ASSOCIATION OF FINANCIAL ADVISERS LTD

Tranche 2

Proposed FOFA Reforms

Submission to Treasury

19 October, 2011

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Mr Richard Sandlant
General Manger, Retail Investor Division
C-/ The Future of Financial Advice
The Treasury
Langton Crescent
PARKES ACT 2600

Email: futureofadvice@treasury.gov.au

Dear Richard,

Exposure Draft – Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011

The Association Of Financial Advisers Limited ("AFA") is a professional organisation that has been serving the financial advising industry for over 60 years. Its aim is to provide members with a robust united voice, continually improve practices and focus firmly on the exciting, dynamic future of the financial advising industry.

With six decades of success behind it, the AFA's ongoing relevance is due to its philosophy of being an association of advisers run by advisers. This means advisers set the agenda, decide which issues to tackle and shape the organisation's strategic plan.

The AFA thanks Treasury for the opportunity to provide comments on the Exposure Draft – Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 ("Tranche 2 Bill").

The AFA supports the Government's objective to see more Australians access financial advice, which is in keeping with the policy intent of the Future of Financial Advice Reforms.

This submission has been prepared by the AFA on behalf of its members and in response to the Tranche 2 Bill. This submission provides comments and recommendations on the following:

1. a ban on conflicted remuneration (including product commissions), where licensees or their representatives provide financial product advice to retail clients;
2. a ban on benefits from financial product issuers;
3. a ban on volume-based shelf-space fees from asset managers or product issuers to platform operators; and
4. a ban on asset-based fees on geared funds.

Our submission aims to provide you with an overview of what we consider to be the main issues concerning our members, contained within the Tranche 2 Bill.

Should you have any questions, please do not hesitate to contact me on either (02) 9267 4003 or 0412 127 834.

Yours sincerely

Richard Klipin

Chief Executive Officer
Association of Financial Advisers Ltd

Prohibition on Conflicted Remuneration

We note that, in its present form, the drafting of the proposed legislation does not limit the ambit of the ban on conflicted remuneration to personal advice situations, but may be interpreted to apply to other financial services and RSE licensees and their representatives. Further, in not limiting the ban to situations where personal advice is provided, this ban would apply to a product issuer receiving management fees in situations where the product issuer provides general product advice relating to their product.

It is the view of the AFA that the prohibition on conflicted remuneration should be limited to situations in which personal financial advice is provided to retail clients, in line with the intent of FoFA Tranche 1.

Further, we note that announcements made by the government prior to the release of the proposed legislation, referred to a 'prospective ban' on conflicted remuneration. In Minister Shorten's media release of 29 August 2011 he specifically stated "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." That media release also specifically referred to grandfathering of volume payments. Despite these commitments, there is no mention of any grandfathering arrangements in the draft Tranche 2 bill.

The AFA is extremely concerned and considers it inappropriate to provide a draft bill, which does not incorporate, conflicted remuneration grandfathering provisions.

Further, the 29 August 2011 media release clearly stated, that the ban on commissions for group life insurance and life insurance in a default superannuation product, would only apply from 1 July 2013. This start date is not reflected in the Tranche 2 draft legislation.

The AFA opposes the ban on commissions for group life insurance and life insurance in a default superannuation product. The AFA recommends that commissions be permissible in all cases where advice is provided.

Proposed Section 963A

Group Risk and Default Superannuation Funds

We note that certain benefits are exempted and in particular benefits related to either life insurance, which is not bundled with a superannuation product, or individual life policies, which are not connected with a default superannuation fund.

We suggest further clarification should be provided around the intent and ambit of the application of the proposed reforms to Group Risk Schemes and Default Superannuation Funds.

We refer to the PCG discussion forums held on 7 October 2011, where the definition of Group Risk schemes was raised and it was clarified that it will be capturing the scenario where an adviser provides insurance advice to a client that holds a group risk policy. Therefore, commissions will be prohibited on group risk inside super and on a life insurance policy, which is for the benefit of members of a default superannuation fund.

However, we understand the proposed intention of the reforms is to target the situation when an adviser is getting commission from all members of a group scheme and did not provide individual advice to each member. Thus the AFA seeks clarification on the application to Group Risk and the definition of a Group Life Policy.

