ASIC

Australian Securities & Investments Commission

REPORT 251

Review of financial advice industry practice

September 2011

About this report

This report details our findings and recommendations from a review of the 20 largest Australian financial services (AFS) licensees that provide financial product advice to retail clients.

About ASIC regulatory documents

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Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

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This report does not contain ASIC policy.

Contents

Executive summary

1 This report presents general findings from the responses to an ASIC questionnaire that were received in 2010 from the 20 largest Australian financial services (AFS) licensees that provide financial product advice to retail clients (top 20 licensees).[1] The questionnaire sought information about industry practices, based on data from the 2008 and 2009 calendar years. This report details those findings and outlines our expectations about good practice.

2 The motivation for approaching the top 20 licensees was to closely examine financial advice compliance systems and to inform our analysis of the key risks facing the gatekeepers in the financial advice industry. Robust compliance systems help licensees actively mitigate risks to their businesses, which maximises the potential to deliver quality financial advice to consumers and increase confidence in advice and financial advisers.

3 The results of the questionnaire were self reported by the top 20 licensees in 2010. As we undertake follow-up surveillances on licensees, we are examining, among other things, how well licensee compliance policies are reflected in actual practice. Having good compliance systems is fundamental to good practice in financial services.

Background

4 The motivation for this work is informed by two of ASIC's legislative objectives:

(a) to ensure the efficient and effective operation of financial markets; and

(b) to promote confident and informed participation of investors and consumers in the financial system.

5 There are significant benefits for ASIC and licensees in conducting these reviews.

6 First, effective regulation of licensees requires a good understanding of their business models. The information obtained from the top 20 licensees has informed a set of risk indicators that we are using to target our regulation of licensees. These indicators build a picture of each licensee and its business models based on key risk categories that we identified. Using this information, along with other more reactive inputs (e.g. complaints to ASIC), we have determined the types of risk to licensee businesses that we need to focus our resources on as part of our regulatory program.

[1] In this report we use the term 'licensee' to mean AFS licensees that provide financial product advice to retail clients.

7 Second, by targeting our activity, we are able to focus on the critical issues affecting licensees and consumers of financial advice. Licensees with robust and strong compliance frameworks and good risk-mitigation processes should benefit over the longer term as we focus our attention on those licensees where risks are not addressed and where compliance frameworks are weaker.

8 Third, the information also provides us with an opportunity to highlight current risk-mitigation practices by licensees and to discuss examples of good proactive compliance. Both individual licensees and the financial advice industry as a whole benefit from having a clear understanding of good practices and our expectations of gatekeepers regarding those practices. As part of this review, we have provided extensive feedback to participating licensees to assist the future assessment of risks in their business. A number of licensees have indicated that this feedback has been beneficial to their forward planning, and most have indicated that they have implemented a number of changes to their practices as a result of engaging with the areas covered by the review.

9 We thank the top 20 licensees for their time and effort in assisting us. The information obtained has been useful to us in numerous contexts. We believe that, as a refined version of this questionnaire is extended to licensees that were not part of the original review, over the longer term this work will assist in raising compliance standards and ultimately improve consumer confidence in the financial advice industry.

What we did

Questionnaire sent to licensees

10 In December 2009, we sent out questionnaires to those licensees we identified as being the 20 largest licensees we regulate. These licensees were identified by the number of advisers that they have under their licence.

11 Together, these top 20 licensees covered just over 13,000 individual advisers[2]—66% of these were authorised representatives and 34% were employee representatives of licensees (these representatives are referred to collectively in this report as ‘advisers’). The top 20 licensees combined had a total of 4.6 million clients, of which almost 1.5 million were identified by licensees as active. As at 2009, 70% of the advisers within the top 100 licensees were part of the top 20 licensees. The estimated average size of a client’s assets was around $131,000.

[2] There will be some double counting as some individual advisers may be a representative of more than one licensee.

12 The questionnaire asked licensees to provide data from the 2008 and 2009 calendar years on such topics as:

(a) their business model;

(b) their training regime;

(c) monitoring and supervision;

(d) the products they advised on and client strategies; and

(e) their complaints handling and compensation arrangements.

13 We conducted follow-up interviews with licensees where the responses indicated further information was needed.

Limitations of using the questionnaire

14 The information presented is based on self-reporting by licensees on activity relating to the 2008 and 2009 calendar years. Some licensees will have altered their compliance frameworks since the questionnaire was completed.

15 Because this information is self-reported, we have relied on licensees to provide accurate answers, information and data. Therefore, it was disappointing to see, during our follow-up surveillance work with selected licensees, that what had been reported in the questionnaire did not always match a licensee’s on-the-ground practices. This is something we are discussing with licensees.

16 In considering our regulatory response to breaches of legislation, one of the factors we will take into account is the robustness of a licensee’s compliance systems and the seriousness with which a licensee takes its responsibilities as gatekeeper.

What we found

17 Across the top 20 licensees, we found that most were taking steps to mitigate key risks. Often, the initial analysis of information supplied by licensees indicated that a risk existed, but further discussion at licensee meetings revealed how licensees were addressing those risks through additional measures or mitigation strategies. There were, however, certain risks that we still think pose some challenges.

Licensee business models

18 Most participating licensees have invested significant time and effort in educating and informing their clients.

19 Management of conflicts of interest remains the critical risk that requires more attention from licensees.

Training of advisers

20 All participating licensees committed significant resources to training their advisers. Some licensees are providing additional training to advisers on non-standard products.

Monitoring and supervision of advisers

21 All participating licensees conducted some advice audits to examine the appropriateness of advice. One area of concern emerged where licensees did not select files for reviews at random (including within a risk-driven approach). We also saw evidence of some licensees notifying their advisers of the files to be reviewed prior to the audit taking place.

22 Many licensees are not checking references for new advisers with their previous licensee. This practice allows ‘bad apples’ to continue in the industry.

23 Identifying and recording breaches is a very important mechanism for licensees in assessing emerging issues around the activities of advisers.

24 Many licensees do not retain copies of client records separately from advisers. This may lead to difficulties for licensees responding to future enquiries or complaints about advice provided.

Product and strategic advice

25 All licensees reviewed use and maintain an approved product list. The median number of products on approved product lists was around 400; however, despite these relatively large product lists, there remained a tendency to concentrate product recommendations into a few key products.

26 Nearly all participating licensees use model portfolios to allocate and diversify client assets. All participating licensees also use risk-tolerance tools to assess their clients’ attitude to risk.

Complaints handling and compensation

27 All participating licensees were able to provide comprehensive complaints statistics and most indicated that they analyse the issues behind the unresolved complaints.

28 All participating licensees reported that their professional indemnity (PI) insurance covered all of their products and services; however, we understand

that some licensees are finding that new or renewed policies have significant exclusions for more risky products and services.

Recommendations

29 Based on our findings from this review, we make the recommendations set out in Table 1.

30 Licensees will already be aware that significant changes affecting the way in which the financial advice industry operates have been included in the proposed Future of Financial Advice (FOFA) reforms announced by the Government in April 2010. All recommendations in this report should be read in conjunction with any regulations that are enacted as part of the FOFA reforms.

