Association of Financial Advisers

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The Treasury
Financial Services Reform Implementation Taskforce
Langton Crescent
Parkes ACT 2600

By email: FOFAGrandfathering@treasury.gov.au

Dear Treasury,

AFA Submission: Ending Grandfathered Conflicted Remuneration for Financial Advisers

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are currently practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

1. Summary

Our starting position on the issue of grandfathered commissions is as follows:

- The AFA acknowledges the recommendation from the Banking Royal Commission to ban grandfathered commissions and that this recommendation has been supported by all sides of politics.
- The AFA does not support arrangements where commissions are being paid and no service is being provided.
- We accept that grandfathered commissions in the main will and in many cases should be removed,
- We are deeply concerned that there are unintended consequences playing out right now that impact the financial integrity of financial advice practices and in turn the emotional health and wellbeing of honest hard-working financial advisers, including those younger

advisers who have recently acquired businesses with debt based on the valuation of revenue including grandfathered commissions.

In this submission we are arguing for a more comprehensive review of the issue, a more pragmatic timeframe and an improved solution for clients who are currently in grandfathered commission products and are receiving services from their financial adviser and are happy with their current arrangements.

The theatre of the Royal Commission, backed up by a rush from certain sectors of the banking and financial services industries to offer up reforms and a climate of great hesitancy to question the Royal Commission recommendations has made this outcome somewhat predictable and unavoidable. Having said that, we still think that the implementation of this policy requires the application of due process and a detailed consideration of the options and practical implications.

We recognise and completely acknowledge that the outcome of this move should be in the public interest. However, we are deeply concerned that in this "purge mentality" environment, there are significant consequences to a subset of the advice community.

We remain concerned as to whether both the policy objective has been clearly defined and whether the winners from this exercise will be the intended winners. We have particular concerns about the extent to which this process will deliver a fair outcome for all.

In this submission we have set out our primary points with respect to this process and the draft legislation as follows:

- There is a lack of clarity on what the policy objective is.
- There is a complete lack of data and analysis on the issue of grandfathered commissions.
- The Royal Commission misrepresented the assertion that grandfathered commissions was a compromise as a result of lobbying pressure from industry groups during the FoFA process.
- Until the Royal Commission raised the issue, there had been no indication at all with respect to a ban on grandfathering. Grandfathered commissions were not in dispute during the 2012 Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the FoFA legislation and both sides of politics agreed to confirm grandfathered commissions in approving a Regulation in November 2014. Neither Treasury nor ASIC have undertaken or indicated the necessity to undertake any activity in this space over a long period of time, with the exception of a recent project by ASIC that appears to suggest that the level of grandfathered commissions is quite small.
- There are a range of reasons why clients may have remained in grandfathered commission products despite continuing to receive financial advice. Nothing has been proposed to address these factors.
- Grandfathered benefits exist at many levels and their removal will involve great complexity and have broad consequences.
- There is a complete lack of clarity with respect to how this ban will be implemented.
- It is therefore unreasonable to seek to ban grandfathered commissions in the timeframe that has been proposed.
- The consequences of this policy will have a significant impact on many small business financial advice practices and the reassessment of business loans on the basis of this policy has already commenced. There will be many people who are unfairly impacted.
- Consideration of the constitutional and property rights issue needs to be undertaken
- There is no regulatory impact statement, which is unacceptable.
- There is a lack of consideration of who will really benefit from this policy.

Our recommendations are set out below in section 15. As a summary, we propose:

- Assuming that there is a ban on Grandfathered commissions that it be implemented after a three-year transition period, subject to the following conditions.
- Certain legacy products such as lifetime annuities and whole of life are exempted.
- Clients have the option to opt-in, in order to continue a grandfathered commission arrangement where they can continue to access financial advice.
- Government to provide CGT rollover relief and Centrelink rollover relief.

2. Introduction

There has been no genuine debate on grandfathered commissions and no apparent appetite to understand the implications of this proposal. This has been a highly political matter that has meant that genuine consideration of the implications has not occurred. We have taken a number of steps to try and ensure that there is a comprehensive analysis of the issue, however in many ways we have been discouraged from speaking up.

This recommendation and the response of the political parties has already had a very material impact upon the financial advice sector. We are aware of some banks who are already telling their financial advice lending clients that they are placing no value on grandfathered commission clients. The outcome in this change of business valuation methodology is that it may put a material number of financial advice businesses in breach of their loan to value ratio obligations and therefore put their loan in default. This is happening even before the law has been passed.

We would like to identify up-front two important fallacies that need to be addressed as part of this debate:

- Despite all the suggestions that it is a sign of failure of the industry that clients remain in grandfathered commission products, there are many reasons why these clients may have remained in these products and in fact for some products, there is no fee for service alternative.
- There have been a number of comments that implied that all grandfathered commission clients do not receive ongoing financial advice or services from their adviser. This is simply not the case. There are many advisers who routinely provide services to their grandfathered commission clients. It is noted that in some cases these may not be the same services as are provided to fee for service clients, however it does reflect the capacity to pay and the needs of these clients. It is recognised that there are also many cases where no services are being provided and we therefore agree that it is right for something to be done.

One important point that we would like to make is that we are not aware of any client research that has considered whether grandfathered commission clients are getting service from their adviser and whether they consider this to be valuable. We believe that client research is essential, particularly if clients are going to be forced to move products or to give up their adviser relationship.

Through this entire debate we ask that consideration is given to both those clients who are in grandfathered commission products and are restricted (for a range of reason) from moving and for those clients who have an existing adviser relationship, are getting services from their adviser and are happy with those arrangements. We equally seek to ask the question, what consideration has been given to allowing clients to chose whether they wish to remain in grandfathered commission products, with their adviser continuing to be paid by that mechanism.

Grandfathered benefits include grandfathered commissions, volume bonuses paid to licensees and shelf space fees. All the discussion has been with respect to grandfathered commissions. Volume bonuses are a very important income stream for licensees and the loss of this revenue will have a

very material impact upon licensees. We note that the heading for the consultation only refers to financial advisers and wonder whether this is deliberate or unintentional.

We note that there is a proposal that grandfathered commissions be rebated to clients, however we see this as a secondary outcome. It would be a much better outcome for clients to be moved to a better product wherever that is possible. Rebating commissions creates a huge level of complexity, which we will address below. The proposal to rebate commissions also opens the question of how these changes will address volume bonuses that are currently paid to licensees and whether this will in any way be rebated to clients.

We remain sceptical about the practicality of a rebate model and suspect that the banning of volume bonuses and grandfathered commissions will actually lead to a windfall for product providers.

3. Policy Objective

Despite all the calls for the removal of grandfathered commissions, no one has put forward a coherent explanation of the policy objective. We now have a situation, with huge political momentum behind a recommendation, without any clarity of what the underlying objective is.

For that reason, we think that it might be worthwhile discussing the potential objectives:

- Address the issue of financial advisers receiving grandfathered commissions without providing any services to these clients.
- Removing a potential obstacle that might be preventing advisers from recommending clients move from old legacy uncompetitive products to newer more competitive products.
- Facilitate the transfer of clients from old uncompetitive products to modern competitive products.
- Facilitating the Royal Commission's objective to eliminate conflicted remuneration.

Although we do not support the payment of grandfathered commissions to financial advisers where no service is being provided, we actually believe that the most important issue is the transfer of clients from uncompetitive products to competitive products. This point was highlighted by the recent Productivity Commission report on the efficiency of the Australian superannuation system. In terms of the Royal Commission objective to remove conflicted remuneration, we would suggest that this is a peripheral issue in the absence of delivering consumer benefits. It is unfortunate that the Royal Commission's intense focus upon the direct issue of grandfathered commissions, has detrimentally impacted the focus upon what is the genuine underlying issue that is driving consumer detriment (uncompetitive products).

If it is accepted that the biggest issue is the transfer of clients from uncompetitive products to competitive products, then we ask the question, does this legislation actually do anything to facilitate that? We would suggest that it does very little to contribute to that objective. In fact, we would argue that the probable removal of a relationship with their financial adviser for these clients, in the absence of any other measures, will increase the likelihood that these clients will stay in these uncompetitive products.

