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CP340: Breach Reporting and related obligations

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

With the exception of Independent Directors, the Board of the AFA is elected by the Membership and Directors are currently practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting their wealth.

Introduction

We thank you for the opportunity to provide feedback on Consultation Paper 340 - Breach reporting and related obligations along with the draft Regulatory Guide 78 – Breach reporting by AFS licensees and credit licensees and the Information Sheet on Complying with the notify, investigate and remediate obligation.

We start by making the point that the AFA supports the self-reporting of significant breaches and effective remediation arrangements. We believe that this is an important part of the financial services regulatory regime and serves to protect the interests of consumers of financial services.

We are however, very concerned that the Government have got the balance wrong in the drafting of the Breach reporting requirements in the Financial Sector Reform (Hayne Royal Commission Response) Bill 2020, as this will lead to a significant increase in the level of complexity and cost. We believe that the impact of this new regime is much greater than what is expected or currently understood.

In the December 2017 final report from the ASIC Enforcement Review Taskforce, they concluded that Breach reporting should continue to be based upon significant breaches as follows:

> *The Taskforce considers that financial services and credit licensees should be required to report significant breaches to ASIC. The 'significance test' should be retained but clarified to ensure that the significance of breaches is determined objectively.*

Royal Commission Recommendation 2.8 on reporting compliance concerns also spoke to the necessity of focusing upon serious compliance concerns, including suggesting that this should be done on a quarterly basis:

> *All AFSL holders should be required, as a condition of their licence, to report 'serious compliance concerns' about individual financial advisers to ASIC on a quarterly basis.*

In Recommendation 7.2, Commissioner Hayne also spoke in terms of supporting the ASIC Enforcement Review taskforce recommendations, including with respect to the retention of significant breach reporting.

Our serious concern with respect to the implications of the Financial Sector Reform (Hayne Royal Commission Response) Bill 2020, is that it is moving away from the concept of significant breach reporting and that this new regime will involve an exponential increase in the number of breaches that need to be reported and many of these will be of a minor or largely administrative nature.

The other key point that Commissioner Hayne made in his interim report was the need to review and reduce the complexity of the requirements of the Corporations Act. Unfortunately, the new breach reporting regime represents a substantial increase in the scale of complexity and in our view, this is virtually impossible for a small financial advice licensee to understand or comply with.

In our view, this legislation is particularly prescriptive, technical, and complex. We suggest that it provides an excellent case study for the Australian Law Reform Commission's Review of the Legislative Framework for Corporations and Financial Services Regulation. Ideally, important legislation like this, should be principle based, intuitive and straight forward to implement.

Our focus in this submission is on issues related to financial advice, where we believe that the impact of this reform is greatest, and the cost to implement will be more challenging.

We are critical of the legislation, which is due to both the incredible complexity and the particularly challenging and resource intensive requirements. Importantly, we recognise that it is not ASIC who wrote this law, and that you are trying to implement it.

Response to Consultation Paper Questions

B. Breach Reporting by AFS Licensees and Credit Licensees

Our proposed approach to guidance

B1Q1 Do you agree with our proposed approach? If not, why not?

Yes. Our focus is very much on the impact of this reform on the financial advice sector and therefore AFS Licensees, however we see no particular problem in the approach of addressing both AFS licensees and credit licensees in the form of consistent guidance.

B1Q2 Are there differences in the structure or operation of credit licensees that require specific guidance on how the breach reporting obligation applies?

We are not in a position to comment on this.

B2Q1 Are there any specific issues, incidents, challenges or areas of concern you think we should include as examples, case studies or scenarios? If so, please provide details and explain why they should be included.

Our feedback on the examples is that they should be focussed on areas of uncertainty rather than address matters that are more obvious. We address this below, however the example on reporting an adviser from another licensee is an obvious one. It would be better to address situations that are less clear cut. The benefit of examples is to challenge the understanding of the boundaries of application.

How our guidance applies

B3Q1 Should we include further guidance to help AFS licensees understand how the existing breach reporting obligation under s912D of the Corporations Act (as in force before 1 October 2021 applies? If so, please provide details.

