ASIC

Australian Securities & Investments Commission

The future of advice post FOFA

A speech by Peter Kell, Commissioner,
Australian Securities and Investments Commission

Association of Financial Advisers / Financial Services Council Leadership Forum

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Thank you to the AFA and FSC for the invitation to speak at your Leadership Forum this morning.

Over the last twelve months, ASIC's chairman and commissioners have been speaking about ASIC's three strategic priorities. They are:

- confident and informed investors and financial consumers;
- fair and efficient financial markets; and
- efficient registration and licensing.

Improving the quality of financial advice is critical to the first priority. If we improve trust and confidence in the financial advisory profession we will have confident investors and consumers. Improving quality and trust will also improve consumers' access to financial advice.

Holding the gatekeepers of the financial service system to account is an important aspect of ASIC's work and is fundamental to consumer trust. Gatekeepers, in the widest definition of the term, include accountants, directors, custodians, product manufacturers, market operators and participants, and of course financial advisers. ASIC has signaled it will take action where gatekeepers do not meet their responsibilities.

ASIC wants to work with your industry to improve consumer trust and confidence. This can be achieved through:

- dealing more effectively with conflicts of interest;
- improving competency and the quality of advice;
- encouraging greater ethics, standards and professionalism.

The Future of Financial Advice (FoFA) reforms, once through the Parliament, will help deliver these outcomes. The package of legislation was introduced into Parliament in late 2011 in two separate but related bills covering the best interests duty, ban on conflicted forms of remuneration, opt-in and changes to ASIC's licensing and banning powers.

The FoFA legislation was passed by the House of Representatives on 22 March 2012. It is awaiting consideration by the Senate.

But before I talk about FoFA, I'd like to cover the recent ASIC shadow shop of retirement advice.

ASIC's shadow shop

As you would be aware ASIC has recently published the results of our most recent shadow shopping research, which looked at financial advice provided to people to assist them prepare and set themselves up for retirement.

Unlike some of our other activities – such as adviser surveillances – which look at compliance with the law, the purpose of this shadow shopping exercise was to look at the quality of advice provided to people around retirement and to furnish industry with examples of what we considered to be good, adequate and poor quality advice.

We also wanted to investigate the personal experience of consumers who actually go and seek advice. What did they think of the advice process? What did they think of their adviser? Do they feel their needs and objectives were met?

All the participants in the research were real consumers who had chosen to seek advice about their own circumstances. They found their own advisers and paid for the advice themselves. We engaged a field work provider to find participants, and to collect information from them including details of their personal circumstances, the SOA [Statement of Advice] and their views on the advice they received.

We had the benefit of an expert advisory panel to assist us determine the appropriate standards of advice and to help assess some of the advice, especially when there was debate about how it should be rated. I'd like to thank the AFA for their contribution to this panel.

So what is good quality advice?

Good quality advice:

- meets the client's needs, as well as satisfying the law;
- refines and clarifies the client's objectives, and helps the client to achieve those objectives;
- can be comprehensive or limited in scope;
- educates clients to make informed decisions about their finances;
- is based on sound strategic advice.

In good quality advice product recommendations follow, rather than direct, the suggested strategies. Finally, good quality advice involves good communication, which is honest and doesn't avoid difficult issues.

How did the advice in our shadow shop measure up against this standard?

Of the 64 examples we reviewed only 2 (3%) met this *good* quality grade.

The majority (37 examples) were *adequate*, which mean that the advice was appropriate for the client but fell short of the standard of good advice in one or more respects. Some adequate advice was close to good quality, others were closer to poor quality. These cases were a missed opportunity to provide significant value for the client.

A significant minority of the advice was rated *poor* (25 examples/39%), which means we thought the advice was most likely inappropriate for the client (i.e. it did not meet the requirements of s945a of the Corporations Act). Poor quality advice was generally deficient in several respects and could result in detrimental outcomes for the client in terms of:

- inappropriate risk exposure;
- unnecessary loss of benefits or income;
- switches into products with higher fees but no offsetting benefits; or
- failure to achieve objectives.

Advisers who provided good advice and many of those who provided adequate advice assisted clients to improve their financial well-being. Close attention was paid to the client's objectives, including whether they were realistic. Wider implications of the advice were carefully considered e.g. impact on Centrelink entitlements. The scope of the advice was appropriate and clearly explained and the recommended strategies met the clients' needs. Different strategies were considered and clear communications ensured that the client was aware of their options.

Perception versus reality

A challenging aspect of our research, both for ASIC and for your industry, was that many consumers were not well equipped to assess the quality of advice they received. In one sense this is not surprising – consumers are rarely experts when it comes to complex financial issues, and they are looking to trust advisers on these matters. But more often than not consumers tended to over-estimate quality, which obviously does not facilitate demand-driven improvements in standards.

