WT | FINANCIAL GROUP

Wine to Water: Significance to Insignificance

An unintended total recall of market-based discretion and judgment

Submission to ASIC

Submission to assist with Consultation Paper 340:
Breach reporting and related obligations

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WT Financial Group Limited
Level 11, 95 Pitt Street
Sydney NSW 2000
Tel: 02 9248 0422

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About the submitter

WT Financial Group Limited (WTL) is an ASX-listed diversified financial services group that contains two distinct channels - being its primary business-to-business operations under its Wealth Today Pty Ltd subsidiary and brand; and its complementary direct-to-consumer operations under its Spring Financial Group brand.

It has more than 100 authorised representatives operating under a “dealer group” structure; and salaried advisers providing services direct to consumers.

Accordingly, it is well placed to make a submission based on firsthand experience in providing, monitoring, and supervising retail financial advice.

Submission Introduction

This submission focuses on *Consultation Paper 340: Breach reporting and related obligations.*

We will comment specifically on three important issues:

- Redefining Significance to Insignificance
- Market-based solutions vs Centralised government solution
- Discretion and Judgment

Redefining Significance to Insignificance

This is not what Commissioner Hayne wanted.

We submit that the most material and damaging consequence of the proposed Breach Reporting changes is the literal interpretation of an ill-considered bullet point written into Recommendation 1 of the ASIC Enforcement Review Taskforce Report.

This is the complete sentence that includes the referred to bullet point.

> ***The nature of matters that should be deemed to be significant includes…Breaches of financial services civil penalty provisions.***

This single sentence is about to change the landscape of financial advice in Australia permanently and damagingly.

We urge ASIC and the government to urgently course correct to avert the inevitable and predictable damage this sentence will cause.

Let's begin with the Royal Commission Final Report Vol. 1 Recommendation 7.2.

> **Recommendation 7.2 – Implementation of recommendations**
>
> *The recommendations of the ASIC Enforcement Review Taskforce made in December 2017 that relate to self-reporting of contraventions by financial services and credit licensees should be carried into effect*.

Next, we look at Recommendation 1 of the ASIC Enforcement Review Taskforce Report.

> *The 'significance test' in section 912D of the Corporations Act 2001 be retained but clarified to ensure that the significance of breaches is determined objectively*.

The recommendation goes on to say the following:

> *To provide greater certainty for licensees and ensure that **particular matters** are always reported to the regulator, the new test should include a number of explicitly specified matters that are deemed to be significant. **The nature of matters that should be deemed to be significant includes**:*
>
> - *Serious misconduct by an employee or authorised individual, including conduct that has resulted in or may result in the suspension, demotion, termination, resignation or referral to a law enforcement agency;*
> - *Breaches that result in or have the potential to result in material loss to clients having regard to the amount invested and the circumstances of the client/s in question;*
> - *In the case of a managed investment scheme, breaches that have or are likely to have a materially adverse effect on the interests of members of the scheme;*
> - *Breaches of a financial services law that carry a penalty of imprisonment; or*
> - ***<u>Breaches of financial services civil penalty provisions</u>.***
>
> [Emphasis added]

So, in an attempt to bolster and improve the "significance test" with some objectivity, "significance" has been redefined to mean "insignificance". This means that **<u>ALL</u>** breaches of the relevant legislative provisions become reportable, ***<u>regardless of frequency, size, or importance</u>***.

The Executive Summary of ASIC Enforcement Review Taskforce Report says:

> *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.* [Emphasis added]

This attempted "clarification" has devolved into a "redefinition".

Here from the Overview of Recommendation 1 of the ASIC Enforcement Review Taskforce Report:

> *Breaches of obligations set out in the Corporations Act span a broad spectrum of severity, from relatively minor contraventions such as one-off administrative failures to serious offences including fraud.* ***Prior to 2003, AFS licensees were required to report all breaches to ASIC, regardless of severity. This requirement put a large regulatory burden on licensees in addition to an administrative burden on ASIC to process and appropriately action an influx of minor and insignificant reports. In 2003 a 'significance test' was introduced to provide a threshold for matters that necessitated self-reporting to ASIC.*** [Emphasis added]

The pathway mechanics of this conversion and redefinition are found in Draft RG 78:

