occur in an efficient and timely way[45]. In that regard, ASIC's experience (which has been further illustrated by evidence in the current round of hearings) has been that remediation is often far too slow, reflecting a failure by licensees to discharge that onus.

41. Again, it is not acceptable in ASIC's view for licensees to fail to undertake any investigation or otherwise to make any effort to determine whether inappropriate advice has been or is likely to have been provided so that clients are not informed for months or even years[46].

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? (Q 16)

42. This is obviously a matter which a licensee needs to approach carefully in each case, applying its judgment in light of the precise circumstances and the obligations of the licensee under the law.

---

[41] ASIC Regulatory Guide 256; *Client review and remediation conducted by advice licensees* at [37]-[38]; [118], [169],[170]-[171], [180].
[42] See Whereat (ANZ) at T1521.17-25; Britt (AMP) at T1606.36-40 and T1617.41-45; Forde (ANZ) at T1723.38-T1724.14. ASIC considers that this would be a breach of the licensee's obligation under s 912A(1)(a) of the *Corporations Act 2001*.
[43] Failing which, in ASIC's view, it will be appropriate to use the RBA cash rate + 6% (equivalent to the Federal Court post-judgment interest rate) – see ASIC Regulatory Guide 256: *Client review and remediation conducted by advice licensees* - http://www.asic.gov.au/media/4009895/rg256-published-15-september-2016.pdf?utm_source=asic&utm_medium=pdfpromotions&utm_campaign=rg256 - at [132]-[133].
[44] For instance, because of the number of clients involved, the number of advice files that will need to be subjected to expert review and the state of record-keeping in those files.
[45] Ibid at [2].
[46] See Whereat (ANZ) at T1521.17-25; Britt (AMP) at T1606.36-40 and T1617.41-45; Forde (ANZ) at T1723.38-T1724.14.

How should financial services licensees recognise and reward ethical conduct by financial advisers? (Q 17)

43. Again, as submitted above, if the financial advice industry had a true professional ethos then one might consider that it ought not to be necessary to "reward" ethical conduct.

44. That said, recognising and rewarding ethical behavior by financial advisers requires that licensees and advisers are first able to identify both ethical and unethical conduct. Ethical education, management that encourages open discussion about ethical dilemmas and policies that promote internal whistleblowing will all contribute to this.

45. Once identified, ethical behaviour should be recognised and rewarded through all aspects of the remuneration and performance management system. This might mean that advisers' remuneration should be calculated by reference to good quality service to clients, rather than by revenue or product sales[47]. The performance management system, including promotions, bonuses and "leader boards", should also reward ethical conduct and, where appropriate, punish unethical conduct.

46. Finally, ASIC notes that remuneration and performance management practices intended to promote ethical conduct are more likely to be effective where they are aligned with an ethical organisational culture[48].

Are there particular characteristics of the financial advice industry which lead to there being a higher incidence of improper, unethical or dishonest conduct than in other industries? If so, what are those characteristics and what should be done to address them? (Q 18)

47. ASIC considers that there are some characteristics of the financial advice industry which have led, and continue to lead, to a higher incidence of improper, unethical or dishonest conduct than in other industries.

48. The first of these is the character of the consumer market for financial advice. Financial products and services are innately more complex and less tangible than most other markets, and thus the ability of consumers to drive better outcomes through demand side pressure is more limited.

49. This observation also applies to financial advice. Financial advice is a complex consumer service, so that it can be difficult for a consumer to assess the quality and true cost of financial advice, and often the consequences of inappropriate advice may not be apparent to the consumer for many years (if at all)[49].

50. Despite these difficulties, one of the consequences of Australia's compulsory superannuation system is that there are a large number of Australians who hold superannuation, in a system which is sufficiently complicated that many feel the need for advice. Hence the demand has continued to grow despite problems with the quality of advice.

51. In this context it is also worth noting that:

---

[47] See further ASIC's responses to Questions 7 and 8 above. Remuneration and performance management practices intended to promote ethical conduct are also more likely to be effective where they are aligned with an ethical organizational culture; see Stephen Sedgwick, *Retail Banking Remuneration Review Report* (19 April 2017) - https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf.

[48] Stephen Sedgwick, Retail Banking Remuneration Review Report (19 April 2017), Section 5 - https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf

[49] Kell; Exhibit 2.1 at [58]

a. the amounts that consumers have saved are often relatively modest by comparison with the cost of financial advice provided under the "personal financial adviser" model;

b. there are a number of consumer biases which operate in relation to financial advice which can be exploited by the unscrupulous. For instance, a consumer may tend to favour short term over long term outcomes, or to assess the quality of the advice given less by rational interest than by whether they like the adviser or whether the adviser appears to be behaving "professionally" so that, in one-on-one advice relationships, rapport and social commitment can have strong effects[50]; and

c. consumers confronted by lengthy or complicated documents may agree to arrangements which they do not fully understand, including ongoing service fees or asset-based fees which may, practically speaking, provide them with little benefit and be invisible to them if they are deducted directly from investment funds.

52. Secondly, the financial advice industry has historically been plagued by conflicts of interest[51]. Although the FOFA reforms removed some of the worst conflicted remuneration practices from the industry, they are subject to a number of exclusions and exemptions, so that there is still a significant pool of conflicted remuneration in the industry[52]. Conflicts also can and do still arise from structural aspects of the industry, including the conflicts which arise:

a. in a "vertically integrated" business, where there is a conflict between a licensee's interest in selling its in-house products and the client's interest in receiving advice that is in their best interests[53]; and

b. in a "one stop shop" business model, where an enterprise provides both financial advice and a range of ancillary services[54].

53. Thirdly, too many licensees have historically operated without adequate monitoring and supervision of their advisers. Although the internal controls of many licensees have improved over time, ASIC believes that they remain deficient in some cases. ASIC's experience has been that the absence of appropriate controls in this area has been and can be a significant cause of inappropriate advice and other improper, unethical or dishonest conduct [55].

54. Fourthly, although the financial advice industry holds itself out as providing independent, disinterested and competent advice, there is a substantial element of the industry which has not yet adopted a professional ethos or approach. ASIC surveillances over time have also found that many financial advisers are not adequately trained or competent to provide appropriate advice to their clients[56].

---

[50] Ibid at [60]; Exhibit 2.1.10 at [186]-[193].
[51] Ibid at [51], [210]-[212].
[52] The Royal Commission heard evidence, for instance, that in each year since 2013, NAB and its associated licensees had paid hundreds of millions of dollars (in some years in excess of $500m) in permitted conflicted remuneration, including by way of grandfathered commissions, asset-based fees for advice and incentive payments calculated by reference to revenue generated by the adviser – Barnwell (NAB); Exhibit 2.8 at [80]-[88] & Annexure A.
[53] Kell; Exhibit 2.1 at [51], [61(a)], [214]-[218]; Exhibit 2.1.7 (ASIC Report 562); note also that AMP advisers invested more than 90% of new customers' funds in in-house products between 2013 and 2017, even though in-house products represented only 30-40% of the approved product list (Counsel Assisting at T1201.38-44, summarising the witness statement of Mr Green (AMP) – Exhibit 2.4).
[54] Kell; Exhibit 2.1 at [46(a)], [48], [51(b)], [61(a)], [219]-[222]; Henderson; T1748.31-1749.24.
[55] Kell; Exhibit 2.1 at [52]-[53]; Exhibit 2.1.9.
[56] Kell; Exhibit 2.1 at [54]-[57], [205]-[209].

55. Fifthly, the permissive regulatory regime around financial products has meant that advisers have been able to recommend and sell products to consumers that create a higher risk of inappropriate, unethical or damaging outcomes. That is, there are no regulatory limits on the products that can be sold to consumers, let alone a product safety regime involving the testing or approval of financial products as there is in the field of medicine and pharmaceuticals.

56. Finally, although the industry universally pays lip service to the values of being customer focused, "doing what is right" for customers and acting with integrity, the reality is that the culture of many participants in the industry has tended, at least historically, to be sales-driven and to favour their short term financial interests over the interests of customers[57].

