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# Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2020 Measures)) Regulations 2021: Breach Reporting

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

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

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

## Introduction

We thank you for the opportunity to provide feedback on the draft Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2020 Measures)) Regulations 2021: breach reporting regulation.

We start by making the point that the AFA supports the self reporting of significant breaches. We believe that this is an important part of the financial services regulatory regime and serves to protect the interests of consumers of financial services.

In our view, this consultation process is an important opportunity to reduce what we see as a substantial increase in the scale and complexity of the new breach reporting regime that has been introduced as part of the Financial Sector Reform (Hayne Royal Commission Response) Bill 2020. We have set out below our

concerns about the complexity and impact of this new regime. We believe that the impact is much greater than was appreciated when the Bill was drafted, and we have therefore recommended that the Government consider a deferral of the commencement of this new regime.

In the December 2017 final report from the ASIC Enforcement Review Taskforce, they concluded that Breach reporting should continue to be based upon significant breaches as follows:

> *The Taskforce considers that financial services and credit licensees should be required to report significant breaches to ASIC. The 'significance test' should be retained but clarified to ensure that the significance of breaches is determined objectively.*

Royal Commission Recommendation 2.8 on reporting compliance concerns also spoke to the necessity of focusing upon serious compliance concerns, even suggesting that this should be done on a quarterly basis:

> *All AFSL holders should be required, as a condition of their licence, to report 'serious compliance concerns' about individual financial advisers to ASIC on a quarterly basis.*

In Recommendation 7.2, Commissioner Hayne also spoke in terms of supporting the ASIC Enforcement Review taskforce recommendations, including with respect to the retention of significant breach reporting.

Our serious concern with respect to the implications of the Financial Sector Reform (Hayne Royal Commission Response) Bill 2020, is that it is significantly moving away from the concept of significant breach reporting and that this new regime will involve an exponential increase in the number of breaches that need to be reported and many of these will be of a largely administrative nature.

The other key point that Commissioner Hayne made in his interim report was the need to review and reduce the complexity of the requirements of the Corporations Act. Unfortunately, the new breach reporting regime represents a substantial increase in the scale of complexity and in our view, this is virtually impossible for a small financial advice licensee to comply with.

Our focus in this submission is on the additional civil penalty provisions that we believe should be exempt from the regime. In the section below, we have set out our recommendations and the rationale for this. We have also focussed our attention on issues related to financial advice, where we believe that the impact of this reform is greatest, and the cost to implement will be more challenging.

It is important to note that the AFA does not have any legal resources and we have therefore approached our review of this matter from a similar position to that of the many small advice licensees, who in our view, will be hugely challenged by the requirements of this regime.

We have started this review from the perspective of an assessment of the civil penalty provisions listed in Section 1317E of the Corporations Act, however we note that this list is limited to the civil penalty provisions that apply at this point in time and that some of the recent reforms will impact this list once they have commenced. This is another factor speaking to the complexity of compliance with the new law.

We are conscious that in making recommendations with respect to which civil penalty provisions should be exempt from the new regime, that this will apply to all breaches picked up by that civil penalty section. As such, we recognise that it is not possible to request that certain types of breaches be excluded, but others remain captured. For this reason, we have needed to make a number of recommendations where we have then needed to rely upon the fact that more serious matters will be picked up through other parts of the new breach reporting regime.

This is very complex legislation and it has very deep and broad implications. We have completed the analysis below to the best of our understanding, however we acknowledge that it is quite possible that we have misunderstood key issues and the implications. It is, however, perhaps very relevant that if we have

misunderstood key issues, then there will be many others who will either be oblivious to these issues or will equally misunderstand their application.

## Background

The AFA has held a number of discussions with our licensee partners, and we are well aware of the serious concerns that many of them have with the implications of this legislation. In one case, a licensee who had 4 breaches reported in 2020, expected on the basis of the new legislation, that this would increase to 198. Their feedback suggests that the exclusion of civil penalty matters for the failure to deliver an FSG and a PDS would only marginally decrease the number of breaches that would need to be reported.

