Exposure Draft: Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014

ISA SUBMISSION

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1. Introduction

Industry Super Australia (ISA) appreciates the opportunity to provide comment on the Exposure Draft of *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014* ("the Bill") and the Exposure Draft of the *Corporations Amendment (Streamlining of Future of Financial Advice) Regulation 2014* ("the Draft Regulation") and their accompanying Explanatory Memorandum and Explanatory Statement.

The stated aim of the Government's amendments is to reduce compliance costs for small business, financial advisers and consumers who access financial advice. However, ISA is concerned that despite providing some cost saving for industry, the amendments will significantly reduce protections for financial advice consumers and compromise the spirit and intent of the FoFA reforms. A return to a culture of sales-driven financial advice is not desirable or sustainable and will cost the economy, consumers and the industry much more in the medium to long term.

2. Executive Summary

The Future of Financial Advice reforms were several years in the making and were developed in response to a series of high profile and distressing instances of financial collapse including Great Southern, Westpoint, Opes Prime, Trio and Storm Financial.

The detailed work of several Parliamentary Committees which examined in detail the causes and impact of these collapses, particularly the 2009 Report on the Storm and Opes Prime collapses, confirmed that conflicted remuneration structures coupled with the absence of a requirement for advisers to act in the best interests of their client were key contributing factors to the collapses, and unanimously and explicitly recommended that reform be undertaken to address these deficiencies in the law.

After several years of consultation the Future of Financial Advice reforms were legislated, premised on two key pillars: the banning of the receipt of conflicted forms of payment for financial advice and the imposition of a requirement for financial advisers to act in the best interests of their clients. These laws were the subject of significant compromise with industry in order to pass the last hung Parliament and came into effect on 1 July 2012, but with compliance not required until 1 July 2013. The FoFA reforms should be given an opportunity to settle in and it is premature for any assessment of their impact to justify further amendment.

While it may be true that the existing FoFA laws will not prevent every instance of further financial collapse, by re-permitting conflicted forms of remuneration and lowering conduct requirements by removing the operative parts of the best interests duty, the likelihood of future scandals are considerably increased, some would say a certainty.

The changes to advice laws set out in the Bill and the Draft Regulation would:

- Allow the return of commissions in 10 ways, most of which could be paid for personal advice and for advice on superannuation including MySuper, leveraged funds and complex products
- Dilute the best interests duty so that it would be possible to meet the test without acting or even considering the client's best interests
- Increase the cost of advice
- Reduce individual and national savings
- Reduce consumer trust and confidence in advice
- Increase the likelihood and impact of future Storm-like financial collapses.

ISA makes the following recommendations in relation to the Bill and the Draft Regulation:

Process of reform

- ISA submits that there should be a full assessment of the impact of proposed regulatory reform on consumers.
- ISA recommends that, due to the risk of legal uncertainty and potential litigation or a disallowance motion, the Government should not proceed with making regulations to give effect to the proposed legislative amendments.
- ISA notes that if the Government does decide to proceed with making such regulations, draft regulations must be released and consulted on.

Proposed changes to the best interests duty

- ISA does not support any of the proposed amendments to the best interests duty, which have the effect of repealing the duty to act in the best interests of the client and would result in lower obligations than existed prior to the passage of the FoFA reforms.

Proposed amendments to the conflicted remuneration prohibition

- ISA does not support any of the proposed amendments to the conflicted remuneration provisions. We recommend that the existing regulatory framework for conflicted remuneration is already heavily compromised and that any further concessions fatally compromise the stated objective of the reforms, to raise the quality of advice and thus improve levels of consumer confidence and trust in advice.
- In particular, given the compulsory and heavily taxpayer subsidised nature of superannuation, ISA strongly recommends against any capacity for conflicted remuneration to be paid or received on superannuation monies.

Proposed repeal of the opt-in and removal of requirement for fee disclosure to be provided to existing clients

- ISA does not support the proposed repeal of the annual renewal requirement as this will allow asset based fees to replicate all the ill-effects of commissions.

Consideration of reform should be referred to the Financial System Inquiry

- ISA recommends that, to the extent that consideration of reform is required, it should be considered as part of the Financial System Inquiry.

3. Background to the FoFA legislation

Over the past decade, Australia has seen a series of financial advice scandals in which investors have suffered significant losses. At the centre of these scandals was conflicted remuneration where commissions and other incentives encouraged planners to recommend certain products coupled with the lack of a legal requirement for financial planners to act in their client's best interests.[1]

However, large-scale scandals were only one of the systemic problems caused by the commission system. Since 1996, conflicted remuneration has contributed to around $97 billion in national savings being foregone due to planners recommending poorly performing products.[2] In addition, around two million super fund members were paying ongoing fees for financial advice but not receiving any financial advice at

[1] Parliamentary Joint Committee on Corporations and Financial Services (2009) *Inquiry into financial products and services in*

[2] Industry Super Australia analysis based upon APRA data

all.[3] Ongoing fees can be particularly erosive in superannuation and can reduce the average Australian's retirement savings by around $46,000 over their working life.[4]

The conflicts also eroded trust in the industry. Research has repeatedly found that a majority of consumers don't trust financial advisers and don't believe that advisers act in clients' best interests.[5] In fact, a 2010 survey found that 'one of the main reasons for not seeking advice is the lack of trust they (consumers) have in financial planners.'[6]

3.1 High profile financial collapses

Leading up to the introduction of the FoFA reforms, there were a number of high profile financial advice collapses which highlighted the inadequacy of the regulatory settings to protect consumers and to set minimum conduct requirements for providers of financial advice.

The Parliamentary Joint Committee on Corporations and Financial Services, in its Inquiry into Financial Products and Services in 2009, emphasised that the regulatory regime (i.e, pre-FoFA) was 'failing to protect consumers from poor financial advice and its consequences.'[7]

The report pointed out serious problems, including conflicts of interests, commission-based remuneration and the limited regulatory power of ASIC.

It can be said the financial advice industry was used as a distribution and marketing channel for financial products to retail customers. There were limited regulatory requirements or assurances of advice quality. The framework at the time was premised on the disclosure of conflicts of interests, which resulted in inadequate protection for consumers. The financial incentives provided by some product providers led to biased and poor quality advice.

The following table summarises the major financial collapses in Australia since 2006 and the scope, remuneration arrangements and impacts.

Table 1 – Financial collapses in Australia between 2006 and 2010

Company	Year	Scheme	Commissions and Fees	Clients Affected	Total Losses
Westpoint	2006	Margin Lending	10% up front commission	3,524	$388 million
Bridgecorp	2007	Property Investment	Unknown	14,500	$459 million
Fincorp	2007	Property Investment	$3 million in fees	8,102	$201 million

[3] Roy Morgan (2011) *Retirement Planning Report*, June 2011 and ISA estimates

[4] Using ASIC Moneysmart superannuation calculator (Inputs: AWOTE, .5%, 40 year time span, starting balance $10k)

[5] State Street and Center for Applied Research, The Influential Investor: How investor behavior is redefining performance, Nov 2012, p 20, quoted in ASIC (2012) Future of Financial Advice: Best interests duty and related obligations, Dec 2012, p 5

Roy Morgan (2013) Image of Professions Survey, April 2013. Quoted in Roy Morgan (2013) *Superannuation and Wealth Management in Australia*, Report 15, Dec 2013, p 50

[6] Australian Securities and Investment Commission (2010) *REPORT 224 Access to financial advice in Australia*, Australia Government, Dec 2010, p 60

[7] Parliament Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia*, November 2009

Company	Year	Scheme	Commissions and Fees	Clients Affected	Total Losses
Opes Prime	2008	Non-standard margin loan, or 'equity finance scheme'	trail commissions of up to 0.75% to referring brokers	1,200 retail customers	up to $1 billion
Storm Financial	2009	Margin lending/ Financial Planning	6-7% upfront commission with two trail commissions of between 0.22 – 0.385% and 0.33% pa. Volume based rebates also paid.	14,000	$830 million
Timbercorp / Great Southern	2009	Managed Investment Schemes (MIS)	10% up front commission, ongoing fixed based fee, and 27.5% performance fee	18,000 (Timbercorp) 47,000 (GS)	$3 billion+
Trio/Astarra	2009	Corporate and Retail Super	4% up front commission and 1.1% trail commission Additional volume rebates also paid to advisers	6,000 approx.	$176 million
Commonwealth Financial Planning Limited	2009-2010	Financial Planning	Unknown. But there was report of trailing commissions of 0.44% - 0.83%	1,127 clients receiving compensation	$50 million in compensation. Actual losses unknown.
A fully sourced and referenced version of this table is reproduced in Appendix 1					

In aggregate, these collapses resulted in total losses over $6 billion and affected over 120,000 Australians.

However, there are many other pieces of research which have demonstrated the significant public policy problems caused by the existence of commissions and other forms of conflicted remuneration.

3.2 Will FoFA laws prevent a future Storm occurring?

Inquiries into the collapses of Storm, Opes and Trio revealed conflicted remuneration as a key element in the sale of financial products which would result in significant losses for many clients. Commenting on their participation in many of these inquiries, ASIC stated in their most recent submission regarding Commonwealth Financial Planning:

> *"At the heart of these problems were conflicts of interest embedded in financial advice distribution and remuneration that led to poor quality and inappropriate advice."*[8]

Inquiries into WestPoint and Trio specifically point to high commissions as a major contributor to the recommendation of the products.[9]

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[8] ASIC (2013*) Initial submission by ASIC on Commonwealth Financial Planning Limited and related matters,* Senate inquiry into the performance of the Australian Securities and Investments Commission August 2013, p 5

[9] Parliamentary Joint Committee on Corporations and Financial Services, *Final Report: Inquiry into the collapse of Trio Capital*, May 2012, p 30 and ASIC, Submission 378 quoted in Parliamentary Joint Committee on Corporations and Financial Services (2009), p 76

The specific details of the Storm Financial business model and collapse however, are cause for the greatest concern regarding the proposed changes to the current FoFA legislation. In broad terms, Storm Financial provided one-size-fits-all advice to all clients recommending lending against one's home to invest in a managed investment product. An abridged version of the business model provided in the final report is as follows:

> *"Typically [Storm] investors, who included retirees or people intending to retire in the near future, were encouraged to take out loans against the equity in their own homes in order to generate a lump sum to invest in the share market, via index funds (primarily Storm-badged Colonial First State managed funds and Storm-badged Challenger managed funds). Clients were generally then advised to take out margin loans to increase the size of their investment portfolio.*
>
> *Clients were charged an up-front fee of around seven per cent for the advice they were given by Storm. Before they became clients, they were required to participate in a number of "education" sessions.*
>
> *For those attendees who ultimately signed up to become Storm investment clients, margin loans were organised with a loan-to-value ratio (LVR) of around 80 per cent, with a buffer of 10 per cent. There were some variations in these figures, depending on the finance provider and individual contract, but as a generalisation Storm clients were put into margin loan facilities with more generous LVR and buffer provisions than was the industry standard.*
>
> *Storm tendered out the client's requirements to a number of banks with which it did business and claims to have made a selection on the basis of service and conditions offered. Home lending was organised through a range of banks; margin loans were largely (although not exclusively) through either Colonial Geared Investments, which is wholly owned by the CBA, or through Macquarie Investment Lending."*[10]

The availability of generous and multiple forms of conflicted remuneration were undeniably a key motivating factor for the advisers involved. The proposed broad and numerous exemptions to the conflicted remuneration rules, coupled with weakened conduct requirements, will undoubtedly be exploited in the future if these amendments are passed.

Table 2 – Conflicted Remuneration used in Storm Financial's strategy

Conflicted Remuneration used in Storm Financial's strategy	Are these payments allowed under current FoFA laws?	Will these payments be allowed under proposed amendments?
Upfront & trail commissions on general advice including seminars	No	Yes
Upfront & trail commissions	No	Yes[11]
Ongoing asset-based fees (other than on leveraged amounts)	No	Yes
Volume-based rebates on badged products	No	Yes
Volume-based remuneration on leveraged products	No	Yes[12]

[10] Parliamentary Joint Committee on Corporations and Financial Services (2009) *Final Report: Inquiry into financial products and services in Australia*, Commonwealth of Australia, p 21-23

[11] Commissions/conflicted remuneration payments will be permitted via the general advice exemption, the client consents exemption, the volume rebates exemption, the execution only exemption (even if personal advice provided by another representative of the licensee) and the exemption for volume payments to bank staff

[12] Commissions/conflicted remuneration payments on leveraged products will be permitted via the general advice exemption, the client consents exemption, the volume rebates exemption, the execution only exemption (even if personal advice provided by another representative of the licensee) and the exemption for volume payments to bank staff

Conflicted Remuneration used in Storm Financial's strategy	Are these payments allowed under current FoFA laws?	Will these payments be allowed under proposed amendments?
Sales incentives for employed staff (i.e. bank staff)	No	Yes

Firstly, exempting general advice would permit commissions on products such as the geared investment products which were integral to the Storm strategy, and promoted through the general education sessions. Secondly, the further exemption for execution-only services could reintroduce commissions for services such as those provided to Storm by the banks, even where personal advice is provided by another representative of the licensee. Further incentives include the volume-based shelf fees on products such as the geared investment products, while open-ended ongoing asset-based fees may incentivise non-leveraged Funds Under Management (FUM) maximisation such as the 80 per cent loan-to-value ratio as occurred in the Storm strategy. Finally, Storm director Emmanuel Cassimatis argued at the inquiry that Storm clients were self-selecting.[13] Such an opinion demonstrates that allowing an informed adviser and generally trusting client to 'agree' on the scope of advice can result in advice which falls a long way short of "best interests advice".

While it may be true that the existing FoFA laws will not prevent every instance of further financial collapse, by re-permitting conflicted forms of remuneration and lowering conduct requirements by removing the operative parts of the best interests duty, the likelihood of future scandals are considerably increased, some would say a certainty.