Table 1: Recommendations for licensees and advisers

Licensee business models See Section A	Licensees should ensure that they effectively manage (and, where applicable, avoid) conflicts of interest in their business models. Disclosure alone will not always satisfy a licensee's obligations, and this needs constant oversight. Licensees should refer to Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181) for more information on our expectations on how to deal with conflicts of interest.
Training of advisers See Section B	Licensees should continue to give training a high priority, as this lessens the risk of poor advice being provided.
Monitoring and supervision of advisers See Section C	Licensees need to make sure that their stated procedures are fully complied with by their advisers and are constantly refined based on assessments of audit outcomes. The consequences for failing to meet licensee standards should be clear to all parties and strictly enforced by licensees without fear or favour. Licensees should always conduct reference checks on their new advisers by contacting previous licensees. We expect licensees to be active in reporting breaches and clearly demonstrate to ASIC that they have an adequate remediation plan. Licensees should retain access to client records so that they can respond to client complaints or disputes and can review adviser conduct whenever they need to do so.
Product and strategic advice See Section D	Conflicts of interest within the approved products need to be actively managed. If advisers are recommending high levels of a few products, then the reasons need to be explored and justified. When considering what strategies to recommend to clients, licensees and advisers should educate clients about risk and return so that their expectations are more realistic.
Complaints handling and compensation See Section E	We expect licensees to invest significant time, funding and resources, including senior management support, into ensuring they handle complaints well. We expect licensees to carefully consider the terms of their PI insurance policy, including any exclusions for risky products or services, and ensure that they can demonstrate that they are in a position to compensate clients for potential losses that may occur anywhere in their business operations.

Future risk-based surveillance activity

31 We will shortly approach the 30 next largest AFS licensees that provide financial product advice to retail clients with a reduced and more targeted questionnaire, which has been informed by the results of the first questionnaire. It is expected that this second phase of the project will commence in the first half of the 2011–12 financial year. ASIC will not use its information-gathering powers to seek this information, unless requested to do so by the licensee, as feedback from the first questionnaire indicated that most licensees are willing to participate voluntarily.

32 Licensees will be aware that, if engaging in credit activities, they must hold an Australian credit licence (credit licence) or be an authorised representative of a person who holds a credit licence. AFS licensees are reminded that they need to consider whether they also require a credit licence: see our information sheet *Does the new credit regime apply?* (INFO 101) and Regulatory Guide 203 *Do I need a credit licence?* (RG 203).

33 This year, as part of our routine surveillance work, we will be checking whether licensees are properly licensed for any credit activities. We strongly encourage licensees to consider this issue and make an application for a credit licence as soon as the need is identified.

A Licensee business models

Key points

Most licensees have invested significant time and effort into educating and informing their clients.

Management of conflicts of interest remains the critical risk that requires more attention from licensees.

34 We expect licensees to have strong controls and procedures in their businesses that address all potential risks, both at the licensee level and the consumer level.

35 In our review we found that there were some significant variations in the business models of the top 20 licensees. We did not assess one business model of a licensee against another; rather, in reviewing the business models, we expected to see that key risks were recognised and mitigation strategies in place. It is not sufficient to have good mitigation strategies in policy manuals if audits demonstrate that they are not being effectively or consistently implemented.

Client education

36 All the top 20 licensees had devoted educational resources to help consumers to get the most out of the financial advice they are receiving. This is important, as engaged consumers are more likely to probe adviser recommendations, and advisers are better able to 'tease out' client needs and objectives from engaged consumers.

37 Overall, there was a good appreciation of the additional tools and assistance consumers need when accessing and understanding financial advice. Examples included interactive tools on licensee websites, educational communications, support for the provision of pro bono advice, and no minimum monetary balances to access advice.

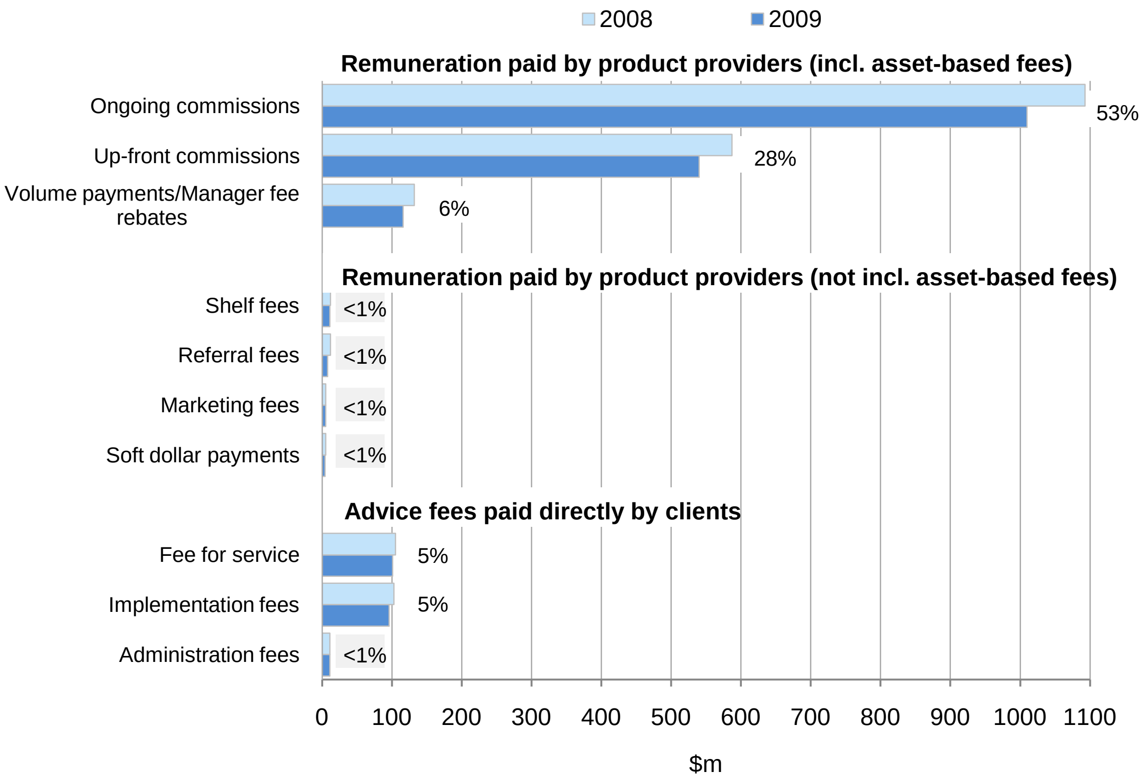
Conflicts of interest

Licensee revenue and adviser remuneration

38 Our questionnaire identified a number of conflicts of interest around licensee revenue and adviser remuneration.

39 The majority of licensees filling out the questionnaire indicated that they remunerated their advisers based on the volume of financial products sold. This remuneration included ongoing commissions, up-front commissions and volume rebates: see Figure 1.

Figure 1: Licensees' remuneration paid by product providers and directly by clients



Note: Figures are based on information provided by the top 20 licensees.
Source: ASIC

40 Similarly, the top three revenue streams for licensees are linked to volume sales paid by the fund manager or product provider to the licensee.

41 Some licensees filling out the questionnaire indicated that they have approved products that are exclusive to that licensee. This gives rise to a potential conflict of interest when advisers recommend the product, particularly where the product may have higher profitability or remuneration for the licensees or advisers.

