Stockbrokers
Association of Australia
Incorporating SDIA

Senate Economics References Committee

Inquiry into the Scrutiny of Financial Advice

Submission

5 December 2014

The Stockbrokers Association of Australia would like to make the following submission to Senate Economics References Committee Inquiry into *the Scrutiny of Financial Advice*.

The Inquiry

Terms of Reference: On 4 September 2014, the Senate referred the following matter to the Committee for inquiry and report:

> **Implications of financial advice reforms**, with particular reference to:
> (a) the **current level of consumer protections**;
> (b) the role of, and **oversight by, regulatory agencies** in preventing the provision of unethical and misleading financial advice;
> (c) whether existing mechanisms are appropriate in any **compensation** process relating to unethical or misleading financial advice and instances where these mechanisms may have failed;
> (d) mechanisms, including a **centralised register**, that would ensure financial planners found to have breached any law or professional standards in their employment are transparent, for both the sector and consumers;
> (e) how **financial services providers** and companies have **responded** to misconduct in the industry;
> (f) **other regulatory or legislative reforms** that would **prevent misconduct**; and
> (g) any related matters.

A. INTRODUCTORY POINTS

This is a very wide ranging review – yet another in fact, in this year of FOFA and post-FOFA reviews, which has included:

- **Jan 2014**: ASIC announces pause in CP153 (Training & Supervision Standards) pending Government decisions; Government announces it will work with industry to '*consider opportunities to enhance*' professional standards
- **Feb 2014**: *Financial System Inquiry* (adviser competence included in TOR)
- **July 2014**: *Parliamentary Joint Committee* Inquiry into lifting professional, ethical and education standards
- **Aug 2014**: *AFSL Industry Working Group* on Adviser Register and Professional Standards (reporting to Minister Nov 14)

'Financial Advice Reforms'

The Terms of Reference above state that the Inquiry will examine the implications of 'financial advice reforms'. Since the *Financial Service Reforms* (FSR) became effective in 2004, the assumption is that this Inquiry will concentrate on the FOFA reforms, including:

- the statutory best interests duty (s961B)
- the duty to provide appropriate advice (s961G)
- the duty to prioritise the client's interests (s961H), and
- the ban on Conflicted Remuneration (s963E-L)

The position of Stockbroking

The Stockbrokers Association of Australia has consistently supported the lifting of professional standards.

The Stockbroking industry has been largely immune from the extensively reported financial advice issues that have arisen since the GFC. There are very good reasons for this, which we would like to note as a preliminary matter before addressing the specific terms of reference:

- ***Higher Management and Supervision Standards:*** while they hold Australian Financial Services Licences (**AFSLs**), as Market Participants under the ASIC market integrity rules[1], Stockbrokers also have much more defined and stringent

[1] In this Submission, *Market Integrity Rules* principally refers to the *ASIC Market Integrity Rules (ASX Market) 2010*. However, it is noted that there is a set of MIRs for each market, e.g. Chi-X, and that the Competition MIRs (*ASIC Market Integrity Rules (Competition in Exchange Markets) 2011*) also apply where securities are traded on more than one exchange. The Competition MIRs themselves impose additional requirements on

management and supervision requirements than those which apply to AFSLs. Responsible Executives must be appointed, which reinforces the firm's liability to comply with the applicable laws and rules. These requirements are separately enforced by ASIC under the market integrity rules. Breaches of the management and supervision requirements under the market integrity rules can render firms liable to serious penalties not applicable to the rest of the financial advice industry, including fines of up to $1,000,000.

