21 October 2011

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By email: futureofadvice@treasury.gov.au

Dear Ms Vroombout

Submission to Exposure Draft – Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 and Explanatory Memorandum

Thank you for the opportunity to comment on the exposure draft of the *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* (the exposure draft) and the accompanying explanatory memorandum (the EM).

Please contact me on 02 9776 7997 or tlyons@afma.com.au if you would like to discuss any aspect of this submission.

Yours sincerely

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1. Need for a Transition Period

Before making any detailed comments about the exposure draft and EM, AFMA wishes to highlight the difficulties that will be faced by its members in implementing the future of financial advice (FOFA) reforms based on the current timetable.

The first tranche (Tranche 1) of the draft legislation was released on 29th August 2011 with a very short consultation period of 14 business days not including the day it was released. AFMA's observations, and that of its members and other sectors of the industry, is that the first tranche included a number of unexpected and unanticipated provisions (the best interests duty being a case in point), which is an unfortunate result given the extended period of discussions that have occurred about the reforms. Ideally, there would have been no surprises for industry at this stage of the process.

As you are aware, AFMA and other representatives of the stockbroking industry made significant efforts in the lead-up to the release of Tranche 1 to ensure that stockbroking and capital raising activities, which were not the focus of the Parliamentary Joint Committee (PJC) inquiry or the reforms announced by the Government, would not be captured by the legislation. While AFMA very much appreciates the Minister's confirmation that broking and capital raising activities will not be unduly impacted by the reforms, it is generally held within industry that the FOFA reforms have gone well beyond the focus of the PJC inquiry and now capture most forms of financial services business models and remuneration structures if they touch retail investors, even where there is no prospect or only a very remote prospect of a retail investor receiving conflicted advice. This fundamental underlying principle of the reforms – to prevent a retail investor from receiving conflicted advice that is motivated by inappropriate incentives – has been lost sight of. Appropriate incentive structures can and do promote productivity and innovation and are common in many types of industries. It cannot be assumed that all forms of incentive structures results in negative outcomes for retail investors in all cases. However, the proposed reforms have the effect of eliminating many of the existing incentive structures in financial services even if they are not problematic and have not been shown to produce bad outcomes for investors.

The second tranche (Tranche 2) of the legislation was released on 28th September 2011, again with a very short consultation period of 14 business days not including the day it was released. From the perspective of AFMA members, there are critical provisions not contained in either Tranche 1 or Tranche 2 – not the least of which are the grandfathering provisions, and the arrangements to ensure that broking and capital raising activities are *clearly and unambiguously* excluded from the application of the legislation.

At the Peak Consultation Group meeting on 7th October, Treasury officers indicated that these matters will be dealt with by regulation, but it is unlikely that draft regulations will

be available for public consultation before the end of this year. AFMA would appreciate early involvement in the formulation of those regulations, and before the public consultation period if possible.

Many AFMA members operate complex, sophisticated and integrated businesses. In the absence of a complete package of reforms, including all of the legislation and all of the necessary regulations, it is extremely difficult for our members to understand how the reforms will affect the totality of their business, let alone commence to make all the changes to systems, client documentation and agreements, training and compliance programs, employment and other HR arrangements that will be needed to ensure they will be FOFA compliant.

The FOFA reforms are at least as significant as those introduced by the *Financial Services Reform Act 2001*. Those reforms commenced on 10th March 2002 and included a two year transition period, ending on 10th March 2004. We are concerned that the final FOFA legislation will not likely be passed through Parliament until towards the end of the first quarter of 2012, with many obligations due to commence from 1st July 2012. This means that the financial services industry will have only around 3 to 6 months (depending on date of passage) to comply with the new legislative obligations. However, the systems, processes and procedural changes required to implement the reforms will be significant, comprehensive and impose costs on financial service providers. It is unrealistic to expect organisations to be in a position to be FOFA compliant on 1st July 2012.

It is also important to recognise that the FOFA reforms are being introduced at or around the same time as a number of other significant financial services regulatory changes, including the Basel III reforms, G-20 reforms for financial services and markets regulation, the Personal Property Securities Act, stronger superannuation reforms, consumer credit reforms, banking competition reforms, insurance capital regime changes, tax agent services reforms, the US Foreign Account Tax Compliance Act (FATCA), and ongoing AML/CTF requirements.

Recommendation 1

AFMA believes that given the significance of the FOFA reforms and their wide ranging impact on the financial services sector, a transition period of at least 12 months (from the date of commencement) should be provided.

