Australian Government

The Treasury

FINANCIAL SERVICES ROYAL COMMISSION

SUBMISSION

HEARINGS ON FINANCIAL ADVICE

INTRODUCTION

1. This submission is directed to four topics arising from questions posed by Counsel Assisting the Commissioner as part of the second round of hearings. The submission responds to those questions that Treasury considers have broad, and potentially far reaching, implications for the regulatory framework and the Australian financial system. These questions concern:

   - whether and how to further address conflicts of interest in the provision of financial advice, including within vertically and horizontally integrated institutions;
   - the culture of firms in the sector, and how to increase accountability within financial institutions;
   - what changes in the regulatory culture could assist in reducing the incidence of misconduct; and
   - whether changes to the existing licensing framework are necessary.

2. In Treasury's view, the hearings so far have made clear that poor institutional culture and misaligned incentives are a key cause of the misconduct issues identified and of failures to meet community standards, and naturally led to the questions asked by Counsel Assisting of what the financial services sector can do to change and how the regulatory culture (including the powers, culture and capability of regulators) and other elements of the regulatory framework can be improved to support such change.

3. In considering these matters, the Commission will need to consider what, if any, trade-offs are involved in tackling misconduct of the nature identified in the hearings against the implications for access to and the cost of financial services, competition in the financial system and for the economy generally. That will also require consideration of the implications of underlying trends that will influence both the demand for and supply of financial services, such as technological and demographic trends.

4. The challenge of striking a balance between competing objectives while taking account of longer-term trends has been one constant in the development of the existing regulatory framework over time.[1] At a firm and industry level, however, there should be no trade-off between long-term profitability and having a good culture and providing services of value to customers, where there is effective competition.

5. The Commission will also need to consider how any reforms it may recommend will work together as a whole, both in addressing misconduct and as part of the overall regulatory framework. This will also require taking account of interactions with existing arrangements and other reforms currently being progressed by the Government.

6. This submission outlines the considerations underpinning the development of relevant parts of the current regulatory framework as well as further reforms that have been announced or recently introduced. The submission also seeks to highlight a number of policy choices and considerations that may further inform the Commission's thinking. Given that future hearings will undoubtedly shed further light on some of these matters, our views are preliminary only.

7. The Treasury would welcome further opportunities to assist the Commission in considering these and other policy issues as the Commission develops its views and recommendations.

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1 As described in Treasury's information note to the Commission, 'Overview of the regulatory framework for the Australian financial system' (25 January 2018).

8. A navigation table is included in Attachment A of this paper to assist the Commission to consider the matters raised in this submission.

The role of financial advice for consumers

9. Consumers in Australia have access to a wide range of financial products and services which are offered through a diverse range of financial institutions with different business models. Many of these products are complex and choices made regarding them can also have taxation, estate planning and other significant consequences.

10. This inherent complexity is the norm for consumers in an advanced economy. The Australian regulatory framework, while seeking to provide protections for consumers purchasing financial services or products, has historically not sought to prescribe or mandate the design of financial products or the types of financial products that may be provided to retail clients. This approach to regulation recognises that consumers have diverse needs and preferences for financial products and accordingly seeks to enable industry to continue to innovate and develop new products to meet changing consumer needs and preferences.

11. While more recent reforms, such as the proposed design and distribution obligations and the MySuper reforms, indicate a shift in regulatory focus towards simplifying the choices required of consumers and thereby reducing the need for advice, the market for financial products and services is expected to remain complex and crowded. For example, there are 4,000 different residential property loans available for consumers.[2]

12. For individuals to successfully navigate decision making in these circumstances, they must have knowledge of, or access to, information or advice on relevant financial products sufficient to enable them to make informed decisions having regard to their circumstances and objectives. The extent of the requisite knowledge and access can change over time in keeping with the typical financial decisions made by consumers over their life time, such as when starting a family, buying a house and at retirement.

13. Research commissioned by the Australian Securities and Investments Commission (ASIC) shows that while many Australians say they feel confident about managing their money day-to-day, 42 per cent do not. 36 per cent of Australians say they find dealing with money stressful and overwhelming, and 21 per cent have difficulty understanding financial matters.[3] While improving financial literacy can assist some consumers to make some financial decisions — and ASIC leads a National Financial Literacy Strategy — it is far from a complete solution.

14. Australia's ageing demographics are also relevant. Old age can be associated with declining cognitive abilities and the development of cognitive impairments, for example Alzheimer's disease and dementia. These conditions generally result in a reduced ability to make sound financial decisions, that is, a reduced financial capacity. While potentially increasing the demand for advice, in such cases the ability of those affected to understand and assess the quality of financial advice and then act appropriately will also be further limited.

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2 Productivity Commission, 'Competition in the Australian Financial System - Draft Report' (7 February 2018) available: http://www.pc.gov.au/inquiries/current/financial-system/draft

3 Australian Securities and Investments Commission, 'Report 541 Australian Financial Attitudes and Behaviour Tracker: Wave 5 Key Findings' (March 2017) available: http://www.financialliteracy.gov.au/media/560717/afab-tracker_wave-5_key-findings_final.pdf

15. Access to quality financial advice will, therefore, be important for consumers to help them make informed decisions around financial planning, managing their wealth and the purchase of some financial products (for example, some insurance products). It is clear that the industry is currently falling short in the provision of quality advice and that consumers are often not well placed to assess the quality of advice they receive.