> **Draft RG 78.19**
>
> *You must report to ASIC all '**reportable situations**'*
>
> **Draft RG 78.20**
>
> *In this guide, we refer to four types of reportable situations…breaches or 'likely breaches' of **core obligations** that are significant*
>
> **Draft RG 78.25**
>
> *Reportable situations, core obligations and objective determinations of 'significance' are important and interrelated concepts underlying the breach reporting obligation*
>
> **Draft RG 78.36**
>
> *If a breach is a '**deemed significant breach**', you must not take additional steps to determine whether the breach is 'significant' before reporting to ASIC.*
>
> **Draft RG 78.37**
>
> *Deemed significant breaches include breaches…of a **civil penalty provision**.*
>
> [Emphasis added]

In summary, a Reportable Situation will include Core Obligations that will include Deemed Significant Breaches that will include Civil Penalty Provisions.

That is how wine is turned back to water. Significance to Insignificance.

The industry and the whole eco-system are about to be set back 18 years to a pre-2003 model.

Draft RG 78 Table 2: Examples of deemed significant breaches

> ***Example 2(e): Quality of advice and failure to act in interests of the client (civil penalty provision)***
>
> *If you identify conduct by financial advisers acting as your authorised representatives that indicates they have **failed to comply with their duty to act in the best interests of clients** (in breach of s961B of the Corporations Act) or provide appropriate advice (in breach of s961G of the Corporations Act), you must report those breaches to ASIC as those obligations are **civil penalty provisions**.* [Emphasis added]

From here you need to refer to RG 175 to look at the totality of duties that constitute quality advice that is in the best interest of the client:

> **RG 175.226**
>
> *AFS licensees also have an obligation to take reasonable steps to ensure that their representatives comply with:*
>
> *(a) the best interests duty in s961B;*

(b) the appropriate advice requirement in s961G;

(c) the obligation to warn the client if advice is based on incomplete or inaccurate information in s961H; and

(d) the obligation to prioritise the client's interest in s961J: s961L.

The list of ways you can breach the civil penalty provisions related to quality of advice are almost endless. Many of the steps embedded within these duties are **subjective, they require discretion and judgment**. The whole eco-system will now veer towards further conservatism and be "better safe than sorry" and start reporting on almost every advice file in the country.

There is not a single advice file audit report that doesn't find several insignificant "breaches".

We do not believe this was the intent of the ASIC Enforcement Review Taskforce, and strongly believe this was neither the intent of Commissioner Hayne's recommendation.

We do not believe this is ASIC's intent either based on ASIC Deputy Chair Karen Chester when she said:[1]

'Breach reporting is a core component of Australia's financial services and credit regulatory framework. The reforms will better position us to act decisively to disrupt misconduct and escalating harms and identify patterns of non-compliance across industry.'

ASIC expects a significant increase in the volume of reports received as a wider range of entities will be required to report and a wider range of breaches will be subject to reporting. ***Entities are not required to report every instance of non-compliance or trivial breaches****, but a targeted set of 'reportable situations' defined under the law*. [Emphasis added]

This is an unintended consequence that is about to destroy the very foundations of the market-based monitoring and supervision system in Australia.

We believe that this is a system worth preserving for reasons we will address in this submission.

Before we move on, and while still in Draft RG 78

Table 7: Examples of reportable situations about other licensees

Example 6(b): Client received inappropriate advice from previous financial adviser who was authorised by another licensee

*A client is seeing a new financial adviser and provides the new adviser with the Statement of Advice (SOA) received from a financial adviser that the client had previously engaged****. The SOA demonstrates that the previous adviser provided inappropriate advice*** *to the client that resulted in material loss or damage for that client.*

The new adviser brings the SOA to the attention of their authorising licensee. ***The new licensee has reasonable grounds to believe that a reportable situation has arisen*** *in relation to the previous adviser, on the basis that they have contravened their obligation to give advice that is appropriate to the client and act in the best interests of the client.*

The new licensee must lodge a report with ASIC and provide a copy to the previous adviser's licensee.

The requirement to "dob in" other advisers is clear overreach.

The ASIC Enforcement Review Taskforce Report made ten recommendations related to self-reporting of contraventions, not one of these recommendations related to reporting on colleagues and competitors.

This is an unimaginably corrosive overreach that has been woven into the new laws and Draft RG 78 with no basis in either Commissioner Hayne's recommendations or ASIC Enforcement Review Taskforce Report.