- ***Prohibition on Unprofessional Conduct:*** Market participants must comply with market integrity rules which prohibit Unprofessional Conduct, and which require firms to ensure that employees are of good fame and character: *ASIC Market Integrity Rules (ASX Market) 2010* Rule 2.1.5 and Rule 2.1.4. Breaches of these rules carry a maximum penalty of $1,000,000. The concept of **Unprofessional Conduct** sets high standards of conduct for Market Participants and their advisers in their dealings with clients. Under Rule 1.4.3, Unprofessional Conduct includes:
  (a) conduct which amounts to impropriety affecting professional character and which is indicative of a failure either to understand or to practise the precepts of honesty or fair dealing in relation to other Market Participants, clients or the public;
  (b) unsatisfactory professional conduct, where the conduct involves a substantial or consistent failure to reach reasonable standards of competence and diligence; and
  (c) conduct which is, or could reasonably be considered as likely to be, prejudicial to the interests of the Market Operator or Market Participants, by a Market Participant, or an Employee, whether in the conduct of the Market Participant's business as a Market Participant or in the conduct of any other business, and need not involve a contravention of these Rules or any law.

  No other sector of the retail financial advice industry is subject to such rules.

- ***Market Supervision Fees***: Market Participants pay market supervision fees of around $15,000,000 per annum to ASIC for its regulation of the sector. No other sector pays such fees.

- ***MDP Supervision***: there is a dedicated disciplinary regime for the market integrity rules which does not apply to other sectors. ASIC addresses matters in the first instance through its Markets Disciplinary Panel, a body of senior industry practitioners built on the peer review model. Since 2011, the MDP has issued Infringement Notices with a total of over $2,000,000 in penalties. If a market

Market Participants, including the duty of best execution. *ASIC Market Integrity Rules (ASX Market) 2010* & *ASIC Market Integrity Rules (Chi-X Australia Market) 2011*

participant does not comply with and MDP Infringement Notice, ASIC has the power to take the matter to Court as a Civil Penalty action.

- ***Capital Standards***: More detailed and rigorous capital adequacy standards apply to Market Participants than other financial advisers.

- ***NGF***: The National Guarantee Fund stands behind market transactions and broker defalcations to protect clients and their assets.

FOS data: One of the indicators of the healthy state of the retail stockbroking industry is the trend of lower complaints against Stockbrokers. According to the latest figures released by the Financial Ombudsman Service in October[2], for the 2014 Financial Year complaints against Stockbrokers fell 17% to 42, with only 8 of those relating to **Advice**. Moreover, this was not an extraordinary result: complaints to FOS against Stockbrokers have consistently fallen over the last 5 years, to be less than half they were for 2010.

ASIC Surveys: a survey by ASIC in 2010 of Stockbroking Advice found a very positive response. In the seemingly endless flood of bad news on financial advice in the last few years, it was somewhat disappointing that this positive news was never released by ASIC.

The result of this rigorous compliance structure and good ethical background is an environment where clients' interests are paramount. If issues arise, they are normally addressed in the client's best interests, which is one reason for the low rate of complaints to the external complaints resolution scheme.

[2] Financial Ombudsman Service *2013-2014 Annual Review* released 9 October 2014

B. SUBMISSIONS

We would now like to comment in turn on each of the Inquiry's Terms of Reference:

1. Implications of financial advice reforms, with particular reference to:
(a) the current **level of consumer protections**;

Adequate protections exist, enhanced by the additional protections afforded by FOFA, including the statutory best interests duty and the ban on conflicted remuneration. ASIC reported in September 2014 that licensees have improved compliance and that the 'feeling of professionalism' has increased[3].

We note the above figures on the low number of complaints against Stockbrokers to FOS. For those matters that *do* go to FOS, there is no issue with Stockbrokers paying FOS Determinations, which is due to a very small number of rogue AFSLs. It has been reported that there is a high rate of non-payment of FOS determinations, so that somewhere in the region of 30% of awards are not paid. As FOS figures show, if this is so, it is certainly not from the stockbroking sector, but from a relatively small number of rogue financial services firms[4]. Stockbrokers should not have to subsidise these lesser capitalised and regulated sectors.

As also noted above, consumers of Stockbroking services are also protected by the National Guarantee Fund, Liquid Capital requirements, compulsory Professional Indemnity Insurance, segregation of clients funds in Trust Accounts, and segregation of client securities in CHESS on a name-on-register basis, and regulated nominee companies for custodial services.

