Ending Grandfathered Conflicted Remuneration for Financial Advisers

Draft Regulations

Submission to Treasury 13/5/19

Contents

1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2. Response to Draft Bill & Regulations

2.1. Policy Positions

Redirecting grandfathered conflicted remuneration

We recently made a submission to Treasury in response to its consultation regarding the draft Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Bill (**Draft Bill**).

The submission re-stated our position as follows:

> *"The FSC supports:*
>
> - *the ceasing of the grandfathering of conflicted remuneration payments (apart from payments made under the LIF grandfathering regime[1]) and, so far as is possible and practicable, issuers redirecting these payments to consumers; and*
> - *the ceasing of the grandfathering of volume-based shelf space fees,*
>
> *via legislated change.*
>
> *We support the cessation of these payments as soon as practicable (to enable implementation). We recommend that there be consultation on this aspect.*
>
> *The FSC would like to reinforce that it strongly supports the LIF Reforms and reiterates its comments in this regard in its submission in relation to the Round 6 Insurance Hearings, responding to policy question number 8."*
>
> (***FSC's Position***)

We understand from the Government's announcement on 4 February 2019[2], the Draft Bill and discussions with Treasury that the Government's position is as follows:

- grandfathering of conflicted remuneration to end, effective from 1 January 2021; and
- the benefits of removing grandfathering to flow to clients where financial services providers have obligations under contracts to continue to provide any previously grandfathered conflicted remuneration.

We seek clarification from Treasury on whether it is the Government's view that where financial services providers end such contracts before 1 January 2021, sections 963M and N of the Draft Bill would not apply, that is, they would not be obliged to pass through benefits to clients.

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[1] "LIF grandfathering regime" is a reference to the grandfathering regime that was introduced by the *Corporations*
Amendment (Life Insurance Remuneration Arrangements) Act 2017 (Cth) and the *Corporations Amendment (Life Insurance Regulation Arrangements) Regulations (2017)* (Cth).

[2] See: https://treasury.gov.au/publication/p2019-fsrc-final-report

We note that whilst this appears to be the practical outcome of the way the Draft Bill and Regulations have been drafted, it is inconsistent with the Treasurer's Direction to ASIC on 21 February 2019 which asked ASIC to commence investigating the extent to which organisations are ceasing grandfathered payments and passing benefits onto customers from 1 July 2019. Any clarity you can give on this point would be appreciated.

Redirecting Volume Based Shelf-Space Fees

We consider that the obligation to pass the benefit of grandfathered payments to clients expressed in the Draft Bill and Regulations should be extended to Volume Based Shelf Space fees so that the benefit of the cessation of grandfathering is somehow passed on to clients.

We consider this issue needs further consideration and consultation, and would be happy to open a dialogue with Treasury on this issue.

Entity responsible for the pass through

As indicated in our submission on the Draft Bill, we consider that the Product Manufacturer[3] generally is better placed to pass the benefit to the client in the majority of circumstances.

The position is appropriate for clients who hold a direct interest in the financial product. In these circumstances, the Product Manufacturer will generally have the information in relation to the client and the client's investment to facilitate the passing of the conflicted remuneration directly to clients, that is the legal and beneficial ownership details will coincide. This information may include the name of the client, their contact details, bank account details, and the amount they have invested (**Client Payment Information**).

However, in circumstances where a client holds an indirect investment in a product through an investment platform or another form of omnibus account, the Product Manufacturer may not have the necessary Client Payment Information (including names of clients) to make payments to the clients directly, as legal and beneficial ownership will not coincide. In addition, the Product Manufacturer is highly unlikely to have sufficient information:

a) to determine if a payment can be attributed to a particular client; and
b) where the payment cannot be attributed to a particular client, to consider the factors referred to in draft Regulation 7.7A.15AM(4) to determine if the amount is "just and equitable in the circumstances" (**Regulation Information**).

In the case of indirect investments, Product Manufacturers such as fund managers would not have access to the Client Payment Information and Regulation Information. Such information is generally held by financial advisers and/or investment platforms. Imposing

[3] For clarity, we define "Product Manufacturer" as those financial service providers who manufacture products designed for retail clients. This definition includes life insurers, fund managers, superannuation funds and investment managers.

such an obligation on a fund manager in the absence of such information would be highly inefficient and is unlikely to result in the best outcome for clients.