Additionally, in the absence of amendments to ensure the salary packages and performance payment systems of employees of banks and financial service providers are not adversely impacted, it will be necessary for grandfathering provisions to be introduced so that employment arrangements and contractual agreements can be adjusted in an orderly and legal manner.

2. Exemption and Modification Power for ASIC

In addition to the transition period proposed above and in light of concerns about the scope of Tranche 2 below, AFMA believes that the reforms should incorporate an exemption and modification power for ASIC, so that any unintended consequences of the new legislation may be considered and dealt with in an efficient and timely way. The inclusion of an exemption and modification power will create flexibility for ASIC in the way it administers the reforms. It will also allow financial services industry participants to seek relief in circumstances where the reforms have an unintended or unanticipated application, are overly burdensome, or have a technical application to certain activities or products that is unnecessary to achieve the policy purpose of the reforms.

Recommendation 2

The exposure draft should be amended to incorporate an exemption and modification power for ASIC.

3. The Scope of FOFA Tranche 2

The current draft legislation is so broadly drafted and so potentially wide in scope that our members already see unintended consequences for their businesses, regulatory uncertainty and complexity, scope creep from the original PJC inquiry recommendations, and the prospect of significant cost and administrative burdens to industry. This results in a high level of uncertainty for business and makes it very difficult to start planning for, and dedicating resources to, implementation.

The current draft legislation lacks clarity in that it is not clear what it is (and is not) attempting to regulate, and it is not clear what activities and products are in scope and which are not. Instead, the draft legislation takes a high level “all in” approach, with certain elements to be dealt with under a subsequent “carve out” approach. By adopting such an approach, a long list of carve outs is already emerging. This will ultimately result in a regime that is unwieldy, extremely complex for our members to comply with, and difficult for ASIC to administer.

4. General versus Personal Advice

One of the primary concerns we have with the conflicted remuneration provisions is the fact that they apply to the provision of both general and personal advice. Expanding the scope of FOFA to general advice unnecessarily complicates the implementation and administration of the regime and results in a number of what AFMA believes are unintended consequences.

The inclusion of general advice goes well beyond the original intention behind FOFA – that is, to remove the risk of retail clients receiving conflicted advice that may be inappropriate for them due to the fact that the adviser/financial planner is paid a commission. By definition, general advice does not take into account a person's needs or objectives, so it is not appropriate to apply a conflicted remuneration regime when a recommendation is not being made based on the person's individual circumstances.

Since FOFA was first announced, Ministerial statements have consistently referred to financial advisers and the financial planning industry. This is consistent with the terminology used in the PJC inquiry recommendations. However, the proposed legislative framework will go well beyond the focus of the PJC inquiry.

Recommendation 3

The scope of FOFA should be narrowed back to its original intent, and the definition of conflicted advice should be amended to exclude general advice. We understand that Treasury may be concerned that if only personal advice is captured, then parties providing financial advice will rely on general advice as a business model. With respect, this is an unlikely scenario because the fundamental value proposition of any party that provides personal advice is that they provide advice that is tailored to the needs of their clients. This value proposition is not possible within a framework where only general advice is provided.

5. Section 963H - Employers Paying Employees and 'Conflicted Remuneration' Definitions

There is concern about the potential application of the section that relates to employers paying employees conflicted remuneration under section 963H.

At face value, this section can be interpreted to mean that there can be no sales incentives payable by employers to employees who are involved in business development activities involving sales of financial products to retail clients, where remuneration is linked to numbers of sales or volume (and the employer is a AFSL licensee and employees are representatives of the licensee).

More broadly, this section could be interpreted to mean that even a balanced scorecard approach, whereby non sales staff who work for a licensee which also provides general advice to retail clients (eg product managers, marketing, and many other kinds of staff) with annual revenue targets as even one component of the 'key performance indicators' which determine an annual bonus, would therefore be prohibited under section 963H.

In practice, a bank or other financial service provider can only generate revenue from the sale or offer of financial products, and therefore the payment can only ever be

related to value or number. This would result in no employees, agents, authorised representatives, or others being able to receive a payment.

Appropriate incentive structures can and do promote productivity and innovation and are common in many types of industries. We contend that the provisions under section 963H are also evidence of significant scope creep under FOFA, and that incentivising sales staff is fundamental to robust and legitimate corporate activity.

It seems likely that the scenarios outlined above are unintended consequences of the broad brush nature of the draft legislation, rather than explicit policy intent by Treasury.

6. Section 964 – Benefits from Financial Product Issuers

Our members have a number of serious concerns with respect to draft section 964.

