Proposed Quality of Financial Advice Rating System

A White Paper for
Adviser Ratings Pty Limited

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Contents

Executive Summary

This white paper makes the case for and outlines an approach to a rating system for quality of advice in the Australian financial planning industry.

Adviser Ratings proposes to establish a new rating system for Licensees designed to align the quality of advice to customers with the institutional attributes of those institutions and to enhance the clarity and consistency of information used by clients to select financial advice providers.

The proposal reflects insights gained from extensive consultation, including roundtable discussions held in early 2018. We believe that a well-constructed, evidence-based rating methodology will lead to greater discrimination across purveyors of financial advice based on quality and risk. The current proposal reflects our experience and previous research. The proposal incorporates plans for scientific validation of the key drivers of our rating model as well as its ongoing maintenance, stress testing and development.

The proposed approach has two main components: an unsolicited rating - an assessment of the quality of a Licensee using largely publicly available and commercially procured data; and a solicited rating – an analysis of the provider incorporating proprietary data and qualitative information.

Our unsolicited rating methodology incorporates both qualitative and quantitative analysis and retains classic drivers of advice provider risk. These include Licensee-, adviser-, external partner-, and support systems-related factors. Our quantitative analysis draws on data chosen for their predictive capacity, which we assess in the context of the regulatory and financial environment in which advice providers operate, while drawing on a broader set of indicators of risks and their ameliorators. To incorporate our forward-looking analysis of provider quality, we further assess other qualitative considerations, including the business model, ownership structure and the degree of opacity and complexity. Together, these factors help form a set of analytical judgments that drive the quality of financial advice rating that we assign to each Licensee. This rating expresses our view on the likelihood of favourable outcomes for a client, including reduced risk of misconduct and fraud.

We plan to publish all baseline ratings, which we call unsolicited ratings. There will be scope for bespoke ratings developed with the active participation of the Licensees, typically for internal use. The solicited rating so produced incorporates the baseline unsolicited rating, augmented with private internal information provided by the Licensee.

Quality of advice will continue to evolve in response to the profound shifts still being felt in the wealth management industry and its regulation. We have structured our revised framework to provide the flexibility to respond to such changes and enhance both the accuracy and transparency of our ratings. We are seeking market feedback on our proposed methodology by 30 September 2018.

Request for Comment

This Request for Comment ("RFC") describes proposed changes to the Quality of Financial Advice Rating Methodology for Licensees. We are seeking feedback on the entire RFC.

We invite market participants to comment on the RFC by September 30, 2018, by emailing responses to rfc@adviserratings.com.au

Upon appropriate consideration of received comments, once finalized and published, the Licensee Rating Methodology will be updated and published by 15 December 2018.

Key Questions

1. Do you have comments on the key metrics selected for our rating methodology?
2. Do you have comments on the methodology's proposed focus on Licensees?
3. What are your views on the predictive power of Licensees' previous records such as ASIC sanctions and enforceable undertakings?
4. To the extent to which we include proprietary internal data obtained from Licensees, what would be the impediments to broadening our coverage of the market?
5. Do you have comments on our plan to publish all unsolicited ratings?
6. From your experience, how do you rank the importance of the factors that determine quality of advice at the Licensee level? Do you have weightings that you can suggest for the importance of what you consider to be the main factors?
7. Do you have suggestions of important factors determining conflicts of interest that can be obtained but are missing from our proposal?
8. Do you have comments on our approach to incorporating adviser level information under the current privacy legislation?
9. In the absence of adviser-specific data, is our approach to aggregate adviser profiles such as educational qualifications, using ASIC Register data, reasonable?
10. Are our views on the role of external related parties in the determination of a Licensee Rating reasonable?
11. Do you have comments on our usage of a 5-star or 1000 points-based rating symbology?
12. To what extent should our rating analysis try to anticipate potential future changes in Licensee and adviser group ownership structures? On what basis?
13. Do you have comments on our approach to charging licensees for solicited ratings? Do you have a preference for the model of charging licensees a flat fee for a solicited rating, or for the model of charging licensees a licensing fee only if they choose to publicly market the solicited rating?

1. Introduction

Context for this Request for Comment

The past decade has marked a period of increasingly deteriorating confidence and trust in Australia's financial planning industry. The crisis in confidence, exacerbated by a frenetic flow of reports of provider misconduct, has had profound consequences for advisers, Licensees, regulators and, not least, for clients. A widespread response to the crisis has been the introduction of new supervisory and disclosure regimes, together with legislation designed to reduce the risk of misconduct, and to professionalise the financial planning industry. These developments have fundamentally altered the landscape of the industry. At the same time, arguably, client mistrust of financial advisers has worsened.

Approximately four years ago, shortly after the Future of Financial Advice (FOFA) legislation became mandatory, Adviser Ratings introduced a customer rating methodology based on client assessments of their experience with financial advisers. Adviser Ratings Pty Ltd develops and operates a platform that helps clients to find and rate a financial adviser. The company's rating system incorporates information on individual planners from customers, industry bodies, and Australian Financial Services Licensees and applies percentages to each component to come up with an overall adviser rating percentage. It helps users compare advisers based on qualifications, memberships, experience, and customer satisfaction. The company was incorporated in 2011 and is based in Sydney, Australia.

