



ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Future of Financial Advice: Best interests duty and related obligations

December 2012

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals to improve our administration of the new obligation for advice providers to act in the best interests of the client (best interests duty) and related obligations in Div 2 of Pt 7.7A in the *Corporations Act 2001* (Corporations Act).

What this Regulation Impact Statement is about

- 1 This RIS addresses ASIC's proposals to improve our administration of the best interests duty and related obligations in Div 2 of Pt 7.7A of the Corporations Act.
- 2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We aim to strike an appropriate balance between:
 - maintaining, facilitating and improving the performance of the financial system and entities in it;
 - promoting confident and informed participation by investors and consumers in the financial system; and
 - administering the law effectively and with minimum procedural requirements.
- 3 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:
 - the likely compliance costs;
 - the likely effect on competition; and
 - other impacts, costs and benefits.

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A Introduction

Background

The Future of Financial Advice reforms

- 4 In April 2010, the former Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen, announced the Australian Government's Future of Financial Advice (FOFA) reform package.
- 5 The FOFA reforms represent the Australian Government's response to the *Inquiry into financial products and services in Australia* by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) in 2009. The inquiry examined the issues associated with the collapses of Storm Financial Limited, Opes Prime and other similar corporate collapses of financial services businesses.
- 6 The PJC found that the law relating to how personal advice is provided could be improved, noting that:
- The committee supports the proposal for the introduction of an explicit legislative fiduciary duty on financial advisers requiring them to place their client's interest ahead of their own. There is no reason why advisers should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide advice not in their clients' best interests, yet comply with section 945A of the Corporations Act. A legislative fiduciary duty would address this deficiency: paragraph 6.28.
- 7 The PJC also recommended that the Corporations Act should be amended to include a fiduciary duty for financial advisers, requiring them to place the interests of their client ahead of their own: Recommendation 1, paragraph 6.29.
- 8 The Australian Government implemented the PJC's recommendation by introducing a statutory duty for Australian financial services (AFS) licensees, authorised representatives and advice providers to act in the best interests of the client. It also enacted other conduct obligations in Div 2 of Pt 7.7A of the Corporations Act: see Table 1.
- 9 The Explanatory Memorandum to the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 states:
- The underlying objective of the reforms is to improve the quality of financial advice while building trust and confidence in the financial advice industry through enhanced standards which align the interests of the adviser with the client and reduce conflicts of interest. The reforms also focus on facilitating access to financial advice, through the provision of simple or limited advice.
- 10 ASIC's Report 279 *Shadow shopping study of retirement advice* (REP 279), which sets out the results of the 2011 shadow shopping research into personal advice about retirement, demonstrates that there is room for improvement in the

- quality of advice many retail clients receive. The report highlighted that 39% of advice examples were poor and did not meet the appropriate advice requirements in s945A, 58% were adequate and only 3% were good.¹
- 11 REP 279 also found that there was evidence that conflicts of interest, such as those created by links to product issuers, had a detrimental effect on the quality of advice being delivered.²
- 12 Poor investor confidence in financial advisers has also been identified as a barrier to investors seeking personal advice.³ The ANZ *Adult Financial Literacy in Australia* survey found that 42% of respondents would not trust financial planners nor accept what they recommend.⁴ In Report 224 *Access to financial advice in Australia* (REP 224), we noted that one of the main reasons some investors do not seek personal financial advice is the lack of trust they have in financial advisers.
- 13 In addition, around two-thirds of retail and institutional investors do not believe that advice providers act in the best interests of their client. These investors also report that the financial education they receive from advice providers is not adequate.⁵
- 14 The *Corporations Amendment (Future of Financial Advice) Act 2012* and the *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (FOFA Acts) amend the Corporations Act to implement the FOFA reforms. These include:
- (a) the best interests duty;
 - (b) the ban on conflicted remuneration;
 - (c) the requirement to give retail clients an annual fee disclosure statement where there is an ongoing fee arrangement;
 - (d) an opt-in requirement for advice providers to renew their client's agreement to ongoing fees every two years. This applies unless ASIC is satisfied that the licensee or representative is bound by a code of conduct that, among other things, obviates the for the opt-in requirement; and
 - (e) enhanced licensing and banning powers for ASIC.
- 15 The FOFA Acts commenced on 1 July 2012 and compliance will be mandatory from 1 July 2013. However, AFS licensees may elect to voluntarily comply with Pt 7.7A of the Corporations Act from 1 July 2012.

¹ REP 279, p. 11

² REP 279, p. 10

³ REP 279, p. 60

⁴ ANZ, *Adult Financial Literacy in Australia*, December 2011

⁵ State Street and Center for Applied Research, *The Influential Investor: How investor behavior is redefining performance*, November 2012, p. 20

Regulation of financial advice

16 The provision of financial product advice to retail clients is regulated under the Corporations Act.

Note: All sections (s), chapters (Chs), parts (Pts), divisions (Divs) and subdivisions (Subdivs) referred to in this RIS are from the Corporations Act unless otherwise stated.

17 Subject to some limited exclusions, a person who provides financial product advice to retail clients must hold an AFS licence and comply with the disclosure and conduct obligations in Pt 7.7 of the Corporations Act. These obligations are designed to ensure that retail clients receive reliable advice about financial products.

18 The FOFA Acts impose additional conduct obligations on those who provide personal advice to retail clients.

19 The existing requirements for personal advice provided to retail clients in Div 3 of Pt 7.7 apply only to AFS licensees and their authorised representatives. In contrast, the best interests duty and related obligations are set out in Div 2 of Pt 7.7A and apply to an ‘advice provider’. This is generally the individual providing the personal advice to retail clients (e.g. a financial adviser).