2. Implications of financial advice reforms, with particular reference to:
(b) the role of, and **oversight by, regulatory agencies** in preventing the provision of unethical and misleading financial advice;

Historically, regulatory agencies have not usually been concerned with unethical or misleading financial advice, until issues occur.

Within their resource constraints, agencies should be more willing to intervene in particular cases, rather than just relying on overarching licensing and disclosure regimes, as has been the case with risky retail products like CFD's and margin FX.

Ideally it would be preferable for agencies to take a proactive stance on matters of concern, ahead of losses occurring. This is a difficult task, but these areas are usually forseeable. Currently, the increase in SMSF advice should be a priority area.

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[3] ASIC Report 407 *Review of the financial advice industry's implementation of the FOFA reforms* Sept. 2014
[4] Financial Ombudsman Services *The Circular – Unpaid Determinations: Update* August 2014

3. Implications of financial advice reforms, with particular reference to:

(c) whether existing mechanisms are appropriate in any **compensation** process relating to unethical or misleading financial advice and instances where these mechanisms may have failed;

The stockbroking industry has led the way in compensation arrangements. For many years, our Members have been subject to compensation requirements in excess of ASIC or legislative requirements. These existed under former ASX requirements, which are now (since the changes to market supervision in August 2010) set out in the *ASIC (ASX) Market Integrity Rules*. Our Member firms who provide services to retail clients are already subject to the following requirements, which ensure compensation for retail clients:

- Compulsory Professional Indemnity insurance requirements;
- Minimum liquid capital requirements in excess of normal AFS licensees' which are a key feature to ensure that funds are available for compensation to clients; and
- NGF cover: additional client protection exists through the National Guarantee Fund, which guarantees the completion of transactions and protects client property on insolvency or unauthorised transfer on the part of the broker.

We have already noted how these higher standards, are reflected in figures from the **Financial Ombudsman Service** of complaints against Stockbrokers[5].

Accordingly, we do not see the need for any change in this area.

In saying this, we agree with the recommendations of Mr Richard St.John, who conducted a major review of compensation arrangements in the financial services sector for the then Government in 2011-12[6].

A 'Last Resort' Scheme?

In relation to the establishment of a **last resort scheme** for compensation of clients unable to recover awards of damages from FOS or the Courts, Mr St.John concluded that it would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.

In his Report, Mr St.John stated[7] -

> *7.43 A last resort scheme would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees. It would not work to improve the standards of licensee behaviour or motivate a greater acceptance by licensees of responsibility for the consequences of their own conduct. It could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangements.*

[5] See further, Point 1 above

[6] Richard St.John *Report on Compensation arrangements for consumers of financial services* April 2012

[7] Richard St.John *Report* page 143 paragraph 7.43

The Stockbroking industry is an example of a better capitalised sector with higher standards. Any proposal to establish such a scheme must take into account our sector's excellent record in relation to client complaints and award recovery, otherwise it would introduce the risk of **moral hazard**, where less ethical sectors obtain the benefit of protection from better regulated and more ethical sectors like ours. We also showed that Stockbrokers have an excellent record of investor protection, and should not have to subsidise less scrupulous operators. As Mr St.John said[8] –

> *To put it another way, the regulatory platform for financial advisers and other licensees needs to be made more robust and stable before a safety net, funded by all licensees, is suspended beneath it.*

4. Implications of financial advice reforms, with particular reference to:

(d) mechanisms, including a **centralised register**, that would ensure financial planners found to have breached any law or professional standards in their employment are transparent, for both the sector and consumers;

We welcome the recent decision by the Government to commence a centralised register, effective March 2016[9]. This year, we participated in the Government's *AFSL Working Group* which advised the Acting Assistant Treasurer on the Enhanced Public Register of financial advisers.

While the **Enhanced Public Register** is a worthy initiative, and will allow consumers to access more information on the status of their advisers than is currently the case, we trust that the register can go much further in the future. This is essential to address the problem of *Bad Apples*.

