



ASIC

Australian Securities & Investments Commission

REPORT 362

Review of financial advice industry practice: Phase 2

July 2013

About this report

This report details our findings and recommendations from a review of the 21st to 50th largest Australian financial services (AFS) licensees that provide financial product advice to retail clients.

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Executive summary

- 1 This report presents findings from the responses to an ASIC questionnaire that were received from the 21st to 50th largest Australian financial services (AFS) licensees that provide financial product advice to retail clients (top 21 to 50 licensees). This follows on from an earlier questionnaire sent to the top 20 licensees.¹ The findings of this earlier questionnaire are contained in Report 251 *Review of financial advice industry practice* (REP 251), dated September 2011.
- 2 As with REP 251, the motivation for approaching the top 21 to 50 licensees was to examine licensees' risk management and compliance systems in order to inform our understanding and analysis of the key risks facing the financial advice industry.
- 3 ASIC believes that maintaining robust risk management and compliance systems is essential for the delivery of good quality financial advice, dealing with changes in the regulatory landscape and increasing consumer confidence in the industry.
- 4 This report details our findings about the advice industry's risk management and compliance systems and outlines some of our expectations about good practice.
- 5 We acknowledge and appreciate the time and effort spent by the top 21 to 50 licensees in responding to our questionnaire.

Background

- 6 In December 2009, ASIC sent questionnaires to the 20 largest AFS licensees that provide financial product advice to retail clients (top 20 licensees). Together, these licensees covered just over 13,000 individual advisers with a total of 4.6 million clients.² In September 2011, we published REP 251, containing our findings, observations and recommendations to industry based on the information provided to us.
- 7 When we published REP 251, we advised industry that we would repeat this exercise with the 30 next largest AFS licensees.
- 8 ASIC's legislative objectives include:
 - (a) ensuring the efficient and effective operation of financial markets; and
 - (b) promoting the confident and informed participation of investors and consumers in the financial system.

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

² REP 251, page 5.

- 9 These objectives have informed the motivation for this study and for the earlier review set out in REP 251.
- 10 As we saw from our 2011 review of the financial advice industry, these reviews provide significant benefits for both licensees and ASIC. The responses strengthen ASIC's understanding of the different business models used and the types of risks licensees are exposed to. This, in turn, enables us to efficiently use our resources by focusing more on those licensees with inadequate risk and compliance frameworks.
- 11 The information received also assists industry and the participating licensees by providing an opportunity for ASIC to highlight good industry practice and to convey our expectations of advisers and financial advice licensees as gatekeepers of those practices.
- 12 As a follow-up to REP 251, we provided feedback to participating licensees, which resulted in a number of licensees implementing changes to their practices.
- 13 As part of this review, we are again providing extensive feedback to the participating licensees about their practices and our expectations of them, thereby providing those licensees with an opportunity to enhance their risk management and compliance frameworks.

What we did

Questionnaire sent to licensees

- 14 In December 2011, we sent out questionnaires to those licensees identified as being the 21st to 50th largest licensees that we regulate.³ The licensees were identified by the number of representatives that they had under their licence (including both employee representatives and authorised representatives). These representatives are referred to collectively in this report as 'advisers'.
- 15 Together, these top 21 to 50 licensees covered 4,436 individual advisers, of which the smallest licensee had 37 advisers and the largest licensee had 351. Sixty-four per cent of the total advisers were authorised representatives and 36% were employee representatives of the licensees. The top 21 to 50 licensees had a combined total of 1.35 million clients, of which almost

³ Although we sent questionnaires to 30 licensees, we received 31 responses as a result of one licensee operating under two separate AFS licences rather than just one.

270,000 (20%) were active. In REP 251, the proportion of active clients was approximately 33%.⁴

- 16 The questionnaire asked licensees to provide data for the 2011 calendar year (and previous years for certain questions) on topics such as:
- (a) their business model;
 - (b) their risk management and compliance frameworks;
 - (c) their adviser training regime;
 - (d) their adviser monitoring and supervision;
 - (e) the products they advised on and their client strategies; and
 - (f) their complaints handling and compensation arrangements.

Limitations of using the questionnaire

- 17 During the completion of REP 251, we consulted with industry about the lessons to be learned from that review, and have considered the feedback received about the length and format of the questionnaire used.
- 18 The questionnaire sent in 2011 contained approximately 20% of the number of questions contained in the 2009 questionnaire. Although there was less information available, we have endeavoured to maintain a similar level of detail in this report as in REP 251.
- 19 While the responses in the 2009 questionnaire were generally restricted to dollar amounts or choices in a drop-down list, the 2011 questionnaire allowed for the majority of responses to be in free form. This resulted in a greater variety of responses as licensees were better able to explain their business. However, this has also necessitated some professional judgement on ASIC's part (e.g. where similar committees had slightly different names, we have grouped them together).
- 20 The 2011 questionnaire was provided to the licensees on a voluntary basis, whereas the 2009 questionnaire was provided to the licensees under formal notice. As a result, a number of questions in the 2011 questionnaire were not answered by some licensees. It was not always specified by the licensee whether this was because the question was inapplicable, whether the licensee was unable to retrieve that information, or even whether the intended response was 'nil'. Thus, we have been unable to include these responses in our statistics, which explains why some of the figures are based on sample sizes that are less than the total number of licensees.

⁴ In REP 251, a higher proportion of total clients were active (33% compared with 20%). However, we had specifically asked the licensees in December 2009 to specify the number of active clients, whereas for the current questionnaire, we have made the assumption that 'active' means those clients that have acted on the advice provided to them within the past 12 months.

- 21 Finally, as was the case with the 2009 questionnaire, the information presented is based on self-reporting by licensees. As a result, we have relied on licensees to provide accurate answers, information and data.

What we found

- 22 We found that most of the top 21 to 50 licensees were taking steps to mitigate key risks. There were certain risks, however, that we still think pose some challenges.

Licensee business models

- 23 We observed that around half the licensees were either wholly owned or majority owned by a product issuer. We also observed that the majority of licensees' income was received from product issuers. This may give rise to both potential and actual conflicts of interest, especially where advisers recommend products issued by related parties. Consistent with our findings in REP 251, management of such conflicts of interest remains a critical risk that requires ongoing attention from licensees.
- 24 Product concentration also represents a significant risk for licensees. Any product failure will have a much greater impact on licensees whose product recommendations are concentrated into a small number of products, not only in relation to client losses but also in relation to the licensees' income if a large proportion of their income is from commissions.
- 25 The majority of the top 21 to 50 licensees had invested substantial time and resources into a dedicated risk management committee, which met at least quarterly in most cases. Just over one-third of respondents outsourced at least some of their risk management activities.
- 26 The most reported high-impact risk to the business identified by the top 21 to 50 licensees was non-compliance with legislation, whereas the most reported high-probability risk was the provision of inappropriate advice. Staff retention was another risk that featured prominently as both a high-impact and a high-probability risk.
- 27 The participating licensees recognised that the Future of Financial Advice (FOFA) reforms, which became mandatory on 1 July 2013, would have an impact on their business, and that they would have to make a significant effort to update not only their business practices, but also the policies and procedures that govern those practices.

Training of advisers

- 28 All participating licensees committed significant resources to training their advisers. The majority of the licensees also provided numerous optional training courses to their advisers.
- 29 The data showed that most of the advisers under the top 21 to 50 licensees had more than five years experience—significantly more than our findings in REP 251.

