

Royal Commission Interim Report Summary relating to Financial Planning Advice

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established on 14 December 2017. The Commission's work, so far, has shown conduct by financial services entities that has brought public attention and condemnation.

The interim report was published on 28 September 2018 and covers the first four rounds of hearings: customer lending, financial advice, small- and medium-sized enterprise (SME) lending, agricultural lending, and remote community. In the Interim Report these questions – 'why' and 'how' – are asked with particular reference to banks, loan intermediaries and financial advice, without making any specific recommendations.

The interim report of the Royal Commission analyses and identifies the critical drivers of misconduct, which include:

- remuneration practices aligned with profit and sales;
- the pursuit of short-term profit instead of fulfilling the customers' real needs;
- misconduct, when revealed, was not adequately addressed; and
- regulatory consequences and censures for misconduct were not stringent enough to discourage misconduct.

The report draws light to several fundamental weaknesses of the financial services industry, the key being remuneration structures being focused on sales and maximising profit, which contributed to actions skewed against the interests of the customers and the reputation and public service responsibilities of the financial services industry.

The report in page xix (Executive summary) noted that *"when misconduct was revealed, it either went unpunished or the consequences did not meet the seriousness of what had been done. The conduct regulator, ASIC, rarely went to court to seek public denunciation of and punishment for misconduct. The prudential regulator, APRA, never went to court"* and *"Infringement notices imposed penalties that were immaterial for the large banks. Enforceable undertakings might require a 'community benefit payment', but the amount was far less than the penalty that ASIC could properly have asked a court to impose."*

Inherent conflicts of interest were worsened by lack of clarity from intermediaries of whether duties and obligations are owed by institutions or their intermediaries (financial advisers, brokers, and introducers). The regulator brought few civil penalty proceedings, and thereby, failed to test, and clarify for the sector, many key provisions of the complex financial services legislation.

Issues in relation to Financial Planning Advice

The public hearing and case studies exposed the following key issues, as identified in the Interim Report:

- Fees for no service, which concerned licensees or advisers charging fees to clients for financial advice that was not provided; e.g., CBA identified instances in the period from July 2007 to June 2015 where clients of its subsidiaries CFPL, BW Financial Advice and Count Financial were charged ongoing fees for financial advice where no such services were provided. CBA acknowledged that as at 31 December 2017, approximately \$118.5 million in refunds (including interest) has been offered or paid to customers affected by this conduct;
- Inappropriate financial advice, which can be broadly described as financial advice that does not comply with the 'best interests' obligation and related obligations in Part 7.7A of the *Corporations Act 2001* (Cth) or advice that does not take proper account of a client's circumstances; e.g., AMP acknowledged that inappropriate advice by 14 advisers between 1 January 2009 and 30 June 2015 had resulted in compensation to 1,079 customers (The amount of compensation was not provided). CBA has paid or offered to pay approximately \$96 million to customers relating to the provision of poor financial advice or adviser misconduct as at 31 December 2017;
- Improper conduct by financial advisers, which included falsifying documents, misappropriating customer funds and engaging in misleading or deceptive conduct in relation to clients; e.g., NAB acknowledged that between 1 January 2010 and 30 September 2017, it had paid approximately \$38 million to customers, which it said included amounts (which were not specified) paid as compensation to customers for financial adviser misconduct. NAB also acknowledged that, in the period from 2008 to March 2016, approximately 150,000 customers received deficient disclosures either in statements of advice or Financial Services Guides in relation to investment management products; and
- Gaps in the existing system with respect to how disciplinary matters involving financial advisers are now dealt with; e.g., the Interim Report mentions that civil penalty proceedings have seldom been invoked since ASIC views that civil penalty proceedings generally are time-consuming and resource intensive. More particularly, in the context of financial advice, a civil penalty order could not include a banning order. The Interim Report, therefore, suggests that civil penalty proceedings must be weighed against other ways that breaches of the provisions may be dealt with which are speedier, less time-consuming or more effective in deterring similar conduct.

The issues that have emerged in connection with financial advice can be categorised into the following three broad themes:

1. *Culture and incentives*

The report identifies that the roots of the industry are in sales and that has had a key influence in shaping the culture of the industry. The report recognizes that there are systemic issues in the way industry participants are paid, including how bonuses and other incentives are calculated for mortgage brokers, financial advisers, and point of sale agents for consumer lending. The report also draws attention to other structural issues, in particular where entities are vertically integrated: manufacturing, selling and providing advice on financial products.

2. *Conflicts of interest and duty; and confusion of roles*

Fiduciary duties or other general law obligations that may attach to financial advisors conflict with their employment conditions. The financial advice industry is caught in a structural link between product issuers and advisor's legal obligation to act in the best interests of the client. The payment mechanism directly contributes to the conflict of interest and duty, and confusion of roles, compounded by FoFA's treatment of conflicts of interest as conflicts that can, and should be 'managed' (by advisers and licensees meeting the 'best interests duty' and giving the client's interests priority over the interests of the adviser and licensee).

3. *Regulatory effectiveness*

The report also highlighted the need for improving the regulatory effectiveness. The process of making a banning order, which is the chief regulatory tool used by ASIC, takes time. The time between ASIC becoming aware of the conduct that might warrant making a banning order and deciding to investigate the matter may vary from 'a couple of months' to 'any length of time up to a year. Also, the disciplinary system (or systems) supervising financial advisers currently consists of a number of bodies. Each is directed at regulating different, though related, norms of behaviour and each is geared to different outcomes. The report calls into question whether this segmentation imposes a satisfactory standard of behavior on financial advisers.

Policy Questions

The interim report raises the following policy questions relating to financial planning, which could be relevant to APESB's Standard APES 230 *Financial Planning Services*:

- How does a financial adviser's employer encourage provision of sound advice (including, where appropriate, telling the client to do nothing)?
- How do advice licensees encourage advisers aligned with the licensee to provide sound advice (including, where appropriate, telling the client to do nothing)?

- Can conflicts of interest and duty be managed?
- How far can, and how far should, there be separation between providing financial advice and manufacture or sale of financial products?
- Should financial product *manufacturers* be permitted to provide financial advice:
 - At all?
 - To retail clients?
- Should financial product *sellers* be permitted to provide financial advice:
 - At all?
 - To retail clients?
- Should an authorised representative be permitted to recommend a financial product manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated:
 - At all?
 - Only on written demonstration that the product is better for the client than comparable third-party products?
- Should the *grandfathered* exceptions to the conflicted remuneration provisions now be changed, and if so:
 - How far should they be changed?
 - When should the change or changes take effect?
- Should the *life risk* exceptions to the conflicted remuneration provisions now be changed, and if so:
 - How far should they be changed?
 - When should the change or changes take effect?
- Should any part of the remuneration of financial advisers be dependent on value or volume of sales?
- Should all financial advisers (including those who now act as authorised representatives of an advice licensee) be licensed by ASIC?
- Are current disclosure requirements sufficient to allow customers to make fully informed choices?
- Should the period after which a client must positively review an ongoing fee arrangement be reduced from two years to one?
- Should platform operators be permitted to deduct fees on behalf of licensees without the express authority of the client of the platform operator?
- When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?

- When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidents of misconduct?

Potential impact from the Royal Commission

The interim report has only provided policy questions, it has not provided conclusions or recommendations. We need to wait for the final report for recommendations. Considering the widespread community concern, there is a general expectation that the final report will include a number of policy recommendations that will have a significant, positive impact on the financial planning industry.