We have previously stated the view that the strong level of commentary and demand for change on this issue of grandfathered commissions, in the absence of a clearly articulated policy objective, is a sign of a process that is out of control. How is it possible that an issue that has had little focus over the five years since the start of FoFA and has not been the subject of any case studies demonstrating client detriment at the Royal Commission, is now apparently on the top of the list of reforms for so many different stakeholders? This is a question that we would suggest needs to be asked by more than just the financial advice community.

It is important to make the point that we would fully support a review to assess how clients can be moved to modern competitive products and would further support the pragmatic and considered removal of grandfathered commissions as part of that process, where it can be demonstrated that it is clearly for the benefit of clients.

4. Banking Royal Commission and AFA Position

The AFA represents a broad range of members, some of whom have no grandfathered commission clients and some who have no empathy for those who still have such clients or who recently acquired businesses or client books that contain grandfathered commission clients. We have other members who have a greater level of exposure to grandfathered commissions, some of these will be at great risk as a result of this policy being implemented.

We accept that grandfathered trail commissions are a form of remuneration that is no longer ideal, and we certainly support the phasing out of grandfathered commissions where they can be replaced with the more contemporary fee for service model and in a manner that is beneficial to clients.

It is apparent that the Royal Commission did not fully appreciate our position as is demonstrated by the following statement from Senior Counsel Assisting on 19 November 2019 (Reference - ROYAL COMMISSION - 19.11.18 P-6512):

"Third, there was very strong support for ending grandfathered commission payments to financial advisers and from superannuation accounts. Each of the major banks has already announced steps to reduce or eliminate payments of grandfathered commissions in their financial advice businesses. Each of them, along with other industry participants supports legislation to repeal the grandfathering provisions under the Corporations Act. Of the industry submissions received by the Commission, only the association of financial advisers was wholly opposed to ending grandfathered commissions."

We do not feel that this accurately or fairly reflected the position that we had taken. The AFA provided testimony during Round 2 and provided submissions in response to Rounds 2, 5 and 6 and also in response to the Interim Report. In each of these submissions where we addressed Grandfathered Commissions, we specifically stated that we do not support the payment of grandfathered commissions where no service is being provided. We presented a number of recommendations to address the issues of uncompetitive legacy products and the failure to provide service with respect to grandfathered commission clients. We went to particular lengths to explain the complexity of this issue and to highlight what needs to be done to address this issue for the benefit of clients. We were particularly disappointed that our input was not given due consideration, nor properly represented in the final report.

Whilst we accept that there are a number of clients who are in poor products and/or are not being serviced, we continued to challenge the assumption that the continuing existence of grandfathered commissions was universally contrary to the best interests of clients. As we have said repeatedly, clients in broadly competitive products who are being serviced by their adviser should not be forced to move products. There are many clients who are happy with the product that they are in and their adviser relationship.

In our submissions we summarised this position in the following table, including setting out what we think should happen.

	Broadly Competitive Products	Uncompetitive Legacy Products
Adviser Services Provided	No Action Required	More analysis is required to understand why these clients have not been moved to a more competitive product.
Adviser Services Not Provided	Licensee action to ensure that services are being provided.	Licensee action to ensure that clients are assisted where possible to move to more appropriate products.

Our summary from the table above is that clients who are in broadly competitive products that are paying trail commissions to their adviser and are receiving services from their financial adviser are not being disadvantaged and we were of the view that it would be inappropriate to force them to move.

5. Lack of Data, Analysis and Understanding

There appears to be no reliable data to explain the extent of grandfathered commissions and other grandfathered benefits or the potential implications of removing them. It seems strange that if this was such an important issue, then why is there no data to support that conclusion. In the context of the work that ASIC has done on fee for no services since at least 2016, it is surprising that they have done virtually nothing on grandfathered commissions, yet it has now become such a critical issue.

We have provided below some context on the apparent lack of analysis on this issue.

ASIC provided a written response to the following question on notice from Senator John Williams at a 30 May 2018 Senate Estimates hearing (Senate Economics Legislation Committee):

"2. Has ASIC identified the potential obstacles in moving clients from legacy products to modern products and called on the government to find solutions such as the removal of exit fees, CGT rollover relief and Centrelink deeming rules?"

The response from ASIC was "ASIC understands there are several obstacles in moving clients from legacy products to modern products (i.e. product rationalisation), such as, ensuring no consumer is disadvantaged and the tax consequences that may apply."

In that same set of questions, Senator Williams asked ASIC if they had done any assessment of the current level of grandfathered commissions across the industry and if so, what is the outcome of that assessment. ASIC's response was "No, ASIC has not undertaken an assessment of the current level of grandfathered commissions across the industry."

We note comments made by Treasury in paragraph 174 in their 13 July 2018 submission to the Royal Commission (Background Paper 24):

> At the time FOFA was introduced, it was believed that grandfathered commissions concerning arrangements in place prior to 1 July 2013 would have a short natural life, and that grandfathering would give firms and the industry the opportunity to adjust their business models. Grandfathered payments have, however, persisted for longer than expected.

We object to the suggestions being made that the financial advice sector has not adequately responded to the prevalence of grandfathered commissions. There was no explicit or implicit message that the Government expected a steady decline in grandfathered commissions. Paragraph 176 of the Treasury Background Paper 24 makes the following statement.

> "Precise estimates of the remaining extent of grandfathering are not available. One estimate is that grandfathered conflicted remuneration makes up between 9 and 19 per cent of adviser total revenue mix."

This statement above from Treasury highlights the fact that little investigation has been undertaken by either Treasury or ASIC into the remaining level of grandfathered commissions, the products that these clients are invested in or the extent to which the continuation of grandfathered commissions is inappropriately impacting upon the quality of financial advice or consumer outcomes.

This issue was also recently addressed at a 20 February 2019 Senate Estimates hearing, as per the following exchange:

Senator KETTER: …. Firstly, on grandfathered commissions, do you have any estimate of the extent of grandfathered commissions for conflicted remuneration out there at the moment? This is bearing in mind that the royal commission recommended that these grandfathering provisions be repealed as soon as reasonably practicable.

Ms Bird: We don't have reliable estimates of the extent of grandfathered commissions. We know that they're reducing. We know that a number of institutions have unilaterally announced that they're turning them off. We've done our own research on a small sample, which would indicate that the amount of grandfathered commissions is now quite small. But the sample we had was 20 licensees across various sectors, so I can't give you an absolute percentage figure.

Analysis from the research firm Investment Trends, indicates that grandfathered commissions have declined from 30% of total practice income in 2010 to just 9% of total practice income in 2018. This suggests a significant rate of decline.

In addition, neither are we aware of any research into the other forms of grandfathered benefits, such as volume bonuses and shelf space fees which equally need to be addressed as part of this overall reform process.

We find it quite remarkable that this issue has apparently become so important, when there is no analysis as to the extent of it, no research related to the obstacles to resolve it and then a subsequent statement from ASIC suggesting that it is now quite small.

There are numerous legacy products where the solution for this issue is much more complicated. We would think that the starting point would include an investigation that leads to an awareness of the following matters:

- The number of clients and the amount of money invested in products that pay grandfathered commissions.
- An assessment of how many of these clients are receiving service from their nominated financial adviser.
- How many product providers and products does this impact?
- The number of products and impacted clients and assets under management where it is possible for the grandfathered commissions to be turned off and directly rebated to the client.

- The extent to which, if clients were forced to move products, that they will be impacted by exit fees, capital gains tax, loss of grandfathered Centrelink deeming treatment on income stream products or loss of insurance.
- The number of financial advisers who are impacted and the extent to which they have purchased businesses or books of clients in recent years that include grandfathered commissions, and where business loans are in place whether the loan security includes grandfathered commission clients.
- The impact that this will have on the viability of these financial advice practices.
- The impact on other benefits such as volume bonuses that are paid to licensees and the likely impact on these businesses of the removal of such payments.

6. Grandfathering was not a FoFA Compromise – But Rather had Broad Political Support

The Royal Commission made a number of statements with respect to grandfathered commissions, some of which were incorrect.