Monitoring and supervision of advisers

- 30 All licensees conducted advice reviews to examine the appropriateness of the advice provided. One of the concerns arising from our review was that some licensees may not have sufficient resources to properly conduct these reviews.
- 31 There are still some licensees that are not checking references for new advisers with their previous licensee. This is a surprising and significant shortcoming because it allows ‘bad apples’ to move between licensees, thereby transferring the risk of their poor advice.
- 32 New advisers, regardless of their experience in the industry, are required by most of the licensees to have their advice pre-vetted for a minimum period before the advisers can provide advice on an unsupervised basis. This is a strong proactive control.
- 33 Consistent with our findings in REP 251, many licensees do not retain copies of client records separately from advisers. They rely on contractual obligations with the advisers that require the advisers to retain all relevant documents and provide them to the licensee when requested. This may give rise to difficulties for licensees in responding to future inquiries or complaints about the advice provided by advisers who have since left the licensee. This will also make it difficult for licensees to comply with their obligation to ensure that advisers comply with the best interests duty that is part of the FOFA reforms.

Product and strategic advice

- 34 All of the top 21 to 50 licensees use and maintain an approved product list, although the reliance on external research providers when compiling and varying the approved product list varied among the licensees. Some licensees approved individual products, whereas others used a filtering method to approve all products that had a specified rating from an external research provider.
- 35 Outsourcing product approval in this way may lead to risks for the licensee (e.g. not being aware of some product features that do not suit the risk

appetite of their business) that will need to be managed. Despite the large number of products on the approved product lists of most licensees (often several hundred), there was a clear tendency for product recommendations to be concentrated into a few key products within each class. This is consistent with the findings in REP 251.

- 36 Nearly all licensees permit their advisers to advise on products outside the approved product list (by following a documented exceptions or waiver process). As outlined in Section D, this is important to ensure that advisers act in their clients' best interests, which is an integral part of the FOFA reforms. We are therefore encouraged that most licensees are able to facilitate such advice.
- 37 Almost all of the participating licensees use a risk profiling tool to assess their clients' attitude to risk. Licensees need to be mindful that, while a risk profiling tool may be a useful gauge of risk appetite, they should also consider whether the client actually has the ability to absorb the level of risk identified by the risk profiling tool.

Complaints handling and compensation

- 38 While all participating licensees were able to provide comprehensive complaints statistics, the responses show a high degree of variance in this data, even among licensees with similar business models.
- 39 All participating licensees reported that their professional indemnity (PI) insurance covered all of their products and services. The licensees reported that there were significant exclusions for more risky products and services. Some licensees reported that their authorised representatives had their own PI insurance.

Recommendations

- 40 Based on our findings from this review, we make the recommendations set out in Table 1.
- 41 Licensees will already be aware that significant changes enacted in the FOFA reforms were made compulsory on 1 July 2013. All recommendations in this report should be read in conjunction with the laws and regulations that have been enacted as part of the FOFA reforms.

Table 1: Recommendations for licensees and advisers

Licensee business models See Section A	Recommendation 1 Product concentration	Licensees should consider whether excessive product concentration represents a risk to their business, and how this risk can best be managed.
	Recommendation 2 FOFA implementation	While licensees are updating their business practices to ensure compliance with the FOFA reforms, they should also ensure that their policies and procedures are consistent with those FOFA-related changes.
	Recommendation 3 Risk management	Licensees should dedicate adequate resources to their risk management function. The resources should be proportionate to the nature and scale of their operations. Licensees should ensure that effective controls are implemented that are commensurate with the level of risk identified, focusing more heavily on those risks that would have a greater impact on the business and/or investors, and a higher probability of occurring.
Training of advisers See Section B	Recommendation 4 Training of advisers	Licensees should ensure that even experienced advisers remain abreast of all regulatory and product changes, and continue to develop their skills.
Monitoring and supervision of advisers See Section C	Recommendation 5 Adviser file reviews	Licensees need to ensure that they and their advisers fully understand and comply with their monitoring and supervision procedures. Such procedures also need to be continually refined and updated, based on the results of previous reviews of advice quality. If these procedures are neglected by advisers, the licensee should strictly and consistently enforce the consequences.
	Recommendation 6 Recruitment	Licensees should always conduct reference checks on their new advisers by contacting previous licensees. Police and criminal checks alone are not adequate. Where references are not available, licensees should ensure that additional controls are in place to monitor new advisers.
	Recommendation 7 Breach reports	Licensees should be familiar with our expectations of when a breach or likely breach becomes reportable to us and should report such breaches or potential breaches accordingly. Where clients have been disadvantaged, the licensee should explain in its breach reports how the clients' circumstances will be remediated (where this information is available within the specified timeframe for breach reporting).
	Recommendation 8 Document retention	Rather than relying solely on contractual agreements with advisers, licensees should retain access to client records in a more proactive way (e.g. by using electronic storage platforms). This will allow the licensee to respond to regulators, auditors, clients and product issuers, whenever they need to do so, in a timely and efficient manner.

Product and strategic advice See Section D	Recommendation 9 Approved product lists	Where licensees effectively outsource part of their product approval process, they must ensure that they have adequate controls in place to manage any risk that may arise from that practice.
	Recommendation 10 Risk profile	Advisers should ensure that risk profiling tools are just one of the methods used to understand their clients' risk profile, and that any limitations of such tools are considered when recommending a client strategy.
	Recommendation 11 Higher-risk strategies	Licensees should implement additional controls where more risky or complex strategies are being recommended.
Complaints handling and compensation See Section E	Recommendation 12 Complaints handling	Licensees should ensure that a trend analysis of complaints is undertaken, and that the results of complaints are fed back to the business, so that the likelihood of similar issues arising in the future at both a licensee and adviser level is reduced.

Future surveillance activity

- 42 Based on the studies conducted using the 2009 questionnaire and the 2011 questionnaire, we have gathered useful market intelligence about the top 50 licensees. This covers over 17,000 advisers and almost six million clients. Given the breadth of these reviews, and having provided the second of two detailed reports to the industry, we will now be increasing our focus on risk-based surveillance activities.
- 43 We intend to focus on the key risks identified through our analysis of the top 50 licensees' risk management frameworks, and aim to use this information to target future surveillance activities across the industry.
- 44 We will continue to reassess our approach to gathering information from the market, especially given the current changes in the regulatory and business environment.

A Licensee business models

Key points

Managing conflicts of interest remains an important risk for licensees, especially in a post-FOFA environment.

The majority of the top 21 to 50 licensees have a dedicated risk management committee.

Some licensees' product recommendations to clients appear to be concentrated into a relatively small number of products, but licensees may not have fully considered whether this product concentration represents a material risk to their business.

Licensees must ensure that their risk management framework is proportionate to the nature and scale of their business.

- 45 We expect licensees to have procedures that identify all potential risks (including conflicts of interest), both at the licensee or adviser level and at the investor level. We also expect that strong controls, which are proportionate to the nature and scale of the licensee's operations, are implemented to mitigate or eliminate the key risks.
- 46 A business model that has poorly managed conflicts of interest is more at risk of producing deficient or inappropriate advice.