57. As to what is to be done to redress these characteristics, ASIC responds as follows. First, in relation to the characteristics of the consumer:

    a. ASIC seeks to facilitate consumer understanding and to arm consumers with the ability to demand and better assess good quality financial advice through its Moneysmart website[58]; and

    b. the FOFA reforms have recognised and responded to consumer biases to some extent; for example, by requiring clients to "opt in" to ongoing fee arrangements every two years. In ASIC's view, however, other such measures can and should be employed; for instance, by introducing a requirement for advisers to invoice clients for ongoing advice services.

58. It will remain the case, however, that the amounts of superannuation or other investments involved for the average consumer will often be modest by comparison with the costs of financial advice provided under the "personal financial adviser" model. Moreover, many of the recent and ongoing reforms designed to lift conduct standards for advisers, reduce the impact of conflicts of interest on financial advice and lift education and professional standards of advisers are likely also to increase the direct cost to consumers of such advice. There is also reason to question whether viable business models will evolve that will provide broad, affordable access to personal professional advice to all Australian consumers who need financial advice. To some degree this is not surprising as, in other fields, few, if any, genuinely professional services are broadly available to all Australian consumers without Government subsidy.

59. Accordingly, providing the average consumer with cost-effective access to financial advice is likely, in ASIC's view, to be challenging and to require more than simply further regulation of the "personal professional adviser" model. ASIC therefore believes that consideration should be given to other mechanisms that will promote and secure the financial well-being of Australian consumers who are not able to access personal professional advice through that model. This might, for example, involve:

    a. facilitating the provision of basic, more commoditised, personal or general advice offerings to a large proportion of the population;

    b. simplifying financial products or mandating some basic, simple financial products that are suitable for Australian consumers (on the basis that consumers are less likely to require access to financial advice where safer and less complex products are readily available);

[57] Ibid at [200]-[204]; see also Regan (AMP) at T1113.38-39; Wright (Westpac) at T1567.10-28; Rixon (ANZ); Exhibit 2.152 at [47]; T1724.20-24; Hagger (NAB) at T1681.40 and T1694.21; Forde (ANZ) at T1827.1-14; Kewin (AFA) at T1445.21-22.
[58] https://www.moneysmart.gov.au/investing/financial-advice

c. restricting access to more complex, riskier products (which are more likely to require access to financial advice);

d. allowing for basic advice services to be provided at low cost, subsidised by industry or Government; and

e. in the longer term, seeking to minimise the impact that changes to superannuation, tax and social welfare regulation have on the complexity of financial decision-making faced by consumers with limited access to professional, personalised financial advice.

60. Secondly, in relation to conflicts and the monitoring and supervision of advisers, ASIC has made submissions elsewhere in this document in relation to conflicted remuneration (Question 28), the grandfathering of commissions (Question 3), issues arising from "vertical integration" (Questions 4 and 27) and the importance of effective systems for the monitoring, supervision and disciplining of advisers (Questions 25 and 26).

61. Thirdly, in relation to the lack of a proper professional ethos, in ASIC's experience, the professionalism in the industry has improved over time as a result of the FOFA reforms and is expected by ASIC to continue to improve as the reforms required by the *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* come into effect[59].

62. Finally, in relation to regulatory culture, ASIC has addressed this issue in its response to Questions 25 and 26 below.

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

63. ASIC considers that proper reference checking by recruiting licensees, and the disclosure of information by former licensees, is an important means of ensuring that the community is protected from adviser misconduct and ensuring that advisers in need of it are subject to supervision or other corrective action by their authorising licensees[60].

64. A brief history of ASIC's concerns and efforts in this regard is set out in Ms Macaulay's evidence[61]. For instance, in ASIC Report 515: *Financial Advice: Review of how large institutions oversee their advisers*[62], ASIC found, as recently as March 2017 that, while licensees generally contacted an adviser's former licensee before appointing the adviser, and often requested details of the adviser's compliance history, there was a widespread failure by former licensees to respond adequately to such requests for information.

65. Those concerns on ASIC's part have been illustrated by evidence in the current round of hearings[63].

66. While ASIC welcomes the ABA reference checking and information sharing protocol as a move in the right direction, it does not consider that it alone is

[59] Kell; Exhibit 2.1 at [205]-[209].
[60] Macaulay; Exhibit 2.247 at [38].
[61] Macaulay; Exhibit 2.247 at [39]-[41].
[62] Exhibit 2.1.9; see also Macaulay; Exhibit 2.247 at [41].
[63] See, for example, T1459.39-1463.26 (in relation to Dover's request for a reference from Westpac); T1546.34-1548.34 (in relation to Dover's request for a reference from Millennium3 (ANZ)); and T1640.32-1641.43 (in relation to AMP's attitude to a potential request for a reference from Dover (which was not in fact made)).

sufficient to protect the public when financial advisers transfer between licensees, for the reasons explained in Ms Macaulay's evidence[64].

67. In ASIC's view, consideration should be given to law reform to introduce mandatory reference checking and information provision (including qualified privilege) when financial advisers transfer between licensees.

Should licensees be required to attain 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? (Q 20)

68. In ASIC's view, the obligations set out in ss 912A(1)(a), (ca), (e) and (f) already require licensees to attain a minimum degree of satisfaction as to the competence and integrity of applicants to become authorised representatives before authorising them[65].

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? (Q 21)

69. In ASIC's view, the general obligations in s 912A are not expressed at too high a level of generality to be capable of being effectively enforced.

70. On the contrary, ASIC considers that the obligations imposed by s 912A are appropriate and form an important part of the current regulatory regime. The only defect with s 912A, in ASIC's view, has been that it is not a civil penalty provision and which the Government has recently announced will be remedied by law reform.

71. The most general obligation is s 912A(1)(a), which imposes an obligation on licensees to do all things necessary to ensure that their financial services are provided "efficiently, honestly and fairly". These are words which first appeared in the corporations legislation in 1980[66], have been considered and construed by the Courts on several occasions[67] and have "*become the benchmark in legislation and rules outside the operation of the Corporations Act*"[68].

72. This provision in s 912A(1)(a) is thus not unlike other obligations in the law which set general normative standards of conduct in order to give effect to "matters of high public policy"[69], such as:

    a. the provision in the Australian Consumer Law that a person must not, in trade or commerce, engage in "misleading or deceptive conduct"; and

    b. the various statutory prohibitions on "unconscionable conduct" (for instance, s 12CB of the ASIC Act).

---

[64] Macaulay; T1919.1-17; see also Exhibit 2.1.9 (ASIC Report 515 *Financial Advice: Review of how large financial institutions oversee their advisers*) at [237]-[245].
[65] See also Exhibit 2.1.9 at p. 71, which sets out guidance by ASIC as to the background checking of advisers.
[66] ss 48, 48A and 62C of the *Securities Industry Act 1980* (Cth); see also P Latimer, "*Providing financial services 'efficiently, honestly and fairly'*" (2006) Company & Securities Law Journal 362 at 383-384, referencing the ASX market rules and the *Tobacco Products (Licensing) Act 1988* (Cth).
[67] *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661 at 672; *R J Elrington Nominees Pty Ltd v Corporate Affairs Commission (SA)* (1989) 1 ACSR 93 at 110; *Re Hres and ASIC* (2008) 105 ALD 124 at [237].
[68] P Latimer, "*Providing financial services 'efficiently, honestly and fairly'*" (2006) Company & Securities Law Journal 362 at 383.
[69] *Marks v GIO Australia Holdings Ltd* (1998) 196 CLR 494 at [99].

73. Such standards require broad evaluative judgments, by reference to all of the circumstances[70] and have the considerable advantages of the flexibility to deal with market developments such as the emergence of new financial products and the ability to evolve over time, so as to adequately reflect changing industry and community standards[71].

74. In contrast, the absence of such standards can result in technicalities and arbitrary distinctions and a "tick the box" approach to regulatory compliance and risk being circumvented by a technical approach by licensees to their obligations[72].

75. In other words, the general obligations in s 912A facilitate "principles-based" and "outcome-based" regulation, rather than regulation by strict rules[73].

76. To the extent that the question is directed to sub-paragraphs of s 912A other than s 912A(1)(a) (for example, the need to have "adequate arrangements" for conflict management (912A(1)(aa)); the need to take "reasonable steps" to ensure that representatives comply with the law (912A(1)(ca)) and the obligation to have "adequate" risk management systems in place (912A(1)(h))), ASIC submits that the generality of those sub-paragraphs is appropriate on the same basis and that they are well capable of being effectively construed by the Courts and enforced.