For context, financial advice licensees are required to undertake a detailed audit of a number of financial advice files for each adviser every year. This process inevitably results in a number of matters being identified, even for those advisers with a good compliance track record. The vast majority of these matters would involve no consumer detriment and are largely administrative or record keeping matters. The reality is that the compliance regime for financial advice is very complex, and this means that minor breaches are common. It does not in any way suggest that the quality of the advice is poor, or that the clients are at a greater risk of the prospect of detriment.

In the context of what has been rapidly rising costs for financial advisers and their licensees over recent years, we are motivated to ensure that the cost impact of this reform is not excessive. It is important to note that licensees will need to carefully review each potential breach and for licensees that lack in-house lawyers or compliance resources, they will need to seek external guidance before deciding to report a breach. It is this cost, along with the extra management time and oversight that will be necessary, that will have a very material impact on the cost of financial advice. Ultimately clients will end out paying for this.

## General Obligations of Financial Services Licensees

Whilst we started our review of the general obligations section assuming that all these matters should be included in the new breach reporting regime, it became apparent to us that this would capture a range of matters that we believe are largely administrative and also heavily impacted by recent reforms that are yet to be implemented or bedded down.

In our analysis we will focus upon the fact that any failure to comply with Section 912A(1)(g) on internal dispute resolution, will result in a reportable breach. This is because Section 912A(2) requires that licensees comply with standards, and requirements, made or approved by ASIC. ASIC has recently, through a legislative instrument, made a number of the obligations under the new Regulatory Guide 271 on Internal Dispute Resolution enforceable. This new regulatory guide is due to come into force on 5 October 2021, just days after the new breach reporting regime is due to start. Under this new regulatory guide, the maximum timeframe for the completion of a complaint has been reduced from 45 days to 30 days. The AFA strongly objected to this, on the grounds that financial advice complaints are often very complex and require input from multiple parties. We understand that it takes AFCA on average over 100 days to finalise investment and advice matters. A failure to provide a final response within the maximum timeframe would become a reportable breach. Other issues that would be captured would be breaches of the new definition of a complaint and any potential failure to treat a critical social media post as a complaint.

We are therefore calling for the exemption of subsection 912A(5A) on the grounds that it will pick up a range of relatively minor breaches of Section 912A(1)(g), although noting that serious matters will otherwise be picked up through other provisions of the legislation such as subsections 912D(2) or 912D(5). Therefore, the exclusion of 912A(5A), will not undermine the intent of the breach reporting regime. As an alternative, ASIC could review the IDR standards or reconsider the enforceability of these standards.

## Need to Comply with Obligation to Notify ASIC

Subsection 922M(5) picks up a failure to comply with a number of different obligations to notify ASIC of certain matters related to the register of financial advisers, including Sections 922D, 922H, 922HA, 922HB, 922HC, 922J and 922K. In looking at Section 922H, and the obligation to notify ASIC where there is a change in a matter for a relevant provider, it is important to note that this could include administrative matters such as a change of the principal place of business, or a change in the products that an adviser is authorised to provide advice on, or the completion of any training courses, or changes to membership of any professional association. Licensees have 30 business days to notify ASIC of any changes to these matters. We have recently been made aware that some licensees have been fined by ASIC for failing to notify ASIC within 30 business days that one of their advisers had passed the FASEA exam. This is despite the fact that the passing of the FASEA exam is not something that is displayed on the Financial Adviser Register and is not a mandatory requirement until 1 January 2022. All financial advisers need to complete the exam by this date if they wish to remain a financial adviser. Most advisers also need to complete further study, which must also be reported to ASIC. We envisage that over the next few years there will be a substantial number of issues with delayed notification to ASIC of the completion of courses by their advisers which is not within the required 30 business days.

