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Submission on

CORPORATIONS AMENDMENT (FUTURE OF FINANCIAL ADVICE) BILL 2011
EXPLANATORY MEMORANDUM

Specifically, Chapter 2 - Charging ongoing fees to clients

Explanation of Terms

FOFA is the government's name for the changes that it intends to make to laws and regulations affecting the provision of financial advice. We use the term FOFA to refer to the government's stated intentions with regard to "opt in".

"Opt in" is the term in common use to describe new obligations to be imposed on licensed financial advisers and their clients through FOFA by which all future clients will have to renew their advice contracts every two years.

"Opt in" applies to new contracts for the provision of financial advice entered into between advisers and their clients after 1st July 2012.

"Opt in" affects all Clients

- The Government's Explanatory Memorandum for FOFA states that "opt in" is designed to protect disengaged clients from paying ongoing financial advice fees where they are receiving little or no service.

- These clients have all of the standard remedies available to them if they are not receiving the services that they are paying for. They can change their adviser. They can stop the payment of fees. They can demand that the service they are paying for be provided. They can take an action at law.

- Additional remedies to protect the "disengaged" clients of financial planners could be readily devised, if needed. Examples follow.

- FOFA could sanction failures by licensed advisers to provide the services that they have contracted to provide. Compliance with these measures could be checked in annual audits of licensees.

- FOFA could mandate that client's right to "opt out" of advice contracts is re-stated, at least annually.

- Instead, FOFA affects the rights of all clients. FOFA nullifies the most common and logical form of advice contract offered by "fee for service" advisers. This preferred form of contract is to

provide on-going financial planning advice for a fee, with the client's right to "opt out" available to them at any time.

- Because financial planning services are focused on changing client needs and investment performance over the long term, on-going advice contracts are the logical and preferred option for both clients and advisers. "Opt in" outlaws this preferred form of advice contract.

"Opt in" is a way of structuring choices

- By requiring clients to "opt in" to maintain continuity of advice, FOFA is structuring client choices with the known effect that fewer clients will renew advice contracts.

- Structuring choices to guide behavior is a practice that is well understood within the field of behavioral economics.

- If choice is structured so that, to end an arrangement, you have to "opt out", far higher levels of participation will continue, than if, to maintain the arrangement you have to "opt in". Behavioral science literature about guiding behavior by structuring choices makes this quite clear.

- And the reasons for the known differences in outcomes are well known. People are being obliged to make a difficult decision, one that many may not want to make.

- Specifically, clients are being offered the opportunity to save on advice fees by not renewing, that is, by doing nothing. Or they can take action to renew their advice contract with the intention of improving their long term financial security.

- Behavioral science demonstrates that people show a marked preference for immediate reward, reward that arrives sooner rather than later.

- Inertia, over confidence, absence, oversight and indecision all result in disengagement. Disengagement is the default position.

- By structuring the choices in the way chosen under FOFA, the government will reduce the number of people who maintain on-going advice relationship with a financial planner. No other outcome is remotely likely and the government's is proceeding knowing that this will be the outcome.

Foreseeable Consequences

- "Opt in" will harm rather than help "disengaged" investors.

- "Opt in" will cost money rather than save money for disengaged" investors.

- "Opt in" will increase the costs of advice for low income earners.

- "Opt in" will shrink the independent adviser sector and strengthen the vertically integrated major institutions and industry super funds.

- "Opt in" breaches the rights of adviser and their clients to enter into contracts that are mutually beneficial

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"Opt in" will harm rather than help "disengaged" investors.

- Most investors find it difficult to assess the suitability, costs, on-going performance and risks of financial products that they own or are offered to them.
- The retirement savings of Australians are now fully exposed to market risk and product risk, as the GFC illustrated dramatically.
- The financial services regime in Australia is deregulated. The operating principle is "let the buyer beware".
- The system assumes that non-expert investors will manage risks by taking advice from a licensed adviser.
- And if fewer consumers take financial advice, more costly, risky and inappropriate financial products will be sold to or continue to be held by uninformed consumers. As a by-product, the government and not their former advisers will be held responsible for their losses.
- "Opt in" is certain to harm rather than to help disengaged clients.