Note: All references to ‘advice’ or ‘personal advice’ in this RIS mean financial product advice given or directed to a person (including by electronic means) in circumstances where the provider of the advice has considered one or more of the client’s objectives, financial situation and needs, or a reasonable person might expect the provider to have considered one or more of these matters: s766B (3).

20 Table 1 provides an overview of the key obligations in Div 2 of Pt 7.7A of the Corporations Act.

Table 1: Key obligations in Div 2 of Pt 7.7A for advice providers providing personal advice to retail clients

Obligation	Summary
Acting in the best interests of the client: best interests duty (s961B)	<p>Advice providers must act in the best interests of their client in relation to the advice.</p> <p>One way an advice provider can demonstrate they have done this is by showing they have carried out certain steps in advising their clients. These steps, which act as a ‘safe harbour’ for complying with the best interests duty, are set out in s961B(2).</p> <p>To satisfy the steps for safe harbour in s961B(2), an advice provider must:</p> <ol style="list-style-type: none"> 1. identify the objectives, financial situation and needs of the client that were disclosed by the client through instructions; 2. identify the subject matter of the advice sought by the client (whether explicitly or implicitly); 3. identify the objectives, financial situation and needs of the client that would reasonably be considered relevant to the advice sought on that subject matter (client’s relevant circumstances);

Obligation	Summary
	<ol style="list-style-type: none"> 4. if it is reasonably apparent that information relating to the client's relevant circumstances is incomplete or inaccurate, make reasonable inquiries to obtain complete and accurate information; 5. assess whether the advice provider has the expertise required to provide the client with advice on the subject matter sought and, if not, decline to provide the advice; 6. if it would be reasonable to consider recommending a financial product: <ul style="list-style-type: none"> – conduct a reasonable investigation into the financial products that might achieve the objectives and meet the needs of the client that would reasonably be considered relevant to advice on that subject matter; and – assess the information gathered in the investigation; 7. base all judgements in advising the client on the client's relevant circumstances; and 8. take any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.
Providing appropriate advice (s961G)	Assuming the advice provider has complied with the best interests duty in s961B, the resulting advice must only be given if it is reasonable to conclude that it is appropriate for the client.
Warning the client if advice is based on incomplete or inaccurate information (s961H)	If it is reasonably apparent that the advice is based on incomplete or inaccurate information about the client's objectives, financial situation and needs, advice providers must give a warning to the client.
Prioritising the interests of the client (s961J)	Advice providers must prioritise the interests of the client over their own interests and those of some of their related parties, including their AFS licensee or associates of their licensee.
Complying with the modified best interests duty	<p>A modified form of the best interests duty applies when advice is provided:</p> <ul style="list-style-type: none"> • on a basic banking product only, and the advice provider is an agent or employee of an Australian authorised deposit-taking institution (ADI), or otherwise acting by arrangement with an Australian ADI under the name of the Australian ADI; • on a general insurance product only; • a basic banking product, a general insurance product or a combination of those products, where the advice provider is an agent or employee of an Australian ADI, or otherwise acting by arrangement with an Australian ADI under the name of an Australian ADI; or • general insurance and other products. <p>When the modified best interests duty applies, advice providers:</p> <ul style="list-style-type: none"> • only need to undertake a limited number of steps to have acted in the best interests of their client—specifically, steps 1–4 of the safe harbour for complying with the best interests duty; • must comply with the appropriate advice requirement; • must comply with the obligation to warn the client if advice is based on incomplete or inaccurate information; and • do not need to comply with the requirement to prioritise the client's interests.

ASIC's role in administering the law

- 21 As Australia's corporate, markets and financial services regulator, ASIC is responsible for administering and enforcing the best interests duty and related obligations.
- 22 Our administration of the best interests duty and related obligations is guided by the following principles:
- (a) the provisions are intended to enhance trust and confidence in the financial advice industry;
 - (b) increased trust and confidence in the financial advice industry should lead to more consumers accessing financial advice;
 - (c) the provisions should lead to a higher quality of advice being provided compared to the general standard of advice being provided under s945A and 945B;
 - (d) whether a reasonable advice provider would believe the client is likely to be in a better position if the client follows the advice; and
 - (e) the best interests duty in s961B, the appropriate advice requirement in s961G and the conflicts priority rule in s961J are separate obligations that operate alongside each other and apply every time personal advice is provided.

Financial advice industry

- 23 A broad range of people provide personal advice to retail clients including:
- (a) financial advisers;
 - (b) some staff at ADIs;
 - (c) customer service staff at general insurance companies;
 - (d) insurance advisers
 - (e) stockbrokers;
 - (f) accountants; and
 - (g) employees or outsourced customer service representatives at trustees of superannuation funds and responsible entities.
- 24 The industry data in this section relates to financial advisers only. It does not capture all advice providers.

Size of the industry

- 25 As at 30 June 2012, there are approximately 2,720 AFS licensees and 28,750 authorised representatives who are authorised to provide personal financial product advice to retail clients in Australia.

