

**ISN Submission to Treasury on the Corporations  
Amendment (*Further Future of Financial Advice  
Measures*) 2011 (Tranche 2)**



**Industry  
Super  
Network**

## Executive Summary

Tranche 2 of the FOFA Reforms includes all the key provisions which tackle the range of conflicted forms of remuneration which dominate financial planning practice. ISN is very supportive of the policy objectives of prohibiting and regulating payments or benefits which incentivise financial planners to recommend particular products or strategies.

The primary issues raised in ISN's submission on this second tranche of exposure draft FOFA legislation are:

- While ISN is strongly supportive of the drafting intention to create a broad prohibition on conflicted remuneration, we are concerned that as currently drafted it may inappropriately impact upon payments by super funds for administration services with outsourced providers, as general advice is necessarily provided in the course of administering a fund. Similar unintended impact on outsourced superannuation arrangements might also result from s964. Clarification may be required to ensure that payments for outsourced administration arrangements are not inadvertently caught by the prohibition.
- ISN is aware that some stakeholders are advocating for further dilution of the commission ban, to allow some commissions to be paid from group life policies in superannuation, where individual advice is provided to the client. Industry super funds believe that the current drafting must not be diluted any further, as this would enable retail super funds to continue to pay commissions on retail products (from the insurance component of the product). Any further dilution of this measure will significantly compromise both the FOFA and Stronger Super reforms.
- The proposed drafting of volume based shelf fees will not be effective in tackling conflicting payments and the only effective regulation is to permit such payments only if they are passed through to the end consumer.
- To the extent that intra fund advice services are impacted by the provisions in Tranche 2, exemption will be required.

The Government has not yet released the grandfathering provisions for Tranche 2, nor the definition and exclusions for intra fund advice (both are expected by end October). ISN will make further submissions on both the grandfathering arrangements and the regulatory framework for intra fund advice once they have been released.

## Ban on Conflicted Remuneration

### Section 963

Section 963 provides a broad definition of "conflicted remuneration" which captures any benefit, monetary and non-monetary, given to a financial services licensee or a representative of a financial services licensee who provides financial product advice to retail clients that "might" influence the choice of product recommended or otherwise influence the financial product advice given.

ISN is supportive of the Government's policy objective to ensure that all financial advice is provided in a manner which is impartial and not biased by conflicted remuneration.

**Payments to Related Parties should be covered**

- The definition of conflicted remuneration should also prohibit benefits provided to related parties.

**Unintended impact of conflicted remuneration ban to superannuation administration arrangements**

- The problems which the reforms are seeking to address have primarily related to financial advice which has been biased by receipt of commissions and other conflicted payments and which result in bad advice being given to retail clients.
- ISN is concerned about the unintended impact that this definition might have on superannuation administration arrangements with outsourced providers.
- Most industry super funds outsource the administration of their members' accounts to an external administration company. The role of the administrator is to:
  - Operate and maintain the core administration platform;
  - Maintain member and employer records;
  - Allocate contributions to members;
  - Pay benefits to members;
  - Prepare and distribute correspondence, including periodic member statements;
  - Operate the call centre;
  - Fund accounting functions; and
  - Other general fund administration.
- Super fund trustees' payment arrangements with outsourced administration companies will usually be based (in part) on the number of member accounts administered, which is appropriate recompense for the work undertaken in administering the fund.
- Call centre operators provide the point of contact for fund members and employers and also for prospective members and employers. Administration companies would provide some general advice in relation to the fund in the course of their administration business (both in written communications with members and by phone/email/over the counter interactions). While remuneration arrangements are in no way structured to influence the general advice given by the administrator's call centre, the fact that the call centre is only paid to provide general advice on the client super fund is arguably sufficient to be caught by s963.
- We think that there should be clarification that payment for outsourced superannuation arrangements (which include provision of general advice) are not conflicted remuneration.

**Impact on Payments Made to Outsourced Providers of Intra fund Advice**

- ISN is also concerned about the potential impact of s963 where a super fund outsources the provision of intra fund advice services to an external licensee (which is often the case, even if it is a related party provider). The yet to be released draft provisions which give effect to the Government's policy on intra fund advice will need to ensure that payments made with respect to intra fund advice services are not prohibited by s963.