That methodology has proven sufficiently flexible to reflect the quality of advice from the perspective of real customers. Yet the confluence of scandals, organisational failures and acrimonious debate about proposals to improve the quality of training and educational standards, and open defence of conflicted remuneration and fee arrangements by large sections of the industry, has prompted a review and revision of the methodology. This RFC sets out proposals for a new methodology aimed at rating the proprietors – license holders.

The Licensee Rating system is intended to be an important component of a subsequent new individual financial adviser rating system. This initiative will ultimately replace the current adviser ratings approach. This step is an enhancement (in addition to the establishment of a unique, new rating system on the Licensees).

What makes this proposal timely and imperative are the obviously high stakes for the industry and Australia's financial system. A non-exhaustive snapshot follows:

- Superannuation assets totalled $2.6 trillion at the end of the December 2017 quarter (ASFA).[1]
- Australia's investment management industry is the sixth largest in the world by AUM (Austrade).[2]
- 2.4 Million (13.9%) Australians are advised (Adviser Ratings)[3] but the numbers have been in freefall - 34% in 2005 and 2008; 20% in 2014 (ANZ). [4]
- More than 50% of financial advisers are predicted to exit the industry over the next five years, leaving $900 billion of wealth looking for new home (Adviser Ratings).[5]

More than at any time before, a client seeking to identify a financial adviser to utilise faces an overwhelming amount of information to process during the decision-making process. Consider the following intuitive considerations of a prospective client:

- The Licensee's brand,
- Information from official sources, e.g. the Australian Securities and Investments Commission (ASIC) Register, including an adviser's educational qualifications, professional memberships etc, and
- An adviser's professional history (such as accolades, bannings and other sanctions).

1 See https://www.superannuation.asn.au/resources/superannuation-statistics [accessed 30 June 2018].

2 See https://www.austrade.gov.au/News/Economic-analysis/australias-funds-management-industry-is-the-largest-in-theasian-region [accessed 30 June 2018]

3 Adviser Ratings, 2018 Australian Financial Advice Landscape, available at https://www.adviserratings.com.au/pdf/AdviserRatings_2018LandscapeReport_5PageSummary_FINAL.pdf.

4 ANZ Survey of Adult Financial Literacy in Australia (2006, 2009, 2015), available at www.anz.com.au.

5 See supra note 3.

We believe the availability of a summary indicator of adviser quality in the form of a Licensee Rating based on a consistent and transparent methodology would vastly improve the way customers search for and track the ongoing status of financial advice providers.

Our key objectives in this proposal are as follows:

- Integrate insights gained from the behaviour of financial advice providers over recent years, as well as reflect the new regulatory and compliance regimes that have been put in place or are currently under consideration.
- Present a transparent assessment of each Licensee's operating environment and how it impacts our rating analysis.
- Enhance our evidence-based rating analysis to improve its power as a predictor of Licensee risk, using financial and other metrics supported by empirical experience.
- Provide a framework to guide our future rating committee in governing the rating methodology tailored to each Licensee by incorporating forward-looking views, additional metrics and qualitative adjustments.
- Maintain a consistent, transparent framework for the global application of our methodology while recognizing substantial differences between regimes and individual institutions.

The main indicators of quality of advice we analyse are likely correlated with the views expressed in current customer reviews and will be familiar to advisers who have claimed their ratings, Licensees and clients. However, our presentation of this analysis differs from that conducted previously. In particular, there is a greater focus on the organisation – the license holder. Our approach now aims fully to capture our rating committee's views on the range of factors affecting Licensee risk, including past behaviour and forward-looking assessments as appropriate.

Acknowledgments

This proposal represents the culmination of extensive consultations, including three round tables held in February 2018. The participants in these consultations are listed in Appendix 1. We also gratefully acknowledge the views of participants at Professional Planner's 2018 Licensee Summit.

2. Our Proposed Approach

Framework underlying our rating methodology

Our proposed approach to analysing adviser risk is at the Licensee level. This recognizes the more significant influence that we believe a Licensee's operating environment plays in the propensity of its advisers to engage in actions that are either beneficial or detrimental to clients. The determination of this organisational profile is closely related to the quality of the constituent parts of a financial advisory entity:

- License holding entity and its executives,
- Advisers,
- External service providers, and technology and support infrastructure.

We use an approach combining the analysis of these four simple pillars of a financial advisory entity – applying adjustments where necessary to make them as consistent as possible with forward-looking judgments. We consider this balance to be integral to adviser quality analysis, where risks can never be known with certainty ex ante and tend to emanate from multiple sources within a complex comprising the infrastructure that delivers advice.

Basis for methodology and key terms

A key departure of our approach from customer ratings is its focus on the Licensee. We acknowledge that there is scope for the co-existence of our proposed approach with customer ratings of advisers. As demonstrated in other markets, 90% of consumers read online reviews prior to visiting a store (Saleh 2015) and 88% of consumers place as much trust on online reviews as on personal recommendations despite reviews being written by total strangers (DeMers 2015).[6] During our consultative roundtables, we received submissions that client centricity reflected in customer reviews is a key determinant of adviser choice, particularly among the millennial generation.