Product manufacturers who do not hold the necessary information to facilitate the pass through due to the nature of the retail client's investment being indirect should be obliged to make the payment to the entity with whom they have the contractual arrangement to make the payment (referred to here as '**Intermediary'**). This Intermediary will generally be a trustee or custodian who holds the omnibus investment on behalf of the underlying customer, such as a superannuation fund provider, an advice dealer group or a platform operator. The Intermediary should then be responsible for passing on the benefit to underlying clients.

We consider that the Explanatory Memorandum to the Draft Bill (**EM**) should include additional wording so that it is clear under the Draft Bill that:

- Product Manufacturers generally will be responsible for rebating clients; and
- where the client holds an indirect investment, to satisfy rebating obligations, the Product Manufacturer can pay the Intermediary; and the Intermediary would then be responsible for paying the client. In this instance, the Product Manufacturer's liability would end upon making payment to the Intermediary.

Flexibility regarding rebating

As indicated in our previous submission, we believe that Product Manufacturers should be given flexibility as to the manner in which they pass the benefit back to the customer whether or not the grandfathered payment could be attributed to particular clients. Such flexibility would be able to accommodate atypical or complex product arrangements, and also allow the Product Manufacturer the opportunity to deliver optimal client solutions. For example, whilst there may be some instances where a cash rebate is appropriate, there may be other instances where a reduction in the product fee or a lower insurance premium may be more advantageous to the client. We are therefore of the view that it should not be the case that where conflicted remuneration can be attributed to a particular client that only a rebate by way of payment to a client be acceptable (Regulation 7.7A.15AL). In these circumstances, we think it may also be appropriate to pass the benefit through to the client in other ways (such as those referred to above).

Please also see our specific comments on Regulations 7.7A.15AK, 7.7A.15AL and 7.7A.15AM in the table on pages 10 and 11 in relation to our request that flexibility in rebating be afforded under the Draft Regulations.

We submit that Product Manufacturers should be able to choose how best to pass on the grandfathered payment to retail clients. This should include:

a. The ability to transfer the retail client from a pre-Future of Financial Advice reforms (**FOFA**) product to a post-FOFA product of equivalent or better quality and services. Please see our comments under the section headed *Limited Product Rationalisation* in this submission;

b. A fee reduction across the whole product class that is calculated for example as total grandfathered payments made over total Funds under Management (**FUM**) which are referable to the grandfathered payments. This would mean that the Product Manufacturer would return the benefit of volume-based payments to all clients invested in the relevant platform, not merely clients in respect of whom grandfathered conflicted payments were made; and

c. The Product Manufacturer (or the Advice Licensee or Intermediary, whichever is appropriate) issuing a rebate to the client. This would only be possible for payments that can be attributable to particular clients.

Of course, Product Manufacturers need to keep consumers' interests at top of mind when making decisions regarding which is the best way to pass through the benefit of ceasing grandfathered payments to clients.

Asset-based fees on borrowed amounts

We reiterate the policy position contained in our previous submission regarding ceasing grandfathering on the ban on asset- based fees on borrowed amounts. We do not agree that the current grandfathering arrangements relating to this ban should be removed for the following reasons:

- the mischief which the ban was designed to address is no longer at issue. That is, there is no longer an inducement for advisers to increase the size of a client's borrowing in order to increase their fees; and
- Product Manufacturer and Advice Licensees often do not know whether or not a client has used borrowed amounts to acquire a financial product. It would be even more difficult to determine this for products a customer purchased before 1 July 2013.

In our discussions with Treasury, concern was expressed that, by continuing with the grandfathering on this ban, advisers have an incentive to advise clients to stay in products in relation to which advisers are receiving a fee referable to a borrowed amount. However, the same argument could be used for any asset-based fee. In its Interim Report, the RC asked the following question:

> *"Should any part of the remuneration of financial advisers be dependent on the value or volume of sales?"*

Following submissions received on this and other questions, the RC decided not to recommend a ban on asset-based fees. In light of the above, we therefore submit that the Government does not need to cease the grandfathering relating to this ban as no, or negligible consumer benefit would result.

