AIST submission

Response to: Exposure Draft - Corporations Amendment (Further Future of Financial Advice) Bill 2011

October 2011

Australian Institute of Superannuation Trustees

Background

On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced the Future of Financial Advice (FOFA) reforms. The FOFA reforms represent the Government's response to the 2009 Inquiry into Financial Products and Services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services (PJC Inquiry), which considered a variety of issues associated with corporate collapses, including Storm Financial and Opes Prime.

The *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* ("the Bill") implements the FOFA reforms. The first tranche of legislation (*Corporations Amendment (Future of Financial Advice) Bill 2011*) covered the best interests obligation, the client agreement requirements for ongoing fees and enhancement of ASIC's powers with respect to licensing and banning.
The first tranche was introduced to the House of Representatives on 13 October not including the best interests obligations which will appear in a separate bill.

The second tranche of legislation is set out in this Bill, which is designed to set up the following framework:

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

The reforms focus on the framework for the provision of financial advice. The underlying objective of the reforms is to improve the quality of financial advice while building trust and confidence in the financial planning industry through enhanced standards which align the interests of the adviser with the client and reduce conflicts of interest.

The Explanatory Memorandum ("the EM") to the Bill also discusses potential new additions to the *Corporations Regulations 2001* ("the regulations", "the regs").

Additional reforms yet to be drafted include:

- Replacement for the exemption currently available to accountants from the provisions of AFSL licensing;
- Definition of the term "financial planner";
- Details of the carve-out of volume based fees associated with capital raisings and other corporate actions undertaken by stockbrokers;
- Grandfathering arrangements for existing clients of financial advisers where there are ongoing fee or commission arrangements; and
- Scaled and intra-fund advice provisions.

AIST

The Australian Institute of Superannuation Trustees (AIST) is an independent, not-for-profit professional body whose mission is to protect the interests of Australia's $450 billion not-for-profit superannuation sector. AIST's members are the trustee directors and staff of industry, corporate and public-sector superannuation funds, who manage the superannuation accounts of two-thirds of the Australian workforce.

AIST is a registered training organisation and has recently expanded its education program to encompass the growing and changing needs of all members of the not-for-profit superannuation sector.

AIST offers a range of services including compliance and consulting services, events - both national and international - as well as member support. AIST also advocates on behalf of its members to relevant stakeholders.

AIST has recently undergone a vast overhaul, elevating its status as a professional institute to further benefit our members. AIST has introduced a new department – Trustee Governance and Professional Standards – responsible for implementing industry policies and developing a comprehensive framework for the not-for-profit sector.

AIST's services are designed to support members in their endeavour to improve the superannuation system and build a better retirement for all Australians.

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1 Executive Summary

AIST strongly supports the intent of the reforms to be implemented by the Exposure Draft ("the ED"). We consider the conflicted remuneration measures to be a major new paradigm in financial advice, where advice provided to members is the primary focus.

With respect to the features proposed in this tranche, we make the following recommendations:

- AIST would support these measures being extended beyond retail investors;
- The definition of conflicted remuneration from employers to employees should not be limited to volume payments;
- Licensees should be liable for payment of conflicted remuneration, not just for receipt;
- Scale-based discounts must be passed on to investors in all instances;
- The term 'reasonable value of scale efficiencies' should be tightly defined in the Bill;
- The requirement that professional development must be provided in Australia or New Zealand precludes licensees or their representatives from learning about best practice and new developments in the global financial services industry;
- No further concessions should be made to commissions from life insurance premiums as these are already unacceptable;
- AIST recommends release of the grandfathering provisions for discussion immediately to enable informed discussion on other tranches of legislation;
- Civil penalties should apply where an adviser may have an incentive to deliberately neglect their client base; and
- The commencement date for this Bill should be brought forward to the date of Royal Assent to prevent abuse of fee or commission arrangements that will be grandfathered.

AIST also recommends that an end date be provided to the grandfathering arrangements and considers 1 July 2017 to be entirely appropriate for this to coincide with the end of the MySuper transition. AIST supports all other proposals in this Bill.

2 Commentary and recommendations

AIST supports the intent behind these measures. We broadly welcome the context of where these obligations are to apply, as well as the situations to which these measures apply. We also consider strongly that these measures constitute much needed consumer protection.

2.1 Note to this submission

Unless otherwise indicated, please note that all section and subsection numbers referred to throughout this submission refer to those used to number the proposed new or amended sections of the *Corporations Act 2001* ("the Act") as described in the ED and not those of the ED itself.

2.2 The new financial paradigm

AIST continues to broadly support the *Future of Financial Advice* (FOFA) initiatives, and those that deal with conflicted remuneration specifically. AIST has long supported the notion that although financial products recommended by advisers are historically regarded as "the product" in the financial world, we believe that this is not appropriate.

AIST considers that it is more appropriate that "the product" in financial services should refer to the advice provided by financial advisers. In this context, financial products (as defined in the Act) themselves should be used to supplement or to execute the advice and the quality of "the product" should not be influenced by inappropriate pressures.