## Section 963(2)

Section 963(2) provides some specific examples of conflicted remuneration by reference to a benefit, access to which is dependent on the total value of products recommended to retail clients, or the number of products recommended to retail clients, or the total value of investments made by retail clients to whom advice is provided.

- Some institutional stakeholders raised concerns that the definition would capture any salary payment “access to which” was dependent on product sales, therefore suggesting that this would prohibit salary payment in any environment in which a business was profitable. The prohibition is intended to prevent conflicting payments which make remuneration to licensees/ representatives/ employees contingent on sales targets being reached. It is critical to ensure that the FOFA measures are effective in ensuring that all conflicted means of rewarding advisers are prohibited.
- We do not believe that s963(2) is ambiguous – we think that it focuses on remuneration arrangements where the motivation is to encourage recommendations of product/FUM rather than going to the source of gross profits which fund the business’s activities. We would support some further explanation of this in the EM, perhaps even the inclusion of some examples to allay the concerns of the banks.

## Section 963A

This section lists certain monetary benefits which the Government had agreed to carve out, and deems them not to be conflicted remuneration, including:

- general insurance commissions
- life insurance commissions which are not Group Risk or life policies within MySuper funds
- payments for execution-only services where no advice is given at all
- asset-based arrangements paid by clients to advisers
- other prescribed benefits (which will be prescribed in regulations to follow and will include carve outs for stock brokers).

- ISN wants it to be explicit that the deeming is relevant only for the purposes of Sub-Division B. In particular, an adviser can’t assume that these carved out payments are not conflicting when fulfilling their best interests obligation.
- We reiterate that we disagree with carving out any payments, particularly in circumstances in which personal advice is provided.
- ISN believes that it would be appropriate for a sunset clause to be included in the legislation beyond which all risk insurance commissions would be prohibited. We will provide further comments on our position when making submissions in relation to the yet to be released grandfathering arrangements. However, the rationale that risk insurance needs to be “sold” via personal advice will not survive once the financial advice industry moves towards meeting a more professional standard. ISN would propose a sunset clause of 1 July 2017.
- ISN also maintains its position that asset-based fees are conflicted remuneration and can only be tolerated if advisers are required to seek client re-approval on a regular basis.

### **Commissions must be completely prohibited on group life insurance**

- However, in relation to payment of insurance commissions from the superannuation environment, ISN is strongly of the view that commissions must be completely prohibited in relation to group life policies for members of a superannuation fund and life policies for a member of a default superannuation fund (as contained in s963A(1)(b)(i)&(ii).
- Group life policies in particular are an embedded feature of superannuation products and to permit any commissions to be paid for advice on group policies would effectively permit commissions to be paid on super products, significantly undermining both the FOFA and Stronger Super reforms. In practice, this would mean that commissions on group life would drive the sales of Choice products. Further, commissions are unnecessary to fund any advice a member may have in relation to group insurance – as the parameters of the policy are already determined and the member’s advice needs are limited only to their level of coverage. Members will be able to access intra fund advice, or if further advice is required, then they can authorise a fee for service payment from their super account.
- We note that some stakeholders have promoted the need for commissions to be paid on group life in order to avoid arbitrage between group life and individual life. However, it is clear that to allow any commissions to be paid from group life policies would then result in arbitrage between super funds which permitted commissions on group policies (retail funds), and those which did not (industry super funds and other not for profit funds). The reforms will have achieved little in relation to protecting our super system from commission selling if the ban on commissions on group life is diluted in any way from the current wording.

### **Section 963B**

Section 963B lists non-monetary (soft dollar) benefits which the Government had agreed to carve out, and deems them not to be conflicted remuneration, including:

- Benefits of less than \$300 provided on an irregular basis
- Genuine professional development benefits which meet prescribed criteria
- IT software or support that meets prescribed criteria, which relates to the provision of financial advice
- When the benefit relates to recommendations of general insurance products

- As with s963A, ISN wants the legislation to be explicit that the deeming is relevant only for the purposes of Sub-Division B. In particular, an adviser can’t assume that these carved out benefits are not conflicting when fulfilling their best interests obligation.
- ISN submits that the exemption for IT software or support is too broad and should be limited to benefits which are not commercially available – that is, they are in-house software tools such as platform administration tools or planning software. Current drafting would include software and IT support such as subscription services or software which is commercially available.
- There should be no carve-out for general insurance products.

