Stockbrokers and Financial Advisers Association Limited

28 February 2020

The Manager
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: FSRCconsultations@treasury.gov.au

To The Manager

HAYNE ROYAL COMMISSION RESPONSE – EXPOSURE DRAFT BILL AND EXPLANATORY MEMORANDUM
SUBMISSION BY STOCKBROKERS AND FINANCIAL ADVISERS ASSOCIATION

We refer to the Exposure Draft of the Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2020 Measures) Bill 2020 (the Draft Bill) and Explanatory Memorandum (the EM) issued for comment on 31 January December 2020. The Stockbrokers and Financial Advisers Association ("SAFAA") appreciates the opportunity to make this submission in relation to the Draft Bill and EM.

The SAFAA Submission deals with the following subject matter areas in the Draft Bill:

- Reference Checking and Information Sharing
- Breach Reporting
- Fee Disclosure

Reference Checking and Information Sharing

SAFAA has for over a decade been prominent in calling for a Bad Apples framework to address the issue of advisers who have engaged in misconduct moving freely throughout the industry from employer to employer without any details of their previous record being available to investors or to Licensees.

The Draft Bill takes steps to implement such a framework through the compulsory record checking provisions. Whilst the attempt is well intentioned, SAFAA is concerned that there are serious issues with the framework that has been adopted.

SAFAA has always favoured a central register of the information, whether through the use of the ASIC Financial Adviser Register (FAR) or some other central body, and we strongly submit that this remains the preferable approach. The reference checking framework that has been adopted in the Draft Bill has some serious defects, in our view, that call into question whether the framework can be effective.

Qualified Privilege

We note that the provisions contain a qualified privilege for Licensees providing information under a reference checking request. SAFAA supports this privilege as being essential. Liability for statements made including negligent misstatement, has always been one of the key obstacles to reference checking, and such a framework cannot exist without the privilege being afforded.

Potential for Harm to the Advisor

There is a fundamental defect in the framework in that it compels the hiring Licensee to request information from the adviser's current employer. There is a real risk that this can expose the adviser to retribution or serious harm from the existing employer, if they were so minded.

The fact is that not all employers will look favourably on an adviser seeking to leave their current position. Some employers may adopt a vindictive approach as soon as they become aware, and the adviser may suffer some form of retribution or dismissal. Firms may not always be motivated by ill will , but in the case of advisers with a client base, a firm may view the prospective departure of an adviser, who may seek to take with them the clients they had been servicing, as a potential threat to their business, requiring steps to minimise any potential threat.

In the case of advisers who are currently not employed, these risks may be not great, however the likelihood more often than not is that advisers will be looking to move whilst they are currently in employment. It is natural for any employee to look for opportunities that might be more rewarding, and is it is also not uncommon for approaches to be initiated by other Licensees looking to attract good advisers to change firms.

For these reasons, SAFAA has always preferred the model where there is a central source of information about the compliance record of an adviser, which is capable of being checked not only by prospective employers but also potentially by members of the public, who may be looking to see for themselves whether there is any issue with an adviser whom they are looking to entrust with their investment.

We note that the US has adopted this central repository approach. For many years now FINRA has administered a framework under which Licensees and advisers are obliged to file reports of any compliance issues relating to advisers (and other relevant information). If an adviser leaves a firm, there is required to be lodged a form which will indicate whether there were any compliance issues in connection with the departure. The information is able to be searched by the public.

SAFAA has urged that Australia adopt a similar approach. This would avoid the problems that we identify with the compulsory reference checking framework in the Draft Bill.

If this is a function that FINRA is able to carry out effectively in the US Market, then it is difficult to see why ASIC could not do so as an adjunct to the FAR in the Australian Market.

Alternatively, in the context of the separate question of consideration of a single disciplinary body to deal with financial advisers, which is the subject of Recommendation 2.10 of the Financial Services Royal Commission, if ASIC does not consider that it should perform this function, then this could be a function for any new disciplinary body.

Relevance of Breach Reporting Regime

The enhanced Breach Reporting obligations set out in the Draft Bill (on which we make comment later in this Submission) are of relevance to the question of reference checking. Given the more far-reaching regime of reporting "reportable situations", significant breaches, and the commencement of investigations, to ASIC that is proposed under the Draft Bill, then ASIC would be in an ideal position to maintain a searchable source of information about a whole range of compliance concerns about advisers. In our view, this reinforces the model that SAFAA favours, of there being a central source for enquiries rather than enquiries directed to the adviser's current employer.

Consent by the Advisor

We note that the reference checking framework makes the information sharing dependant on the consent of the financial advisor.

On one hand, SAFAA acknowledges that this could address the concerns that are raised above regarding potential harm to the adviser once the refence check is made. If an adviser believes that they may suffer harm, then they could decline to consent to the reference check.

However, there is a real uncertainty surrounding the question of consent, and what is to happen if an advisor were to refuse consent. This is left entirely silent in the Draft Bill.

If it were the case that an advisor could simply refuse consent, then the entire scheme could potentially become ineffective.

