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ASIC Enforcement Review
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: asicenforcementreview@treasury.gov.au

19 May 2017

Dear Panel Members,

AFA Submission – Self reporting of contraventions by financial services and credit licensees

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

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

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

Summary of the AFA’s position

The AFA agrees with the Taskforce’s position that the primary purpose of the existing breach reporting regime is to enhance ASIC’s intelligence and better enable it to carry out its functions. This is a necessary function of the co-regulatory model to assist the regulator to distribute resources where they are needed. The AFA supports the majority of the Taskforce’s proposals to improve the breach reporting system and to support the Taskforce’s positions recommends that:

1. ASIC support a co-operative approach by licensees by using Regulatory Guide 78 as the means to provide clear and unambiguous guidance about breach reporting requirements;
2. ASIC be required to include within Regulatory Guide 78 better and more examples of specific breach reports received and when the 10-day reporting timeframe begins to help guide the regulated population’s appreciation and understanding of what constitutes a reportable breach;
3. Regulatory Guide 78 not duplicate the requirements of the professional standards regime with regard to Continuing Professional Development;
4. the Taskforce ensure ASIC includes general information about qualified privilege within its update of Regulatory Guide 78;
5. pecuniary penalty points could be increased for licensee offences provided that a more appropriate system of calculating penalties were implemented.
6. penalties be based on the size of the licensee, the financial impact of the breach and take into account mitigating effects such as the extent of the licensee’s cooperation in order to be an appropriately proportionate incentive to maintain good standards;
7. the Taskforce consider creating separate levels of breach reporting forms with the first report required to be lodged within 10 days outlining the basic information and a subsequent form and timeframe to submit further supporting information and documentation; and
8. to reduce duplication, the proposed credit licensee breach system and the financial services licensee reporting system should interact effectively and allow for efficient reporting across both systems rather than to lodge separate reports for the same affected clients.

Particular recommendations of the AFA

The AFA considers that to better protect consumers of financial services in Australia and engage licensees more effectively in the co-regulatory approach, the following measures should be recommended by the Taskforce to the Government:

Taskforce Position 1: The ‘significance test’ in section 912D of the Corporations Act 2001 (Cth) should be retained but clarified to ensure that the significance of breaches is determined objectively.

The AFA supports this position as it should bring greater clarity and consistency to breach reporting by licensees. The AFA considers the significance test to be a difficult test to apply across licensees and largely results in too much reference on the licensee’s size, scale and complexity rather than focusing on the type of breach and the consequences for the client, licensee and adviser. While imperfect, the AFA acknowledges that the significance test aims to strike a fair balance between the interests of consumers, individuals and licensees. Accordingly, the Taskforce’s proposal to remove subjectivity from the test is a welcome development and should go some way to taking the variability out of the level of and approach to breach reporting.

The AFA contends that breaches also go unreported in businesses with low ethical standards or where incentives are offered to avoid consequences. The focus on making the significance test more of an objective interpretation should not be the sole method to improve reporting. The AFA recommends that Regulatory Guide 78 be amended to include examples of where reporting should take place. Whilst we acknowledge that attempt has been made to clarify examples within paragraphs 29.1 to 29.8 of the Position and Consultation Paper, there are several difficulties with some of these options and categories.

The AFA supports better guidance being included in Regulatory Guide 78 to help licensees understand the types of situations and behaviours that ASIC would consider are reportable. Many of those suggested at paragraphs 29.1 to 29.8 are helpful and could form the basis of the first redraft of the Guide. The AFA recommends that ASIC be required to include within future revisions of the Guide generalised but de-identified examples of specific breach reports received by ASIC to help guide the regulated population’s appreciation of what constitutes a reportable breach and supplement the significance test definition.

Taskforce Position 2: The obligation for licensees to report should expressly include significant breaches or other significant misconduct by an employee or representative.

The AFA supports this proposal as a measure to bring some clarity to the system. For small licensees, their advice firm is the vehicle by which they provide their professional services and

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therefore can be an extension of their own identity. Creating this express obligation should put large licensees on the same level as small licensees by removing the incorrect distinction in their minds that only licensee breaches are reportable, while employee or representative breaches are not.

