ISN Submission to Treasury on the Corporations Amendment *(Future of Financial Advice Bill)* 2011

Industry
Super
Network

Executive Summary

1. Industry Super Network (ISN) welcomes the opportunity to make a submission on the first tranche of draft legislation *Corporations Amendment (Future of Financial Advice) Bill 2011* (the FOFA Reform Bill).
2. It is critical that the Future of Financial Advice reforms are robust and effective. Weaknesses in the legal requirements that apply to the provision of financial advice have eroded the retirement savings and financial wellbeing of millions of Australians, contributed to the failure of prominent financial institutions, and undermined the confidence of Australians in financial advice. ISN has long advocated for the strengthening of these legal requirements to achieve the policy objectives of increasing the professionalism of financial advice in Australia, increasing consumer confidence in advice and facilitating better access to financial advice (in particular, simple and affordable personal financial advice).
3. This tranche of legislation includes the best interests obligation which is the cornerstone FOFA and must create a clear and watertight obligation that protects Australian consumers from the self serving and structurally corrupt business model which dominates the financial planning industry. The current draft is flawed in a number of key respects and must be formulated as a principles-based obligation which ensures that all personal financial advice (whether holistic or limited scope) prioritises the client's interests over the interests of the adviser, licensee or other related party.
4. A highly prescriptive or process-driven best interests obligation will be used by the financial planning industry to create loopholes and will impede the provision of affordable advice.
5. Post reforms, the provision of personal financial product advice to retail clients should give rise to two primary professional obligations:
    1. **Best interests obligation** which requires the provider of advice to act in the client's best interests and give priority to their interests in the event of a conflict, which is not scalable – either you put the client first or you don't.
    2. **A requirement for advice to be appropriate** measured against a reasonable standard of care, which sets out the minimum process undertaken in providing advice to ensure it is properly scoped, well researched and that the advice provided is appropriate for the client's needs and objectives. This component of the professional duty is tested against what a reasonable adviser who put their client's interests first would do, and is scalable, based on the client's needs/objectives/personal circumstances.
6. The reforms should make clear that the best interests obligations apply to existing clients who are paying ongoing commissions and fees, to ensure that advisers do not avoid providing advice to their existing 'passive' client base, which research indicates is around two million Australians.
7. Furthermore other aspects of the reforms such as annual disclosure and opt-in apply inconsistency to clients depending on when they first sought advice.

8. The annual disclosure requirement for advice fees must apply to all clients, existing and new, and must require disclosure of all payments. It is inconceivable that the current regulatory gap, which means clients receive no ongoing disclosure of fees from financial planners, would not be rectified in this process.
9. Industry Super Network continues to oppose the deduction of any asset based or ongoing fee for financial advice as it enables the industry to replicate all the ill-effects of commissions. However, if the renewal obligation is to be applied then the definition of existing client must be limited to clients currently paying ongoing fees for personal financial advice.
10. ISN fully supports the proposed increase in ASIC's powers to ensure that they are better equipped to tackle 'bad apples' and to move more pre-emptively in their surveillance of the financial planning industry.

Best interests

ISN supports the best interests obligation but it should be formulated as a stand-alone obligation

11. ISN strongly supports the concept of a best interest obligation. When an adviser provides a retail client with personal advice, the nature of the relationship, including the differences in knowledge and sophistication, establishes a relationship of trust and confidence between the parties. Clients deserve, and the law should require, advisers to act in a way that respects that trust: advisers should owe their clients unflinching loyalty. The best interests obligation, in concept, accomplishes this goal.
12. If properly constructed, the imposition of a best interests obligation will improve the professionalism of personal financial advice delivered in Australia and, in particular, will oblige providers of advice to prioritise the interests of their clients over their own interests.
13. However, the proposed formulation of the best interests obligation in 961C of the FOFA Reform Bill is complex and lengthy. While endeavouring to give the duty application to financial practice is a worthy objective, the draft duty is expressed in a very prescriptive manner. ISN maintains that a higher level principles-based approach would be preferable, as it would create a more effective and sustainable professional obligation for the provision of financial advice.
14. Post reforms, the provision of personal financial product advice to retail clients should give rise to two primary professional obligations:
    i. **Best interests obligation** which requires the provider of advice to act in the client's best interests and give priority to their interests in the event of a conflict. This aspect of the adviser's professional obligation is concerned with ensuring the advice provided is impartial and disinterested. <u>This aspect of the professional duty is not scalable – either you put the client first or you don't</u>.
    ii. **A standard of care** which establishes a measure of reasonable adviser and requires the advice to be properly scoped, thorough, well researched and appropriate for the client's needs and objectives. <u>This component of the</u>