42 For a few licensees, share options or share purchase arrangements formed part of adviser remuneration arrangements. By sharing in the profitability of licensees, advisers often have an incentive to recommend products (e.g. products exclusive to the licensee) because the product may have higher profitability for the licensee.

43 Where conflicts of interest are prevalent in business models, there is more likelihood of poor or deficient advice being generated. In further discussions, some licensees were able to demonstrate effective approaches to managing

these conflicts, while other licensees were not. We expect to see licensees implement processes and controls that address these risks and that are seen to be effective and fully supported by advisers.

44 Some of the conflicts of interest that the questionnaire identified raised real and present risks to licensees' businesses, including:

(a) increased possibility of deficient or inappropriate advice—volume-based remuneration of advisers can increase the possibility of inappropriate advice and open the licensee up to costly litigation and/or external dispute resolutions (EDR);

(b) increased possibility of client complaints about exclusive product recommendations—if a licensee recommends a product that is exclusive to itself, clients may not be able to continue to hold the product if they move to a different licensee at a later stage. We encourage all licensees to review their disclosure of any restrictions that may apply to products recommended by their advisers, and ensure that this disclosure is specifically brought to clients' attention. Licensees should also be targeting their file audits on exclusive product recommendations to ensure that the advice is appropriate to the client's needs; and

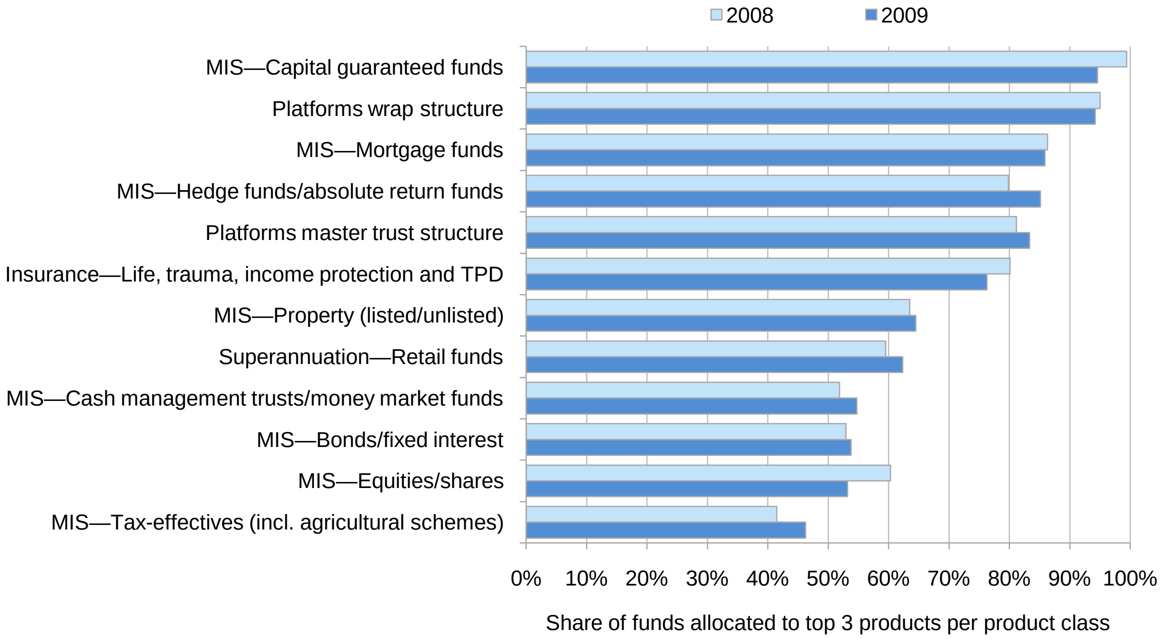
(c) product concentration opening the licensee up to significant risks if there is product failure—because the majority of licensees rely on remuneration based on volume of sales as their primary source of revenue, this may well be generating a pattern of significant product concentration among the top 20 licensees. Ongoing commissions from the top three products recommended by all 20 licensees represented 37% of all ongoing fees. Similarly, up-front commissions on the top three products that licensees recommended generated 43% of all up-front commissions.

Product concentration

45 Figure 2 shows the proportion of funds under advice flowing from each licensee into the top three products (by total funds invested) for each product class (e.g. managed investment schemes, platforms, superannuation).[3] For example, in platforms with wrap structures, around 95% of funds are held in the top three products, while around 60% of all funds are in the top three retail superannuation products.

[3] Data for insurance products refers to premiums rather than investment amount.

Figure 2: Percentage of funds under advice per product allocated to the top three products/providers



Note 1: MIS = managed investment schemes; TPD = total and permanent disability.
Note 2: Figures are based on information provided by the top 20 licensees.
Source: ASIC

46 Product concentration needs to be managed and risk-mitigated by licensees because, if the majority of their clients' funds are held in one or two products, there is significant concentration risk. Failure in one product could be very serious for the licensee (as well as its clients). As Figure 2 shows, the top three products for most licensee groups received a high share of total funds for that product class.

Buyer of last resort programs

47 At least a third of licensees continue to participate in 'buyer of last resort' programs with their advisers. These programs are generally structured so that when an adviser decides to retire (and does not sell its business to another adviser), the licensee will buy the business and the adviser will receive a payment based on a multiple of recurring revenue. The figure will generally vary depending on the types of product recommended to clients. There is a potential conflict of interest in these programs where the multiples used are higher for licensee products.

FOFA reforms

48 We note that the proposed FOFA reforms may radically change these remuneration models. In the meantime, we expect all licensees to carefully manage the conflicts caused by such remuneration structures. We note that

disclosing conflicts of interest may not be sufficient and that licensees should also consider how they actively avoid conflicts of interest: see Section C.

Licensee business models—Conflicts of interest

Licensees should ensure that they effectively manage (and, where applicable, avoid) conflicts of interest in their business models. Disclosure alone will not always satisfy a licensee's obligations, and this needs constant oversight. Licensees should refer to Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181) for more information on our expectations on how to deal with conflicts of interest.

B Training of advisers

Key points

All the top 20 licensees committed significant resources to training their advisers.

Some licensees are providing additional training to advisers on non-standard products.

Through Consultation Paper 153 *Licensing: Training and assessment framework for financial advisers* (CP 153), we are proposing a three-stage assessment and professional development framework for financial advisers.

49 Given the importance of training to the quality of financial advice and to ensuring that advisers understand their legal obligations, particularly to clients, we were encouraged to see significant resources and effort put into adviser training.