16. While poor advice is expensive at any price, the regulation of the provision of financial advice inevitably needs to balance the tension between increasing the quality of financial advice while ensuring that such advice is available if needed and as affordable as possible. It also needs to take account of other consequences, such as how changes in financial advice arrangements can improve competition and innovation in the system for the benefit of consumers, including allowing new firms to enter and expand when incumbents are complacent and inefficient.

ADDRESSING CONFLICTS OF INTEREST IN THE PROVISION OF FINANCIAL ADVICE

17. Counsel Assisting the Commission has posed a number of questions concerning the conflicts of interest inherent in vertically integrated business models where a firm, alone or together with a related firm, provides financial advice while also manufacturing products and providing platforms for their distribution. These include questioning the value to consumers of platform operators with advice licensees and whether the provision of advice should be separated from the provision of products.

18. The Commission also heard evidence, from ASIC and in the case study on disciplinary processes, of the conflicts of interest that arise from horizontally integrated firms where advice is provided by a firm and that firm or a related firm provides ancillary services. For example, establishing and providing services for a self-managed superannuation fund (SMSF) and assisting with real estate investments by that SMSF.

19. The challenge of how to manage the conflicts of interest arising from integrated business models and other arrangements in respect of advice, both from a regulatory frameworks perspective and also by institutions in their remuneration practices of staff, are not new, nor are they restricted to the Australian market. Similar issues have been the focus of regulatory attention in jurisdictions such as the United Kingdom[4] and India.[5]

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4 See Financial Conduct Authority (UK) 'Retail Distribution Review' (06 January 2017) available: https://www.fca.org.uk/news/news-stories/post-implementation-review-retail-distribution-review; Financial Conduct Authority (UK) 'Financial Advice Market Review' (30 June 2017) available: https://www.fca.org.uk/publications/research/financial-advice-market-review-famr-baseline-report

5 See Securities and Exchange Board of India, 'Consultation Paper on Amendments/Clarifications to the SEBI (Investment Advisers) Regulations, 2013' (7 October 2016) available: https://www.sebi.gov.in/sebi_data/attachdocs/1475839876350.pdf

20. Integrated business models in the financial system have also been the subject of Australian inquiries. They were considered by the Financial System Inquiry (FSI) and are currently being considered by the Productivity Commission in its inquiries into Competition in the Australian Financial System and into Superannuation: Assessing Efficiency and Competitiveness.[6] These inquiries have considered a broader range of integrated business models other than those that integrate advice (for example, of groups that include both banks and insurers) and from other perspectives than misconduct such as the impact on efficiency and competition.

21. The hearings have provided evidence that conflicts of interest continue to lead to poor consumer outcomes, and have contributed to poor firm culture, notwithstanding a number of reforms in recent years that have sought to eliminate or mitigate such risks.

22. One approach that the Commission could adopt to frame its consideration of how to tackle these problems is to look at what more could usefully be done to remove or mitigate conflicts of interest without altering the status quo acceptance of integrated business models. Consideration could then also be given to what additional benefits, and costs, requiring structural separation would entail against that improved status quo benchmark.

Improving the status quo — further reforms to address conflicts of interest

23. The current regulatory approach is the outcome of previous reforms (such as the Future of Financial Advice (FOFA) reforms) that have sought to minimise the extent to which conflicts of interest in providing advice lead to poor consumer outcomes. As the Commission is aware, this has been done primarily through imposing duties on entities and individuals to identify and manage conflicts of interest and by banning certain types of conflicted remuneration. These reforms have application in addressing conflicts of interest beyond those arising from integrated business models.

24. Further reforms that are currently being progressed, or could be considered, are set out below.

Further measures to reduce the potential for consumers to access inappropriate products or services

25. The Government's proposed Design and Distribution Obligations (DDO) and Product Intervention Power (PIP) address shortcomings in the current regulatory regime, which focuses primarily on disclosure to protect consumers from unsuitable products.

26. The FSI recommended that financial product DDOs be introduced to address gaps in the regulatory system that cannot be addressed through relying on disclosure requirements to support informed consumer choice. The DDOs are intended to promote the provision of suitable financial products to consumers of those products.

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6 Productivity Commission, 'Competition in the Australian Financial System - Draft Report' (7 February 2018); Productivity Commission, 'Superannuation: Assessing Competitiveness and Efficiency Issues paper' (21 August 2017) available: https://www.pc.gov.au/inquiries/current/superannuation/assessment/issues

27. Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017, released by the Government for consultation in December 2017, would require issuers to identify a target market for their products, such that it would be reasonable to conclude that the product would generally meet the likely objectives, financial situations and needs of the persons in the identified target market. Issuers of financial products would be required to select appropriate distribution channels for their products and review arrangements as necessary to ensure they continue to be appropriate. In addition, distributors would be required to put in place reasonable controls to ensure products are distributed in accordance with the identified target markets, and comply with reasonable requests for information from the issuer in relation to the product's review. A further round of consultation will occur on these proposals.