professional duty is scalable based on the client's needs/objectives/personal circumstances.

15. The draft bill conflates the two aspects because the process based steps of scoping, researching and delivering financial advice have been built into the best interests duty. The conflation of 'best interests' and the 'standard of care' provisions, combined with the level of prescription, is likely to have one of two effects- neither of which would be good. On the one hand, practitioners may believe that satisfying the processes related to the standard of care will also result in satisfying their duty to act loyally and put their clients' interests above their own. High prescription provides the opportunity for practitioners to create loopholes. On the other hand, the conflation of care and loyalty may make providers of advice more nervous that the standard of care will become about achieving the best result for the client as opposed to doing what is reasonable in the circumstances. This latter risk might present a significant obstacle for providers wishing to provide limited scope advice, and will impede the provision of affordable advice.
16. In essence, the best interests obligation is a duty of loyalty which should not be confused with the standard of care, which is concerned with regulating a minimum quality of advice.
17. Therefore, the best interests obligation should be a standalone duty which is only qualified by the requirement to prioritise client interests in the event of a conflict. The requirement to prioritise client interests should also apply to related party interests, not just to the interests of the provider, licensee or authorised representative.

The requirement to ensure that advice is appropriate should establish a reasonable standard of care and set out the minimum steps to ensure advice is appropriate for the client

18. The requirement to ensure that the advice is appropriate for the client should establish the required standard of care and should also set out the steps required to ensure that advice is appropriate, as is the case with the existing legislation.
19. The standard of care should be an objective measure. An adviser should be required to exercise the degree of care and diligence that a reasonable person would exercise, if they had a reasonable level of expertise on the subject matter of the advice being provided to the client, and had satisfied the best interests obligation. The 'reasonable' standard of care ensures that an adviser need only do what is reasonable in the circumstances in which the advice is provided, and it is this reasonableness measure which facilitates scaled advice.
20. In ISN's view it is critical that the process steps do not attach to the best interests test, because the latter is an absolute obligation related to the adviser's requirement to set aside any self interest in the advice process.
21. The FOFA Reform Bill includes clarification of the minimum steps which need to be followed to ensure that the advice provided is appropriate and adds to the current requirements to "know your client" and "investigate the subject matter of the advice". ISN submits that the steps which should be required of an adviser in the legislation should include:
    i. identifying the client's needs and objectives based on the client's instructions;
    ii. identifying the subject matter of the advice;
    iii. making reasonable inquiry into the client's needs, objectives and personal circumstances relevant to the subject matter of the advice;

iv. formulating a strategy which is appropriate for the client, having regard to their needs, objectives and financial situation;
v. where the strategy involves a product recommendation, conducting a reasonable product investigation in the relevant class of products; and
vi. basing all judgements on the client's objectives, needs and financial situation

22. In our view some of the steps provided in the draft would be better placed in the Explanatory Memorandum (EM) including:
    i. declining to advise if you do not have the required expertise
    ii. advising the client in writing if their needs and objectives would be better served by obtaining advice on a different subject matter (but see submissions below- the adviser should retain ultimate responsibility for properly scoping the advice)
    iii. considering strategies which do not involve the acquisition of financial products (but again, based on our submission, that the adviser should be subject to an overarching obligation to ensure the subject matter and strategy is appropriate for the client).