Bad Apples

Bad Apples is the term used to refer to individuals who move from Firm to Firm, causing legal and regulatory problems for the organisation, and significant losses for clients. Lack of a mechanism for licensed firms to properly identify past misconduct by prospective employees – particularly client losses or breaches which have not given rise to concluded regulatory action – has exacerbated this problem. ASX removed a rule requiring reference checking in 1998. In 2013, ASIC proposed such a rule for *all* AFSL holders, not just for Market Participants[10].

In 2004, the Association formulated a scheme for specified misconduct by representatives to be reported by Member Firms to a central register. This register would then be checked

[8] Richard St.John *Report* page 145 paragraph 7.50

[9] Senator the Hon Mathias Cormann *Media Release: An enhanced public register of financial advisers* 24 October 2014

[10] ASIC *Main Submission to Senate Economics Committee Inquiry into the performance of the Australian Securities and Investments Commission* October 2013 (Submission 45) *Mandated reference checking* page 156, paragraph 581

by Member Firms, prior to hiring. However, due to the **risks** inherent in running such a scheme, the Board resolved not to proceed. (These risks include the Association and/or its Members facing litigation or regulatory action for defamation, malicious falsehood, negligence, interference with contractual relations, TPA anti-competitive and/or misleading or deceptive conduct, and/or breaches of Privacy legislation. In addition it may not capture representatives who move from other sectors - e.g. financial planning - into stockbroking.) Accordingly, the Association has since 2006 sought law reform to establish a reporting scheme with appropriate legal protections for the financial services industry, along the lines of well-established international schemes. Various statutory models (U.S., U.K., Hong Kong, etc.) provide for compulsory reporting of specified misconduct, and protection in making and accessing such reports. The U.S. scheme, administered by FINRA, is proposed by the Association as a model for an Australian scheme.

In the United States, when a person leaves a licensed firm, the Firm must lodge a 'Form U-4' which discloses matters regarding the person, including:

- Investigation Disclosure – ongoing investigations or proceeding by a regulator
- Internal Review Disclosure - internal review for fraud, etc.
- Criminal Disclosure – convictions for felonies or investment-related misdemeanours
- Regulatory Action Disclosure – concluded actions by a regulator
- Customer Complaints – client claims of over $15,0000
- Termination Disclosure – circumstances of the termination

The Form U-4 disclosures are accessible to investors via FINRA's BrokerCheck, and must be searched by prospective employers. The U.S. system is based on the premise that **consumer protection outweighs the individual adviser's right to privacy**. We trust that in Australia, one day this premise will drive the regulatory approach to this issue.

ASIC has also re-enforced to industry what it expects in regards to Reference checking and has always indicated to the industry they would likely provide a 'heads up' to a licensee if they looked to hire a certain person of interest. However, without any formal ASIC action, this presents difficulties for the regulator. The industry as a whole could potentially do more and perhaps be more open in providing comment on a potential hire, but people are afraid of the risks in doing so. Referring a new licensee to an Enforceable Undertaking from the previous employer may be helpful to some extent but EUs rarely refer to specific, named advisers.

5. Implications of financial advice reforms, with particular reference to:

(e) how **financial services providers** and companies have **responded** to misconduct in the industry;

Stockbrokers have responded appropriately to misconduct in the industry.

No client has been left uncompensated where compensation has been awarded in their favour.

6. Implications of financial advice reforms, with particular reference to:
(f) other **regulatory or legislative** reforms that would **prevent misconduct**; and

Other regulatory or legislative reforms that would prevent misconduct include:

- Codes of conduct, and
- Regulatory Equivalence with the market integrity rules

Code of Conduct

One regulatory or legislative reform that is currently under review is the introduction of a regime on professional standards. This would fill a gap in the conduct requirements. At present these requirements are only principles-based at best. For example the primary obligations of AFSL holders is to always act in manner that is '***efficient, honest and fair***'[11]. Market participants have tighter regulatory standards under the market integrity rules, for instance management and supervision arrangements, and the prohibition against '***unprofessional conduct***'[12]. However, these don't apply to the vast majority of AFSLs, some of whom are covered by voluntary, industry-based schemes.