Products and conflicts of interest

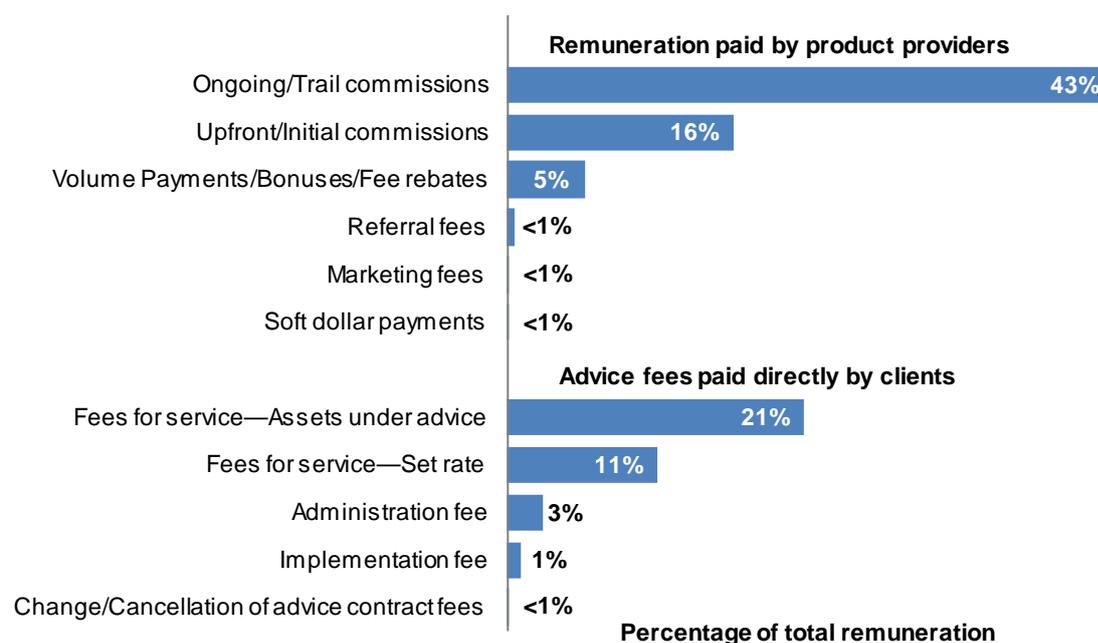
Licensee revenue and adviser remuneration

- 47 Around half of the top 21 to 50 licensees we surveyed were either wholly owned or majority owned by a product issuer. We also found that the majority of licensees' remuneration was received from product issuers (e.g. volume based or commission based), which may give rise to both potential and actual conflicts of interest. Business models that have poorly managed conflicts of interest are more at risk of providing inappropriate advice. The FOFA reforms will remove many, but not all, such conflicts. Licensees should analyse their business in light of the new legislation to determine their conflicts and how best to manage them.⁵

⁵ Many types of commission are banned under the FOFA reforms, but 'grandfathered' commissions and commissions on some insurance products are still allowed. Furthermore, advice relating to financial products issued by related parties may still give rise to conflicts of interest even when commissions are not paid.

48 The majority of advisers were remunerated by product providers based on volumes, receiving upfront and trailing commissions: see Figure 1. Not surprisingly, there has been a significant shift towards a fee-for-service model since REP 251 was published. Of the top 21 to 50 licensees, 11 received less than 5% of their remuneration directly from clients, two received over 90% of their remuneration directly from clients, while, on average, approximately 36% of revenue was received directly from clients (compared with an average of 11% for the top 20 licensees in REP 251).⁶

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



Note: Figures are based on responses from 31 licensees. This includes all of the top 21 to 50 licensees, with an additional response from one licensee operating under two separate AFS licences.

Source: ASIC.

49 Around half of the licensees offered a 'white label' platform to their clients. These platforms may contain customised features that benefit the client, but also represent a potential conflict of interest. If advisers are directing clients to the in-house product without proper justification, they are not acting in the best interests of their clients.

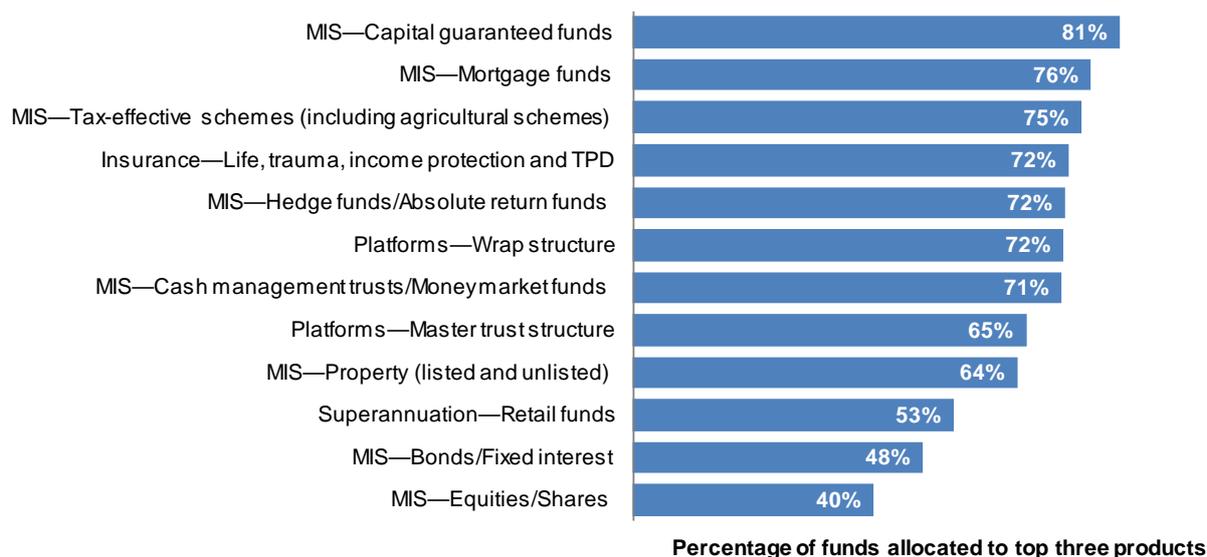
Product concentration

50 Figure 2 shows the proportion of funds under advice for each licensee allocated to the top three products (by total funds invested) for each product class. For example, in capital guaranteed managed investment schemes, 81% of funds are held in the top three products, while 53% of all funds in retail

⁶ The higher percentage of revenue received directly from clients for the top 21 to 50 licensees (compared with the top 20 licensees) may be a result of the top 21 to 50 licensees having commenced their FOFA readiness programs at the time of submitting their questionnaires.

superannuation products are concentrated into the top three products within that class. The findings in this figure may be skewed by the fact that there may be fewer product choices in the classes of investments at the higher end of the table, making it more likely that there will be product concentration within those product classes.

Figure 2: Product concentration within the top three products for each product class



Note 1 MIS = managed investment scheme; TPD = total permanent disability.

Note 2: Figures are based on responses from 22 of the top 21 to 50 licensees.

Source: ASIC.

- 51 Product concentration can represent a significant risk for licensees. If a product (or group of related products) collapses or fails, this will have a much greater impact on the overall business model of licensees that are heavily exposed to a smaller number of products. This exposure arises not only from commissions received (something that will reduce after the FOFA reforms are fully implemented) but also as a result of an increase in complaints and client losses. Where licensees have significant product concentration, they should ensure that they have appropriate controls in place to monitor and manage any related potential risks.

Recommendation 1: Product concentration

Licensees should consider whether excessive product concentration represents a risk to their business, and how this risk can best be managed.

FOFA reforms

- 52 The FOFA reforms will alter the remuneration models used by most licensees in the survey. Key to the reforms is the removal of conflicts of interest arising from commissions and issuer-paid, volume-based

remuneration (with the exception of certain products such as general insurance and most life insurance). Mandatory compliance with the new regime began on 1 July 2013 (though ‘grandfathering’ provisions allow continuing payments of commissions in certain circumstances). We note that some licensees are exploring alternative income sources, while others are expecting lower revenue streams in the future.

- 53 Licensees must ensure that they update their written policies and procedures to reflect the changes that they are making to implement the FOFA reforms. If they do not update these documented procedures, we believe that they will find it difficult to comply—and prove that they are complying—with the new obligations.
- 54 It is important for licensees to review their policies and procedures on an ongoing basis to ensure that they accurately reflect their current business practices. Therefore, licensees should use this opportunity to refresh their policies and procedures more generally, to ensure that they not only comply with the FOFA regime, but also accurately reflect their business practices as a whole.
- 55 We have announced that we will take a facilitative approach during the first 12 months of implementation of the FOFA reforms. This means that we will adopt a measured approach where inadvertent breaches arise, or systems changes are underway but are not yet finalised. However, our facilitative approach will not apply where licensees have not made reasonable efforts to comply with the new regime.⁷

Recommendation 2: FOFA implementation

While licensees are updating their business practices to ensure compliance with the FOFA reforms, they should also ensure that their policies and procedures are consistent with those FOFA-related changes.