Conflicted remuneration can be considered an inappropriate pressure and AIST supports any measure in implementing a paradigm where advice is central, rather than incidental.

AIST applauds efforts to reduce conflicted remuneration along the value chain. We note that there are a significant number of relationships addressed in this Bill, but are concerned that some of the relationships are treated unequally or are not covered, e.g. the carve-out of stockbroking commissions where such arrangements relate to advice provided during capital raisings and other corporate actions.

2.2.1 Proposed section 963 – Retail clients

Although not within the scope of this measure, AIST supports good consumer protection measures being made available to all investors, regardless of their level of sophistication or of how much money that they have to invest. For this reason, we would support the ban on conflicted remuneration being extended beyond retail clients.

2.2.2 Proposed section 963C – Payments by employers not conflicted remuneration

We note that under the proposed section 963C, ordinary payments for work carried out is only considered conflicted remuneration if it satisfies the criteria contained within proposed subsection 963(2). Consider the following example:

Example
Boris is a financial adviser who works for Bruce. In Boris' key performance indicators (KPIs), he is required to:

Consider recommending Acme Equity Fund/Option in all advice provided to clients ahead of other similar funds or investment options.

Meeting this KPI requires Boris to actively note in fact finds/financial needs analyses or supporting documentation that he has considered the product prior to other similar products/options. At the end of the year, Boris is able to demonstrate that he has met this KPI and qualify for a bonus.

Since volumes sold are not a consideration, this arrangement would be allowed to continue, as it does not breach any of subsection 963(2).

We consider that this is flawed, as clearly bonuses of this nature fall within the scope of the proposed subsection 963(1).

To ensure that this situation does not arise, we recommend that the proposed subsection 963C(1)(a)(ii) be reworded to ensure that it refers to all of the proposed section 963, not just subsection (2).

2.2.3 Proposed sections 963D and 963E – Licensee obligations

We note that the proposed section 963D prohibits the acceptance of conflicted remuneration by licensees, and that proposed section 963E obliges licensees to take reasonable steps to ensure that representatives do not accept conflicted remuneration. However, we cannot find a section that prohibits *payment* of such remuneration by licensees, unless the licensee is either the employer of a recipient (covered in proposed section 963H), or the licensee responsible for an authorised representative who is a recipient (covered in proposed section 963E).

Whilst we accept that it is fair and reasonable to outlaw the receipt of such payments by licensees, their representatives (including authorised representatives) and employees who are either licensees or representatives of licensees, we believe that such bans should be extended to those who make these payments as well.

Example
Jill is an authorised representative of Star Financial Planning ("Star"). Star does not issue financial products, as defined by the *Corporations Act 2001*, but they do provide a number of back office services to Jill. Jill prefers not to use Star's paraplanning and tends to use Ace Financial Services' ("Ace") paraplanning service, mostly. Both Ace and Star are AFS licensees and are unrelated companies.

Jill is aware that it is Ace's policy to recommend Beta Financial Management ("Beta") products by default, unless Jill instructs them otherwise. Beta is both a product issuer and is not related to Ace or Star.

In 2013, Ace provides Jill with a new Apple iPad 5 which it says is a bonus for requesting more than 30 statements of advice during the 2012 calendar year. The iPad 5 retails for $700. Ace tells Jill that she should be OK to accept the iPad, as a paraplanning service is not a financial product.

Jill is concerned that this is conflicted remuneration under subsection 963(1) because of the Star products default, and believes that she may be in breach of subsection 963F(1) in accepting the iPad, and doesn't believe that relying on Ace statement is reasonable under subsection 963F(2).

Star believes that Jill may have breached section 963F as they do not consider the iPad to be appropriate and are concerned that if 'reasonable steps' aren't taken to avoid this breach, they will have breached section 963E.

Ace has no concerns whatsoever: As far as they are concerned, acceptance of the gift is entirely Star's or Jill's issue.

We believe that not making licensees liable for the payment of conflicted remuneration to third parties is an oversight and is unfair, given that representatives and their licensees and/or their employers are liable for the receipt of these amounts. To ensure that licensees do not provide conflicted remuneration, we believe that this could be easily fixed by strengthening the proposed section 964 to ban licensees, rather than product issuers from paying conflicted remuneration in all other instances, and that civil penalties should apply.

2.3 Exemptions and unintended consequences

AIST has concerns about exemptions to the ban that may lead to unintended consequences. We have identified some of these in the section to follow.

2.3.1 Scale-based discounts

It is AIST's opinion that where these scale-based discounts or rebates are genuine and provided in accordance with the proposed section 964B, such discounts or rebates must be passed on to customers in all instances. To do otherwise can only raise additional questions about the nature and transparency of such arrangements.

We also consider that the criterion of not exceeding 'reasonable value of scale efficiencies' as described in the proposed subsection 964B(2)(b) is vaguely defined and open to abuse and that this term must be tightly defined in this Bill, or in the Regulations.