28. The draft legislation also seeks to provide ASIC with a PIP to help reduce the risk of harm to consumers from financial products. This power would allow ASIC to intervene in relation to a product (or class of products) where ASIC is satisfied that the product (or class of products) has resulted in, or is likely to result in, significant consumer detriment to retail clients. The actions ASIC could take include: requiring the amendment of product marketing and disclosure materials; imposing new consumer warnings and labelling changes; restricting how a product is distributed; and banning products.

29. ASIC would also be empowered to ban aspects of remuneration practices where there is a direct link between remuneration and distribution of the product. Before it uses the new power, ASIC would be required to consider a range of relevant factors, to consult affected parties, and to publicly release a statement of reasons for any intervention. The relevant factors ASIC would be required to consider include: the nature and extent of consumer detriment, including any actual or potential financial loss to consumers; and the impact that the detriment has had, or is likely to have, on consumers.

30. The PIP and DDO regimes would not involve pre-vetting of products by ASIC. Issuers and distributors would be responsible for ensuring their products are suitable for the customers to whom they are sold.

Additional prescription on the application of best interest duty for superannuation

31. The current operation of the best interests duty is principles-based so does not explicitly require advisers to compare against specific products or types of products in the construction of their advice.[7] Instead, advisers complete a "fact find" to establish the needs and objectives of the consumer and then provide advice in the consumer's best interest to meet these goals. This approach to discharging the best interest duty recognises that there may be multiple types of products that are appropriate to meet consumer needs. However, to meet the safe-harbour in relation to the best interests duty advisers must undertake a 'reasonable investigation' into the financial products that might achieve the objectives of the client that would reasonably be considered relevant to the advice (including any product specifically identified by the client).

32. In addition, ASIC guidance for superannuation account switching suggests that advisers should compare their proposed approach to the customer's current arrangements.[8] It appears that this is not always done in practice.

33. The Government is developing a framework for Comprehensive Income Products for Retirement (CIPRs) following recommendations made by the FSI. This seeks to increase the range of retirement

7 This issue was raised in Counsel Assisting's examination of Mr Sam Henderson (24 April 2018).

8 Australian Securities and Investments Commission, 'Information sheet 182 - Super switching advice: Complying with your obligations' (August 2013) available: http://download.asic.gov.au/media/1347770/Super-switching-advice--complying-with-your-obligations-INFO182.pdf

income products to meet a wider variety of retiree needs and improve the standard of living of retirees. As part of this, options to expand intra-fund advice are being considered to help guide members into a suitable retirement income product.[9]

34. To ensure members are advised of the most appropriate product, one option under consideration is to expressly require financial advisers to demonstrate that any product they offer through financial advice would result in the member being better off when directly compared with the CIPR (a hybrid retirement product) the member has or would be offered in their fund in the absence of financial advice.

35. While this approach is being considered in the context of superannuation, it could prove more complex in the case of other financial products that do not offer a regulated default product. How such a provision could work in these instances would require careful consideration.

Disclosure of conflicted ownership structures

36. Recommendation 40 of the FSI was that advisers and mortgage brokers be required to disclose ownership structures. The FSI found that often consumers do not understand their financial adviser's or mortgage broker's association with product issuers and recommended making ownership and alignment more transparent. The Government has accepted this recommendation and will be developing the necessary legislation.

37. While disclosure is an important regulatory tool, Treasury is not suggesting that the implementation of this reform is sufficient, in and of itself, to address conflicts of interests within integrated institutions.

Structural separation

38. Consideration of options for structural separation requires weighing costs and benefits. An integrated financial services business can offer consumers the ability to access a one-stop shop for their financial needs, the potential for lower costs through economies of scale and access to sufficient financial resources to compensate consumers in the event of certain losses (provided effective remediation arrangements are in place). However, conflicts of interest are also inherent in such business models and the true prices of products and services lack transparency due to cross-subsidies arising from the ability to set prices at multiple points.

39. A more targeted and cost-effective approach could be achieved by considering the types of consumers that are most at risk of harm, for example retail consumers or older Australians, from the existence of such conflicts of interest. Wholesale or institutional consumers have access to significantly greater resources and capability to understand pricing models used by these institutions. They may also have comparable bargaining power to the integrated financial institution. In such cases the need for and appropriateness of requiring structural separation of advice provided to them is likely to be less.

40. It is also important to consider the distinctions in the regulatory framework between general and personal advice. The current regulatory framework defines the provision of mandated product and

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9 Legislation allows superannuation funds to provide simple, non-ongoing personal advice to members and spread the cost of this advice across all members of the fund rather than charging individuals directly. This advice is called 'intra-fund advice' and it must be offered to all members on the same terms. The types of advice which are likely to fit into this category include advice to members on increasing contributions and changing investment options within a fund. The rationale for allowing collective charging was to continue to allow easy access to simple, non-ongoing financial advice on members' superannuation account. Options to expand intra-fund advice (including scaled intra-fund advice) are being considered as part of the CIPRs reforms.

service disclosure documents as general advice. This means that the provision of general advice is an essential part of product manufacture or distribution. Therefore, the separation of advice from product manufacture would necessarily be limited to personal advice or, alternatively, require a change to the definition of general advice. However, the impact on such an approach on consumer outcomes would need to be considered in light of the lesser protections that exist in the provision of general advice.