Royal Commission Final Report – page 19
"Creating exceptions that depart from underlying principles has consequences. Those consequences are amply demonstrated by the grandfathering arrangements made in respect of FoFA. 'Temporary' or 'transitional' carve outs departing from principle too often become (and in this case did become) entrenched. Carve outs and exceptions are too often exploited (and in this case have been exploited) for purposes having nothing to do with the stated purpose of their creation.

Royal Commission Final Report – page 131
"The content and extent of changes to be made in 2012, and later in 2014 and 2015, were contested. Before the introduction of the legislation that was enacted in 2012, the Government established a 'Peak Consultation Group' drawn from bodies as diverse as the Association of Financial Advisers (AFA), the Australian Bankers' Association (ABA), CHOICE, Industry Super Australia and the Property Council of Australia. For about 12 months before the legislation was enacted, this group met each month to discuss the proposals. It is, therefore, not surprising that the resulting provisions show signs of compromise and accommodation of widely divergent interests.

In the Interim Report, I focused on two of those compromises. The first was that conflicts of interest between adviser and client should be permitted to remain but be 'managed'. The second was that some forms of conflicted remuneration were, and still are, allowed to continue. Both of those compromises lie at the heart of the issue that I will deal with in the third section of this chapter – the provision of poor advice – and I will return to them there."

Royal Commission Final Report – page 182
"As I noted in the Interim Report, after the commencement of the FoFA reforms, payment and receipt of some forms of conflicted remuneration for financial advice was permitted to continue by 'grandfathering' provisions made by Subdivision 5 of Division 4 of Part 7.7A of the Corporations Regulations 2001 (Cth). It is neither necessary nor profitable to trace the detail or history of those grandfathering provisions. At the risk of some minor inaccuracy it is enough to note that certain arrangements made before the FoFA reforms came into force in July 2013 that would otherwise have fallen within the ban on conflicted remuneration were, and remain, excluded from the definition of conflicted remuneration."

Contrary to what the Royal Commission have said, we believe that it is necessary to confirm the history of what happened with the FoFA legislation, as to do otherwise, would allow a misrepresentation to go unchallenged. In our view, this does not reflect a minor inaccuracy. We also make the point that there are two principles at play here. One is the principle that legislation should not apply with retrospective application. The second is the removal of conflicted remuneration. These principles

conflict, and the Government in the past has placed greater emphasis on the principle of not applying legislative reform in a retrospective manner.

We also reject the suggestion that grandfathering has been exploited, as it is evident that there has been a material decline in the level of grandfathered commissions and there is also the reality that it could not have been completely removed to this point, as a result of the obstacles to moving clients. The actual minimum possible amount of grandfathered commissions is not known; however it needs to be recognized as a part of this process. As we have repeatedly said there are numerous financial advisers who are both continuing to service their grandfathered commission clients and acting in their best interests. Some of these statements lack balance.

The FoFA reforms were first announced by Chris Bowen, the Minister for Financial Services, Superannuation and Corporate Law on 26 April 2010. The announcement included:

- a **prospective** ban on conflicted remuneration structures including commissions and volume based payments.
- The introduction of a statutory fiduciary duty so that financial advisers must act in the best interests of clients.
- Increasing transparency and flexibility of payments for financial advice by introducing 'adviser charging' that will help align the interests of the financial adviser and the client; is clear and product neutral; and where the investor will be able to opt-in to the advice in response to a compulsory annual renewal notice.
- Percentage-based fees will only be charged on ungeared products or investment amounts and only if this is agreed to with the retail investor.

The announcement clearly set out that the ban on conflicted remuneration was a "prospective" ban, which meant that it would not apply to existing business. Importantly, the announcement clearly stated that it did not initially apply to risk insurance. It also clearly stated that it did not initially apply to soft dollar benefits.

The final version of the FoFA package included grandfathering provisions for existing commission arrangements, consistent with the initial intent of a "prospective" ban. The final package also included an exemption for life insurance, except for group life arrangements and for default superannuation arrangements, which was an outcome that went further than the April 2010 position. Importantly, the consultation also led to the introduction of a ban on soft dollar or non-monetary benefits. The consultation was not simply a series of measures to weaken the package.

Expressed directly, the original proposal included an exemption for existing business and for life insurance. If anything, it could be argued that the consultation led to an increase in the requirements with respect to life insurance and non-monetary remuneration. It is incorrect to suggest that the exemption for grandfathered commissions and life insurance were a compromise as a result of the consultation with industry.

None of the Ministerial media releases from 2010 and 2011 or the Explanatory Memorandum to the FoFA Bills made any statement about the expected timeframe for the decline in the volume of grandfathered commissions or that it was temporary in any way. The position can be further clarified by the following statement in the 29 August 2011 media release from Bill Shorten, when he released the FoFA legislation, and specifically referred to grandfathering:

> "Following legal advice from the Australian Government Solicitor, the Government has determined that the ban on conflicted remuneration (including the ban on commissions) will not apply to existing contractual rights of an adviser to receive ongoing product commissions.
>
> This means that, in relation to trail commissions on individual products or accounts, any existing contract where the adviser has a right to receive a trail commission will continue after

> 1 July 2012, or in the case of certain risk insurance policies in superannuation, 1 July 2013. This means that trail commissions will continue to be paid in these circumstances."

There was no statement that suggested that these arrangements were temporary or transitional. The original legislation also specifically provided for grandfathering through a number of Sections. To the extent that it was a matter of law (as set out above by Bill Shorten), that it could not apply to existing businesses, then how could you assert that it was a temporary arrangement. That is not possible.

Parliamentary Joint Committee on Corporations and Financial Services Inquiry – January 2012

We believe that the testimony of the CEO of the Industry Super Network (now ISA) at the Parliamentary Joint Committee on Corporations and Financial Services hearing into the FoFA legislation on 24 January 2012, (page 25 of the Hansard from that hearing) directly and specifically contradicts the suggestion from the Royal Commission that grandfathering was a compromise:

Mr Whitely: I would like to make a further point on this, just to reiterate a point I made in my opening statement. You have very substantial grandfathering, comprehensive grandfathering, of a whole range of conflict and remuneration payments. That is not something which there has ever been any objection to by any industry fund, consumer groups or whatever, I believe. In fact, it has been quite the opposite to be frank. I would like to think we have taken a pretty pragmatic and practical approach to this.

In the final report (paragraph 5.97), the PJC Committee majority report did not question the inclusion of the grandfathering of commissions in any way and their primary comment in this section was the lack of clarity with respect to the treatment of commissions from platform operators, that they felt did not adequately reflect the intent or the Explanatory Memorandum.

The Coalition members released a dissenting report, which made the following specific comments with respect to grandfathering on pages 182 and 183 of the final PJC Report:

"Coalition Committee members consider that it is a fundamental expectation of any legislative reform that existing contractual arrangements should be recognised and grandfathered to preserve existing property rights."

"We therefore recommend that appropriate amendments be made to the grandfathering provisions to recognize and preserve existing and long standing property rights and to ensure that commission payments from platform providers are not banned retrospectively."

In conclusion, the response from both sides of politics in February 2012 was in support of grandfathered commissions, and in fact was seeking greater certainty.

FoFA Amendments – November 2014

The FoFA reforms were the subject of further Parliamentary and community debate throughout 2014, with some refinements to the reforms put forward by the new Coalition Government. This process played out in terms of a regulation that was ultimately disallowed by the Senate on 19 November 2014. Grandfathered commissions were not an issue that was subject to debate at that time, however one element of the regulations was intended to provide greater clarity with respect to the retention of grandfathered commissions when an adviser moved from one licensee to another. On 26 November 2014, Senator Mathias Cormann, who was the acting Assistant Treasurer and therefore the Minister responsible for Financial Services, issued a media release that indicated that agreement had been reached with the Opposition that a revised regulation to progress the broadly supported elements of the disallowed Future of Financial Advice (FOFA) Regulation would be remade. The first item on this list was "amendments to the grandfathering provisions that will address unintended consequences,

and facilitate competition in the financial advice industry, by enabling advisers to move licensees with their clients whilst continuing to receive grandfathered remuneration."