Lastly, we note that it is proposed at sections 964C and 964D that financial services and RSE licensees may not accept shelf-space fees, however there is no ban on the *payment* of such amounts. For the same reasons as we considered previously, we consider that there should be a ban on licensees paying shelf-space fees in the interests of fairness. Civil penalties should apply to such a prohibition.

2.3.2 Professional development

AIST supports the exemption proposed at subsection 963B(c), where benefits with a genuine education or training purpose that is relevant to providing financial advice and compliant with the Regulations are not considered to be conflicted remuneration. We also agree with most of the planned restrictions on this exemption, including the proposed majority time requirement and the proposed expenses requirement that are cited in the second and third dot points of paragraph 1.34 of the EM.

However, to require that professional development must be provided in Australia or New Zealand precludes licensees or their representatives from learning about best practice and new developments in the global financial services industry. (First dot point, paragraph 1.34, the EM).

Example
Trang is an adviser with and representative of the Widget Industry Superannuation Trust (WIST), an AFS and RSE licensee. Trang provides a personal advice service to WIST's members, and only has the WIST product on her approved product list.

WIST would like to pay for and send Trang to a conference in the USA on new financial advice technologies and associated member services only available in the USA. However, after reading the Regulations, they realise that, unless the conference is held in Australia or New Zealand, such a conference may be considered to be conflicted remuneration. They are unable to send Trang or any of their advisers.

2.3.3 Life insurance

AIST refers back to the fourth recommendation made by the Ripoll enquiry, where:

> *The committee recommends that the government consult with and support industry in developing the most appropriate mechanism by which to cease payments from product manufacturers to financial advisers.*

We note that the government supported this in their response of 26 April 2010. Since that time the measures have changed to, firstly, allow commissions to be paid on non-super life insurance premiums, then, allowing them on all individual risk insurance premiums, inside and outside of super except for default arrangements.

We strongly recommend against any further watering down of provisions that go against the grain of the Ripoll Report's original findings. There cannot be any further changes to the planned bans on commissions on group insurance within superannuation, or the ban on commissions on insurance arrangements that are part of default super arrangements. We consider that the concessions that have already been made to allow commissions on individual policies to be unacceptable and therefore recommend that no further changes be made to the Bill.

2.4 Grandfathering

We are aware that the proposed grandfathering arrangements are yet to be released. We are concerned that our submissions to date may be misinformed due to the absence of information. We strongly recommend that these arrangements are released for consultation in the next tranche of legislation to enable proper comment.

2.4.1 Deliberate neglect

It is anticipated that existing fee and commission arrangements that relate to existing clients will be grandfathered. We wish to point out circumstances whereby clients of financial advisers could be *deliberately* neglected, where an adviser could decline to provide *any* advice to a client if there is the chance that existing fees and/or commissions could be extinguished. Furthermore, we believe that advisers may not attempt to proactively initiate future advice with their clients for the same reasons.

It is planned that the bans on conflicted remuneration will only be prospective, that is, it will only apply to arrangements where new advice is provided on or after 1 July 2012. We wish to draw attention to the definition of the term financial advice, generally defined at subsection 766B(1) of the Act as follows:

> *For the purposes of this Chapter, **financial product advice** means a recommendation or a statement of opinion, or a report of either of those things, that:*
>
> *a. is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or*
> *b. could reasonably be regarded as being intended to have such an influence.*

We note that the Australian Securities and Investments Commission (ASIC) presently consider advice that satisfies this description can include even minor recommendations of a non-financial nature, such as the nomination of beneficiaries on a superannuation interest. (ASIC *Consultation Paper CP 164*)

Therefore, any existing commission arrangements must come to an end if any new advice is provided (for that product) and existing ongoing fee arrangements will be subject to the 'opt-in' provisions that are contained in the *Corporations Amendment (Future of Financial Advice) Bill 2011* presently before Parliament.

AIST believes that such a situation cannot be allowed to arise and believe that civil penalties must apply where an adviser deliberately neglects their client-base.

2.4.2 Incentives to enter into conflicted remuneration arrangements

A similar problem could arise due to the time-lapse between Royal Assent for these provisions and the anticipated commencement date of 1 July 2012.

This period could be overly long and advice providers could feasibly utilise this period to transfer existing clients into arrangements that will be grandfathered. Further, advisers may have an incentive to negotiate unconscionable fee and/or commission arrangements for any new advice provided during this period prior to the commencement date.

We strongly recommend that the commencement date be brought forward to the Royal Assent date for this reason.

2.4.3 Ending low value arrangements

With respect to the proposed grandfathering arrangements, AIST would support that these are transitional and recommend that they be given an end date. A logical date would be the end of the MySuper transition period being 1 July 2017. We are not aware of any reasons whatsoever why clients in existing fee/commission arrangements could be conceptually different from default superannuation investors.