3.3 Evidence regarding impact of commissions and conflicted remuneration

> *"The financial advice industry has significant structural tensions that are central to the debate about conflicts of interest and their effect on the advice consumers receive. On one hand, clients seek out financial advisers to obtain professional guidance on the investment decisions that will serve their interests, particularly with a view to maximising retirement income. On the other hand, financial advisers act as a critical distribution channel for financial product manufacturers, often through vertically integrated business models or the payment of commissions and other remuneration-based incentives."* [14]

Parliamentary Joint Committee on Corporations and Financial Services (2009) *Final Report: Inquiry into financial products and services in Australia*, Commonwealth of Australia

Sales commissions and other incentives between financial product providers and financial advisers remain the dominant remuneration structure in the financial advice industry. Many of these arrangements are underpinned by vertically integrated product and advice businesses. According to ASIC, '85 per cent of financial advisers are associated with a product manufacturer, so that many advisers effectively act as a product pipeline for a product manufacturer.'[15] A 2011 ASIC review of the top 20 advice licensees found that the majority indicated that they 'remunerated their advisers based on the volume of financial products sold,' with 90 per cent of total licensee remuneration paid as commissions and asset-based fees from product providers and only 10 per cent paid directly by clients.[16] The same survey found that despite all licensees using relatively large approved product lists (the median number of products on APL was 400)

[13] Ibid., p 28

[14] Ibid., Paragraph 5.6

[15] ASIC (2009) *Submission to PJC Inquiry into Financial Products and Services*, August 2009, p 110

[16] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 11

“there remained a tendency to concentrate product recommendations into a few key products.”[17] Around 95 per cent of funds in platforms with wrap structures are held in the top three products, while around 60 per cent of all funds are in the top three retail superannuation products.[18]

This concentration in product recommendations is reflected in the revenue streams of the licensees. Ongoing commissions from the top three products represented over a third (37 per cent) of all ongoing fees while up-front commissions on the top three products generated nearly half (43 per cent) of all up-front commissions.[19] A more recent survey of the next 21 to 50 largest licensees found consistent results with a higher proportion of revenue from fees paid directly by clients (36 per cent). [20]

In relation to superannuation, Roy Morgan research has found that over the past seven years financial planning groups associated with the ‘Big Six’ fund managers (ANZ/ING/OnePath, AMP and AXA (now merged), CBA/Colonial First State, NAB/MLC, and Westpac/BT) have been consistently increasing the allocation of their sales to their own super products from 71 per cent in 2006FY to 77 per cent in 2013FY.[21] Of all the superannuation products sold through the major planning groups, only seven per cent are held by fund managers who do not pay commissions (six per cent to industry funds and one per cent to public sector funds).[22]

These systemic conflicts significantly erode the quality of advice, which will not improve until the commissions and other incentives which underlie these conflicts are removed from the financial advice industry.

Research over the past few years has shown that an unacceptably high proportion of financial advice continues to be of poor quality. In 2003, an ASIC survey found only 50 per cent of financial advice was at an acceptable level.[23] In 2012, only 58 per cent of retirement advice surveyed was at an acceptable standard.[24] The main features of poor advice in the surveys were (i) inadequately assessing or addressing the client’s personal circumstances, needs or objectives; (ii) conflicted remuneration structures (e.g. product commissions and percentage asset-based fees) affecting the type of advice and recommendations, and the quality of advice given; and (iii) failing to provide adequate justification for recommendations.

In 2006, ASIC found that superannuation advice was three to six times more likely to be unreasonable in the presence of a commission or the recommendation of an associated product. [25] A follow-up investigation into retirement advice in 2012 found that the scoping of advice was only adequately disclosed in half of all advice examples where limited advice was provided, while in ‘several instances, particular topics were excluded from the scope of the advice, to the potential benefit or convenience of the adviser, and to the

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[17] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 7

http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep251-published-13-September-2011.pdf/$file/rep251-published-13-September-2011.pdf

[18] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 12

[19] ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 12

[20] ASIC (2013) *Report 362 Review of financial advice industry practice: Phase 2*, July 2013, p 12

[21] The annual allocations have been 71 per cent in2006, 73 per cent in 2007, 74 per cent in 2008, 73 per cent in 2009, 72 per cent in 2010, 77 per cent in 2011, 75 per cent in 2012, and 77 per cent in 2013. Roy Morgan Wealth Management Reports, 2007 to 2013

The most recent data is published in Roy Morgan (2013) *Superannuation and Wealth Management in Australia*, Report 15, Dec 2013, p 48. Note: 2010 data is for the calendar year

[22] Roy Morgan (2013) *Superannuation and Wealth Management in Australia*, Report 15, Dec 2013, p 49

[23] ASIC (2003) *Report 18 Survey on the quality of financial planning advice*, 5-6

[24] ASIC (2012) *Report 279 Shadow shopping study of retirement advice*, p 8

[25] ASIC (2006) *Report 69 Shadow shopping survey on superannuation advice*, p 8. Note: ASIC (2006) *Report 69: Shadow shopping survey on superannuation advice*, April 2006, did not publish advice quality measures equivalent to ‘adequate’ or ‘acceptable’. However, it did find that 21% of advice was not compliant with the law and that in 46% of cases where a Statement of Advice was required to be provided, it was not

significant detriment of the client.'[26] Last year, an ASIC study of advice regarding retail structured products found only half of the advice to have a 'reasonable basis'. In addition, two thirds of the advice featured a 'narrowing of the scope of advice to a single structured product' with little or no consideration of alternatives strategies/products and 'inadequate consideration of the client's needs and relevant personal circumstances.'[27]

In the market for life insurance, commission structures do not just lead to biased advice. Commission structures result in excessive churn of life insurance policies, with clients often recommended into more expensive polices with no increase in cover. There are documented instances in which this was found to occur without the client's personal circumstances being taken into account and often executed through the falsification of client information.[28] According to the estimates of members of the Financial Services Council (FSC), 'around one in six (and as many as one in three) new business applications for life insurance may be existing policies moved from one insurer to another.' Moreover, 'this practice is not in the best interest of consumers as it inevitably leads to an overall increase in the cost of insurance for all policyholders'.[29]

In 2007, the Financial Services Authority (FSA) in the UK found that the retail investment market suffered from similar market failures to those documented above. This was addressed by a best interests duty and fee-for-service based remuneration.[30] In 2010, the FSA banned all conflicted remuneration from Dec 31, 2012, stating that 'There is a need to reconnect the adviser and client, where one pays for the services of another, and without the distraction of commission. Only then can consumers have real confidence and trust in the advice they are receiving.'[31]

3.4 Evidence regarding consumer advice needs

The provision of financial advice in Australia is inadequate, especially considering the increasing retirement savings held by Australians due to superannuation. At a national level, a 2013 survey of 1000 Australians found only 15 per cent of respondents to be using a financial adviser.[32] Industry modelling estimates that the proportion of the adult population receiving advice has fallen 20 per cent in the last five years.[33] Looking more closely, research has found that advice is predominantly accessed by the wealthy segments of society. Australians earning over $150,000 are two-and- a-half times more likely to be receiving advice than those earning under this amount[34], while Roy Morgan has found that 50 per cent of advice is provided to the wealthiest 20 per cent. [35] This has increased consistently from 46 per cent in 2009.[36] A 2010 review of

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[26] ASIC (2012) *Report 279 Shadow shopping study of retirement advice*, p 12-13, and p 36

[27] ASIC (2013) *Report 377: Review of advice on retail structured products,* Dec 2013 p 13-15

[28] Peter Kell (2013) *FoFA and the new reality*, speech at Money Management and Financial Services Council (FSC) Breakfast Series, 12 March 2013.

[29] FSC Consultation Paper (2012) *Replacement Business Framework*, 3 April 2012, p 3

[30] Financial Services Authority (2007) *Discussion Paper 07/1: A Review of Retail Distribution*

[31] Financial Services Authority (201) FSA publishes rules on adviser charging FSA/PN/056/2010, 26 Mar 2010. Note: a limited exception is applied to stand alone personal risk products which have no investment component. These are called 'pure protection' policies

[32] Blackrock (2013) *Investor Pulse Survey*. This finding is consistent with other findings which survey financial advisers and accountants as separate categories. See for example ANZ (2011) *Adult Financial Literacy in Australia*, p 33, finds 18% of the 3500 surveyed adults had used a financial planner or adviser (not including accountants) in the 12 months to August, 2011, and the Investment Trends *Advice & Limited Advice Report* September 2013, estimates 14%, p 13

[33] Investment Trends (2013) *Advice & Limited Advice Report* September 2013, p 13

[34] Blackrock (2013) *Investor Pulse Survey*

[35] Roy Morgan (2013) *Superannuation and Wealth Management in Australia: An analysis of consumer behaviour, advice and fund performance*, p 19

[36] Roy Morgan, *Superannuation and Wealth Management in Australia: An analysis of consumer behaviour, advice and fund performance*, Reports 11 (2009), 12 (2010), 13 (2011) and 15 (2013)

access to financial advice in Australia found that the low level of advice provision is 'not due to a mismatch between the areas of advice consumers want, and the areas of advice financial planners currently address.'[37] Rather, the low level of advice provision is due to mismatches between the types of advice sought, how advice is provided, the cost of advice and the perceptions of the advice industry.

Advice is mostly commonly sought around defined "trigger points" such as purchasing a home or nearing retirement age.[38] Consequently, the most sought-after type of advice is "piece-by-piece" advice, especially for those who have not seen an adviser previously.[39] Yet, only 27 per cent of advisers promote the availability of piece-by-piece advice to their clients[40], with such transactional advice models not having the ongoing fees which are embedded in ongoing advice arrangements. In addition, the most recent Investment Trends survey found that 83 per cent of respondents preferred paying a flat-fee or hourly rate for financial advice.[41] This is in stark contrast to the remuneration breakdown document above with 90 per cent of total licensee remuneration paid as commissions and asset-based fees from product providers.

In 2012, a State Street survey found that about two-thirds of investors do not believe that advice providers act in the best interests of their client.[42] A Roy Morgan survey conducted in April 2013 'showed that only 25 per cent of the population rated financial planners as either "Very High" or "High" for ethics and honesty'.[43] This low rating of the ethics and honesty of financial planners remained unchanged since it was first tracked in 2009. Asked what makes you distrust a financial adviser, 87 per cent of the respondents in an Investment Trends survey stated fees and conflict of interests.[44] Industry research from last year found that "only one in three (34 per cent) Australians know where to find a financial planner they can trust"[45] and that the poor perception and experience of financial advice was the most common reason (49 per cent of 2409 respondents) why respondents would not look for a new adviser.[46]

3.5 Behavioural economics and the inadequacy of disclosure as the basis of the regulatory settings

The FoFA legislation was influenced by global advances in financial services reform following the Global Financial Crisis (GFC), a better understanding of behavioural economics and a view that disclosure alone is not enough to protect consumer interests.

The Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in Australia provided much of the foundations of the FoFA reforms. The final report gave extensive consideration to the effectiveness of disclosure in relation to consumer protection.

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[37] Australian Securities and Investment Commission (2010) *Report 224 Access to financial advice in Australia*, Australia Government, December 2010, p 19

[38] Baker, A. (2010) *Consumer Attitudes to Financial Advice: Research Insights*, p 18

[39] Investment Trends (2013) *Advice & Limited Advice Report* September 2013, p 17

Australian Securities and Investment Commission (2010) *Report 224 Access to financial advice in Australia, Australia Government*, December 2010, p 22. Note: Adviser includes accountants for tax advice

[40] Australian Securities and Investment Commission (2010) *Report 224 Access to financial advice in Australia*, Australia Government, December 2010, p 22

[41] Investment Trends (2013) *Advice & Limited Advice Report* September 2013, p 227

[42] State Street and Centre for Applied Research, *The Influential Investor: How investor behavior is redefining performance*, November 2012, p. 20, quoted in ASIC (2012*) Future of Financial Advice: Best interests duty and related obligations*, December 2012, p 5

[43] Roy Morgan (2013) *Image of Professions Survey*, April 2013. Quoted in Roy Morgan (2013) *Superannuation and Wealth Management in Australia*, Report 15, Dec 2013, p 50

[44] Investment Trends (2013) *Advice & Limited Advice Report* September 2013, p 117

[45] Financial Planning Association of Australia (2013), *Australians eager for financial advice*, Tuesday, 10 September 2013, http://www.fpa.asn.au/default.asp?action=article&ID=23091

[46] Investment Trends (2013) *Advice & Limited Advice Report* September 2013, p 97

"The complexity of investment strategies leaves the prospect of clients determining the quality of financial advice they receive, through the filter of personal knowledge, beyond the capacity of many. Most clients quite legitimately trust in the knowledge and professionalism of their financial adviser to provide them with good advice, and do not have the confidence in their own understanding of the subject to challenge the advice they are given. Therefore the regulatory system should, to a reasonable extent, protect consumers from poor advice, rather than relying on consumers being sufficiently financially literate to determine for themselves whether their adviser's recommendations are in their interests."[47]

Other evidence suggested that there are inherent limitations on what disclosure can do to protect consumers, no matter what the disclosure regulations provide for in terms of brevity and clarity. ASIC's submission suggested that 'disclosure can be an inadequate regulatory tool to manage the conflicts of interest created by commissions'.

They indicated that this is due to 'the strength of the conflict and consumers' difficulty in understanding their impact'. In evidence ASIC commented on the difficulty of ensuring that complex remuneration structures are clearly disclosed:

"...when you have multiple types of remuneration that are predominantly paid by the product manufacturer to the adviser and to the licensee for the sale of that product, on top of volume bonuses and potential conferences that you can go to, that complexity leads to the consumer's lack of understanding of how much it is costing them at the end of the day. So you do come across people who believe to a large degree that, because they have not written a cheque, they have not had to pay for the advice that they have received."[48]

More recent research in Australia and overseas has also found that people can be readily confused, and therefore vulnerable to misleading advice[49], and that without an understanding of how consumers receive and process information, greater disclosure can be ineffective or even counterproductive in relation to consumer protection. [50]

A number of surveys have found that Australians have relatively low levels of financial literacy, with less than half of those in most surveys feeling confident in participating in the financial system.[51] However, when seeking advice, quite possibly to remedy their situation, consumers are also poor at judging the independence of advisers[52] and the quality of advice.[53]

3.6 The genesis of the FoFA reforms

The sales-driven culture of the financial advice industry pre-FoFA, which created an environment where these numerous and large-scale financial scandals were possible, called for swift reforms. Following various

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[47] Parliament Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services in Australia, November 2009, p 101.