The point of all of this is that there was bipartisan support for grandfathering of conflicted remuneration throughout the FoFA reform process and even after that time. Grandfathering was not a compromise, and neither was there any statement that suggested that it was temporary. To the extent that it was a fundamental expectation of any legislative reform to preserve existing property rights, there was no message that would or could suggest that there was any end date on this arrangement.

Financial advisers have made decisions since this time based upon this clear understanding, and now they are exposed to serious losses as a result.

7. Reasons Why Clients Cannot be Moved Out of Grandfathered Commission Products

There are a number of client cases where there were obstacles that prevented advisers from recommending clients to move to modern products or where it was not in the client's best interests to move.

We have been very disappointed to see inadequate coverage on the existence of these factors that might prevent a client from being moved from a non-competitive product to a modern product. These reasons include:

- The older product is a better product than the modern products. The rate of return on lifetime annuities and fixed term annuities is typically set on the basis of interest rates prevailing at the time of commencement. Given that we are now in a historically low interest rate environment, there are many older annuity products paying returns that are simply not available at this time.
- Some legacy products may have an exit fee. Forcing the client to move from a trail commission paying product to a post FoFA product could result in the payment of a large exit fee and would not be in the client's best interests. We note that the Government has enacted legislation to ban exit fees from 1 July 2019 for superannuation products. This has certainly been an important issue in the past and even came up as an example during the Royal Commission, where an adviser recommended a move to a modern product despite the exposure to a sizeable exit fee. In terms of lifetime and fixed term annuities, there are also what is called break fees if an annuity is broken and the contract is cancelled.
- The client's existing product may contain significant capital gains that would be crystallised if the client moved to a new product. Recognising the capital gain and paying capital gains tax at that point in time may not be in the best interests of the client. It may be better for them to realise this gain at a later time when they have a lower taxable income (i.e. after retirement).
- Grandfathered Centrelink deeming treatment of older pension products (discussed in more detail below) may be lost, which could result in the loss of the age pension or a reduction in pension benefits. It may also be the case that it is practically not possible for clients to exit some of these income stream products.
- Insurance in bundled superannuation products may be lost which could be difficult to replace for people whose health has deteriorated. The additional cost of insurance or loss of benefits could far exceed any saving in reduced fees in a modern product.
- The cost of appropriate advice to change products could exceed the benefit the client would receive from moving to a modern product.

We do not have statistics on the prevalence of the above factors, however we expect that they are common. Financial advisers who are offering quality advice, are considering all the factors, including those above, before recommending that a client move to a new product or stay in their current product.

Another important consideration is that where a client was not able to move to a modern product, their older product may not actually allow for an adviser service fee to be paid. It is expected that there would be a number of older products that have no provision for adviser service fees. In this case there is no alternative, other than to stay in the existing product.

Grandfathered trail commissions are typically at a much lower level (typically around 0.5% of the account balance) when compared to ongoing adviser service fees. Clients on trail commission arrangements also tend to have lower account balances. Often the commissions that are being paid are relatively small amounts, however these arrangements still give them access to ongoing adviser services and access to an adviser when they need it. Financial advice businesses still need to be run in a financially viable manner, and it may therefore not be possible to provide a full annual review to all grandfathered commission clients with low balances. The relationship with a trail commission only client is often a different relationship to one with an ongoing adviser service fee arrangement client and the level of service is often commensurate. They may have a service package that is more based upon the provision of regular updates, oversight of the performance of underlying investments and access to an adviser when required. Such an arrangement may meet the specific needs of the client. Importantly, however, when offered the choice to change to a post-FoFA product, many clients choose to stay with their existing arrangement and product(s). They may not be able to afford the full cost of an ongoing fee arrangement, or justify the benefit. They might just be genuinely happy with a lower touch service offering.

It is often asked why clients may still be in grandfathered commission products, even now more than five years after the start of the FoFA regime. Please see the following illustrative cases that explain exactly why these clients have not been moved:

Lifetime Annuity and Centrelink Grandfathering

Jan is a 75-year-old widow who is living on a lifetime annuity and a part Age pension. She has $200,000 in the lifetime annuity that she commenced on 1 July 2007, that continues to deliver a return that is not currently available on new products in a low interest environment. The product provider pays a 0.5% trail commission to her adviser. Jan has a low tolerance for risk and also has a $175,000 term deposit. Jan is a homeowner and also has $10,000 in a bank account. She meets with her financial adviser every six months to plan for the roll-over of the term deposit and to check that nothing material has changed and that her Centrelink details are correctly updated. Jan's adviser is paid $1,000 per year from the lifetime annuity that covers the cost of the six monthly meetings with Jan, advice on the term deposit and other administration activity involved with Centrelink.

Jan's lifetime annuity includes beneficial grandfathering treatment (a 50% asset test exemption) and she would not like to lose this if she was forced to move to a new product. In addition, she would be exposed to a break fee if she was to withdraw from her current product. These products are unlikely to have fee for service capability. If the grandfathered commissions were rebated to her, this would also cause problems from a Centrelink perspective.

Capital Gains Tax

Joseph is a 58 year old who is preparing for retirement. He has a corporate superannuation plan and $200,000 in a managed investment scheme unit trust that he first invested in back in 1994, that is paying a grandfathered commission of 0.5% to his financial adviser. He is still working, but plans to retire in around 3 to 4 years' time. He is working hard to maximise his contributions to super in preparation for his retirement. The unit trust is sitting on a $100,000 capital gain.

Joseph's adviser is paid $1,000 a year in grandfathered commissions from the unit trust and this pays for Joseph to meet his adviser each year to discuss the performance of his unit trust investment and what he is doing to maximise his superannuation contributions in preparation for retirement.

Joseph does not want to sell his unit trust as this will crystallise the capital gain and lead to a capital gains tax bill. He is thinking that he would prefer to sell it down after he is retired, where he will be able to achieve a better tax outcome. He is working closely with his adviser in the lead up to retirement to be as best prepared as possible. He wants to hold onto his adviser relationship.

Insurance Complication
Richard is 42 and holds a retail superannuation fund with life and TPD insurance (through a group policy) that pays a grandfathered commission of 0.5% on the small superannuation balance of $5,000 and a grandfathered commission of 20% on the insurance premium of $2,500 (this is also grandfathered as it is a group policy, which was banned under FoFA).

Three years ago, Richard had an accident and injured his back. He was back working a couple of months afterwards; however he continues to experience pain and as a result also experiences bouts of depression. He also currently holds an industry fund superannuation account where his employer contributions are going with a small amount of insurance. Richard is married with a couple of young children and a large mortgage. After the accident, when he was starting a new job, he discussed his insurance needs with his adviser, and they agreed that the sensible thing was to hold onto his original retail insurance, but to start a new super fund with his new employer (the industry super fund) as it would not be possible for him to get new individual insurance as a result of the accident (other than via a group super arrangement). Any application for insurance is likely to be declined or subject to important exclusions and loadings.

Richard's adviser receives $525 per year in grandfathered commissions from the retail superannuation fund (including the insurance commission) which enables them to meet once a year to monitor developments in his health and discuss changes in his personal circumstances. They are both keeping a close watch on his health, with an awareness that a claim for TPD might be possible if his health situation deteriorates further. Richard is determined to hold onto his existing retail insurance arrangement and his financial adviser relationship. Put simply, he must keep his existing insurance.

These are put forward as some illustrative examples, however these cases will be common amongst an adviser's client base. There are very real reasons why an adviser could not recommend a client to move to a new product and why the client may not have wanted to move. There are particular products where we expect that there will be greater issues, including:

- Whole-of-life policies,
- Endowment policies,
- Lifetime annuity products,
- Fixed term annuities,

All of these products stand out as examples where there is a need to more carefully consider the situation, because in many cases either the client has no option, but to retain these products or doing anything else would be contrary to their best interest. We cannot see any case to argue that it would be beneficial for clients, if life insurers were forced to add fee for service capability and grandfathered commission rebate capability to any of the above pre-FoFA products.