Another key issue to raise in this section is the obligation under Section 922HC for a Code Monitoring Body to report any breaches by a financial adviser to comply with the FASEA Code of Ethics. Whilst the Government chose not to proceed with the Code Monitoring Body model, if this was changed in the future to require licensees to report breaches of the FASEA Code of Ethics to ASIC, then we are concerned that this could capture all breaches of the law, through the application of Standard 1 of the FASEA Code of Ethics:

> ***Standard 1:*** *You must act in accordance with all applicable laws, including this Code, and not try to avoid or circumvent their intent.*

It is not apparent to us that there are any obvious cases where the exclusion of the reporting of a breach of the obligations to notify ASIC of one of the matters required under Subsection 922M(5) will cause serious risk or detriment for consumers. And in any case, if this was likely, then we expect that the matter would be reportable to ASIC under subsections 912D(2) or 912D(5).

## Failure to Provide a Financial Services Guide

We support the inclusion of subsections 941A(3) and 941B(4) in regulation 7.6.02A. The failure to provide the latest version of an FSG does occur from time to time, however this is typically an administrative matter that relates to a lack of awareness of when an FSG was last provided and whether any changes have been made to the FSG since it was last provided.

We support the exemption of these two subsections, and do not believe that this will expose clients to any disadvantage or detriment.

## Best Interests Duty and Related Obligations

The most significant type of breaches of civil penalty provisions by financial advice licensees is breaches of the Best Interests Duty and Related Obligations, which includes:

- Section 961B – Provider must act in the best interests of the client.
- Section 961G – Resulting advice must be appropriate to the client.
- Section 961H – Resulting advice still based on incomplete or inaccurate information.
- Section 961J – Conflict between client's interests and those of provider, licensee, authorised representative or associates.

The civil penalty provisions include subsections 961K(1) and (2), section 961L and subsection 961Q(1).

Most of the breaches of these sections relate to inadequate record keeping to prove compliance with the seven steps in the Best Interests Duty safe harbour. In the vast majority of cases, this does not impact the overall quality of the financial advice or lead to consumer detriment. This is evident in a series of ASIC reports, including ASIC Report 413 (37% non-compliance rate), ASIC Report 562 (75% non-compliance rate), ASIC Report 575 (91% non-compliance rate) and the most recent ASIC Report 639 on the quality of advice provided by superannuation funds, that demonstrated a 51% non-compliance rate. ASIC's own conclusion with respect to report 639 was that overall the advice was of a reasonable standard with little evidence of detriment, despite the high fail rate. This means that there would be a huge number of reportable breaches if every breach of the Best Interests Duty and Related Obligations needed to be reported to ASIC.

We acknowledge that in a small minority of cases that a breach of the Best Interests Duty and Related Obligations could lead to client detriment. In these cases, however, we expect that the matter would otherwise be reportable to ASIC as a result of it being covered by subsections 912D(2) or 912D(5).

We strongly recommend that civil penalty provisions caught through subsections 961K(1) and (2), section 961L and subsection 961Q(1) be exempted from the new ASIC reportable breaches regime.

### Fee Disclosure Statement Breaches

ASIC Report 636 on compliance with the Fee Disclosure Statement and Renewal obligations found a number of issues, including:

- 9% of FDSs being provided late,
- 80% of FDSs not including accurate information about the services clients were entitled to receive.
- 73% did not receive all the required information about the services clients received.
- 44% did not include the amount of each fee clients paid under the ongoing fee arrangement.
- 8% of renewal notices were given outside of the required timeframe.

Each of the above matters would be considered as a breach of the obligations and a breach of a civil penalty provision, thus necessitating reporting to ASIC.

In Report 636, ASIC acknowledged what is now understood to be a fundamental issue with the entire FDS regime. ASIC expects that FDSs are prepared on the basis of the amount and the timing of when the fee comes out of the client's account. Since there can be a delay of a number of days before the money is paid to the licensee, this can result in a difference in the fees that are paid during a specified reporting period. Differences could also emerge as a result of different treatment of GST versus RITC and just as a result of small errors. Financial advisers prepare their FDSs based upon their remuneration systems, not the systems used by product providers. There is no obvious fix for this issue, other than a legislative change. ASIC have suggested that financial advisers should log into product systems to check exactly when fees were deducted from each client account. This would be very costly and subject to a high level of risk of error. Until a legislative solution is implemented, a high rate of breaches can be expected.