[1] 21-080MR ASIC consults on draft guidance on breach reporting reforms

Market-based solutions vs Centralised government solution

Consultation Paper 340 Para 1

> *Breach reporting is a core component of Australia's financial services and credit regulatory framework, where AFS licensees and credit licensees act as the **'first line' of compliance**.*

We agree.

The AFSL system is the first line of compliance. It is the first line of monitoring and supervision.

It is a market-based system of compliance that works well, and certainly works far better today that it did before the Royal Commission.

Consultation Paper 340 Para 10

> *The concerns underlying the existing breach reporting obligation are expressed in the Explanatory Memorandum to the Financial Sector Reform (Hayne Royal Commission Response) Bill 2020 (Explanatory Memorandum): ASIC and industry participants have raised concerns about the existing breach reporting regime in the Corporations Act. The concerns mainly relate to the test for whether a breach or likely breach is significant and therefore reportable, as this requires a financial services licensee to make a **judgement** based on a broad range of matters. As a result, breach reporting is largely inconsistent amongst licensees in terms of the matters reported and the timeliness of reports.*

That is the whole point of a market-based monitoring and supervision system. Discretion and judgment!

Judgments naturally lead to subjective inconsistencies. If the system is made intolerant to inconsistency, then it is intolerant of a market-based solution.

It is the market-based dynamics that are the downward pressure on costs. Impeding these competitive market forces will directly lead to higher costs and less affordability.

A new centrally controlled and managed system is being built that is recalling the discretion and judgment currently embedded within AFSL authorities.

Proposed Breach Reporting changes and the new Single Disciplinary Body will combine to create the foundations of a "Single Government AFSL".

This published 22 April 2021 from ASIC Deputy Chair Karen Chester[2]

> *Set to commence on 1 October 2021, these key Government reforms flow from the Financial Services Royal Commission and findings from the ASIC Enforcement Review Taskforce.*
>
> *Announcing the consultation, ASIC Deputy Chair Karen Chester said, 'We support the reform goals to promote consistent, timely and high-quality reports. **The Financial Services Royal Commission expressed concern about prolonged and repeated failures by large entities to make breach reports required by the law.***
>
> *'Breach reporting is a core component of Australia's financial services and credit regulatory framework. The reforms will better position us to act decisively to disrupt misconduct and escalating harms and identify patterns of non-compliance across industry.' [Emphasis added]*

It was always a "large entities" problem.

- **Single Disciplinary Body (SDB)**

This idea, born out of the Royal Commission, was Commissioner Hayne's solution to, what was essentially a large, vertically integrated, institutional problem. Many of those institutions (mostly banks) have now

[2] 21-080MR ASIC consults on draft guidance on breach reporting reforms

abandoned the space, and or remediated their issues, and the vertically integrated model, although not legally dismantled, holds no sway over this next industry chapter.

- **It was never a systemic individual adviser problem.**

There is no evidence that we are aware of that there was, or is, systemic disciplinary issues at the individual adviser level that is not being adequately monitored, supervised and consequenced by industry.

This new centralisation of authority over the adviser body is a solution to a problem that no longer exists if it ever existed outside of the major institutional licensees.

The interface of the SDB and new sweeping changes to AFSL Breach Reporting, as it currently stands, will create a tidal wave of reports to ASIC that will ultimately be paid for by a further sharp rise in the financial adviser ASIC Funding Levy.

This cost will directly feed into the cost of advice.

Judgment may have been lacking within large vertically integrated institutions, but the market has responded. This market-based is not being valued nor factored into the relevance of further legislative layering.

We are witnessing a delayed response to a problem that has already been resolved. It no longer exists.

The primary reason for the increase in licensee fees is because the market has responded.[3] Licensees have:

- employed more compliance staff and built better compliance systems and architecture
- committed to far more upfront review and monitoring of advice (pre-vetting)
- invested more into RegTech and compliance technology

The market has adapted and responded to the:

- removal of investment commissions and other forms of conflicted remuneration
- reduction and standardisation of insurance commissions
- reduction into insignificance of the vertical integration subsidy

As these commissions, subsidies and other offsets have been removed from the eco-system, the market has re-calibrated pricing, and we are now discovering the true cost of delivering advice.

At the same time, the government has layered on more and more regulatory burden.

But correlation should not be confused with causation.

The primary cause for fees licensee fees rising is the removal of the aforementioned subsides. If you also remove the competitive market-based dynamics cost will rise far higher than it otherwise would.