The AFA supports the inclusion of examples of individuals' conduct that should be considered to generally reportable, but the four examples provided at paragraphs 38.1 to 38.4 are not without their issues. For example, the perception of what is a fit and proper person is often subjective without some guidance as to the types of conduct and behaviours that could be considered as a deficiency to this requirement. Further, whilst it is admirable to include a requirement that licensees should self-report where their representatives are discovered to not be adequately trained, qualified and competent, many may use the significance test as a means to permit remediation over reporting. It should not be overlooked that the professional standards regime is going to require licensees to report advisers' failure to complete Continuing Professional Development requirements.

Accordingly, the AFA recommends that ASIC be required to include within the Regulatory Guide 78 further generalised but de-identified examples of individual conduct deemed to be reportable, but that which does not duplicate the requirements of the professional standards regime.

Taskforce Position 3: Breach to be reported within 10 business days from the time the obligation to report arises.

The AFA supports the proposal to make the reporting timeframe start when the licensee becomes aware of all breaches or possible breaches which will give licensees 10 business days to determine the significance of the breach. The AFA considers this is a better approach than the existing one where licensees are interpreting their obligation as beginning from when they determine that the breach is a significant one.

The AFA also considers there is merit in extending the reporting trigger to where the licensee "has information that reasonably suggests" a breach has or may have occurred, as in the United Kingdom's approach to self-reporting. When accompanied with greater awareness of the qualified privilege defence, this could increase the effectiveness considerably. The AFA is concerned, however, that this may result in licensees taking the easier option of erring on the side of caution and reporting every situation they come across that is less than optimally compliant – thereby increasing ASIC's workload considering breach reports, which under the industry funding model may result in firms' costs increasing and having a contingently adverse impact on the future accessibility of financial advice. If such a measure is to be taken by the Taskforce, the AFA

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recommends clear guidance of the types of situations that would 'begin the reporting clock' so to speak, which again, should be updated to reflect ASIC's experiences.

Taskforce Position 4: Increase penalties for failure to report as and when required.

Taskforce Position 5: Introduce a civil penalty in addition to the criminal offence for failure to report as and when required.

Taskforce Position 6: Introduce an infringement notice regime for failure to report breaches as and when required.

The AFA considers that the current penalty regime for failing to comply with reporting obligations is unsatisfactory. Permitting imprisonment for failing to report a breach can be disproportionate in many cases for the scale of the infraction and may not be an appropriate deterrence given that many in the industry are not aware there are criminal sanctions and offences for failing to lodge a breach report. Further, with the degrees of interpretation highlighted by the Taskforce, the AFA does not consider that imprisonment for a difficult to understand (and somewhat vague) obligation is fair. The AFA supports criminal offences for misleading a regulator and supports the court's ability to imprison people for serious crimes such as fraud and theft, but failing to comply with an administrative requirement should not attract criminal sanctions.

The AFA agrees, however, with the Taskforce's position that the obligation to report is important and it should carry pecuniary penalties to reflect the importance and act as an effective deterrence. Financial services companies stand up and take notice of pecuniary penalties because it hits their bottom line and hurts them. Having said that, we also recognise that insolvency laws unfortunately remain attractive for firms to engage in misconduct and avoid pecuniary penalties or compensation awarded against them, which is why we have called for reform to insolvency laws to deter this sort of behaviour and make directors of those companies more accountable for abhorrent corporate behaviour.

To improve the measures that support the breach reporting regime, the AFA agrees that ASIC should have the power to issue infringement notices in order to apply judgement in exercising its enforcement mandate. Whilst we recognise that there may be moral hazard in introducing an infringement notice regime to deal with simple or minor contraventions of breach reporting obligations, the AFA considers the benefits to outweigh the risks of deliberate under-reporting. Introducing an infringement notice system would be a step in the direction of effective co-regulation because it recognises that oversights are unfortunately a by-product of a complex and difficult to understand system and is therefore a standard of trust in the regulated population.