The ban on conflicted remuneration has as its focus the giving of benefits that might influence choice of financial product or the advice given. The ban on benefits from product providers in section 964 is not restricted to conflicted remuneration. The Government has indicated in the EM at paragraph 1.42 that without section 964, a product issuer could make a large payment in kind to a licensee which is not based on volume and for which it might be hard to establish that the payment might conflict with financial product advice.

The approach Treasury has taken in drafting section 964 is to include <u>any</u> monetary or non-monetary benefit given by a product issuer to a financial services licensee or representative unless it is specifically carved out in section 964(2). In our view, this approach will require an extremely long list of carve outs due to the significant flow of funds that legitimately occur within an efficiently operating financial system and that have no possibility of resulting in conflicted advice being provided to the end client. The approach taken of including any benefits and carving out the exceptions is an unworkable approach, as any list will be unable to capture every possible scenario in which a monetary or non-monetary benefit may be paid.

Having considered section 964 in the context of the operations of our members, AFMA believes that the breadth of this section needs to be narrowed by linking the payment back to having the ability to influence the personal advice provided to the end client. While section 964(2)(g) does allow for regulations to be made that could ameliorate the situation, it would be better to attempt to recognise the need for the expanded carve outs in the Act itself.

The four elements of the ban in section 964 as currently drafted are as follows:

i) *any* issuer or seller of a financial product

ii) is banned from giving *any* monetary or non-monetary benefit

iii) to *any* financial services licensee (or representative)

iv) who provides financial product advice to retail clients.

Some key points from these elements are:

- There is no need for any link between the advice and the benefit;
- All that is necessary is that the payer/giver of the monetary or non-monetary benefit is an issuer or seller of a financial product;
- There is no necessary link between the financial product of the issuer/seller and the financial product advice given by the licensee or the retail clients to whom the advice is given;
- As the expression "financial product advice" is not limited in any way, this means the advice could be general advice provided by the licensee. It is not limited to personal advice;
- There is no clarity about the timing or regularity with which the financial product advice is required to be provided by the licensee, in order for the section to be invoked. The assumption therefore has to be that if there has been any occasion when the licensee has provided general advice, then this will satisfy the test; and
- There is no definition of the key expressions "monetary benefit" or "non-monetary benefit" so it is necessary to assume a broad meaning to both expressions. They do not appear to be limited to the commissions and soft dollar benefits that have been the main focus of this tranche of amendments.

A number of carve outs are listed in section 964(2) including:

- the benefit is a fee for service where the fee reasonably represents the market value of the service (s964(2)(a)); and
- the benefit is the purchase price of property and the benefit reasonably represents the market value of property (s964(2)(d)).

Despite these carve outs, there are a significant number of legitimate benefits that may be prohibited under the current drafting of section 964. Just two examples are:

- 'Business to business' arrangements where Contracts for Difference (CFDs) are offered. In this scenario, a broker (Company A), who also provides general advice, may be the issuer of CFDs, with back office services provided by another specialist organisation (Company B). There is a splitting of brokerage, and interest payments between Company B and Company A, which recognises the sharing of services between the two parties. Under a strict interpretation of

section 964(1) and (2) it may be that such arrangements are inadvertently captured; and

- Injections of capital by a parent or related company.

Recommendation 4

Section 964 needs to be reconsidered and redrafted so that it is more aligned to the objectives of FOFA. Rather than prohibiting the movement of funds between financial product issuers or sellers, the section needs to be redrafted so that it has some nexus to the actual definition of *conflicted remuneration* – that is, where a benefit is given to a licensee or their representative in respect of advice provided that might influence the financial product recommended or the financial advice given.

7. Grandfathering and Crystallisation of Volume Payments

The detailed arrangements for grandfathering under the regulations will be essential information for businesses when assessing the impact of FOFA.

The Minister's media release on 29th August 2011 referred (at paragraph 3 on page 5) to grandfathering of future payments to licensees (or their representatives) in respect of investments in a platform accumulated prior to 1st July 2012, and that this will mean that the level of volume payments from platform providers to dealer groups will "crystallise" and should not increase in size after the commencement of the reforms.

We would like to highlight that the ramifications of "crystallisation" at a practical compliance level for product providers are substantial and will require significant system reconfigurations. In addition, so far the reference to crystallisation has only been in the context of "platforms", when there are in fact many other examples of such payments across the financial products spectrum.

Clarity on the details of the regulations that will bring about crystallisation is required as soon as possible.