Some potential implications of structural separation for access to advice

41. In current integrated business models involving personal advice, the costs incurred in the provision of financial advice may be cross-subsidised by revenue generated through the sale of products and payments to platforms obtained through such advice. By removing any cross-subsidisation of the advice business, through separation, the real cost of advice to a customer is likely to become more obvious and upfront.

42. This increased transparency of the total cost of advice may reduce demand for financial advice from consumers as experienced in the UK following reforms to allowable commission structures in financial advice. While greater trust in the advice provided may offset the price effect, consumers choosing not to seek advice, following a sensible assessment of the likely value of that advice, would not be a negative outcome. For example, where consumers are faced with less complex product choices and/or have confidence in their capability to make an informed decision, it may be appropriate (and rational) that consumers do not choose to incur the additional cost of advice. It is also the case that other reforms may reduce consumers' need for advice (for example, DDO as noted above).

43. Innovation and developments in technology are also relevant here. Technology based advice products, often referred to as 'robo-advice', can offer opportunities for cost-effective advice for consumers. While robo-advice remains a nascent development in Australia and in other similar jurisdictions, the Government is introducing reforms to facilitate the entry of such fintech-led advice models in the market.[10]

44. Any consideration of structural separation would also require particular consideration of how it would apply to superannuation funds given superannuation's compulsory nature and funds' integrated approach to advice.

ACCOUNTABILITY WITHIN FIRMS FOR CULTURE AND ADHERENCE TO THE LAW

45. The hearings have raised questions regarding the culture within financial institutions that gives rise to failures by institutions to meet their legal obligations and, where appropriate, broader community standards and expectations. Counsel Assisting has asked a number of questions that go to the culture of the financial services industry.

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10 The *Treasury Laws Amendment (2018 Measures No.2) Bill 2018*, currently before Parliament, proposes to introduce an Enhanced Regulatory Sandbox. In October 2017, the Government released exposure draft regulations, the *Corporations (FinTech Sandbox Australian Financial Services Licence Exemption) Regulations* 2017 and the *National Consumer Credit Protection (FinTech Sandbox Australian Financial Services Licence Exemption) Regulations 2017*, containing the detail of the Enhanced Sandbox. The Enhanced Sandbox builds on ASIC's existing licence exemption, details available at: http://asic.gov.au/for-business/your-business/innovation-hub/regulatory-sandbox/

46. The regulatory framework, while placing a number of obligations and duties on boards and senior management of financial services entities to manage the governance of institutions effectively, does not seek to regulate explicitly for culture within institutions. A range of penalties exist as enforcement mechanisms to ensure such obligations are adhered to.

47. The FSI, in considering the role of regulation in setting culture, took the view that responsibility for culture in the financial system ultimately rests with individual firms and the industry as a whole as attempts by financial regulators to create the right culture using rules would likely lead to over-regulation and unnecessary compliance costs, while negatively impacting competition.[11]

48. Regulation and regulators do, however, have important supporting roles to play. One area where this is the case and that was highlighted in the hearings is the need to ensure that misconduct and poor culture and practices are not transferred from one firm to another through poorly performing senior management, employees and appointed representatives moving between firms. Given the need for co-ordinated action, firms acting individually will always struggle to address such problems. For advisers, the licensing and disciplinary regime for advisers is relevant here and discussed further below.

49. It is also the case that while responsibility for a company's culture and internal governance framework and systems ultimately rests with boards, effective regulation and regulators can again assist. The report of the Prudential Inquiry into the Commonwealth Bank of Australia has underlined this point.[12] Recent legislative reforms — in particular, the Banking Executive Accountability Regime (BEAR) — have also sought to increase the accountability of directors on a board, including non-executive directors.

50. The BEAR was passed by the Parliament in February 2018 and commences on 1 July 2018. It introduces an enhanced accountability framework for authorised deposit-taking institutions (ADIs) and their directors and senior executives (termed accountable persons). By increasing transparency and accountability, the objective of the BEAR is to improve the operating culture of ADI groups by:

   - setting out expectations for how ADIs and their accountable persons conduct their business;
   - introducing significant consequences where these standards are not met, including civil penalties of up to $210 million for large ADIs, $52.5 million for medium ADIs and $10.5 million for small ADIs where an ADI breaches the BEAR, and stronger powers for APRA to disqualify accountable persons;
   - providing for minimum deferral arrangements for senior executives' variable remuneration; and
   - requiring registration of accountable persons and the production of accountability maps and accountability statements, to give APRA greater visibility over lines of responsibility and ensure there is accountability for all aspects of an ADI group's business.