There are a number of regulatory mechanisms currently under discussion, including -

- a new licensing obligation that all advisers be subject to an ASIC-approved Code of Conduct (*industry-based*), and
- a new Code of Conduct administered by ASIC (*regulatory*)

In any scheme, whether industry-based or regulatory, the Code administrator would need to include appropriate compliance and enforcement mechanisms.

Regulatory Equivalence with the market integrity rules (MIRs)

In Australia, there are a growing number of dealers and advisers in listed securities who are not themselves market participants. They have arrangements with market participants for the trading, clearing and settlement of securities transactions, predominately on the ASX and Chi-X markets.

Many of these dealers were formerly Market Participants, or employed by one. The 'culture' therefore may be similar. However, while they may offer a similar service to Stockbrokers, they are not market participants and are not directly subject to the MIRs. This means that their compliance and regulatory burden and costs are much lower than a market participant.

Accordingly, we agree with ASIC that the MIRs should be extended to include the actions of these dealers which are not market participants.

[11] *Corporations Act* section 912A(1)(a)
[12] See discussion above at page 3

In terms of **cost recovery**, the securities dealers which are not market participants pay nothing towards ASIC market supervision. (Stockbrokers pay about $15m per annum.) However, they are taking-up a significant amount of the time of ASIC's participant supervision team. Indeed, in its 6-monthly reports on supervision of markets and participants[13], ASIC reports separately on its activities in relation to Market Participants, and in relations to *securities dealers*, namely dealers which are not market participants. Therefore, it could be said that Market Participants are cross-subsidising the supervision of these other dealers.

A logical consequence of the extension of the MIRs to dealers which are not market participants would be the **extension of cost recovery** to this sector. This is consistent with ASIC's calls for a broader and more predictable funding base, rather than being reliant on allocations by Government.

In the interests of **regulatory equivalence**, dealers who provide stockbroking-like services should be regulated in the same manner as Stockbrokers. To paraphrase the ASIC Chairman in a speech he gave in 2013[14],

> '*if it looks like a broker, it should be regulated like a broker*'.

7. **Implications of financial advice reforms**, with particular reference to:
(g) **any related matters**.

Two adverse implications of financial advice reforms that we would like to comment upon are:

- the Significant rise in Compliance Costs, and
- Use of Share Registers.

Significant rise in compliance costs

There has been a significant increase in the burden and cost of regulatory compliance which has been imposed on the stockbroking industry over the last 5 years.

Much of the new regulation has been introduced in response to the Global Financial Crisis. There has been a significant increase in regulatory obligations, particularly dealing with conduct, supervision, trade surveillance and monitoring, and financial stability (particularly liquid capital and margining requirements designed to address risks in clearing and settlement).

Some of the regulation has also resulted from market structure changes. During this same recent period, there have been enormous changes in market structure, including the

[13] The latest is REPORT 405 *ASIC supervision of markets and participants: January to June 2014* dated August 2014

[14] G Medcraft, ASIC Chairman, Speech to the *2013 Annual Stockbrokers Conference*, Hilton Hotel, Sydney, 30 May 2013

introduction of competing exchanges, dark pools and other alternative execution venues and trading arrangements, accompanied by massive advances in trading technology. The rate of technological advances, including in high speed electronic order entry, and algorithmic trading platforms, has been dramatic. These changes have generated a significant body of extra regulation, such as best execution obligations.

The end result of these trends has been that the stockbroking industry has had to shoulder very large implementation cost, including the cost of developing new IT systems, as well as internal operational and compliance processes, to deal with the changes and the new regulatory obligations.