8. Application of Sections 963 and 964 to Fees Paid in Connection with Capital Market Activities

The EM contains the following comments in relation to fees paid in connection with capital raisings:

> *It is proposed to exclude certain stockbroking activities from being considered conflicted remuneration, allowing persons undertaking these stockbroking activities to receive third party 'commission' payments from companies where those payments relate to capital raising. The precise breadth of the carve-out would be subject to*

> *further consultation, but it is proposed that the receipt of 'stamping fees' from companies for raising capital on those companies' behalf not be considered 'conflicted remuneration' where the broker is advising on and/or selling certain capital-raising products to the extent that they are (or will be) traded on a financial market. It is proposed that the carve-out would apply to any person authorised to undertake the relevant stockbroking activities pursuant to the capital raising carve-out, including both direct and indirect market participants.*

The EM also states:

> *The regulations will also ensure that the traditional remuneration arrangements of employee brokers (often paid as a percentage of brokerage) are not unduly impacted by the conflicted remuneration.*

Notwithstanding these statements in the EM, as they are currently drafted, it appears that sections 963 and/or 964 could prohibit the following types of payments that are commonly made in connection with capital raisings:

- "sub-underwriting" or "firm allocation" fees paid by a lead or joint lead manager to an IPO or placement of securities to licensees (such as co-managers and brokers) which provide financial product advice to retail clients, as consideration for that licensee undertaking to subscribe for, or procure others to subscribe for, an agreed quantity of financial products. These payments would arguably be caught by the draft provisions on the basis that they are either payments which "might otherwise influence the financial product advice given to retail clients by the licensee" (draft section 963(1)), or payments made by an issuer or seller of a financial product (draft section 964(1)) – although in relation to draft section 964, it is not clear whether an "issuer or seller" would include a lead manager in this situation;
- "stamping fees" paid to licensees who provide financial product advice to retail clients, on successful applications for financial products issued or sold in an IPO or placement which were lodged by that licensee for its clients. These payments would also arguably be caught by draft sections 963(1) or 964(1);
- "stamping fees" paid to licensees who provide financial product advice to retail clients, where the capital-raising product in question is not (or will not be able to be) traded on a financial market, for example, unlisted equity, hybrid and debt securities and units in managed investment schemes;
- fees paid by an issuer to a lead or joint lead arranger/manager to an IPO or placement of securities, where the arranger/manager is licensed to give advice to retail clients. Despite the intention to exclude certain stockbroking activities from being considered conflicted remuneration, it appears that these fees would still be prohibited by draft section 964(1) (see also comments below). This would apply in relation to all types of securities, ie equity, hybrid and debt

securities, and units in managed investment schemes, listed and unlisted. It is important to note that this could also affect issues to institutional investors, for example, dealer panel fees on issues of bonds, MTNs and commercial paper;

- fees for other activities such as corporate fundraising advice, which in many cases is provided to entities that are or may become "issuers". Whilst this may fall within the exemption provided by draft section 964(2)(a), this needs to be clarified.

In each of the above cases, the relevant payment would be banned regardless of whether it bore any relationship to the retail advice business – the mere fact it is paid to a licensee with a retail advice business would be sufficient for the payment to be banned. For example, the section could operate to prevent issuers and sellers of wholesale only products giving a benefit to a licensee which offer a retail advice service, even though that advice will clearly never apply in relation to that product.

In addition, it appears the current drafting of section 963 would prohibit payments made by licensees to their representatives that are determined according to the level of brokerage and other capital market related fee revenue generated for the firm by the adviser's efforts. Brokerage fees themselves are arguably carved out of the current draft (on the basis that they are a benefit given by the client to the licensee in connection with financial product advice given by the licensee under draft section 963A(d)), but incentive payments made by the licensee to its representatives that are based on brokerage levels or other capital market related fee activity would currently be banned by section 963(2) of the draft legislation.

Clarification of section 964 is also required in relation to the meaning of "seller" of a financial product – for example, is an underwriter who intermediates the placement of securities (but never owns them), or a distributor of financial product generally, considered to be a "seller" of that product?

<u>Recommendation 5</u>

The ban in section 964 should be qualified so that (like the definition of conflicted remuneration in section 963) it applies only in respect of payments which "might influence the choice of financial product recommended by the licensee or representative to the client, or might otherwise influence the financial product advice given by the licensee or representative".

<u>Recommendation 6</u>

That the terms "issuer" and "seller" be clarified, particularly in the distribution context.

<u>Recommendation 7</u>

It is essential for the continued sound functioning of Australian capital markets that the proposed regulations are sufficiently broadly drafted to enable the continued payment

of fees of the nature described above, and to enable licensees to continue to pay their representatives incentives that are based on the amount of those fees.