- 86% of participants felt they had received good quality advice.
- 81% said they trusted the advice they received from their adviser a lot.
- *People rated their advice and adviser highly even when they received poor advice.*

This underlines the importance of rigorous standards in this sector, and the need to deal with conflicts of interest.

Conversely, lower consumer satisfaction with the advice they received does not necessarily mean the adviser has done a bad job. In one example of good advice the client was dissatisfied. This was because the adviser had clearly explained that it would not be sensible for the consumer to retire just yet, that they needed to repay debts and get their cashflows under control. But too often it seems these more difficult messages were avoided or not clearly presented.

Across the survey several other areas for improvement emerged:

Communication is key

- Good advisers coached and educated the client.
  For example, in several SOAs the adviser not only stated the client's objectives but coached the client to set more realistic objectives.
- Several advice examples were downgraded because of glaring omissions.
  For example, failing to note that their retirement capital is likely to be exhausted in four or five years.

Appropriate and accurate investigation of personal circumstances is necessary

- In 16 of the advice examples, the investigation of the client's personal circumstances was clearly poor.
- In 15 of these 16 examples (94%), the advice was rated poor overall.

Strategies and products also need to be appropriate

- In most cases (64%), the financial products recommended were appropriate, however in 16 cases they were inappropriate.
  For example, switching multiple superannuation funds into a more expensive fund, without sufficient other benefits.

Pro-forma advice – there were several examples where the advice was not adequately tailored to the client. At its worst we saw advice where the previous client's details were still in the SOA provided to the new client.

Scope of advice – Limited or scaled advice is not itself an indicator one way or another of advice quality. However, there were too many examples where limitations of the advice were not made clear and/or essential topics were excluded from the scope of the advice.
For example, excluding consideration of a client's significant debts from their retirement advice. In this case, retirement advice could not have been properly provided without considering these debts.

There are some lessons from this survey that ASIC will factor into our FoFA guidance on scaled advice.

In summary, ASIC's most recent financial advice shadow shop has underlined the need for reform. ASIC would like to see an improvement in the quality of advice so that our expectations, and the expectations of consumers who seek advice, are met. We want to increase the amount of good quality advice and reduce poor advice.

The positive message is that, in ASIC's view, in many cases it will not take much to turn *adequate* advice into *good* advice. ASIC is pleased to work with the FSC and AFA on the lessons from the shadow shop.

Overall the results highlight the importance of putting client needs at the centre of the advice process – which brings me to FoFA.

Future of Financial Advice (FoFA) reforms

Introduction

About one in five Australians obtain financial advice. ASIC wants to see this increase, in line with our strategic outcome of confident and informed investors and financial consumers. Trust needs to be improved. I know that the AFA and FSC support these aims.

It should be unacceptable to anyone in this sector, including ASIC as the regulator, to see results such as those from the recent ANZ financial literacy survey, which indicated that 42% of consumers would not trust financial professionals nor accept what they recommend.

Since its inception in 1991, ASIC has supported reform to improve the quality of advice. ASIC supports measures, such as those contained in the FoFA reforms, that will improve the standard of adviser conduct, remove conflicts of interest, and improve engagement by retails clients with advisers and advice. The FoFA reforms are designed to improve trust and confidence in the financial planning sector, as well as access to quality financial advice.

The government proposes that the FoFA reforms will commence on 1 July 2012 and compliance will be mandatory from 1 July 2013. However, licensees can choose to comply with the FoFA reforms from 1 July 2012.

The Future of Financial Advice package includes the following:

- A prospective ban on conflicted remuneration structures including commissions and volume based payments, in relation to the distribution and advice of retail investment products including managed investments, superannuation and margin loans.
- The introduction of a statutory best interest or fiduciary duty so that financial advisers must act in the best interests of their clients, subject to a 'reasonable steps' qualification, and place the best interests of their clients ahead of their own when providing personal advice to retail clients.

- Increasing transparency and flexibility of payments for financial advice by introducing 'adviser charging' that will help align the interests of the financial adviser and the client; is clear and product neutral; and where the investor will be able to opt in to ongoing payment for advice in response to a compulsory, two-yearly renewal notice. This 'opt-in obligation' requires advice providers to renew their clients' agreement to ongoing fees every two years. As you know, ASIC will have the ability to exempt advisers from the opt-in obligation if they are satisfied that the adviser is signed up to a professional code which 'obviates the need' for the opt-in provisions.
- Percentage-based fees (known as assets under management fees) will only be charged on ungeared products or investment amounts and only if this is agreed to with the retail investor.
- Expanding the availability of low-cost 'simple advice' to improve access to and affordability of financial advice.
- Strengthening the powers of ASIC to act against unscrupulous operators through, for example, expansion of our powers to ban advisers. These powers commence on 1 July this year.