51. The BEAR is focused on conduct that would adversely affect the prudential standing or prudential reputation of an ADI. While prudential matters are often portrayed as concerned with financial risk, they extend to include areas such as non-financial risk management and governance.[13] The initial application of BEAR to only ADIs, within the wider scope of prudentially regulated entities, reflects the

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11 Commonwealth of Australia, 'Financial System Inquiry' (November 2014), p 6, available: http://fsi.gov.au/

12 J Laker et al, 'Prudential Inquiry into the Commonwealth Bank of Australia Final Report' (April 2018) available: http://www.apra.gov.au/AboutAPRA/Documents/CBA-Prudential-Inquiry_Final-Report_30042018.pdf

13 Wayne Byers, 'Speech: Beyond the BEAR Necessities', UNSW Centre for Law Markets and Regulation Seminar, Sydney (2 May 2018) available: http://www.apra.gov.au/Speeches/Pages/Beyond-BEAR-Necessities-2May18.aspx

identification of banking by Government as the priority sector in which to address poor behaviour and accountability.

52. While the BEAR has yet to commence, the initial evidence from the UK, which has had a Senior Managers and Certification Regime (SMCR) in place since March 2016, is that such a regime can be expected to improve clarity of responsibilities and internal governance and controls.[14] In the UK, SMCR has been implemented jointly by the Prudential Regulation Authority and the conduct regulator, the Financial Conduct Authority (FCA).

53. In addition to banks, the SMCR also applies to investment firms regulated by the Prudential Regulation Authority and some insurers. The UK is in the process of extending the SMCR to all sectors of the financial services industry, including those regulated only by the FCA.[15]

54. Increasing clarity of responsibilities and internal governance and controls can play an important role in fostering a culture of accountability. If this is a regulatory tool that the Commission is minded to consider then options may include:

    - to extend the BEAR to other prudentially regulated institutions on similar terms as will apply to ADIs and their subsidiaries. Extension to general and life insurers is likely to be simpler than to private health insurers, which are continuing to transition to APRA's supervision, or the superannuation sector, which has a more complex regulatory structure; and/or

    - to extend features of the BEAR beyond the prudentially regulated sector to all financial services businesses.

55. As the BEAR was designed to be consistent with APRA's prudential mandate, the latter option would raise issues beyond the type of businesses to which it was applied as there would be a wider diversity in the structures the regime would apply to and many would be much smaller in scale. Consideration would also need to be given as to which aspects of the BEAR would be relevant and appropriate for the wider set of businesses, and whether they would apply in the same way as they would to ADIs. The benefit of a wider application, however, would be that it would capture a wider range of institutions and conduct issues.

56. Treasury notes that the ASIC Enforcement Review Taskforce (the Taskforce) considered whether aspects of BEAR should be applied to non-prudentially regulated financial institutions.[16] Having regard to the likely burden created by an accountability regime similar to BEAR on small businesses (which constitute the majority of the institutions solely regulated by ASIC) and the reforms recommended by the Taskforce, the Taskforce did not consider that such a regime was merited. The Taskforce's recommendations are discussed further below.

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14 Mark Carney, 'Remarks at the Banking Standards Board Panel "Worthy of trust? Law, ethics and culture in banking"' (21 March 2017) available: https://www.bankofengland.co.uk/speech/2017/banking-standards-board-worthy-of-trust-law-ethics-and-culture-in-banking

15 Refer to the Financial Conduct Authority (UK) consultation paper: 'CP17/40: Individual accountability: Transitioning FCA firms and individuals to the Senior Managers & Certification Regime', available: https://www.fca.org.uk/publications/consultation-papers/cp17-40-individual-accountability-transitioning-fca-firms-and-individuals-senior-manager

16 The ASIC Enforcement Review Taskforce has been looking, since October 2016, at a range of matters relevant to enhancing accountability and improving culture in the financial services sector. The Taskforce report and government response were released in April this year.

REGULATORY CULTURE AND THE WILLINGNESS AND ABILITY TO IDENTIFY AND REPORT BREACHES AND REMEDIATE

57. The culture within financial firms as it concerns their adherence to legal obligations and, where breaches or failings are identified, their willingness to undertake effective and timely remediation, is also influenced by the regulatory culture that exists.

58. Counsel Assisting has raised questions as to the role of regulatory culture in giving rise to the cases of misconduct and conduct falling below community expectations that have been identified, and asked what changes in the regulatory culture could usefully be made.

59. An often unacknowledged element of an effective regulatory environment is the ability of market forces to discipline firms for breaches of the law or behaviour falling below community expectations. Incumbents not subject to competition can be more complacent about legal sanctions and community concerns.

60. Well-functioning competition is particularly valuable as it represents a non-distortionary and low cost mechanism to improve consumer outcomes. Market forces are also more dynamic and responsive than regulation through legislative solutions.

61. This is one reason why successive governments and inquiries, including the FSI, have placed emphasis on enhancing competitive pressures in the financial system. A number of recent regulatory reforms have accordingly sought to strengthen competition in the financial system. As regulation and the regulatory culture can act as a barrier to the entry of new competitors and their expansion, care needs to be taken to avoid or minimise any barriers to competition arising from them.

62. More obviously, an effective regulatory culture also depends on regulatory agencies having appropriate enforcement powers and a high level of capability to apply them. A number of recent reviews have examined the issue of regulator performance including the FSI (which examined both ASIC and APRA, and the broader regulatory architecture), the ASIC capability review and the Senate inquiry into the performance of ASIC.[17]

63. The ASIC Enforcement Review Taskforce is the most recent official examination of these issues in Australia, and its recommendations are relevant to many of the matters raised in the hearings, as the Commission itself has made clear. Given its significance, relevant elements of the Taskforce's recommendations are outlined below.

