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Streamlining Amendments to Future of Financial Advice.

Thank you for the opportunity to comment on the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 and the Corporations Amendment (Streamlining of Future of Financial Advice) Regulation 2014. The views in this submission are mine in my personal professional capacity. They are not the views of the Financial Planning Association for whom I act as the independent chair of their professional disciplinary tribunal, nor of the Financial Markets Authority of New Zealand of whose Code Committee I am a member.

Background

In Australia every employed person is required to be a 'financial citizen': that is they must enter the financial markets through superannuation, and they are encouraged to be financially self-sufficient. The Australian government now foregoes an annual amount of tax revenue in support of superannuation, equal to the old-age pension. This tax support is most generous for high income earners and those in continuous employment. It is the tax supported superannuation savings of financial citizens which comprise the bulk of funds for which Australians need financial advice. Self-managed superannuation funds and superannuation

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fund choice, mean that most Australians will need financial advice some time in their financial life cycle.

All the research shows that most financial citizens lack financial knowledge, don't understand fees and commissions and half cannot calculate percentages. Many, overwhelmed, simply trust their financial adviser. For these reasons, all Australians deserve advice to be independent, professional and to put clients first.

The Labor government introduced the Future of Financial Advice (FOFA) reforms to improve the independence and professionalism of advice to financial consumers. The FOFA legislation was recommended by the Ripoll Committee which investigated the conduct of advisers at Storm Financial and managed investment schemes.

The Coalition in its 'Streamlining of FOFA' Bill 2014 seeks to roll-back some of the most effective aspects of FOFA. Most notably it intends to remove the prohibition on conflicted remuneration (commissions, bonuses for sales volumes, 'soft commissions' such as travel costs for training and the like) for general advice: far and away the kind of advice most frequently offered to Australians. The Streamlining proposals would also remove the one paragraph of the 'best interests' duty on advisers, that requires advisers to exercise their personal judgment outside a checklist. It also removes the 'opt in' requirement which encourages clients to review the advisor's performance every two years or the advisory agreement will end.

Conflicted Remuneration

The FOFA reforms ban advisors from accepting benefits (monetary or non-monetary) that influence the advice they give a client. The Streamlining proposals limit the ban to 'personal advice' when most Australians receive general advice. Personal advice is based on a review of a client's circumstances: general advice does not match the product to the client and provides information only about the product and its general appropriateness.

The FOFA reforms did not ban bank sales staff from conflicted remuneration when selling 'basic banking products'. Insurers too were able to earn commission on general insurance

products (eg car, home contents) and life risk insurance sales *outside* superannuation. This was permitted because basic banking products and general and life risk insurances are familiar to most people. The FOFA ban did not allow conflicted remuneration on life insurance attached to super. The Streamlining proposals will allow commissions and bonuses to return to life insurance inside super. The only way to avoid this is for members to acquire life risk insurance when their balances are in a MySuper default fund.

The likely results of these changes are unhelpful and unfair. First they are unhelpful since advisors will have an incentive to offer general advice (paid by commission from the bank or insurer) and not more detailed personal advice for which the client pays directly a management fee or hourly rate fee. Second, it is not always clear whether advice is general or personal. An electronic flyer sent to 200 clients, may be worded as general advice in legal terms while appearing as directed to the recipient's personal circumstances. Third, as I discuss later the Streamlining proposals also promote scaled advice. Here the scope of personal advice can be narrowly focused. But if that has the effect of denying commissions advisers may not bother to scale. They may simply sell a product with general advice and earn commission.

The proposals are unfair because they polarise the quality of advice between the small (and wealthier) population (less than 20%) which obtains personal advice, and the vast majority of Australians who will now pay commissions to receive general advice. While an upfront personal advice fee may seem a hurdle, the combination of initial and trailing commissions (paid annually thereafter) certainly does not mean that commissions are always cheaper. The UK tried a polarisation remuneration policy for a decade: they have abandoned it over the last 5 years.

The proposals are also unfair because they ignore the concentrated and related structure of the Australian financial sector. About 70% of financial advisers are owned or related to the four big banks and AMP. Australian Securities and Investments Commission (ASIC) research shows that over half of investment recommendations are concentrated in a small band of less than 10 products. The Ripoll Committee identified conflicted remuneration as the leading cause of poor financial advice: the Streamlining proposals reverse much of that Committee's work.