### **Section 963C**

Benefits (monetary or non-monetary) provided by an employer is not conflicted remuneration if it is for work to be carried out as an employee and is not volume based (value of particular products, number of particular products, total FUM).

This will prohibit any bonus or contingent remuneration to staff involved in provision of general or personal advice, which is measured in any way based on sales or FUM. We support the breadth of this prohibition to ensure it is effective within the vertically integrated planning sector where most planners are employees.

### **Section 963D**

Section 963D contains the actual prohibition against a licensee receiving conflicted remuneration. It makes a licensee responsible where any representative accepts conflicted remuneration.

### **Section 963E**

Section 963E requires a licensee to take reasonable steps to ensure that its representatives do not accept conflicted remuneration.

ISN supports the manner in which these provisions has been drafted and believes that it is appropriate to make the Licensee primarily responsible for compliance.

### **Section 963F**

Section 963F prohibits an authorised representative of a licensee from accepting conflicted remuneration but provides them with a defence were they reasonably acting in reliance on information from the licensee that the payment was not conflicted.

ISN supports the manner in which these provisions have been drafted.

### **Section 963G**

Section 963G prohibits a representative from accepting conflicted remuneration.

ISN supports the inclusion of this measure, which ensures advisers are not receiving money that is paid to them directly, rather than through their licensee.

### **Section 963H**

Section 963H prohibits an employer of a licensee or a representative of a licensee from giving conflicted remuneration for work carried out as an employee.

ISN supports this measure, especially given that the majority of planners work within vertically integrated institutions. It is therefore critical that conflicted remuneration arrangements provided to employees are also captured.

## Section 964

Section 964 approaches the remuneration ban from the alternative position to s963 and prohibits a product issuer from giving a monetary or non-monetary (soft dollar) benefit to a licensee or a representative of a licensee who provides financial advice to retail clients but excludes:

- A fee for service payment which reflects the market value of the service
- Payment for property and the benefit reasonably represents the market value of the property
- The benefit is in relation to a general insurance product
- The benefit is in relation to a life insurance product other than group life or default fund life insurance policy
- The benefit is an allowed soft dollar benefit
- The regulations can prescribe other excluded benefits.

### **Unintended impact of this measure on superannuation administration arrangements**

- While ISN supports the Government's objective in creating a comprehensive ban on payments which are made to incentivise product distribution, we are concerned again about the unintended impact of s964 on outsourced superannuation arrangements (see above comments).
- ISN believes that this provision would be more appropriately aimed at financial services licensees who provide *personal* financial advice to retail clients.
- Where intra fund advice is delivered by an outsourced provider, the regulatory framework will need to ensure that payment for such service by a trustee is not caught by s964.

### **Possible impact on 'profit share' arrangements in Group Risk Insurance**

- Many industry and not for profit super funds also have arrangements in relation to their group risk insurance policies which are referred to as "profit share". There has been much misinformation regarding these arrangements, and attempts to characterise them as commissions or volume rebates.
- As pricing for group risk policies within a super fund will be impacted by past claims experience, to avoid having to change premium levels every year, a profit share mechanism is put in place between the trustee and the group insurer. Under this mechanism, the group insurer will be required to return profits made above a specified threshold to the trustee (which results from claims experience, not the number or level of insured members). This enables a fund to keep premiums at a (lower) competitive level without risking having to frequently increase premiums across the membership.
- In a not for profit fund, where a trustee receives a rebate it is paid into the operational reserve and used to fund administration costs associated with insurance claims and product innovation. ISN does not believe any carve out is required other than to clarify that payments which are passed on for the benefit of the client are permitted to be paid (which is relevant not only to s964 but also possibly to ss963 & 964A.)