Risk management

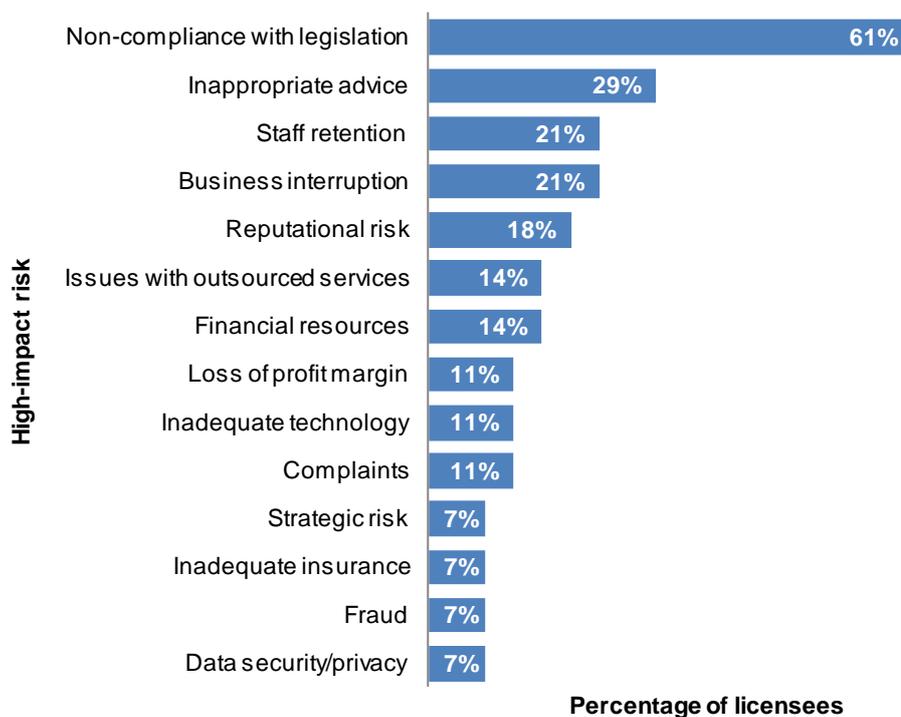
- 56 Risk management represents an ongoing challenge for all licensees. Licensees should have appropriate systems in place to identify their risks, and monitor and evaluate the effectiveness of internal risk management frameworks at mitigating each risk.
- 57 The majority of the licensees (61%) reported that they had a dedicated risk management committee, of which most reported to the executive board. These risk management committees met at least quarterly in 84% of cases.

⁷ Media Release (12-257MR) ASIC consults on code approval under FOFA and confirms facilitative approach to FOFA introduction (23 October 2012).

58 We found that, on average, there was one risk management staff member for every 85 advisers (although there was a high degree of variance among the licensees). We noticed a small number of outliers, who reported that the ratio was more than double the average, and we will be following up on this with the relevant licensees to understand how their risk management activities are effectively conducted.

59 We also asked for information about the top three high-impact and high-probability risks. As seen in Figure 3, non-compliance with legislation featured as one of the top three high-impact risks for 61% of the licensees, potentially resulting in the business having variations made to, or ultimately losing, its AFS licence. The second most featured high-impact risk was advisers giving inappropriate advice, potentially resulting in disputes or litigation.

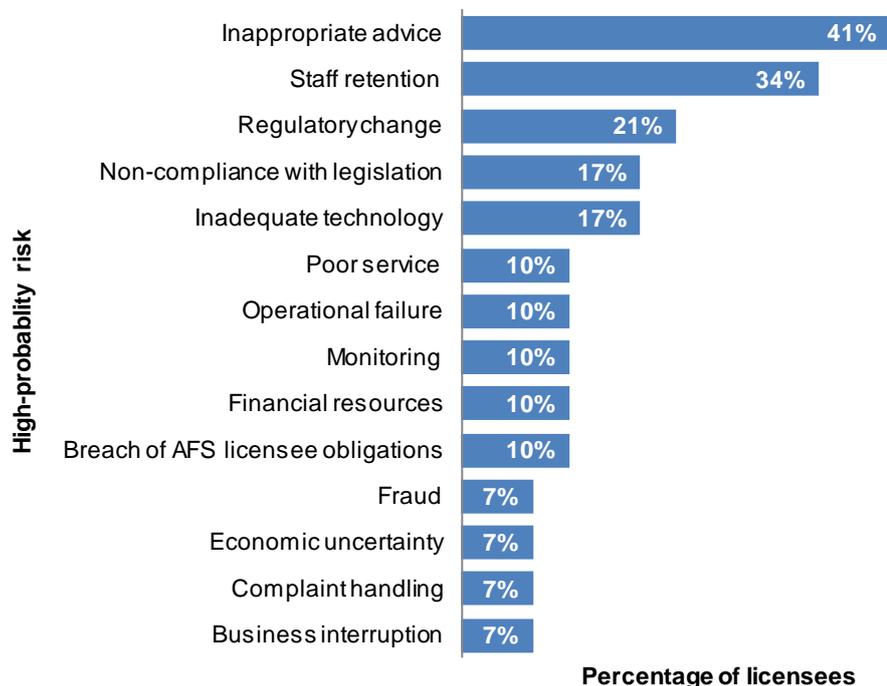
Figure 3: Top three 'high-impact' risks identified by risk management frameworks



Note: Figures are based on responses from 28 of the top 21 to 50 licensees.

Source: ASIC.

60 Providing inappropriate advice was identified as a top three high-probability risk for 41% of the licensees, with disputes and adverse publicity a likely result. As seen in Figure 4, staff retention was the next most probable risk, featuring in 34% of the licensees' responses. Staff retention was also prominent in the high-impact risk question, highlighting the concern that licensees have about attracting and retaining skilled and competent staff.

Figure 4: Top three 'high-probability' risks identified by risk management frameworks

Note: Figures are based on responses from 29 of the top 21 to 50 licensees.

Source: ASIC.

- 61 Licensees should implement appropriate systems and controls to help mitigate the risks that have been identified by the risk management framework. We therefore expect that greater focus will be placed on effectively managing the risks that are of greater concern to the business.
- 62 Such controls may be more complex or more difficult to implement than, for example, some of the controls aimed at mitigating certain lower-impact risks. It is, however, important that licensees do not just manage risks where it is cheap or easy to do so.
- 63 During our future surveillance activities, if appropriate, we will consider whether licensees are adequately embedding their risk management frameworks so that the most crucial controls are actually being implemented and are operationally effective. Where appropriate, we will also consider whether the risks identified by the licensees are consistent with our own expectations and our experience with other similar licensees.

Recommendation 3: Risk management

Licensees should dedicate adequate resources to their risk management function. The resources should be proportionate to the nature and scale of their operations. Licensees should ensure that effective controls are implemented that are commensurate with the level of risk identified, focusing more heavily on those risks that would have a greater impact on the business and/or investors, and a higher probability of occurring.

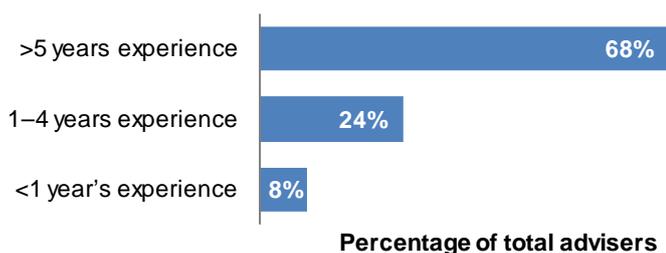
B Training of advisers

Key points

Continuing education is key to maintaining and improving the standard of financial advice within the industry.

We found that all of the top 21 to 50 licensees committed significant resources to adviser training.