- **Impact on Affordability ASIC Funding Levy**

These changes add to layer upon layer of legislation from recent years - solving mostly historical problems that no longer exist, at all different levels, putting cost imposts and administrative overhead in place, which the consumer ultimately needs to carry the burden of - making advice unaffordable for millions of Australians.

The government – we are certain unwittingly - is turning advice into an elite service for the wealthy.

The Levy currently sits at $2,426 per Financial Adviser. It began at $934 in FY2018. That is already a 114% increase in just two years. Borne by the licensee, passed onto the Financial Adviser who passes it onto the client.[4]

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[3] $38,500 the new benchmark for licensing fees | Professional Planner

[4] ASIC levy increase due to declining adviser numbers | Money Management

The current number of Financial Advisers sits at just over 20,000 and is likely to drop to about 17,000 by the end of this year (with the looming deadline of the FASEA Exam). With a bottom of 13,000 being a distinct possibility in a few years.[5]

If ASIC regulatory costs were not to increase from current levels, but adviser numbers alone were to reduce to 13,000, that would produce an approximate ASIC Funding Levy of $3,700 per adviser.

But with the sharp budget increase required to fund the SDB and other new ASIC obligations, all of these new costs will be recovered by the ASIC Funding Levy and from a much smaller pool of advisers.

We do not think it improbable that the industry is heading towards a Levy in the range of $6,000 - $7,000 per adviser.

This cost will directly feed into the cost of advice and is incompatible with the government's affordability agenda.

[5] 13,000 or 16,000? Industry questions adviser low-point estimate | Professional Planner

Discretion and Judgment

Discretion and experienced Judgment are the grease in the cogs of a complex systems. Without it the central planning bureaucracy grows and grows.

They are both being removed from the system.

AFSL level discretion is being removed by these proposed changes.

These changes include but are not limited to obligations related to FDSs, Ongoing Fee Arrangements, FSGs, RoAs and pretty much anything involved in the provision of financial advice. Surely this was not Commissioner Hayne's intent.

AFSLs have and should be allowed to retain the discretion to deal with the overwhelming majority of these day to day "breaches". This is an explicit redefinition of an AFSL's monitoring and supervision duties and a mechanisation of minutiae reporting to be dealt with by an ever-expanding bureaucracy.

ASIC level discretion is also being removed as any and all reported breaches will require an FSCP panel. So, for example if an adviser were to complete their 40 CPDs for the year, but only completed 4 of 5 required Client Care and Practice related CPDs, this new system, as it is currently written, would mandate the reporting of this "breach" to ASIC and ASIC would be obliged to convene an FSCP Panel.

The FSCP might quickly dispense with it via a warning, but to get to that point would be absurdly and disproportionately expensive and damaging to the overall functioning of the industry.

The costs incurred at a Licensee and adviser level will directly feed into the cost of advice.

It is the proverbial sledgehammer to a walnut.

Again, surely this was not Commissioner Hayne's intent, and even if it was the Government should use the pragmatism and wisdom available to it to push back against this unnecessary bureaucratic expansion.

This entire legislative architecture will elevate the "threat to the public" of "jaywalking" offences to a new and absurd level.

The current system works. It can be tweaked to work better, but it fundamentally works.

AFSLs across the county have dramatically increased their resourcing and attention to relatively minor matters. The level of alertness within the eco-system has already changed dramatically. The "market" response has worked.

This new, top down, heavy handed centralisation of power and authority is detrimental to all participants and most importantly will not deliver any practical systemic consumer benefit. Quite the contrary, it will increase the cost of advice, reduce the number of advisers in the industry even further and it will further scare off even more potential new advisers.

In fact, we already have a "single disciplinary body" it is called the Corporations Act - the Law. It is not fit for purpose though, so let us fix that and many if not most of these expensive and unproductive tactics will be able to simply fall away.

Disciplinary bodies should be about industry associations that try and position themselves as different to the rest of the industry because of their particular code of conduct. Advisers can get to choose whether that matters to them and whether they are going to be a member or not. Then consumers can choose whether they want to deal with those members or they're happy to deal with anyone that's not a member. That's what those bodies are for.

A single disciplinary body is simply repeating the mistakes made in allowing a single mandated member driven consumer complaints authority to exist (AFCA). What should have been a dispute resolution body quickly morphed into a complaints authority, the equivalent of a government sanctioned consumer advocacy. The singular nature of this new system redesign will create another version of government consumer advocacy.