9. Subdivision C – Ban on Asset Based Fees on Geared Funds

In AFMA's view, the proposed ban on asset based fees on geared funds should only apply to the extent that "gearing advice" is provided to the client on the portfolio where the asset based fee is being charged. If the spirit of Subdivision C is to remove the potential conflict where an adviser might encourage a client to gear (and so receive a higher asset based fee), then it should not apply where the adviser does not advise on how the client funds (that is, pays for) their investment activity.

The FOFA reforms promote the concept of scaled advice. However, Subdivision C appears to constrict this. For example, if an adviser is forced to consider how a client is funding their investment activity, even though the client has not requested any advice on this aspect, then the adviser is arguably providing a more detailed level of personal advice, and not scaled advice.

10. Section 964H – Definition of Asset Based Fee

Section 964H states that an asset based fee is a fee dependent upon the amount of funds used or to be used to acquire financial products. Taken literally, it appears that this fee is based on the client's original investment amount and not on what their portfolio might be worth after their investment is made. We assume that this wording contemplates fee scenarios where all asset based fees are charged upfront. This wording does not work for ongoing percentage based fee arrangements, given that it does not contemplate that client portfolio values and net equity will fluctuate.

Clarification is needed as to how the ongoing operation of the asset based fee prohibition will work.

11. Internally Geared Products and Instalment Warrants

The rationale for the ban on asset based fees for geared investments is to remove the incentive for advisers to gear up a client's investments for the purpose of increasing the value of funds under management and thereby maximise the fees chargeable.

This policy rationale does not hold in relation to internally geared/leveraged products, as compared to externally geared products where the client's increased equity in the assets can affect the adviser's remuneration.

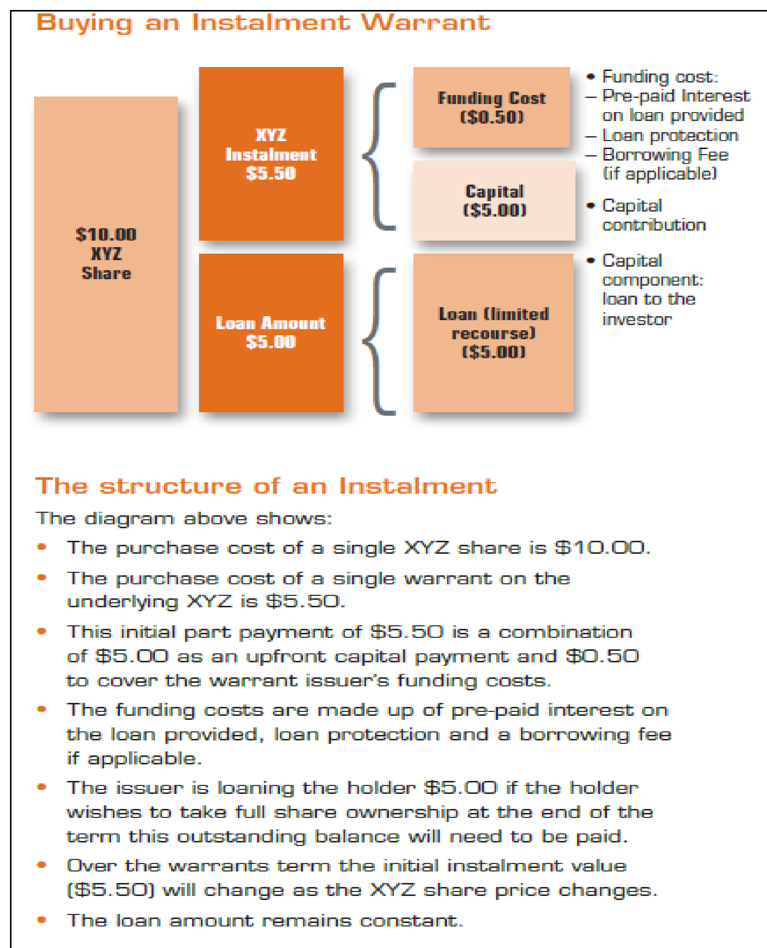
Draft section 964J(1) defines "geared funds" as borrowed funds. "Borrowed" means borrowed in any form whether secured or unsecured, including the raising of funds through:

(a) a credit lending facility within the meaning of the regulations; and

(b) a margin lending facility.

In the case of an internally geared managed fund, the fund borrows money and pays for the loan from dividends and income received from the fund's investment. On this basis, AFMA understands that internally geared products will not be captured under the ban because the client does not borrow any funds in relation to their investments.

The exposure draft and the EM are silent about the treatment of products such as instalment warrants. An instalment warrant gives the investor the right to buy the underlying asset, sometimes with an initial part payment (although there may not be an initial part payment), and an optional final payment. A simple example is set out in the below diagram.