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? (Q 22)

Does that division of responsibility create gaps in the disciplinary systems? If so, what are they? (Q 23)

77. The responsibility for the professional discipline of advisers is not accurately characterised, in ASIC's view, as being "divided" between licensees, ASIC and professional associations, with "gaps" between. Rather, each has its own distinct, overlapping role to play.

78. Thus, under the current legislative regime, misconduct by an adviser is, in the first instance, to be dealt with by the licensee[74]. This is consistent with the fact that the licensee is generally responsible for the conduct of its advisers regardless of whether the conduct was within authority[75] and, more generally, that, under the present regulatory framework, the fundamental responsibility for ensuring that their businesses and representatives comply with the law[76] and that those representatives are adequately trained and competent[77] rests on licensees[78].

79. ASIC's work in recent years, however, has found failings in internal monitoring and supervision processes at licensees which gives rise to serious concern as to

---

[70] *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51; *Commonwealth Bank v Kojic* (2016) 249 FCR 421 at [59]; *Kakavas v Crown Melbourne Ltd* (2013) 250 CLR 392 at [15]-[18].

[71] P Latimer, "*Providing financial services 'efficiently, honestly and fairly'*" (2006) Company & Securities Law Journal 362 at 384.

[72] See Kell; Exhibit2.1 at [36], [38(g)], [39] and [158]

[73] As explained by Professors Latimer and Maume, the analogy is between a "rule" that the speed limit is 60 km per hour and the "principle" that one not drive faster than is reasonably prudent in all the circumstances; the first is certain but inflexibly applies in all conditions whereas the second is uncertain but adapts to changed circumstances – ibid. at p. 6. See also the submission by Professor Paul Latimer and Phillip Maume to the Financial System Inquiry 25 August 2014 – https://fsi.gov.au/files/2014/08/Latimer_Paul.pdf - at p.8

[74] Macaulay; T1917.41-46.

[75] See Division 6 of Part 7.6 of the *Corporations Act 2001*.

[76] s 912A(1)(ca) of the *Corporations Act 2001*.

[77] s 912A(1)(f) of the *Corporations Act 2001*.

[78] Kell; Exhibit 2.1 at [181]-[193].

whether those processes have been effective to ensure that all financial advisers will face appropriate consequences for breaching their statutory or professional obligations[79].

80. ASIC's role as regulator is thus to oversee compliance with the financial services laws by the licensee and advisers, but it is not primarily responsible for their discipline, any more than it is for their recruitment, training, monitoring or supervision. ASIC has regulatory responsibility for the industry, but it is not practically possible for ASIC, or any regulatory body, to itself monitor and supervise the thousands of advisers who give financial advice to their customers every day[80].

81. Given the limitations on its powers and resources[81], ASIC is thus obliged to:

    a. confine its interest primarily to those advisers who are identified by it as having engaged in significant or serious breaches of their statutory and professional obligations; and

    b. select which of those cases it will investigate for possible enforcement action (based on a range of factors, including the seriousness of the misconduct, available evidence, likely outcome of any available action, age of the misconduct and whether it is ongoing and general and specific deterrent benefits[82]).

82. If that process establishes misconduct then ASIC will take a decision as to which of the enforcement remedies available to it is best suited to the circumstances of the case and what it wants, and is able, to achieve[83]. If the investigation establishes serious misconduct that is dishonest, intentional or highly reckless, then ASIC will generally consider criminal action and will very frequently take such action, usually after acting to ban the adviser[84].

83. The professional associations currently play only an incidental and *ad hoc* role in the disciplining of advisers, although this may change with the implementation of the *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017*, when some professional associations are likely to become bodies that formally monitor advisers' compliance with the Code of Ethics.

Is it possible to implement a single system for professional discipline of financial advisers? Would structural change 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? (Q 24)

84. It would be possible to implement a single system for professional discipline of financial advisers. For example, in the United States, the Financial Industry

---

[79] For instance, ASIC Report 515: *Financial Advice: Review of how large institutions oversee their advisers* (Exhibit 2.1.9) exposed serious deficiencies in the systems being operated by AMP, ANZ, CBA, NAB and Westpac for the monitoring and supervision of their advisers, including internal audit processes which were fully effective in identifying areas of non-compliance in only 18% of sampled files, 47 out of 131 cases in which some form of corrective action should have occurred following the results of an internal audit, but did not and concerns about several aspects of those internal audit processes, including as to the adequacy of the file audit questionnaire and the adequacy of audit record keeping (Kell; Exhibit 2.1 at [174]). Evidence adduced in the current round of hearings has only served to confirm those concerns.

[80] Ibid at [184].

[81] See further ASIC's responses to Questions 25 and 26 below.

[82] See Exhibit 2.247.2 at p.4.

[83] Ibid.

[84] Exhibit 2.247.3 at p. 8; Macaulay; T1925.30-41.

Regulatory Association (FINRA) performs such a role. FINRA was created in 2007, through the consolidation of the National Association of Securities Dealers Inc and the member regulation, enforcement and arbitration functions (and subsequently the market surveillance and related enforcement functions) of the New York Stock Exchange.

85. In relation to the present regime, the *Financial Services Reform Act 2001* introduced a single licensing regime for financial advice and dealings in financial products in order to address opportunities for regulatory arbitrage and to reduce regulatory overlap and confusion.[85]

86. As ASIC understands this question, it contemplates that responsibility for disciplining advisers would be removed from licensees and devolved upon a single disciplinary body independent of licensees.

87. Such a system would necessarily involve significant structural change. Apart from identifying or establishing an entity to perform that function, it would be necessary to consider how a single system for professional discipline of financial advisers would impact on the management of licensees' risks associated with their liability for any misconduct of their advisers[86] and the general obligations of licensees under s 912A.

88. With regard to the question whether a system of licensing at both an individual and an entity level is more appropriate than the existing system of licensing only at the entity level, ASIC has previously considered the possibility of licensing of individual advisers in connection with the Ripoll Inquiry.

89. In its submission to that inquiry, ASIC noted that other jurisdictions (Hong Kong, Singapore and the United Kingdom[87]) had a greater focus on the individual as part of the licensing process[88], but ultimately submitted[89] that:

    "… whilst requiring ASIC to approve individuals involved in the financial services industry might improve ASIC's ability to ensure those who may engage in unacceptable conduct cannot enter the financial services industry, ASIC believes that the costs of such a reform would outweigh this benefit. Such a reform would dilute the key responsibility of the licensee and significantly increase regulatory costs."

90. The Ripoll Report[90] accepted that submission, concluding that[91]:

    "The committee is also of the view that licensing individual planners would be far too costly to justify any regulatory improvements that may result."

---

85 See the Explanatory Memorandum to the *Financial Services Reform Bill 2001* at [1.4]-[1.5].
86 See Division 6 of Part 7.6 of the *Corporations Act 2001*.
87 It is to be noted that the United Kingdom has subsequently moved to some extent away from a system of individual licensing. Thus, on 1 March 2016, the Senior Managers and Certification Regime (SMCR) replaced the previous Approved Persons regime for employees of banks, building societies, credit unions and dual regulated investment firms, so that the onus could be placed back on firms to take responsibility for the quality of staff that they engage. The SMCR requires persons performing prescribed Senior Management Functions in an authorised firm to have approval from the Financial Conduct Authority (FCA). Financial advisers in firms subject to the SMCR need to be 'certified' by their employer as being fit and proper to perform their roles, at least on an annual basis. The Approved Persons regime continues to apply to individuals in other firms.
88 *PJC Inquiry into Financial Products and Services in Australia Submission by ASIC*, August 2009 at [101].
89 Ibid at [102].
90 *Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia*, November 2009; Exhibit 2.1.5.
91 Ibid at [6.150].

91. ASIC acknowledges a dual system of licensing could increase its ability to ensure that only appropriate people become advisers.

92. However, ASIC considers that any dual licensing system should address the two significant issues referred to above: (a) individual licensing may dilute the responsibility of a licensee and create ambiguity and uncertainty about the relative responsibilities between a licensee and ASIC; and (b) the close scrutiny involved in an individual licensing would require substantial resources to administer effectively.