ASIC's approach to FoFA implementation

ASIC has announced its intention to publish regulatory guidance on various aspects of the FoFA reforms, in particular:

- best interests duty;
- scaled advice;
- conflicted remuneration; and
- ASIC's amended licensing and banning powers.

In addition to these areas I am also flagging that we will publish guidance on our approach to the approval of codes in the financial advisory sector.

A key issue for ASIC in regulating FoFA is scaled advice, which is designed to expand access to quality financial advice. Our research has found that one reason more people don't get advice is that they want advice about single issues or a limited number of issues rather than a holistic financial plan.

Our guidance will address issues such as having to do a fact-find when giving scaled advice, and adviser and client agreement on the scope of the advice. ASIC fully expects that scaled advice can be provided in a manner that is consistent with the best interests duty.

We will release papers on the above topics soon after the legislative process is completed (i.e. passed by both Houses and assented to). Once we have final legislation, ASIC, industry and consumer representatives will have sufficient certainty to discuss ASIC's implementation approach in more detail.

We will issue consultation papers on these issues. The exception is in relation to ASIC's amended administrative powers. This is consistent with ASIC's normal approach – while we will certainly provide guidance on such matters it is not ASIC's practice to consult about how we should use our administrative or other enforcement powers. We will issue our guidance as soon as practicable on our new licensing and banning powers, as the intention is for these powers to come into effect from 1 July this year.

We have also announced that we will take a facilitative compliance approach during the first 12 months of the FoFA reforms. That is, ASIC will adopt a measured approach where inadvertent breaches arise, provided industry participants are making reasonable efforts to comply.

Codes of conduct in the advice sector

Now to turn to the issue of codes of conduct.

As you would be aware the Government made recent changes to the FoFA Bill to give ASIC the ability to exempt advisers from the opt-in obligation if we are satisfied that the adviser is signed up to a professional code which 'obviates the need' for opt-in. The Government has created this exemption, in the words of the Minister for Financial Services and Superannuation, 'to provide greater flexibility to industry whilst ensuring consumer protection is maintained'.

I've seen some interesting commentary on this issue, not all of which has been well-informed. So I'd like today to provide some basic information and context around the code approval process from ASIC's perspective at this early stage.

These new FoFA code approval and relief powers are contained in s962CA of the first FoFA Bill. In this context I should make a few points:

- This proposed section is not yet law and (to state the obvious) we are unable at this time to approve any codes for the purposes of this new section.
- Not surprisingly, we do not yet have a detailed, concluded view as to what would be required to meet the proposed test that 'ASIC is satisfied that the code of conduct obviates the need for persons bound by the code to be bound by the opt-in requirement'.
- The proposed section also refers to ASIC being satisfied of any other matters prescribed in any regulations made under this proposed section.

> We are not aware of other matters that will be prescribed in the regulations.

As I've already noted, we will consult on our approach to code approval. But before talking about this, a bit of history and context is needed.

ASIC's existing code approval powers

Our ability to approve codes is not new. We have had the power to approve codes under the Corporations Act since 2000, under s1101A. Guidance already exists about our minimum expectations in this area – our Regulatory Guide 183. I'd also add that ASIC has had considerable experience in approving other industry regulatory schemes, notably external dispute resolution schemes.

Under the statutory code approval criteria set out in s1101A(3) of the Act, we may only approve a code of conduct where:

- the code is not inconsistent with the Corporations Act or any other law of the Commonwealth under which ASIC has regulatory responsibilities; and
- ASIC considers that it is appropriate to approve the code having regard to the following matters:
  - the ability of the applicant to ensure that persons who claim to comply with the code will comply with the code;
  - the desirability of codes of conduct being harmonised to the greatest extent possible: and
  - any other matters that ASIC considers are relevant.

We have not yet approved (nor rejected, for that matter) any codes under s1101A.

As you can see, existing legislation puts emphasis on code compliance requirements. The provision dealing with harmonisation is obviously relevant should multiple codes be submitted to us under the FoFA regime.

Stemming from this provision ASIC has long had a public policy statement on how it will exercise its existing code approval power, Regulatory Guide 183 *Approval of financial services sector codes of conduct* (RG 183). This guide explains how and when we will approve financial services sector codes of conduct under our existing powers.

It includes a code approval checklist which covers both the *content* of codes and the process for their development and review. This includes criteria such as:

- freestanding and written in plain language;

- comprehensive body of rules (not single issue);
- enforceable against subscribers/members;
- meets the statutory criteria;
- consultative process for code development;
- effective and independent code administration;
- compliance is monitored and enforced;
- appropriate remedies and sanctions ;
- code content addresses stakeholder issues;
- code is adequately promoted;
- mandatory regular review of code.

