What's on ASIC's financial advice radar?

In 2011, ASIC will be focusing on the following financial advice themes:

- Aggregator licensees;
- Quality of advice;
- Advice relating to complex products such as capital guaranteed products; and
- The use of managed discretionary accounts (MDAs).

Aggregator licensees

All licensees are required to have robust systems and processes in place to ensure quality financial advice is provided to consumers. Inappropriate advice not only impacts the individual client that suffers the loss, but also damages the reputation of the industry when consumers lose confidence in the advice process.

Under the licensing regime all licensees are expected to properly manage and supervise representatives and employees, ensure conflicts of interest are appropriately managed or avoided, ensure staff are competent and adequately trained, and ensure client complaints are dealt with promptly and adequately.

In recent years, a number of licensees have sought to rapidly grow their business by acquiring other financial advice businesses. Concerns have been raised that some of these aggregators are not properly resourced and funded and as a consequence might not be meeting their licence obligations. The perception is that they might be running what ASIC refers to as 'lite touch' business models.

In 2011, ASIC will be looking closely at licensees who may be running such business models. When we become aware of these licensees, we will visit the licensee's business and 'kick the tyres' to scrutinise how well they are complying with their licence conditions, as well as the advice being provided to clients.

Some hallmarks of lite touch business models that we have seen already include:

- licensees who operate a one size fits all business model;
- licensees who have inadequate or poor quality compliance resources;
- licensees who have a poorly resourced and inadequate dispute resolution process; and
- licensees who fail to do simple things like retain copies of client files.

One-size-fits-all business models

One size fits all business models are a red flag to ASIC as there is a very high probability that some clients will be receiving inappropriate advice from a licensee who provides all their clients with the same type of advice.

When ASIC becomes aware of such business models, we will closely examine the model being used as well as the advice that has been provided to clients.

Inadequate or poor quality compliance resources

Where a licensee has a low ratio of compliance staff to advisers it is likely the advisers are not being properly monitored and supervised. This is also the case where compliance staff are poorly trained or do not have the skills, mandate and experience demanded of the role.

Making a proper investment in the compliance function and ensuring good quality advice is given to clients can save licensees a considerable amount of time and money down the track.

ASIC is often asked 'how much is enough' when it comes to compliance. This is a difficult question to answer as each licensee's business model is different. Some key points to note are that:

- a strong compliance culture starts at the top. If senior management only plays lip service to compliance, the organisation as a whole will not value compliance. This creates an environment where inappropriate advice and poor business practices are likely to be more prevalent;
- compliance staff should not have a dual function where they also provide advice to consumers. They need to be independent from the day-to-day advice process to ensure they are not conflicted;
- compliance staff need to be given the time and mandate to properly conduct file audits. A proper file audit is not a simple tick the box exercise. It involves critically assessing whether appropriate advice has been provided to the consumer; and
- compliance staff need to be in a position to require individual adviser follow-up where inappropriate advice has been given or other non-compliance issues are identified. The follow-up should always include additional file reviews and may also involve additional adviser training and in some cases disciplinary action.

Inadequate dispute resolution processes

In ASIC's experience, the quality of a licensee's dispute resolution system is a good indicator of the overall quality and soundness of the licensee's business. Licensees that manage complaints well tend to have higher overall levels of compliance as it ensures mistakes are identified and dealt with quickly, staff training gaps are spotted and fixed, and bad apples terminated.

Licensees that take dispute resolution seriously invest a good deal of time and effort (including management time) into resolving complaints. These licensees are passionate about customer satisfaction and see complaints management as a way of turning a dissatisfied customer into a happy and loyal customer.

Complaints management tends to be an early indicator of problems with a licensee. If ASIC hears of a rise in complaints against a licensee, it can be a signal that problems are starting to surface and the licensee is likely to require increased regulatory attention and supervision.

Non retention of client records

When a licensee is failing to retain client records it is often an indication that a licensee's business is poorly run and/or does not take its license conditions seriously. Standard licence conditions stipulate that client files must be retained for a period of seven years. Licensees are required to retain client files even when advisers leave the business. Client records can be retained electronically or in hard copies. Some licensees rely on agreements with former advisers to provide client files on request, however these agreements rarely work in practice and the licensee is often left exposed.