93. If the current system is maintained, ASIC submitted to the Enforcement Review Taskforce that (i) its ability to ensure that only appropriate persons are able to participate in the financial services and credit industry would be enhanced if the grounds for exercising ASIC's power to ban individuals were expanded; (ii) there should be a duty for individuals to take reasonable steps to achieve compliance in the activities they manage (with the potential to ban individuals for serious failures to meet that duty) and (iii) for very large entities, a requirement to map key responsibilities to avoid ambiguity in management accountability. The Enforcement Review Taskforce did not accept that submission but instead proposed that ASIC should have power to impose such a ban where a person is not fit and proper; is not adequately trained or competent; or has more than once been an officer of a licensee which has been the subject to a report by the Australian Financial Complaints Authority (AFCA) regarding failure to comply with a determination; or which has been the subject of a report by a liquidator about inability to pay its debts[92].

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? (Q 25)

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? (Q 26)

94. 'Regulatory culture' is a broad concept. In ASIC's understanding, it extends to the approach to regulation both of industry participants and the organisations (both government and industry) that are involved in regulating the financial advice industry.

95. It is important to note at the outset that the financial advice industry has undergone, and is continuing to undergo, considerable change in the last 10 to 15 years. This includes changes in the regulatory regime, as well as changes in the approach of ASIC as a regulator. Further, as noted elsewhere in these submissions, there are substantial reforms and changes to the sector that have yet to be implemented (e.g. the professional standards reforms). Accordingly, the regulatory culture has been evolving and continues to evolve.

Regulatory culture and the regulatory framework

96. Regulatory culture is critically influenced by the laws and policies that constitute the regulatory regime. As Professor Hanrahan observes in Background Paper 7, the regulatory settings in the financial advice sector have historically involved a relatively permissive regime, both around how advisers could be remunerated and what products they could sell. These regulatory settings have also enabled the 'authorised representative' model to proliferate to an extent that requires licensees

[92] *ASIC Enforcement Review Taskforce Report December 2017* at pages 52-54.

to apply more resources to monitor and supervise their advisers than they have to date devoted to that task. Educational and professional standards have been low and there has been a dominant sales-driven culture in the industry.

97. Professor Hanrahan's paper also illustrates the difficulties in separating the regulation of the provision of financial *advice* from the regulation of financial *products*. The regulatory regime for financial products, particularly investment products, is relatively open, with the expectation that (a) disclosure and (b) high quality advice, can ensure that financially inexperienced consumers make appropriate choices.

98. Furthermore, disclosure has also been seen as a key component of good quality financial advice. That is, a fundamental feature of the regulatory regime historically has been a reliance on disclosure to address both conflicts of interest in adviser remuneration and pricing/risks in financial products. Some elements of this approach have been the subject of reforms in recent years (e.g. through FOFA) and more reform is envisaged (e.g. through the introduction of product intervention powers for ASIC).

99. There are several layers in the regulatory framework, with legal or ethical responsibilities resting variously on individual advisers, licensees, external advisers (e.g. legal, accounting and compliance firms), ASIC and even consumers themselves.

100. In the current regulatory framework, however, the starting point is the role of licensees. Fundamental responsibility for ensuring that financial services businesses and their representatives comply with the law rests on licensees; as exemplified in their obligations in s 912A of the *Corporations Act 2001* to take reasonable steps to ensure that their representatives comply with the financial services laws and to ensure that their provision of financial services is efficient, honest and fair.

101. Accordingly, all licensees are called upon in the regulatory regime to play a critical and fundamental role in the effective regulation of the industry, which requires them to put compliance with their legal and ethical duties to their customers at the forefront of their priorities[93]. This has too often failed in practice.

102. Whilst the regulatory framework places fundamental responsibility on licensees and relies on them taking up that responsibility, it has to date only provided ASIC with restricted tools to address situations where they fail to do so. For instance:

    a. the impact of a banning order as a public denunciation of misconduct is limited by the legislative requirement that the banning process is private[94], so that the reasons for (although not the fact of) the decision are also private[95], and ASIC can make only limited public disclosure of the reasons for the banning[96];

    b. an attempt to suspend or cancel a licence for non-compliance by the licensee with its general obligations under s 912A is, in practice, often

[93] Ibid.
[94] See s 920A(2)(a) of the *Corporations Act 2001*.
[95] For the reasons explained in ASIC Information Sheet 152: *Public comment* - http://asic.gov.au/about-asic/asic-investigations-and-enforcement/public-comment-on-asics-regulatory-activities/ - ASIC does not generally disclose information about its investigations and will not normally publicise matters which are the subject of private hearings, although it generally issues a media release on the outcome of administrative proceedings (once the decision is gazetted). See also Macaulay; T1910.16.
[96] See, for example, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-109mr-asic-bans-former-suncorp-financial-services-financial-adviser-for-four-years/

successfully defended by the licensee putting forward evidence that it has recently reformed its compliance systems to address the concerns said to justify the suspension or cancellation[97];

c. ASIC does not currently have the power to ban an individual from being a senior manager or controller of a financial services business[98];

d. section 912A of the *Corporations Act 2001* (which sets out the general obligations of a licensee) is not currently a civil penalty provision[99];

e. the potential deterrent impact of civil penalty proceedings has been limited by the modest size of the available penalties[100], coupled with the fact that such proceedings are time-consuming and resource intensive for ASIC[101]; and

f. ASIC presently has no power to direct licensees to take specific action in the conduct of their business, so that it cannot intervene directly to ensure that a licensee complies with its legal obligations (e.g. by employing qualified compliance staff, or putting in place arrangements to ensure the full and timely remediation of customers)[102].

103. The structure of the financial advice industry has also contributed to its broader regulatory culture. For instance, the dominance of financial advisers in the distribution chain has meant that products have been designed in many cases to make them attractive for advisers to "sell" rather than so as to best meet consumer needs and objectives. Further, the complexity of financial products and advice has meant that consumers are often ill-equipped to assess the quality of the advice they are getting (at least until its consequences are manifest).

104. Further, there has been, up to this point, little scope in the regulatory regime for professional industry bodies to play a meaningful regulatory role. Historically, these bodies have generally acted primarily as advocates in relation to proposed industry reforms, and the multiplicity of such bodies has also mitigated against any of them taking a strong leadership role in setting or enforcing strong ethical standards (lest they risk losing members to those bodies with less rigorous standards).

ASIC's approach to regulation

105. ASIC's responsibilities in relation to the financial advice industry are wide and varied, and its resources are limited. For instance:

a. ASIC's Financial Advisers Team has increased over the last few years to 60 employees[103], who are charged with the regulation of an industry comprising

---

[97] Macaulay; Exhibit 2.247 at [47]; T1926.43-1927.3.
[98] Macaulay; Exhibit 2.247 at [19].
[99] Macaulay; T1927.13.
[100] Which are presently, in ASIC's experience, not adequate to effectively punish and deter wrongdoers in the financial advice industry – Macaulay; T1928.1.
[101] Macaulay, Exhibit 2.247 at [51].
[102] Measures to address a number of these limitations are now the subject of recommendations by the Enforcement Review Taskforce, which the Government has either accepted or accepted in principle subject to the report of the Royal Commission.
[103] Including ten staff funded by the Enforcement Special Account as part of ASIC's Wealth Management Project; Macaulay; Exhibit 2.247 at [4]; T1904.1. There are also approximately 10 members of ASIC's Financial Services Enforcement Team who work mostly on enforcement action in relation to the financial advice industry. By comparison ASIC Investment Managers and Superannuation Team has 53 staff as of 30 June 2017, and ASIC's Deposit-Takers, Credit and Insurers Team has 70 staff as of 30 June 2017

around 6,000 licensees and 25,000 individual financial advisers[104], the majority of whom work in small firms (about 90% of which have less than 50 advisers[105]); and

b. ASIC receives approximately three reports each week of misconduct in relation to financial advice and, after initial analysis of all of them, investigates approximately 40% of these[106] and, in the 2016/17 financial year, received 106 breach reports in relation to financial advice, of which it investigated approximately 46%[107].

