‘ENDING GRANDFATHERED CONFLICTED REMUNERATION FOR FINANCIAL ADVISERS’.

Submission to Treasury by the AIOFP

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Executive Summary

At the outset it is important to note what “Grandfather Conflicted Remuneration” is and what it is not.

Grandfather remuneration refers to the accrued contractual right of financial advisors (**Advisors**) to be paid with respect to lawful arrangements entered into on or before 1 July 2013 (**Grandfathered Revenue**).

Grandfathered Revenue relates to contractually agreed remuneration. A large proportion of the revenue in question originates from platform or administration services and is unrelated to any investment funds the Adviser may have recommended.

Advisors did not design products that offered them a commission, rebate or other types of now impermissible platform payment. Further, remuneration arrangements of this kind were generally the prevailing form of remuneration offered prior to 1 July 2013. Payments of a similar kind of remuneration remain available with respect to other types of services and advice[1].

The Association acknowledges that commission arrangements were not theoretically or practically a perfect method of Advisor remuneration, but like many issues, the debate about Grandfathered Revenue is a distraction from the systemic issues that exist with respect to unprofessional financial advice, poor product design and vertically integrated firms.

As part of the Future of Financial Advice Reforms extensive consideration and debate took place on the subject of the remuneration of advisors and in particular, the payment of commissions rebates and other commission based remuneration.

Ultimately, the decision of the Parliament was to preserve Grandfather Revenue. In so far as the decision to preserve Grandfathered Commissions is explained, it is explained on the following basis in the Second Reading Speech of the Future of Financial Advice Bill (2013):

> *the proposal to ban particular remuneration structures can only operate prospectively, due to constitutional restrictions concerning acquisition of property.*

The decision to preserve Grandfathered Revenue may also partially reflect the fact that typically, Grandfathered Revenue is not paid at the expense of advice clients, but, instead, are paid as an expense by large financial institutions. Grandfather Revenue forms part of the management expenses associated with particular products rather than a drag on the return to the consumer.

[1] Including, most problematically, in relation to the payment of commissions in relation to property investment by SMSFs to trustees.

If financial institutions failed to pay amounts due with respect to Grandfather Commissions, then they could be sued for that debt by the Advisor. Similarly, some financial advisors rebate some or all of their commission payment (whether Grandfathered Revenue or otherwise) to their clients.

While the circumstances of individual Advisors obviously vary, many independent financial planning practices rely to some extent on the payment of Grandfathered Revenue to continue the operation of their practice. Further, many Advisors have acquired practices on the basis that there would not be changes to Grandfathered Revenue following the FOFA debate.

So, in summary, Grandfathered Revenue is a lawfully obtained, contractually agreed method of the remuneration of financial planners with respect to advice given before 1 July 2013. Many Advisors legitimately rely to some extent on those payments. If the payment of Grandfather Revenue is abolished it will produce a windfall gain for some parties at the expense of Advisors. The parties who obtain the windfall gain are the parties who designed and implemented products that feature now outlawed forms of remuneration.

The Unsatisfactory nature of the proposed amendments

The Exposure Draft is unsatisfactory in so far as it:

1. is retrospective in its effect and the Association notes that such legislation is, as a matter of policy, only appropriate in particular circumstances which do not apply in this case;

2. relies for its operative effect on removing savings and transitional provisions from the existing legislation and is unsatisfactory as a matter of legal drafting;

3. contemplates an unconstitutional acquisition of property on other than just terms and should, in order to be lawful, contain a provision to the effect that:

    Compensation for acquisition of property

    (1) If the operation of this Act would result in an acquisition of property from a person otherwise than on just terms, the Commonwealth is liable to pay a reasonable amount of compensation to the person.

    (2) If the Commonwealth and the person do not agree on the amount of the compensation, the person may institute proceedings in a court of competent jurisdiction for the recovery from the Commonwealth of such reasonable amount of compensation as the court determines.

(3) In this section: acquisition of property has the same meaning as in paragraph 51(xxxi) of the Constitution. Just terms has the same meaning as in paragraph 51(xxxi) of the Constitution.

4. does not provide any certainty to advice customers in receipt of fee rebates as to the nature of those arrangements and confines them to matters of regulation;

5. inconsistently provides that the Commonwealth intends to end any obligation to pay grandfathered commissions but then creates a civil penalty which seems, in the circumstances, unnecessary; and

6. does not rationally address the issues of allocation of loss identified above.

Recommendations

Despite the 2013 FOFA legislation, the Australian Financial Services industry still has severe conflicts and fundamental legal/regulatory flaws that has and will continue to threaten the security of consumers savings unless it is comprehensively addressed[2].

Our recommendation is to address all three issues of Grandfather Revenue, Institutional vertical integration and SMSF/direct property simultaneously where –

1. Institutions must compensate each Adviser for their Grandfather Revenue.

2. Institutional vertical integration models can no longer cross subsidise their advisers and the adviser investment recommendations to clients are closely analysed by third parties with best interests scrutiny in mind.

3. SMSF Advisers can no longer offer direct property to clients and the advisers financial affairs are subject to regular audits to detect 'banned' property developer commission payments.

If item 1 does not eventuate then the Grandfather Revenue must be given back to the consumer in the form of a mandated increase in return equal to the saving achieved by the institution having obtained immunity from any claim for the payment of Grandfathered Revenue

[2] The Association notes the recent Doctoral Thesis by Dr David Millhouse "Systemic and Cyclical Failure in the Australian Financial Services and Financial Products Sector: Have Weaknesses in the Law Contributed to these Failures" identifies a lack of political will to address the underlying cause of poor consumer outcomes arising by reason of inconsistent or unprincipled regulation.

If the above is not feasible [and we cannot see why not], then the compensation regime for rebated fees should be spelt out in legislation and not subject to a complicated discretionary regime set out in regulations.

We thank you for the opportunity to respond.