Source: ASX Fact Sheet – Instalment Warrants, Getting Started

Unlike other products that can be used to leverage an investment exposure, an instalment warrant does involve lending and the investor pays interest on the underlying loan. In the above simple example, there is a limited recourse loan for the second instalment, which is not drawn down until the investor makes the decision that they want to own the share at the end of the warrant term. The investor's liability is limited to the underlying asset and in the event of a default on the loan, the borrower can extinguish their liability by handing back the asset.

For instalment warrants that are internally geared, the internal gearing is limited recourse and the client will only lose, at most, the initial instalment payment (if any) and it is not a product feature for that initial instalment to be loaned by the issuer.

The instalment warrant is itself the investment, and arguably the investor would need to borrow to purchase the instalment warrant for it to be considered a geared investment. In the above example, the investor has not borrowed the initial instalment payment of $5.50. There are also instalment warrant products that have a loan to value ratio (LVR) of 100% that do not have an initial instalment payment at all, but in any case the internal gearing is limited recourse so that the client may walk away without any further liability if they choose not to pay any final instalment or interest payment during the life of the product.

Some instalment warrants have a loan reset, where the loan amount may increase or decrease. Even if the loan amount decreases so that if the client is asked to repay part of the loan amount, it remains limited recourse and the investor can simply walk away. Where it increases during the term of the product, the client will receive further funds or can apply the funds against another liability and the limited recourse nature of the product is unchanged.

Furthermore, in practical terms, an asset based fee charged on an instalment warrant would be based on the equity component of the warrant – that is, the market value of the warrant – and not on the value of the underlying shares/units. Difficulties in distinguishing between the geared and ungeared component would not arise in this case.

In Class Order 10/1034, ASIC has declared that an instalment warrant:

(a) that is in a class of financial products that are admitted to quotation on the licensed market operated by ASX Limited;

(b) that is issued by a financial services licensee; and

(c) that is a standard margin lending facility

is not a margin lending facility. The class order should put it beyond doubt that instalment warrants are not captured by the reference to a margin lending facility in draft section 964J(1)(b).

On this basis, AFMA is of the view that instalment warrants are not captured under Subdivision C of Division 5 of the exposure draft. Clarification of this point would be useful. Alternatively, to the extent there is any doubt about whether instalment warrants are captured, AFMA recommends that instalment warrants be carved out from the application of the reforms via regulations. We are happy to provide any assistance required to draft the regulation.

Recommendation 8

Treasury should clarify that Subdivision C of Part 5 of the exposure draft does not apply to instalment warrants.

12. Business Banking and Risk Management Products

In previous submissions to Treasury, AFMA has set out the potential issues surrounding the application of the FOFA reforms to business banking and risk management products. In particular, I refer you to the examples of risk management products that might be issued by a bank to a customer in an established business banking relationship described in the AFMA discussion paper provided to Treasury on 22nd July 2011, and discussed at our meeting on 26th July 2011.

Business banking customers are not ordinary retail investors for the purposes of the Corporations Act. Ordinarily, these customers have a banking relationship with a financial institution and not an investment or wealth management relationship that is akin to the relationship between a retail investor, their adviser and their financial institution(s).

As described in the discussion paper, these customers may from time to time acquire certain types of financial products that are for legitimate business risk management purposes. This is particularly the case where the customer's business is exposed to interest rate movements, currency movements and events that may impact on future pricing or volume of commodities, for example. These products are bespoke and are not ordinarily acquired for investment or speculative purposes. Investors who are seeking arbitrage or speculative opportunities are more likely to acquire an exchange traded product, to take advantage of pricing and timing differences between markets.

At the meeting between AFMA representatives and Treasury on 26th July 2011, Treasury officers commented that it can be difficult to separate products acquired for hedging and risk management purposes from products acquired for investment and/or speculative purposes.

In our view, it is possible to distinguish the issue of these products by a bank, and the purpose for which the customer acquires this type of product, in principle and in

practice. As noted above, these products are bespoke and tailored to the needs of the customer. Ordinarily, the business banking adviser will have an existing relationship with the customer, the main purpose of which is business banking solutions. Under the proposed best interest duty, the adviser (the provider) will be obliged to act in the best interest of the customer. In the course of providing financial services to the customer, under best practice the adviser will document the reasons why a particular type of business risk management product has been recommended to the customer, in the context of the client's business activities.

As previously discussed with Treasury, these products are akin to certain types of insurance products, that protect the customer from adverse movements in exchange rates, interest rates and other future events.

In our view, FOFA was never intended to capture this kind of advice in relation to risk management products that are not for investment or speculative purposes, in the context of SME business.

