Australian Government

The Treasury

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011

22 December 2011

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INTRODUCTION

1. Treasury's submission to this Inquiry addresses the measures contained in Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (the Bill). It should be read in conjunction with our submission on the Corporations Amendment (Future of Financial Advice) Bill 2011.

2. Further, the submission provides an overview of the initiatives the Government has announced in relation to its ***Future of Financial Advice*** (FOFA) reforms.[1]

FINANCIAL ADVICE

The provision of financial advice

3. The Government has announced reforms in relation to the provision of financial advice, focused on enhancing the quality of financial advice.

4. Concerns about the quality of financial advice and in particular the potential for conflicts of interest to result in consumer detriment were considered by the 2009 ***Inquiry into Financial Products and Services in Australia*** (the Ripoll Report)[2] by the Parliamentary Joint Committee on Corporations and Financial Services, which was established following the collapses of a number of financial services providers including Storm Financial and Opes Prime.

Future of Financial Advice reforms

5. In response to the recommendations of the Ripoll Report, the Government announced the FOFA reform package, which is focused on improving the quality of advice, strengthening investor protection and underpinning trust and confidence in the financial advising industry.

6. The objectives of the FOFA reforms are twofold:

   - ensuring that financial advice is in the client's best interests – distortions to remuneration, which misalign the best interests of the client and the adviser, should be minimised; and

   - making financial advice accessible to those who would benefit from it.[3]

7. Among the key reforms is a best interests duty for financial advisers, requiring them to act in the best interests of their clients (when giving personal advice to retail clients). Once implemented, the best interests duty will increase the trust that consumers have in advisers, and in the long-term it should increase the overall quality of financial advice.

8. There will also be a prospective ban on conflicted remuneration structures, including commissions, volume-based payments and soft-dollar benefits of $300 or more, in relation to the distribution of and advice on retail investment products. The ban

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1 Further information is available at futureofadvice.treasury.gov.au.

2 Further information is available at www.aph.gov.au.

3 'Overhaul of Financial Advice', media release by the former Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, 26 April 2010, available at futureofadvice.treasury.gov.au

extends to up-front and trailing commissions. In addition, the reforms will ensure that percentage-based fees (known as assets under management fees) can only be charged on ungeared investment amounts.

9. The reforms will reduce conflicted remuneration structures in relation to advice on, and distribution of, retail financial products and certain risk insurance policies within superannuation. The measures are targeted at removing the current potential for product providers to influence adviser recommendations, as well as targeting other payments which have similar conflicts to product provider set remuneration and that otherwise do not engender the right behaviour. The measure in relation to percentage-based fees is targeted at conflicts of interest where an adviser is incentivised to recommend leverage to increase funds under management and hence fees.

10. In order to ensure clients understand ongoing fees and to give them an opportunity to consider whether they are receiving value for money, advisers will also be required to get retail clients to opt-in (or renew) their advice agreement every two years.

11. The reforms include other measures to improve the quality of advice, enhance consumer protection and enshrine the focus of the adviser on the best interests of the client.

12. In addition to these changes to enhance consumer protection and improve the quality of financial advice, the Government has committed to ensuring that Australians have greater access to affordable advice. To this end, the reforms facilitate the provision of limited or scaled advice, which will be of particular benefit to individuals and families who may only want piece-by-piece advice rather than a complete financial plan.

13. The majority of the reforms, including the ban on conflicted remuneration, compulsory renewal (opt-in), and the best interests duty, are intended to apply from 1 July 2012.

Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011

14. The Bill represents the second of two legislative tranches to implement the FOFA reforms. This Bill (tranche 2) contains the following key FOFA measures:

- The imposition of a best interests duty on financial advisers, requiring them to act in the best interests of retail clients when providing personal financial product advice;
- A ban on financial advisers receiving remuneration which could reasonably be expected to influence the financial product advice provided to retail clients;
- A ban on the charging of asset-based fees (fees calculated as a percentage of client funds under advice or management) on the borrowed monies of retail clients; and
- A ban on volume-based shelf-space fees from funds managers to administration platform operators.