50 In particular, the top 20 licensees all:

(a) provided internal training to their advisers;

(b) provided training on compliance and an adviser's legal obligations, which was nearly always mandatory;

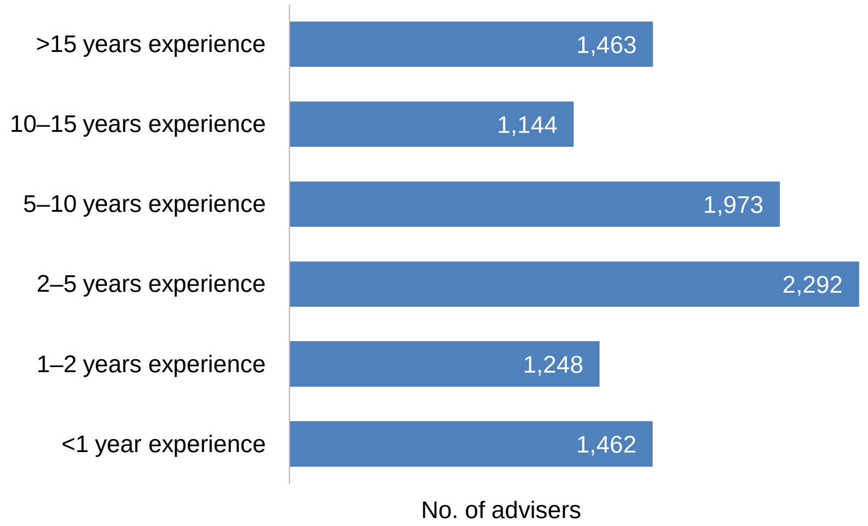
(c) had a set number of development days, key compulsory areas of training and continuing professional development days; and

(d) made use of external professional providers to help train their advisers.

51 The minimum number of hours devoted to training ranged from 10 to 40 compulsory hours per year, and this was provided at regular intervals throughout the year (semi-annual, quarterly or even monthly) by all the top 20 licensees. Figure 3 shows that around 47% of advisers (of the participating licensees) have been in the industry for over five years; therefore, five years or more has elapsed since initial training was completed for most advisers. This highlights the importance of continuing professional development and education for advisers.

52 We require all licensees' adviser training to be compliant with Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146) and all advisers to have completed any necessary training as determined by their authorisations. We note that not all licensees completing the questionnaire indicated that all their advisers were compliant with RG 146. This is something that we are following up.

Figure 3: Advisers of licensees—Years of experience in industry



Note: Figures are based on information provided by 16 of the top 20 licensees, who were able to provide information on this topic.

Source: ASIC

53 There were some licensees that provided their advisers with additional training for some non-standard or higher-risk products (e.g. hedge funds or capital guaranteed funds). However, the additional training did not always cover all such products and varied in approach between examinations with accreditations and additional product updates. We expect that where new products involving complex structures (e.g. derivatives) are being made available for recommendation, advisers will be given the appropriate authorisations and have specific training on the features and particular risks of these products before they make recommendations to clients involving these products.

54 We were also encouraged to see that licensees have regular monitoring and oversight of their training programs. We particularly support those licensees that have mechanisms for identifying new adviser training needs and early identification of any training or skill gaps.

55 Despite the efforts of the top 20 licensees in training, we and many in the industry are of the view that there remains a need to lift standards among some licensees. Through CP 153, we have recently consulted on proposals to require:

(a) all new and existing advisers who provide personal or general advice to retail clients on Tier 1 products to pass a national examination;

(b) all new advisers, following their certification, to be monitored and supervised by a supervisor (who has at least five years experience in the industry) for a minimum period of 12 months full time or equivalent;

(c) all advisers to undertake a knowledge update review in the form of an e-learning module within the first two years of passing their adviser certification examination, and every three years after that, on changes to laws, market issues and new products; and

(d) the creation of a central register of examination and knowledge update review results, which will be made available to the public.

Training of advisers

Licensees should continue to give training a high priority, as this lessens the risk of poor advice being provided.

C Monitoring and supervision of advisers

Key points

We expect licensees to have a tailored monitoring and supervision strategy that includes a well-documented, consistently implemented methodology.

Monitoring and supervision are much more than audits and compliance checks. They are about proactively ensuring that advice is appropriate and clients are treated fairly.

Many licensees are not checking references for new advisers with their previous licensee. This practice allows 'bad apples' to continue in the industry.

Identifying and recording breaches is a very important mechanism for licensees in assessing emerging issues around the activities of advisers.

Many licensees do not retain copies of client records separately from advisers. This may lead to difficulties for licensees responding to future enquiries or complaints about advice provided.

56 Licensees are the gatekeepers of the financial advice system in Australia. The robustness with which licensees oversee the advice provided by their advisers is an essential measure of a licensee's compliance culture. We strongly support an approach where the licensee's obligations to provide appropriate advice are properly monitored, where breaches or problems are identified at an early stage, and any client detriment is quickly and seamlessly rectified.

57 We support some best practice initiatives in monitoring and supervision, including targeted risk-based methodologies for choosing files to review as part of audits, building internal risk-classification methodologies within approved product list processes, providing rigorous training and competency checks of new advisers and having in place a well-understood and clearly documented consequence framework for when advisers are deemed non-compliant.

58 Monitoring and supervision are much more than audits and compliance checks. They are about proactively ensuring that advice is appropriate and clients are treated fairly. We expect licensees to proactively monitor their advisers, including by:

(a) pre-vetting the advice of more junior advisers;

(b) monitoring exposure limits and concentration of client portfolios;

(c) using mystery shopping and other methods of surveying customer experiences;

(d) peer review and support of advisers; and

(e) ensuring remuneration policies encourage and do not detract from good compliance and customer service practices.

Advice audits

59 All of the top 20 licensees conducted some advice audits to examine the appropriateness of advice. Audits check the advice provided meets the obligations under s945A of the Corporations Act. Some licensees informed ASIC, through the recent feedback process, that they had significantly enhanced their monitoring and supervision processes, recognising the importance of this area to their business.

60 Most licensees carried out annual audits of their advisers, although when compliance issues were identified, these usually became more frequent. We recognise the cost implication of more frequent audits, but emphasise the importance of licensees regularly reviewing samples of advice provided by their advisers.

61 One area of concern emerged where licensees did not select files for reviews at random (including within a risk-driven approach). We also saw evidence of some licensees notifying their advisers of the files to be reviewed prior to the audit taking place. This could give rise to a situation where advisers might try to 'game' the audit process and alter the client files before the audit takes place. We strongly encourage all licensees to include a random selection of files as part of their overall audit approach, and not to notify advisers which files have been selected in advance of the audit.

62 We expect licensees to have a tailored monitoring and supervision strategy that includes a well-documented, consistently implemented methodology for the monitoring and supervision of advisers. The methodology should reflect the licensee's risks; at a minimum, it should include a mix of both targeted and random audits, appropriate for the licensee's business model, number of advisers, number of clients, and types of products recommended. The size of the audit sample should have a statistical basis that assures the licensee that the results will reflect the standard of advice being given to clients and that is likely to detect non-compliance. Licensees should also consider what compliance controls can be embedded within their existing business processes to further enhance their monitoring and supervision of advisers.

63 Where an adviser fails a licensee audit, all licensees indicated that they implemented formal remediation processes for the adviser. However, we note that only a few licensees had financial penalties for advisers that failed audits. Regardless of the remediation model used, licensees must

demonstrate they are effective in correcting any issues relating to the appropriateness of advice and other legal obligations of advisers.

Monitoring and supervision of advisers—Advice audits

Licensees need to make sure that their stated procedures are fully complied with by their advisers and are constantly refined based on assessments of audit outcomes. The consequences for failing to meet licensee standards should be clear to all parties and strictly enforced by licensees without fear or favour.