Treasury has indicated that this issue may be more appropriately dealt with in the review of the retail/wholesale definition in the Corporations Act, possibly by way of introduction of new categories of investor that are not "retail" investors. AFMA members are concerned that they may be required to take steps to become FOFA compliant in relation to these types of financial products and this type of financial advice, only to then no longer be required to comply if and when the retail/wholesale definition is amended. This would be an unsatisfactory and costly result.

Recommendation 9

This issue should be resolved as expeditiously as possible, either by way of carve out from the conflicted remuneration and other banned remuneration provisions in the draft legislation, on the basis that this type of financial advice can be distinguished from other types of financial advice given to retail customers; or through finalisation of the review of the retail/wholesale definition in the Corporations Act before affected entities and providers are required to be fully FOFA compliant. This will be assisted by the introduction of a transition period.

13. Intermediary Arrangements

Despite some previous indications from Treasury that certain carve outs from the conflicted remuneration provisions under FOFA will be provided in relation to 'intermediary share broking' arrangements, our members remain concerned that a number of their business models could be adversely impacted by the FOFA reforms. There appears to be minimal risk to customers of receiving conflicted advice and no evidence of any historical market failure that needs to be corrected with the business

models described below. The below examples are being reiterated to assist in the drafting of carve out regulations that will be applicable to stockbroking activities.

Note that in the following examples 'ABC Corp' is the market participant who provides share trading technology services to an intermediary.

13.1. Dealer groups and financial advisers

Dealer groups and financial advisers may have agreements with stockbrokers (ABC Corp in this example), to execute transactions on-market for their clients. Most financial advisors are not market or CHESS participants, so rely on these arrangements with brokers to efficiently relay orders to buy/sell securities for execution on-market.

In these arrangements, the financial adviser may provide personal advice to their client, and the client then decides to buy or sell listed securities. ABC Corp executes the trade and settles direct with the end client, charging the client brokerage on the trade. This enables the client to obtain the advantage of share registration and transfer under the ASX CHESS system.

The brokerage is collected by ABC Corp on each trade on behalf of each adviser in the dealer group and submitted to the dealer group on a monthly basis. ABC Corp retains a proportion of the overall brokerage charged to the client, for provision of the underlying share trading execution. The fee collection and reimbursement arrangement is fully disclosed in the Financial Services Guide which the client acknowledges they have read and understood, when they sign the agreement to begin using the service.

There are robust governance obligations and oversight of market participants which we believe provide negligible opportunities for conflicts to arise under this model. There are no volume related payments made by ABC Corp to the financial adviser or dealer group that might encourage higher trading volume. We believe it is appropriate for these arrangements to be exempt from the definition of 'conflicted remuneration' as defined in section 963 of the exposure draft.

13.2. White label arrangements – direct to customer

White label arrangements are for partners who want to provide share-trading and associated services to their end-clients under their own brand, and avoid the high barriers to entry for organisations which provide these services. Partners outsource to ABC Corp to leverage their economies of scale in technology, ability to meet regulatory capital and licensing requirements, support services and experience. In the case of a white label partnership, ABC Corp provides the partner with a fully branded stand-alone website and trading platform – including branded forms and agreements.

ABC Corp registers a trading name (ABN), maintains an AFSL, is a full participant on the Australian Stock Exchange (ASX), and potentially other markets such as Chi-X, and is a member of the Financial Ombudsmen Service (FOS). While the white label partner is able to retain the relationship they have with the client, the partner bears no credit risk or market risk for trading, as the client is contracting with a trading name of ABC Corp. End clients can be directed to the white label platform from the partner's website in order to open an account online and access ABC Corp's platform.

The partner does not provide personal financial advice to its clients. General advice may be provided and market data and company information is sourced from independent third party providers, such as the ASX or research houses (eg Morningstar, Thomson Reuters, etc.) and displayed on ABC Corp's website.

When a client lodges a request online to buy or sell shares, brokerage is debited by ABC Corp directly from the customer bank account. Brokerage rates and all fees and charges are disclosed in the Financial Services Guide which the client acknowledges they have read and understood when they sign the agreement before using the service. Revenue is generally calculated by ABC Corp, and a portion paid to the partner on a monthly basis – fees deducted/retained by ABC Corp are either calculated on a revenue share or fees for discrete service basis. This arrangement remunerates both parties as both contribute to the overall service to the end client.

This is a 'direct to client' model and as neither ABC Corp nor the partner firm are providing personal advice to the end client, we do not see any material possibility of conflicts which disadvantage the customer. We submit that:

- this model is product neutral and does not encourage trading in any particular security;
- the model is transparent in that all charging and revenue arrangements are disclosed to the client; and
- there are no volume bonuses or payments related to sales targets paid to the partner in this example.