As well, we acknowledge that our approach departs from directly measuring the investment value added by financial advisers, for example, by way of Morningstar's "Alpha, Beta, and now…Gamma" (Blanchett & Kaplan, 2013), Vanguard's "Advisor's Alpha" (Kinniry Jr., Jaconetti, DiJoseph, Zilbering, & Bennyhoff, 2016), and Envestnet's "Capital Sigma" (Envestnet 2016).[7] However, we believe performance outcomes are subject to market conditions and other time-varying factors not entirely under the control of a Licensee or financial adviser. As such, we allow performance to be subsumed by all the other factors outlined below that proxy for the quality of the Licensee.

The focal point of our methodology is to predict actions within a Licensee that are detrimental to clients' interests. Chief among these are instances of misconduct. At stake is the threat to retail customers' willingness to access financial planning services. It has been argued in theory that a key function of financial advisers is to convince households to trust the financial system.[8] However, recent studies demonstrate that even indirect exposure to misconduct destroys trust and results in non participation.[9]

It is a widely-held belief that the role of the Licensee is to create and develop a culture for the provision of high-quality professional advice. Smith (2010) shows that the prevalence of unethical conduct in Australian financial planning groups should be identified by the AFS Licensee's risk management and compliance systems, but are not.[10]

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6 Saleh, K. (2015), "The importance of online customer reviews," Available at: www.invespcro.com/blog/the-importance-of-online-customer-reviews-infographic;
DeMers, J. (2015), How Important are Customer Reviews for Online Marketing? Forbes Available at:
https://www.forbes.com/sites/jaysondemers/2015/12/28/how-important-arecustomer-reviews-for-online-marketing/#be4a5f819284;
Gao, G. G., Greenwood, B. N., Agarwal, R., & McCullough, J. 2015. Vocal minority and silent majority: How do online ratings reflect population perceptions of quality? MIS Quarterly 39, 565-589.

7 Blanchett, D. & P. Kaplan (2013). Alpha, Beta, and Now.. Gamma. Journal of Retirement, 1(2), 29-45; Kinniry Jr., F. M., Jaconetti, C. M., DiJoseph, M. A., Zilbering, Y., & Bennyhoff, D. G. (2016). Putting a value on your value: Quantifying Vanguard Advisor's Alpha. Valley Forge, Pa.: The Vanguard Group; Envestnet, Inc. (2016). Capital Sigma: The Return on Advice, Envestnet, Inc.

8 Gennaioli, N., Shleifer, A., & Vishny, R. (2015). Money doctors, Journal of Finance 70, 91–114.

9 Georgarakos, D., & Inderst R. (2014). Financial advice and stock market participation, Working paper, Goethe University; Giannetti, M. & Wang, T. Y. (2016). Corporate scandals and household stock market participation, Journal of Finance 71, 2591–2636.

10 Smith, J. (2010) Ethics and Financial Advice: The Final Frontier, Australia: Victoria University [Online].
Available from: https://www.professionalplanner.com.au/wp-content/uploads/2011/01/Pub_Research_Ethics-and-financial-advice_Dec2010.pdf (Accessed: July 1, 2018).

This suggests that AFS Licensees are inadequately identifying some of the key ethical risks associated with the provision of financial advisory services or that those risks are not being appropriately managed, monitored and supervised. That provides the raison d'être for the focus of our proposed methodology on Licensees. This overarching concern does not ignore the traditional core value propositions of Licensees for advisers:

1. Buying power - negotiating cheaper products and services for clients;
2. Managing risk – providing compliance tools, processes and related education, and intermediating between advice practices and regulators; and
3. Providing a community – facilitating peer networks to share best initiatives, ideas and practices.

If anything, we believe that the role of the Licensee is evolving into a deeper value proposition directly concerned with helping advisers better understand and engage with clients, with greater emphasis on:

1. Protecting advisers' reputations;
2. Facilitating transitions to new qualification frameworks; and
3. Providing state of the art technology to streamline customer interaction, from an efficiency and risk-management perspective.

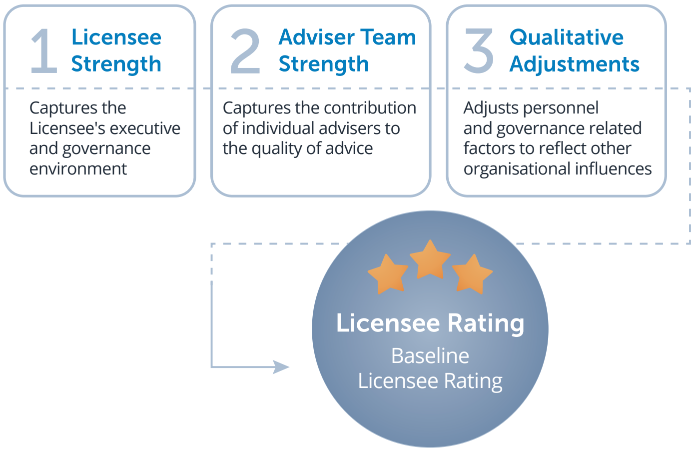
The Adviser Ratings Licensee Rating system will synthesize quantitative and qualitative information predicting the quality of the advice environment at the Licensee level.