[48] PJC 5.60

[49] Andrew Reeson and Simon Dunstall (2009) *Behavioural Economics and Complex Decision-Making: Implications for the Australian Tax and Transfer System*, CSIRO CMIS Report Number 09/110, 7 August 2009

[50] Kristine Erta, Stefan Hunt, Zanna Iscenko, Will Brambley (2013) Applying behavioural economics at the Financial Conduct Authority, Occasional Paper No.1, Financial Conduct Authority, April 2013, p 25

[51] Australian Securities and Investment Commission (2013) *Stakeholder Survey*, p 21.

[52] Roy Morgan (2013) *Superannuation & Wealth Management in Australia: an analysis of consumer behaviour and fund performance: Report 15,* Dec 2013, p 50. See also Roy Morgan (2011) *Superannuation & Wealth Management in Australia: an analysis of consumer behaviour and fund performance: Report 13*, July 2011; Roy Morgan (2007) *Superannuation Choice: A Tracking Study into Consumer Behaviour and Fund Performance in Australia*, July 2007

[53] John Collett (2014) 'Good advice is hard to find', *Sydney Morning Herald*, February 16, 2014, http://www.smh.com.au/money/good-advice-is-hard-to-find-20140215-32siw.html

parliamentary inquiries[54], the Government announced an intention to undertake a series of reforms to financial advice laws[55], and then embarked on extensive consultations with industry on the detail of policy settings and the drafting of the reform measures. The legislation was then introduced in two main Bills in 2011.[56]

The FoFA legislation contains a number of interdependent components to improve the quality and availability of financial advice. ISA has always advocated strongly for the FoFA reforms, including the best interests duty, the ban on conflicted remuneration and the opt-in and transparent disclosure of ongoing fees. ASIC's regulatory power was also extended in relation to refusing, cancelling or suspending a licence or banning an individual in circumstances in which they are likely to contravene their obligations. Importantly, the imposition of personal advice obligations on the individual provider of advice facilitates ASIC's power to administratively ban individuals.

The FoFA reforms were intended to assist in transforming the financial planning industry to a professional footing. According to research commissioned by ISA from Rice Warner Actuaries, the FoFA reforms will have an unambiguously positive impact on the affordability and provision of financial advice and a very positive impact on the future level of superannuation and other savings.[57]

ISA notes that over the past year many financial planning businesses have demonstrated a strong commitment to improving standards, ensuring that conflicted forms of remuneration are phased out, and to building the professional basis of financial planning. The FoFA reforms have supported these efforts and ensure that minimum conduct requirements for providers of financial advice are significantly raised. It will undermine, if not jeopardise, the professional ambition of financial planners if product providers are able to recommence the practice of providing volume-based payments to incentivise the sales of their products.

4. The FoFA legislation

Commenced on 1 July 2013, the aim of the FoFA laws is to make sure consumers can obtain quality, impartial financial advice at a reasonable price.

The objectives of the reforms are to improve the trust and confidence of Australian retail investors in the financial services sector and improve access to advice.

Notably the legislation:

- Introduced a best interests duty requiring that financial advice be in the best interests of the client
- Prohibited sales commissions and other forms of conflicted remuneration for new clients
- Required advisers to seek biennial client approval to charge ongoing fees (the 'opt-in' requirement)
- Prohibited sales commissions on life insurance inside super

[54] Parliament inquiries from 2009 to 2011 include the PJC Inquiry into Financial Products and Services (2009), Inquiry into the collapse of Trio Capital (2011) and Inquiry into the Future of Financial Advice Reforms (2011)

[55] *Overhaul of Financial Advice*, Media Release, Treasury, Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, 26 April, 2010

[56] *Corporations Amendment (Future of Financial Advice) Bill 2012; Corporations Amendment (Further Future of Financial Advice Measures) Bill 2012*

[57] Rice Warner (2013) *The financial advice industry post FoFA*, prepared for Industry Super Australia, July 2013 http://www.industrysuperaustralia.com/wp-content/uploads/2013/07/Rpt-The-financial-advice-industry-post-FoFA-2013.pdf

5. FoFA Streamlining Proposals

5.1 Intention to implement legislative components of the proposals via regulation

The material released for Exposure Draft includes a set of amendments to the FoFA Regulations and to the FoFA legislative provisions. The Government has announced that it will move to make almost all of its proposed changes by way of Regulation before any legislation is debated or passed. However, draft regulations have not been released in relation to the "legislative" amendments, which represent the more significant aspects of the Government's proposals, including:

- Removing the catch-all provision from the best interests obligation
- Facilitating the provision of scaled advice
- Amending the application of the ban on conflicted remuneration
- Removing the opt-in requirement
- Removing the requirement to provide an annual fee disclosure statement to clients in ongoing fee arrangements prior to July 2013

The Minister's Explanatory Statement states:

> "As outlined above, the proposed Regulation will mirror the changes to the primary legislation to the extent allowed under the regulation-making powers in the Act. For the purposes of consultation, please provide comments on the draft legislative amendments.
>
> Incorporating these amendments into this Regulation will provide certainty to industry until the primary legislation can be put in place, and the amendments repealed following commencement of the Corporations Amendment (Streamlining of Future of Advice) Bill 2014."

However, ISA submits that rather than provide certainty, following this course of action is likely to create substantial confusion and uncertainty, for two reasons.

Firstly the regulatory powers could be challenged as the Government will be relying on provisions which allow the Minister to make exceptions only in 'prescribed circumstances' or a 'particular situation'. The Parliament would probably not have envisaged the provisions would be used to provide wholesale industry-wide exemptions. ISA has sought legal advice on the issue of whether the regulation making powers included in the FoFA legislation, on which the Government would need to rely, would support the making of regulations to implement the legislative amendments pre-emptively, as proposed. This advice, provided by the law firm Arnold Bloch Liebler, unequivocally states that such regulations would be at risk of being found to be invalid. As a finding of invalidity operates retrospectively, this would leave any advice provider who relied on the regulations at risk of being found to have acted unlawfully.

"'A court declaration of validity would operate retrospectively. This means, for example, financial advisers who relied on the obligations could be found to have acted unlawfully.

The regulations would therefore create significant uncertainty and could well become the subject of protracted litigation between financial advisers and their clients, for example in an investor class action."

Legal advice, Arnold Bloch Liebler - See Appendix 2

Secondly, given the substantial debate around the appropriate policy settings, the regulations are at risk of being disallowed by the Senate.

The only mechanism which will deliver a certain outcome is for the proposals to be legislated by the Parliament, and subjected to the scrutiny and debate which is inherent in the democratic process. ISA submits that given the extensive consultation, debate and scrutiny of the original FoFA legislation and the substantial concessions which were made to pass the FoFA reforms through the last hung Parliament, it is appropriate that Parliamentary approval be sought for the significant changes proposed.

Certainly, we submit that if *certainty* for industry is the desired objective, implementing the proposed amendments by making regulations is likely to produce the opposite effect.

In addition, by way of process, we strongly submit that it is impossible for interested parties to properly comment on the drafting of regulations based on the items in the Exposure Draft Bill. If the Government intends to proceed with making regulations on the "legislative" amendments, it is imperative that draft regulations be released. Especially given that the regulation making power is not unlimited, the proposed drafting of regulations is critical to enable parties to comment on the validity of the proposed regulations and to flag drafting errors or unforeseen consequences caused by the manner of drafting.

5.2 Cost vs benefit of proposed changes

The amendments detailed below will effectively repeal the best interests duty, remove the opt-in requirement and relax the ban on commissions in a number of areas. Treasury has estimated that the amendments will save the industry $190 million a year.[58] This estimate of industry saving is consistent with the previously published annual savings of $187.5 million per year estimated by Rice Warner Actuaries.[59] The Treasury estimate does not quantify any benefit or costs for consumers. The Rice Warner analysis on the other hand, finds that the benefits to consumers are more than twice that of the cost to industry over the next 15 years. In total, the benefits of the FoFA reforms are estimated to be $6.8 billion, far exceeding the cost of $2.4 billion over the next 15 years. This saving is consistent with another estimate of $6.6 billion in annual commissions paid by super members and consumers of financial products per year prior to FoFA.[60]

Modelling of the FoFA reforms also highlight benefits in addition to the savings to super members and consumers of financial products. Rice Warner Actuaries predict that by 2027 the FoFA reforms will:

- Boost Australians' savings under advice by $144 billion
- Reduce the average cost of advice from $2,046 (before the reforms) to $1,163, and
- Double the provision of financial advice from 893,000 pieces to 1.88 million pieces[61]

5.3 Regulatory Impact Statement

ISA believes the options stage RIS is wholly inconsistent with the guidelines in the Best Practice Regulation Handbook[62]

Specifically the Options Stage RIS does not provide rigorous evidence based assessment of the proposals. The handbook states that **(emphasis added)**:

> ***"Best practice regulation-making***
>
> *1.11 While regulations are necessary for the proper functioning of society and the economy, the challenge for government is to deliver regulation that is:*
>
> *a. effective in addressing an identified problem*
>
> *b. efficient in maximising the benefits to the community,* ***taking account of the costs****.*
>
> *1.12 Government intervention should* ***lead to an overall improvement in community welfare****.*

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[58] Treasury (2013) *Future of Financial Advice Amendments – Options-stage Regulation Impact Statement*, Commonwealth of Australia

[59] See Appendix B in Rice Warner (2013) *The financial advice industry post FoFA*, prepared for Industry Super Australia, July 2013.

[60] Rainmaker Information (2011) Commissions Revenue Report 2010, prepared for Industry Super Australia, August 2011

[61] Rice Warner Actuaries, *Transformation of the Financial Advice Industry*, March 2010

[62] http://www.dpmc.gov.au/deregulation/obpr/handbook/Content/01-productivity-evidence-based-policy.html

> *1.13 Determining whether regulation meets the goals of effectiveness and efficiency requires a structured approach to policy development that **systematically evaluates costs and benefits**."*

Although the Government's proposals are deregulatory in nature they represent a government policy intervention which will have measurable impacts on business, community, and the economy.

The regulation of financial advice is systemically important in Australia's finance system through promoting efficient and fair market conduct. The system is characterised by a fundamental information asymmetry between advisers and many retail investors. Without effective and efficient regulation these information asymmetries may lead to detrimental outcomes.

The regulatory settings for financial advice are especially important as superannuation constitutes around 60 per cent of funds under management in advisory practices. The security and performance of these savings will directly impact on retirement income adequacy and long term age pension outlays.

ISA notes that the Government has chosen not to undertake a full Regulatory Impact Assessment (RIA) as its proposals are election policies. Given the systemic importance of these changes the Government should undertake a full RIA which would include consideration of alternative policy options which may be preferable.

Assessment of impacts in the Options Stage RIS

The Option Stage RIS needs significant improvement to achieve the Best Practice Handbook guidelines which state[63]:

> *"**Element 4: Impact analysis—costs, benefits and risks***
>
> *7.40 A details-stage RIS should contain a comprehensive assessment of the expected impact (costs and benefits) of each identified option. The RIS should provide the net benefit of each option. Your objective here is to inform decision-makers of the likely merits of available options, and thereby inform their decision. The impact analysis in the details-stage RIS should be informed by the options-stage RIS and the results of subsequent consultation on the proposed options.*
>
> *7.41 When analysing each option, you should consider who would be affected if the option were implemented, what costs, benefits and, where relevant, levels of risk would result, and how significant they would be. Where possible, quantify the impacts; at a minimum, your analysis should attempt to quantify all highly significant costs and benefits. All assessments of costs and benefits, whether quantitative or qualitative, should be based on evidence, with data sources and assumptions clearly identified.*
>
> *7.42 Where it is not possible to quantify impacts, qualitative analysis may be acceptable as long as you clearly set out the reasons why the impacts are not quantifiable."*

The Options stage RIS is not suitable for decision making as it currently does not adequately assess the costs of the intervention, the risks involved and their significance. Further the options stage RIS does not adequately identify data sources and assumptions for the estimated benefits and their incidence.

Section 2.15 of the OBPR Handbook specifically recommends both positive and negative effects to be quantified in monetary terms where possible as well as impacts on competition.

ISA would note that there is robust information available in the public domain to assess the benefits of the reforms including a high level cost benefit analysis undertaken by Rice Warner Actuaries[64].

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[63] http://www.dpmc.gov.au/deregulation/obpr/handbook/Content/07e-preparing-regulation-impact-statement.html

[64] http://www.ricewarner.com/images/newsroom/1374717972_Rpt%20The%20financial%20advice%20industry%20post%20FoFA%2002013.pdf

The Options Stage RIS assessment of individual measures glosses over potentially detrimental outcomes from the regulatory changes or ignores them completely.

As a consequence the Options Stage RIS provides an unbalanced assessment of the reforms and does not, in its current form, allow decision makers to assess whether the savings to business from the proposed reforms exceed the potential consumer detriment. Without such an assessment a manifestly poor economic and public policy outcome will almost certainly eventuate.

ISA notes that 11 of the 16 measures do not have a quantifiable compliance cost saving. For these measures any consumer detriment from the measures will result in an unambiguously detrimental public policy outcome. In ISA's view most if not all of the 11 measures without a quantifiable business cost saving will result in detrimental outcomes for consumers.

To assist in the preparation of a better quality details stage RIS ISA makes the following comments:

Table 3: Regulatory Impact Statement

Issue	RIS Comment
Economic and competition impacts	The RIS should include an assessment of the economic and competition impacts from the changes in isolation and in combination. The proposed changes will re-permit the payment of currently prohibited conflicted remuneration through a number of channels. The availability of such incentives will undermine merit based product selection. They may distort advice leading to a narrowing of products which an adviser is prepared to recommend. This will impair competition and could lead to sub-optimal product recommendations to retail investors who would bear the cost through lower investment returns and potentially inappropriate exposure to risk. Further the availability of conflicted revenue channels will reverse pressure on the industry to operate their business transparently on a fee for service basis. This is likely to lead to an increase in the cost of advice for consumers and reduce the capacity for consumers to assess value for money for advice services between providers. Sections of the industry will not be prepared to pay conflicted remuneration and their products may be excluded from adviser's product considerations. As a consequence product recommendations risk not being made on merit. This will reduce competitive pressures in the market place resulting in less product innovation. Increased costs (and lower net investment returns) for consumers will flow through directly to reduced retirement savings. This will result in a lower standard of living in retirement and greater pressure on the taxpayer funded age pension. The proposals will also reduce the legal obligations in respect to the Best Interest Duty and allow advisers to limit the scope of advice. These changes could expose consumers to greater risks and impact on competition by narrowing advice in an anti-competitive way (for instance narrowing the scope of advice such that there is no comparison of an investor's existing product and an alternative product).