If it is the case that a Licensee who hired an adviser who had refused to give consent faced action from ASIC for a breach of its AFS License for having done so, then this puts both the Licensee and the adviser in a predicament. On the one hand, refusing consent for a reference check could be a red flag, on the other hand, in view of our comments above, there may be entirely reasonable fears that an adviser may have if they were to consent to a check. Quite simply, a Licensee may not know one way or another whether the refusal to give consent is a red flag or not.

If the only safe course for a Licensee is to treat every refusal to give consent as being a red flag, then the end result of the reference checking framework could be to chain advisers to their current Licensee for fear of the consequences if they were to seek a change in employment. Advisers who are being under-remunerated could lose the ability to seek better positions elsewhere, which would be unreasonable.

Once again, this question would disappear if the central repository approach which SAFAA supports were to be adopted instead of the reference checking framework.

Penalty for failure to conduct reference checks

SAFAA notes that the failure to comply with the reference checking framework is to be a breach of a civil penalty provision. As noted in many places, the potential penalty for a corporation will be a fine of up to $525 million.

Without wishing to downplay the importance of preventing the movement of bad apples, which SAFAA has been vocal about for some time, there needs to be some gradation in the level of penalties applied. A $500 million fine for not conducting a reference check is excessive.

Breach reporting

SAFAA notes that the Draft Bill will result in a major increase in the volume of breach reports sent to ASIC.

The extra volume of breach reports, together with the requirement to report the commencement of Investigations, will have 2 major outcomes:

- The volume of reports to ASIC is likely to create an amount of "noise", given that many will relate to trivial failures, that will have the perverse effect of making ASIC's job harder, rather than assisting ASIC.

- The resource cost of ensuring that the additional reporting is carried out within the timetable imposed, both to individual firms and spread across the industry, will be considerable.

SAFAA's recollection at the time that the existing breach reporting obligations were enacted was that the "significant" threshold was adopted for good reason. Without a materiality requirement, ASIC would be required to receive and deal with minor issues that did not deserve resources or regulatory attention.

SAFAA notes that this territory is being revisited again, due we understand to ASIC's belief that there has been a failure to report matters that ASIC believes should have been reported, due to the interpretation of the term "significant".

We note that these provisions do not stem from the Final Report of the Royal Commission, the recommendations of which related only to the addition of mandatory reporting of serious compliance concerns about an adviser.

SAFAA also questions why, if ASIC is correct in its belief that there is a large volume of matters that were not reported as they should have been, that ASIC does not appear to have brought very many, or even any, prosecutions for non-compliance with the significant breach reporting requirement.

In establishing an objective test for what constitutes a “significant” breach, the Draft Bill, particularly section 912D (5)(b), will result in minor matters e.g. sending a FSG to a client a day late, being required to be lodged. Reporting will be required for breaches of the core obligations which result in *any* loss to client – not a material loss or some other threshold. In SAFAA’s view, this is unlikely to assist ASIC. It will add considerably to the complexity of ASIC business and increase its costs to supervise, which will result in an additional cost recovery burden imposed on Licensees.

SAFAA remains a supporter of there being a materiality threshold on the matters requiring reporting in order to manage the size and substance of breach reports.

Reportable Situations regarding other Licensees

SAFAA members have raised concerns in relation to the obligation to provide a copy of a report to ASIC regarding a “reportable situation” by a second Licensee, to that other Licensee.

It is one thing to create an obligation for one Licensee to report the situation regarding the Second Licensee to ASIC. However, going further and requiring the first Licensee to send a copy of the Report to the Second Licensee is entirely unnecessary and fraught with difficulty.

Firstly, the situation could give rise to litigation by the Second Licensee and/or by individual advisers for damage to reputation. Secondly, the copy of the report has the potential to jeopardise any action by ASIC, including obstruction of an investigation, by alerting parties to that potential, and providing an opportunity to destroy evidence, etc.

SAFAA notes that in the case of a similar obligation to report created by Part 5.11 of the ASIC Market Integrity Rules, namely, requiring a Market Participant to report insider trading or market misconduct to ASIC, the Market Participant is expressly prohibited from notifying the other person that the report has been made to ASIC. The reasoning for this is, we believe, obvious. It is therefore strange for the proposed obligation in the Draft Bill to take the opposite course.

SAFAA acknowledges that the reasoning behind the Draft Bill is presumably to alert the Second Licensee to the potential breach as soon as possible so that steps can be taken to prevent further misconduct and to remediate clients. However, SAFAA submits that the better approach would be to leave this notification for ASIC to make.

In our view, providing anonymity to the First Licensee should eliminate any competing consideration and risk assessments, and should encourage and expedite these reports being made to ASIC. The obligation to furnish the report to the Second Licensee should be dispensed with.

Civil Penalty Breach

SAFAA notes that failure to report a reportable situation by a Second Licensee is a breach of a civil penalty provision. Similar to our comments above in relation to reference checking, there should be a scaled approach to the way that any breach of these provisions are dealt with, with penalties of $525 million not being proportionate to the nature of the obligation.