Our proposed approach incorporates and builds upon our own research, our experience of market developments, and the academic literature. Our approach to assigning Licensee Ratings will employ a sequential analysis illustrated in Exhibit 1, comprising:

- An assessment of the executive and governance strength of the Licensee
- An assessment of the advisers under the Licensee

The third set of factors represent assessments that are overlaid over the largely quantitative first pair of assessments. We combine these assessments, stage-by-stage, to generate ratings for each Licensee.

Exhibit 1: Licensee Rating Structure



A scorecard will be built based on this framework. The scorecard will provide the structure to express the analysis that determines the Licensee Ratings by capturing and communicating in a systematic fashion the following:

- Historical performance based on authenticated data;
- Our expectations for future trends in determinants of quality of advice; and
- Qualitative adjustments to the model-driven scores, capturing other relevant qualitative information as well as broader considerations that the metrics do not necessarily capture.

Our approach is designed to capture, express and explain in summary form the rating committee's judgment. When read in conjunction with our underlying research, a fulsome presentation of our judgment is expressed.

Sources of data

Throughout our analysis, our approach enables us to assign ratings based on public and proprietary data. Our choice of factors is oriented towards relatively broad and simple metrics in order to have a consistent, globally comparable analytical framework. This reflects both our evidence based analytical view that simple metrics are often more effective than complex ones, as well as the necessity of identifying universally available ones.

3. Scope of methodology

This methodology is intended to cover Licensees, by which we mean institutions recognised as Australian Financial Service License (AFSL) holders. Licensees are required to maintain their details on ASIC's registers under s 922Q of the Corporations Act. Information contained on the Australian Financial Services Licensee Register is made available to the public. Most Licensees are companies. Currently, the largest Licensees both by number of representatives and by funds under advice are either financial institutions or dealer groups owned by financial institutions. AFSL holders provide services to clients through their authorised representatives, including directors and advisers.

Where necessary, we would include within the scope of this proposed methodology institutions that are "Licensee-like". For example, the authorised representative concept, which forms the basis of the dealer group structure, allows unrelated entities to provide financial services on behalf of Licensees. It might be necessary to separately rate such entities as Licensees by "group brand" if our rating committee deems such an approach necessary for ease of communicating outcomes in a meaningful manner. Similarly, our ratings may be arranged by categories of Licensees based on their size, since even individuals may register as an AFSL holder. In these cases, we may assess the institution's rating under a different methodology, or a combination of methodologies, according to what we consider the most appropriate fit to the institution's business and risk profile.

Some institutions are sub-authorised by AFSL holders. This is because an authorised representative may be an individual or a body corporate. While individuals cannot sub-authorise others, a body corporate may, with the consent of the Licensee, authorise an individual or class of individuals (for example, all directors of the corporate authorised representative from time to time) to provide the services on the Licensee's behalf. In such cases, we will typically employ the methodology that we consider corresponds best to the bulk of the entity's business.

How do Licensees benefit from the quality of advice rating system?

1. Improved adviser-client relations
2. Improved regulator relations
3. Increased awareness of customer welfare issues
4. Greater focus on preventive compliance and early problem detection
5. Strong benefits to support reputational risk management
6. Access to a mechanism for benchmarking against best-practice

How do Advisers benefit from the quality of advice rating system?

1. Improved relations with their Licensees
2. Greater practice focus on clients' access to advice
3. Increased level of customer service
4. Greater focus on preventive services for peace of mind, early detection and risk compliance that matches their individual needs
5. Strong benefits to support reputational risk management
6. Access to a reference / differentiation / risk defining focal point when an adviser is considering switching licensees

How do Customers benefit from the quality of advice rating system?

1. Access to an independent aggregator of data on Licensee quality and summary measures of the state of the industry
2. Ability to identify changes in Licensee quality for use in determining whether to switch advisers
3. Increased ability to learn about the quality of past and future decisions regarding choice of advisers

How do other stakeholders benefit from the quality of advice rating system?

1. Superannuation funds would gain a tool for recommending advisers to members
2. General insurance companies would have access to metrics for risk assessment (e.g. for personal indemnity insurance)
3. Banks and other financiers (e.g venture capitalists) would benefit from transparent risk assessments on potential funding targets (Licensees)
4. Regulators and government would have a secondary source of macro and micro intelligence to augment their own industry surveillance and supervison.

Detailed overview of the rating methodology

In the following sections, we provide more details on the key factors predicting quality of advice that we plan to focus our research on, as well as our approach to their measurement and assessment. We group this analysis around three components:

- Licensee level factors;
- Adviser level factors; and
- Related party and support factors.