- 64 Continuing professional development and education are paramount in providing good quality financial advice and improving advice standards across the industry. We found that all of the top 21 to 50 licensees committed significant resources to initial and ongoing adviser training, ensuring that advisers understood their legal obligations, particularly to their clients.
- 65 In many cases, we saw evidence of training being provided by both internal and external providers. This is encouraging, particularly if licensees are acknowledging a lack of internal expertise in providing training and are subsequently looking to external training providers to fill any gaps in knowledge or experience.
- 66 The minimum number of hours devoted to training ranged from 20 to 40 compulsory hours (with an average minimum of 33 compulsory hours). This compares with 10 to 40 compulsory hours for the top 20 licensees. The training was provided by a variety of in-house and external providers, as well as face-to-face training and professional development days. Online delivery was available, but was largely provided by the external providers.
- 67 We expect that, during the implementation phase of the FOFA reforms, many licensees will devote more hours to training than usual in conducting FOFA-related training. As noted in paragraph 55, ASIC will take a facilitative approach to inadvertent breaches of the FOFA reforms, provided that licensees have made reasonable efforts to comply with the new regime. We will consider the quality and timeliness of FOFA-related training provided by licensees in deciding whether they are making reasonable efforts to comply with the new regime.
- 68 The majority of advisers had five or more years experience in the industry (see Figure 5), whereas for the top 20 licensees, only 48% of advisers had five or more years experience. Although this reflects a wealth of experience, it also reinforces the need for continuous training because it will have been at least five years since the majority of these advisers completed their initial training.

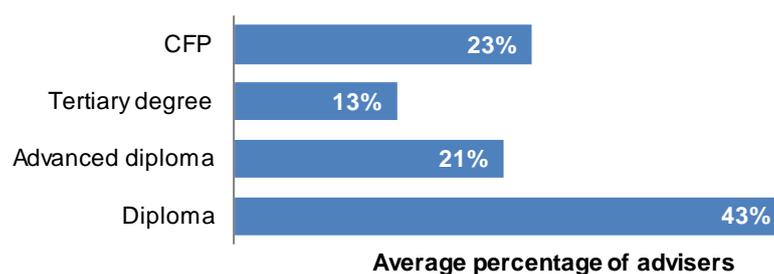
Figure 5: Advisers' experience in the industry

Note: Figures are based on responses from 26 of the top 21 to 50 licensees.

Source: ASIC.

69 Licensees were asked to report on the highest qualification attained by their advisers. It was reported that 23% of all advisers held a certified financial planner (CFP) accreditation and 13% held tertiary qualifications as their highest qualification: see Figure 6. The remainder held either diploma or advanced diploma qualifications. However, the concentration of these qualifications varied across the licensees.

70 We have recently published a consultation paper proposing enhancements to the training standards for people who provide financial product advice: see Consultation Paper 212 *Licensing: Training of financial product advisers—Updates to RG 146*.⁸ We have previously consulted on strengthening the minimum standards for advisers and implementing a national examination: see Consultation Paper 153 *Licensing: Training and assessment framework for financial advisers* (CP 153). We have, however, announced that we will delay the implementation of the national examination so that industry can more fully implement and embed other major reforms, such as the FOFA regime.⁹

Figure 6: Highest level of adviser qualification

Note 1 CFP = certified financial planner.

Note 2: Figures are based on responses from 29 of the top 21 to 50 licensees.

Source: ASIC.

⁸ Media Release (13-149MR) *ASIC consults on enhancements to training standards* (24 June 2013).

⁹ Media Release (13-078MR) *Update on financial advisers exam* (11 April 2013).

- 71 We require all licensees' adviser training to comply 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. RG 146 provides guidance on what we consider to be the minimum standards of adviser education, and it was encouraging to note that many licensees expected higher standards than those mandated by RG 146.

Recommendation 4: Training of advisers

Licensees should ensure that even experienced advisers remain abreast of all regulatory and product changes, and continue to develop their skills.

C Monitoring and supervision of advisers

Key points

Licensees should ensure that their monitoring activities are driven by the risks associated with their particular business.

Adviser file reviews should be at least partially targeted at advisers with poorer compliance records.

We remain concerned that some licensees are not checking references for new advisers with their previous licensee.

Proactive monitoring and supervision should be instrumental in detecting incidents and breaches (including potential breaches).

While most licensees are moving towards electronic storage of documents, some do not retain copies of client records separately from advisers. We encourage all licensees to retain access to client records in a more proactive way (e.g. by using electronic storage platforms).

- 72 As we have previously stated, advisers are among the gatekeepers of the financial services system in Australia.¹⁰ Failure by these gatekeepers to adequately discharge their obligations is likely to lead to significant client detriment. We expect all licensees to have a monitoring and supervision strategy that is tailored to the specific risks identified in each individual business.
- 73 We therefore support the following initiatives that some of the top 21 to 50 licensees are reportedly implementing:
- (a) data analysis to help consolidate, manage and monitor risks at a licensee and adviser level;
 - (b) targeted risk-based methodologies for choosing files to review;
 - (c) internal risk-classification methodologies for products on the approved product list;
 - (d) rigorous training and competency checks of new advisers; and
 - (e) clearly documented consequence frameworks applied strictly and consistently when advisers are deemed to be non-compliant.

¹⁰ 'ASIC's priorities—Financial advice, licensing and supervision', speech by Greg Medcraft, Chairman, ASIC, 25 October 2011.

Adviser file reviews

- 74 Adviser file reviews (often called advice audits) are an important mechanism for licensees to check the advice provided to clients. As a result, we expect licensees to conduct these reviews on a regular basis and for the sample size to be significant so that the results can be used to draw accurate conclusions about the advice being given to clients.
- 75 All participating licensees conducted adviser file reviews. These reviews not only checked that advisers were meeting their obligations under the *Corporations Act 2001* (Corporations Act), they also checked for compliance with the internal policies of the particular licensee. The majority of licensees carried out these reviews at least annually, with a small number conducting six-monthly or quarterly reviews. When compliance issues were identified, the majority of licensees implemented additional (or more frequent) compliance reviews or increased training before considering revoking the adviser's authorisation. However, only a small number of licensees had financial penalties resulting from a failure during the review process.
- 76 With the implementation of the FOFA regime, we would expect these adviser file reviews to be updated to reflect the requirements of the new legislation. For example, we would expect these file reviews to explicitly consider whether an adviser has acted in the best interests of the client and how the advice is likely to leave the client in a better position.
- 77 To properly conduct these reviews, it is necessary for a licensee to have an adequate number of properly skilled human resources. Around half of the respondents used external consultants to assist in the file review process, either to supplement internal resources or to help address particularly complex or difficult questions.
- 78 While the average number of advisers for each file reviewer was 53, there were some licensees with double or triple that number. During our discussions with these licensees, we will seek to better understand how their file reviews are being conducted and whether there are adequate resources to conduct sufficient reviews of the standard we expect.
- 79 We are concerned that a small number of licensees did not have a formal remediation process for advisers that fail the adviser file reviews. Our experience is that informal processes are more likely to be applied inconsistently and this can give rise to a poor compliance culture. Therefore, we expect formal processes to be implemented and consistently followed.
- 80 If licensees cannot demonstrate that they are effective in correcting issues identified in adviser file reviews (including compensating clients), ASIC is more likely to intervene to achieve an appropriate outcome.

Recommendation 5: Adviser file reviews

Licensees need to ensure that they and their advisers fully understand and comply with their monitoring and supervision procedures. Such procedures need to be continually updated, based on the results of previous reviews of advice quality. If these procedures are neglected by advisers, the licensee should strictly and consistently enforce the consequences.