64. While having appropriate enforcement and other powers are important, equally important, if not more so, is regulators having the capability to target and use such powers and a coherent strategy to do so. The financial advice hearings have raised issues concerning ASIC's approach to enforcement, and these and other issues that go to the current effectiveness and capability of the regulators is something that the Commission will undoubtedly continue to assess and test over the course of the hearings.

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17 Commonwealth of Australia, 'Fit for the future: A capability review of the Australian Securities and Investments Commission' (December 2015) available: https://static.treasury.gov.au/uploads/sites/1/2017/06/ASIC-Capability-Review-Final-Report.pdf; Commonwealth of Australia, 'Performance of the Australian Securities and Investments Commission' (June 2014) available: https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Final_Report/index

ASIC Enforcement Review Taskforce

The ability to enforce general licensing obligations

65. Counsel Assisting questioned the adequacy and enforceability of the general licensing obligations.

66. The licensing obligations in the *Corporations Act 2001* (Corporations Act), introduced by the *Financial Services Reform Act 2001*, are expressed broadly so as to be capable of accommodating different market structures and different financial products and services, without needing constant amendment as new and innovative products and services come into the market.

67. The principles-based approach was intended to establish, in law, the standards that financial firms would be required to meet, while allowing the firm the commercial freedom to adopt the most appropriate systems and procedures in their circumstances to meet those standards. It was also intended to provide the flexibility to change those systems and procedures as relevant; for example, if the nature or the manner in which services were provided changed.[18] In designing its systems and procedures, it was expected that the firm would also have regard to regulations, any conditions imposed on their licence, industry codes and ASIC regulatory guidance.

68. Enforcement of these obligations has, however, proved cumbersome, with ASIC's only effective options being to revoke licences or negotiate enforceable undertakings. In considering options to improve the enforceability of the obligation, the Commission may wish to have regard to the recommendations of the Taskforce to:

    - provide ASIC with a new directions power to be used where ASIC has reason to suspect that a licensee has or will contravene licensing requirements; and

    - make non-compliance with general licensing obligations civil penalty provisions, exposing licensees to large fines, which could reach $210 million (for licensees with large turnovers).

69. The Government has agreed to the second of these recommendations and agreed-in-principle to the first.

70. While these duties are not imposed on individuals under current law or Taskforce recommendations, under Taskforce proposals accepted by the Government, breaches of the general obligations of directors and officers of companies, such as to carry out their duties with due care and diligence, are already civil penalty provisions, and will attract maximum penalties of more than $1 million (up from $200,000).[19]

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18 Treasury, 'Corporate Law Economic Reform Program Proposals for Reform Paper No 6 – Financial Markets and Investments Reform' (April 1997), p 1, available: http://archive.treasury.gov.au/contentitem.asp?NavId=017&ContentID=286

19 *Corporations Act 2001* (Cth), ss 180-183.

Banning powers

71. The Taskforce also recommended that ASIC's banning power be extended so that the circumstances in which it is enlivened include where ASIC has reason to believe that the person is not:

    - fit and proper to provide a financial service, or to perform the role of officer or senior manager in a financial services business;[20] and/or

    - adequately trained, or is not competent to provide a financial service, or to perform the role of officer or senior manager in a financial services business.

72. This recommendation, also accepted by the Government, would significantly broaden the circumstances in which ASIC could ban directors and officers. The scope of the ban would also be expanded so that ASIC could ban a person from performing any role in a financial services business, addressing an existing anomaly whereby ASIC can ban a person from providing financial services but not necessarily from owning or holding a substantial office in a financial services business.

Breach reporting obligations

73. Currently, Australian Financial Services (AFS) licensees have an obligation to report 'significant' breaches, or likely breaches of their obligations, to ASIC. Self-reporting breaches allows ASIC to monitor non-compliance and take law enforcement and regulatory action (including surveillance) where necessary. Breaches must be reported within 10 business days of the licensee 'becoming aware' of the contravention or likely contravention.

74. The Taskforce recommended and the Government agreed-in-principle to the following:

    - clarifying that the test for the 'significance' threshold for reporting is to be determined objectively rather than subjectively;

    - expanding the obligation for licensees to report a breach to include credit licensees;

    - requiring licensees to report breaches or suspected breaches within 30 days, even where the breach is still being internally investigated; and

    - increasing current criminal penalties for failure to report and also making the requirement to report a civil penalty provision, subjecting licensees in breach to the (recommended to be increased) penalties under that regime.

75. The Commission has heard evidence of significant delays in reporting breaches to ASIC due to the often lengthy time taken by firms to investigate and confirm whether a significant breach has occurred. The recommendations propose a more timely and effective framework for reporting of breaches. The recommendations broaden the threshold for when a breach needs to be reported by requiring cases under investigation to be reported regardless of whether a breach has been determined to have occurred. In recognising the broader obligations, the recommendations provide additional time (an increase from 10 to 30 days) for an institution to make its report.

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20 The Taskforce recommends that this test replace the 'good fame or character' test in section 920A of the *Corporations Act 2001*.