106. ASIC's regulatory culture is reflected in the regulatory choices that it makes. With limited resources, it is inevitable that ASIC's regulatory choices will entail difficult decisions as to what matters to investigate and to take action on and in what manner, so as to most *effectively change the behaviour of industry participants and improve consumer outcomes*. Difficult choices and trade-offs are required to be made, not only in the context of the financial advice sector, but across the full range of ASIC's jurisdiction and responsibilities.

Strategic regulation theory

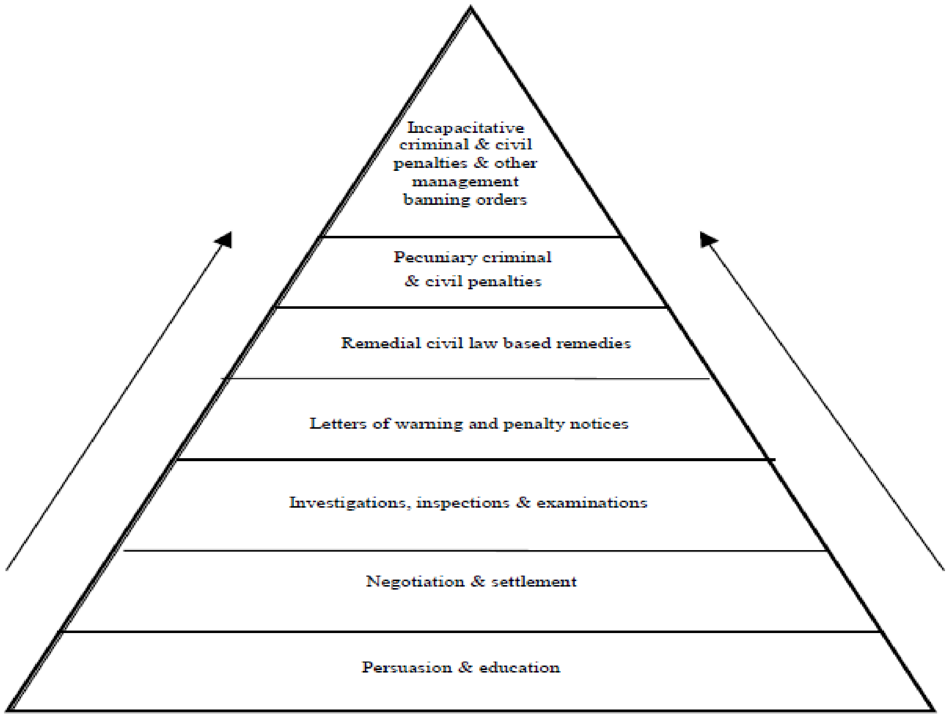
107. ASIC's general approach to regulation and enforcement is supported by the theory of "strategic" regulation. This is a key regulatory theory, on which significant parts of Corporate Law in Australia has been based[108] and which was developed by Professor Ian Ayres and John Braithwaite[109]. The strategic regulation model follows from an acceptance that regulators cannot detect and punish every contravention and hence must encourage intrinsic compliance[110]. Braithwaite summarised the approach as follows:

"My contention is that compliance is most likely when the regulatory agency displays an explicit enforcement pyramid. … Most regulatory action occurs at the base of the pyramid where initially attempts are made to coax compliance by persuasion. The next phase of enforcement escalation is a warning letter; if this fails to secure compliance civil monetary penalties are imposed; if this fails, criminal prosecution ensues; if this fails the plant is shut down or a licence to operative is suspended; if this fails, the licence to do business is revoked. The form of the enforcement pyramid is the subject of the theory, not the content of the particular pyramid." [111]

---

[104] Kell; T1030.45-1031.3.
[105] Counsel Assisting; T1007.45.
[106] Macaulay; T1904.20-30. It is important to note that ASIC's role as an industry regulator does not involve it in pursuing individual redress for consumers. Accordingly, consumers are generally referred by ASIC to an approved External Dispute Resolution service for the pursuit of such redress.
[107] Macaulay; T1904.32-38. In selecting which reports to formally investigate for possible enforcement action, ASIC considers a range of factors including the seriousness of the misconduct (including the harm that has occurred), strength of the available evidence, likely outcome of any available action relative to the resources required to pursue the matter, age of the misconduct and whether it is ongoing, extent to which the matter fits within ASIC's current strategic priorities and general and specific deterrent effect of taking action – see Exhibit 2.247.2 at p.4.
[108] See Vicky Comino, "Towards better corporate regulation in Australia" (2011) 26 *Australian Journal of Corporate Law* 1, p.7.
[109] John Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (Albany, NY: State University of New York Press, 1985). Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (New York: Oxford University Press, 1992).
[110] Welsh, M., "Civil Penalties and Responsive Regulation: The Gap between Theory and Practice" (2009) 33 *MULR* 908 at 910.
[111] Quoted in F Haines, Corporate Regulation; Beyond Punish or Persuade (1997) Clarendon Press, Oxford, 218. See also Australian Law Reform Commission Report Principled Regulation: Federal civil and administrative penalties in Australia (ALRC Report 95, December 2002)

108. In the strategic regulatory approach, enforcement action which incapacitates an individual or firm from further participation in the industry sits at the top of an "enforcement pyramid", and is used in response to "incompetent or irrational actors". This is illustrated by the example below of an enforcement pyramid depicting the enforcement options available to ASIC in relation to directors[112]. As can be seen, as the ultimate incapacitating action, banning orders sit above pecuniary criminal and civil orders.



109. While the effectiveness of 'strategic regulation' in the financial sector has been questioned[113], the 'enforcement pyramid' as an effective foundation for addressing corporate misconduct was endorsed by the June 2014 Report of the Senate Economics References Committee into the Performance of ASIC:

"The enforcement pyramid model of sanctions of escalating severity is a sound foundation for enabling a regulator to address corporate misconduct. The application of this model to Australia's corporate laws has generally proven effective[114]."

Application of strategic regulation

110. If, after investigation, misconduct is identified by ASIC, then it must make a decision as to which of the regulatory options available to it is best suited to the circumstances of the case and what it wants, and is able, to achieve within its resource constraints and strategic priorities[115].

---

[112] Gilligan, Bird and Ramsay, Civil Penalties and the Enforcement of Directors' Duties (1999) 22 *UNSWLJ* 417 at 428.
[113] See, for example, D Kingsford Smith, "A Harder Nut to Crack? Responsive Regulation in the Financial Services Sector" (2011) *University of British Columbia Law Review* 717.
[114] https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Final_Report/index - at [17.50]
[115] Exhibit 2.247.2 at p. 4.

111. In making a decision as to enforcement action, as is explained in ASIC Information Sheet 151: *ASIC's approach to enforcement*[116], ASIC will consider all the facts and circumstances of the matter, particularly the seriousness of the alleged contravention, and will generally consider criminal action for serious misconduct that is dishonest, intentional or highly reckless[117]. One factor in that decision is the likelihood that the business community will be generally deterred from similar conduct[118].

112. In considering its enforcement options, ASIC considers that bannings are an effective regulatory tool in the financial advice industry. They have a strong specific deterrent effect and, at least for the duration of the banning order, effectively prevent the recurrence of the offending conduct and protect consumers. Whilst the principal purpose of a banning is protective, bannings also have a strong punitive impact on an adviser's livelihood.

113. It is strongly arguable that bannings also have a general deterrent effect, because of their impact on individuals and the wide awareness of them in the advice industry. Although ASIC can make only limited public disclosure of the reasons for banning, they receive extensive publicity in industry media and are permanently recorded against an adviser's name on the Financial Advisers Register.

114. A civil penalty does not itself prevent an adviser from continuing to provide poor quality advice to Australian consumers and has historically, because of the relatively low level of penalties able to be imposed, been of limited punitive effect.