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If infringements are to be issues for breaches of reporting obligations, the AFA also considers that pecuniary penalty points could be increased for licensee offences provided that a more appropriate system of calculating penalties were implemented. The AFA recommends penalties be based on the size of the licensee, the financial impact of the breach and take into account mitigating effects such as the extent of the licensee's cooperation in order to be an appropriately proportionate incentive to maintain good standards.

Taskforce Position 7: Encourage a co-operative approach where licensees report breaches, suspected or potential breaches or employee or representative misconduct at the earliest opportunity.

The AFA considers that this is where Regulatory Guide 78 can come to the forefront as a means of understanding the regulator's mindset and expectations. This should be a living document or accompanied by an annexure that is regularly updated to bring clarity to the situations where ASIC considers situations to be reportable. Currently, aside from eight example cases that cover just a proportion of the range of conduct that is reportable, the Regulatory Guide could be significantly enhanced with practical guidance to help with interpreting the obligation to report.

Whilst we appreciate ASIC's reluctance to be seen to be providing legal advice to its regulated population, the regulator's clear and unambiguous guidance has been more valuable to the Australian community than academic interpretations of ASIC's role as regulator. The licensee population and adviser population wants to know what they should and should not do. They want to know this from the regulator, just as much as students want to know this from their teachers and vocational trainers. Providing guidance does not equate to holding their hand. Clear unambiguous guidance is the foundation for licensees to develop understanding and self-determination in regulatory compliance matters.

Regulatory Guide 78 should be a companion document to ASIC's Information Sheet 172 – Cooperating with ASIC by setting out the way in which ASIC assists its regulated population to understand its obligations. Accordingly, the AFA supports measures for licensees to adopt a co-operative approach to their regulator. To this end, the AFA recommends that the regulator take a similar approach with its guidance to the regulated population by using Regulatory Guide 78 as the means to provide clear and unambiguous guidance about breach reporting requirements.

Taskforce Position 8: Prescribe the required content of reports under section 912D and require them to be delivered electronically.

Whilst the AFA acknowledges that not every breach report will, or should, look identical because they should reflect the subjective circumstances of the incidents and behaviour being reported, the

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current FS80 form can be difficult to understand, which underscores the variability in quality of breach report information reported by ASIC. The AFA agrees that prescribing a greater level of detail and the types of information that should be included in the report could in many cases improve ASIC's understanding and assessment of the report, the FS80 form is already a lengthy and somewhat repetitive document. The solution to improving breach assessments may be to create separate levels of reporting forms with the first report required to be lodged within 10 days outlining the basic information and to create a requirement to then submit further supporting information and documentation within a reasonable timeframe thereafter.

The AFA recommends the Taskforce consider this solution as one option to improve the effectiveness of breach reports, but acknowledges it may not be the solution that resolves the issue for all reports. However, by staggering the information tranches over time within timeframes that reflect the impact on consumers the breach reporting function could become more manageable for licensees and create a more reliable information gathering system that accommodates the different structures of licensees and knowledge management systems used by licensees and advice firms.

As for electronic reporting, the AFA supports this measure. Whilst we appreciate that some advice practices have substantial volumes of records that have yet to be digitised, the systems employed by financial product providers over the last seven years have favoured electronic lodgement with increasing frequency. Further, more and more advice practices are seeking technological solutions to drive efficiencies within their firms. Accordingly, the need to scan hard copy documents in order to submit a breach report will become less and less likely over time.

Taskforce Position 9: Introduce a self-reporting regime for credit licensees equivalent to the regime for AFS licensees under section 912D of the Corporations Act.

The AFA supports this proposal because a portion of financial advisers are also mortgage brokers and there is uncertainty in those firms about their respective obligations when dealing with clients who may receive both credit services and financial services. As more advice firms broaden their services to their client base as the professional standards regime is implemented and move firms more toward strategic and/or holistic advisory services, the need for consistency and certainty around compliance and notification will increase. The AFA recommends that to reduce duplication, the two systems should interact effectively and allow for efficient reporting across both systems rather than separate reports for the same client(s).

Taskforce Position 10: Ensure qualified privilege continues to apply to licensees reporting under section 912D.