- 26 The financial advice industry in Australia has around 770 adviser groups operating over 8,900 practices and employing around 18,300 people.⁶
- 27 Industry revenue for the 2012–13 financial year is expected to be \$4.41 billion, an approximate increase of 0.5% compared with the previous year. However, industry revenue is expected to grow at an annual compound rate of 4.3% in the next five years through 2017–18 to reach \$5.43 billion.⁷
- 28 ASIC’s Report 251 *Review of financial advice industry practice* (REP 251), which set out the findings of a review of the top 20 AFS licensees regulated by ASIC, identified that in 2008–09 these AFS licensees had a combined total of 4.6 million clients. Of these, only 1.5 million clients (or 32.6%) were identified by AFS licensees as ‘active’ clients.⁸

Structure of the market

- 29 The financial advice industry is structured predominantly in the form of dealer groups or financial advisory networks. The industry has undergone significant structural change in recent years, with nearly all the largest dealer groups now owned by the financial institutions.
- 30 The market is dominated by the top seven firms who control a total market share of over 50%, with most of these firms employing between 700 and 2,000 financial advisers each.⁹
- 31 Industry consolidation to date has largely been driven by economies of scale, with firms trying to employ larger numbers of financial planners within the same dealer group.¹⁰ This has resulted in a situation where the relationships between financial advisers, product providers and investment platforms are becoming more inter-dependent.
- 32 Generally, in the financial advice industry, AFS licensees determine what products their advisers can provide advice on to retail clients. The most common way for AFS licensees to do this is through the use of approved product lists. The profitability of particular products to the AFS licensee is one factor that influences the construction of approved product lists. Other factors may include the quality of assessment processes and issues related to insurance.
- 33 It is estimated that 85% of financial advisers are associated with a product issuer, so that many advisers effectively act as a product pipeline.¹¹ Of the remainder, the vast majority receive commissions from product issuers and so have incentives to sell products.

⁶ Rainmaker Information

⁷ IBIS World Industry Report, Financial Planning and Investment Advice: K7515, October 2012, p. 4

⁸ REP 251, p. 5

⁹ IBIS World Industry Report, Financial Planning and Investment Advice: K7515, October 2012, p. 20

¹⁰ IBIS World Industry Report, Financial Planning and Investment Advice: K7515, October 2012, p. 20

¹¹ IBIS World Industry Report, Financial Planning and Investment Advice in Australia: K7515, May 2009, p. 7

Assessing the problem

- 34 The Corporations Act imposes high-level principle-based obligations on advice providers to act in the best interests of their clients, to provide clients with appropriate advice and to prioritise the interests of their clients. However, it does not define these obligations or provide detail on the processes that advice providers should adopt to comply with their obligations.
- 35 Terms used in the Corporations Act that have not been defined or require further explanation include:
- (a) ‘best interests’ in the requirement for advice providers to act in the best interests of the client in s961B(1);
 - (b) ‘reasonable investigation’ for the purpose of determining when it is reasonable to recommend a financial product in s961B(2)(e);
 - (c) ‘appropriate’ advice for the requirement on advice providers to give personal advice that is appropriate to the client in s961G; and
 - (d) ‘prioritise’ the interests of the client in s961J where the advice provider knows, or ought reasonably to know, that there is a conflict of interest between the client’s interests and their own interest or the interests of some of their related parties which are specified in the Corporations Act.
- 36 Lack of certainty in what the law requires causes confusion for advice providers in determining what behaviour is required to comply with their obligations. The majority of submissions we received on Consultation Paper 182 *Future of financial advice: Best interests duty—Update to RG 175* (CP 182) indicated that industry participants do not know what they need to do to comply with the law.
- 37 There are no examples of poor practices among advice providers that breach the best interests duty and related obligations as the law is still new and will not fully commence until 1 July 2013.
- 38 Since the key terms in the law are not defined or explained, there is a risk that advice providers could apply the law in a way that does not achieve the Australian Government’s objectives to:
- (a) improve the quality of advice being provided to retail clients; and
 - (b) improve trust and confidence in the financial advice industry through enhanced standards that align the interests of the adviser with the client (see paragraph 9).
- 39 Retail clients who rely on personal advice may be persuaded to purchase unsuitable products if the advice is not of good quality or is the subject of a conflict of interest. As noted above, in REP 279, we found that there was significant room for improvement in the quality of advice that is currently being provided to retail clients: see paragraphs 10–11. This is because of the

complexity of financial products and disclosures and the low levels of financial literacy among many retail clients.¹²

40 It is also important to note that currently almost two-thirds of investors do not believe that advice providers act in their best interests: see paragraph 13.

41 If advice providers are uncertain about what the law requires, this could also result in advice providers giving less advice to retail clients because they are concerned that the processes they adopt may be in breach of the law. This would result in a key policy objective of the FOFA Acts not being achieved—namely, to increase access to advice for retail clients.

Objectives of government action

42 The Australian Government passed the FOFA Acts to implement the best interests duty and related obligations in Div 2 of Pt 7.7A. As noted above, the underlying objectives of the reforms are to enhance trust and confidence of retail clients in the financial advice sector and improve the quality of personal advice that advice providers give: see paragraph 9.

43 As noted above, the problem we identified indicates that there is a lack of certainty about how industry should meet the best interests duty and their related obligations. ASIC's objective is to ensure that AFS licensees, authorised representatives and advice providers have greater certainty about the application of the law and, in turn, how they can meet their legal obligations.

44 Our objectives are not intended to ensure that advice providers give perfect advice to their client. Nor can we guarantee that, even if an advice provider gives good quality advice, that the client will follow that advice or that the end result of the advice will always be favourable to the client. This is because advice providers have no control over the investment performance of market products their clients hold.

¹² Our Report 224 *Access to financial advice in Australia* (REP 224) found that gaps in financial literacy prevent consumers from engaging and seeking advice on financial matters: see p. 5

B Options and analysis

Options

45 Options to achieve our objectives are:

- (a) **Option 1:** the current requirements in the Corporations Act for the best interests duty and related obligations apply (*status quo*).
- (b) **Option 2:** ASIC provides guidance on our expectations for what that advice providers must do to comply with the best interests duty and related obligations.

46 We have also considered an option which involves the financial advice industry addressing through self-regulation the lack of clarity in the law on how AFS licensees, authorised representatives and advice providers should comply with their obligations.