Yes. We understand that the current regime applies in the circumstances where the relevant obligation is breached before 1 October 2021 and the licensee knows that it has been breached before 1 October 2021. The key to the interpretation of this is in assessing the knowledge that it is a breach before 1 October 2021. It would be beneficial to include an example of something that arises just prior to 1 October 2021 and is in the course of being investigated in late September 2021. It would be beneficial to be clear on what constitutes this knowledge and what evidence would be required. This would be more useful than a transition example related to March 2021.

What must be reported to ASIC

B4Q1 Do you agree with our proposed approach? If not, why not?

We agree with your proposed approach as set out in Proposal B4. This is exactly what ASIC should seek to do. Moreover, we are of the view that this legislation is extremely and unnecessarily complex. It is very difficult to explain the requirements of this legislation to the regulated population that includes small businesses and those who are self-licenced, and have limited access to legal or compliance resources.

B4Q2 Should we include further guidance on what constitutes a 'core obligation'? If so, please provide details.

The definition of a core obligation is extremely complex. It starts with a definition in Section 910A, which is as follows:

> **core obligation** has the meaning given by subsection 912D(3).

This then links to Section 912D(3), which then in large part connects through Section 912A(1)(c), and then links to Section 761A that defines financial services law, which includes Chapter 7 of the Corporations Act, but refers to it as this chapter. It relates to four of the six paragraphs under the definition of financial services law. This also includes a reference to certain parts of the ASIC Act. The bottom line, and what needs to be well understood is that any breach of Chapter 7 is a core obligation. We do not accept that this should be the definition of a core obligation, however it could be explained more clearly.

How is it possible that all chapter 7 obligations are core obligations, and was it really appropriate for the

Government to make this so complex to ascertain this final outcome?

We note the reference at the bottom of paragraph RG 78.27 to the appendix, that sets out a summary of the core obligations. The list in the appendix is very long and likely to confuse. For example, despite a specific reference to the Corporations Regulation we are unsure as to whether core obligations include all Corporations Regulations. We understand that elements of Regulatory Guide 271 on internal dispute resolution will be captured as core obligations, however there is no specific reference to this.

B4Q3 Should we include further guidance on how to determine whether a breach or likely breach of a core obligation is 'significant'? If so, please provide details.

Yes. The significance test is also incredibly complex. We question how a small licensee or self-licensed financial adviser is going to know what offence provisions are above a certain threshold level or what obligations in chapter 7 of the Corporations Act are civil penalty provisions (other than those that are ultimately excluded as a result of an exemption via regulation).

It is also the case that whilst some of this information can be found by looking at Schedule 3 and Section 1317E of the Corporations Act, these sources only cover the current Corporations Act offences and civil penalty provisions and not those that have been legislated, however are yet to commence. In addition, Schedule 3 only covers offence penalties for Corporations Act breaches. Where does a licensee go for information on maximum prison penalties for breaches of other laws?

In the context of the extreme complexity of this, we can only suggest that it would be appropriate for there to be a website or app tool to load in a section of the Corporations Act and other Acts to assess if it is caught or not.

With respect to the first example in Table 3, inadequate compliance arrangements, risk management systems and resources would lead to a breach of a core obligation under Section 912A and would therefore be a "deemed significant breach" and not need to be picked up under Section 912D (5). The second and third examples on ability to supply financial services and compliance with obligations may also be picked up as "deemed significant breaches" and would therefore be picked up firstly as a breach of core obligations.

Equally, the examples listed in Table 4, may be picked up as breaches of core obligations and would therefore not be picked up under Section 912D(5).

We therefore question whether the examples adequately address matters that might be picked up under Section 912D(5).

B4Q4 Should we include further guidance on reporting an 'investigation' to ASIC? If so, what should be clarified? Please provide examples of scenarios (where relevant).

We do not have any feedback on the discussion of investigations. The issues in this area appear to have been adequately addressed.

B4Q5 Should we include further guidance on what constitutes 'material loss or damage'? If so, what are the challenges licensees face in determining whether loss or damage is material? Please provide examples of how you consider questions of material loss or damage.

Yes. Whilst we note the discussion on "material loss or damage" in paragraph RG 78.38, we do not feel that this has adequately explained how this might be assessed, and further relevant examples would be beneficial. At this stage most licensees would not know where to start this assessment.