"Opt in" will cost rather than save money for disengaged investors

- Licensed financial advisers bear much of the risk at law if a financial product that they recommend under-performs or fails.
- If a financial institution sells an unsuitable financial product to a consumer who has not taken advice, the product provider increases its risk.
- Financial institutions will respond rationally by differentiating between clients who invest on the recommendation of a licensed adviser, and clients who invest without taking advice.
- Logically, clients who invest on the recommendation of a licensed adviser will pay lower fees.
- "Opt in" will cost the disengaged investor money, rather than save them money.

"Opt in" will increase the costs of advice for low income earners.

- Commissions paid to advisers were a popular means of providing affordable financial planning services to low income clients.
- An equally viable alternative for the future is to charge low income clients modest on-going fees deducted from investment earning, but for "opt in".
- Adviser will have to allow for expected client attrition because of "opt in". A continuing stream of fees over the long term can no longer be counted on to amortise initial costs.
- So, costs for initial "Statements of Advice" from independent advisers will have to increase, as will entry fees and brokerage charges.

- Low-cost initial advice will be less available. Low income earners will find advice more costly because of “opt in”.

"Opt in" will strengthen the big financial institutions and industry super funds.

- Vertically integrated financial institutions (mainly owned by banks) will find it to their advantage to subsidise initial advice to attract and to retain clients. These institutions are also likely to benefit from “opt in” by charging higher fees to clients who buy their products without taking advice.

- Industry Super Funds are the prime sponsors of “opt in”.

- Its self evident that Industry Super Funds are in the funds management and advice business and they regard independent financial planners as business rivals.

- What particularly upsets Industry Super Funds is that many people with substantial retirement assets (say plus $300,000) seek personalised advice and far more control and transparency over their retirement assets than the industry super funds offer under their mass market models.

- Financial planners are likely to recommend a self managed super fund or a retail super fund for such people.

- Industry Super Funds have spent large amounts of their member’s money on public advertising, with the message that people will be better off if they don’t pay fees to financial planners, and implying that if they join an industry Super Fund they don’t pay for advice.

- “Opt in” dovetails perfectly with the industry Super Funds’ campaigns.

"Opt in" breaches fundamental rights

- On 1st January 2011 the new Australian Consumer Law became fully operative.

- Under Australian Consumer Law contracts:

  - Must not be misleading or deceptive.
  - There can be no unfair terms.
  - The conduct of the parties must not be “unconscionable”.
  - The services provided must be fit for the purpose.

- Provided that contracts preferred by advisers and their clients do not offend any of the above standards set by law, there is no rational basis for the government to interfere with these contracts.

- The right of citizens to enter into contracts on terms that are mutually beneficial is a foundation right in a liberal democracy.

International Examples

- Consider an alternative to “opt in” adopted in the United States. To increase participation in their 401(k) (retirement) plans, many United States companies now automatically enroll employees. Where US corporations switched to an automatic enrollment policy from opt-in enrollment, participation increased from 49% to 86%. Furthermore, most of these employees remained enrolled and continued to participate. *Madrian and Shea (2001).*

- A study by Johnson and Goldstein, of European countries, found that the rate at which people opted to donate their organs in different countries centered around two poles. In some countries the rate hovered around 80%, while in other countries it was around 20%, and there was no in between.

- What accounted for the difference was the way the question is structured on the registration form. In countries with high organ donation rates, people are opted in by default and must check a box to opt out of donating. In countries with low organ donation rates people must check a box to donate their organs.

  Source: Johnson, E. & Goldstein, D. (2003, November 21). Medicine: Do Defaults Save Lives? *Science Magazine*, *302* (5649), 1338-1339.