Issue	RIS Comment
Remove opt-in requirements.	The removal of the opt-in requirements will have a number of potentially negative impacts. Rather than reducing the cost of advice it will likely increase costs due to the capacity of advisers to earn revenue from disengaged clients for which no service is being provided. Ongoing asset based fees are up to 17 times more costly[65] than fee for service alternatives. The RIS can quantify this cost by using and average account balance and projecting the actuarial cost of an ongoing fee for the proportion of disengaged members[66] who would otherwise their fees automatically cease with the opt-in trigger. The risk of this measure is significant due to the possible negative impacts on retirement savings for individuals and long run age pension outlays for Government. Both of these impacts could be quantified using Treasury's RIMHYPO and RIMGROUP models with sensitivity analysis. The removal of the opt in is also likely to reduce the provision of lower cost scaled advice by advisers who will be incentivised instead to offer opaque ongoing service arrangements in full knowledge that fees can continue to be charged even when no service is actually provided. As noted above some sections of the industry will not permit ongoing fee deductions from member accounts thus impacting on merit based product selection and competitive dynamics.
Limit the annual fee disclosure requirements to be for prospective clients only.	Limiting fee disclosure to new clients only is likely to reduce positive action by consumers to terminate or negotiate better fee arrangements with their adviser. This could also be quantified as a consumer cost in the RIS using assumptions about what proportion of consumers who would otherwise opt-out following fee disclosure and what the fees would otherwise be. Sensitivity analysis would be appropriate.
Removal of the 'catch all' provision in the best interests duty.	The removal of the provision may impact on the thoroughness and care exercised by advisers when preparing advice. Consumers may be disadvantaged if it results is advisers delivering poorer advice. It could increase the likelihood of misselling and inappropriate advice. The potential costs of this measure are difficult to quantify but it could increase the risk of financial advice scandal with accompanying losses.
Explicit provision of scaled advice.	Allowing advisers to negotiate the scope of advice could result in a diminution of competition and a narrower range of product offerings to consumers. To the extent that it facilitates the recommendation of more costly products there is a consumer cost. For example the provision may allow an adviser to provide advice to transfer a superannuation interest to a Choice super product without explicitly considering the cost of a MySuper product which they may currently be invested in. The average fee differences between these products coupled with a hypothetical balance could be used to quantify potential consumer detriment.

[65] http://www.industrysuperaustralia.com/rice-warner-research-value-of-advice

[66] http://www.industrysuperaustralia.com/roy-morgan-research-supports-need-for-opt-in-provisions

Issue	RIS Comment
Limit the ban of commissions on risk insurance to circumstances where no personal financial advice has been provided, specifically where automatic cover is provided under a default (MySuper) fund.	There is no business compliance benefit from this measure, however there is a significant consumer cost since the price of risk insurance with adviser commissions is significantly more than without even after allowing for fee for service advice alternatives. A consumer impact can be quantified by taking the actuarial value of a typical 30% commission on a risk product through to retirement and comparing to a fee for service or intra-fund advice alternative. Sensitivity analysis would be appropriate to determine aggregate consumer impacts depending on take-up. Additional second round effects occur since it may incentivise the recommendation of a Choice super product over a cheaper MySuper alternative where the commissions on the packaged risk are not permitted.
Exempt "general advice" from definition of "conflicted remuneration".	The consumer costs of this measure are difficult to quantify, however it may have a number of detrimental effects on consumers including: • Incentivising planners to only provide general advice rather than personal advice (where conflicted remuneration is generally prohibited) even when personal advice may be more appropriate; • Reduce the capacity of consumers to evaluate the suitability of products as the advice is not tailored to their circumstances; No requirement for advisers to disclose commissions accruing on products sold through general advice .
Clarify the exemption from the ban for execution-only services.	There is no business compliance benefit from this measure, however it may involve significant consumer detriment through the payment of commissions on advice simply through separating the advice and execution functions. Employees could work in tandem to maximise commission revenue for each other by splitting functions.
That the training exemption permits training expenses related to conducting a financial services business, rather than just the provision of advice.	There is no business compliance benefit from this measure, however it will increase the flexibility of financial services businesses to link advice provision to training rewards (such as conference attendance and accommodation) not necessarily related to advice services.
Amendments to volume-based shelf-space fees.	There is no business compliance benefit from this measure, however it will adversely affect consumers as it will permit the payment of volume bonuses through platforms. It may result in consumers being placed in more costly products because there is a financial incentive for the adviser to do so. Such wholesale commissions are not disclosed to consumers and represent a cost which they bear through lower investment returns. Volume based shelf fees can be quantified.
Clarify the definition of intra-fund advice.	There is no business compliance benefit from this measure. ISA does not believe there is any significant consumer cost.
Grandfather existing remuneration from the ban on conflicted remuneration.	There is no business compliance benefit from this measure however there is a clear consumer cost similar to the effects from the repeal of Opt-in. Under the proposal commissions will continue to be paid to an adviser if they change jobs and move to a new licensee rather than clients being given the opportunity to consider better value alternatives. The cost can be quantified by assessing the extent of adviser turnover, average 'book size' and quantifying the fee impact from different fee structures that would otherwise be offered (including those who wish to opt-out of any ongoing fee arrangement)

Issue	RIS Comment
Explicitly recognise that a "balanced" remuneration structure is not conflicted remuneration.	There is no business compliance benefit from this measure however there is a clear consumer impact (assuming full pass through of the cost of a volume incentive) equal to 10% of the payroll of bank aligned financial planners. The impact of this can be actuarially determined over a working life.
Allow bonuses to be paid in relation to revenue that is permissible under FOFA.	There is no business compliance cost benefit from this measure but this will allow volume rebates to be paid from platforms direct to advisers. The cost of such bonuses will ultimately be borne by consumers through lower investment returns. The impact of this can be actuarially determined over a working life.
Allow banks to continue to take advantage of the basic banking carve-out, even when providing financial advice on other products.	There is no business compliance cost benefit from this measure but could affect the quality of advice by allowing conflicted basic products to be packaged with otherwise exempt products. The commissions on basic banking products could be structured to maximise packaged benefits. The impact of this is difficult to quantify but it could facilitate practices used in previous financial advice scandals.

5.4 Proposed changes to the best interests obligation

The Government has proposed to make a number of changes to the "best interest duty" which, along with the ban on conflicted remuneration, was a key pillar of the FoFA reforms. The introduction of the duty was aimed at raising professional standards and by doing so, increasing consumer trust and confidence in financial advice. The Government's reason for proposing changes to the duty is to 'reduce compliance costs for small business, financial advisers and consumers who access financial advice[67]'.

However, the proposed amendments will substantially lower the conduct obligations for providers of financial advice and will no longer require an adviser to act in the best interests of their client. ISA strongly contends that it would be counterproductive to seek to increase access to financial advice if that advice is of a lower standard and is not in the client's best interests.

Our comments on the changes are summarised in table 4:

Table 4 – Proposed changes to the best interests duty

Change	Background/ impact
Removing the requirement for planners to consider a client's best interests by removing sections 961B(2)(g) and 961E	If (g) is removed, planners will be able to meet the best interests duty without having to act in, or even consider, the client's best interests. While the advocates for this change argue that (g) is a "catch all", the other six steps in (a) to (f) of the best interests duty do not mention the client's best interest but rather deal with process-related steps. S961E states that the adviser's conduct will be judged by what a "reasonable adviser" would do. Its deletion deprives a provider of advice of any legislative guidance as to the level of conduct against which their conduct will be judged.
Reducing planners' responsibility to investigate client circumstances by removing section 961B(2)(a) and replacing it with a new section 961B(2)ba)	This significantly narrows the adviser's responsibility for investigating the client's needs and circumstances – no explanation is provided in the explanatory memorandum for this change. The drafting means that a "fact find" will only be required on the defined subject matter of advice and information "provided" by the client.

[67] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 7

Change	Background/ impact
Clients and advisers are to “agree” on the scope of advice	This proposed change would mean that if the “agreed” scope of advice is not in the client’s best interests, the planner will not be responsible. Determining the scope of advice is arguably the most important aspect of providing financial advice. This is like a doctor being able to avoid responsibility for diagnosing a patient by getting the patient’s agreement on the symptoms to be treated. Given the disparity in knowledge between financial planners and their clients, “agreement” would be open to abuse. This results in a weaker obligation than what pre-existed FoFA when an adviser could not use client “agreement” to narrow their legal duties.

Removal of (g) effectively repeals the best interests duty

The construction of the best interests duty in s961B includes two subsections. Subsection (1) creates the principles-based obligation for an advice provider to act in their client’s best interests. Subsection (2) creates a “safe harbour” – a set of steps, which if a provider can show they have followed, is proof that they have acted in the client’s best interests. At the time the original drafting of the obligation was being consulted upon, ISA strongly favoured the inclusion only of subsection (1). However, the safe harbour was included as it was the preference of most of the industry to have more certainty about expected conduct.[68] However, it is unusual for a best interests obligation to specify a finite number of steps as a safe harbour – these are more typical of a “duty of care”. The steps in subsections (a) to (f) are of course important and relevant to the financial planning process, but they fall short of requiring advice in the client’s best interests. The steps in (a) to (f) do not even mention a client’s best interests. Further, the proposed deletion of s961E deprives a provider of advice of any legislative guidance as to the level of conduct against which their conduct will be judged.

We attach legal advice we have obtained from Arnold Bloch Liebler which concludes that the regulations/proposed legislation are:

- *Inconsistent with the nature of a best interests duty*
- *Would significantly reduce the protection that the duty affords to clients of financial advisers*
- *Do not eliminate the legal uncertainty associated with financial advisers; and*
- *Do not eliminate the legal uncertainty associated with financial advisers attempting to reduce the scope of the duty by agreements with their clients*

Legal advice, Arnold Bloch Liebler - See appendix 2

The industry has raised significant concerns that (g) gives rise to legal uncertainty due to its open-ended nature. Given that one of the core objectives of the reforms was to improve the quality of advice and raise the professionalism of financial planning, it would be concerning if the new requirements did not necessitate some adjustments in the industry. Indeed, it will inevitably take some time for the industry to adapt to the new higher conduct obligations to require “best interests advice” The new requirements should be given an opportunity to be fully implemented and we strongly contend that it would be premature to set about any changes to the duty after less than a year since the commencement of the requirements.

[68] Parliamentary Joint Committee on Corporations and Financial Services (2012) *Final Report: Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, February 2012, p 46-51

However, if the "safe harbor" is amended as proposed in the Exposure Draft, and includes only process based steps with no requirement for the adviser to exercise any professional judgment, it will fail to require advice in a client's best interests.

'Agreement' on scope can allow advice not in client's best interests

The Exposure Draft also proposes the insertion of a 'note' as s961(4A) which provides as follows:

> *"Client seeks scaled advice*
>
> *(4A) To avoid doubt, nothing in subsection (2) prevents a client from agreeing the subject matter of the advice sought by the client with the provider."*

The Draft Explanatory Memorandum explains that the inclusion of this wording in the duty is intended to 'better facilitate the provision of scaled advice[69]'. However, this wording is highly problematic. The wording appears to allow agreement on a scope of advice which a reasonable adviser would know is not in the client's best interests. The drafting would seem to permit "agreement" to exclude important and relevant matters from the subject matter of the advice, "agreement" to only consider certain products or ignore obvious alternative strategies which are less lucrative, for instance, a recommendation to pay off the client's mortgage rather than make new investments. Given the knowledge asymmetry which exists between client and adviser, it is unlikely that most clients would be able to understand the impact of such an agreement. Such an agreement was never permitted even under the duty which pre-existed FoFA (s945A). There have been numerous past cases in which the opportunity for abuse of such a mechanism has been revealed. For instance, in 2006, AMP entered into an enforceable undertaking with ASIC after having obtained the "consent" of thousands of their clients to switch their super into AMP Financial Planning approved products without undertaking any analysis or comparison of the product in which their super was held. Such analysis would have revealed that in many cases their existing products were superior products, and that the super switch would leave them significantly worse off.[70] Similarly, in a recent shadow shop survey of retirement planning advice ASIC found that in "several instances [of scoped advice], particular topics were excluded from the scope of the advice, to the potential benefit or convenience of the adviser, and to the significant detriment of the client."[71] Examples of poor scoping included not addressing a client's existing debt, and excluding a client's cash flow, expenses, defined benefit fund and insurance within superannuation from the scope of advice. Moreover, in half of all advice examples surveyed where limited advice was provided, there was inadequate disclosure regarding the limitations of that advice.[72]

So even under the old pre-FoFA requirements, an adviser could not seek to limit their responsibilities by obtaining client 'consent'.

So, if the proposed clause would facilitate "agreement" by simply obtaining the client's signature on a page, it would certainly represent a very significant dilution of an adviser's legal obligations. However, if the notion of "agreement" is interpreted by the courts as requiring a client's "informed consent", this would undoubtedly introduce an element into the obligation which will result in considerable legal risk, uncertainty and significant litigation.

In any case, ISA refutes that the current wording of s961B prevents the delivery of scaled forms of advice. Indeed, the section explicitly acknowledges that scaled advice is possible. Currently, if a client wants advice limited to a particular issue, then all an adviser must do is check the factors which might reasonably mean that the limited advice is not in their interests. However, this should not be an onerous task and certainly does not necessitate an investigation into the client's entire financial circumstances. This was made clear in

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[69] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 7

[70] *Enforceable Undertaking – AMP Financial Planning Proprietary Ltd*, ASIC, 27 July 2006

[71] *ASIC (2012) Report 279 Shadow shopping study of retirement advice,* p 13

[72] *Ibid., pp36-38*

the note below s961B (also proposed to be deleted) and in the Explanatory Memorandum issued with the original legislation.

> *"As long as the provider acts reasonably in this process and bases the decision to narrow the subject matter of the advice on the interests of the client, the provider will not be in breach of their obligation to act in the client's best interests."*[73]

However, the obligations set out in the current s961B does prevent limiting the scope of advice if done in a self-serving manner – for instance, to exclude obvious strategies from consideration which may be less lucrative to the adviser, or to only consider the products of one provider without any benchmarking to ensure the product represents value.