115. Criminal sanctions are an important feature of the regime and ASIC regularly undertakes criminal enforcement for more egregious misconduct. However, their deterrent effect in corporate crime is not well researched[119]. Such research as exists suggests that criminal sanctions on their own have only weak, variable and transient general deterrence effects (i.e. beyond the individual or entity sanctioned) and that the most effective deterrence results from a mix of regulatory strategies, including co-operative and educational components[120]. One Australian study on the impact of enforceable undertakings found that they were experienced by those undergoing them as involving significant cost and other burdens, well in excess of the penalties otherwise likely to be imposed[121]. ASIC's experience has

---

[116] Macaulay; Exhibit 2.247.3.
[117] Macaulay; Exhibit 2.247.3, p. 8.
[118] Macaulay; Exhibit 2.247.3, p. 9.
[119] Natalie Schell-Busey, Sally S Simpson, Melissa Rorie and Mariel Alper, "What works? A systematic review of corporate crime deterrence" (2016) 15(2) *Criminology & Public Policy* 387; John Braithwaite, "In search of Donald Campbell: Mix and multimethods" (2016) 15(2) Criminology & Public Policy 420; footnote 61 (p. 14) of the Kingsford-Smith report "A Harder Nut to Crack? Responsive Regulation in the Financial Services Sector" (2011) University of British Columbia Law Review 717.
[120] ibid
[121] In that regard, at T1923.7, Ms Macaulay expressed the view that the community benefit payments of $3 million each which ANZ and CBA undertook to make in the recent EUs were not large amounts for ANZ and CBA and, at T1927.21-36, expressed the view that they were nonetheless likely more than the level of penalties which might have been imposed if ASIC had taken proceedings in relation to that conduct. In considering that evidence, it should be noted that, of the potentially applicable civil penalty proceedings:

- s 12DB of the ASIC Act does not apply to disclosure documents including Statements of Advice, which was the medium by which an annual review was generally promised to customers;
- s 12DF of the ASIC Act requires the relevant misleading conduct to have a public character;
- s 12CB of the ASIC Act (unconscionable conduct) would likely require substantial evidence of knowledge in order to establish the requisite degree of moral obloquy; and
- s 12DI of the ASIC Act would require proof of intention or reasonable grounds for believing that, at the time of accepting payment, it would not be able to supply the service, in respect of specific, identified customers.

been that enforceable undertakings can play a significant role in changing industry behaviour as one component of a mix of approaches which also include other punitive and protective measures[122].

ASIC's evolving regulatory approach

116. ASIC's regulatory approach to the financial advice sector has involved a significant enforcement component. ASIC has thus, in the last 10 years:

a. banned 229 financial advisers from the industry[123];

b. accepted 33 enforceable undertakings from financial advisers providing for a range of remedies, including removing themselves from the industry (temporarily or permanently), engaging in further training and subjecting themselves to supervision regimes[124]; and 24 enforceable undertakings from licensees;

c. taken criminal action against 50 financial advisers[125];

d. cancelled 121 licenses and imposed licence conditions on 18 licensees[126]; and

e. commenced 6 civil penalty proceedings against licensees (all of which have been commenced in the last 3 years because this was not an option open to ASIC prior to the FOFA reforms)[127].

117. Over the last ten years, ASIC has given close scrutiny to its approach to regulation, both in the financial advice sector and more broadly, including in response to a range of inquiries and reviews, ASIC recognises that its approach needs to continually evolve.

118. Prominent features of ASIC's changing regulatory approach in recent years, for instance, have included:

a. a greater commitment to consumer remediation. ASIC has had a greater focus on obtaining remediation for financial advice customers in recent years and, since July 2011, has obtained over $1.6 billion in compensation and remediation for consumers. ASIC's approach has been driven by a view that a focus on remediation is a feature of a well operating market (recognising that the financial impact of misconduct on consumers can be substantial), the failure of firms (especially large firms) to implement appropriate remediation programs and the reality that the amounts paid in remediation are in many cases likely to be considerably larger than any

---

Further, on proof of contravention of one or more of the above sections, the Court would need to consider whether the course of conduct principle applied and, in the case of ANZ and CBA, the same central failing arguably existed in respect of the conduct (i.e. inadequate systems for tracking and ensuring provision of annual reviews). The maximum civil penalty for a single contravention would be 10,000 penalty units (i.e. depending on timing, between $1.8m and $2.1m). Further, in imposing a penalty, the Court would also take into account that both ANZ and CBA had remediated, or were in the process of remediating, customers for the incorrectly charged fees plus interest.

[122] Natalie Schell-Busey, Sally S Simpson, Melissa Rorie and Mariel Alper, 'What works? A systematic review of corporate crime deterrence' (2016) 15(2) Criminology & Public Policy 387 at 388-9; footnotes 44 (p. 10) and 58 (p. 14) of the Kingsford Smith report "A Harder Nut to Crack? Responsive Regulation in the Financial Services Sector" (2011) University of British Columbia Law Review 717.

[123] Macaulay; Exhibit 2.247 at [20].

[124] Macaulay; Exhibit 2.247 at [33]. See also Ms Macaulay's evidence at T1916.28-40, where she explains that ASIC only accepts an enforceable undertaking where it considers that it will give a better outcome than any alternative enforcement outcome.

[125] Macaulay; T1925.30-41. See also per Counsel Assisting at T1015.40.

[126] Macaulay; Exhibit 2.247 at [43].

[127] Bearing in mind that it has only had power to do so since 1 July 2013 – see Macaulay; T1924.27.

penalty obtained through enforcement action. ASIC recognises, however, that a greater focus on remediation is often resource intensive, which diverts ASIC's resources from other activities; and

b. greater transparency in relation to enforcement action*.* ASIC has in recent years taken steps to increase transparency in its dealings with financial firms (although it is constrained in doing so to a significant extent by legislative confidentiality requirements). For example:

   i. since 2014, ASIC has issued a public release in relation to all regulatory outcomes (whether achieved through court action, administrative action or by agreement);

   ii. ASIC has strengthened its practices in relation to publicity and enforceable undertakings; its regulatory guide[128], for instance, now provides for public reporting on compliance with enforceable undertakings (including the release of public summaries of independent expert reports obtained pursuant to an EU);

   iii. in 2012, ASIC published its enforcement policy, which sets out its decision-making framework for enforcement action[129]; and

   iv. since 2011, ASIC has published twice-yearly enforcement reports, which provide an overview of ASIC's enforcement outcomes in the previous six months.

c. a focus on large institutions (including in relation to 'legacy issues'*).* ASIC has for several years had a major program underway to address the quality of advice in large institutions, particularly the big four banks, AMP and Macquarie. While this has incorporated work on current practices, it has also included a significant 'backward looking' component to ensure that high risk advisers are identified and appropriate action taken, that systems are improved for the future, and that customers are appropriately remediated[130]; and

d. the greater use of industry data in its regulatory work.[131]

119. ASIC has also increasingly sought pro-actively to address cross-industry issues as part of its regulatory activity, alongside its regulatory actions against individual firms or advisers. This has included a number of large, pro-active surveillance programs that have resulted in public reports highlighting industry-wide issues and have in most cases been followed by significant review and remediation, enforcement activity or law reform. In the last four years, for instance, these have included:

---

[128] ASIC Regulatory Guide 100: *Enforceable undertakings* - http://download.asic.gov.au/media/2976014/rg100-published-19-february-2015.pdf.

[129] Exhibit 2.247.3 (INFO 151: *ASIC's approach to enforcement*).

[130] See, for instance, the work reported in ASIC Report 515 *Financial Advice: Review of how large institutions oversee their advisers*; Exhibit 2.1.9.