Background on Issues Related to Centrelink Grandfathering

There has been a history of changing the Centrelink treatment of income stream products and it is important that this is considered as part of the deliberations on grandfathered commissions. In many cases it has not been possible for financial advisers to move clients from older products to new products due to the risk of losing this grandfathering treatment. The most relevant legislative change impacting clients in super or non-super income streams (including annuities) were:

1 January 2015: Deeming of account-based pensions (ABPs)

Any ABP commenced on or after 1 January 2015 is treated as a financial investment for Social Security means testing purposes and subject to deeming.

An ABP commenced before 1 January 2015 will be grandfathered under the pre-1 January 2015 assessment where the pensioner:

- Retains their existing ABP; and
- Continues to hold a Commonwealth Seniors Health Card.

The rules that applied to the grandfathered pre 1 January 2015 products are generally seen as being more "concessional" under the income test. Moving from a grandfathered ABP to a new ABP could increase a pensioner's Social Security assessable income which could, in turn (and where the pensioner was income test sensitive) reduce that pensioner's Age Pension entitlement.

Asset Test Exempt (ATE) income streams purchased before 20 September 2004 (100% exempt) and 20 September 2007 (50% exempt)

Grandfathered ATE income streams continue to provide pensioner's either a 100% or 50% asset test exemption.

There are very limited circumstances in which an ATE income stream can be rolled over to another income stream and retain the relevant asset test exemption. The loss of grandfathering for these income streams could significantly increase assessable asset and income for a pensioner which, in turn, could reduce Age pension entitlements.

Other Important Income Stream Considerations

There are also other considerations which would potentially impact the ability of an income stream provider to re-direct grandfathered commissions from Licensees/Advisers to clients via a rebate scheme, including:

- Legislative restrictions on increases in certain income stream payments (which may be limited to a fixed percentage or by CPI for example). Rebating of grandfathered commissions would increase the benefit paid and may result in a breach of the legislation, and
- The potential tax and social security consequences for pensioners as a result of the receipt of additional payments to a client on their income stream products.

Government Action is Required

We recommend that the Government offer CGT roll-over relief and Centrelink Asset and Income testing relief to better enable impacted clients to move to modern products, where this can be shown to be beneficial.

8. The Requirements and Cost of Moving Clients to Modern Products

Up to this point, the predominant way to proactively turn off grandfathered commissions, whilst retaining an ongoing advice relationship, was to move the client to a new modern product. This is not a simple exercise. For an adviser to move a client from one product to another, they would need to get the client's agreement to prepare a Statement of Advice, which may take around 10 - 15 hours to prepare, and typically cost at least $1,500. If the client refused to let the adviser prepare the advice or refused to move to a modern product, then there was little that the adviser could do?

As we have discussed above, there were often significant factors that may have caused an obstacle and would have prevented the adviser from recommending that the client moved to a new product. Often detailed analysis would need to have been undertaken to consider issues like exist/break fees, capital gains tax and for age pensioners the likely impact upon age pension entitlements. Where there is any complication, detailed analysis of the issues was required, which may have required specific technical guidance. This is costly to prepare. Where the benefit to the client was not expected to exceed the cost of the advice, then it would not have been appropriate for the adviser to recommend that they prepare the Statement of Advice. In some limited cases, advisers may have chosen to provide advice for free or at a heavily discounted rate, however this is not practical on any significant scale.

If an adviser had 50 or even 100 clients in grandfathered commission products and was required to prepare 100 Statements of Advice, this would take a very long time and prevent them from focussing on their other clients. In the timeframe that has been proposed and whilst the likely solutions remain unclear, it is likely that many advisers will simply need to walk away from a number of clients as they just do not have the time to provide each of these clients with a Statement of Advice.

It is important to note that this is occurring at the same time as financial advisers are expected to undertake further study and to pass an exam. The work required to move clients to modern products or to adjust business models is significant and will compete against these other priorities. This will also contribute to additional stress and anxiety.

One item of feedback that we have had from our members is the genuine concern that they have about being forced to communicate with clients who they have looked after for many years to say that they can no longer provide them with services as the commissions will be turned off. They believe that their clients should be able to choose to stay with them if that is what they want.

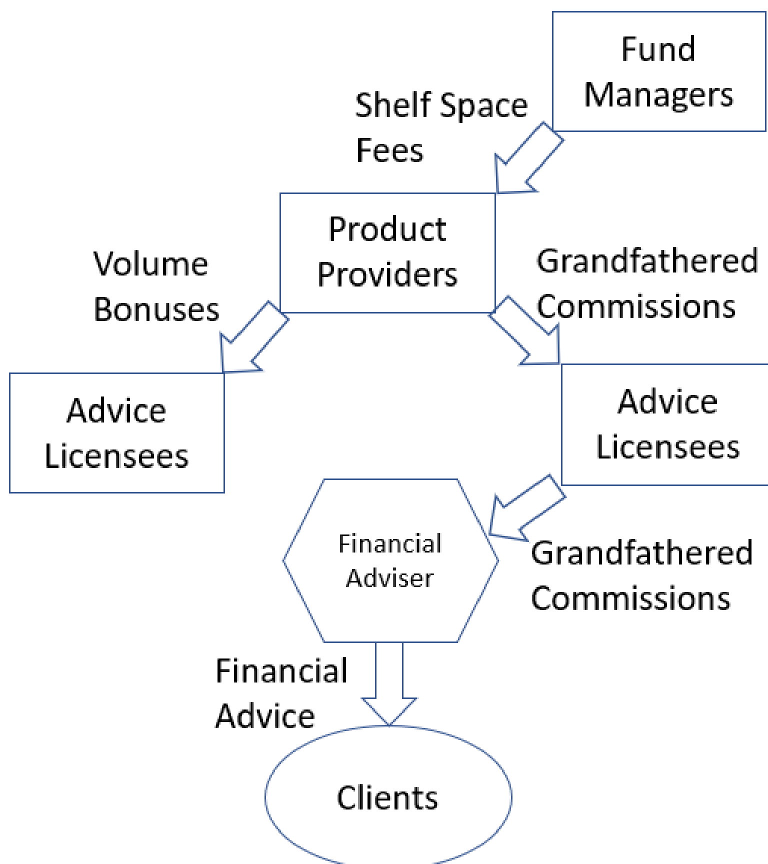
We believe that it is appropriate for ASIC to give consideration to situations where advisers may be permitted to recommend clients move to new products via the provision of a Record of Advice, which is much quicker and cheaper to provide.

9. Complexity of Grandfathered Benefits

Complexity exists in multiple levels in terms of grandfathered conflicted benefits. Firstly, there are the following historical benefit types that are applicable:

- **Shelf space fees.** These are payments from fund managers to product providers and typically platform operators that had a range of investment option available on their platform. Other than where this is on a cost recovery basis, or a fee for service basis, it is considered to be conflicted, although potentially subject to grandfathering.
- **Volume bonuses.** These payments are from product providers to advice licensees and were typically paid on the basis of the level of business that was in place. These arrangements may have applied to some licensees, but not all licensees. These payments might have been in the range of 0.10% to 0.25% of assets invested and differ between licensees.
- **Grandfathered commissions.** These are payments from the product that are paid via the licensee to the adviser. This is typically in the range of 0.25% to 0.5% of the value of the account.

These payments are set out in the following diagram:



In terms of each of these payments, there has been no detailed discussion as to what the implications are. It is assumed that if they are all banned then:

- Fund managers will keep the shelf space fee payments.
- Product providers will keep the volume bonus payments and the grandfathered commission products, although they may be required to rebate some or all of these grandfathered benefits to clients in some circumstances.

We ask for greater clarity as to what is expected to happen with volume bonuses and shelf space fees. We note that the Explanatory Memorandum does not even refer to volume bonuses.

Products Sold Through Different Channels

At a product level, there is also a range of complexities.

With some products that were sold via an adviser, there may have been a trail commission payable, whereas with the same product sold directly to retail clients, there was no trail commission involved. It could be argued that this payment of a trail commission to a financial adviser was instead of the cost of marketing the product to the public. There would also be a third group of clients who were those originally placed into a product when an adviser was involved, however the adviser is no longer involved and where the trail commission has been turned off. Thus, for some products, there are three types of clients. On a going forward basis they all have the same interest in the product, however the advised client has the potential benefit of access to financial advice. They are also probably the only ones who might be eligible for a rebate.