1. Licensee level factors

We begin our analysis with an assessment of the Licensee level factors that we believe are predictive of the quality of advice. This is the subject of our own and other academic studies. These factors include:

- Director background – including, bannings, penalties or disqualifications at the board and/or practice level.
- Quality of AFSL governance (e.g. director concentration and diversity)
- Previous license conditions imposed on the AFSL
- Previous enforceable undertakings of AFSL and any advisers under its license [commercial (ASIC) and credit (Equifax) histories]
- Licensee's approved product list (content and construction)
- Group size

The basis for our focus on director level information is our belief that a Licensee's leadership "sets the tone" for the behaviour of individuals who constitute the financial planning practice(s). Leadership has the power to stop and deter malpractice.

We plan to be guided by the empirical evidence when it comes to the impact of Licensee size. There is mixed evidence on how the size of a distribution group can potentially affect the quality of advice. Some studies suggest that increasing size is correlated with higher adviser misconduct.[11] A 2003 ASIC study finds the opposite for medium-large.[12] Others still have found that smaller firms offer limited services and restricted advice.[13] Further, we plan to use the Licensee level profile to position the scores determined by individual Licensees relative to the market – for example, a Licensee within a given size group may be assigned a lower score than a Licensee with the same metrics in another size bracket.

2. Adviser level factors

Licensees conduct actual financial planning activities through authorised representatives or advisers. The next step of our analysis is focused on aggregating the attributes of individual advisers working under a Licensee that are hypothesised to correlate with quality of advice, including:

- Previous adviser bannings and disqualifications within the Licensee
- Qualifications of advisers within AFSL
- Results of FASEA imposed annual examinations and ethics tests
- Type of professional memberships the AFSL requires adviser to hold
- Employment history of advisers within industry (i.e. how many Licensees have they switched between)
- Demographic data, such as age and industry experience.

Most of the factors considered here are related to advisers' careers. Three important studies have validated our focus on advisers' previous records of misconduct. The first influential study by Smith (2010), based on a sample of complaints about unethical conduct by Australian financial advisers, roundtable interviews and a survey of a large sample of practising planners, is instructive in providing correlation evidence on some of the factors that predict unethical decision making.[14] Smith carefully motivates a set of key individual, situational and contextual factors that are likely to be correlated with unethical adviser decision making including:

- Demographic characteristics, including proxies of their level of cognitive ethical reasoning such as their age, gender, education level, experience and professional designation;
- The size of the organization; and
- The context or organisational environment, including the ethical climate and culture, ethical leadership seniority of individuals within the organization, and remuneration and reward structures.

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11 Egan, M., Matvos, G., & Seru, A. (2016). The Market for Financial Adviser Misconduct. Journal of Political Economy, forthcoming.

12 Australian Securities and Investments Commission. (2003). Survey on the Quality of Financial Planning Advice. Sydney, Australia: ASIC - Australian Securities and Investments Commission.

13 Eckardt, M., & Rathke-Doppner, S. (2010). The quality of insurance intermediary services: Empirical evidence for Germany. Journal of Risk and Insurance, 77, 667-701.

14 See supra note 10.

In the second important study, Egan, Matvos and Seru (2016) document the prevalence of misconduct among financial advisers in the US and how advisers' careers progress in the aftermath of episodes of misconduct.[15] They found that some 7 percent of the advisers in their sample have records of misconduct, and that a third of those are repeat offenders. The market disciplines misconduct - around half of advisers lose their jobs after episodes of misconduct. However, some 44 percent of offenders are able to find new jobs within the same industry within a year—typically in firms that have higher-than-average rates of misconduct themselves. The result is an uneven geographical and firm-level concentration of misconduct, with up to 15 percent of advisers in some of the largest firms having misconduct records. There is also some evidence that firms prone to misconduct target areas with lower education levels, large elderly populations, and high incomes.

Finally, another important study is by Dimmock, Gerken and Graham (2018), who demonstrate that individual advisers previously charged with misconduct in the US seem to influence others in the same firm to commit misconduct.[16] This result also applies when advisers migrate across firms in mergers and acquisitions, for example, the authors writing "The probability of an advisor committing misconduct increases if his new coworkers, encountered in the merger, have a history of misconduct".

With regards to our concentration on factors related to adviser education and professionalism, the key consideration is the current state of financial planning practice in Australia. Our view is that the status of financial planning education has far-reaching implications for attracting professionals and how those working in the sector see and conduct themselves. Some have questioned whether financial planning is a profession yet when considered against a set of attributes of professionalism, including public/societal responsibility, rigorous body of theory, professional authority and ethical responsibility.[17] Others still have suggested that minimum training standards set by the Australian regulator have allowed private education providers to capture the training and education agenda away from the profession with the result that financial planning in Australia could be described as an industry rather than a fully-fledged profession.[18]

Our proposed evidence-based approach will be supported by a rigorous, standing research function designed to perform the following tasks, among others:

- Validating the weights to be placed on Australia-specific indicators of advisers' propensity to commit misconduct through our ongoing research.
- Establishing the appropriate scaling of the variables in the manner they enter the rating modelling.[19]
- Keeping track of the evolution of such factors across time, e.g. with changing legislative and compliance regimes and carefully account for interdependence among predictive factors.

[15] See supra note 11.