This appears to be an anomaly in light of the above intention, which creates an outcome beyond what was originally contemplated.

With respect to a life policy for a member of a default superannuation fund, we seek guidance on the situation where a member does (either initially or subsequently) actively make selections of product features (investment option or insurance level) within a company's default superannuation arrangement. What actions does a member need to take for their arrangement to no longer be classified as a default fund? What are the implications for calculating commission on a particular fund where the ban on commissions is applicable for some members, but not for other members?

Proposed Section 963A(1)(c)

Monetary benefit given in certain circumstances not conflicted remuneration

We note that this proposed provision provides a specific exemption from the prohibition of conflicted remuneration principles in execution only advice situations and where financial advice is provided to wholesale clients. We note that this exemption attempts to carve out the situation in which remuneration is received by an adviser where a client decides to invest in a financial product and that decision is made without the benefit of financial advice.

We further note that this provision does not carve out the provision of general advice.

Proposed Section 963B

Professional Development Exemption

We note that the explanatory statement, released with the draft bill, provides guidance as to the proposed additional requirements in relation to professional development. However, we consider that there remains a lack of clarity in certain respects. In particular, based on the information currently available, it is not clear if an employer/AFS Licensee can pay for overseas conferences for its employees/ representatives.

If the intention is to stop third party providers funding overseas conferences as a reward for sales and generating "funds under management", we question the effect that the proposed provisions will have on an employer/AFS Licensee who wishes to conduct offshore conferences.

This issue is especially relevant given the current strength of the Australian dollar and the potential cost effectiveness of overseas venues. Should an employer or AFS Licensee wish to conduct an overseas conference, under the proposed legislation, this may be deemed a "pay off", when in reality it may be cost effective to run training and personal development offshore. We also note that the lead time for organising conferences can be up to 2 years, and thus there will be existing bookings that will potentially be impacted by this proposed legislation/regulations. Thus in order to avoid unnecessary wasted cost for events already booked, we recommend that a 2 year transition period apply.

We request that in considering this issue for inclusion in the regulations, that clarity be provided with respect to licensee conferences for their own representatives/authorised representatives. Further, in the context of cost advantages and venue availability, we recommend that the domestic requirement, as suggested within the explanatory memorandum, be reconsidered.

Proposed Section 963C

Certain benefits given by an employer to an employee not conflicted remuneration

Whilst acknowledging that volume based incentives can run contrary to the objective of providing quality, prudent and objective financial advice, the AFA has concerns as to the breadth of the prohibitions as they currently stand.

As presently drafted and read in conjunction with the explanatory memorandum, the proposals provide that basic banking products are the only contemplated category upon which volume benefits can be paid. It is submitted that this category is too narrow and should be expanded to encompass other products.

In particular, there is a concern about bonus pool arrangements and the ability for all staff to access bonuses from this pool. The limitation on banking products does not give sufficient scope for a licensee to structure incentives to reward performance of an adviser and associated employees in the advice provision chain.

We also have an issue with the proposed view that a recommendation of a basic product in conjunction with another financial product will trigger the conflicted remuneration provisions.

Further we note that there are transition issues that need to be addressed. For example, situations where employee actions prior to 1 July 2012 give rise to bonus payments that would not normally be paid until after 1 July 2012, need to be addressed. The AFA is concerned that there will be significant implications for employment contracts, which will be very time consuming to resolve, when management focus should be directed elsewhere. This is a clear case where an extended transition timeframe should be allowed.

We understand that the elimination of the provision of all incentives to reward appropriate effort and diligence in the provision of advice is not the intent of the proposed legislation and submit that the proposed provisions be revised in light of this.

Proposed Section 963E

Licensee must ensure compliance

Under the proposed provisions of Section 963E there is insufficient clarity on the definition of “reasonable” and it is submitted that the reasonableness concept be attributable to a specific and nominated individual within the relevant organisation.

Given the necessity to reinforce the regulatory principles, and having regard to the manner in which AFS Licensees and representatives operate, it is expected that the AFS Licensee develop, maintain and enforce an appropriate compliance policy and undertake periodic auditing of adherence, in order to comply with this requirement.