Impacted Products

In terms of different types of products, all of the following will be impacted:

- Whole of life and endowment life insurance policies
- Insurance bonds and friendly society bonds
- Bank accounts
- Unit trusts or managed investment schemes
- Superannuation products
- Margin loans
- Account based pensions
- Immediate annuities, including lifetime annuities and fixed term annuities

In some cases, such as Whole of life, the commission might have been based upon a percentage of each year's premium. These are not unit linked products, but rather subject to an annual bonus.

Some of these products are run on outdated computer systems that will not be easy to update to reflect any likely changes to ban grandfathered commissions. As we said above, what benefit would there be in adding adviser service fee capability and commission rebate capability to a product like whole-of-life, which has been closed for many years.

10. How Could Grandfathered Commissions be Removed?

No party has explained how grandfathered benefits are to be removed. It is envisaged that it could be done by one of the following mechanisms:

- The client is moved from an older grandfathered commission product to a modern fee for advice product, based upon the advice of a financial adviser. Grandfathered commissions would simply be turned off at the time of the transfer.
- The product provider negotiates with the licensees to agree to an amount of compensation to be paid in exchange for cancelling all outstanding grandfathered commission entitlements. The grandfathered commissions would cease from the date of the agreement. In this case it is not clear what the client's rights would be to ongoing financial advice. This issue would need to be addressed.
- The product provider modifies the product to enable trail commissions to be rebated to clients. In this model it is assumed that the advisers could renegotiate with the client to put in a new adviser service fee in place of the trail commission. It should be noted that this solution will result in added complexity for the client as each rebate might attract separate tax implications, including being treated as income for the client. This could happen at the time that it is agreed between the adviser and the client.
- Product providers could just choose to turn off grandfathered commissions and leverage the option to do this without any compensation as a result of the Government's proposal to remove the applicability of Section 1350 of the Corporations Act. In this model, the contract would be unilaterally cancelled and, subject to any legal action, no ongoing obligation would apply. This could happen at any time after the legislation is passed. In this scenario the client would lose access to financial advice.
- AFSL licensees or financial advisers are required to refund any grandfathered commissions that they receive to their clients. Such a solution is simply putting a cost impost on advisers and will cause great confusion for clients. Services would need to be turned off.
- No action taken and the product provider would simply rely upon the application of the law to ban grandfathered commissions and rebate them to clients from 1 January 2021.

How this is done, will have very different implications for salaried advisers with inhouse products as opposed to self employed advisers with external products. Who ultimately benefits will depend upon any compensation arrangements, what happens to volume bonuses and whether there is any ongoing services provided to the client.

Historically, when trail commissions were turned off, the payment was retained by the product provider, rather than returned to the client or used to reduce the product fee for the client. This meant that the client received no benefit through a product fee reduction and would also lose access to the financial adviser, unless they agreed to establishing an ongoing fee arrangement, however that would involve a material additional cost. A small number of institutions have the facility to turn off trail commissions and rebate these payments to clients, however this is not common.

Client Impact of Banning Grandfathered Commissions

In terms of the impact on clients we offer the following feedback:

- Where the client can be moved to a competitive product and is continuing to receive financial advice, then the best outcome would be to move to the new product and put an ongoing fee arrangement in place.
- Where the client is no longer receiving advice from a servicing adviser for the trail commission, then a rebate of this commission will give them a better financial outcome. However, if they are in an uncompetitive product then they are left with that problem and do not have access to financial advice to explain what they should do.
- Where the client is in a grandfathered commission product and is prevented from being moved to a modern product and they are receiving financial advice that they want to continue, then it would be better for them to stay in their current arrangement. If the outcome was the rebating of a grandfathered commission and the introduction of an adviser service fee, then there will be a lot of additional transactions on their account for no benefit. In fact, the fees are likely to increase due to the additional complexity.

Detailed analysis needs to be undertaken to ensure that clients will benefit from this change. We once again emphasise the point that clients should have the ability to chose how their financial adviser is paid, and removing that choice is unreasonable.

11. Direct Consequences for Financial Advisers

We have set out above a key point, that in advance of the Royal Commission, there was no indication that the continuation of grandfathered commissions was at risk. There were a lot of advisers who had formed the view that it was subject to greater risk and was not going to be part of their longer term future. In some cases, they will have sold grandfathered commission clients to other advisers as part of their efforts to exit this space. In some cases, where contact with the client has been lost, advisers will have simply chosen to turn off these grandfathered commissions and walked away from any ongoing relationship with these clients. Importantly in these cases, it was the product provider that historically kept this benefit.

Nonetheless, there are many financial advisers who have recently acquired books of grandfathered commission clients as part of an initiative to build their business. This has been a common strategy for younger advisers, and often encouraged by their licensee or a related party. For these younger advisers, it was an opportunity to acquire a book of clients that they could then work with and over time, transition to a fee for service arrangement. Quite often these younger advisers borrowed money in order to acquire these businesses and have large business debts that they need to service.

Banks always require security for business loans. In the case of financial advisers this is typically on the basis of a combination of business assets and personal assets such as family homes. Where it

comes to the business assets, the key asset is the ongoing arrangements with clients. Valuation models in the past typically placed a valuation multiplier on the recurring revenue for different types of clients. Life insurance ongoing commissions and fee for service clients would attract a certain multiplier. Grandfathered commissions have previously attracted a multiplier of between 2.5 and 3.5 times recurring income. Thus, a book of grandfathered commission clients with recurring income of $100,000 might have been valued at between $250,000 and $350,000. This was treated as security on the loan. Loans are typically arranged on a maximum loan to value ratio. The removal of any value attributed to these grandfathered commission clients will place these businesses at risk of exceeding the maximum permissible loan to value ratio and therefore being non-compliant with their loan agreement. The impact of this is very real and unless the banks are prepared to show some discretion, it is very likely that we will see a sizeable number of businesses both in distress and failing. With the declining value of financial adviser businesses this will also put the homes of a number of advisers at risk.

We have been contacted by a number of members who have been adversely impacted by recent purchases of businesses or client books with grandfathered commission clients on the basis of loans that have been secured by these client books. In one case, a single adviser practice acquired a book of grandfathered commission clients as recently as September 2018 for $100,000 that was entirely via borrowed funds. This was in addition to existing bank debt of $280,000. The resultant total debt is secured against the business and the family home, which is also highly leveraged. In this case, the transaction was facilitated by the licensee. We understand that there are some businesses that have million dollar plus loans who are now at risk of the bank withdrawing the loan. There are many small businesses that are at risk as a result of this proposal.

As stated previously we understand that some banks have already changed their valuation models and advisers are being informed of these changes as part of loan renewal discussions. We believe that this is a very material risk over the entire sector and would suggest that analysis of this as part of the regulatory impact statement is essential.

We believe that Treasury needs to undertake the following investigative work:

- Seek information on the amount of bank debt in the financial advice space and the number of advice practices and financial advisers involved.
- Understand the extent to which this debt is backed by security over grandfathered commission business.
- Understand the number of businesses where the re-assessment of the value of the business on the basis of the Royal Commission recommendations, including the banning of grandfathered commission will put the practice in default of their loan agreement.
- Seek the support of the banks involved in the financial advice sector to ensure that they offer support to financial advisers during any transition process.

At the licensee level, there is also a significant risk from the removal of volume bonuses. These payments have been a significant source of funding for licensees for many years and their removal will result in a need for significant structural and business change. It is expected that one outcome will be a significant increase in the licensee fees paid by financial advisers. Thus, this is another potential outcome that will work to the disadvantage of small business financial advisers. We expect licensee fees to rise materially, which will put more pressure on financial advice practices, all of which ultimately needs to be passed on to clients. This will only serve to make financial advice less affordable and less accessible. This is a very real issue and this reform, along with other recent reforms, will have a very material impact on business viability.