15. The Corporations Amendment (Future of Financial Advice) Bill 2011 (tranche 1), which was introduced into Parliament in October 2011, contains further FOFA measures, including:

    - A requirement for providers of financial advice to obtain client agreement to ongoing advice fees and enhanced disclosure of fees and services associated with ongoing fees; and

    - Enhancements of the ability of the Australian Securities and Investments Commission (ASIC) to supervise the financial services industry through changes to its licensing and banning powers.

16. Treasury provided a submission on tranche 1 to this committee on 25 November 2011.

Best Interests Duty

17. An important FOFA measure in the current Bill is the introduction of a best interests duty. The rationale for the duty is to ensure that consumers receive personal financial advice that is in their best interests, particularly given there is some uncertainty about the precise duty that advisers owe to their clients at common law. The aim is to ensure that the objectives, financial situation and needs of the client are the paramount consideration when going through the process of providing advice. Advisers will be prohibited from placing their own interests ahead of their clients' interests.

18. The best interest duty applies only where personal advice is provided to retail clients. The duty, like the other key FOFA reform measures, focuses on advice to retail clients, and the need to ensure a higher standard of consumer protection for those retail clients. Financial advice to wholesale clients is not covered by the duty, however the appropriateness of the current definition of retail clients is being considered as a discrete component of the FOFA reforms.

19. There is a general obligation on providers of advice to act in the best interests of the client.[4] This general obligation is supplemented by a provision setting out steps that, if the provider can prove they have taken, will be taken to satisfy the general obligation. These steps recognise that the requirement to act in a client's best interests is intended to be about the process of providing advice, reflecting the notion that good processes will improve the quality of the advice that is provided. The provision is not about justifying the quality of the advice by retrospective testing against financial outcomes. The steps are based on the specific conditions under which advisers currently operate, and include:

    - Identifying the objectives, financial situation and needs of the client;

    - Identifying the subject matter that has been sought by the client and the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on the subject matter;

[4] Under the Bill, the duty is applies directly to the individual who is to provide the advice. An individual may be a provider of advice even if the individual is a representative of a licensee and is to provide advice on behalf of the licensee.

- Making reasonable inquiries to obtain complete and accurate information where it is reasonably apparent that the information relating to the client's relevant circumstances are incomplete or inaccurate;

- Assessing whether the provider has the expertise required to provide the client advice on the subject matter sought;

- If, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product, conducting a reasonable investigation into the financial product that might achieve those objectives and meet those needs of the client that would be considered as relevant to advice on the subject matter;

- Basing all judgements in advising the client on the client's relevant circumstances; and

- Taking any other step that would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

20. The aforementioned steps are not intended to be an exhaustive and mechanical checklist of what it is to act in the best interests of the client. A provider may be able to demonstrate that it has, in fact, acted in the best interests of the client under subsection (1), without having recourse to subsection (2).

21. The steps are designed to facilitate the provision of 'scaled advice' which is advice about one issue, or a limited range of issues (as opposed to 'holistic' advice that looks at all aspects of the client's financial circumstances). As long as the provider acts reasonably and bases the decision to narrow the subject matter of the advice on the interests of the client, they will not be in breach of their obligation to act in the client's best interests.

Priority of interests

22. The provider must give priority to the interests of the client in situations where the provider knows, or reasonably ought to know, there is a conflict between the interests of the client and the interests of the:

- provider; or

- licensee of whom the provider is a representative; or

- authorised representative that authorised the provider (where relevant).

23. The obligation to give priority to the interests of the client also extends to conflicts arising as a result of the interests of an associate (as defined in the Corporations Act) of the provider, licensee or authorised representative. This is designed to prevent the use of related parties as a means of circumventing the obligation.

24. However, the obligation is only triggered in situations where the provider knows, or reasonably ought to know, there is a conflict of interest. This means that in situations where the provider has no knowledge of a conflict of interest (for example, because the client did not disclose a particular interest to the provider), the provider will not be in breach if it failed to give priority to the interests of the client unless it can be established that that the provider ought to have known about the conflict.