B4Q6 Should we include further guidance on reportable situations involving serious fraud or gross negligence? If so, what are the challenges licensees face in identifying when serious fraud or gross negligence has occurred?

Yes. The discussion on gross negligence and serious fraud in paragraphs RG 78.58 to RG 78.60 is very brief. It does not address the definition of "gross" in "gross negligence" or what constitutes serious fraud. It is unclear to us what type of fraud might not be considered serious fraud. We believe that it would be appropriate to include a more detailed explanation of these two key concepts and also some examples.

B4Q7 Should we include further guidance on reportable situations about other licensees? If so, please provide details.

We find it quite remarkable that this requirement to report breaches by other licensees only applies in the case of financial advisers and mortgage brokers. If an AFS licensee becomes aware of fraud or misleading behaviour by a product provider, they do not have an obligation to report this to ASIC, however if they become aware of a minor or administrative breach of a civil penalty provision by a financial adviser, they need to report it to ASIC. There is something most unbalanced in this law, particularly when the focus of the Banking Royal Commission was on the conduct of institutions, rather than small businesses.

We believe that there are a number of important unanswered questions with respect to this obligation to report advisers from other licensees, including the following:

- Does the Licensee have an obligation, where one of their advisers might become aware of an issue, however this information is not relayed to the licensee.
- What time limit might apply to historical matters? For example, if an adviser sees a statement of advice prepared by another adviser from 2014, where it might be argued that the adviser did not comply with the Best Interests Duty, then what should they do?
- If an adviser sees a new client and the client shows them Fee Disclosure Statements prepared by their previous adviser and the new adviser notices that one of them was issued after the 60 day time limit, then what should they do?

We see this issue of reporting advisers from other licensees coming up in two common contexts. Firstly, it will occur where advisers meet new clients who bring in documents that they received from their former adviser. To what extent should advisers investigate these documents? Might they now be incentivised to avoid looking too closely? The second issue relates to licensees who are recruiting existing advisers from other licensees, and the extent to which they undertake a due diligence process on these recruits. A comprehensive review of a number of the adviser's files could lead to the identification of a range of minor breaches. They would therefore be forced to report all that are considered breaches of core obligations, that are civil penalty provisions. This would become a hugely challenging process. What would be the obligations for the licensee, if they were to outsource this due diligence process to a third-party compliance consultant? Presumably in that case there would be no obligation to report specific matters to ASIC. We are concerned about the implications of this part of the new regime, when it comes to the recruitment of existing advisers from other licensees.

In terms of the provision that a licensee doesn't need to report if there are reasonable grounds to believe that ASIC is already aware, how would one licensee know if another licensee had already reported it? In the case of a licensee that has already reported an adviser from another licensee on a specific matter, are they required to report that adviser on another matter in the event that they subsequently become aware of it?

The example 6(b) that is provided in Table 7 is too simplistic and does not address some of the complexity that is involved in this matter. Firstly, it addresses a matter where material loss or damage is evident. What if it is not? It is also based upon the assumption that the adviser brings the SoA to the attention of their licensee. What happens if they did not do this? Neither is there any discussion on when the breach

appears to have occurred.

We are also very concerned about the cost impact of this new obligation with respect to the financial advice sector.

We are also concerned about the implications of notifying the other licensee in the case of a serious fraud matter. This might compromise a potential police investigation.

There would have been a better way to improve the flow of intelligence to ASIC, which could have been done through a whistle blower model. We believe that this reporting on advisers from other licensees approach, is highly problematic and is potentially going to create more problems than it addresses. Equally, from ASIC's perspective, there will be a level of responsibility, if it fails to address matters that have been brought to its attention through this mechanism.

When to report a reportable situation

B5Q1 Should we include further guidance to help licensees understand when to report to ASIC? If so, please provide details, including what guidance would be helpful and why.

Broadly we are comfortable with the guidance on when to report to ASIC, however we question the appropriateness of point (b) in paragraph 78.80. The audience for this Regulatory Guide includes the many small licensees and self-licensed financial advisers who will struggle greatly with understanding their reporting obligations in the context of the extreme complexity in this legislation. The suggestion that they should not wait until the matter has been considered by external legal is, in our view, unreasonable. Small licensees will have a great deal of trouble in complying with this legislation in the absence of some form of advice or guidance.