The industry has carried these high costs in a subdued economic environment post-GFC, during which volumes transacted in the equities market have remained low for some years, and investor confidence has remained weak. Investors have remained in less risky investments such as cash and fixed income products, rather than return to equities. In addition, the impact of advances in electronic trading technology, and high levels of competition in the stockbroking sector, have combined to drive commission down to unprecedented low levels.

Consequently, the revenues of stockbroking firms have remained under pressure for some years now, and broking firms have had to carry these additional costs during a time when revenues have been weak.

The Australian Government has also chosen this time to implement a Cost Recovery policy in respect of the cost of ASIC's Market Supervision function. The cost recovery model that has been employed has resulted in approximately 80% of ASIC's Market Supervision costs ($28 million total cost over the first 18 months, $42 million over the following 4 year cycle) being imposed on Market Participants (essentially, stockbroking firms).

Whilst the assumption, we presume, was that – like Fund Managers who now impose a '***FOFA Levy***' on their investors - Market Participants would pass the impact of Cost Recovery levy on to their clients, this has not eventuated. The stockbroking sector in Australia is so highly competitive that firms are *not* in a position to be able to pass these costs on to clients. The result has been that firms have absorbed the cost themselves, and have done so by significantly reducing costs. As one of the few areas where sufficient cost savings can be made is in head-count, it is no surprise that broking firms have made substantial cuts to staff numbers in order to meet these costs.

Hence, Cost Recovery was imposed using a flawed model and has been borne by stockbroking firms at a time when they were least able to do so. The detriment to the stockbroking sector, and on employment in the sector, has been pronounced. The impact

on Australia as a financial centre has been significant, and has seen the departure of two major exchange traded option market-makers from the ASX.

The industry is also having to cope with the introduction of the new *Tax Agents Services Act*, AML/CTF changes, Austrac Cost Recovery and US *Foreign Account Taxation Compliance Act* (**FATCA**) requirements (to name a few). At present many product issuers (LICs / ETFs) are looking to the Market Participants to fulfil the FATCA obligations in terms of client verification for them. The obligation to provide a Product Disclosure Statement under the ASX *mFunds* service has been forced onto the Market Participant as executing broker, rather than the Issuer which bears the legal obligation under the *Corporations Act*.

Use of Share registers

As we have pointed out to Government over a number of years, there is a serious anomaly in the law regarding access to, and the use of, share registers. This resulted not from the FOFA reforms of 2013, but from reforms to the *Corporations Act* which came into effect in 2010[15]. These reforms were intended to address the potential for shareholders to be unfairly taken advantage of by unscrupulous operators who make unsolicited offers for their shares. The anomaly is that dealers in securities which are not Market Participants have the right to gain access to share registers of companies for solicitation of business, but Market Participants (i.e. Stockbrokers) are specifically prohibited from doing so.

The anomaly appears to be an unintended consequence for which there is no proper policy basis. It could be fixed very simply, by the removal of one paragraph in the *Corporations Regulations*[16]. Our pleas to do so since 2011 have fallen on deaf ears.

CONCLUDING COMMENTS

Clearly, higher standards, tighter regulation and better internal management are bearing fruit in the advice space in stockbroking. This is the legacy of ASX regulation of Stockbrokers which has now been taken over by ASIC, for which Stockbrokers pay supervision fees to ASIC of around $15m per annum.

However, we acknowledge that there is always room for improvement. In this regard, we support moves to increase and improve training and professional standards.

Our Members also acknowledge that providing good quality and appropriate advice to clients (particularly retail clients) is in the public's interest. The danger is that the **cost** of

[15] *Corporations Act* 2001 s173(3A); *Corporations Regulation* 2C.1.03
[16] namely, *Corporations Regulation* 2C.1.03(b)

providing good advice may be at the tipping point of outweighing what retail clients can pay or are prepared to pay.

Thank-you for the opportunity to present these matters for the assistance of the Committee. We look forward to further expanding on these matters during the hearings to be conducted by the Committee in the near future.

Should you require further information, please contact me, or Doug Clark, Policy Executive dclark@stockbrokers.org.au .

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