47 We do not think that self-regulation is an appropriate solution for complying with the best interests duty and related obligations. This is because self-regulation requires significant compliance and cooperation from industry.

48 The primary problem that we see is that currently advice providers operate across a variety of different industry sectors (e.g. the financial planning, stockbroking, superannuation, accounting and banking sectors). We do not think there is an industry body that can effectively enforce a self-regulatory code that applies, and discipline non-compliant advice providers, across the different industry sectors.

49 If the expectations for compliance with the best interests duty and related obligations are set by industry, this may result in a wide variation in how standards are applied across the different sectors and a poorer level of compliance among advice providers.

50 We recognise that self-regulation is an important part of the wider regulatory process. However, through our surveillance and enforcement activities, we have found that there are inherent issues in the practice. Considering our objective of providing greater certainty to industry and given the range of industry associations, self-regulation is unlikely to lead to a consistent understanding of the relevant obligations.

Option 1

51 Option 1 is to maintain the *status quo*. This means that individual advice providers will be required to develop their own procedures for complying with the law.

52 Under this option, we would continue our normal surveillance activities and take enforcement action in accordance with our usual practice.

Option 2

53 As noted above, the law imposes high-level principle-based obligations on
advice providers without defining or providing further explanation of some
of the key terms.

54 Under Option 2, we would provide guidance setting out our interpretation of
the undefined terms in the law and our expectations of how we will administer
the best interests duty and related obligations in Div 2 of Pt 7.7A. It is a matter
for AFS licensees, authorised representatives and advice providers to determine
and comply with their legal obligations.

55 A brief overview of the key points in our guidance is set out below.

Acting in the best interests of the client

56 Option 2 provides guidance on our interpretation of an advice provider
acting in the ‘best interests’ of the client.

57 When assessing whether an advice provider has complied with the best
interests duty, we will consider whether a reasonable advice provider would
believe that the client is likely to be in a better position, if the client follows
the advice. We refer to this as the ‘better position’ standard.

58 This assessment would depend on the circumstances and include the
following factors:

- (a) the position the client would have been if they did not follow the
advice;
- (b) the facts at the time the advice is provided that the advice provider had,
or should have had, if they followed their obligations;
- (c) the subject matter of the advice sought by the client;
- (d) the client’s objective, financial situation and needs;
- (e) where relevant, product features that the client particularly values,
provided the client understands the cost of, and is prepared to pay for,
those features; and
- (f) if the client follows the advice, they receive a benefit that is more than
trivial.

59 We understand that many clients seek advice with the objective of improving
their financial position. However, the guidance recognises that a client’s
objectives, financial situation and needs may also encompass other things,
such as improving a client’s understanding of their financial position or
aligning their financial position with their appetite for risk.

60 Our guidance makes it clear that when assessing whether the advice provider has acted in the best interests of the client, we will not examine investment performance retrospectively.

Complying with the safe harbour for the best interests duty

61 Advice providers may rely on the ‘safe harbour’ in s961B(2) to demonstrate they have complied with the best interests duty—that is, if an advice provider has taken the steps in s961B(2), they have met their obligation to act in the best interests of their client.

62 Under Option 2, we will provide guidance on our expectations for satisfying each step in the safe harbour.

63 The better position standard would also be relevant for showing whether an advice provider has satisfied the steps in the safe harbour for complying with the best interests duty.

When it is reasonable to recommend a financial product

64 To rely on the safe harbour for the best interests duty, an advice provider must also:

- (a) conduct a reasonable investigation into the financial products that might achieve the objectives and meet the needs of the client that would reasonably be considered relevant to advice on that subject matter; and
- (b) assess the information gathered in the investigation: s961B(2)(e).

65 Before recommending that a client acquire a financial product, we expect advice providers to formulate the strategy they are basing the advice on, taking into account their obligations to act in the best interests of the client in s961B.

66 We consider that there will be some cases where it will not be reasonable for the advice provider to recommend a financial product to the client in light of the subject matter of the advice sought by the client. We expect that to comply with the best interests duty, advice providers will :

- (a) provide the client with advice that is not product-specific (which may include advice for the client to do nothing);
- (b) advise the client to dispose of a financial product; or
- (c) advise the client to make an increased investment without acquiring new financial products.

67 To demonstrate that they have conducted a reasonable investigation for the purpose of s961B(2)(e), we consider that advice providers may need to:

- (a) use research reports produced by external research report providers to identify products that may be suitable for clients;

- (b) benchmark, at appropriate intervals, the product against the market for similar products to establish its competitiveness on key criteria such as performance history over an appropriate period, features, fees and risk;
- (c) investigate or consider a product that is not on their AFS licensees approved product list in some cases—for example:
 - (i) if the client’s existing product is not on the approved product list;
 - (ii) if the approved product list is restricted to one class of product and there are products that are not on the approved product list that would better suit the client’s relevant circumstances; and
 - (iii) if the client requests the advice provider to consider a specific financial product that is not on the approved product list.

Complying with the modified best interests duty

- 68 In some circumstances, a modified form of the best interests duty in s961B(1) applies where the subject matter of the advice sought by the client is:
- (a) a basic banking product, where the advice provider is an agent or employee of an Australian ADI, or otherwise acting by arrangement with an Australian ADI under the name of an Australian ADI;
 - (b) a general insurance product only;
 - (c) a basic banking product, a general insurance product or a combination of those products, where the advice provider is an agent or employee of an Australian ADI, or otherwise acting by arrangement with an Australian ADI under the name of an Australian ADI; and
 - (d) general insurance and other products.
- 69 Option 2 clarifies our expectations for how advice providers in the banking and general insurance sectors can comply with the modified best interests duty. We state that, to comply with the modified best interests duty, we consider that an advice provider should comply with our guidance on the safe harbour requirements in s961B(2)(a)–(c).
- 70 The better position standard also applies when the modified best interests duty applies: see paragraphs 57–60.