B5Q2 Should we include further guidance on what may amount to 'knowledge', 'recklessness' and 'reasonable grounds'? If so, please explain what specific guidance would be helpful and why.

Yes. Paragraph RG 78.70 refers to the definition of 'recklessness' and 'knowledge', however does not set these definitions out. We believe that it would be appropriate to do this.

Example 7 on recklessness might not be that useful, as the decision by a licensee's executive committee to not escalate any matters to the legal and compliance area for 6 months, is most probably a breach of Section 912A, and therefore is automatically reportable in its own right. This might not be the most useful example of reckless behaviour.

B5Q3 Should we include any additional or alternative guidance to help licensees provide reports to ASIC in a timely manner? If so, please give details.

We note the explanation in RG 78.82 on reporting investigations, including that the obligation to report is by 30 days after the investigation has already been underway for more than 30 days. Thus, it is not until 60 or 61 days after the investigation commenced. This might need to be more clearly explained as otherwise it could be assumed that the reporting needs to occur within 30 days of the investigation commencing.

This also opens up questions about what would be required if a decision is made that something is reportable after day 30, but before the report of the investigation is due. Or alternatively, if it is decided that it is not reportable, but only after the investigation has been underway for more than 30 days and before the investigation has been reported to ASIC. This situation is largely addressed in Example 8.

How to report a reportable situation

There is no discussion on how to report related matters or groups of similar matters. If a licensee has an adviser who has failed to comply with their obligations with more than one client or with respect to a range of different matters, can they all be reported as one issue? Equally, if there are multiple financial advisers who have each breached the same or similar obligations, can they be reported as a group rather than as individuals?

B6Q1 Do you have any feedback about the types of information we propose must be included in the prescribed form? If so, please provide details, and identify any issues.

It should be noted that under the section for "Description of the reportable situation" in Table 8, that the obligation that has been breached may not necessarily be a Corporations Act or National Credit Act section. Where it relates to an offence matter, above the stated minimum imprisonment threshold, it could be an offence under any law. This is Federal, State or Territory.

B6Q2 Should we include any other information in the prescribed form? If so, please provide details.

We do not propose that any other information should be provided.

B6Q3 Do you have any concerns about the types of information in the prescribed form and whether this information can be provided within the prescribed 30-day time period? If so, please provide details.

We note that not all of this information might be available at the time the breach is initially reported. The option to provide incomplete information should be addressed. There is very little reference to the requirements or expectations with respect to updating a previous report with additional information. Further guidance on this would be beneficial.

How licensees can demonstrate compliance

B7Q1 Do you agree with our proposed approach? If not, why not?

Yes. Within the context of the legislation, we agree with your proposed approach and what has been recommended is appropriate for larger entities. We are conscious that many of the licensees that will be covered under this regime are small businesses or self-licensed individuals and they are unlikely to operate in the same manner as larger institutions. Most of them will never have received a complaint, nor reported a breach to ASIC. Neither will they have dedicated resources to manage compliance and breach reporting. It would be appropriate to address the expectations of small licensees.

B7Q2 Are there any other specific areas that we should consider including in our guidance? If so, please provide details.

No, other than the point that we raise above about the expectations for small licensees.

B7Q3 Are there any challenges that you would face in applying our guidance to your specific circumstances (i.e. the nature, scale or type of your business)? If so, please provide details.

We are not an AFSL, so this question is not relevant to us.

C Notifying, investigating and remediating breaches of the law

Once again we express our amazement that this legislation only applies to financial advisers and mortgage brokers. If these obligations are appropriate to apply to financial advisers and mortgage brokers, then they

are equally applicable to product providers. Why is it that the obligation to notify clients is not replicated with product providers? We know that ASIC is not responsible for the law, however this is just one more case where the Banking Royal Commission law reform has focussed on small businesses, as opposed to the large institutions, who were the focus of the Banking Royal Commission. The banks were a big part of the Royal Commission hearings, however basic banking products have been excluded from this regime.

Our proposed approach to guidance

C1Q1 Do you agree with our proposed approach? If not, why not?