The types of consumers who seek limited forms of advice are typically less engaged and financially literate, and are the group most in need of the protection of a "client's best interest" test. The proposed changes represent a significant deregulation of the requirements when providing advice, and will allow financial advice to be about selling products rather than providing impartial professional services.

The Minister's Statement noted that consumers would still be protected by the requirement for advice to be appropriate. However, the unanimous findings of the Parliamentary Joint Committee into the Storm collapse were that that the "appropriateness test" was inadequate to protect consumers.

The proposed amendments in the *Corporations Amendment (Future of Financial Advice Streamlining) Bill 2014* will render the best interests duty ineffective. Financial advisers will again be the only professionals not subject to a rigorous, unequivocal and legally enforceable obligation to act in the interests of those who engage them. The best interest duty is crucial to ensuring that consumers can expect impartial, trustworthy and quality advice, and that mis-selling does not lead to financial scandals like those we have seen in the past.

Table 5 – Comparison of legal obligations under the various regimes

Legal obligations	Pre FoFA Obligations	FoFA Obligations	Proposed Amendments
Scoping of advice	Planner responsible for determining scope of advice based on client's personal circumstances	Planner responsible for ensuring the scope of advice is in the client's interests	Planner not responsible for advice which is not in the client's interests if the scope is agreed with the client
Fact find obligations	Determines and makes reasonable inquires about the client's relevant personal circumstances relevant to giving the advice	Planner must ask about circumstances relevant to the advice sought	Planner must ask about circumstances relevant to (agreed) scope of advice and what client volunteers
Recommendations	Recommendations must be appropriate (even if a reasonable planner would know that the advice was not in the client's interests)	Recommendations must be in the client's best interests, judged by what a person with reasonable expertise in the subject matter, exercising care and objective judgment would do	Recommendations must be appropriate, and based on the client's circumstances relevant to advice sought (even if a reasonable planner would know that the scope of advice or resulting recommendations were not in the client's interests)

[73] *Explanatory Memorandum, Corporations Amendment* (Further Future of Financial Advice Measures) Bill, 2010-11 p 12

The best interests duty obviously sits alongside other conduct obligations in Part 7.7A of the Corporations Act. Notably, these include the obligation for advice to be appropriate (s961G) and for the provider to give priority to the client's interests when giving the advice (s961J). Our submission above has already addressed the documented inadequacies of the appropriateness test, which fails to meet the expectations most Australians have of their financial adviser. In addition, were the insertion of 961B(4A) to be undertaken, the obligation in s961G is weaker than the previous appropriateness obligation in s945A, because at least in the latter the adviser retained an obligation to scope advice having regard to the client's needs and circumstances.

Similarly, while the priority obligation is an important supporting obligation it is less effective as a conduct requirement than the best interests obligation. Furthermore, the priority obligation is owed in relation to "the advice" given to the client (s961J(1). The advice is the subject matter or scope of advice. Therefore, once again, the proposed changes to s961B(2) and s961E and the proposed insertion of s961(4A), which narrow an adviser's responsibilities in determining the scope of advice will impact on the duty owed in s961J, because the duty of priority will be owed only on "the advice" provided.

5.5 Proposed Repeal of the opt-in requirement and limiting of annual fee disclosure statement to new clients

The opt-in requirement attracted more objections from the industry than perhaps any of the other measures at the time the provisions were initially legislated. The Exposure Draft sets out the intended repeal of the renewal requirement (commonly called the "opt-in") in section 962K-N, and defers the fee disclosure requirements so that all existing clients of financial advisers will not receive an annual disclosure of fees.

> *"The Government has committed to remove the requirement for advisers to obtain their client's approval at least every two years in order to continue an ongoing fee arrangement (known as the 'opt-in' requirement) on the basis that it would unnecessarily increase costs, red tape and uncertainty for both consumers and businesses*." [74]

The opt-in measure requires that a planner charging an ongoing fee asks their client at least once every two years if they can continue to deduct the fee. The opt-in is already a compromise measure, necessary only because FoFA allowed ongoing percentage-based fees to continue. It was originally proposed as an annual requirement, but its frequency was reduced as a concession to industry. The "opt-in" requirement was proposed to ensure that asset-based fees do not replicate sales commissions. Like commissions, asset-based fees are deducted indefinitely on a regular basis from a client's account, paid via product provider to adviser. In many cases these fees remain in place through client inertia and disengagement. A report by ASIC found that of the largest 20 financial advice licensees less than a third of financial planning clients are "active".[75] Without a trigger such as the opt-in millions of Australians will continue to pay for advice services which they don't receive. Analysis of Roy Morgan research and APRA data suggests around two million super fund members were paying ongoing fees for financial advice but not receiving any financial advice at all.[76]

Asset-based fees have exactly the same effect as sales commissions in the following ways:

- Financial planners' remuneration – as under the sales commission-system – is dependent on the sale of a product or is linked to the accumulation of assets under management

[74] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 13

[75] ASIC (2011) Report 251 Review of financial advice industry practice, September 2011.

[76] Roy Morgan (2011) *Retirement Planning Report*, June 2011 and ISA estimates

- Asset-based fees will perpetuate the planning industry's bias towards product providers who are prepared to allow asset-based fees to be deducted from members' super and investments, rather than on the investment performance of the product
- Ongoing asset-based fees are much more erosive of long term investments and savings (when compared to a flat fee for service payment structure) due to their compounding effect
- Asset-based fees provide an annuitised payment from the product provider to the adviser, which continues indefinitely with no requirement for ongoing advice to be provided
- Ongoing asset-based fees also obscure the full cost of advice and lead to fees escalating over time with assets, whether or not the increase in assets was due to the advice
- Ongoing asset-based fees for advice do not necessarily have any connection with the quantity or quality of advice provided
- Purchases of advice by retail consumers in other industries, such as legal, medical, accounting, architectural or engineering services, are charged on a one-off time or service-based fee model. Proper fee-for-service arrangements, which are one-off or paid for by installment and which relate to a particular piece or quantity of advice, are more likely to generate a professional and product-neutral advice industry
- Given the potential for ongoing fees to replicate the ill effects of commissions and other conflicted forms of remuneration, the renewal requirement and the annual disclosure requirement are both critically important to the FoFA reforms
- In particular the renewal requirement is the only safeguard to specifically ensure that consumers who are paying ongoing advice fees continue to receive advice services, to minimise the potential for fees to be passively earned by advisers and to protect against the erosion of the client's superannuation and other assets

Without the opt-in, there is no mechanism to ensure that ongoing fees are only being charged where ongoing advice (or at least ongoing communication) is being received. Removing the opt-in will cost consumers – even a 0.5% ongoing fee can cost an average member around $46,000 from their super over their working life.[77] Advice paid for by ongoing fees or commissions is estimated to cost up to 17 times more than advice paid for on an up-front basis.[78] For this reason, we submit that this requirement is critical to ensuring that charging for financial advice shifts to a more professional and economically efficient basis, and one in which there is a mechanism to ensure fees are not charged unless ongoing advice is being provided.

The Exposure Draft also seeks to remove the requirement for annual disclosure of adviser fees to be provided to the existing clients of financial advisers at the time the FoFA laws commenced.

Prior to FoFA there was no obligation for financial advisers to provide a consolidated annual statement of the fees they received on behalf of clients. To determine annual fees paid, clients would need to go through all product statements to add up the fees received by their adviser.

Under the amendments the annual fee disclosure statement will only apply to new clients. Existing clients will have no consolidated communication of ongoing fees. Notwithstanding the complaints of industry regarding the cost of compliance with this measure, the benefits to consumers far outweigh the estimated cost to industry.

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[77] Using ASIC Moneysmart superannuation calculator (Imputs: AWOTE, .5%, 40 year time span, starting balance $10k)

[78] Rice Warner Actuaries, *Value of IFFP Advice*, May 2011

Table 6 – Proposed changes – Opt-in and fee disclosure

Change	Background	Impact
Removal of the opt-in requirement	The opt-in measure requires that a planner charging an ongoing fee asks their client at least once every two years if they can continue to deduct the fee. The opt-in is already a compromise measure, necessary only because FoFA allowed ongoing percentage-based fees to continue. It was originally proposed as an annual requirement, but its frequency was reduced as a concession to industry.	Without the opt-in, there is no mechanism to ensure that ongoing fees are only being charged where ongoing advice (or at least ongoing communication) is being received. Removing the opt-in will cost consumers – even a 0.5% ongoing fee can cost an average member around $46,000 from their super over their working life.[79] Currently around 3 million Australians are paying commissions and ongoing advice fees but are not receiving any ongoing financial advice[80].
Fee disclosure only for new clients	Prior to FoFA there was no obligation for financial advisers to provide a consolidated annual statement of the fees they received on behalf of clients. To determine annual fees paid, clients would need to go through all product statements to add up the fees received by their adviser	Under the amendments the annual fee disclosure statement will only apply to new clients. Existing clients will have no consolidated communication of ongoing fees.

5.6 Proposed changes to create further exemptions to the conflicted remuneration prohibition

The second major pillar of the FoFA reforms was to prohibit the payment and receipt of conflicted forms of remuneration which have been proved, time and again, to bias and compromise the quality of financial advice received by Australian consumers and in extreme cases fuel blatant mis-selling of risky or poor quality products.

Conflicted forms of remuneration for financial advice are problematic because they:

- Cause a conflict of interest because the adviser is paid by the product provider not the client, and so will only be paid for recommending a certain product and receives payment only after a recommendation is implemented
- Are often combined with other conflicted remuneration structures such as shelf fees and volume rebates
- Are anti-competitive in the sense that products with higher commissions are favoured; good products which do not pay a commission will seldom be recommended even if they are superior
- Are economically inefficient in the sense that they are not tied to the provision of a quantity of advice – commissions are paid irrespective of ongoing provision of advice services

[79] Using ASIC Moneysmart superannuation calculator (Imputs: AWOTE, .5%, 40 year time span, starting balance $10k)

[80] Roy Morgan (2011) *Retirement Planning Report*, June 2011 and ISA estimates

- In some cases, lead to bad advice because they encourage the planner to steer consumers into strategies which inflate their investments or exposure, to increase up front commissions (for example, the gearing strategies used in the Storm cases)
- Are difficult for consumers to understand; this reduces the capacity for consumers to compare prices or to digest the financial impact that commissions have on their investments
- Are more erosive on retirement savings and other investments than one-off advice fees (the longer term the investment, the more erosive commissions are)
- Deeply compromise the ambition of financial planners to be regarded as a true profession
- Damage consumer trust and confidence in advice

The original FoFA legislation and grandfathering provisions included a number of very significant exemptions and concessions to various parts of the industry as follows:

- General insurance
- Risk life insurance, other than group life or life in a default super product
- Basic banking products (which are also excluded from most of the best interests duty)
- Other benefits prescribed in regulation
- Soft dollar benefits which relate to genuine professional development training or IT software or support
- Ongoing asset-based fees
- Products entered into prior to July 1, 2013 (inclusive of additional interests in those products)
- Execution-only services (provided that no advice at all was provided to the client by any representative of the licensee in the prior 12 months)
- Stamping fees
- Timesharing schemes
- Brokerage fees
- Balanced scorecard arrangements (provided the criteria and quantum benefits available are structured so that they do not influence advice provided)

In addition to the various exemptions, the reforms grandfathered a total of $11.4 billion in payments over the next 15 years.[81] These grandfathered arrangements include commissions; volume rebates; ongoing fees; soft-dollar benefits and other forms of conflicted benefits which pre-existed the reforms.

ISA submits that no further concessions to the conflicted remuneration prohibitions should be contemplated because they would seriously compromise the objective of ensuring that consumers can trust that they are receiving impartial financial advice which is not tainted by commissions. Many of the new exemptions would permit conflicted remuneration to be received in relation to personal advice recommendations, and many would also enable commissions to be paid on superannuation and complex types of products.

Ultimately, the reason why industry seeks the capacity to pay volume based remuneration is because it is effective in influencing the activities of advice providers. It is precisely for this reason that volume based remuneration is problematic.

The following table includes a summary of the proposed amendments and our analysis of their impact. We will then set out more detailed submission on each of the measures.

[81] Rice Warner Actuaries (2013) *The Financial Advice Industry Post FoFA*, prepared for Industry Super Australia, p 35

Table 7 –Proposed changes – conflicted remuneration

The proposed change	Impact
Commissions for general advice allow product suppliers to once again pay commissions to advisers for promoting their products when providing 'general financial advice' (this would include activities by financial advisers, bank tellers, call centre staff, business development staff, providers of seminars)	This change would establish a broad exemption to the ban on conflicted remuneration and would permit commissions and other conflicted remuneration to be paid when general advice is provided. While general advice is not tailored in the way that personal advice is, it still involves interaction where a product is being promoted and recommended. Exemption would apply even where general advice is provided by a financial planner. Problematically, the exemption would apply even where MySuper, superannuation and other complex products are recommended (including leveraged products). There would be no limit on how much a supplier can pay as a commission. There is no requirement for disclosure of the receipt of the conflicted remuneration, nor is there any record of advice provided making regulatory scrutiny extremely challenging. *'The Government considers that the application of the ban on conflicted remuneration risks limiting the availability of general advice and unnecessarily burdens industry by capturing staff not directly involved in providing advice to clients.' (Draft Explanatory Memorandum p19)*
Allow product suppliers to pay commissions to advisers for sales of super products via the insurance premiums	More and more people are taking up life and income protection insurance as part of their superannuation account. This proposed change will reopen the prospect of advisers recommending superannuation products based on the possibility of receiving commissions. The Cooper Review recommended against allowing the payment of any commissions from super. *'The Government has committed to minimize the market distortions and cost impacts that may result from the differing treatments of these benefits inside and outside of superannuation by broadening the exemptions provided for benefits paid in relation to life risk insurance offered inside superannuation.' (Draft Explanatory Memorandum p.20)*
Allowing banks and other suppliers to pay 'wholesale' commissions to advisers based on the volume of the suppliers product sold. This type of payment is referred to as a 'volume rebate' by the industry.	Advisers and advice firms currently receive billions of dollars in wholesale commission via a rebate which is based on the amount of money directed to a particular fund manager. These payments are justified by the industry as a payment reflecting 'economies of scale' in investment. However, unless these rebates are passed through to the client, they represent a significant and opaque wholesale commission worth billions of dollars per year. Exemption would apply even where personal advice is provided by a financial planner. Problematically, the exemption would apply even where MySuper, superannuation and other complex products are recommended (including leveraged products).