We expect an effective code to do at least one of the following:

- address specific industry issues and consumer problems not covered by legislation;
- elaborate upon legislation to deliver additional benefits to consumers; and/or
- clarify what needs to be done from the perspective of a particular industry or practice or product to comply with legislation.

We also expect a code to satisfy the following criteria:

- the rules contained in the code must be binding upon (and enforceable against) code subscribers through contractual arrangements;
- the code must be developed and reviewed in a transparent manner which involves consulting with relevant stakeholders including consumer representatives; and
- the code must have effective administration and compliance mechanisms.

In other words, a code is something that has to be taken seriously. It cannot be entered into lightly, either by industry associations or individual code members. We think that industry codes of conduct can play an important part in how financial products and services are regulated in Australia. Our view is that, where they enjoy the support and commitment of the sponsoring industries, codes can deliver real benefits to both consumers and industry members.

In fact, codes sit at the apex of industry self-regulatory initiatives. For ASIC, a code is essentially a set of enforceable rules that sets out a progressive model of conduct and disclosure for industry members that are signed up. Codes should therefore improve consumer confidence in a particular industry or industries.

In case it's not clear by now, the code approval process will be careful and rigorous. Any code will take a considerable amount of time to develop and it will take months (at least) rather than weeks for us to assess a code.

Furthermore, when developing their codes, we expect applicants to undertake a proper consultation process. This will ensure that stakeholders are engaged in the code's development and that relevant issues are identified. It's particularly important for potential members to understand their obligations. ASIC does not want to see codes put forward that have not benefited from appropriate input by interested stakeholders.

Codes under FoFA

The guidance in RG 183 that I've just outlined is broad-based and is intended to apply to codes across the finance sector, not just in the advisory industry. It is therefore our intention to assist your industry by undertaking consultation around how RG 183 applies to the advice sector.

We plan to consult publicly on our approach to our approach to code approval and relief powers once the legislation is finalised. At this stage, we anticipate our consultation paper will cover matters such as:

- appropriate content of a code submitted for approval, including methods to obviate the need for opt-in;
- administration, governance, monitoring and enforcement of codes; and
- ASIC's approval and relief process.

For a financial advice industry code to be 'not inconsistent' with the law, as required under the Corporations Act, it will need to be consistent with the broader rules included in the FoFA legislation (once finalised). In any case we expect that, as well as the opt-in issue, codes will inevitably include provisions that cover various other aspects of FoFA, such as how to ensure proper dealings with clients. We will therefore take into account the outcomes of our consultation on regulatory guidance on subjects such as the best interests test and conflicted remuneration in developing our approach to code approval.

Realistically, this means it will be some time before codes that are consistent with the FoFA legislation are out in the marketplace. However, there is nothing to stop potential applicants for an approved code from starting to consider how they can work to make their code consistent with FoFA.

As for 'obviating the need' for opt-in, there is obviously still work to be undertaken around this issue. However, I'm sure it will not come as a surprise to hear that at this early stage our view is that obviating the need for opt-in via subscribing to a code does not mean that financial advisers will suddenly have no responsibilities and obligations in this area.

We expect that codes will contain provisions that require members to have active obligations towards their clients that will achieve the same outcome as the opt-in requirement intends to achieve.

As I've noted, ASIC intends to consult further on what those responsibilities and requirements on code members will be, and our expectations as to what actions will 'obviate the need' for opt-in.

Finally, I'd make the obvious point that ASIC approval of any code is not guaranteed. As we state in RG 183, 'It is up to the code applicant to establish how the code meets the approval requirements.'

Conclusion and next steps

In conclusion, ASIC is committed to working through the implementation of the FoFA reforms in a way that assists industry compliance. We've announced our intention to publish regulatory guidance on various aspects of the FoFA reforms, in particular:

- best interests duty;
- scaled advice;
- conflicted remuneration;
- ASIC's amended licensing and banning powers;
- codes of conduct and their potential impact on the opt-in requirements.

As always, our guidance process will be consultative. We are already talking to many in the industry about FoFA implementation, and once the legislation is finalised we will issue draft guidance for consultation.

We will be providing as much helpful information and guidance as we can to support implementation of the FoFA reforms. We suggest that if you wish to keep up with news on FoFA implementation you:

- regularly visit ASIC's FoFA page on our website (www.asic.gov.au),
- subscribe to our FoFA newsletter (see our website above), and
- if you have any questions not answered by these sources, you can email ASIC's FoFA implementation team at fofa@asic.gov.au.

As I said at the outset, ASIC is determined to improve consumer confidence and trust in the financial advisory industry. We look forward to working with the AFA and FSC, as well as other financial services firms and groups, to achieve this aim. We believe that the FoFA reforms have an important role to play in raising the confidence of Australian consumers.