Facilitating scalable advice

23. One of the primary objectives in this reform process has been to facilitate the provision of limited advice, an objective which is strongly supported by industry super funds, which have been at the forefront of the provision of these services to members over the past few years. The current appropriate advice requirement has presented no obstacle to industry super funds developing affordable limited advice offerings for members.
24. Retail funds and financial planning organisations have argued that it is necessary for the adviser and client to be able to agree to the scope of advice in order to facilitate scalable advice. ISN strongly disagrees – a client can certainly have input into defining their needs and objectives in their instructions but <u>an adviser's professional duty must include the requirement to appropriately scope the advice and formulate their recommendations having regard to the client</u>. Clients should not be expected to be responsible for properly determining the scope of financial advice they need.
25. The current draft is based on the client having input into the *subject matter* of the advice (as opposed to identifying their needs and objectives), which we think does not reflect the expectations of most retail clients. In addition, the wishes of even sophisticated consumers should not excuse a professional in a relationship of trust and confidence from meeting their professional obligations.
26. As noted above, ISN submits that shifting the process steps back into the standard of care provisions which are tested against a 'reasonable adviser' measure will be more facilitative of the provision of scalable advice than the current drafting.

Reasonable investigation

27. ISN strongly supports the requirement to conduct a 'reasonable investigation' in connection with recommending a product. However, consistent with our overall recommendation that the best interests test be principles-based, ISN believes that a definition of 'reasonable investigation' is unnecessary if, as we suggest, the level of care to furnish 'appropriate' advice is measured against the conduct of a reasonable adviser who has satisfied the best

interests obligation. A flexible principles-based approach will, by nature, scale requirements to the facts and circumstances, including costs and benefits. As a result, it is unnecessary to state that a reasonable investigation generally need not include consideration of every product available. Moreover, there are some limited instances where a reasonable investigation will require consideration of every relevant product, such as where there is only a small handful of products in the relevant class, and the cost to consider such products is small.

28. In addition, defining the term 'reasonable investigation' has the potential to undermine consumer protection by excepting conduct that would be, under the facts and circumstances, unreasonable. For example, it would be unreasonable for an adviser only to consider products on an Approved Products List if the list failed to include the products that are widely known to be the best performers in their class (net of fees and tax).
29. Clearly, products should not be recommended to clients simply because they are manufactured by the dealer group or a related party of the dealer group. Alarmingly, a report released by ASIC this week revealed that conflicts of interest are rampant in the financial advice industry,[1] and that funds under advice disproportionately reside in related-party products.[2] A key failing of current financial advice practice is that the suitability rule has not generally been interpreted to require an adviser to look beyond their Approved Product List to substantiate a product recommendation - if the product is generally compatible with the strategy for the client then it is recommended irrespective of how it compares with market benchmarks in terms of key criteria of risk and net returns (or net benefit if an insurance product). By contrast, a reasonable investigation – that is, the investigation that an objective and well-informed adviser would conduct in faithfully serving their clients – would at least consider products that are widely known and have performed at the top of their class. Post the FOFA reforms, products should only be recommended if they are competitive against the market in terms of the key metrics of risk, performance history and net return (and for insurance products, it would be cost of premiums against level and scope of cover).
30. If any clarification of 'reasonable investigation' is considered desirable then it could be included in the EM. For instance, that an adviser should consider any product the client already holds which is relevant to the subject matter of the advice and that the key factors to be considered in a reasonable investigation are risk and net return (including historical performance) of the products. Bells and whistles should not enable an adviser to overlook the key objective of maximising financial return.

31. If, however, it is determined to be appropriate to include a definition of reasonable investigation in the legislation then it is insufficient to define it negatively- that is, by what is not required. If there is definition of a reasonable product investigation, it is critical that it requires a provider of advice to benchmark products in terms of the key criteria of risk, historical performance and net return (and for insurance, cost versus scope and level of

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[1] See, Australian Securities & Investments Commission, Report 251: Review of financial advice industry practice, September 2011 (finding that approximately 90% of industry revenue comes from product providers, with 87% of that coming in the form of ongoing commissions, up-front commissions, asset-based fees for advice and volume rebates).

[2] See, id at paragraph 72 (stating that "there were high levels of funds under advice in certain types of products issued by companies related to the licensee.").

benefit cover). If the final legislation uses a prescriptive duty then it must be very clear that an adviser must include consideration of any existing product held by a client which is relevant to the subject matter of the advice.