Recruitment of new advisers

64 Another important gatekeeper role undertaken by licensees involves the recruitment of new advisers. Given the problems that a poor adviser can bring to a licensee, it is important that they are effectively screened and their background checked. Nearly all the top 20 licensees conducted police checks on new advisers; however, we note there was inconsistency between the licensees in their approach to reference checking of new advisers. A number of licensees said that they had difficulty obtaining responses from other licensees when seeking references. Other licensees simply did not check references. The inconsistency of reference checking is a concern to ASIC. This issue needs to be resolved consistently across the industry and we are seeking to do this through our current review of the 'Bad Apples' project, which was originally carried out in 2007.[4]

65 We were encouraged to see that many licensees imposed a mandatory pre-vetting or supervision period for new advisers to the business (although the length of this process and the number of examples of advice that needed supervision varied).

Monitoring and supervision of advisers—Recruitment

Licensees should always conduct reference checks on their new advisers by contacting previous licensees.

[4] The 'Bad Apples' project is aimed at disrupting the movement within the industry of financial advisers with dubious employment records who, in some instances, have been able to resign from one position and move to a similar position in another firm that is unaware of their history. The information collected in this review has assisted the current 'Bad Apples' project and we will shortly release a consultation paper outlining details of our proposals.

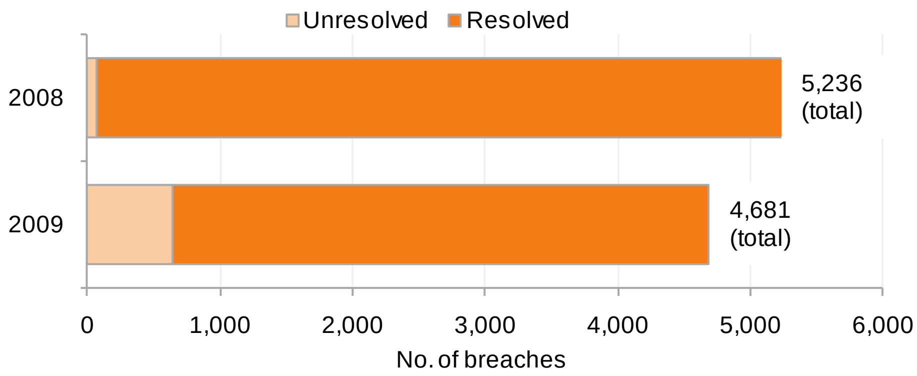
Breach reports

66 Licensees are required to report significant breaches of the Corporations Act to ASIC. The number of recorded breaches that were resolved in 2009 decreased in comparison to 2008: see Figure 4. It was not clear from responses whether this was due to fewer breaches occurring, fewer being identified and recorded, or fewer being resolved.

67 Nonetheless, the number of unresolved breaches had increased in 2009, compared to 2008. However, as the data was captured at a certain point in time, some of those unresolved breaches might have already been resolved or were on the path of resolution.

68 The number of total breaches recorded appears to be fairly steady from 2008 to 2009. The key difference is that *less* of them were resolved the same year they were recorded. This suggested that breaches may have increased in seriousness and complexity, and we encourage licensees to review whether they are allocating sufficient resources to their compliance and breach reporting teams.

Figure 4: Breaches of Corporations Act and/or Corporations Regulations



Note 1: This graph relates to all breaches including minor breaches.
Note 2: Figures are based on information provided by the top 20 licensees.
Source: ASIC

69 Another issue is what licensees might report or consider as a breach. Some licensees have reported large numbers of breaches while others reported one or two only. The inconsistency of breach reporting by licensees is a concern for ASIC. Breach reports help licensees and ASIC to identify whether there are any emerging issues of significance around the activities of advisers. We are more concerned by licensees that had no or minimal breach reports than licensees with a small flow of breach reports. We are encouraged by licensees that are up-front and active in reporting breach reports to ASIC, as it shows that they are actively monitoring the work of their advisers. We are also encouraged when licensees can demonstrate to ASIC that they have a plan to fix breaches as part of their licensee responsibilities.

Monitoring and supervision of advisers—Breach reports

We expect licensees to be active in reporting breaches and clearly demonstrate to ASIC that they have an adequate remediation plan.

Document retention

70 We remind licensees of their obligation to have access at all times to client records so that they can respond to client complaints or disputes and can review adviser conduct whenever they need to do so. We are concerned that many licensees do not retain copies of client records, but leave record retention to the discretion of their advisers. Contractual obligations between the adviser and licensee were often relied upon to ensure that a licensee could access client information. However, if an adviser leaves the licensee and does not cooperate in providing client information, it can be difficult for licensees to respond to future enquiries or complaints about advice provided. Most licensees are moving towards storing their records electronically, which is a positive step forward in terms of fulfilling their record retention obligation.

Monitoring and supervision of advisers—Document retention

Licensees should retain access to client records so that they can respond to client complaints or disputes and can review adviser conduct whenever they need to do so.

D Product and strategic advice

Key points

We expect licensees to have rigorous oversight of any conflicts of interest that may exist when recommending products issued by companies related to the licensee (licensee group products), including, but not limited to, additional disclosure to clients. Licensees should be able to demonstrate to clients that these products are appropriate for each client to whom they are recommended.

When considering what strategies to recommend to clients, it is important to educate clients about risk and return so that their expectations are more realistic.