Providing appropriate personal advice

- 71 Option 2 provides guidance about our expectations for complying with the requirement for advice providers to give appropriate personal advice to the client in s961G, including where the modified best interests duty applies.
- 72 Advice provided to a client is appropriate if it would be reasonable to conclude, at the time the advice is provided, that:
- (a) it is fit for its purpose—that is, following the advice is likely to satisfy the client’s relevant circumstances; and

(b) the client is likely to be in a better position if they act on the advice.

73 In assessing whether advice is appropriate, an advice provider is assumed to know all the information about the client, strategy and product (if any) that they would know if they have properly complied with s961B.

74 The better position standard also applies to the appropriate advice requirements: see paragraphs 57–60.

75 The requirement to provide appropriate advice also applies when the modified best interests duty applies: see paragraphs 68–69.

Prioritising the interests of the client

76 An advice provider must not act to further their interests or those of one of their related parties over the client’s interests when giving advice to the client. We refer to this obligation in s961J(1) as the ‘conflicts priority rule’.

77 The conflicts priority rule does not apply if the advice provider does not know of the conflicting interest. Nor do we expect an advice provider to make inquiries to determine what conflict of interests their related party has.

78 In complying with this obligation, we expect an advice provider to identify what interests they or one of their related parties have and consider what a reasonable advice provider without a conflict of interest would do. The more material the conflict of interest is for the advice provider or their related party, the more we would expect an advice provider to prioritise their client’s interests.

79 If an advice provider with a conflict of interest is unable to prioritise the interests of the client, we expect them to decline to provide the advice.

80 The conflicts priority rule does not apply when the subject matter of the advice sought by the client relates to a basic banking product or general insurance product. These are both cases when the modified best interests duty applies: see paragraphs 68–69.

Record-keeping obligations

81 We expect AFS licensees to keep records of how their advice providers have acted in relation to providing advice. This includes the inquiries an advice provider has made into the client’s relevant circumstances and considering and investigating of any financial products they are advising on.

82 We consider that the Corporations Act requires AFS licensees to keep adequate records about their financial services business, including records of personal advice and how the advice is prepared.

- 83 As a matter of good practice, we expect advice providers to ensure that:
- (a) client records contain evidence of the basis on which a reasonable advice provider would believe that the advice is likely to leave the client in a better position if the client follows the advice; and
 - (b) more detailed records are kept in cases where there is a conflict between the client's interests and those of the advice provider or one of their related parties. For example, these records should cover the reasoning behind any recommendation that the client acquire new financial products.

Impact analysis

Option 1: Current requirements apply (status quo)

Impact on industry

- 84 The best interests duty and related obligations are principles-based.
- 85 AFS licensees and authorised representatives will generally have compliance systems in place to assist their advice providers in complying with the law. However, the lack of prescriptive guidance will make this difficult.
- 86 As a result of the FOFA reforms, industry will incur compliance costs to meet the new best interests duty and related obligations. Although the direct impact on industry would vary from entity to entity, we expect these compliance costs to include:
- (a) changes to IT systems and existing compliance processes to comply with the law—for example, to document that they have undertaken the necessary steps to comply with the best interests duty and related obligations;
 - (b) additional training for advice providers and support staff due to the different characteristics and skill sets required to comply with the law;
 - (c) in some cases, advice providers having to consider and investigate products that are not on the AFS licensee's approved product list before recommending a financial product to a client; and
 - (d) record keeping requirements in light of the new obligations.
- 87 As noted above, there is considerable uncertainty among AFS licensees, authorised representatives and advice providers about how to comply with the requirements in the law.
- 88 We recognise that the FOFA Acts may be the subject of judicial interpretation in the future, which may establish a body of precedent that could guide the development of compliance programs by AFS licensees and their authorised representatives. However, in our experience, it may take a

long time before a suitable case comes before a court for decision.¹³ Court action will also involve significant cost for any advisory group defending a case. In the meantime, AFS licensees and their authorised representatives will be operating in an uncertain regulatory environment.

89 If AFS licensees and authorised representatives are uncertain about the requirements in the law, they will need to spend more time developing a compliance plan and training their staff and seek legal advice to understand what behaviour is required to comply with their legal obligations. The cost of supervising their advice providers and support staff to ensure they comply with the law may also be high.

90 While industry may benefit from having more flexibility to develop their own compliance processes, there is a risk that AFS licensees and authorised representatives will spend significant time developing compliance processes and systems which a court or ASIC may later find does not comply with the law because of the high-level way in which the best interests duty and related obligations have been drafted.

Impact on consumers

91 If advice providers lack certainty about what the law requires, this could lead to advice providers adopting personal advice models that fail to deliver quality advice to retail clients. This could in turn exacerbate the lack of trust that is already evident among many retail clients, notably those who have never used an advice provider or those who had a negative experience with an advice provider.

92 The uncertainty in the law could also lead to advice models that do not allow advice providers to adequately identify conflicts of interest and prioritise the client's interests in accordance with the law. As noted above, conflicts of interest could have a detrimental effect on the quality of advice provided to retail clients: see paragraph 11.