Recruitment of new advisers

- 81 A thorough approach to recruiting new advisers should be taken by licensees to avoid the problems that a poor adviser can bring to the business. Potential advisers should have background checks undertaken. As with REP 251, nearly all of the licensees conducted background police checks. There were inconsistencies, however, with reference checking for new advisers. Some did not conduct reference checks, while others attempted to but found that previous licensees were reluctant to provide references or there were restrictions on the references provided.
- 82 Lack of adequate reference checking allows ‘bad apples’ to remain in the industry. Our experience is that the effort involved in remediating the poor advice and compensating clients affected by such ‘bad apples’ is almost always significantly greater than the effort involved in properly vetting a new adviser in the first place.
- 83 Where a new licensee fails to discover that an incoming adviser is providing poor advice for some time after they have joined the licensee, it will not be a defence that the new licensee has not yet had the opportunity to audit the adviser. The licensee will still be liable for the adviser’s poor advice, and for breaches committed by the adviser.
- 84 While we understand that prospective licensees sometimes find that previous licensees are reluctant to provide, for example, references or the results of previous file reviews, we believe that prospective licensees should, in all cases, at least attempt to obtain such information. Relying simply on police checks or credit checks may be insufficient. If references are unavailable, licensees should ensure that additional controls are in place to monitor new advisers. Such controls could include pre-vetting of all advice for a period of time.
- 85 Where new advisers join from a previous licensee that had a poor compliance culture, the new licensee should identify any particular risks that may arise from hiring the new advisers and take effective steps to mitigate those risks. The licensee should also pay careful attention to ensure that the advisers comply with the high standards that are expected within its organisation.

- 86 We are encouraged by the number of licensees that supervise or pre-vet the advice of new advisers or advisers that are new to the licensee. We consider this a best practice for the industry, because it should identify non-compliant advice early on in a new adviser's time at the licensee, thereby minimising the risks assumed by the new licensee.

Recommendation 6: Recruitment

Licensees should always conduct reference checks on their new advisers by contacting previous licensees. Police and criminal checks alone are not adequate. Where references are not available, licensees should ensure that additional controls are in place to monitor new advisers.

Breach reports

- 87 Licensees are required to report significant breaches (or likely breaches) of the Corporations Act to ASIC. Regulatory Guide 78 *Breach reporting by AFS licensees* (RG 78) provides guidance on reporting breaches to ASIC. Although 29 licensees identified a total of 669 breaches, over half of the licensees did not report a significant breach of the Corporations Act to ASIC during the previous 12 months. We cannot determine from the responses whether licensees are classifying breaches as 'not significant' and thus avoiding reporting to ASIC, or whether they are not detecting breaches properly in the first place. We will continue to focus on this area during our ongoing surveillance activities.
- 88 In recent surveillance activities, we have noted some instances where the licensee has not reported a breach (or has reported it after a significant delay) because of lengthy internal assessment processes or because the licensee has not yet resolved the breach. RG 78 makes clear that the reporting period of 10 business days commences on the day the licensee becomes aware of a breach (or likely breach) that it considers could be significant. As such, while we would like breach reports to explain how the client's circumstances will be remediated, reporting breaches within the 10 business day timeframe takes priority. If licensees' internal procedures for assessing breaches are lengthy or complicated, this may increase the risk that licensees do not lodge breach reports within the specified timeframe.
- 89 We are encouraged by licensees that are proactive in reporting breaches to ASIC, especially where these reports show that the licensee's monitoring activities are producing results. In addition, we are reassured by licensees that demonstrate an ability to effectively rectify breaches as part of their licensee obligations.
- 90 Of the 669 total breaches reported, 34 remained unresolved at the time that licensees submitted their responses. Approximately 75% of the breach

reports resulted from proactive risk management activities and we would hope that this number continues to grow as licensees enhance their risk management processes. We recommend that licensees that are not identifying breaches as a result of proactive activity should consider the appropriateness of their current risk management strategies and monitoring processes.

Recommendation 7: Breach reports

Licensees should be familiar with our expectations of when a breach or likely breach becomes reportable to us, and should report such breaches or potential breaches accordingly. Where clients have been disadvantaged, the licensee should explain in its breach reports how the clients' circumstances will be remediated (where this information is available within the specified timeframe for breach reporting).

Document retention

- 91 Licensees have an obligation to have access to client records at all times. This will facilitate responding to client complaints and disputes, or reviewing adviser conduct, as well as responding to formal requests for information by ASIC. Our concern remains from REP 251 that a large number of licensees rely on contractual arrangements with the adviser to access client information. This arrangement can make it difficult for a licensee to respond to complaints or inquiries when an adviser leaves the licensee or fails to cooperate when information is requested.
- 92 If information is missing or unable to be produced by a licensee, it will be difficult for the licensee to demonstrate that it is taking reasonable steps to ensure that its advisers are complying with the best interests duty under the FOFA reforms. In addition, it will be difficult for a licensee to satisfactorily conduct adviser file reviews if documents are missing or unavailable. We have noted the positive development that around two-thirds of respondents are currently using, or moving towards, using electronic storage facilities. The reported extent of this usage and the types of documents stored varied among licensees. We will be issuing a consultation paper on document retention.

Recommendation 8: Document retention

Rather than relying solely on contractual agreements with advisers, licensees should retain access to client records in a more proactive way (e.g. by using electronic storage platforms). This will allow the licensee to respond to regulators, auditors, clients and product issuers, whenever they need to do so, in a timely and efficient manner.

D Product and strategic advice

Key points

We expect licensees to have robust and well-documented approval processes when adding products to their approved product lists.

When considering alternative strategies to recommend to clients, it is important for advisers to adequately inform clients about the associated risks and returns to ensure that clients understand the advice and how it is appropriate to their circumstances.

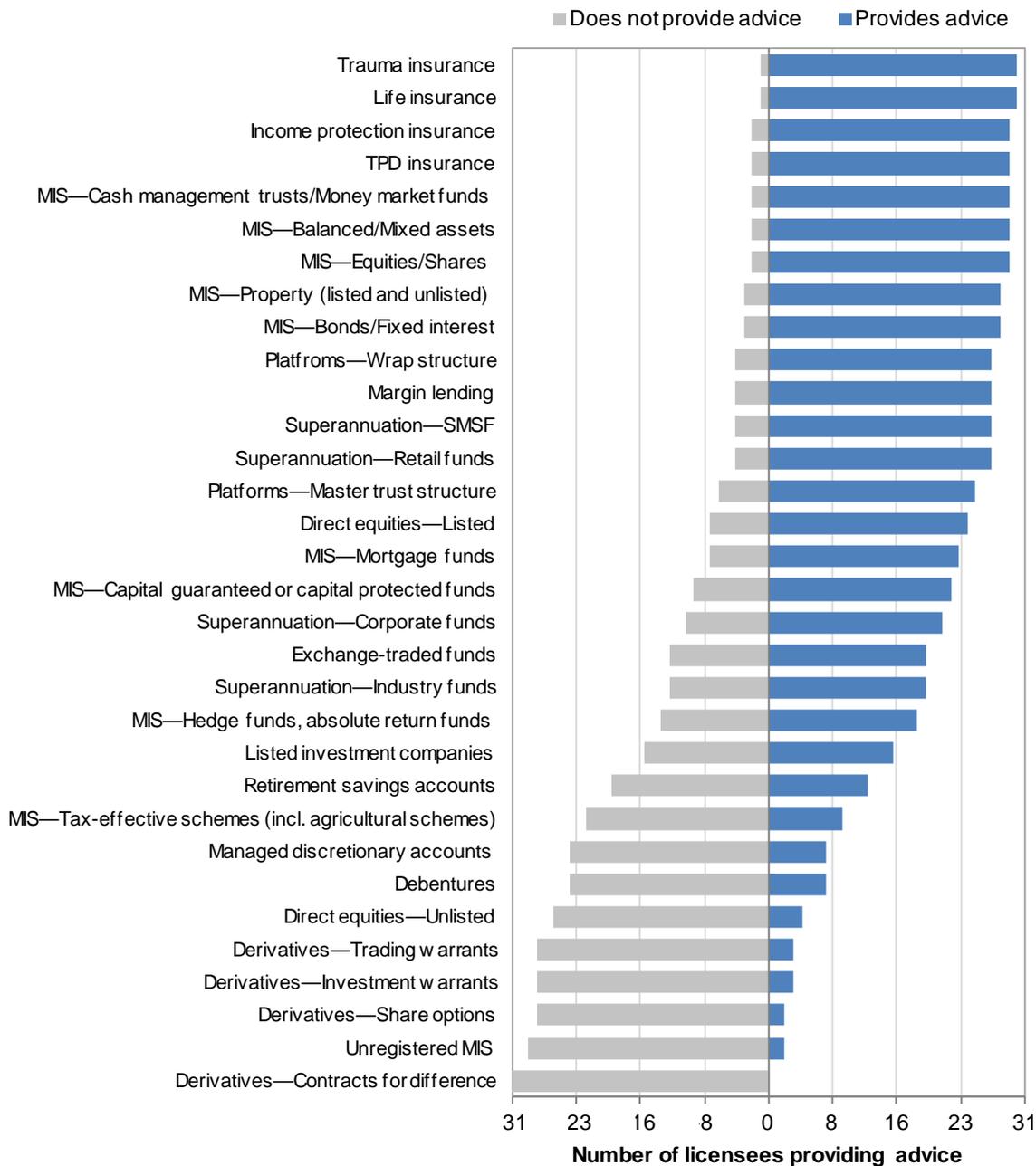
Advisers should not rely on the outcomes of risk profiling tools without also considering whether such outcomes are appropriate for their client's circumstances.