The solution from a regulatory perspective may be to restrict the application of FOFA to personal advice situations only as suggested in section 4 of this letter. Alternatively, general advice given by way of marketing material and/or reports needs to be carved out of the regime. If neither of these options are acceptable to Treasury, we request a similar carve out (via the proposed section 963A(1)(c) for prescribed benefits in the exposure draft) as requested in point 13.1 above.

The alternative may be that providers of online broking services have to remove market reports from their website completely and advise customers that they will have to make

their own arrangements to receive (and pay) for this vital information. This is a far from an ideal outcome and contrary to the fundamental principles of FOFA.

13.3. Referrer models

In this model, a referrer may not have stockbroking as their core business focus, but rather it may be a service demanded by their end clients. An example of this type of referrer would be a company specialising in SMSF accounting, who as part of their service would refer business to ABC Corp as a 'preferred' provider. ABC Corp may be one of a number of preferred stockbroking providers that the referrer provides access to. The regulatory relationship is directly between ABC Corp and the end client. The referrer does not provide personal financial advice to its clients. General advice may be provided and Market data and company information is sourced from independent third party providers, such as the ASX or research houses, and displayed on ABC Corp's website.

Revenue is generally calculated by ABC Corp, and a portion paid to the partner on a monthly basis. Our argument against prohibitions on these kinds of referral payments are that these are legitimate arrangements to extend the reach of share trading services to a greater range of customers through intermediaries who do not possess the infrastructure to offer these services in their own right. As for the white label model above, they are product neutral, transparent and there are no volume bonuses or payments related to sales targets.

14. Retail Structured Derivative Products

Following on from the intermediary arrangements discussion above, in Australia providers of retail structured derivative products such as CFDs provide products predominantly over currencies, indices, commodities and equities.

As set out in AFMA's July discussion paper and at the meeting between AFMA representatives and Treasury officers on 26 July 2011, these providers have arrangements with intermediary companies (referred to as partners), to whom the provider pays a commission or rebate for the referral of the client to the provider, or for a trade placed by or on behalf of the client in respect of certain CFD products, with or without the provision of financial product advice.

As the definition of conflicted remuneration covers both the provider of general advice to a retail client and the issuer of a financial product, this will impact CFD partner relationships for those partners who are providing general or personal advice and receiving a monetary benefit.

The FOFA FAQs note that the focus of the ban on conflicted remuneration structures is removing conflicts of interest that may cause bias, or the potential for bias, in financial advice due to payments from product providers to those providing advice.

The nature of CFD relationships are such that CFDs are presented as a stand-alone option to partner clients – that is, they are a unique and specific product that are not issued with or as an alternative to, or as a substitute for a suite of similar products with varied commission structures. Fees, commissions and rebates to partners are clearly transparent and are disclosed in disclosure documentation. Consequently the likelihood of potential bias as contemplated by the FOFA reforms is slim.

In addition, the FOFA FAQs state that it is not the intent that a transparent and product neutral regime with a client-paid fee would be subject to the ban, unless it is an asset-based fee relating to geared products or investment amounts. Treasury originally stated these reforms were aimed at sectors which were not transparent about certain payments. It is clear from this that the CFD industry was not contemplated when the reforms were drafted.

The execution-only exception contained in section 963A(1)(c) might apply to partner relationships if:

(a) the benefit is given to the licensee in relation to the issue or sale of the financial product to a retail client; and

(b) no financial product advice in relation to the product has been given to the client by the licensee, representative of the licensee or the representative.

As a number of partners are operating under an execution only model currently (and are licensed to provide general advice only), providers may be able to rely on this exception for execution only services; however the exception has been drafted in such a way that the applicability to certain circumstances such as partner relationships is unclear.

It would be helpful if the exception could be clarified.

15. Anti-avoidance Provisions are Too Broad

The anti-avoidance provision in section 965 as drafted is extremely broad. It appears to have some basis in the general anti-avoidance rules in Part IVA of the Income Tax Assessment Act (ITAA), but without many of the specific concepts in the ITAA being re-produced – for instance, the need to identify some sort of counterfactual in determining whether what the person is doing is for the sole or dominant purpose of avoiding the effect of the provisions. Without all of the other elements that are contained in the ITAA, the jurisprudence for FOFA is doubtful, and there is little guidance in the EM as to

what might be caught by the anti-avoidance rule. This will result in a high degree of uncertainty for industry.

__Recommendation 10__

Section 965 should be amended to incorporate similar elements to the general anti-avoidance provisions in the ITAA.

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