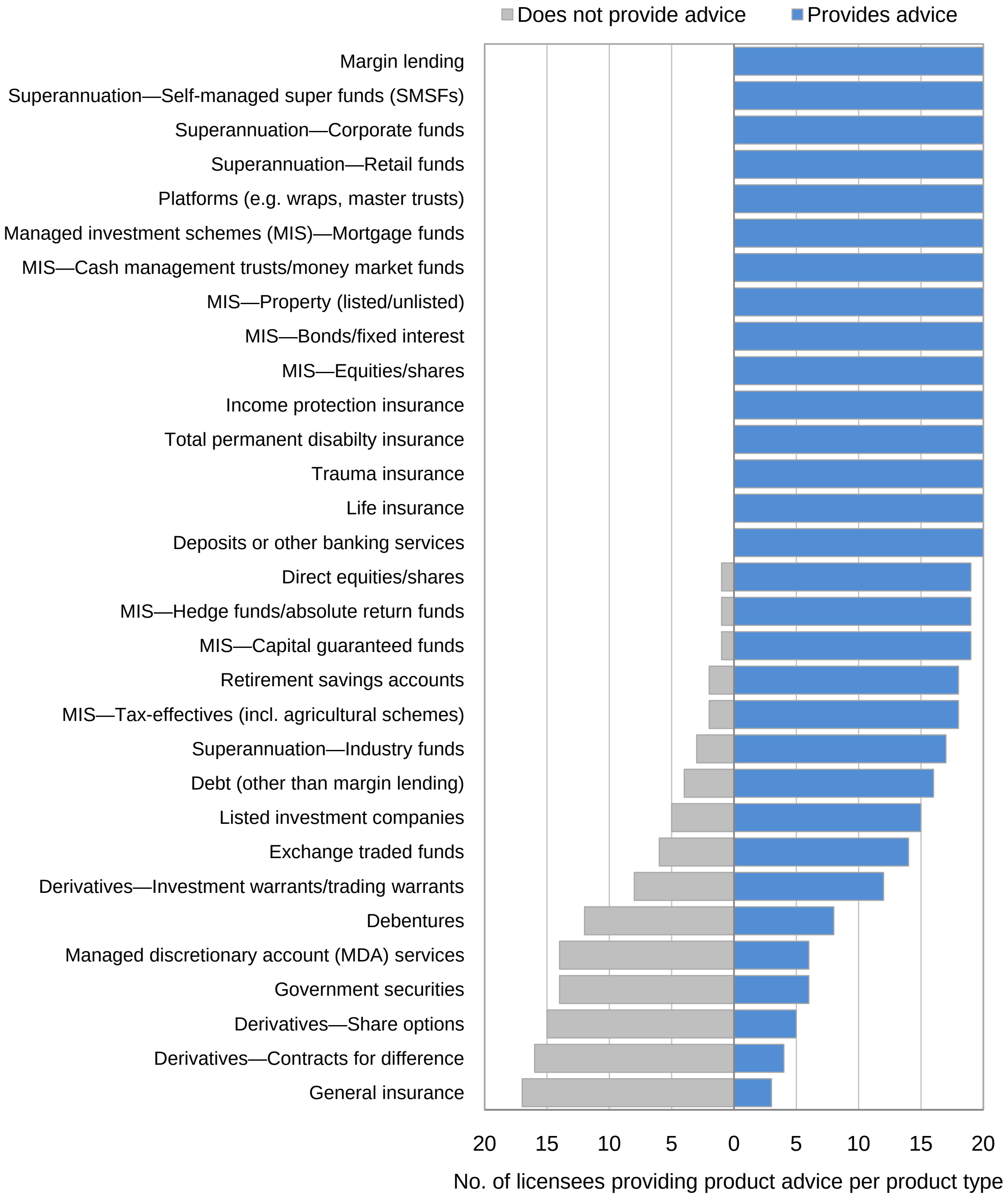
Product advice

Approved product lists and licensee group products

71 All licensees reviewed use and maintain an approved product list. The median number of products on approved product lists was around four hundred. Some licensees had larger approved product lists, but these included all managed funds that had attained a minimum fund rating—which increased the number of products significantly. Figure **5** shows the product types that licensees advise on. While licensees advise on a wide range of products, fewer licensees advise on relatively more risky and complex products such as derivatives, managed discretionary accounts, debentures and contracts for difference.

72 As we noted in Section A, despite these relatively large product lists, there remained a tendency to concentrate product recommendations into a few key products. The top three products on many licensees' approved product lists dominate and concentrate most of the asset allocation. It was apparent for some licensees that there were high levels of funds under advice in certain types of products issued by companies related to the licensee (licensee group products).

Figure 5: Types of product that licensees provide advice on



Note: Figures are based on information provided by the top 20 licensees.
Source: ASIC

73 While this may be a consequence of an integrated business model, we expect licensees to have rigorous oversight of any conflicts of interest that may exist when recommending licensee group products, including, but not limited to, additional disclosure to clients. Licensees should be able to demonstrate to clients (and ASIC) that these products are appropriate for each client to whom they are recommended. Extra care needs to be taken when recommending switching from another product to a licensee group

product. The licensee's monitoring and supervision should be particularly rigorous in this area to ensure that there is a reasonable basis for such switching and that the disclosure requirements of s947D are complied with. We expect that licensees will be regularly checking any concentration risks where high levels of exposure to particular products exist, both at a licensee level and at a client level.

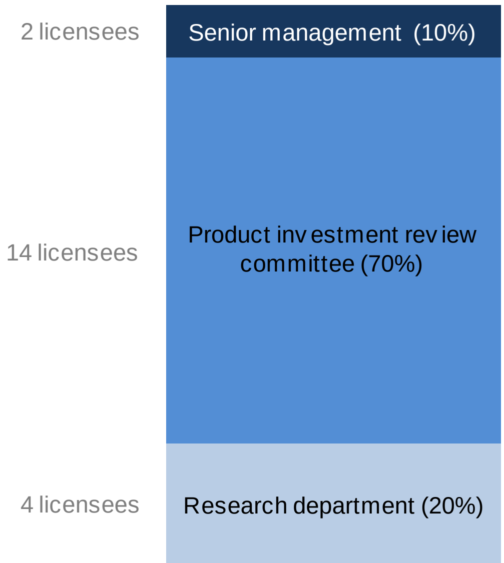
Product and strategic advice—Product advice

Conflicts of interest within the approved products need to be actively managed. If advisers are recommending high levels of a few products, then the reasons need to be explored and justified.

Approval and monitoring processes for approved products

74 The approved product list is an important way of minimising the risk of deficient products being recommended by advisers. Figure 6 shows that licensees used a combination of a research department, an internal investment review committee and/or senior management to approve products. All the top 20 licensees used external research companies as an input to their process of reviewing and approving new services and products, and the average number of research houses used was four.[5] All licensees conducted regular reviews of their product lists, with the majority reviewing their lists on an annual basis. We were particularly encouraged to see a few licensees reviewing their product lists on an ongoing basis.

Figure 6: Approved product list—approval processes used by licensees



Note: Figures are based on information provided by the top 20 licensees.
Source: ASIC

[5] ASIC is currently conducting a review of research houses.

75 A few licensees had relatively high concentrations of client money in particular higher risk products (e.g. tax-effective agricultural managed investment schemes). Given the complex nature of these schemes, combined with recent collapses in this sector, we expect licensees' monitoring and supervision strategies to recognise this risk by targeting file reviews on the appropriateness of advice about these products, to ensure they are being used in a manner consistent with client needs and risk profiles. It was encouraging, therefore, to see that quite a few licensees applied a percentage limit on the amount of agricultural managed investment schemes that could be maintained in client portfolios. Similarly, there were often limits placed on the amount of a client portfolio that could be invested in hedge funds or derivatives. It is also expected that audits of any replacement product advice concentrate additionally on the disclosure obligations of s947D of the Corporations Act, which require the significant consequences of the advice to be disclosed to the client.

76 Some licensees did not have data available for certain types of products. This was usually because licensees' record-keeping systems concentrated on the revenue streams received by the licensee and did not record the total funds under advice or numbers of clients in certain products. This appears to be a shortcoming in licensees' risk management arrangements and we encourage licensees to address this.

Client strategies

77 Nearly all licensees reviewed use model portfolios to allocate and diversify client assets. All licensees also use risk-tolerance tools to assess their clients' attitude to risk. For many licensees the risk-tolerance tool was based on psychometric testing. Approximately half of the top 20 licensees used an external provider to provide risk-tolerance assessment tools. We note that risk-tolerance testing should not be the sole way the adviser determines the client's attitude to risk and that good advisers will check the validity of the test by probing their clients' views on risk during client interviews. We would also hope that licensees encourage their advisers to do this. It is also important to educate clients about risk and return in this context. As clients become better educated about financial matters, their expectations are more realistic and for long-term savings plans they become more willing to accept some moderate risk for a better long-term outcome.

Product and strategic advice—Client strategies

When considering what strategies to recommend to clients, licensees and advisers should educate clients about risk and return so that their expectations are more realistic.