Fee Disclosure

SAFAA members have expressed a number of concerns about the Fee Disclosure obligations for ongoing fee arrangements contained in the Draft Bill.

1. The start date of 1 July 2020 is not practical or feasible. The sheer size of the task of furnishing clients with Fee Disclosure Statements (FDSs), and the complexity of making changes to systems needed to generate FDSs, should not be underestimated. Firms would need to be commencing system development work already in order to meet a 1 July start date, however that is unreasonable given the law is not in place or even settled yet, and the full details unknown. A more realistic commencement date needs to be chosen.

2. The transitional arrangements are similarly not practical.
    a. For a client where a FDS or renewal is due under existing provisions before 1 July 2020 but are not disclosed before that date, the current arrangements cease on 1 July 2020 and an FDS, and where required, renewal notice, must be provided under the transitional arrangements between 1 July and 31 December 2020. The fee recipient must also seek the client's consent prior to 1 January 2021 to make fee deductions from the client's account. Where the consent is obtained prior to 1 January 2021, some of the new provisions apply from that date (s962U and s962X), which brings forward some of those obligations.
    b. For clients to whom the former Subdivision C did not apply (i.e. grandfathered clients), during the period 1 July 2020 to 30 June 2021, the fee recipient will need to give a FDS and renewal notice and seek the client's consent to deductions before 1 July 2021. As with the comments above, where the consent is obtained prior to 1 July 2021, some of the new provisions apply from that date (s962U and s962X), which brings forward some of those obligations.
    c. Each of these provisions have another, potentially unintended, consequence. That is, the renewal and consent requirements will potentially be separated in terms of timing. Consent to deductions has to be obtained every 12 months and in advance of a deduction occurring, whereas the FDS (and renewal) is required on the anniversary date of the relevant service arrangement. There will be a requirement to obtain two different confirmations at different times from the client, increasing complexity. During the

transition arrangements, there should be an extension of the consent to deduct to align with the next FDS and renewal anniversary date.

3. The consent to deduct is particularly complex. Each "account holder" will have to give consent to automatic deductions from a bank account. This will require multiple tracking of consents to debit (even though a direct debit authority will already have been executed). For example, if an account had four trustees (or account holders) on a bank account, each one would have to consent to the deductions. If one of those trustees did not provide their consent in the required timeframe, the deductions would have to cease. This is not in alignment with standing instructions a client can have with their bank (e.g. "one to sign" is a common arrangement). This will be very complex for clients to manage, and for systems to be developed to track multiple authorisations.

4. The requirement to give notice within 5 days of a variation or termination of a consent to deductions is simply not practical nor reasonable.

   Even more complexity is added to the consent to deduct requirements, in that "ASIC may, by legislative instrument, determine requirements for the giving of consent to deductions…" (s962T) and this includes specific content and wording requirements. In other words, if ASIC determines a particular format of wording should be used, this will need to be implemented and there is no indication of what transitional provisions (or timelines) would apply to updating to the mandated wording required.

5. Difficulty of disclosing fees in dollar terms in advance. In many cases, disclosing the fees in $dollar terms at the beginning of the period presents great difficulty.

   a. For clients on a standard / fixed fee, this might be less complex: the fee should be ascertainable in dollar terms and should be explained relatively simply.
   b. For clients on a variable fee – such as a tiered or percentage fee, this will present great difficulties. There is a requirement to disclose the fee for the next 12-month period in dollar amounts, or to provide a "reasonable estimate" of the amount of the future 12 month's fees and the method used to work out the estimate.

      Many clients are now charged on ongoing fee based on a percentage of assets under management. However, the value of AUM may change throughout the year, as the value of assets will vary with market moves, or assets may be added to or reduced based on changes in circumstances. If there is to be an estimate based on a snapshot taken at a fixed point in time before the FDS is sent, then given the logistics of preparing and sending out the FDS, the estimate might already be out of date by the time the client receives the FDS, if market moves have taken place in the intervening period of time.

      There is no guidance on how reasonable estimates are to be made in practical terms.

In practical terms, there were very good reasons why the previous framework was based on disclosure at the end of the period. Apart from the ability to more accurately calculate the amounts, disclosure of amounts at the end of the period permitted clients to compare the actual amounts paid by them with the disclosure of the fee basis in the FSG. The existing framework actually makes a great deal of sense in terms of informing clients.

Given this uncertainty, and as this legislation is still in draft stage, and subject to change, it is unreasonable to expect Licensees to be already changing systems in order to meet the 1 July 2020 deadline.

There is a need for further Guidance to be issued to explain how this Fee Disclosure is to be made in various contexts. The transition arrangements do not provide sufficient time to program the considerably complex changes. The consent requirements on their own are a considerable change which is not required under existing legislation and should have a longer implementation period.

Conclusion

We would be happy to discuss any issues arising from these comments, or to provide any further material that may assist. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@stockbrokers.org.au.

Yours sincerely

Judith Fox
Chief Executive Officer