Whilst we support the importance of the Fee Disclosure Statement and renewal processes, we do not believe that individual breaches of these obligations are significant and should not warrant reporting to ASIC. We do believe that where there is a systemic issue with the provision of FDSs or renewal notices, then this should be reported to ASIC, however this is most likely to be picked up by a breach of Section 912D(5). Thus, we do not believe that there would be any client disadvantage or detriment that would result from the exclusion of the FDS and Renewal obligations from the breach reporting regime.

We strongly recommend that civil penalty provisions caught through section 962P, and subsection 962S(1) being exempted from the ASIC reportable breaches regime.

### Product Disclosure Statement Breaches

We support the inclusion of subsections 1012A(5), 1012B(6), 1012C(11) and 1021E(8) in regulation 7.6.02A. The failure to provide a Product Disclosure Statement does occur from time to time, however this is typically an administrative matter.

We support the exemption of these four subsections, and do not believe that this will expose clients to any disadvantage or detriment.

### Other Matters

We have no additional feedback, other than with respect to item 11(3) of the draft regulation, which refers to item 7, when it should be item 9.

### Concluding Comments

We are particularly concerned about the implications of the new breach reporting regime for the financial advice sector, where we anticipate an exponential increase in the number of matters that need to be reported. We have highlighted in this submission the most important categories of civil penalty breaches that we would like to ensure are exempt from the new reportable breach regime.

It is also important to make two further points on the importance of the sensible broadening of the civil penalty provisions that are to be exempted from the new reportable breach regime:

- This will reduce the significant consequences of the new requirement for a licensee to report breaches by an adviser from another licensee, which we envisage will be very challenging.
- This will reduce the number of matters that would otherwise need to be included as part of the new reference checking regime that is scheduled to start on the same day.

This regulation will only provide relief with respect to the civil penalty provision element of this new regime. We are also particularly concerned about the capture of offence provisions, such as record keeping obligations for FDSs, which is subject to a maximum jail term of 5 years, and would therefore be automatically caught, despite being largely administrative in nature.

We are also very conscious that we may have only identified some of the most significant issues in our analysis of these civil penalty provisions and that there may be other important issues that are going to lead to significant additional non-value adding work, that will only flow through to an increase in the cost of financial advice for clients. We therefore ask Treasury and the Government to undertake further analysis of this issue and consider a deferral of the commencement date of the new breach reporting regime.

We would be happy to discuss this matter further, or to provide additional information if required. Please contact us on (02) 9267 4003.

Yours sincerely,

**Phil Anderson**
Acting Chief Executive Officer
Association of Financial Advisers Ltd

## Civil Penalty Provisions – AFA Recommendations | Appendix 1

| Section/Subsection | Heading | AFA Recommendation |
|---|---|---|
| Subsection 912A(5A) | General obligations of a financial services licensee | Exempt due to implications for subsection 912A(1)(g) |
| Subsection 922M(5) | Need to comply with obligation to notify ASIC | Exempt due to coverage of a number of administrative matters |
| Subsections 941A(3) and Subsection 941B(4) | Financial Services Guide | Support proposed exemption |
| Subsections 961K(1) and (2), section 961L and subsection 961Q(1) | Best Interests Duty and Related Obligations | Exempt on the basis that this will capture a very large number of minor or administrative matters |
| Sections 962P, and subsection 962S(1) | Fee Disclosure Statements | Exempt on the basis that these matters are largely minor and administrative |
| Subsections 1012A(5), 1012B(6), 1012C(11) and 1021E(8) | Product Disclosure Statements | Support proposed exemption |