The proposed change	Impact
Allowing commissions and other conflicted payments if the client consents	The FoFA legislation allowed the client to authorise payment for advice from their own investments. This proposal, however, would enable commissions and other conflicted payments to be paid by third parties provided the client "consents". Allowing conflicted payments from product providers to be paid, provided the client "consents" ignores the knowledge gap between the adviser and the client. An adviser should not be able to get around the prohibition on conflicted remuneration by having the client sign something. Exemption would apply even where personal advice is provided by a financial planner. Problematically, the exemption would apply even where MySuper, superannuation and other complex products are recommended (including leveraged products). *'The Government has committed to reduce unnecessary complexity by clarifying that the exemption applies in circumstances where the benefit is paid directly by the client or <u>by another party</u> where the benefit is given at the direction of the client and with the client's clear consent.' (Draft Explanatory Memorandum p. 21)*
Allowing commissions to be earned on execution services where the client has received advice from another individual in the same licensee	The FoFA legislation included a carefully worded exemption for execution-only services which ensured that the prohibition could not be circumvented if advice had been provided by another representative of the licensee. The proposed change creates an obvious loophole which would mean that a consumer could receive advice from one representative and then have another representative implement the advice and earn the commission. Problematically, the exemption would apply even where MySuper, superannuation and other complex products are recommended (including leveraged products). *'The Government has committed to clarifying the exemption so that execution-only benefits are exempted except where advice on that class of product has been provided to the client in the previous 12 months by the individual receiving the benefit.' (Draft Explanatory Memorandum p.20)*
Extending exemptions to allow commission based bonuses to be paid by banks	Around 85% of financial advisers are employed within the banking sector. This proposal will enable banks to reward employed planners and other staff based on the amount of product they have sold, based on a 'balanced scorecard'. However, up to half of the scorecard can include sales targets and bonuses of up to 10% will be permitted. Given that average financial adviser income is around $200-$250K, this equates to a concerning loophole which will allow bank planners to earn annual bonuses of $20,000-$25,000 based on the amount of product they have sold in the course of providing personal advice. Exemption would apply even where personal advice is provided by a financial planner. Problematically, the bonuses would apply even where MySuper, superannuation and other complex products are recommended (including leveraged products). *'Item 16 inserts a new regulation to provide where certain performance bonuses are not conflicted remuneration' (Explanatory Statement)*

The proposed change	Impact
Advisers would be able to bundle advice to include products that attract commissions with ones that don't	The current laws ensure that advice cannot combine products which aren't allowed to attract commissions with those that are. The proposals will enable "mixed advice" to be provided on products which are caught by the ban and those which are not. It would also allow commissions to be earned where the advice mixes in products which are outside of the FSR framework – lending and credit products. The potential loophole is for more generous commissions to be earned on exempted products where the 'mixed advice' includes products on which commissions would otherwise be prohibited. *'Mixed benefits are multiple benefits which are paid together. The new regulation… provides that a benefit does not become conflicted remuneration purely because it is paid together with another benefit.' (Explanatory Statement)*
Extending grandfathering arrangements so that commissions can be freely traded, without any opportunity for the client to approve the transfer	Extensive grandfathering was provided to allow the industry to transition. The Government proposes to extend grandfathering arrangements to permit dealer groups and advisers to continue to receive grandfathered commissions when they move between licensees. The proposal makes commissions taken from people's super a tradable commodity. *'..when a business is sold.., the rights to the grandfathered benefits are transferred to the purchaser, who can then receive the ongoing benefit. The purchaser may therefore acquire the same rights to the grandfathered benefits that the seller held prior to the sale taking place.' (Explanatory Statement Items 19 & 20)*
Extending grandfathering so that commissions can automatically continue where the client is recommended to transfer from a super product into a pension product with the same provider without any opportunity for the client to approve the transfer	Extensive grandfathering was provided to allow the industry to transition. This change considerably extends grandfathering of conflicted remuneration to include new recommendations into pension products where the client has an accumulation product with the provider. This means that consumers who are currently paying commissions on their super will pay commissions until they die or until their money runs out. *'Item 21 inserts a sub-regulation… to provide that when a retail client elects to switch from the growth phase to the pension phase within the same superannuation interest… grandfathered benefits [will be allowed] to continue to accrue.' (Explanatory Statement)*

5.6.1 **Exempting general advice from the ban on conflicted remuneration**

The Exposure Draft Bill proposes to amend the definition of conflicted remuneration in s963A to exclude its application to general advice.

In the Draft Explanatory Memorandum, this proposal is justified on the following basis:

> The Government has committed to exempt general advice from the ban on conflicted remuneration. The Government considers that the application of the ban on conflicted remuneration risks limiting the availability of general advice and unnecessarily burdens industry by capturing staff not directly involved in providing advice to clients.[82]

This is a very significant carve out.

[82] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 19

Under the proposed exemption, banks and other product providers will be able to pay commissions and other forms of conflicted remuneration to financial planners, tellers, providers of seminars, call centre operators and all other staff, based on sales of product through general advice. Traditionally, ISA is not aware of general advice staff being paid commissions or other volume based remuneration based on volume of sales (other than employee bonus arrangements measured on individual/group basis within the banking sector). Directly rewarding general advice staff through payment of commissions is likely to lead to more aggressive product sales channels, with consumers largely unaware of, or alerted to, the existence of the conflicted payments.

The blanket nature of the exemption in the draft legislation is particularly concerning especially as it does not restrict those who are also authorised to provide personal advice from earning commissions for general advice. Perversely, this could lead to advisers moving away from provision of personal advice in order to take advantage of the exemption, even where it would be in the client's interests to receive personal advice.

In addition, the proposed exemption is problematic because other consumer protection measures are lower for general advice, for instance, if commissions or other forms of conflicted benefit are going to be received by the provider of the advice there is no requirement to disclose this to the unsuspecting consumer. Further, as there is no requirement to keep a record or give a Statement of Advice, there is no paper trail and many general advice channels involve face to face interactions which make regulatory surveillance extremely challenging.

In addition, the exemption would permit commissions to be paid in relation to superannuation including MySuper products, as the SIS Stronger Super laws refer back to the definition of conflicted remuneration in the Corporations Law. Problematically, the exemption would also allow commissions to be paid on leveraged and other complex products such as:

- Agribusiness managed investment schemes (based on individual contracts)
- Exchange-traded options strategies
- Hedge funds
- Hybrid securities Leveraged derivative products (e.g. contracts for difference (CFDs) and margin foreign exchange (margin FX) contracts)
- Managed funds with complex non-standard or non-linear payoffs
- Structured products
- Warrants (non-vanilla)

The exemption is opened ended and would mean there is no limit on the quantum of commissions paid.

While less tailored than personal advice, general advice still involves an explicit or implicit recommendation of a product. General advice still involves an interaction where a product is being promoted and recommended.

For this reason we strongly do not support the exemption for general advice from the conflicted remuneration provisions as proposed in the Exposure Draft.

5.6.2 **Allowing commissions on group insurance inside superannuation**

The Exposure Draft Bill also proposes to amend s963B to re-permit commissions to be paid in relation to super products (via the insurance premiums which are part of the product), except for MySuper products.

The Draft Explanatory Memorandum states:

> "*The Government has committed to minimize the market distortions and cost impacts that may result from the differing treatments of these benefits inside and outside of superannuation by*

broadening the exemptions provided for benefits paid in relation to life risk insurance offered inside superannuation."[83]

This proposed amendment would re-permit commissions to be paid in relation to super products (via the insurance premiums which are part of the product), except for MySuper products. This would reopen the prospect of advisers recommending super products based on the availability of commissions. This proposal is contrary to the clear recommendation of the Cooper Review, which advised that all commissions be removed from the super system, including from the insurance premiums.

The rationale for this change relates to the potential for "market distortions" if commissions are available on life insurance outside super, or on individual policies inside super but not on group risk cover. It is argued that there is a risk that advisers will prefer the products on which commissions are payable even if this is not necessarily in the client's interests. However, in creating a new carve out for group life insurance, which is rarely a standalone product but is always attached to a superannuation product, the exemption gives rise to a more problematic arbitrage – that financial advisers will preference superannuation products which offer commissions on their insurance component.

The cost of paying for insurance products by commission is up to 80 per cent higher than paying fee for service. Commissions on insurance within super erode retirement savings by between $60,000 and $100,000 after 30 years. The total cost to consumers has been estimated to be approximately $10 billion over the next decade.[84]

Later in our submission, we also note that a higher duty attaches to Government regulation of superannuation which is a compulsory investment. A permissive policy setting on commissions and other forms of conflicted remuneration in superannuation will erode unnecessarily individual superannuation accounts and will increase the cost of pension outlays on future taxpayers.

The United Kingdom's Retail Distribution Review, which came into effect on 31 December 2012, prohibits financial advisers in the retail investment market from earning commission on the products they sell. Under the RDR, firms providing restricted or independent advice on retail investment products can only be remunerated by a charge approved by the client, not by a commission set by the provider of the product.

All life policies which include an investment component are included in the ban. Only products which are standalone life insurance products (called "pure protection") are exempted from the commission ban.

5.6.3 **Amendment to the definition of volume rebates**

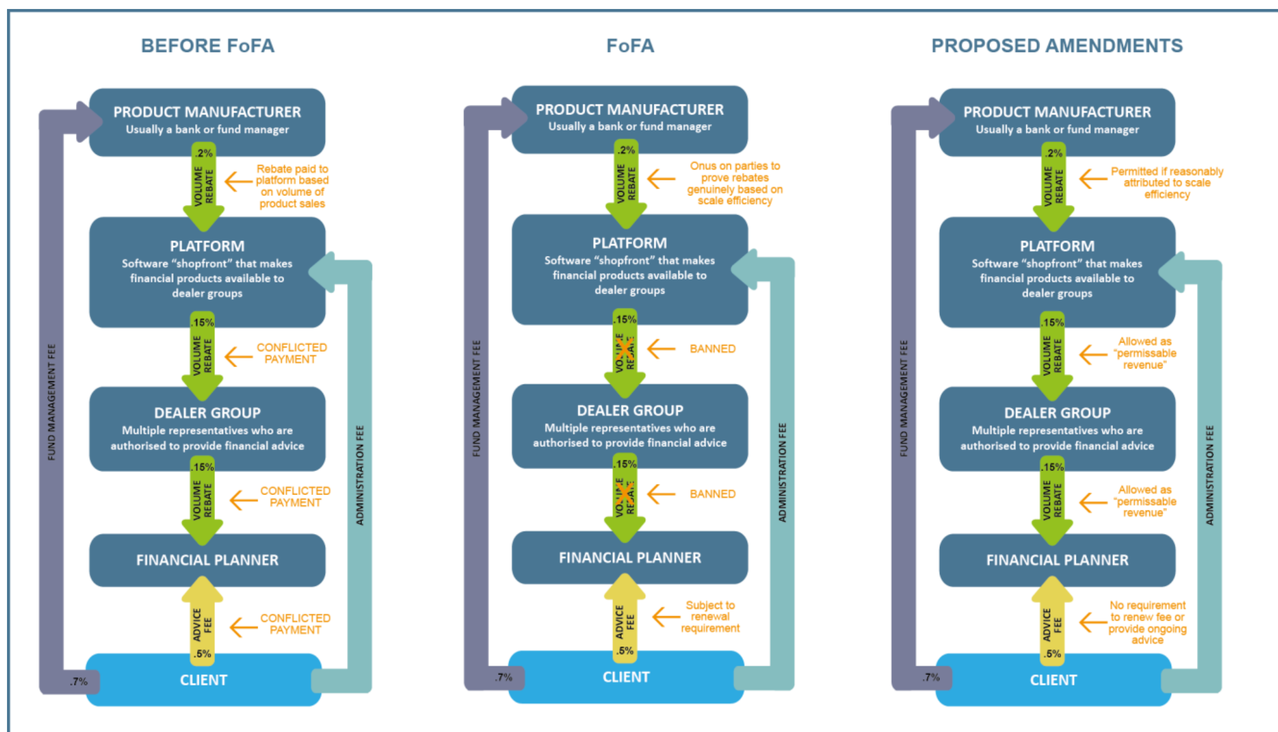
Volume rebates are a payment mechanism used by most of the financial advice sector and for the "non-aligned" or "independently owned" sector are a primary source of income for dealer groups.

When a financial planner recommends a product, that investment will invariably occur through a platform. Figure A illustrates the transactions involved in making an investment through a platform.

[83] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, p 20

[84] Research by Rice Warner Actuaries, *Impact of Banning Commissions on Affordability of Risk Insurance*, prepared for Industry Super Australia.

Figure A



The client, on the advice of the financial planner, makes an investment through the platform, which in turn invests the funds with a funds manager. The client will typically pay an administration/platform fee, an advice fee and a funds management fee. However, the fund management fee is typically structured so that a discount is provided (in the form of a rebate) if the levels of investment made in aggregate by a platform or a dealer groups passes certain thresholds. These "volume rebates" reflect the economies of scale achieved in funds management where larger sums are being invested, and mean that billions of dollars will be refunded back down from funds managers each year. Powerful incentives therefore exist to direct flows to the funds managers who pay these rebates.

Arrangements relating to volume rebates are extremely complex and challenge even informed commentators. As the transactions are conducted at the wholesale level, there is very little publicly disclosed information regarding these transactions, and certainly the quantum of payments made are not required to be disclosed.[85]

The FoFA legislation sought to regulate volume rebates by distinguishing between payments made by a fund manager to a platform (which were regulated as "volume-based shelf fees") and the pass through of those benefits from the platform to a dealer group or adviser (which were to be captured by the general prohibition on conflicted remuneration in s963A and in particular the presumption in s963L that volume based payments are conflicted remuneration until proved otherwise).

The Exposure Draft amends s964A which provides that a platform operator must only accept volume-based shelf fees where they 'are reasonably attributable to economies of scale gained' because of the number or volume of funds invested with the funds manager. It also exempts volume-based shelf fees which relate to general insurance or life risk insurance.