Product advice

Approved product lists

- 93 All of the top 21 to 50 licensees used and maintained an approved product list. The median number of products on the approved product lists was 272. This figure is skewed, however, by a small number of licensees that had approximately four times that amount, as a result of these licensees employing a 'filtering' qualification method, whereby a product is included on the approved product list as long as it attains a minimum research rating. When eliminating these outliers, the median number of products on the approved product lists reduces to 245. The median number of products on the approved product lists for the top 20 licensees was 400.
- 94 The best interests duty and related obligations stipulated by the FOFA reforms apply directly to advisers. Advisers relying on the safe harbour in s961B(2) need to demonstrate that, if it is reasonable to consider recommending a financial product, they have conducted reasonable investigations into the financial products that achieve the objectives and meet the needs of the client, and have assessed the information gathered in that investigation. Advisers may rely on investigations conducted by their licensee. However, it will not be sufficient to rely only on the fact that the product is on the approved product list.
- 95 Although the top 21 to 50 licensees advised on a wide range of products (see Figure 7), few licensees advised on products known to be relatively more complex and/or risky, such as derivatives, managed discretionary accounts, debentures and tax-effective schemes. This is largely similar to the trends evident in REP 251.

Figure 7: Types of product advised on



Note 1 MIS = managed investment scheme; TPD = total permanent disability; SMSF = self-managed superannuation funds.

Note 2 Figures are based on responses from 31 licensees. This includes all of the top 21 to 50 licensees, with an additional response from one licensee operating under two separate AFS licences.

Note 3: The responses for each product do not always add up to 31 because some licensees did not give responses for certain products.

Source: ASIC.

Research, approval and monitoring processes for approved products

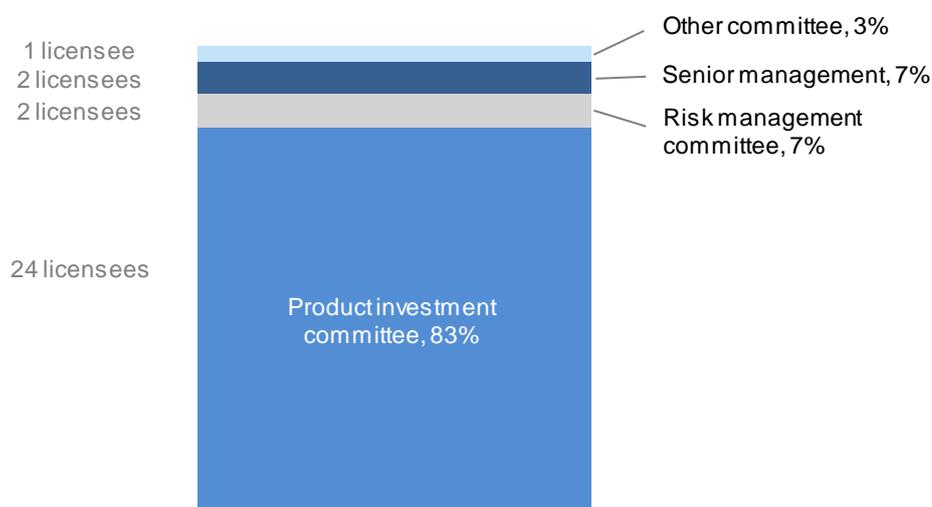
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Almost all of the top 21 to 50 licensees used external research providers. The survey identified several research providers commonly used, demonstrating that there are many choices—and potentially different voices—available to

advisers. Regardless of any rating provided by an external research provider, advisers must understand the features of each product they advise on. Because not all research is the same, we expect that advice providers will perform due diligence on potential external research providers, so that they understand the research provider's business model, product selection process, ratings methodology and ratings spread (i.e. what percentage of products receive each level of rating).

- 97 Of some interest was the fact that not all of the licensees that obtained external research provided it to all of their representatives. Some respondents reported that they did not provide this research to their representatives at all, while others provided it only to certain representatives. While the result of independent research is only one reason for an adviser to recommend a product, as part of our discussions with participating licensees, we will be seeking to better understand why licensees do not always make this research available to all of their advisers.
- 98 We also found that, when approving new products for the approved product list, around 83% of the licensees required authorisation to be provided by the product investment committee, as seen in Figure 8. The remaining licensees required approval by other committees or senior management.

Figure 8: Approved product list—Approval sign-off used by licensees



Note: Figures are based on responses from 29 of the top 21 to 50 licensees.

Source: ASIC.

- 99 Approximately 87% of the licensees required individual approval of each product on the approved product list. The remaining licensees approved groups or categories of products rather than individual products, usually on the basis of that product group achieving a particular rating from a specified research provider.

- 100 Where such a ‘filtering’ method is effectively outsourcing the approval process, advice providers still retain the obligation to know and understand the features of the products that they offer and the associated risks.
- 101 This ‘filtering’ method may also give rise to the risk that licensees’ approved product lists contain products or product features that are inappropriate for their risk appetite and irrelevant to their client base.

Recommendation 9: Approved product lists

Where licensees effectively outsource part of their product approval process, they must ensure that they have adequate controls in place to manage any risk that may arise from that practice.

- 102 All of the licensees that provided a response on this issue reviewed their approved product list regularly. Out of the 29 licensee responses, 48% reviewed their approved product list annually, 24% reviewed it quarterly, and 17% reviewed it monthly. A few licensees reviewed their approved product list either fortnightly or on an ongoing basis.
- 103 Nearly all licensees permit their advisers to advise on products outside the approved product list in certain circumstances. Licensees that permit this typically require the advice to have gone through a waiver process and to be signed off in advance by the licensee.
- 104 Our guidance in Regulatory Guide 175 *Licensing: Financial product advisers—Conduct and disclosure* (RG 175) makes clear that there may be some cases where an adviser will be required to investigate and consider a product that is not on their licensee’s approved product list (e.g. if a new client’s existing products are not on the approved product list). Failure to consider these existing products may lead to a breach of the best interests duty under the FOFA reforms. We are therefore encouraged that most licensees were already able to facilitate such a consideration.