[131] For instance, ASIC's life insurance lapse data project was established in September 2016 to make greater use of data to focus ASIC's surveillance of life insurance advice. Under that project, ASIC receives reports from life insurers that list the names of advisers who meet specific thresholds relating to lapsed policies. ASIC then analyses these reports and other data to identify "high risk" advisers for further surveillance and achieved a number of regulatory outcomes based on that analysis – see Kell; Exhibit 2.1 at [226(b)]

a. ASIC Report 413: *Review of retail life insurance advice* (October 2014)[132] – which identified an industry-wide problem with the impact of adviser conflicts of interest on the quality of life insurance advice;

b. ASIC Report 499: *Financial advice: Fees for no service* (October 2016)[133] – which identified systemic issues at AMP, ANZ, CBA, NAB and Westpac in relation to the charging of ongoing advice fees to customers without providing that advice and led to ASIC engaging with those licensees both to effect improvements to their monitoring and compliance systems to ensure that this did not recur and to ensure that affected customers were fully remediated (a process which has to date resulted in payments being made or agreed to be made to over 305,000 customers totaling more than $216 million[134]);

c. ASIC Report 515: *Financial advice: Review of how large institutions oversee their advisers* (March 2017)[135] – which considered the way in which the five largest licensee groups (the four major banks and AMP) monitored and supervised their advisers. The study identified 149 financial advisers for whom there were "serious compliance concerns"[136], almost half of whom (73) had not previously been the subject of any notification to ASIC and approximately 60 of whom have been banned, or are in the process of being considered for banning[137];

d. ASIC Report 562*: Financial advice: Vertically integrated institutions and conflicts of interest* (January 2018)[138] – which considered how the five largest banking and financial institutions dealt with the conflict of interest that exists when they are engaged in both providing personal financial advice to clients and manufacturing financial products. The study found that, in 75% of the advice files reviewed, the advisers did not demonstrate compliance with the duty to act in the best interests of their clients, including by "switching" clients from external to in-house products where the pre-existing product appeared to be suitable to meet the client's needs and objectives; and

e. ASIC Report on SMSF Advice (Pending)[139] – this project obtained and then assessed 250 client files in total, from 137 different licensees who had advised the client to set up an SMSF. The study found that in 91% of the files, the adviser did not demonstrate compliance with the requirement to provide advice that complies with the best interests duty and related obligations.

120. A fundamental element of the regulatory regime is the responsibility that licensees have to ensure compliance by their businesses and advisers with the financial services laws. However, it is apparent from ASIC's experience, including the subject of the above ASIC Reports, that licensees have not consistently fulfilled that role. Accordingly, in recent years, ASIC has had to become increasingly 'hands on' in undertaking large-scale, pro-active surveillance to expose compliance failures by the large licensees and then engaging

[132] Exhibit 2.1.8.
[133] Exhibit 2.1.1; see also Kell; Exhibit 2.1 at [172]-[173], [204].
[134] Kell; Exhibit 2.1.3.
[135] Exhibit 2.1.9; see also Kell; Exhibit 2.1 at [174], [204].
[136] Being advisers whom the licensee believed on credible information had engaged in dishonest conduct, had deliberately not complied with the law or were grossly incompetent.
[137] Macaulay; T1925.43-1926.18.
[138] Exhibit 2.1.7; see also Kell; Exhibit 2.1 at [214]-[218].
[139] Kell; Exhibit 2.1, Annexure A.

substantively with them to achieve the review and remediation of service failures and the improvement of monitoring and compliance systems. This approach has achieved substantial change, but it has also had significant resource implications for ASIC.

121. These resource implications are significant in part because the identification and investigation of advice failures is resource intensive[140], requiring ASIC to undertake a process[141] which entails, for each adviser being investigated, a detailed, expert assessment of a significant number of client files for compliance with the law. Moreover, in practice, this process has often been made more difficult, costly and time-consuming by:

a. undue delay by licensees, both in identifying adviser misconduct and in reporting it to ASIC[142];

b. delays by licensees in responding to notices for the production of documents[143];

c. poor record-keeping by the adviser or licensee[144]; and

d. failures on the part of licensees to share the details of misconduct by their advisers with ASIC, including by asserting legal professional privilege in relation to reports as to the outcome of internal investigations[145].

Regulatory culture and ASIC

122. With regard to regulatory culture and the role of ASIC, ASIC's regulatory approach and regulatory culture are not fixed or static, but continue to evolve as the regulatory challenges which it faces change with its assessment of where the risks of harm being done to consumers are at their greatest. Having identified those challenges, ASIC endeavours to make use of the powers which it has, to achieve the best possible results with its available resources. Some of these ongoing changes to ASIC's regulatory approach are set out above.

123. Recent law reforms announced by the Government will significantly expand ASIC's enforcement capabilities in this area. These reforms relevantly include:

a. strengthening the obligations to report significant breaches;

b. making s 912A a civil penalty provision;

c. substantially increasing penalties;

d. expanding ASIC's powers to ban an individual from being a senior manager or controller of a financial services business;

e. giving ASIC a temporary product intervention power[146]; and

f. giving ASIC power to make directions to licensees to take or refrain from taking specific action in the conduct of their businesses.

---

[140] Macaulay; Exhibit 2.247 at [18]; T1908.45-1909.26; Kell; Exhibit 2.1 at [193]; see also Britt; T1609.43.

[141] Of course it is possible that some of these steps may be attenuated in what were referred to in Ms Macaulay's oral evidence as "jaw-dropping" cases – T1909.43-1910.2. Even in such cases, however, it remains incumbent on ASIC to take steps to identify the full extent of the misconduct in question (including identifying which customers may have been affected by it) and to prepare a thorough brief of evidence, whether to support a banning by an ASIC delegate or to provide a body of admissible evidence for a Court to make serious findings of misconduct (to the appropriate level of satisfaction).

[142] Macaulay; Exhibit 2.247 at [15].

[143] Kell; Exhibit 2.1 at [165].

[144] Macaulay; T1925.16.

[145] Macaulay; T1925.14-28.

[146] Kell; Exhibit 2.1 at [229].

124. These changes will be able to be, and will be, deployed by ASIC to help ensure that ASIC's decisions about regulatory action can be better targeted at reducing misconduct and minimising harm to consumers, for instance:

a. the enhanced obligation to report significant breaches will help to ensure that ASIC's regulatory action is more timely and effective;

b. the ability to take action against management and executives, as well as the power to direct remediation, will reduce the diversion of ASIC's resources to remediation activity and provide greater resources for taking enforcement action; and

c. this and the changes to make s 912A a civil penalty provision will enable ASIC to seek a broader range of (increased) penalties and remedies for breaches of the law.

125. A further law reform measure which might be considered by the Royal Commission and which would enhance the transparency and denunciatory impact of the banning process would be to provide for:

a. an entry to be made in the Financial Advisers Register on the sending out by ASIC of notice to an adviser of a hearing to consider whether a banning order will be made[147]; and/or

b. the publication by ASIC of the ASIC delegate's reasons for decision.

Regulatory culture and industry

126. With regard to regulatory culture and the role of the licensee, the case studies heard by the Royal Commission in the current round of hearings have served to illustrate the experience of ASIC that:

a. although many of the banking and financial services institutions regulated by ASIC publicly state that their core values include being customer focused, 'doing what is right' for customers and acting with integrity, the reality of their conduct does not always reflect that professional ethos[148];

b. a substantial impediment to effective regulation of the industry has been the failure by licensees fully and consistently to engage with, and fulfill, their role and responsibilities to ensure that they and their advisers behave towards their customers in accordance with the standards which the community expects and the law requires[149];

c. there are a range of circumstances in which ASIC has found that the large financial services entities too often engage with it in a manner which is less than constructive, including by:

i. responding to requirements to change their practices, or remediate customers, in an overly technical or legalistic way, rather than by acting fairly so as to produce good outcomes for their customers[150];

---

[147] It is to be noted that, in an analogous situation, rule 15-1 of the *Insolvency Practice Rules (Corporations) 2016* provides that particulars of any disciplinary action taken against a liquidator must be entered in the Register of Liquidators. As stated in the Explanatory Statement - https://www.legislation.gov.au/Details/F2016L01989/Explanatory%20Statement/Text - "*Placing any disciplinary action taken by ASIC against the practitioner on the public register will assist in improving community confidence in the regulation of practitioners by making the timing of disciplinary matters transparent*".

[148] Kell; Exhibit 2.1 at [203].

[149] Kell, Exhibit 2.1 at [196]; see also, for example, T1115.16-19 (AMP); T1724.20-24 (ANZ).

[150] Kell; Exhibit 2.1 at [38]-[39], [156], [158], [173(g)].

ii. failing to notify ASIC of advisers identified by them as being subject to serious compliance concerns, so that a significant number of those advisers were able to continue to be active in the industry, without ASIC being made aware of those concerns[151].

127. As to what changes in the regulatory culture within licensees might assist in reducing the incidence of misconduct in the industry, in ASIC's view such changes must start at the top, with a firm commitment by the Boards and senior management of licensees to put compliance with their legal and ethical duties to customers at the forefront of the organisation's priorities, and then permeate every aspect of the engagement of licensees with their financial advisers, including in their recruiting, training, monitoring and supervision, and remuneration. At the individual adviser level, what is required is the sincere adoption of proper professional standards, as contemplated by the pending reforms required by the *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017*.