93 There is evidence which suggests that some investors may not understand the impact that conflicts of interest have on the advice they receive. For example, the *ANZ Adult Financial Literacy in Australia* survey found that, of the respondents who had a financial adviser, around 40% said they do not consider the possibility of conflict when their adviser made investment recommendations.¹⁴

94 If AFS licensees, authorised representatives and advice providers do not have certainty about the processes they should adopt to meet the best interests duty and related obligations, there is also a risk that some advice providers may be reluctant to provide advice to clients because they are concerned the advice may be in breach of their obligations. This would not meet one of the key objectives

¹³ There has been no case before a court for decision on s945A of the Corporations Act (which preceded the best interests duty) in the last 10 years.

¹⁴ ANZ, *Adult Financial Literacy in Australia*, December 2011.

of the FOFA reforms, which is to increase access to financial advice for retail clients. It is important that retail clients receive good quality advice because of the complexity of financial products and disclosures and the low levels of financial literacy among many retail clients.

Impact on government

95 Although we would not issue regulatory guidance under Option 1, we would still be required to allocate resources to help industry develop its own policies and processes for meeting the best interests duty and related obligations.

96 As part of ASIC's business as usual, we respond to requests for information or clarification of the law on a case-by-case basis. It is likely that under Option 1 there will be a large number of inquiries because of the uncertainty among advice providers about how the new law will apply. This will require ASIC to divert resources away from other business as usual activities.

97 It is also very likely that we will need to allocate additional resources to our normal surveillance of AFS licensees, authorised representatives and advice providers with a personal advice authorisation to ensure they are meeting their obligations. This is at the expense of other business as usual surveillance of the financial services industry. We expect that industry will apply a variety of standards and processes to meet their obligations, which may make our surveillance and enforcement activities even more difficult.

Option 2: ASIC provides guidance on the best interests duty and related obligations

Impact on industry

98 Advice providers that provide personal advice to retail clients will be subject to the best interests duty and related obligations in the Corporations Act.

99 As noted above, industry will incur fixed compliance costs to meet the new best interests duty and related obligations: see paragraph 86. The direct impact on industry would vary from entity to entity, although we expect that these compliance costs would be disproportionately burdensome on smaller entities.

100 However, we expect that ASIC guidance will reduce these compliance costs as advice providers will have more certainty about what behaviour is required to comply with the law.

101 Where ASIC guidance does impose compliance costs on advice providers, we believe that this will be limited. These compliance costs may include those incurred by AFS licensees, authorised representatives and advice providers in:

- (a) monitoring their compliance plan to ensure that the advice meets the best interests duty;

- (b) keeping better records to show that, in providing personal advice, they have taken the necessary steps under our guidance, in addition to other requirements in the law;
- (c) adapting their IT systems and compliance processes as needed to introduce additional compliance processes and IT system changes; and
- (d) providing training to advice providers and support staff to comply with certain aspects of our guidance, which is in addition to the training required by the law. We consider this compliance cost is likely to be minimal because any additional training programs required as a result of our guidance can be rolled out at the same time as the training on the legal requirements.

102 In submissions on CP 182, respondents from the insurance and not-for-profit superannuation sectors indicated that, for some AFS licensees and their authorised representatives, ASIC's guidance should not have any significant impact in terms of cost because the guidance would not fundamentally alter the approach or model they use to provide advice. One submission also indicated that they expect our guidance to marginally reduce the costs of complying with the new law.

103 However, some submissions to CP 182 from the financial services, banking and legal sectors said that our guidance may require AFS licensees and authorised representatives to implement new or changed processes, in addition to what is required under the law.

104 One industry association submitted that our guidance on the best interests duty and related obligations will add cost and complexity to the advice process, estimating that our guidance will increase the costs to its members by approximately 20–40%, which is in addition to the costs of complying with the law in this area. In training alone, they suggested that the costs to its members of complying with our guidance could increase by around \$5–\$40 million.

105 In contrast, one AFS licensee indicated that the cost of complying with the law and our guidance, including the need to engage obtain legal advice and to implement a training and education program for authorised representatives, will be at least \$100,000.

106 We have carefully considered the different feedback from industry. On balance, we anticipate that the costs to industry of complying with our guidance will be minimal. If industry is required to alter the approach or business model they use to provide advice as a result of our guidance (which we think is unlikely), they should be able to do this at the same they alter their approach or business model to comply with their new legal requirements.

107 Further, it is difficult to quantify the direct impact on industry because the cost of complying with our guidance would vary from entity to entity. Although we anticipate that, to the extent that our guidance will require advisers to adopt different procedures, the compliance costs may be disproportionately heavy for smaller entities.

Impact on consumers

108 Under Option 2, we anticipate that providing industry greater certainty about how we expect AFS licensees, authorised representatives and advice providers to comply with the best interests duty should help industry to meet the Australian Government's objective to increase trust and confidence in the financial advice industry and facilitate access to financial advice for retail clients. We expect that this in turn will lead to a greater demand for personal advice from retail clients, especially with respect to scaled advice (i.e. personal advice that is limited in scope).

109 In addition, if industry has more certainty about how to comply with their legal obligations, this should help them develop compliance processes that will better ensure that advice providers meet the requirements under the law to act in the best interests of the client when giving advice to retail clients and to prioritise the client's interests when giving advice. We consider that if retail clients receive such advice that is of higher quality, they will be better informed and feel more empowered to make financial decisions that meet their objectives, financial situation and needs. As noted above, almost two-thirds of investors do not believe that advice providers act in their best interests or provide adequate financial education: see paragraph 13.

110 Improving the conduct standards of advice providers who give personal advice will also help to improve the perception of retail clients about the professional standard of advice providers. As noted above, approximately two-thirds of retail and institutional investors do not believe that advice providers act in their client's best interests: see paragraphs 12–13.