[16] Dimmock, S. G., Gerken, W. C., & Graham, N. P. (2018). Is fraud contagious? Co-worker influence on misconduct by financial advisors, Journal of Finance 73, 1417-1450.

[17] Murphy, B. & Watts, T. (2009). Financial planning in Australia: industry or profession? 14th Finsia-MCFS Banking & Finance Conference (pp. 1-24). Melbourne, Australia: Melbourne Centre for Financial Studies.

[18] Bruce, K., & Gupta, R. (2011). The financial planning education and training agenda in Australia. Financial Services Review 20, 61-74.

[19] To illustrate, in relation to employment history and adviser movement, we would scale the number of moves by years of industry experience in order to condition the data to treat multiple moves in a short space of time more seriously. Similarly, rigorous methods will be deployed to determine the statistical distribution properties of each factor so as to determine whether to use raw or transformed variables.

3. Related party and support factors

The next set of factors considers the advice we have gleaned from market consultations that the organisational environment affects advisers' incentives and behaviours, and should be assessed in any quality of advice analysis. First, the boundaries of a Licensee's business extend to third parties who may have a bearing on the quality of advice. Direct relationships with third parties include:

- corporate authorised representatives under whom advisers act on behalf of the AFSL holder,
- product issuers, and
- operators of investor directed portfolio services (IDPS) or IPDS like schemes (investment platforms).

Further, in vertically integrated financial planning groups, it is typical that there are related persons outside the Licensee that provide investment management and other financial services and products to the Licensee's investment advisory clients, which may be material to its advisory business. The parent company, its subsidiaries or affiliates often act in one or more capacities, including investment adviser, sub-adviser, consultant, administrator and principal underwriter (insurer) in cross-selling arrangements with a Licensee. Relationships with agent companies could negatively affect quality of advice, especially in relation to multilevel marketing systems.[20] Looser structures with lower emphasis on group-incentivizing do enhance advice quality.[21]

Second, we consider the quality of technology supporting the Licensee's activities and impacting on quality of advice. An example is the quality and diversity of investment platforms. Our intent in this analysis is to capture operational risk, which we define as the risk to a quality of advice rating resulting from inadequate or failed internal processes, people and systems or from external events.

One way to gather data on these otherwise qualitative factors is to request a detailed statement of qualifications and business practices of the Licensee or to obtain such information from regulatory filings.

Where discernible risks identified at the level of third parties and technological arrangements can be linked to adviser quality, a qualitative adjustment would be made to the Licensee Rating accordingly.

[20] Reifner. U., Neuberger. D., Rissi. R., Riefa. C., Knobloch. M., Clerc-Renaud. S., & Finger, C. (2012). Study on Remuneration Structures of Financial Services Intermediaries and Conflicts of Interest. Working Paper, IFF - Institut fur Finanzdienstleistungen.

[21] Danilov. A., Biermann. T., Kring, T., & Sliwka, D. (2013). The dark side of team incentives: Experimental evidence on advice quality from financial service professionals Journal of Economic Behavior & Organization 93, 266-272.

Solicited/unsolicited ratings and use of proprietary information

The methodological approach outlined above will result in the production of our basic quality of advice rating. It is envisaged that such ratings will cover the whole market. We refer to such ratings as unsolicited ratings. Parallel to this effort, we plan to provide Licensees with an opportunity to supply their own proprietary information that enables more bespoke ratings to be developed for internal use. We refer to such ratings as solicited ratings, which will be based on an enhanced rating methodology. The governance principles around the separation and treatment of solicited and unsolicited ratings are outlined further below.

The enhanced rating methodology that produces solicited ratings will incorporate management information such as:

- Licensee compliance records
- ASIC "found" breaches
- Licensee reported breaches
- Number of FOS complaints
- FOS rulings
- Results of external compliance review reports
- Internal adviser reviews and supervision data
- Financial data (profit and reinvestment)
- Their internal compensation schemes
- Staffing data (e.g. ratio of compliance staff to advisers).

We are developing a consistent methodology for collecting and standardising the internal data. Apart from structured data obtained from this survey, we plan to also process and codify qualitative information from internal sources such as the liability clauses in the Authorised Representative Agreements/Employment Agreements.

In terms of the organisational environment as suggested by Smith (2010), ideally, we require information on:

- Licensee protocols for accepting / screening new advisers to the Licensee, including any background checking protocols (e.g. some Licensees utilise ABA-type protocols for screening new advisers).
- Licensee protocols for dismissing / releasing advisers (e.g. is there a 3-strikes policy).
- Protocols for adviser on-boarding / ongoing training / reporting in relation to the licensee risk and compliance protocols and documentation of such within the licensee.
- Systems for customer screening / fact finding / risk profiling process.[22]

We also require information that allows us to infer the incentives that drive individual advisers' behaviours. A litany of regulator and policy maker studies recognises that some remuneration practices within the financial services sector, including payment of some commissions, may lead to unresolved conflict of interest and inappropriate or unethical advice (see, for example, ASIC 2006 and the Ripoll Report 2009).[23] Furthermore, failures to fully disclose all remuneration and benefits and associated conflicts of interest, have been identified as predictors of misconduct. Despite these widely held views, our consultations have yielded some resistance from industry representatives to the notion of reflecting remuneration related factors in the rating methodology. Our view is that this is one area where "lifting the veil" would go a long way to improving trust in the Australian financial planning industry. The solicited ratings mechanism facilitates participation by financial planners in our attempts to open up of the black box of fees and remuneration practices and their relation to adviser misconduct.