We are not convinced that there is meaningful benefit in splitting this information sheet into Part A on "How do the obligations apply?" and Part B on "How do you comply with the obligations?". Some of the content seems to be discussed in both parts.

C1Q2 Should the guidance we provide on the new obligations be provided in the form of a separate information sheet, or be incorporated into RG 256? Please provide details.

There are benefits and disadvantages in preparing this as a separate information sheet. Firstly, the fact that it is separate and a smaller document, probably means that it is more likely to be read, however it is a disadvantage to have another separate document for licensees to find and read.

C1Q3 Should we include further or more specific guidance on the circumstances in which licensees must:

(a) notify affected clients of a breach of the law;

(b) investigate the full extent of that breach; or

(c) remediate affected clients?

If so, what other information would be helpful in determining how these obligations apply?

We note that these new obligations apply to reportable situations that arise on or after 1 October 2021. We suggest that the 'arise on or after' should be further explained. Presumably, it relates to the underlying matter arising after 1 October 2021, rather than the reporting of the matter.

We feel that the issue of "loss or damage" could be more fully articulated. What form of loss might this involve and to what extent does it need to consider potential or hypothetical loss? Examples would be beneficial. We also note the importance of a legally enforceable right to recover the loss. In the case of a late Fee Disclosure Statement, does this represent a loss or damage and is there a right to recover a loss. It would be beneficial if further details and examples were included.

We note the suggestion that it is prudent to keep affected clients informed of the progress of the investigation. We question the necessity for this in the event that the loss is minor, or the investigation is expected to be completed relatively quickly. Clients will not want to get updates for minor matters or ones that do not provide meaningful additional information.

What should be included in notices to affected clients

C2Q1 Do you agree with our proposed approach? If not, why not?

Whilst we do not disagree with the proposed inclusions in the notice to clients, we make the point that this should be kept very high level and avoid going into detailed descriptions of the nature of the reportable situation or breach, which the clients are unlikely to understand. With all disclosure documents, it is better to focus on being clear, concise and effective and not long and complex.

We also ask what is meant by "their relevant consumer rights"? Is this a reference to sections of the law or access to IDR and AFCA?

C2Q2 Should the form of the notices referred to in Actions 1 and 3 of the information sheet be approved by ASIC? If so, what information, or types of information, should be mandatory, and what should be left to the discretion of the licensee?

If this question relates to a general template for such notices, as opposed to something more specific for individual licensees, then our suggestion would be that this could reasonably be addressed through this information sheet, rather than the need to go into a more prescriptive legislative instrument. The effectiveness of this would need to be assessed over time.

D Regulatory and financial impact

We note the statement on page 18 that the Australian Government has confirmed that a process and analysis equivalent to a RIS has been undertaken through the Financial Services Royal Commission.

Whilst this statement is factually correct, in that this is what the Government has said, the reality is very different. The Banking Royal Commission did not make a specific detailed recommendation with respect to changes to breach reporting. They did not suggest moving away from a focus upon significant matters, or suggest a requirement to report advisers from other licensees. The Banking Royal Commission did not prepare an assessment of the impact of these reforms, or to estimate the cost to industry to implement and operate these changes. ASIC should be well aware of this, and we are therefore concerned that no Regulation Impact Statement has been prepared by either Government or ASIC.

We further note that ASIC thinks that the proposals strike an appropriate balance and would not lead to incurring unreasonable costs. We disagree with this statement. This reform will result in significant additional complexity and cost for the financial advice sector, along with many other sectors.

Concluding Comments

We are very conscious that this law results from the Parliament and that ASIC is not responsible for the design and creation of this legislation. We are nonetheless, very concerned about the complexity of this legislation and the potential implications in terms of cost and efficiency for licensees. This new regime will be extremely difficult for small licensees to implement and operate. We do not feel that this additional cost will deliver a consummate benefit for consumers. In our view the impact of this legislation is going to be unnecessary and extreme and will result in the overloading of licensees and ASIC. It will be important to closely observe the impact of this legislation and once the consequences have been demonstrated, for the Government to implement sensible reforms, to moderate the impact.

We would be happy to discuss this submission further, or to provide additional information if required. Please contact us on (02) 9267 4003.

Yours sincerely,

Phil Anderson
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