[85] FSC and FPA did have a Standard which required their members to disclose these volume payments in a publicly available register however this standard was repealed http://www.fsc.org.au/downloads/file/FSCStandards/14S_Jan_2010_JointCodeofPracticeonAlternativeformsofRemuneration.pdf

The amendments relax the onus of proof requirements upon parties paying/receiving volume based shelf fees so that it will be easier to satisfy the requirement to demonstrate that a rebate reflects an economy of scale (and thus make/receive the benefit).

ISA does not take issue with the fact that volume rebates reflect economies of scale. However, we strongly object to the retention of these payments by intermediaries – the beneficiaries of these investment economies of scale should be the end client.

However, notwithstanding the fact that these payments reflect economies of scale, traditionally these payments have operated as very significant yet opaque wholesale commissions because they are nearly always retained within the platform/advice value chain rather than being rebated back to the client. And if these scale efficiency dividends are not refunded back to the end client, they generate billions of dollars in wholesale commissions each year and are highly problematic because quantum of payments is not disclosed, the payments are opaque and are very difficult for consumers to understand.

Despite the introduction of the FoFA laws, there is still great uncertainty around the legality of volume rebates and endless innovation by larger players to create alternative mechanisms which enable these volume rebates to be paid back down to the dealer group level. For instance, dealer groups "white label" platform products and become entitled, in their capacity as a platform provider, to the rebates. Other avoidance measures include equity arrangements and attempts to rename volume rebates, for instance as dealer facilitation fees.

ISA's concern is that the proposed amendments to s964A, could be combined with the proposed new Regulation 7.7A.12HA (the "permissible revenue exemption") to facilitate the pass through of volume-based shelf fees. (Our concerns about the broad drafting of the draft Regulation 7.7A.12HA go beyond its interplay with s964A, but those further concerns will be dealt with in the next section.)

The Explanatory Statement states

> *"Item 17 inserts a new regulation… which provides that a benefit is not conflicted remuneration where the amount of value of the benefit is calculated by reference to another benefit that is not considered conflicted remuneration… This form of benefit is commonly referred to as "permissible revenue"*[86]*."*

The regulation enables a benefit to be paid if the amount or value of the benefit is calculated by reference to another benefit that is not conflicted remuneration or to which Division 4 of Part 7.7A (the conflicted remuneration division) of the Act does not apply. The Regulation does not limit to whom benefits can be paid under this regulation. Under the amended version of s964A, payments made to platforms in respect of economies of scale are not volume based shelf fees, and are not considered to be conflicted remuneration. Section 964A is in Division 5 of Part 7.7A, and so the regulation would make possible the pass through of these scale rebates to dealer groups and financial planners.

Regulation 7.7A.12HA is extremely open-ended and further submission will be made in the section below. However, we submit that it must be made absolutely explicit that in no way does the proposed amendment to s964A displace the presumption in s963L, and that there can be no pass through of volume based payments to advisers or dealer groups under the guise of "economies of scale". We also strongly submit that there should be a requirement for annual disclosure of amounts paid and received as "economies of scale" rebates, unless they are fully rebated to the client.

5.6.4 **Permissable revenue exemption**

As noted above, Regulation 7.7A.12HA is a new and broad exemption which enables a benefit to be paid if the amount or value of the benefit is calculated by reference to another benefit that is not conflicted

[86] *Draft Explanatory Statement, Corporations Amendment (Streamlining Future of Financial Advice) Regulation 2014*, Item 17

remuneration or to which Division 4 of Part 7.7A (the conflicted remuneration division) of the Act does not apply. The heading of this section also flags that this exemption applies to grandfathered benefits.

ISA believes that the drafting of this regulation is problematic and would permit new conflicted payments to be created. It would appear to override the presumption in s963L and enable new payments or benefits to be set up notwithstanding the fact that the payment would otherwise trigger the conflicted remuneration prohibition. This regulation considerably extends the capacity for grandfathered benefits to be recycled and passed through to new recipients in a manner which is inconsistent with grandfathering. This is to be compared to the existing regulation 7.7A.16F which limits pass through to circumstances in which there was a pre-existing arrangement which gave rise to the benefit. [87]

5.6.5 **Client consents exemption**

The Exposure Draft Bill proposes that a note be included after s963A to provide that 'giving a benefit includes causing or authorising it to be given'. The effect of this note is to permit payments to be made by third parties provided the client 'consents'. The Draft Explanatory Memorandum states:

> *"The Government has committed to reduce unnecessary complexity by clarifying that the exemption applies in circumstances where the benefit is paid directly by the client or by another party where the benefit is given at the direction of the client and with the client's clear consent.*[88]
>
> *In order to satisfy the exemption, the client must cause or authorise the benefit to be given. The benefit may be given directly by the client or given by another party, for example, by a trustee of a superannuation fund or a platform operator. Where the benefit is given by another party, it must be given at the direction of the client, with the client's clear consent. However, the mere fact that a client consents to a benefit to be paid, does not mean that the benefit is caused or authorised by the client."*[89]

To ensure there is no misalignment of interests, one of the key premises of the FoFA legislation was to minimise opportunities for payments to be received by dealer groups or advisers from third parties but rather encourage an environment in which the adviser only receives payment for advice from their client. The original legislation exempted benefits received from the client, including where the client authorised payments for advice from their own investments. Facilitating a payment from a client's own monies is of a substantially different nature than permitting third party payments.

Problematically, the exemption would apply even where personal advice is provided, or where MySuper, superannuation and other complex products are recommended (including leveraged products).

As with the proposed change to the best interests duty to incorporate the notion of 'agreement', regulatory settings in financial services which enable 'consent' or 'agreement' to be reached are problematic in light of the asymmetry in knowledge and financial capability between the adviser and client. While the Draft Explanatory Memorandum seeks to set a higher bar for any such agreement, a requirement for 'informed consent' would introduce an uncertain and much litigated notion into the law, as disputes revolve around the client's subjective state of knowledge at the time the consent was required.

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[87] CORPORATIONS REGULATIONS 2001 - REG 7.7A.16F **Application of ban on conflicted remuneration--benefit is a pass through of a grandfathered benefit (benefit is not conflicted remuneration)** A benefit is not conflicted remuneration to the extent that: (a) the benefit is a pass through of a benefit (a ***grandfathered benefit***) to which Division 4 of Part 7.7A of Chapter 7 of the Act does not apply because of subsection 1528(1) or (3) of the Act or a regulation made for subsection 1528(2) of the Act; and (b) the benefit, as passed through, was given under an arrangement that was entered into before the application day, within the meaning of subsection 1528(4) of the Act; and

(c) the benefit, as passed through, is consistent with purposes of the arrangement under which the grandfathered benefit was paid; and
(d) the total amount of the benefit, as passed through, does not exceed 100 per cent of the grandfathered benefit.

[88] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 21
[89] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 30

Furthermore the explanation in the Draft Explanatory Memorandum would suggest the "client consents" exemption would facilitate consent for the deduction of advice fees from a superannuation account. There is no impediment to such a payment facility being set up under the existing law, provided the trustee has some oversight and control of those deductions to ensure compliance with the sole purpose test. This does not mean that a trustee need check every deduction but should have a policy, controls and audit in place to ensure that superannuation monies are not being used to pay for advice which does not relate to a member's retirement benefits, or is a payment where no service is provided at all.

5.6.6 **Execution only exemption**

The current FoFA legislation included a carefully-worded exemption for execution only services which ensured that the prohibition could not be circumvented by a client receiving advice from one representative of the licensee with the commission earned by another representative shortly after.

However, the Exposure Draft amends the exemption s963B(3)&(4) which will allow commissions to be earned on execution services where the client has received advice from another individual in the same licensee.

> "*The Government has committed to clarifying the exemption so that execution-only benefits are exempted except where advice on that class of product has been provided to the client in the previous 12 months <u>by the individual receiving the benefit</u>*." [90]

The proposed change creates an obvious loophole which would mean that a consumer could receive advice from one representative and then have another representative implement the advice and earn the commission. Problematically, the exemption would apply even where MySuper, superannuation and other complex products are recommended (including leveraged products).

5.6.7 **Exemption of volume based performance bonuses for banks**

A new regulation 7.7A.12EB will be inserted to allow performance bonuses based on volume to be paid to employees of banks, including employed planners.

> "*Item 16 inserts a new regulation to provide where certain performance bonuses are not conflicted remuneration." Explanatory Statement*

Around 85% of financial advisers are employed within the banking sector. This proposal will enable banks to reward employed planners and other staff based on the amount of product they have sold, based on a 'balanced scorecard'.

A series of requirements are set out in the regulations in order to qualify for this exemption which include:

- the benefit is given to, or for, an employee of the provider (the definition of 'provider' is given in regulation 7.7A.12); and
- the benefit is an element of the employee's remuneration; and
- the value of (or access to) the benefit is partly dependent on the total value of financial products of a particular class, or particular classes, that are recommended by the employee or acquired by clients to whom the employee has provided advice; and
- the financial products in the class or classes are not financial products to which any of the following applies (that is, products that are not already exempt from the ban on conflicted remuneration): – paragraph 963B(1)(a) of the Act (general insurance products);
    - paragraph 963B(1)(b) of the Act (life insurance products within the meaning of that paragraph);

[90] *Draft Explanatory Memorandum, Corporations Amendment* (Streamlining of Future of Financial Advice) Bill, 2014 p 20

- section 963D of the Act (basic banking products); and
- regulations made for the purposes of paragraph 963B(1)(e) of the Act; and

- the benefit is low in proportion to the employee's total remuneration.

Typically all criteria in a balanced scorecard will be 'hurdle' requirements. In particular, the sales targets are required to be met in order to access any of the benefit.

The Draft Explanatory Memorandum proffers that bonuses of up to 10 per cent will be considered as "low". Given that the average financial adviser income is around $200-$250K, this equates to a concerning exemption which will allow bank planners to earn annual bonuses of $20,000-$25,000 based on the amount of product they have sold in the course of providing personal advice. In addition, the regulations provide that the weighting given to the volume-based measures be outweighed or balanced by other matters, however, this would still permit up to 50 per cent of the criteria to rest on volume measures.

Problematically, the exemption would apply even where personal advice is provided, or where MySuper, superannuation and other complex products are recommended (including leveraged products).

5.6.8 **Extension of grandfathering: transfer of entitlement to commissions to another adviser or business**

The Draft Regulations also insert new regulations 7.7A.16A(5A) and 7.7A.16B(4A) which further extend the grandfathering provided to financial planners and dealer groups.

Extensive grandfathering was provided to allow the industry to transition. The Government proposes to extend grandfathering arrangements to permit dealer groups and advisers to continue to receive grandfathered commissions when they move between licensees.

> "*..when a business is sold.., the rights to the grandfathered benefits are transferred to the purchaser, who can then receive the ongoing benefit. The purchaser may therefore acquire the same rights to the grandfathered benefits that the seller held prior to the sale taking place*." [91]

The commodification of the entitlement to conflicted remuneration is inefficient and goes beyond the intent of the grandfathering. This amendment to the regulations will significantly increase the capacity for grandfathered commissions to be recycled and will erode individual and national savings.

ISA does not support the amendment to insert new regulations 7.7A.16A(5A) and 7.7A.16B(4A).

5.6.9 **Extension of grandfathering: automatic extension of commissions on a super product if the member is transferred into a pension product with the same provider**

The Draft Regulation also proposes the insertion of new regulation 7.7A.16B(5A).

> "*Item 21 inserts a sub-regulation… to provide that when a retail client elects to switch from the growth phase to the pension phase within the same superannuation interest… grandfathered benefits [will be allowed] to continue to accrue*."[92]

Extensive grandfathering was provided to allow the industry to transition. This change considerably extends grandfathering of conflicted remuneration to include new recommendations into pension products where the client has an accumulation product with the provider.

There is absolutely no justification for this extension of grandfathering which will mean that consumers who are currently paying commissions on their super will pay commissions until they die or until their

[91] Explanatory Statement Items 19 & 20

[92] Explanatory Statement, Item 21

money runs out. Invariably the point of retirement is the main trigger for advice being sought, and it is critical that that should be provided with the opportunity to refresh the remuneration arrangements in place for their advice. Ironically, the grandfathering of commissions in the manner proposed in this regulation would act as a disincentive for the provision of advice, which might require the adviser to look beyond the product which will pay the commission. Given that at the point of retirement, Australians would usually have more money than they have probably ever had, or will ever have again, it would be counterproductive to extend the availability of commissions as proposed.

5.7 Additional public policy concerns with permitting conflicted remuneration to be paid on superannuation products

The compulsory, long-term, and government-supported nature of superannuation savings gives rise to additional public policy concerns with permitting conflicted remuneration to be paid on superannuation products.

Superannuation is a compulsory long-term investment. Its sole purpose is to provide benefits to people in retirement. The superannuation system is heavily subsidised by the taxpayer through the tax concessions provided to encourage superannuation savings. The regulation of super must ensure that both private savings and public contributions are protected through appropriately stringent regulation. Regulation must address the systemic conflicts of interest, remove commissions and other incentives which erode individual and national savings and minimise future instances of financial collapse.

Member inertia and disengagement are well -documented market failures in the superannuation system. The majority of consumers are passive and disengaged from their superannuation, which is typically the only investable asset they hold. While the average retirement balance for Australian workers is still reasonably modest, balances will increase as our superannuation system approaches maturity (in around 2031). Hence, in the near future, consumers will have even more to lose if the system designed to benefit them and protect their savings fails at this task. Ongoing fee arrangements are particularly erosive of superannuation as it is a long-term savings preserved until retirement.

Financial disengagement and low levels of financial literacy also means that where consumers seek financial advice they are nearly always utterly reliant on their adviser.

A number of the proposed exemptions will enable commissions and other forms of conflicted remuneration to be paid in relation to superannuation products including MySuper products. This is because the limitation on payment of conflicted remuneration in the SIS Stronger Super laws refer back to the definition of conflicted remuneration in the Corporations Law. Therefore, the amendments proposed in the Bill and the Draft Regulation will enable the multiple forms of conflicted remuneration exempted from the prohibition to be paid on superannuation including MySuper, ‘choice’ super products, pension and retirement incomes products. ISA strongly submits that there should be no capacity for conflicted remuneration to be paid or received in relation to any superannuation products.