78 It was encouraging to see that all the top 20 licensees had specific rules for advisers providing gearing advice, with gearing limits applied to client recommendations. Monitoring the loan-to-value ratios was primarily handled by the individual advisers, but most licensees had specific policies in place to educate and keep clients informed about the risks of margin calls.

79 Some licensees did allow ‘double gearing’ strategies to be recommended by their advisers (where home loans are used to invest and then margin loans are taken out using the original investments as security). We have strong expectations of licensees about their oversight of this type of advice and are following up with licensees if there appeared to be any gaps in their supervision process.

E Complaints handling and compensation

Key points

Consumers should always be treated fairly and efficiently by licensees, especially when lodging a complaint.

Licensees need to ensure that they fully investigate each complaint and give just and fair settlement of any losses. We will closely examine the fairness of any settlements offered to clients in cases that come to our attention.

We would not expect to see any licensee with inadequate PI insurance, and expect prompt notification from licensees should they become unable to obtain or renew their insurance cover.

80 Complaints handling is a core licensee obligation. We expect licensees to invest significant time and resources, including senior management support, into ensuring they handle complaints well. From time to time, this involves compensating affected clients, so licensees need to ensure that they have the financial capacity to do so. This involves having adequate PI insurance and, more generally, having adequate financial resources.

81 Consumers should always be treated fairly and efficiently by licensees, especially when lodging a complaint. Good practice is to encourage clients to give feedback to the licensee and its advisers about their experiences with the licensee—both positive and negative. This is valuable feedback that helps licensees improve their services, monitor their advisers and ensure their risk-management processes are effective.

Complaints handling

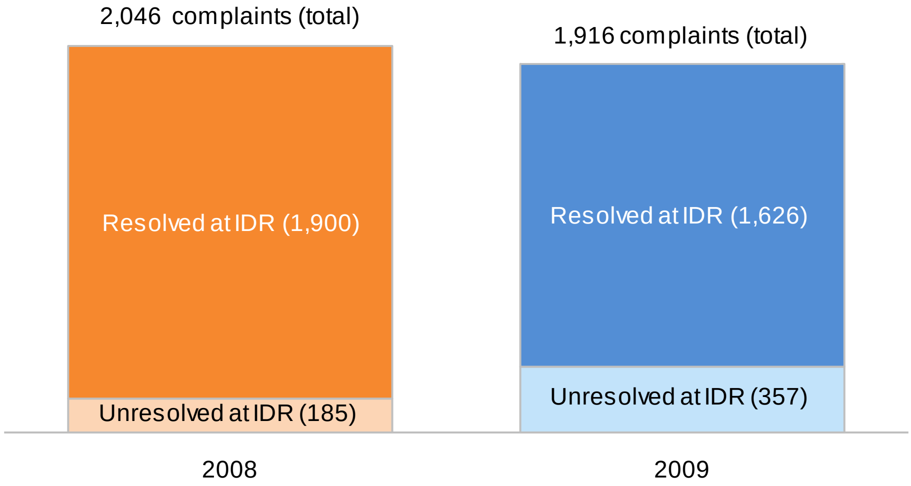
82 In our experience, the quality of a licensee's complaints handling processes is a strong indicator of the overall 'health' of a licensee. Licensees that have poor complaints handling processes tend to have other compliance problems. Poor complaints handling also often means that licensees fail to spot emerging issues early, when they can fix them much more cheaply and easily.

83 Complaints handling processes are a focus area for ASIC in assessing referrals and complaints from the public. If we find that a licensee is not complying with its complaints handling obligations, we will take appropriate action to rectify the situation.

Complaints handling statistics

84 All licensees were able to provide comprehensive complaints statistics, including in relation to internal dispute resolution (IDR) processes and external dispute resolution (EDR) schemes. Most licensees indicated that they analyse the issues behind the unresolved complaints. We were encouraged by the seriousness with which many licensees treated complaints and their desire to understand any systemic issues that arose out of the complaints data.

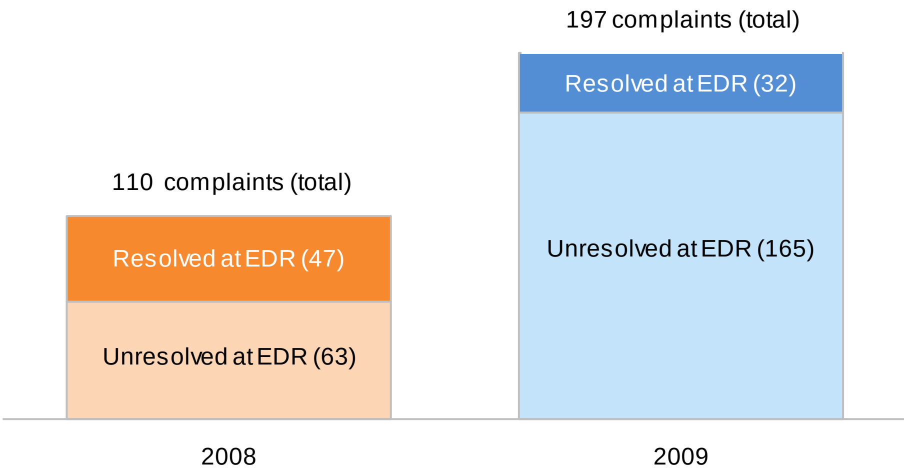
Figure 7: Resolution of complaints—IDR



Note: Figures are based on information provided by the top 20 licensees. Please also note that figures shown are for each calendar year and that complaints from one year may be resolved in the following year.

Source: ASIC

Figure 8: Resolution of complaints—EDR



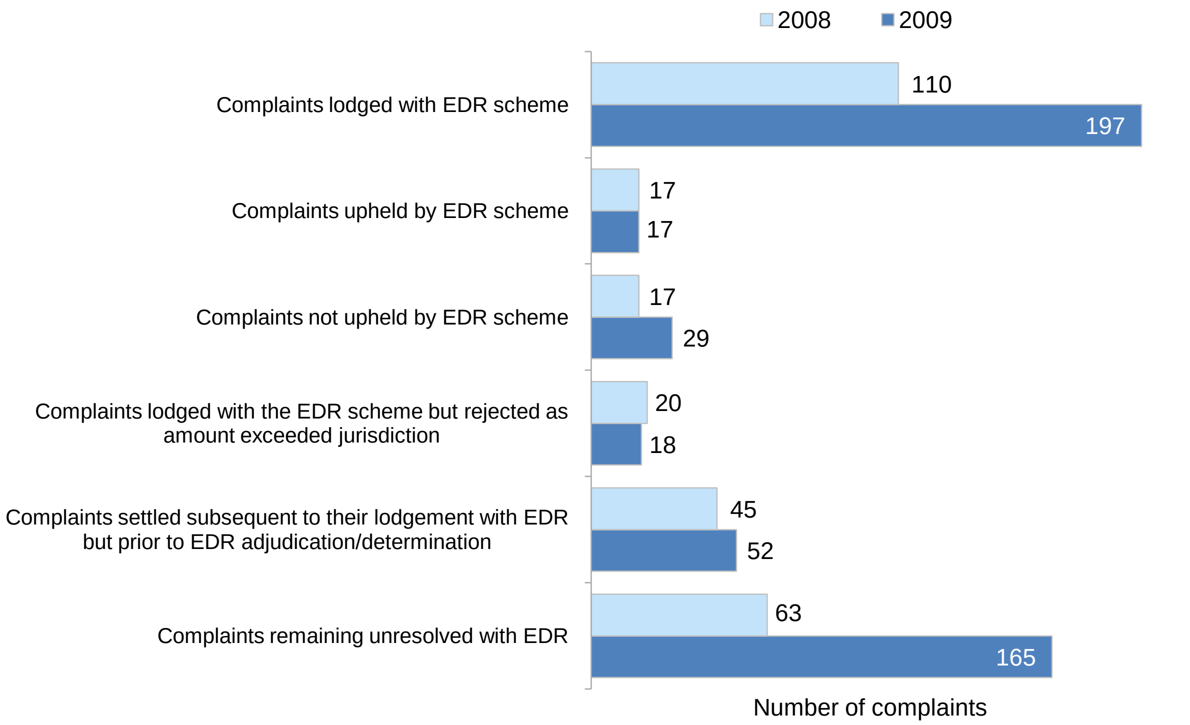
Note: Figures are based on information provided by the top 20 licensees. Please also note that figures shown are for each calendar year and that complaints lodged at EDR in one year may be resolved in the following year.