25. The obligation to give priority to the interests of the client does not mean that the provider can never pursue its own interests or the interests of another party (for example, the licensee). However, the provider will breach this obligation if, in pursuing its own interests or the interests of another party, the provider fails to give priority to the interests of the client if there is a conflict.

26. Consistent with the best interest obligations, there is nothing in the obligation to give priority to the interests of the client that should be interpreted as prohibiting a provider from charging the client for the services that have been performed by the provider. Nor should the obligation be interpreted as mandating or prescribing how much the provider can charge the client. The cost of financial advice services is ultimately determined by competitive market forces.

27. Further, a provider does not breach the obligation to give priority merely by accepting remuneration from a source other than the client (for example, a commission paid by an insurance provider). However, if the provider gives priority to maximising a non-client source of remuneration over the interests of the client, the provider will be in breach of the obligation. Providers of advice solely about basic banking products or general insurance are excluded from the obligation to give priority to the interests of the client.

Appropriate advice

28. The Bill also repeals existing section 945A of the Corporations Act and introduces provisions dealing with appropriate advice that take account of the best interest obligations.

29. In contrast with existing section 945A, the provision does not contain the process-related elements in paragraphs 945A(1)(a) and (b) that have now been incorporated into the steps of the best interest obligation. This has been done to avoid overlap between the provider's best interest obligations and the obligation to give appropriate advice. Incorporating these process elements into the best interest obligation is not intended to lessen the standard of conduct expected of providers. Providers are still expected to follow a 'know your client' and 'know your product' process in providing advice as is currently required by paragraphs 945A(1)(a) and (b). The steps required by the best interests obligations are more expansive than previously required by existing paragraphs 945A(1)(a) and (b) and would be expected to raise the standard of conduct of advisers.

Basic banking products

30. Basic banking products and general insurance are recognised as being simple in nature and are more widely understood by consumers. This means that there is a lower risk of consumer detriment in relation to the provision of advice on these products. For this reason, exclusion from the obligation to give priority to the interests of the client more appropriately balances the benefits to consumers with the compliance costs to providers.

31. Particular arrangements are established dealing with the provision of advice solely about basic banking products given by an employee or agent of an Australian ADI or someone otherwise acting by arrangement with an ADI under the name of an ADI.

32. Basic banking products are: a basic deposit product or non-cash payment facility relating to a basic deposit product; a first home saver account; a travellers' cheque

facility; and other products prescribed by regulation. This provides flexibility to add additional products in the future if it is considered appropriate for them to fall within this arrangement, given the constant rate of development in the financial product market.

33. When an employee or agent of an Australian ADI provides advice in relation to these products, they are deemed to have complied with the best interests duty obligation if they:

- identify the objectives, financial situation and needs of the client;
- identify the subject matter of the advice; and
- make reasonable enquires to obtain further information relevant to the subject matter of advice if it is reasonably apparent the information provided by the client is incomplete or inaccurate.

34. These obligations are based on what is already expected of providers under the obligation in the existing section 945A of the Corporations Act to have a reasonable basis for advice. Providers who are subject to the provision need not demonstrate compliance with the other steps mentioned in subsection 961B(2). In particular, the arrangements do not require a provider to conduct a reasonable investigation. This means that there is no obligation on providers to consider products outside of those offered by the ADI for which they are working.

General insurance products

35. The arrangements that apply in relation to basic banking products also apply in relation to the provision of advice solely about general insurance. The arrangements for general insurance apply regardless of whether the advice is provided by an employee or agent of a general insurer or through another source (like an insurance broker). This is to avoid any regulatory distortion in the provision of advice about general insurance.

36. Basic banking products and general insurance are recognised as being simple in nature and are more widely understood by consumers. This means that there is a lower risk of consumer detriment in relation to the provision of advice on these products. For this reason, a modified best interests obligation more appropriately balances the benefits to consumers with the compliance costs to providers.