5.8 The future for consumers and the advice industry

These amendments will cost consumers, including:

- The many retail super members who will have less super at retirement
- Consumers who rely on financial advice and expect that advice to be in their best interests
- Those who would benefit from financial advice but who remain sceptical of the advice industry

The cost to the advice industry will be in consumer trust – the lost opportunity to transform financial advice industry into a true profession. Progressing the FoFA reforms with reduced protections is likely to lead consumers to believe that their interests are prioritised while the framework continues to allow conflicted remuneration to influence recommendations.

6. Appendix 1

Table 8 – Financial collapses in Australia between 2006 and 2010

Company	Year	Scheme	Commissions and Fees	Clients Affected	Total Losses
Storm Financial	2009	Margin lending/ Financial Planning	6-7% upfront commission with two trail commissions of between 0.22 – 0.385% and 0.33% pa.[1] Volume based rebates also paid.	14,000 [2]	$830 million [3]
Timbercorp / Great Southern	2009	Managed Investment Schemes (MIS)	10% up front commission, ongoing fixed based fee, and 27.5% performance fee [4]	18,000 [5] (Timbercorp) 47,000 (GS) [6]	$3 billion+ [7]
Opes Prime	2008	Non-standard margin loan, or 'equity finance scheme'	trail commissions of up to 0.75% to referring brokers [8]	1,200 retail customers [9]	up to $1 billion [10]
Bridgecorp	2007	Property Investment	Unknown	14,500 [11]	$459 million [12]
Westpoint	2006	Margin Lending	10% up front commission [13]	3,524 [14]	$388 million [15]
Fincorp	2007	Property Investment	$3 million in fees [16]	8,102 [17]	$201 million [18]
Trio/Astarra	2009	Corporate and Retail Super	4% up front commission [19] and 1.1% trail commission [20] Additional volume rebates also paid to advisers [21]	6,000 approx. [22]	$176 million [23]
Commonwealth Financial Planning Limited	2009-2010	Financial Planning	Unknown. But there was report of trailing commissions of 0.44% - 0.83% [24]	1,127 clients receiving compensation [25]	$50 million in compensation. Actual losses unknown. [26]

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7. Appendix 2

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Dear Ms Campo

Proposed FOFA Amendments to Best Interests Duty

This letter sets out our advice on the Commonwealth Government's proposed amendments to the "*best interests duty*", which is part of the Future of Financial Advice ("**FOFA**") legislation in Part 7.7A of the *Corporations Act 2001* (Cth).

For the reasons summarised below, we consider that the proposed amendments:

- are inconsistent with the nature of a "best interests duty";
- would significantly reduce the protection that the duty affords to clients of financial advisers; and
- do not eliminate the legal uncertainty associated with financial advisers attempting to reduce the scope of the duty by agreement with their clients.

Currently, a financial adviser has a statutory duty to act in the client's best interests when providing financial advice (s 961B(1) of the Act). However, financial advisers are taken to have satisfied the duty if they can prove that they carried out seven listed steps (s 961B(2)). These steps act as a "*safe harbour*" for financial advisers. The final step is a "*catch-all*" that requires the financial adviser to "*take any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances*" (s 961B(2)(g)). What steps the catch-all requires is elaborated in a separate section (s 961E).

The proposed amendments are contained in the exposure drafts of the *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014* and the *Corporations Amendment (Streamlining of Future of Financial Advice) Regulation 2014*, which were released by the Government for consultation on 29 January 2014. The Bill makes significant amendments:

- The Bill would repeal the "catch-all" and the section that explains what it involves. According to the draft Explanatory Memorandum (p 7), this is because "*the catch-all provision creates significant legal uncertainty and renders the safe harbour unworkable due to its open-ended nature*".

- The Bill would also amend the best interests duty to include a statement that the duty does not prevent an adviser and a client from <u>agreeing</u> the

subject matter of the advice. According to the draft Explanatory Memorandum, this amendment is (1) to reduce uncertainty as to whether such an agreement can be made and (2) to facilitate the provision of advice that is more cost-effective because the scope of investigations required to be undertaken by the financial adviser is limited ("*scaled advice*").

In our view, the criticism of the catch-all as open-ended and uncertain, and misses the point that, when someone is doing something as complex as providing financial advice, it is not practical to attempt to specify in detail and in advance each and every thing that the person should do. It will depend on the precise circumstances of each case. That is why the law commonly imposes broad and general duties on persons such as directors, employees, trustees and lawyers. It is for the person subject to the duty to assess, in the circumstances of each particular case, what they should do. That type of judgment is what the current catch-all expects of financial advisers.

Repealing the catch-all would mean that financial advisers could comply with the best interests duty without having to exercise their own judgment, in the client's particular circumstances, to consider whether any further steps are warranted. This would likely reduce the overall quality of financial advice given in Australia, with advisers focussed on carrying out the remaining steps in the safe harbour as efficiently as possible — in other words, going through the motions and reducing the best interests duty to a mechanical checklist. The nature of such a duty would be entirely different to a best interests duty, such as the duty of loyalty owed by fiduciaries, which includes directors, employees, trustees and lawyers. The proposed amendments are therefore inconsistent with a best interests duty.

In relation to scaled advice, the draft Explanatory Memorandum (pp8–9) states that, under the new law, financial advisers will no longer be required to undertake a "*fulsome*" investigation into the client's objectives, financial situation and needs before any scaled advice can be provided. Rather, financial advisers will only need to investigate the client's objectives, financial situation and needs that are relevant to the scaled advice to be provided, and the scope of the scaled advice can be agreed. However, under the existing law, the extent of investigations required already takes into account the scope of the subject matter of the advice sought by the client. This is made explicit in an explanatory note that would be repealed under the proposed amendments. Further, in our view, the legal position under the proposed amendments would not be as straightforward as suggested by the Explanatory Memorandum, and there would be considerable legal uncertainty and complexity. It would therefore be unwise for a financial adviser to assume that, under the proposed amendments, he or she could reduce the scope of the best interests duty simply by obtaining the client's signature to a document that purports to confine the subject matter of the advice.

The notion that financial advisers and their clients can agree to limit the scope of the best interests duty, by agreeing to confine the subject matter of the advice, is inherently problematic. This is because both parties do not have the same level of knowledge or understanding of what they are (or should be) agreeing to, or its consequences. In fact, the client's lack of such knowledge and understanding is precisely why the client has consulted the financial adviser in the first place.

The proposed amendment regarding scaled advice would insert the following statement as a new subsection (s 961B(4A)):

> "*To avoid doubt, nothing in subsection (2) prevents a client from agreeing the subject matter of the advice sought by the client with the provider.*"

By its terms, this new subsection does *not* actually empower such an agreement to be made. Moreover, the subsection says nothing about:

- whether there is anything *outside* the safe harbour (subsection (2)) that might prevent such an agreement; or
- *how* such an agreement can be reached.

The legislation makes clear that, for the best interests duty, what matters is "*the subject matter of the advice that has been sought by the client (whether explicitly or implicitly)*" (s 961B(2)(b)(i)). That is a factual issue that would ultimately be decided by a court. It may or may not be the same as what the financial adviser and the client apparently agreed for the purposes of scaled advice. If the client initially sought advice on a broader subject matter (either explicitly or implicitly) but agreed with the financial adviser a narrower subject matter without fully understanding the implications of doing so, then a court might find that, for the purposes of the safe harbour, "*the subject matter of the advice that has been sought by the client*" was still the broader subject matter.

Such an interpretation of the safe harbour is supported by its context, being the financial adviser's statutory duty to act in the client's best interests. With the analogous duty owed by fiduciaries, in order to avoid liability for what would otherwise be a breach of duty, a fiduciary cannot rely on the consent of the person to whom the duty is owed unless the fiduciary first made full disclosure of all relevant and known facts — in other words, there must be fully informed consent (*Parker v McKenna* (1874) LR 10 Ch App 96). Further:

- what is required for fully informed consent depends on all the circumstances and there is no precise formula that can be used in all cases (*Life Association of Scotland v Siddal* (1861) 3 De G F & J 58, 73; 45 ER 800, 806);
- in some cases it may be necessary to obtain independent and skilled advice from a third party (*Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390, 393); and
- the degree of sophistication of the client, and the client's ability to appreciate the consequences of what is being consented to, are also relevant (*Taylor v Schofield Peterson* [1999] 3 NZLR 434, 440).

If the Government's proposed amendments are made, it would ultimately be up to the courts to decide whether the same principles apply to financial advisers who seek to reduce the scope of the best interests duty by agreement.

Please do not hesitate to contact us if you have any queries.

Yours sincerely

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Ms Robbie Campo
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Dear Ms Campo

Proposed Introduction of FOFA Amendments by Regulation

This letter sets out our advice on the Commonwealth Government's ability to make regulations that would implement its proposed amendments to the Future of Financial Advice ("**FOFA**") legislation in Part 7.7A of the *Corporations Act 2001* (Cth).

For the reasons summarised below, we consider that such regulations would be invalid and susceptible to challenge in the courts. A court declaration of invalidity would operate retrospectively. This means, for example, financial advisers who relied on the regulations could be found to have acted unlawfully. The regulations would therefore create significant uncertainty, and could well become the subject of protracted litigation between financial advisers and their clients — for example, in an investor class action.

The Government has released for consultation a draft Bill and draft Regulations for the FOFA amendments. The draft Explanatory Memorandum for the Bill states: "*The Government's approach is that time sensitive FOFA amendments will be dealt with through regulations, to the extent allowed under the relevant regulation-making powers, and then locked into legislation*" (p4, emphasis added). We understand the underlined words to be an acknowledgment that the Government's proposed use of regulations might be invalid.

Despite being foreshadowed in the Explanatory Memorandum, the draft Regulations do not include provisions implementing these amendments. The absence of these provisions is not explained. This suggests that the Government is uncertain about how such provisions would be drafted.

According to the draft Explanatory Memorandum, the FOFA amendments to be "*implemented via regulation*" include:

- repealing the requirement that, in order to qualify for the safe harbour to the best interests obligation, an adviser must take any other step that is reasonably regarded as in the client's bests interests ("**catch-all**");

- amending the best interests obligation to state that that obligation does not prevent an adviser and a client from agreeing the subject matter of the advice ("**scaled advice**");
- repealing the rule that an ongoing fee arrangement terminates automatically unless the client renews it every two years ("**opt-in requirement**");
- repealing the requirement for advisers to provide a fee disclosure statement to clients who entered into ongoing fee arrangements before 1 July 2013 ("**pre-1 July 2013 clients**"); and
- amending the definition of "*conflicted remuneration*" to exclude benefits given to an adviser that could reasonably be expected to influence the adviser when giving general advice (as opposed to personal advice).

These amendments represent policy choices by the Government and significant departures from the current legislation. They are not the sorts of matters that are ordinarily dealt with in regulations. Generally speaking, such changes to legislation are matters for Parliament. By contrast, regulations are usually only a management tool to implement the details of the day-to-day operation of an Act.

The Government may only make regulations if it is empowered to do so by legislation. The Explanatory Memorandum does not identify the "*relevant regulation-making power*" that the Government proposes to rely upon. In s 1364 of the Act, the Government has a power to make regulations but that power is limited to regulations that are either (a) "*required*" or "*permitted*" by the Act or (b) "*necessary or convenient ... for carrying out or giving effect to this Act*".

The "*necessary or convenient*" power does not, in our view, support the proposed amendments. This is because, far from "*carrying out or giving effect*" to the Act (as it currently stands), the proposed amendments vary significantly from and are indeed inconsistent with the Act. As the High Court explained in its unanimous decision in *Morton v Union Steamship Co of New Zealand Ltd* (1951) 83 CLR 402, 410:

> "*Regulations may be adopted for the more effective administration of the provisions actually contained in the Act, but not regulations which vary or depart from the positive provisions made by the Act or regulations which go outside the field of operation which the Act marks out for itself.*"

In that case, the regulations were struck down because they represented "*a new step in policy*" (at 412). That description is apt for the proposed FOFA amendments.

The proposed amendments are clearly not "*required*" by the Act, so the only possible remaining basis is if the amendments are "*permitted*" by the Act. Part 7.7A of the Act does contain subsections that permit the making of regulations but these powers are again limited:

- Regulations may alter the steps financial advisers must take in order to qualify for the safe harbour to the best interests duty, but regulations can only do so in "*prescribed circumstances*" (s 961B(5)).

- Regulations may provide that the opt-in requirement does not apply "*in a particular situation*" (s 962K(3)).
- Regulations may provide that the requirement to give fee disclosure statements to pre-1 July 2013 clients does not apply "*in a particular situation*" (s 962S(2)).
- A benefit is not conflicted remuneration if it "*is a prescribed benefit or is given in prescribed circumstances*" (ss 963B(1)(e) and 963C(f)).

These subsections clearly do not permit the Government, by regulation, to implement some of its proposed FOFA amendments, such as to:

- state that the best interests obligation does not prevent an adviser and a client from agreeing the subject matter of the advice; or
- repeal s 961E, which explains the meaning of the catch-all step.

It could be suggested that, under the subsections listed above, regulations could make the "*prescribed circumstances*" to be "*all circumstances*", and the "*particular situation*" to be "*all situations*", and that this would have the same *effect* as repealing the catch-all, the opt-in requirement and the requirement to give fee disclosure statements to pre-1 July 2013 clients. In our view, however, that would be an artificial and flawed interpretation of the relevant regulation-making powers. "*All situations*" are not "*a particular situation*". This is a matter of ordinary language and applies to the opt-in requirement and the fee disclosure statements. In relation to the catch-all, the word "*prescribed*" is usually interpreted broadly (eg, *Lane v Soutar* [1954] Tas SR 35) but encompassing "*all circumstances*" would make the words "*prescribed circumstances*" redundant. Further, the fact that the Act "*deals specifically and in detail with the subject matter to which [it] is addressed*" indicates that the regulation-making powers are limited (*Morton v Union Steamship Co of New Zealand Ltd* at 410). The fact that the meaning of the catch-all step is enshrined in a separate section (s 961E) also tells against the repeal of that step by regulation.

In our view, the proposed amendment regarding conflicted remuneration is in a different category. That amendment does not relate not to *all* circumstances in which a benefit is given, but rather is confined to circumstances involving the giving of general advice. It might therefore be possible to make regulations that have the same effect as this proposed amendment.

Please do not hesitate to contact us if you have any queries.

Yours sincerely

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