Source: ASIC

85 Overall, the level of complaints had fallen over the year to 31 December 2009: see Figure 7. Many licensees reviewed the types of advice that were subject to the complaints and analysed trends to see if particular advice or advisers were causing any systemic issues.

86 There was a significant rise in unresolved complaints at IDR and EDR over the year to 31 December 2009: see Figure 7 and Figure 8. Many licensees said this was a temporary increase in complaints due to client losses during the global financial crisis. We are monitoring this.

Figure 9: Outcome of complaints lodged at EDR



Note: Figures are based on information provided by the top 20 licensees. Please also note that figures shown are for each calendar year and that complaints lodged at EDR in one year may be resolved in the following year.

Source: ASIC

87 In our experience, most licensees have some room for improvement in their handling of client complaints. While naturally most people find receiving complaints a personally challenging experience, it is important that complaints are handled courteously and professionally. We expect licensees to ensure that complaints are dealt with by someone other than the adviser involved in the original advice. It is important that the person handling the complaint has an independent perspective on the case.

Client knowledge of IDR and EDR

88 Recent research by ASIC showed that 'investors had little knowledge of existing avenues of redress, such as their financial service provider's IDR system or the EDR scheme they belonged to'.[6] Unfortunately, we found that some licensees failed to properly communicate with clients who were in some difficulty during the global financial crisis and tried to lodge or progress complaints with the licensee:

> In all but one case, the financial planners provided no information about complaint mechanisms to these investors, refusing to return their calls, or placating the investors by saying that their loss had been caused by the market downturn. The one case we have of an IDR process was a bank which exonerated its financial planner and apparently provided no information to the investor about the possibility of going to EDR. Therefore, most investors were unaware they could complain to EDR.
>
> These results suggest that consumers need to be given a better way to learn about dispute resolution schemes. Investors need help understanding when they can make a complaint and how to make it.[7]

89 Our research showed many clients had not even been told that the licensee had any kind of IDR arrangement or belonged to an EDR scheme. This is a core obligation—licensees have an obligation to tell clients in writing about their right to take their complaint to the licensee's EDR scheme:

(a) if the consumer's complaint is rejected at the IDR stage; or

(b) if the consumer's complaint remains unresolved at IDR for 45 days or more.

90 Licensees are obliged to inform clients of their dispute resolution arrangements (including their EDR scheme membership) in their Financial Services Guide (FSG). We suggest that licensees make this information much more readily available (including on their website and on signs and brochures in their premises).

91 Finally, it is important that complaints are resolved fairly and reasonably. We have had recent cases with some of the questionnaire respondents where clients have been given what we consider poor settlement offers after the licensee had investigated their complaint. Licensees need to ensure that they fully investigate each complaint and give just and fair settlement of any losses. We will closely examine the fairness of any settlements offered to clients in cases that come to our attention.

[6] Media Release (11-102MR) *ASIC research on the impacts of misconduct* (19 May 2011).
[7] Report 240 *Compensation for retail investors: the social impact of monetary loss* (REP 240), p. 9.

Complaints handling and compensation—Complaints handling

We expect licensees to invest significant time, funding and resources, including senior management support, into ensuring they handle complaints well.

Compensation arrangements

92 We are aware that the market for PI insurance is cyclical, and goes through soft and hard periods. Licensees need to ensure that, even during hard markets, they have adequate cover in place.

93 All firms reported that their PI insurance covered all of their products and services. We understand that some licensees are finding that new or renewed policies have significant exclusions for more risky products and services. We expect licensees to carefully consider the terms of their policy, including any exclusions, and ensure that they are able to demonstrate that they are in a position to compensate clients for potential losses that may occur anywhere in their business operations. In practice, licensees may need to refrain from providing some more risky services or products for which they are unable to obtain adequate insurance cover.

Complaints handling and compensation—Compensation arrangements

We expect licensees to carefully consider the terms of their PI insurance policy, including any exclusions for risky products or services, and ensure that they can demonstrate that they are in a position to compensate clients for potential losses that may occur anywhere in their business operations.

Key terms

Term	Meaning in this document
adviser	A natural person providing financial product advice to retail clients on behalf of a licensee who is either: • an authorised representative of a licensee; or • an employee representative of a licensee
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
authorised representative	A person authorised by the licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee Note: This is a definition contained in s761A.
ASIC	Australian Securities and Investments Commission
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
EDR	External dispute resolution
EDR scheme (or scheme)	An external dispute resolution scheme approved by ASIC under the Corporations Act (see s912A(2)(b) and 1017G(2)(b)) and/or the *National Consumer Credit Protection Act 2009* (see s11(1)(a)) in accordance with our requirements in RG 139
employee representative	A person employed by the licensee, or by a representative of the licensee, to provide a financial service or services on behalf of the licensee
Financial Services Guide	A document that must be given to a retail client in relation to the provision of a financial service in accordance with Div 2 of Pt 7.7 of the Corporations Act Note: See s761A of the Corporations Act for the exact definition.
IDR	Internal dispute resolution
IDR procedures, IDR processes or IDR	Internal dispute resolution procedures/processes that meet the requirements and approved standards of ASIC under RG 165

Term	Meaning in this document
licensee	An AFS licensee that provides financial product advice to retail clients
licensee group product	A product issued by a company related to the licensee
PI insurance	Professional indemnity insurance

Related information

Headnotes

AFS licensees, business model, compensation, complaints handling, financial advice, industry practice, monitoring and supervision, products and strategy, risk-based surveillance

Regulatory guides

RG 146 *Licensing: Training of financial product advisers*

RG 181 *Licensing: Managing conflicts of interest*

RG 203 *Do I need a credit licence?*

Legislation

Corporations Act, s945A, 947D

Consultation papers and reports

CP 153 *Licensing: Training and assessment framework for financial advisers*

REP 240 *Compensation for retail investors: the social impact of monetary loss*

Media releases

11-102MR *ASIC research on the impacts of misconduct*

Information sheets

INFO 101 *Does the new credit regime apply?*