76. Implementation of these recommendations seeks to address the scope of obligations to report breaches by providing greater certainty around which breaches should be reported. It also ensures timely and effective reporting of breaches by clearly establishing when an obligation to report arises.

Remediation and ASIC's directions power

77. ASIC has existing powers to modify an AFS or credit licensee's ongoing systems and conduct after the relevant licence has been granted. These powers include:

- varying, suspending or cancelling the licence if ASIC can establish the licensee has breached the law and the breach justifies this action;
- applying to the court for an injunction; or
- negotiating an enforceable undertaking with the licensee (with their cooperation).

78. The Taskforce identified shortcomings in relation to these powers. These include that varying licenses such as by adding conditions is subject to significant procedural requirements, that there are time, cost and resource implications in applying for injunctions, and that enforceable undertakings require the acquiescence of the licensee.

79. The Taskforce recommended, and the Government has agreed-in-principle, to the following measures to address this:

- enabling ASIC to direct a licensee in the conduct of their business where necessary to address or prevent consumer risk and where ASIC has reason to suspect that a licensee has or will contravene licensing requirements, and
- applying civil penalties for non-compliance with an ASIC direction.

80. Under this proposed directions power, ASIC would be able to direct licensees to establish a suitable remediation program to assess claims for restitution or compensation to customers.

81. The proposed power would be subject to procedural fairness and would allow for review by the Administrative Appeals Tribunal.

82. ASIC can also encourage licensees to establish remediation programs through enforceable undertakings.

THE LICENSING REGIME

83. Counsel Assisting has posed a specific question on whether the regulatory framework should require a dual licencing regime, with licensing at both the individual adviser and the entity level.

84. Outlined below are some of the reasons for the current entity licensing approach, relevant future reforms implemented or committed to by Government, and considerations that the Commission may wish to take into account in considering alternative approaches.

85. As noted above, Treasury considers that it is important that the regulatory framework ensures that poor conduct by advisers is not allowed to persist through a regime that enables advisers with poor practices to avoid discipline by moving from one financial institution to another. Treasury believes that a dual licensing regime and/or additional changes to the disciplinary regime for advisers could provide further protection against such practices — and should be given full consideration. The Commission

would need to consider, holistically, how any changes to the licencing regime would interact with reforms currently underway and any further changes to the disciplinary regime.

Dual level licensing

86. Under the Corporations Act, licensing is at the entity (firm) level rather than at the level of the individual providing the financial service. This approach was proposed in *Corporate Law Economic Reform Program Proposals for Reform Paper No 6* (CLERP 6), which supported moving away from a system of direct licensing of representatives and agents to ensure that regulatory resources were more effectively targeted.[21]

87. In the CLERP 6 report, it was noted that the removal of direct licensing of representatives was balanced by:

    - imposing liability on the principal to compensate any loss suffered by a client as a result of a representative's conduct;
    - imposing standards of conduct which require full disclosure of an adviser's, and their associates', conflicts of interest, and the suitability of recommendations to a client's individual circumstances, investment objectives and particular needs; and
    - specifying the responsibility of the principal for adequate training and supervision of representatives.

88. Subsequent reforms have seen a shift towards increasing the accountability of individual advisers through imposing some legal obligations directly on advisers. For example, the FOFA reforms introduced the best interests duty, a ban on conflicted remuneration and opt-in obligations, all which apply directly to financial advisers. More recently, the 'professional standards' reforms will mean that responsibility for adequate training of advisers no longer rests solely with the licensee.[22] Instead, it is the adviser who will need to meet the education and training standards in order to be able to qualify as a 'relevant provider' of financial advice.[23]

89. If the Commission were to consider a move to dual licensing, consideration would need to be given as to which obligations would be imposed at which licence level, and what resources would be required for regulating each licence level.

90. Also, in relation to responsibility for compensation arrangements for losses suffered as a result of a representative's conduct, were this to be imposed solely on individual advisers, consideration would need to be given to the limitations of professional indemnity insurance. The rationale for the obligation for compensation to be at the entity level is that a firm's increased financial resources, compared with its individual advisers, will mean it is more capable of compensating for consumer losses. This can be seen in the example of unpaid external dispute resolution (EDR) determinations. While the total

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21 Treasury, 'Corporate Law Economic Reform Program Proposals for Reform Paper No 6 – Financial Markets and Investments Reform' (April 1997), p 1, available: http://archive.treasury.gov.au/contentitem.asp?NavId=017&ContentID=286

22 Refer to Treasury's information note to the Royal Commission on the professional standards reforms, provided 2 March 2018.

23 Personal advice to retail clients in relation to relevant financial products can only be provided by a 'relevant provider' (*Corporations Act 2001,* section 910A).

amount of outstanding unpaid EDR determinations at 30 June 2017 was $14,545,956, none of these related to APRA-regulated entities; unpaid determinations were only related to smaller firms.[24]

Professional discipline of financial advisers

91. Counsel Assisting has also posed the question of whether it would be possible to implement a single system for professional discipline of financial advisers.

92. Currently, not all individual financial advisers are required to be part of a professional association that regulates their conduct, in contrast to, say, lawyers and doctors who are required to be individually licensed and members of a professional association. Further, the existence of multiple professional bodies can mean that advisers can switch between bodies and that professional associations may not be aware that advisers are being investigated or that disciplinary action has been taken.