#### **Other comments on s964**

- While the prohibition is currently drafted in broad terms, the exemption in s964(2)(a) is also broad and would potentially make permissible ‘fee for service’ payments related to distribution of a product provider’s product by the licensee. Ironically, it may be possible for commission-like payments to be structured as ‘fee for service’ payments to a licensee, representing the market value of the service in distributing the product provider’s product.
- The current drafting also creates an anomaly because it fails to capture payments to related parties of the licensee.
- There should be a further exemption for any benefit which is passed through to the end client.

### **Prohibition of volume-based shelf fees**

#### **Sections 964A-964D**

Section 964A sets out the application of these provisions, and is intended to capture payments made by fund managers and RSE licensees to platform operators, but is ambiguous as it seems to inadvertently capture research houses.

In summary, section 964B defines volume-based shelf fees as a benefit access to which, or the value of which, is dependent on the value or number of fund manager’s products issued through the platform. If the benefit is a rebate or discount on fees paid to the fund manager, then they are also prohibited if the value of the benefit exceeds the reasonable value of the scale efficiencies.

- Any payment or rebate from a fund manager to a platform provider or RSE based on the number or value of the fund manager’s products issued through the platform give rise to a conflict of interest and are a wholesale commission. Discounts on up-front costs are not problematic and should be permitted.
- Rainmaker Research estimates that across the retail sector around \$2.9 billion is paid per year in volume rebates over and above retail product commissions.
- In ISN’s view this prohibition should be strengthened to ensure that payments which have the capacity to conflict the placement of products through platforms are captured.
- Volume-based payments have been justified on the basis that they enable pricing to reflect scale benefits paid by way of a rebate or discounts. If that is the case, then ISN continues to strongly hold the view that the only effective regulation is to allow such payments to be paid only if they are passed through to the end consumer. Whatever else is in this section of the reforms, rebates which are passed through should be specifically permitted.
- However, even if the policy intent is to seek to permit wholesale commissions to be paid between fund managers and platform providers, then the drafting in the exposure draft still contains a number of weaknesses.
- A clear anomaly of the current drafting is that a platform provider or RSE can only accept a volume-based shelf fee if it is commensurate with the reasonable value of scale efficiencies experienced by the fund manager. As the platform provider can’t really determine the efficiency of the fund manager’s operations, it is likely that they will rely on representations from the fund manager – thus the prohibition will be very easily gamed.
- In any case, what gives rise to the conflict of interest is not whether the rebate or discount reflects scale efficiencies – it is because it provides a payment based on volume of sales



(often very large payments) which the platform provider can keep as extra margin rather than pass on to the end investor. Ironically, the proposed drafting would also prevent a fund manager from competing by lowering their prices further than the value of scale benefits would justify, which also seems would be an unintended consequence of the reforms.

- These sections also fail to capture payments which are not volume-based, and yet significant dollar-based shelf fees can be paid, which are just as problematic. While the Government has consulted on flat dollar shelf fees being permitted where this represents the administrative cost in placing the fund manager's products on the platform, the draft legislation fails to give effect to this. In ISN's view, shelf fees above a specified amount per product (say \$5000) should be prohibited.

### **Ban on asset-based fees on geared funds - Section 964E-964J**

These sections deal with the ban on charging asset-based fees on geared funds used or used to acquire financial products by, or on behalf of, the client to which the advice relates.

An adviser is exempt from this prohibition where it is not reasonably apparent that the funds are geared.

- ISN believes that the prohibition must extend to any adviser-client relationship in which there is any gearing, as opposed to the funds which are geared. Given the heightened risk and potential for volatility in geared investments, and the significant conflict which it has the potential to cause, asset-based fees should be prohibited completely where the strategy involves any gearing.
- ISN also submits that asset-based fees should be banned where inherently geared products are held or recommended to clients within the portfolio.

### **Anti avoidance – Section 965**

These measures seek to ensure that the FOFA provisions are not gamed. The measure is triggered where a person either alone or together with another person/s enters into, or carries out or begins to carry out, a scheme the for the sole or dominant purpose of avoiding the application of this Division. Subsection (b) requires that the scheme or part of the scheme has achieved or would achieve that purpose.

- ISN believes that subsection 965(b) is unnecessary. The contravention should be able to be proved irrespective of whether the scheme has or would have achieved the purpose of avoiding the application of the remuneration bans. Once the motivation is demonstrated, this should be sufficient to establish a contravention.