12. Constitution and Acquisition of Property on Other Than Just Terms

We note the following statement on page 18 of the Royal Commission final report:

> "Whenever change is mooted, someone will suggest that changing the permitted forms of remuneration would lead to constitutional difficulties because it would amount to an acquisition of property otherwise than on just terms. As I said in the Interim Report, two points must be made. First, where would be the acquisition? Who would acquire anything? What proprietary benefit or interest would accrue to any person? Second, if the point is good, it was good at the time when most forms of conflicted remuneration were prohibited. Yet no-one sought then to challenge the validity of the relevant provisions and the Future of Financial Advice (FoFA) ban on conflicted remuneration has now operated for more than five years without challenge.
>
> It is time to ignore the ghostly apparition of constitutional challenge conjured forth by those who, for their own financial advantage, oppose change that will free advice about, or recommendation of, financial products from the influence of the adviser's personal financial advantage."

We challenged this view when similar statements were made in the Interim Report, as it is simply inconsistent with what Bill Shorten said on 29 August 2011, in his media release announcing the release of the FoFA legislation when he referred to advice from the Australian Government Solicitor as follows:

> "Following legal advice from the Australian Government Solicitor, the Government has determined that the ban on conflicted remuneration (including the ban on commissions) will not apply to existing contractual rights of an adviser to receive ongoing product commissions."

It is clear from this and other references, that the Australian Government Solicitor did, in 2011, believe that there was an issue with the acquisition of property on other than just terms.

As further evidence, Sections 1528(3), 1530 and 1531(2) of the Corporations Act and paragraphs 2.83 and 2.86 of the Further Future of Financial Advice Measures Explanatory Memorandum each refer in some way to the acquisition of property (within the meaning of paragraph 51(xxxi) of the Constitution) from a person otherwise than on just terms.

The existence and understanding of the issue with the acquisition of property rights on other than just terms is directly related to the advice provided by the Australian Government Solicitor and the legislation as part of the introduction of the FoFA reforms, not something that has been raised by the industry in hindsight as a basis to hold onto grandfathered benefits as has been claimed by the Commissioner. We reject the claims in the final report.

In terms of the question raised about an 'acquisition', it would seem to us that this was achieved by the potential cancellation of the contractual right to receive trail commission by either product providers or the Government legislating to ban them. Such an action by the Government would in effect be the acquisition of property rights and in the absence of compensation would be on other than just terms.

In terms of the second comment above by the Royal Commission about why the other conflicted remuneration provisions were not opposed on the basis of a similar argument around the acquisition of property rights on other than just terms, this is simply answered by the fact that the other

conflicted remuneration provisions in the FoFA package were all "prospective" provisions. The ban applied to future business, not existing business. In our view, this statement in the final report demonstrated a broader lack of understanding of the nature of the financial advice business.

On 5 February 2019, the AFA submitted a Freedom of Information (FOI) request to the Treasury seeking a copy of the advice from the Australian Government Solicitor that Bill Shorten referred to in his media release of 29 August 2011. Under the FOI rules, Treasury had 30 days to respond to this FOI request and just after 4pm on the 30th day, they responded by declining to make the advice available on the grounds of Legal Professional Privilege. It may be that there are grounds to appeal this decision on the basis that privilege was waived by the disclosure of confidential advice in the media release from Bill Shorten on 29 August 2011 and the Explanatory Memorandum, both of which made reference to the issue of property rights in a manner where the confidentiality provision of the legal professional privilege principle has potentially been triggered. To further illustrate this, please see the following paragraphs from the Revised Explanatory Memorandum:

> 2.83 Division 4 will not apply to the extent that its operation would result in an acquisition of property otherwise than on just terms.
>
> 3.89 It would be able to operate in connection with future provision of advice connected to an existing arrangement with a client. In contrast, the proposal to ban particular remuneration structures can only operate prospectively, due to constitutional restrictions concerning acquisition of property.

It is also reasonable to conclude that the decision to refuse to release this advice from 2011 is an indication that the legal basis for this issue is not as clear as the Commissioner has suggested. We believe that it is appropriate for the Government to disclose why they do not believe that there is an issue of property rights, given that the previous government made it very clear that there was. In our view, with all that is at stake for the impacted advisers, this is not an unreasonable request.

We would also like to raise the issue with the draft legislation seeking to legislate for the removal of the applicability of Section 1350 (Compensation for Compulsory Acquisition) in Sections 1528(3), 1529(2A), 1530 and 1531(2). It is our understanding that Section 1350 provides the right under the Corporations Act for someone to be compensated when property is acquired on other than just terms. The simple fact that the draft legislation is seeking to prevent the application of this section under the Corporations Act and thus requiring advisers to take any legal action under the Constitution in the High Court, suggests that there is a clear awareness that there is an issue with the acquisition of property on other than just terms. If this was being done to average Australians, there would be an absolute outcry from the public.

We would like to pose the question as to whether the efforts to remove the applicability of Section 1350 have been done to protect the Government or product providers, who will now be able to cancel or modify contracts, with no obligation to provide compensation? It is important that Australians know who this will benefit.

13. Feedback on Draft Legislation

In our view, this draft legislation is inadequate for the following reasons:

- The documentation fails to explain what the policy objective is.
- The documentation fails to explain how the Government expects this legislation to be implemented.
- The legislation does not prevent product providers from holding onto the benefits of the cancellation of grandfathered commissions where the contracts are cancelled prior to 1 January 2021.

- There is no specific explanation of how volume bonus payments will be treated.
- There is no discussion on what measures are available to protect the interests of clients where they are seeking to continue to receive the advice that they are currently getting in return for grandfathered commissions.
- The draft legislation is seeking to remove the rights of financial advisers in an inappropriate manner.

13.1 End of Grandfathering Arrangements

We oppose the repeal of subsection 1528(3) as this specifically refers to constitutional rights and the acquisition of property on other than just terms. If this right under the Constitution was consider an issue when the FoFA legislation was first drafted, then why is it no longer considered relevant. In addition, the proposal to substitute the existing subsection 1528(3) with a subsection that states that section 1350 does not apply, is also unreasonable. We strongly oppose the removal of rights from AFSLs and financial advisers where this would have otherwise applied. We also question the reference to 'that Division'. Which Division is this referring to? I In addition it would seem to us that this subsection is more with respect to benefits that are no longer given to a financial services licensee or a representative as a result of this legislation, rather than ones that are.

Consistent with the intent of Section 962Q, we believe that there should be a definitive statement in the legislation that a financial adviser would have no ongoing obligation to provide advice/services following the ban of grandfathered commissions.

Whilst the issue of volume-based shelf space fees is not of the same level of importance to the financial advice sector, our feedback above, equally applies to the proposal with respect to Section 1529.

We also strongly oppose the repeal of the existing section 1530 and the replacement with a statement that Section 1350 does not apply. Once again, this seems to be the removal of rights that otherwise applied.

We have previously felt that the legislation in Section 964D and 964E with respect to charging asset-based fees on a borrowed amount used to acquire financial products lacked adequate specificity. Whenever money is borrowed to invest, then there are two separate products. Firstly, there is a loan product and an investment product. It is not as clear as it should be with respect to whether the ban on asset-based fees applies to both the loan account and the investment account.

We repeat our concern as stated above about repealing a subsection (subsection 1531(2)) that specifically refers to rights that apply with the acquisition of property on other than just terms. We equally disagree with the insertion of a new subsection that asserts that section 1350 would not apply. We also questions whether Subsection 1531(2) lacks adequate specificity in that it simply refers to 'in respect of an asset-based fee'.

In summary we are very uncomfortable that three subsections of the Corporations Act on constitutional rights are proposed to be removed and four new subsections are proposed to be added to suggest that Section 1350, being a specific Corporations Act section on compensation for the acquisition of property on other than just terms does not apply. This certainly has the look of a lot of effort being made to remove the rights of financial advisers. It also seems to have deleted from the FoFA legislation the references to Paragraph 51 of the Constitution. It is our view that the Government has a responsibility to explain the basis for what they are proposing to do to the financial advice sector.