We have drafted a policy on the treatment of solicited and unsolicited ratings that is consistent with international industry best practice (see draft in Appendix 2)

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[22] We are conscious of the formidable problems associated with accessing such management information. In some cases, we expect to encounter privacy law-related impediments to access.

[23] Australian Securities and Investments Commission (2006). Working for Australia – consumers, investors, business and markets, ASIC Annual Report 2005/06, ASIC, Sydney, pp. 1-112; Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia, (Rippol Report), Nov 2009.

Scorecard development, symbology and rating committee discretion

We believe that the consideration of the factors described above, whether for the base or enhanced rating methodology, is sufficiently comprehensive to capture the many features that can influence a Licensee's quality of advice. However, we retain the necessary flexibility to assign scores reflecting our fuller assessment of the various factors, because no mechanical scorecard can anticipate the full range of circumstances and eventualities that may influence the rating.

Consistent with this, the output of our scorecard will be expressed as a range on our rating scale and the rating committee will have the discretion to assign a rating within such a range – and, where necessary, outside it. By design the majority of ratings should congregate around the mid-point of the scorecard range, but the rating committee's ultimate discretion will reflect the balance of residual risks not otherwise captured in the scorecard itself, as well as the positioning of a Licensee relative to its peer group (e.g. based on size).

In terms of publicity, we propose two choices for the rating symbology synthesised from the scorecard - a 5-star system and score type system out of 1000.

Depending on market and individual entity needs, component ratings will be provided on each major area rated. Upon publication, component ratings give users / consumers the discretion to filter and match against their own personal preferences for focusing on either Licensee or Adviser level factors.

Monitoring, Revised Ratings and Related Nomenclature

Once ratings have been released, they will be monitored for a specific period of time and are valid until they are suspended or withdrawn by Adviser Ratings. During the monitoring period, the team of analysts continues to observe the business development of the Licensee under review in order to ensure that the rating is not made obsolete by events. For this purpose, the analysts continue to consult with the management and to request additional data for on-going studies and evaluations. The analysts will also conduct independent research and follow industry developments. If any significant events or developments occur during the monitoring period that may, in the view of the Adviser analysts, adversely or positively affect the Licensee rating, the original rating may be adjusted. If the company under review fails to provide business information of acceptable quantity or quality or within acceptable time intervals (according to the judgement of Adviser Ratings), the Rating Committee may elect to suspend the rating and publicise such a development.

Following is a (non-exhaustive) list of grounds for the suspension and/or revision of a Licensee Rating:

- Corporate reorganisation events such as M&As and divestitures that have the potential to change the risks which are relevant for an assessment of the Licensee,
- Significant action by any regulatory agency that poses a threat to business continuity for the rated entity, and
- Major legal proceedings against a Licensee deemed by the Rating Committee to be of sufficient magnitude to warrant a suspension or revision.

Standard nomenclature for rating suspensions will be "(WD)", and "UR" for ratings under review.

Support and ongoing analysis

An issue that is of vital strategic importance to this proposal is the provision of a standing capability to develop and support the rating methodology from its inception onwards. We plan to embed research resources into the business model that will drive the proposed rating methodology. The research committee will:

- supervise the development of state-of-the-art data collection, verification and safekeeping
- oversee the conducting of thorough econometric analyses and stress tests of all factors underpinning the rating methodology
- provide a governance framework for the ethical conduct of research

It is envisaged that the research committee will comprise experienced researchers and practitioners.

Governance framework for managing conflicts of interest

In order to mitigate conflicts of interest, we will take a number of steps.

In terms of internal arrangements, these measures include, for example, a clear separation of function between those who negotiate the business terms for the ratings assignment and the analysts who conduct the analysis and provide the ratings opinions.

Another safeguard is the rating committee process that limits the influence any single person can have on ratings opinions. The role of the committee is to review and assess the analyst's recommendation for a new rating or a rating change as well as to provide additional perspectives and checks and balances regarding adherence to the ratings criteria. Executives managers, who respond to applicants' ratings requests and deal with commercial matters such as pricing, contract negotiations, and maintaining client relationships, do not participate or vote in rating committees.

A further safeguard is the appointment of a Ratings Committee with a compliance officer as an ex-officio member that has access to all documentation of the Company she/he deems necessary to carry out his controlling and supervisory role and can independently report likely conflicts of interest.

Finally, the Board of Directors establishes clearly defined policies and procedures. To ensure maximum level of independency, the Board is not involved in the issuing rating process but appoints the compliance officer and the rating committee.