Impact on government

111 Under Option 2, we will monitor compliance with the best interests duty and related obligations. The regulatory guide will provide a framework for ASIC to do this. Setting clearer expectations of what behaviour is required from industry to comply with the law means that there may be less of a need for ASIC to undertake enforcement action.

C Consultation

- 112 In August 2012, we issued CP 182 which consulted on proposals to assist those who provide personal advice to comply with the best interests duty and related obligations.
- 113 In response to CP 182, we received 28 submissions from a variety of sources including industry associations, trustees of superannuation funds, financial advisory, stockbroking, and insurance firms, legal practitioners, external dispute resolution (EDR) schemes and consumer representative groups.
- 114 We also held roundtable discussions with the following industry groups and their members:
- (a) Abacus Australian Mutuals;
 - (b) Association of Financial Advisers;
 - (c) Association of Superannuation Funds Australia;
 - (d) Australian Bankers' Association;
 - (e) Australian Financial Markets Association;
 - (f) Australian Institute of Superannuation Trustees;
 - (g) Consumer Advisory Panel members;
 - (h) EDR schemes
 - (i) Financial Planning Association
 - (j) Financial Services Council;
 - (k) Industry Super Network;
 - (l) Insurance Council of Australia;
 - (m) Melbourne Compliance Forum;
 - (n) Stockbroking Association of Australia; and
 - (o) the Joint Accounting Bodies.
- 115 We also held meetings with a wide range of industry participants—including individual firms, industry associations and legal practitioners—over many months to discuss our proposed guidance.
- 116 EDR schemes, consumer groups, the not-for-profit superannuation sector and the accounting sector were very supportive of our proposed guidance.
- 117 However, a number of respondents had significant concerns with aspects of our proposed guidance.

- 118 The main issues raised by respondents related to:
- (a) whether for compliance with the best interests duty, an advice provider should have a reasonable belief that the advice is likely to leave the client in better position, if the client follows the advice;
 - (b) whether an advice provider should investigate and consider products that are not on their AFS licensee's approved product list to determine whether it is reasonable to recommend a financial product; and
 - (c) whether an advice provider should be guided by what an advice provider without a conflict of interest would do to comply with the requirement to prioritise their client's interests.
- 119 We have set out below a summary of how we have modified our guidance in response to the main issues raised in submissions on CP 182.
- 120 For further details on the feedback received in submissions, and our response to those issues, see Report 319 *Response to submissions on CP 182 on the best interests duty and related obligations and CP 183 on scaled advice* (REP 319).

Acting in the best interests of the client

- 121 In CP 182, we proposed to give guidance that when considering whether to take administrative or enforcement action on compliance with the best interests duty, we will give weight to whether, based on the circumstances at the time the advice is given, it was reasonable for the advice provider to believe that the advice would be likely to leave the client in a better position (the better position standard).
- 122 Respondents that supported the better position standard were mainly from consumer groups, EDR schemes, the not-for-profit superannuation sector and the accounting sector. They noted that it is reasonable to expect that client should be in a better position if they followed the advice received. It was also noted that the standard is consistent with how EDR schemes currently resolve disputes.
- 123 However, about half of the submissions on CP 182 from the banking, financial advisory, stockbroking and legal sectors did not support the better position standard.
- 124 These respondents did not support the standard because they believed it placed too much emphasis on the outcome of the advice and implied that the advice should provide the 'best outcome' for the client. They also expressed concern that the standard would be applied subjectively by ASIC and EDR schemes when determining whether an advice provider has breached their obligations.

ASIC's response

- 125 We do not agree with the concerns expressed by some respondents that the better position standard is too outcome-focused. Our guidance clarifies that the better position standard is an objective standard based on what a reasonable advice provider would do in the circumstances at the time the advice is provided. We have also clarified our guidance to state explicitly that we will not examine the performance of an investment product retrospectively.
- 126 We also do not agree with the concerns expressed by some respondents that the standard would be applied subjectively by ASIC and EDR schemes. Representatives from EDR schemes have submitted that they will not apply the better position standard in this way. Our guidance also makes it clear that we will apply the better position standard objectively when considering whether to take administrative or enforcement action.

When is it reasonable to recommend a financial product?

- 127 We proposed to give guidance that, to rely on the safe harbour for complying with the best interests duty, an advice provider should consider and investigate a product that is not on their AFS licensee's approved product list in some cases.
- 128 In CP 182, we listed the following examples of when an advice provider should consider products that are not on the approved product list:
- (a) if the client's existing products are not on the approved product list of the advice provider's licensee; or
 - (b) if an advice provider's approved product list is restricted to one class of product and there are products that are not in that class of products that would better meet the needs of the client.
- 129 A few respondents supported this approach, noting that an advice provider should not be able to abdicate responsibility for complying with the requirement to undertake a reasonable investigation of a product by simply referring to their AFS licensee's approved product list.
- 130 However, most of the submissions on CP 182 recommended that an advice provider should only need to investigate and consider products outside the approved product list to the two examples set out in paragraph 127.
- 131 One respondent recommended that it may be appropriate for an advice provider to investigate and consider a product that is not on the approved product list if the client specifically requests the advice provider to do so.

ASIC's response

132 Our guidance acknowledges that, in satisfying the obligation in s961B(2)(e), in some cases it is possible for an advice provider to conduct a reasonable investigation by considering the products on their AFS licensee's approved product list.

133 Based on the feedback received, we have clarified in our guidance that in some cases an advice provider should consider and investigate products that are not on their AFS licensee's approved product list to demonstrate they have acted in the client's best interests.

134 Examples include if:

- (a) the client's existing products are not on the approved product list;
- (b) the approved product list is restricted to one class of products; and
- (c) the client specifically requests the advice provider to investigate a product that is not on the approved product list.