93. The Government announced that it would raise the education, training and ethical standards of financial advisers to improve consumer trust and confidence in the financial services sector. Professional standards were intended to increase the likelihood of consumers receiving customer-focused quality advice and to facilitate consumer access to information about financial advisers' experience and qualifications to improve transparency and competition. As part of the professional standards reforms, professional associations for financial advisers will have a greater role in monitoring their members, and will themselves be subject to a greater degree of scrutiny.

94. Under the reforms, the Financial Adviser Standards and Ethics Authority (FASEA) will develop a code of ethics.[25] Professional associations will be able to apply for approval by ASIC to be code monitoring bodies, and all advisers will be required to subscribe to the code of ethics of a code monitoring body by 1 January 2020. While the reforms contemplate the existence of multiple code monitoring bodies, advisers will be prohibited from changing schemes while they are under investigation by a monitoring body. Where an adviser breaches the code, the professional association must report the breach to ASIC and the licensee of the adviser. In addition, details of any breaches of the code of ethics and any subsequent sanctions imposed by the monitoring body will be listed on the register of financial advisers.

95. While professional associations will be required to monitor their members for compliance with the code of ethics, associations will have the ability to impose additional conduct and ethical standards that go beyond the code of ethics on their members.

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24 Commonwealth of Australia, 'Review of the financial system external dispute resolution and complaints framework - supplementary final report' (September 2017), p 40, available: https://treasury.gov.au/publication/supplementary-final-report/

25 A draft code of ethics has been released by FASEA for public consultation until 1 June 2018, and can be accessed at https://www.fasea.gov.au/consultations/code-of-ethics/

ATTACHMENT A – SUBMISSION NAVIGATION TABLE

Question Areas	Reference	Additional material and considerations that may assist the Royal Commission
Fees for no service	Treasury does not make a submission on these questions.	
Investment Platform Fees	Treasury has referred to platform operators in paragraph 17 and addresses this as the submission on *Addressing Conflicts of Interest* in paragraphs 17 to 44.	
Inappropriate Financial Advice and Improper Conduct by Financial Advisers	Treasury addresses some of the questions raised in these submissions on *Addressing Conflicts of Interest* in paragraphs 17 to 44. If a question is not addressed in this document, Treasury does not make a submission as to that matter.	Treasury refers to the following: • Retail Distribution Review (United Kingdom) (paragraph 19); • Securities and Exchange Board of India Paper on Amendments/Clarifications to the SEBI (Investment Advisers) Regulations, 2013 (paragraph 19); • The Commonwealth of Australia, November 2014, Financial System Inquiry (paragraph 20 and also at 26, 33 and 36); • The Productivity Commission inquiry into Competition in the Australian Financial System (paragraph 20); • The Productivity Commission inquiry into Superannuation: Assessing Effectiveness and Competitiveness (paragraph 20); • The *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017* (paragraphs 27 to 29); • The proposed Design and Distribution Obligations (paragraphs 25 to 30); • The proposed Product Intervention Power (paragraph 25 to 30); • ASIC Information Sheet 182 Super switching advice: Complying with your obligations (paragraph 32); • Development of a framework for Comprehensive Income Products for Retirement (paragraphs 33 to 35); • Consideration of the costs and benefits of structural separation (paragraphs 38 to 44); and • Consideration of technology based advice products (paragraph 43).

Question Areas	Reference	Additional material and considerations that may assist the Royal Commission
The Disciplinary Regime for the Financial Advice Profession	Treasury addresses issues of the regulatory culture in paragraphs 45 to 64 of these submissions. Treasury addresses the questions regarding licencing and suggestion of a single licensing system in paragraphs 65 to 95 of these submissions.	Treasury refers to the following: • The Commonwealth of Australia, November 2014, Financial System Inquiry (paragraphs 46 to 62); • The Banking Executive Accountability Regime (paragraphs 49 to 56) and consideration of its applicability to a broader set of businesses (paragraphs 54 to 55); • The United Kingdom Senior Managers and Certification Regime (paragraph 52 to 53); • The ASIC Enforcement Review Taskforce (paragraphs 56 to 81); • The Fit for Future: A capability review of the Australian Securities and Investment Commission Review of December 2015 (paragraph 62); • The Performance Review of the Securities and Investment Commission Review of June 2014 (paragraph 62); • The Corporate Law Economic Reform Proposal for Reform Paper 6 (paragraphs 67 and 86 to 87); • Professional Standards Reforms already referred to in Treasury's information note to the Royal Commission (paragraph 88); • Consideration of which obligations would be imposed at which level (paragraph 89); • Consideration of professional indemnity insurance issues (paragraph 90); and • The Financial Adviser Standards and Ethics Authority (paragraph 94).
Other questions	Treasury addresses the separation of products and advice in these submissions in paragraphs 38 to 40. Treasury addresses a possible reform that may address bans on remuneration in paragraph 29, and notes the FOFA reforms in paragraph 88.	Treasury refers to the following: • Consideration of how structural separation will apply to superannuation funds (paragraph 44).