Limited Product Rationalisation

We reiterate our position that this is an opportune time for the Government to develop a product rationalisation regime to allow Product Manufacturers to transfer clients out of legacy products which can be outdated and more expensive and into more contemporary, noncommission paying products. Product Manufacturers should be able to respond to the ending of grandfathering by moving their customers to newer and more contemporary products so long as the transfer is in the customers' best interests (collectively). However, we believe that many customers will remain in legacy products because there are significant barriers to product rationalisation, such as disadvantageous tax, superannuation and/or social security implications of the product transfer for the customer.

If a full product rationalisation regime is not attractive to the Government at this juncture, a targeted mechanism could be established to facilitate the transfer of clients away from older products (paying commissions) to products that do not have grandfathered commissions attached. The newer product would have to provide customer benefits in terms of service and product features commensurate with the older product. The mechanism would only be available to products that were, before the Draft Bill is passed, subject to grandfathered conflicted remuneration. It would allow the Product Manufacturer to move the client to a similar, newer product of equivalent (or better) value. In that regard, the Product Manufacturer would be choosing to pass the benefit of the cessation of grandfathered payments to the clients by utilising option (a) under that part of this submission headed *Flexibility regarding rebating*. In moving the client to the newer product, the tax relief described below would be needed. In addition, relief for Product Manufacturers in relation to regulatory obligations in terms of transferring the client to a newer product would also be necessary, allowing Product Manufacturers to apply a consumer interest test at the collective level to enable the maximum number of consumers to benefit.

Tax consequences

The customer's receipt of the formerly grandfathered conflicted payments in the form of a benefit can raise issues for tax and superannuation regulations. In particular, if the benefit is provided to a superannuation account, we consider this benefit should not be treated as a superannuation contribution, otherwise detriment to the customer is likely (in some cases, significant detriment). If there is any risk that these benefits could be treated as superannuation contributions, we urge the Government to include, as part of this package, appropriate legislative changes to prevent this outcome. We encourage Treasury to engage with the ATO on this issue to provide early guidance to superannuation funds and other financial service firms.

There are also potential GST issues for Advice Licensees and Product Manufacturers in relation to accounting for GST on redirected commission. There are also questions about whether Reduced Input Tax Credits (**RITC**) can be claimed (particularly under Item 25 or 27 of subsection 70-5.02 of the GST regulations) in relation to:

- any permitted alternative payment arrangements that might replace current conflicted arrangements;
- buy-out of future commission arrangements; and
- conflicted remuneration amounts redirected to retail customers.

We would be happy to discuss this issue with Treasury further.

Member Equity Issues

Another area of consideration in relation to passing through these benefits is the operation of a managed investment scheme, and the Responsible Entities' (**RE**) obligation to treat all members of the same class equally and members of different classes fairly (Corporations Act s601FC(1)(d)). One example of our concerns is where two unit holders hold the same class of units and pay the same product fees, but, because of the rebate of variable grandfathered conflicted remuneration arrangements, these unit holders are put in different positions (for example one unitholder receives a rebate of 5 basis points into their investment, while the other unitholder receives a rebate of 10 basis points).

Another example where this could occur is if a cohort of clients receives a benefit as a result of the change to the law but all clients who hold the product do not (as conflicted remuneration is only paid in respect to the investments of some clients). In these circumstances, we consider that the trustee or RE may be in danger of breaching the Corporations Act.

Our members would prefer to treat members of the same class equitably and seek clarity on how the Draft Bill and Regulations would impact their obligations.

2.2. Detailed Suggested Amendments to the Draft Regulations

We deal with the specific changes we seek to the draft Regulations below.