Approved Product Lists

32. The FOFA Reform Bill in s961G includes a proposed section to clarify that where a provider of advice has NO products on their Approved Product List (APL) which are appropriate for the client, they can decline to advise. In our view this is unnecessary and simply adds to the complexity of the reforms. We have already seen interpretations of this clause put forward which provide that where an adviser's choices are constrained by an APL, then they do not need to look beyond the APL to satisfy the reasonable investigation requirement. There is no basis to elevate APLs into a privileged position in legislation. APLs do not guarantee that advisers will consider a broad range of potential products that may satisfy a client's objectives. The ASIC report on the financial advice industry found that advisers "tended to concentrate product recommendations into a few key products," notwithstanding that APLs included a relatively large number of products.[3] Moreover, the presence of a product on an APL does not demonstrate that the product is appropriate to recommend to a client – the products involved in every major scandal including Trio, Storm and Westpoint were all on their dealer groups' APL. In fact, APLs are often used to artificially constrain adviser choices within the commercial objectives of the dealer group (or their Licensee) and so it would be perverse indeed for there to be any capacity to subordinate the best interests obligation to an APL.
33. Further encouraging APLs by giving them special treatment in legislation would be harmful because advisers already constrain recommendations to a few products, concentrating funds under advice to a degree that is hard to reconcile with the notion that advisers provide personal advice that is tailored to the facts and circumstances of a client. ASIC found that the top three products on many dealer groups' approved product lists "dominate and concentrate most of the asset allocation."[4] In addition, high levels of funds under advice were concentrated in products issued by companies related to the dealer group.[5] ASIC itself expressed scepticism, stating about this practice that: "If advisers are recommending high levels of a few products, then the reasons need to be explored and justified." In short, APLs and other mechanisms by which product recommendations are concentrated should not be encouraged in legislation designed to improve the quality and independence of financial advice.
34. The proposed s961G should be deleted from the Bill.

Need for a statutory defence

35. ISN is aware that some stakeholders have pointed to the need for a statutory defence. ISN believes that were a more principles-based reform pursued, then a statutory defence is not needed.

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[3] See, id at paragraph 25 (observing that "The median number of products on approved product lists was around 400; however, despite these relatively large product lists, there remained a tendency to concentrate product recommendations into a few key products.").
[4] Id at paragraph 72.
[5] See id.

Best Interests and Existing Clients

36. ISN believes the reforms should make clear that the Part 7.7A applies to existing retail clients. We are aware of some who, by focussing on the best interests test applying only when personal financial advice is provided, have come to the view that the best interests obligation is only triggered for clients paying commissions or ongoing fees if further advice is actually provided. Analysis of independent research by Roy Morgan Research reveals that there are around two million Australians paying ongoing commissions and fees for which they receive no ongoing advice. Interpreting the best interests test to be triggered only upon a new provision of advice would create a clear incentive for planners to avoid advising their existing passive client base so as not to trigger the best interests obligation. This is inconsistent with the policy goal of facilitating access to high quality financial advice. The EM should make clear that for clients paying an ongoing advice fee or commission, it is assumed that ongoing advice must be provided.

The Renewal and Annual Disclosure Requirements

37. The Future of Financial Advice reforms are banning sales commissions because they are not transparent to consumers, erode retirement savings and bias financial advice. The biennial 'opt-in' was proposed to ensure that asset-based fees do not replicate sales commissions.

38. 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. ASIC has just released a report on the top 20 licensees providing financial advice which disturbingly revealed that less than a third of financial planning clients are 'active'.[6] Roy Morgan estimates that 70% of Australians pay ongoing asset-based fees for ongoing advice which they do not receive.

39. **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.
    - 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. (See table overleaf).
- Ongoing asset-based fees for advice do not necessarily have any connection with the quantity or quality of advice provided.
- The regulator, ASIC, recommended that asset based fees be prohibited in the submission into the collapse of Storm Financial; on their consumer web site 'MoneySmart' they recommend consumers do not pay for advice by asset based fees; and recent report 'Review of financial advice industry practice' include asset-based fees as conflicted remuneration.