Business model

The business model envisaged is akin to the widely-accepted approach taken by global credit rating agencies and Australian investment and superannuation research houses. This comprises a combination of subscription revenues driven by the licensing of research to interested third parties, and the charging of fees to rated entities for solicited ratings. Importantly, in relation to the latter, Adviser Ratings recognises the potential conflict of interest in charging rated entities and for that reason will implement the governance framework described previously. Furthermore, we will explore two alternative fee models for solicited ratings:

- flat fees charged annually to prepare and maintain a solicited licensee rating, with full rights to the licensee to market that rating publicly at no additional cost;
- no fees payable by the licensee for preparing and maintaining a solicited licensee rating, unless the licensee should wish to market the rating publicly, for which there would be an annual licensing fee.

In all circumstances, the fees charged would be entirely independent of the rating outcome and established before the rating engagement.

Implementation

The timing and nature of the rollout of our unsolicited and solicited ratings regime will be partly dependent on the nature of the market feedback however we are seeking to commence no later than January 2019.

In the interim period and following the completion of the industry consultation period ending September 30 2018, we will be seeking expressions of interest from licensees willing to participate in a solicited rating engagement.

Appendix 1: Round tables & consultations

- Australian Banking Association (ABA)
- Association of Financial Advisers
- AMP Limited
- Association of Superannuation Funds of Australia (ASFA)
- Australian Securities and Investments Commission (ASIC)
- AustralianSuper
- BT Financial Group
- Commonwealth Bank of Australia Limited
- Centrepoint Alliance
- Consumer Action Law Centre
- Deloitte
- Financial Adviser Standards and Ethics Authority (FASEA)
- Financial Literacy Australia
- Financial Services Institute of Australasia (FINSIA)
- Financial Ombudsman Service (FOS)
- Financial Planning Association of Australia (FPA)
- Hostplus
- KPMG
- Macquarie Group
- Madisons Financial Group
- Morgan Stanley
- National Australia Bank Limited
- Plenty Wealth Pty Ltd
- SMSF Association
- The Banking and Finance Oath
- The Ethics Centre
- The Treasury

Appendix 2: Draft policy for designating solicited and unsolicited ratings

Statement of purpose

As a publisher of opinions about an afsl holder's quality of advice, adviser ratings issues unsolicited licensee ratings utilizing its base rating methodology. Adviser ratings also issues solicited licensee ratings based in its enhanced rating methodology. The purpose of this policy is to provide transparency to market participants with respect to published licensee ratings.

Policy

1. Quality of advice ratings not initiated at the request of the licensee are unsolicited.
2. Solicitation may be evidenced by a request, rating application or contract, payment of fees or confirmation. Unsolicited ratings for which adviser ratings receives a subsequent solicitation will not be deemed unsolicited any more.
3. The decision by adviser ratings to publish unsolicited licensee ratings will be based, among other factors, on our assessment of the usefulness of the rating to the capital markets, and our determination that sufficient information is available to allow adviser ratings to assign and maintain the rating.
4. When adviser ratings publishes a licensee rating it knows to be unsolicited, it will designate it as such in the initial and subsequent licensee rating announcements, as described in the following procedure.
5. Participation in the rating process alone does not render a rating solicited.

Procedure

1. All unsolicited licensee ratings are published and at inception of such ratings, to the best of adviser ratings' ability, all the rated entities will be informed that:

- We intend to publish a licensee rating;
- The rated entity is invited to participate, and the degree of participation, if at all, is at the discretion of the rated entity; and
- That adviser ratings will inform the rated entity of the rating committee's conclusion prior to the publication of the rating.

2. We will indicate the unsolicited nature of the licensee rating in the text of the licensee rating announcement. In such cases, the following statement will appear prominently in the licensee rating announcement: "This rating was initiated by adviser ratings and was not requested by the licensee."
3. We will indicate whether or not the licensee or a related entity participated in the licensee rating process and whether we had access to the relevant internal documents of the licensee or related entity. For participative licensees, the following statement will appear prominently in the licensee rating announcement: "The licensee or its related party participated in the rating process and adviser ratings had access to the relevant internal documents."

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Jerry Parwada is a Professor of Finance in UNSW Business School, Sydney, Australia. He joined UNSW in 2003 and served as Head of School - Banking and Finance from 2011-2017. Jerry's research specializes in investment management and financial markets. His works have been published in internationally renowned finance journals. He has prior investment banking experience and is an active consultant to industry on issues relating to managed funds and valuation. He has served, since 2012, on the Credit Suisse Endowment Advisory Council. He is on the FINSIA Industry Council for Institutional Markets and the Australian Lenders' Index Expert Panel. Jerry is a regular speaker at local and international finance conferences.

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About Adviser Ratings

Adviser Ratings launched in October 2014, in the wake of the Future of Financial Advice reforms (FOFA), the Financial System Inquiry (FSI) and financial planning scandals of the time. Adviser Ratings' vision is to improve the penetration of advice amongst Australian consumers. There are more than 24,000 financial advisers on its independent platform, enabling consumers to browse and search for an adviser suited to their needs, rated and reviewed by other consumers. Adviser Ratings has evolved into a data and technology company providing services to the wealth management industry including advice licensees, super funds, life insurers, fund managers, investment platforms and software providers.

AR Adviser Ratings | AR data

For more information, visit www.adviserratings.com.au

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