13.2 Application of the Proposed Rebate

Section 963M appears to apply to product providers who are legally obliged to give a benefit that is classified as conflicted remuneration. We assume that legally obliged is a reference to contractually obliged. This provision could be avoided by cancelling the contracts or amending the contracts that would otherwise include an obligation to pay such benefits before 1 January 2021.

Regulations May Provide for Rebate of Conflicted Remuneration

The first point to note about this is that it is only a reference to the fact that Regulations 'MAY' provide for a rebate. If this is to be legislated, then surely this must be more than just a 'may', because otherwise it will be the institutions and other product providers that get to keep the benefit of banned grandfathered commissions. We have set out above an extensive explanation of the complexity that might be involved in solving this issue. It is our view that it is entirely inappropriate to put the legislation in place without giving sufficient thought to how the scheme could be designed, what would be included and how it would work for the benefit of clients. There is a complete lack of detail to support a legislative solution that only gives certainty to the banning of grandfathered commissions and other benefits and gives no certainty to how this might benefit clients.

Section 963N only appears to apply to a person covered by Section 963M. This means that any product provider who extinguishes any legal obligation to pay grandfathered commissions before 1 January 2021 will have no obligation to rebate any conflicted remuneration to anyone.

Putting this issue to one side, we note that the obligation is with respect to "the relevant person to whom the relevant financial services licensee, or relevant representative of a financial services licensee, gave advice as a retail client". Accordingly, consideration needs to be given to the following questions:

- What are the implications of this legislation where no advice was provided? It might have been facilitated by the means of an execution only transaction. How does this apply with respect to discount brokers, who did not provide advice? Does this suggest that they are exempted?
- What are the implications where the current adviser has never provided advice to the client? If the adviser acquired the arrangement with the client and has not provided advice since that acquisition occurred, then presumably they are not covered by this legislation.

The irony of this proposal is that financial advisers who have not been providing financial advice to their grandfathered commission clients may not be caught under this legislation, or at least the clients will not stand to benefit through this legislation, yet those financial advisers who have been providing ongoing advice to their clients will be caught and their clients would be eligible for the rebate. This seems like a very perverse outcome.

Most importantly, how will the product provider know if financial advice has been provided to the client as a retail client? They equally will not know if the client has been treated as a wholesale client either. What is the case if the client has been treated as both a retail and a wholesale client during the period that they have received financial advice?

Complexity in Calculating and Applying Rebates

If we go back to a previous example discussed in this submission, of a financial services product (such as a basic banking product) that had three types of clients:

- Those who bought the product directly, where there is no trail commission payable,

- Those who originally acquired the product through a financial adviser, however no longer work with that adviser and the trail commission has been cancelled and is retained by the product provider.
- The client has an ongoing relationship with a financial adviser who is receiving trail commission on that product.

So, which of these three groups would be eligible to receive the rebate and what would the impact be on the product provider? Presumably, based upon the draft legislation, it would only be the advised client who would be eligible to get the rebate, so despite the product holding being identical in all other regards except that one client receives ongoing advice, they would in effect have a different product that paid a benefit to them that was not available to other clients. It would seem unreasonable for the product provider to pay that rebate to all clients, if that is not reflective of the cost that they are currently incurring.

Now lets also look at the potential implications when volume bonuses are taken into account. Volume bonuses may be paid to some licensees and not others and at different rates (0.1%, 0.15%, 0.2% or 0.25%) depending upon the nature of the relationship between the product provider and the licensee. Would these amounts need to be rebated to the clients at different rates depending upon which licensee the client was advised through? This seems highly problematic, however neither would it be right for the product provider to cease paying these volume bonuses and keep the money instead.

It is our view that a full rebate model will be particularly challenging to design and implement and likely to lead to a significant cost to build. The examples shown above suggest that this will be very confusing to clients and will bestow greater benefits on some clients as opposed to others, in large part based upon chance.

14. Regulatory Impact Statement

This legislation will have significant impact across the financial services industry. The system costs to build commission rebate capability and adviser service fee capability in legacy products and product systems will be huge. It is unlikely that the cost of some of this work could be justified in terms of any benefits that would flow to clients.

It will not only have a material impact upon the financial advice sector, but it could also have a very detrimental impact upon some individual financial advice practices and individual financial advisers. We believe that there is a risk that a number of business loans could be called in by the banks as a result of this legislation, or even the prospect of this legislation.

Such a piece of legislation requires a comprehensive Regulatory Impact Statement.

15. AFA's Recommendation

In response to the discussion of this issue at the Royal Commission and the response from both sides of politics, we accept that more needs to be done to speed up the removal of grandfathered commissions. We think that this needs to be done on the basis of a comprehensive review of the overall matter as part of consideration of the broader issue of uncompetitive financial products. We would strongly support such a review.

The AFA recommends the following:

- Should the removal of grandfathered commissions proceed as proposed that it be done by settlement between product providers and licensees.
- Any legislation to ban grandfathered commissions to be based upon a three-year transition period from the date that the legislation is passed.
- Subject to detailed analysis, consideration be given to exempting some legacy products, such as lifetime annuities, endowment policies and whole-of-life policies where there is no practical solution for rebating the banned grandfathered commissions.
- Exemptions to be available to clients who would be disadvantaged by being moved to another product, and who can elect to continue to be in grandfathered commission products and for their advisers to continue to be remunerated. This might be on the basis of a facility to allow the clients to direct the payment of the rebate to their adviser.
- The Government to provide for CGT roll-over relief and Centrelink roll-over relief to enable impacted clients to move from legacy uncompetitive products to competitive products.

16. Concluding Remarks

In response to the lack of genuine debate on this matter and the extent of misunderstanding, we have gone to additional lengths to put forward a detailed assessment of all the material issues that need to be considered. We are willing to work with all parties to determine a sensible way to move forward that will deliver genuine benefits for clients and avoid excessive damage to the financial advice profession.

We are very concerned about the lack of clarity in what has been proposed and the very real risk that this policy will have for the financial advice profession. We are happy to support a transition away from grandfathered commissions, however this needs to allow for obvious problem areas and where clients will be detrimentally impacted. We also believe that this is a much more complicated matter than has been acknowledged and the timeframe proposed is simply inadequate.

The AFA welcomes further consultation with Treasury should it require clarification of any points raised in this submission. If required, please contact us on (02) 9267 4003.

Yours faithfully,

Philip Kewin
Chief Executive Officer
Association of Financial Advisers Ltd

Appendix 1 – Impact of Royal Commissions on Financial Advice Business Valuations

The following table sets out a scenario of a financial advice practice that started with moderate debt, had a moderate exposure to grandfathered commission income and then in late 2017 purchased another business entirely on debt. The Royal Commission recommendations have significantly impacted business valuations to the extent that the debt now exceeds the value of the business.

1. Starting Position				
	No. of Clients	Revenue	Multiple	Value
Fee For Service	100	150,000	3	450,000
Life Insurance	50	50,000	3	150,000
Grandfathered	50	40,000	2.75	110,000
Total	200	240,000		710,000
Loan				350,000
Loan to Value Ratio				49%
2a. Purchase Business - 1 October 2017				
Fee For Service	10	15,000	3	45,000
Life Insurance	40	40,000	3	120,000
Grandfathered	50	40,000	2.75	110,000
Total	100	95,000		275,000
Loan				275,000
2b. Combined Business as at 1 October 2017				
Fee For Service	110	165,000	3	495,000
Life Insurance	90	90,000	3	270,000
Grandfathered	100	80,000	2.75	220,000
Total	300	335,000		985,000
Loan				625,000
LVR				63%
3. Post Royal Commission World				
Fee For Service	110	165,000	2.4	396,000
Life Insurance	90	90,000	2.5	225,000
Grandfathered	100	80,000	0	0
Total	300	335,000		621,000
Decline in value				$ 364,000
Loan				625,000
LVR				101%

Notes:

- The value of Fee for Service revenue has declined as a result of the recommendation of yearly opt-in requirements.
- The value of life insurance business has declined as a result of the suggestion that commissions should be removed following the 2021 review by ASIC.
- The valuation of grandfathered commission business has been decimated and banks will not lend money on the basis of this type of business.