The AFA agrees with this position. In order for the breach reporting regime to be effective, people with the responsibility within licensees to lodge breach reports and audit representatives should be free to disclose fulsome information to ASIC about individuals in compliance with the licensee's obligations without fear of reprisals from the subject of the report. The AFA is concerned, however, that this privilege is not referred to in Regulatory Guide 78 and the omission impacts the effectiveness of the regime.

Licensees use Regulatory Guide 78 as the primary source of guidance on their breach reporting obligations. If they were to be informed about the existence of the privilege and what the High Court's interpretation of the privilege is, then they are likely to feel less reserved about disclosures – especially when the disclosures may be about prominent individuals. Accordingly, the AFA recommends the Taskforce to ensure ASIC includes general information about the privilege within its update of Regulatory Guide 78.

Taskforce Position 11: Remove the additional reporting requirement for responsible entities.

The AFA supports measures that address unnecessary duplication in the regulatory framework. Accordingly, provided that removal of additional reporting requirements upon responsible entities captures the current level of reporting or improves the level of self-reporting by responsible entities, the AFA would support the Taskforce's position. The AFA prefers that all breaches by responsible entities should be self-reported under section 912D of the Act rather than the current requirement where duplicate reports under s912D and section 601FC(1)(l) may need to be made.

Taskforce Position 12: Require annual publication by ASIC, of breach report data for licensees

While the AFA supports publication of aggregate breach report data, the AFA does not support the public naming of individuals who have been reported to ASIC for contraventions or possible breaches, nor the proposal to identify licensees who submit a particular threshold of reports.

Aside from being an intelligence gathering measure, the purpose of breach reporting is to inform the regulator with the distribution of limited resources to oversee the regulated population. Annual reporting of identifying breach report contents would only provide the media with news which has historically not always been subjected to balanced reporting. The AFA considers that publication of identifying breach report contents would have a substantial effect on small advice firms whose relative infraction may not be distinguished in the eyes of the community. Further,

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as the system requires reporting of possible breaches that have not been confirmed to be a breach of financial services laws, publication of breach report contents and naming of individuals and firms may be unfairly or informedly perceived by the public and media to be an attribution of wrongdoing where there may not be any.

The AFA considers that extending the current level of breach reporting data to the licensee level would unfairly punish larger licensees who have more representatives and therefore more likely to have reportable breaches. Requiring ASIC to publish breach reporting data at a licensee level would involve setting a threshold that would likely be an arbitrary threshold and would be unlikely to allow effective comparison or improve consumer decision making.

The AFA considers the current approach to identifying individuals and firms that have been convicted of criminal offences and civil action taken by ASIC appropriately informs and protects the community from individual misconduct. The approach set out in ASIC's Information Sheet 152 is a fair and measured approach to public comment on action taken by ASIC. Further, the current manner of aggregate breach report data in ASIC's annual reports assists the Government to monitor the scale of regulatory issues in the sector and therefore contribute to assessments of the effectiveness of the regulator.

Concluding comments

The AFA considers the Australian consumer protection regime to be one of the most robust and rigorous in the world, partly as a result of the co-regulatory approach and the contribution of self-reporting to licensee obligations. However, the self-reporting system has been subject to differing interpretations and as a result differing effects upon advisers and licensees. This has contributed to the community's loss of confidence in the sector. Accordingly, the AFA welcomes the Taskforce's review of contravention self-reporting and recommends the Taskforce adopt some minor changes to the proposed positions.

The AFA recommends that Regulatory Guide 78 be revised to provide clearer, practical guidance to the regulated population about the breach reporting obligations. The AFA also supports reforming the penalty system for failing to meet the reporting obligations and suggests a tiered approach would better reflect the nature of the administrative obligation as well as the difficulty in understanding the requirements. Further, a more structured approach to the content of reports would likely in the AFA's view overcome many of the difficulties faced by ASIC and licensees in collecting breach report information and assessing the issues involved. The AFA considers these reforms necessary to increase the certainty, efficiency and effectiveness of the self-reporting system.

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If you require clarification of anything in this submission, please contact us on 02 9267 4003.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'P. Kewin', written in a cursive style.

Phil Kewin
Chief Executive Officer
Association of Financial Advisers Ltd