40. **The solution – financial planners should charge on a genuine up-front fee for service model, or have an agreed fee paid for in instalments over an agreed period of time. This remains ISN's policy position.**

41. 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.
42. 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. Indeed, it is inconceivable that currently an adviser does not have to provide any disclosure of ongoing fees to their client beyond the initial engagement (the FSG and the SOA).
43. The policy intent in terms of the transitioning of these new requirements was to exclude existing clients from the benefit of the renewal requirement to minimise the business impact of this measure. However, the drafting of these measures defines existing client too expansively and also grandfathers the annual disclosure requirements to new clients.
44. In ISN's view the draft legislation needs to be amended to:
    i) Ensure s962A(1)(a) applies only to ongoing fee arrangements that pertain to provision of *personal* financial advice;
    ii) Define existing client in s962(3)(a) only to capture clients who have, prior to the commencement day, arrangements in place for the provision of *personal* financial advice;
    iii) Clients who alter their remuneration arrangements with their adviser or who are transferred to a new adviser should subsequently receive the benefit of the renewal requirements;
    iv) Amend the application of the disclosure requirements so that advice providers are required to disclose all income received in relation to advice for both existing and new clients on an annual basis.

Application of Division 3 – Charging ongoing fees to clients

45. The proposed s 962 which provides for the application of this Division excludes any person who has ever received financial product advice from the Licensee, prior to the commencement of the Reforms. The broad drafting of existing client therefore creates the perverse outcome that:
    - even consumers who alter their remuneration arrangements with their adviser after the commencement of these Reforms will not be entitled to the benefit of the Renewal and Disclosure provisions
    - even consumers who have only ever received general advice from the Licensee would forevermore not be able to receive the benefit of the Renewal and Disclosure provisions from any adviser working under the licence of that licensee.
46. ISN submits that the policy intent was to grandfather existing adviser-client relationships from the new requirements. However, the draft Bill goes a lot further than this and excludes many consumers who should benefit from these provisions.
47. The draft legislation should be amended to define existing client in s962(3)(a) only to capture clients who have, prior to the commencement day, arrangements in place for the provision of *personal* financial advice and to exclude from the definition any consumers who alter their remuneration arrangements with their adviser (including where the client is transferred from one adviser to another) who should subsequently receive the benefit of the renewal requirements.

Definition of Ongoing Fee Arrangement in s962A

48. The definition of ongoing fee arrangement in s962A has been broadly defined to ensure that the obligations cannot be circumvented by creating ongoing arrangements which purport to relate to services other than for ongoing advice. However, the broad definition may lead to unintended outcomes.
49. To better reflect the policy intention of the reforms s962A(1)(a) should be amended to clarify that it applies only to ongoing fee arrangements that pertain to provision of *personal* financial advice. This amendment will then be consistent with the proposed prohibition on a product provider from bundling in product fees the cost of provision of personal advice, to be contained in the second tranche of the legislation.

Annual Disclosure Requirement for Ongoing Fees

50. The draft legislation should be amended to require the annual disclosures statement to be provided not just to new clients but to all existing clients. The Minister's statement made at the time of the release of the draft legislation made clear that the policy intention was to apply the disclosure requirement to existing clients:

    "The 'opt-in' measure requires a financial adviser or planner to send a renewal ('opt-in') notice every two years to new clients, as well as an annual fee disclosure statement to all clients."[7]

51. This amendment would overcome the existing gap in the current disclosure laws which does not require any ongoing disclosure to clients of fees or other payments received by financial

[7] Bill Shorten, Minister for Financial Services and Superannuation, Media Release "Future of Financial Advice Reforms – Draft Legislation, 29 August 2011

planners. While the first year of payment is initially disclosed in the Statement of Advice and Financial Services Guide, this is inadequate for clients who may continue paying ongoing fees on an indefinite basis.

52. This disclosure must include disclosure of all remuneration received by the adviser or dealer group including asset-based or ongoing advice fees, commissions, volume rebates and any other financial benefit.