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 a separation of products and advice? (Q 27)

128. ASIC Report 562: *Financial advice: Vertically integrated institutions and conflicts of interest*[152] considered how five of Australia's largest banking and financial services institutions dealt with the conflict of interest that exists when they are engaged in both providing personal advice to clients and manufacturing financial products.

129. This is a business model that is used in various forms across the financial advice industry and, more broadly, across the financial services sector. In ASIC's view, that business model can provide benefits to consumers such as consumer convenience in dealing with a single institution across a range of financial matters, or having a large institution "standing behind" the adviser if remediation is required for poor advice.

130. As was pointed out in ASIC Report 562[153], the conflict between the interests of the vertically integrated licensee and the interests of the customer is most significant when:

a. the licensee decides which products to include on its approved product list; and

b. the adviser decides which products to recommend to an individual customer.

131. In that regard, ASIC Report 562[154]:

a. identified a clear weighting in the products recommended by advisers towards "in-house" products; and

b. found that, in 75% of the advice files reviewed, the advisers did not demonstrate compliance with the duty to act in the best interests of their clients, including by "switching" clients from external to in-house products in circumstances where the pre-existing product appeared to be suitable to

---

[151] Kell; Exhibit 2.1 at [174]; see also, for example, T1312.25-39 (CBA); T1440.31-1441.13 (Westpac); T1939.38-1940.2 (AMP).
[152] Exhibit 2.1.7.
[153] Ibid at [77].
[154] Ibid at [16], [26]. Part C and Part D

meet the client's needs and objectives.

132. So too, in the advice reviews conducted for ASIC Report 515, ASIC identified a higher level of non-compliant advice where advisers recommended an in-house product compared to where an adviser recommended an external product[155].

133. These findings clearly indicate that there remain significant challenges in the financial advice sector around effectively managing the conflicts of interest that are inherent in vertically integrated businesses. Some of the advice seen by ASIC in these firms is non-compliant and does not appear to prioritise the interests of the client.

134. ASIC Report 562 concluded[156] that licensees should:

a. collect and regularly analyse data on the products recommended by advisers, both generally and individually; and

b. assess why their advisers are recommending such a large proportion of customer funds be invested in in-house products, and whether all necessary controls are in place and working effectively to ensure that conflicts of interest are appropriately managed, including through appropriate remuneration arrangements, training and supervision of advisers, and ensuring that their processes to allow advisers to provide advice on external products are not unduly onerous or difficult to comply with.

135. Further, as explained in ASIC Report 562[157], ASIC is:

a. working on a proposal to introduce public reporting on approved product lists and where client funds are invested, to provide some transparency; and

b. discussing, with each of the licensees studied in ASIC Report 562, an appropriate response to its findings, including consideration of the licensees' conflict management arrangements.

136. This work is in its early stages but it is expected that it will provide further information which will better inform ASIC's views as to the extent to which, and how, the conflict of interest in question can be properly managed (e.g. through disclosure and control measures). ASIC also has plans to undertake further work on services provided by vertically integrated firms in other parts of the industry, including financial advice in superannuation funds.

137. Pending the outcome of that work, ASIC's present view is that:

a. it should be possible for licensees to effectively manage the conflicts of interest associated with providing personal advice to clients and manufacturing financial products; and

b. it should not be necessary to enforce the separation of products and advice.

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? (Q 28)

138. ASIC's position in relation to the exclusions from the conflicted remuneration regime is set out in the evidence of Mr Kell[158].

---

155 Ibid at [26].
156 Exhibit 2.1.7 at [175]-[181].
157 Ibid at [183]-[185].
158 Kell; Exhibit 2.1 at [96]-[100]; T1042.6-16.

139. That position is that, in principle, any exception to the ban on conflicted remuneration, by definition, has the ability to create misaligned incentives, which can lead to inappropriate advice.

140. In setting the parameters of the ban on conflicted remuneration in the FOFA reforms, the then Government said that it had been guided by the dual objectives of, on the one hand, minimising distortions to remuneration which misaligned the best interests of the client and the adviser while, on the other hand, ensuring that financial advice was not put out of the reach of those who would benefit from it[159].

141. At the time that the FOFA reforms were implemented, life insurance commissions were largely excluded from the operation of the ban on conflicted remuneration. In October 2014, ASIC published its Report 413: *Review of retail life insurance advice*[160], which found non-compliant advice in 37% of sampled files and that there was a correlation between non-compliant advice and upfront commission models (compared to hybrid, level or no commission models). ASIC concluded that the impact of adviser conflicts of interest on the quality of life insurance advice was an industry-wide problem.

142. In 2015, following the Trowbridge Report, additional reforms were announced to remuneration arrangements in the life insurance sector. Under those reforms, effective from 1 January 2018, upfront commissions will be progressively lowered and capped. ASIC will be reviewing the impact of these reforms on the quality of advice in 2021 and has started gathering data for this review[161]. The Government has said that if the ASIC review does not show improvements in the quality of advice, it will move to mandate level of commissions[162]. In ASIC's view this course of action should ensure that any further reforms are firmly supported by evidence as to the impact of the current reforms.

143. In addition, ASIC is currently formulating a project to look into aspects of the ban on conflicted remuneration, which is likely to choose one or more of the exemptions and consider their operation and the effect they are having on the quality of advice being provided to clients[163].

144. ASIC accepts that it can be argued that some of the individual exemptions are limited in their scope and impact, but is concerned that the combined effect of the exemptions and the grandfathering arrangements means that there is still a significant pool of conflicted remuneration in the financial advice industry.

145. In that regard, it notes that the evidence given in the present round of hearings included:

a. evidence of NAB that, in each year since 2013, NAB and its associated licensees had paid hundreds of millions of dollars, in some years in excess of $500 million, in permitted conflicted remuneration, including by way of asset-based fees for advice, life insurance commissions, grandfathered investment commissions, and incentive payments calculated by reference to revenue generated by advisers[164];

---

159 See *The Future of Financial Advice Information Pack* (26 April 2010) - http://ministers.treasury.gov.au/Ministers/ceba/Content/pressreleases/2010/attachments/036/Future_of_Financial_Advice_Information_Pack.pdf.
160 Exhibit 2.1.8.
161 Kell; Exhibit 2.1 at [100(a)].
162 Ibid.
163 Kell; Exhibit 2.1 at [96].
164 Barnwell (NAB); Exhibit 2.8, [80]-[88] & Annexure A, Section 1; Counsel Assisting; T1050.27.

b. evidence of Westpac that, in each year since 2013, it had made payments of around $200 million in permitted conflicted remuneration, including by way of grandfathered commissions in relation to superannuation, investment loans, investments and platform products, grandfathered volume based payments and commission payments made in respect of life insurance products [165].

146. Pending further work by it in the area, ASIC is presently most concerned about the carve outs from the conflicted remuneration regime of:

a. grandfathered commissions[166]; and

b. timeshare products[167].

147. ASIC is also concerned, based on its FFNS and other experience (which has tended to be confirmed by much of the evidence adduced in the present round of hearings) that conflicted remuneration structures which are tolerated under the present regime on the basis of an assumption of transparency and fully informed consent should be looked at more closely. These would include, for instance:

a. benefits given by a client authorising a payment from a product issuer or platform provider to a licensee (which can be analogous to commissions and which may be passed on by the licensee to an adviser)[168]; and

b. asset-based fees, which can have the undesirable effect of dis-incentivising an adviser from recommending strategies which might reduce assets under advice (e.g. selling investment assets to pay down debt).

Peter Collinson QC
Mark Steele SC
Conor Bannan
Christopher Tran

Counsel for ASIC
7 May 2018

[165] Wright (Westpac); Exhibit 2.10, [24]-[31] & Schedule 1.
[166] See ASIC's submissions in that regard in answer to question 3 above.
[167] Kell; Exhibit 2.1 at [100(b)].
[168] See s 963B(1)(d) and s 963C(e) of the *Corporations Act 2001* and regulations 7.7A.11C(1)(d), 7.7A.11C(2)(d), 7.7A.11D(1)(d) and 7.7A.11D(2)(e) of the *Corporations Regulations 2001.*