Client strategies

- 105 Nearly all of the licensees used risk profiling tools to assess their clients’ attitude to risk, with the number of questions in the tool ranging from six to 27. The average number of questions in each tool was 13.
- 106 Risk profiling tools should not be the only way an adviser determines the client’s attitude to risk. We are concerned that mechanically allocating a risk profile based on the outcome of a survey may not identify the most appropriate strategy for the client. For example, where the client does not fully understand the questions, or the client has a high risk appetite but does

not actually have sufficient resources to absorb the level of risk, the results of the risk profiling exercise may be misleading.

107 It was therefore pleasing to see that many advisers also employed other methods, including detailed conversations and discussions, to confirm the validity of information gathered and also to further educate clients about the concepts of risk and return.

108 While file notes for such interviews were kept in most cases, we caution licensees that a lack of file notes will make it very difficult to demonstrate (whether to the client, ASIC, an external dispute resolution scheme or other interested parties) that the licensee has complied with the best interests duty under the FOFA reforms.

Recommendation 10: Risk profile

Advisers should ensure that risk profiling tools are just one of the methods used to understand their clients' risk profile, and that any limitations of such tools are considered when recommending a client strategy.

109 We would expect that the robustness of licensees' monitoring and controls appropriately reflect the more complex nature of certain types of client strategies, such as margin lending and other types of gearing. Therefore, it was encouraging that nearly all licensees reported additional rules for this type of advice, such as cash flow tests for principal and interest repayments, adequate personal insurances and limiting advice to clients with a higher risk appetite as well as a longer-term investment horizon.

110 Approximately half of the licensees also permitted their representatives to advise on double-gearing strategies. We have strong expectations of licensees about their oversight of this type of advice, and it was encouraging to see that additional authorisations for providing double gearing included manager-level approval, pre-vetting of advice and internal accreditations and authorisations. There were, however, a small number of licensees that permitted double-gearing strategies and did not subject their advisers to further authorisations or approvals. We will be seeking to understand from those licensees what other mitigating controls they may have in place to help ensure that higher-risk products or strategies are not offered inappropriately.

Recommendation 11: Higher-risk strategies

Licensees should implement additional controls where more risky or complex strategies are being recommended.

E Complaints handling and compensation

Key points

We expect licensees to apply a consistent definition of ‘complaint’ and for advisers to be fully aware of this definition.

We found that all of the top 21 to 50 licensees had PI insurance covering all of their products on offer.

- 111 We expect licensees to invest significant time and resources into ensuring that they handle complaints appropriately. The handling of complaints may involve compensating affected clients. Licensees should have adequate financial resources and PI insurance to compensate clients.

Complaints handling

- 112 Outcomes of licensees’ complaints handling processes should be reported back to the relevant business functions (e.g. those responsible for advice quality and risk and compliance) in order to reinforce the policies and procedures with a view to preventing future complaints. This practice will also assist the licensees in conducting analysis to identify trends in complaints of a systemic nature and subsequently to allocate resources as required.

Complaints handling statistics

- 113 Almost all of the top 21 to 50 licensees were able to provide complaints handling statistics in relation to internal dispute resolution (IDR) processes and external dispute resolution (EDR) schemes.

Figure 9: Resolution of complaints—IDR



Note 1: Figures are based on responses from 27 of the top 21 to 50 licensees.

Note 2: Figures shown are for each calendar year and complaints from one year may be resolved in the following year.

Source: ASIC.

- 114 Overall, the level of complaints has increased significantly over the year to 31 December 2011: see Figure 9. However, the percentage of unresolved complaints for the year has dropped from 38% in 2010 to 31% in 2011.
- 115 For matters that were resolved at EDR, the majority (75%) were resolved in the same year they were received. We are reassured by the fact that the majority of matters heard at EDR were resolved in this timeframe. It is important that the adviser or licensee failings that are reflected in the decisions made at EDR are acted on by the affected licensees, so that similar future complaints and client detriment can be avoided.
- 116 Of particular note was the large variance in the number of complaints recorded by licensees, some with relatively similar-sized client bases, adviser numbers and products offered. Some licensees within the top 21 to 50 licensees recorded no complaints (or almost no complaints), while others recorded several dozen or more. While there may be legitimate reasons for such variance, we are concerned that it may be at least partially due to licensees interpreting complaints differently. As part of our discussions with participating licensees, we will be confirming whether they are consistently applying the definition of ‘complaint’ outlined in Regulatory Guide 165 *Licensing: Internal and external dispute resolution* (RG 165).

Recommendation 12: Complaints handling

Licensees should ensure that a trend analysis of complaints is undertaken, and that the results of complaints are fed back to the business, so that the likelihood of similar issues arising in the future at both a licensee and adviser level is reduced.

Compensation arrangements

- 117 We understand that some licensees have reportedly encountered difficulty in obtaining compliant PI insurance in recent years. This was not reflected in the results of our questionnaire, and it was encouraging to see that all licensees reported that they had PI insurance covering all of their products that was compliant with Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126).
- 118 Consistent with our findings in REP 251, many PI insurance policies excluded certain riskier products and services. In each case, respondents advised that they did not offer such products or services.
- 119 Around one-quarter of the licensees reported that their authorised representatives held their own PI insurance. In such cases it is important that licensees ensure their authorised representatives are covered by compliant PI insurance because licensees are liable for the conduct of, and business

written by, their representatives. If representatives are not covered by the licensee's PI insurance, the licensee must confirm that the representatives' own PI insurance is adequate, and there must be appropriate contractual arrangements in place to indemnify the licensee (as specified in RG 126).

120 We expect appropriate monitoring and controls to be put in place to manage this risk. We will be following up with those licensees that reported their representatives held their own PI insurance to clarify the coverage and scope of these PI insurance policies.

Key terms

Term	Meaning in this document
adviser	<p>A natural person providing financial product advice to retail clients on behalf of a licensee who is either:</p> <ul style="list-style-type: none"> • an authorised representative of a licensee; or • an employee representative of a licensee
AFS licence	<p>An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services</p> <p>Note: This is a definition contained in s761A.</p>
AFS licensee	<p>A person who holds an AFS licence under s931B of the Corporations Act</p> <p>Note: This is a definition contained in s761A.</p>
authorised representative	<p>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</p> <p>Note: This is a definition contained in s761A.</p>
ASIC	Australian Securities and Investments Commission
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
EDR	External dispute resolution
EDR scheme	An external dispute resolution scheme approved by ASIC under the Corporations Act (see s912A(2)(b) and 1071G(2)(b)) and/or the <i>National Consumer Credit Protection Act 2009</i> (see s11(1)(a)) in accordance with our requirements in Regulatory Guide 139 <i>Approval and oversight of external dispute resolution schemes</i> (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
FOFA	Future of Financial Advice
IDR	Internal dispute resolution
IDR processes	Internal dispute resolution processes that meet the requirements and approved standards of ASIC under RG 165
licensee	An AFS licensee that provides financial product advice to retail clients
PI insurance	Professional indemnity insurance

Term	Meaning in this document
REP 251 (for example)	An ASIC report (in this example numbered 251)
top 20 licensees	The 20 largest AFS licensees that provide financial product advice to retail clients
top 21 to 50 licensees	The 21st to 50th largest AFS licensees that provide financial product advice to retail clients

Related information

Headnotes

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

Regulatory guides

RG 78 *Breach reporting by AFS licensees*

RG 126 *Compensation and insurance arrangements for AFS licensees*

RG 146 *Licensing: Training of financial product advisers*

RG 165 *Licensing: Internal and external dispute resolution*

RG 175 *Licensing: Financial product advisers—Conduct and disclosure*

Legislation

Corporations Act, s961B(2)

Consultation papers and reports

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

CP 212 *Licensing: Training of financial product advisers—Updates to RG 146*

REP 251 *Review of financial advice industry practice*

Media and other releases

12-257MR *ASIC consults on code approval under FOFA and confirms facilitative approach to FOFA introduction*

13-078MR *Update on financial advisers exam*

13-149MR *ASIC consults on enhancements to training standards*