Best Interests Obligations

The FOFA 'best interests' duty, which applies only to personal advice, requires the adviser to tick-off a list of investigations and then 'take any other step...in the best interests of the client' that would be reasonable in the client's situation. In short, the duty requires the adviser to exercise professional advisory judgment, especially if the client's circumstances are unusual. This is why personal advice is sought and paid for. The Streamlining proposals would remove this so-called 'catch-all' provision. Removal of the 'catch-all' provision reduces the 'best interests' duty to a check-list: the only remaining standard is that the recommendation given to the client be 'appropriate'. There is a big gap between requiring an advisor to act in a client's 'best interests' and that the advice be merely 'appropriate'.

This reverse is compounded by another aspect of the Streamlining proposals. The proposals will allow 'scaled' advice. Scaled advice is limited personal advice – it may consider only one or two aspects of a client's entire financial circumstances. The idea of scaling is to permit a small scale service for those not wanting to pay for a comprehensive financial strategy. The FOFA reforms allowed scaled advice, mostly through the policy work of ASIC. ASIC's scaling requirements made an advisor's agreement to give scaled advice subject to all the requirements of any personal advice – including that the scaled advice be in the client's 'best interests'.

The Streamlining proposals will reduce the investigations and obligations of the adviser providing scaled advice. There is no overarching protection which explicitly protects the client from advisers who deliberately recommend scaling when comprehensive advice is required. For example, a client who seeks advice about a small inheritance and given scaled advice to invest in a managed investment scheme (earning fees for the adviser) when a wider review would reveal that the client would be better off, paying down their credit card or home mortgage. As we have already showed, there is also no protection against giving general advice, when scaled personal advice is appropriate.

Ongoing Fee Arrangement – 'Opt In'.

A central element of FOFA was the 'opt-in' requirement. Where a client had an 'ongoing fee arrangement' such as a managed account, an advisor every two years had to give their client a notice to 'opt in' – that is, to sign up again, to continue the arrangement. The idea was to give clients a reason to review their financial advisory arrangements not simply to continue paying fees. The Streamlining proposals are to abolish this requirement. They are also to remove another requirement on advisers: sending clients a fee disclosure statement every year if their arrangement was entered into prior to 1 July 2013. If the agreement was entered after that date, the fee disclosure statement will still be required. The government believes the 'opt-in' requirement is too costly. Instead the advisor or client must expressly opt out to end the arrangement.

Conclusion

If the Streamlining proposals go ahead, most Australians will receive commission and volume bonus driven general financial advice. They will also pay conflicted remuneration on life insurance attached to their super. Given Ripoll's findings that conflicted remuneration causes much poor advice, rolling back the prohibition in areas with greatest application to ordinary financial citizens, seems indefensible. The proposal goes against the ethics rules of the leading financial advisers professional body which abolished commissions for its members from 2007 onwards. The UK which does not compel retirement saving has abolished conflicted remuneration, and has no proposals to reverse the change.

An important criticism of regulation is that it is merely 'box-ticking' compliance. The so-called 'catch-all' element of the 'best interests' duty required advisory judgment. If the proposals succeed the 'best interests' duty will be a procedure which requires only that the final advice is 'appropriate'. This standard does not only take us back to pre-Ripoll, it is worse. Before Ripoll there was a requirement for a 'reasonable basis for advice' – that advice be suitable or at least not negligent. This was abolished because the higher standard of 'best interests' was introduced. If the Streamlining proposals succeed, they should at least restore the suitability standard. Tick-a-box 'appropriateness' simply further weakens the position of the financial consumer.

The abolition of 'opt in' is the most anticipated change. The 'Opt-in' idea works to give financial consumers a 'nudge' to monitor their adviser's work. There were however obstacles to implementation: what would happen to the investments under management if the client did not reply – neither opting in, nor out? What if the adviser was compelled to sell at the top or bottom of the market to end the mandate in the absence of instructions? These and other questions were never really resolved, but they could be. The fact that the fee disclosure statement will still be delivered every year may, make some difference to the otherwise acquiescent approach adopted by many clients.

It is true that most economic regulation must find a balance between productivity and protection. There is no productivity gain in allowing citizens' savings and foregone tax revenue to be lost through no advice or partial advice in a sector where related party and concentrated product recommendations are more common than not. The Streamlining proposals over-reach: the Corporations Amendment (Streamlining of Future of Financial Advice) Regulation 2014 pose some serious questions about whether regulations can possibly reverse the Parliamentary legislation in the FOFA statutes. The proposals also threaten to destroy the most important protection of the FOFA reforms, the abolition of conflicted remuneration in relation to general advice. They undermine quality of advice standards: the US has had a requirement of suitability or reasonable basis of advice since the 1930's. The lame proposal that advice be 'appropriate' is not worthy of a country which compels its citizens to invest, and should be more vigilant than ever in their protection.

Yours sincerely,

Dimity Kingsford Smith.