Proposed Section 964

Product issuer must not give monetary or non-monetary benefit to financial services licensee or representative

We note that the proposed section 964 imposes a blanket prohibition on product issuers from providing any form of monetary or non-monetary remuneration to AFS Licensees or representatives.

We query the use and intended definition of 'seller' and 'issuer' for the purposes of the operation of the provision.

Based on the provision, as submitted, we consider it to be focused on the seller of the product as opposed to the marketing of the product and seek clarification as to its definition and application.

The AFA is concerned that there has been a lack of research on the likely impact of a ban on volume bonus payments on the advice industry, particularly with respect to non-aligned licensees. It is likely that this will have a significant impact. In the absence of any coverage of grandfathering provisions, this is very concerning.

The AFA proposes that an additional specific exemption category be created to encompass the provision of technical support and software provided by a third party (ie. fund manager/product provider). Technical support includes the provision of information on the application of tax or Centrelink benefits.

This support underpins the quality of advice provided to existing or prospective clients and ultimately is for the benefit of the industry on a broader level.

Further, we note that 964(2)(a) provides that where the benefit is a fee-for-service and the fee 'reasonably represents market value', the ban in section 964 will not apply to this benefit. In this regard we note that further guidance is required in order to determine the grounds on which reasonable market value may be determined. In addition we would request that 'property' as utilised in section 964(2)(b) be defined.

Having regard to the balance of the proposed legislation, we note that soft-dollar benefits under $300 are not deemed conflicted remuneration in section 963B, however section 964 does not allow for the provision of such soft-dollar benefits. We recommend that section 964 be revised in order to specifically allow for the provision of soft-dollar benefits under $300. We also note that section 964A allows for the payment of non-monetary benefits for life insurance, which is not permitted under section 963B.

Additionally, we request that this section be revised to include payments made from a product issuer for the replacement or establishment of necessary hardware to facilitate business systems.

We recommend that section 964 be reviewed with reference to section 963B, for consistency.

Proposed Section 964A

Volume based shelf space fees

The AFA does not see the need for this subdivision as it is unrelated to the advice provided to the retail client, and thus should not be a core focus of FoFA.

The provisions, as currently drafted, do not appear to factor in the actual function of the various participants within the industry. Platform operators could arguably include a research house that is a conduit of information to the ultimate platform provider. As the provisions currently stand, these research houses would be captured under the provisions.

Accordingly, it is recommended that greater clarity and appropriate definitions, be provided that take into account the specific function and operational activity of the various participants as opposed to simply naming them.

We recommend that clarity be provided as to the intent of the proposed provision with regard to:

1. the use of the term 'dependent on the total number or value of the fund manager's financial products' to ensure that only volume related shelf-space fees should be targeted and banned and not flat dollar.
2. the definition of determining efficiencies and being a 'reasonable value' when it will have many factors that the receiver will not be aware of.

Subdivision C

Ban on asset-based fees on geared funds

We note that the proposed legislation aims to prevent advisers from charging fees on the gross value of a client's portfolio. However, we would recommend that consideration be given to including further clarification on the application, such as the provision of specific examples encompassing structured products (i.e. internally geared funds and protected loan products) and installment warrants.

The source of funds for investment is often not clear, particularly when various sources of funds have been mingled over a period of time. This will make it very difficult for advisers to be certain as to the implications for charging fees.

We seek clarity with regard to the point in time that this obligation falls on the adviser. Does this obligation apply at the time of the provision of the advice, or on an ongoing basis?

Further, we note that a financial adviser may be providing a retail client with on-going advice and that over time the structure and form of the clients investments may change, with or without the adviser's knowledge. We request that clarity be provided to address situations in which an adviser is providing on-going or further financial advice to a client and discovers that due to market movements or client actions post the initial advice, the arrangement is no longer compliant. What action is the adviser required to take in this case?

Also, the AFA seeks confirmation that grandfathering will be applied to existing geared funds and the associated asset based fees.

The AFA is concerned that the application of the ban on asset based fess for borrowed funds will become extremely complex to manage and monitor.

Proposed Section 965

Anti-Avoidance

Subject to the points raised above we do not oppose the intent of Section 965 as proposed.