Reference	Issue	Suggested Solution
7.7A.15J	We would appreciate clarity as to whether Section 963N of the Draft Bill and Regulation 7.7A.15J captures grandfathered volume-based payments where retail client advice has previously been provided but there is no direct nexus to retail client advice with the current recipient of the payment (for example fixed platform fees and grandfathered payments in relation to on-sold commission client books).	Please clarify whether or not the draft Regulation covers situations where there is no direct nexus to the retail client advice and the recipient of the payment.
7.7A.15AK 7.7A.15AL 7.7A.15AM	We note the division in these Regulations such that: a) where the conflicted payments can be attributed to particular clients, the pass through of the benefit must be paid via a cash rebate (see Explanatory Materials (**EM**), page 1) within 10 days of the obligation to pay under the contractual arrangement; and b) where the conflicted payments cannot be attributed to particular clients, the pass through can be made via another monetary benefit, such as an adjustment to a product-based fee (see EM, page 4) within one year of the obligation to pay under the contractual arrangement. Under a) above, some financial service customers will receive multiple small refund payments for the duration of their product holding (which could be a period of years). In some circumstances, we do not believe this is optimal for either the	The obligation to pass through the benefit to clients can be satisfied for both (a) and (b) types of payments by providing another monetary benefit (such as a fee adjustment) to all clients in the affected client group. We reiterate our comments under *Flexibility regarding rebating* in this submission.

	customer or the Product Manufacturer. For example, customers may have difficulty in determining their net annual fees due to the receipt of numerous small rebates. Further, we question why the EM specifically refers to the pass through of the benefit being given to clients as a "cash" rebate. We therefore consider it a more efficient and customer centric approach if the obligation to pass through the benefit could be satisfied for both (a) and (b) types of payments referred to above by providing another monetary benefit (such as a fee adjustment) to all clients in the affected client group.	
7.7A.15AM	We make the following comments in relation to this Regulation: • It is not entirely clear whether the concept of "*each of the clients*" is sufficiently broad to allow the Advice Licensee or Product Manufacturer to comply by, for example, reducing fees for all of the clients invested in the particular product, or whether the Advice Licensee or Product Manufacturer needs to consider each client cohort that has invested in the product separately to determine whether the fee adjustment is "just and equitable" for each client cohort. As noted above, if it is to be for a particular cohort of clients, there may be member equity issues that need to be considered under Chapter 5C of the Corporations Act; and • the Draft Regulations recognise that an amount must be paid to the client that is "just and equitable in the circumstances" (Regulation 7.7A.15AM (3)), and lists the circumstances that a provider must take into account in determining what is "just and equitable". We believe, for the purposes of determining such an amount, the structure/nature of the financial instrument/s to which the conflicted remuneration is referable should be considered.	Please clarify whether or not the provider can make a determination for all of the clients invested in the product without considering particular cohorts of clients. The provider should be able to allocate the benefit (such as fees adjustments) in a fair and reasonable manner as between clients of a product. Amend Regulation 7.7A.15AM(4) so that it includes the structure/ nature of the financial instrument/s under which the conflicted remuneration is referable.

Rebate to clients – annuities S963N	The concept of rebating clients creates issues particular to annuity and pension providers. This is because SIS Regulations 1.05(11A) (b)(ii)(E) and 1.06(9A) (b)(ii)(D) prohibit providers from changing the amount of an annuity or pension payment from year to year unless the change is as a result of an indexation arrangement or the transfer of the annuity or pension to another person.	We note that the Draft Regulations do not deal with issues particular to clients who have invested in annuities or pensions. The power to make Regulations under the Draft Bill is broad. We reiterate that changes to the SIS Regulations are necessary.
Rebate to clients - superannuation products	We question how payments are made with respect to superannuation products where those products are in payment phase such as annuities and pension products. By virtue of superannuation laws, these product types usually have restrictions on amounts that can be contributed in payment phase. If the payment is instead intended to be paid directly to the member, we question whether the member must satisfy a condition of release prior to the benefit being passed through.	We note that the Draft Regulations do not deal with this issue. We consider that changes to the Draft Regulations are necessary.
Non-monetary benefits S963N	While we support the cessation of grandfathering of non-monetary benefits, we consider that, in many instances it would simply not be feasible to pass through a non-monetary benefit to a client.	We note that the Draft Regulations do not deal with this issue. We reiterate that changes to the Draft Regulations are necessary.