Failing to retain client files is a dangerous practice for the following reasons:

- it is a straight breach of a licence condition. There are a number of serious consequences for breaches of licence conditions ranging from the cancellation or suspension of a licence through to a variation of licence conditions.

- if a client claims they have received inappropriate advice the licensee will not be able to defend the allegation as they will have no record of the advice given.

Where we see evidence of lite touch business models we will take strong regulatory action. This might include licence cancellations or suspensions, the imposition of additional licence conditions and the banning of individual advisers and/or directors.

Quality of advice

ASIC will continue to look closely at the quality of advice provided to consumers. For consumers to have confidence in the advice process it is essential they receive good quality financial advice that properly considers their circumstances and meets their needs.

Where we have concerns about the appropriateness of advice provided to clients we will review client advice files ourselves and/or require the licensee or an external auditor to audit the quality of advice provided. Where the licensee or an external auditor conducts the file audits we will conduct random spot checks on the quality of those audits. Reviews of client files involve examining whether:

- The advice addresses the client's identified needs, objectives and financial situation;
- The provider understands and has taken into account the financial, tax, legal and any other consequences for the client should they following the advice;
- The advice addresses the advantages and disadvantages for the client if they follow the advice, including if expected benefits are not received, certain assumptions are not realised or certain risks occur;
- At the time of giving the advice, the client's financial needs and objectives were likely to be advanced by pursuing the advice;
- Having received the advice the client is able to make an informed decision in their best interests; and
- The client has not been inappropriately switched into another product in the chase for fees payable to the adviser or licensee.

Where inappropriate advice has been provided to clients the licensee will be required to inform clients about their IDR processes, explain how to make a complaint, promptly assess the complaint and pay compensation.

Other consequences of providing inappropriate advice include licensing action against the licensee for failing to properly supervise and monitor advisers as well as the banning of individual advisers. Of course, ASIC action can also have a reputational impact as actions are publicly reported.

Complex products such as capital guaranteed products

In the last 18 months we have seen a proliferation of complex products. A number of these products are highly risky and unsuitable for many consumers. While we will be looking at complex products across the board we will be focusing in particular on capital guaranteed products.

During the GFC many clients were alarmed at the unprecedented falls in the value of their investments. Tragically, people were forced to delay their retirement plans and resume working as they watched the value of their investment fall and their retirement nest egg erode. This experience has led to larger numbers of advisers offering structured capital protected and capital guaranteed products.

These products are often very complex and generally no two are the same. If an adviser recommends these products to clients, it is vital the adviser fully understands how the products work and carefully considers whether they are appropriate to the client's circumstances and investment goals. The adviser should also be in a position to explain to the client the risks associated with the product and quantify the potential for loss. This will help ensure the client is fully informed.

In the coming months, ASIC will be conducting a 'Health Check' on structured capital protected and guaranteed products, particularly where these products require the client to borrow up to 100% of the investment amount via a non-recourse loan. Our Health Check will update ASIC's *Review of disclosure for capital protected products and retail structured or derivative products* (Report 201) and our 2010 consumer publication, *Get the facts: Capital guaranteed or protected investments*. The objective of our Health Check is to:

- Identify risks and other issues;
- Provide guidance to the industry on product promotion and disclosure; and
- Review advice on these products to ensure the advice is appropriate.

Managed Discretionary Accounts (MDAs)

There has been a spike in the use of MDA's in recent years, with MDAs becoming a common alternative to managed funds. While the use of MDAs might be appropriate for some clients, we are concerned there is real potential for their mis-use. In particular, when we look at MDAs in the coming months we will be looking at the use of higher risk strategies such as gearing and clients being placed into conflicted products.

Other issues we will be scrutinising include whether:

- the licensee is properly licensed to offer MDA services;
- there is an MDA contract on file;
- the investment program has been reviewed every 12 months and includes an SOA confirming the ongoing suitability of the MDA for the client;
- there is evidence the client's MDA portfolio assets are owned as discrete assets;
- in instances where the client has specified any special instructions regarding the MDA service, whether these instructions have been followed;
- the client has undertaken margin lending to invest in the MDA service and if so, is the margin lending appropriate;
- the client is not invested in any unregistered schemes;
- there is evidence the client is receiving quarterly reports from the MDA service provider which includes a portfolio valuation, transactions during the relevant period including income and expenses; and
- clients are receiving adequate disclosure.