135 However, we have not provided an exhaustive list of when an advice provider should consider and investigate products not on an approved product list. This is because the circumstances when this may be necessary will vary depending on the circumstances and will change over time. It is also not the role of ASIC guidance to provide an exhaustive list.

Giving priority to the client's interests

136 In CP 182, we proposed to give guidance that to comply with the obligation to prioritise the interests of the client in s961J an advice provider should have regard to what an advice provider without a conflict of interest would do.

137 Some respondents expressed concern with this guidance, noting that it may be difficult for advice providers to put themselves in the position of a hypothetical advice provider without a conflict of interest. While some respondents asked for this guidance to be removed, others requested further guidance on the expected conduct of an advice provider to comply with the conflicts priority rule.

ASIC's response

138 Based on the feedback received, we have clarified in our guidance that, in complying with this obligation, advice providers should consider what a reasonable advice provider without a conflict of interest would do. We have provided examples to illustrate how we envisage our guidance will work in practice.

- 139 We have also amended our guidance to clarify that the more material the conflict of interest for the advice provider or their related party, the more that is required of the advice provider to prioritise the interests of the client.

D Conclusion and recommended option

- 140 We recommend Option 2.
- 141 Industry have told us that the principles-based nature of the best interests duty and related obligations has caused some confusion among AFS licensees, authorised representatives and advice providers about how they should comply with the law. Option 2 is likely to provide greater certainty for AFS licensees, authorised representatives and advice providers by setting out our interpretation of those terms in the law which have not been defined or require further explanation. The guidance will also set out our expectations about how advice providers should comply with the best interests duty and related obligations.
- 142 Industry has also expressed a need for guidance to clarify uncertainty around the application and interpretation of the best interests duty and related obligations in submissions on CP 182 because of the high-level way in which the law has been drafted.
- 143 However, in response to CP 182, a number of submissions raised concerns about some of the content of our proposed guidance. The main issues raised by respondents related to our proposed guidance on:
- (a) the better position standard for complying with the best interests duty;
 - (b) how an advice provider should investigate and consider products that are not on their AFS licensee's approved product list; and
 - (c) whether an advice provider should be guided by what an advice provider without a conflict of interest would do to comply with the conflicts priority rule.
- 144 In response to the feedback received, we have modified our approach in the final guidance: see paragraphs 125–126; 132–135; and 138–139 and REP 319.
- 145 We recognise that the FOFA reforms will require AFS licensees, authorised representatives and advice providers to undertake major work so that IT systems and compliance requirements are in place for the new regime. However, we anticipate that the compliance costs that industry will incur as a result of our guidance will be limited. For example, these compliance costs may include those incurred by:
- (a) AFS licensees, authorised representatives and advice providers in keeping better records to show that, in providing personal advice, they have taken the necessary steps under our guidance, in addition to other requirements in the law;
 - (b) AFS licensees, authorised representatives and advice providers in monitoring their compliance plan to ensure that the advice meets the best interests duty; and

- (c) AFS licensees and authorised representatives providing additional training to advice providers and support staff to comply with certain aspects of our guidance, which is in addition to the training required by the law.

146 By providing industry with greater certainty about how to comply with the law, we consider that, on balance, issuing guidance should save industry some time and cost in developing its own compliance policies and procedures.

147 Our guidance on the best interests duty and related obligations is also likely to benefit consumers because it will better address the objectives of the proposed regulation by:

- (a) enhancing the trust and confidence that retail clients have in the financial advice industry, which should lead to more clients accessing financial advice; and
- (b) improving the quality of advice being providing to retail clients compared to the general standard of advice being provided under s945A and 945B.

E Implementation and review

- 148 All AFS licensees, authorised representatives and advice providers who provide personal advice to retail clients must comply with the best interests duty and related obligations from 1 July 2013.
- 149 We would implement our recommendation by:
- (a) publishing a new section in RG 175 which clarifies what we expect an advice provider to do to comply with the best interests duty and related obligations; and
 - (b) making other consequential amendments to RG 175 in light of the best interests duty and related obligations.
- 150 We will issue our guidance in December 2012. This should give AFS licensees, authorised representatives and advice providers a sufficient amount of time to change IT systems and implement compliance processes for the new regime. To the extent that advice providers need more time to comply with our guidance, we will adopt a facilitative approach to compliance with the FOFA reforms: see paragraphs 154–156.
- 151 We will assess whether there is a need for further guidance after observing how industry have sought to comply with these obligations and in light of our regulatory experience and any case law on these obligations.

FOFA reform package

- 152 The guidance on the best interests duty and related obligations in Div 2 of Pt 7.7A is part of ASIC's work on implementing the FOFA reform package.
- 153 We are also separately considering proposals relating to:
- (a) giving information and advice (including scaled advice)—to increase access to advice by facilitating the provision of scaled advice where appropriate;
 - (b) conflicted remuneration—to assist industry to understand the practical operation of the ban on conflicted remuneration and explain how ASIC will administer the ban; and
 - (c) approval of codes of conduct for exemption from the opt-in requirement.

Our approach to enforcement

- 154 ASIC will take a facilitative approach to compliance with the FOFA reforms until 1 July 2014. We will work with industry participants to help them comply with the law.
- 155 We will continue to liaise with industry associations and firms to ensure that we understand where the most significant implementation challenges arise. We will adapt our regulatory approach during the introduction of the FOFA reforms to take into account these issues.
- 156 Where inadvertent breaches arise or systems changes are underway, we will adopt a measure approach provided industry participants are making reasonable efforts to comply. However, where we find deliberate and systemic breaches, we will take stronger regulatory action.