Ban on Conflicted Remuneration and other payments

Conflicted remuneration

37. A key part of the Bill and the FOFA reforms is the ban on the receipt of conflicted remuneration. The approach the Bill takes is to define 'conflicted remuneration', and then to establish rules banning the receipt or payment of conflicted remuneration. For example:

- Licensees and their representatives must not receive conflicted remuneration;
- Employers must not pay conflicted remuneration to their employees;
- Employees must not accept conflicted remuneration from third parties;

- Product issuers must not give conflicted remuneration to a licensee or a licensee's representative; and

- Licensees must take reasonable steps to ensure that their representatives do not accept conflicted remuneration.

38. The Bill takes a principled-based approach to defining conflicted remuneration – in short, the term means any monetary or non-monetary benefit given to a licensee or representative that could reasonably be expected to influence financial product advice to retail clients. This approach provides scope to accommodate the receipt of certain benefits that do not in fact conflict advice, as opposed to a more 'blanket' approach of describing certain benefits as being conflicted regardless of the circumstances surrounding the receipt of that benefit.[5] The term 'benefit' is deliberately broad to capture monetary and non-monetary benefits that are conflicted.

Exceptions from conflicted remuneration

39. The Bill sets out exceptions from the ban on conflicted remuneration. Monetary benefits that are carved out from the ban on conflicted remuneration include:

- General insurance commissions;

- Certain life insurance commissions;[6]

- Execution-only and wholesale commissions; and

- Stockbroking activities.[7]

40. The Bill includes non-monetary or 'soft-dollar' benefits within the definition of conflicted remuneration. To the extent that a soft-dollar benefit could reasonably be expected to influence financial product advice, it will be conflicted remuneration. However, there are a number of soft-dollar benefits which are carved-out of the Bill:

- benefits given in relation to a general insurance product;

- benefits under the amount prescribed by regulations (proposed to be $300), so long as those benefits are not identical or similar and provided on a frequent or regular basis;

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[5] Section 963L sets up a statutory presumption that certain kinds of benefits are conflicted remuneration, unless the contrary is proved. The kinds of benefits included in this section relate to the volume of financial products recommended or funds invested.

[6] In the case of a benefit from a life insurance company to a licensee or representative, the benefit will not be conflicted remuneration if it is given in relation to a life risk insurance product other than: a group life policy for the benefit of members of a superannuation entity; or a life policy for a member of a default superannuation fund (life insurance carve-out);

[7] It is proposed to exclude (by regulation) certain stockbroking activities from being considered conflicted remuneration, by allowing persons undertaking these stockbroking activities to receive third party 'commission' payments from companies where those payments relate to capital raising. The precise breadth of the exception would be subject to further consultation, but it is proposed that the receipt of 'stamping fees' from companies for raising capital on those companies' behalf not be considered 'conflicted remuneration' where the broker is advising on and/or selling certain capital-raising products to the extent that they are (or will be) traded on a financial market.

- benefits with a genuine education or training purpose that are relevant to the provision of financial advice to retail clients and comply with any other requirements detailed in the regulations (exemption for professional development); and

- benefits that are the provision of information technology (IT) software or support, that are related to the provision of financial product advice and that comply with any other requirements detailed in the regulations (exemption for administrative IT services).

- any non-monetary benefits provided by a retail client in relation to the sale of a financial product or provision of financial advice are also excluded from the definition of conflicted remuneration.

Treatment of benefits from employers to employees

41. A monetary or non-monetary benefit given to a licensee or representative by the employer of the licensee or representative is not necessarily conflicted remuneration. If the payment of the benefit is remuneration for work carried out (for example, an employee's salary), then this will not be conflicted remuneration so long as it is not within the definition in section 963A. While this allows the payment of salaries to employee advisers, it means that any proportion of that employee's salary that could reasonably be expected to influence advice is conflicted remuneration. An important consideration in these circumstances would be the extent to which any volume-based proportion of a salary package is presumed to be conflicted remuneration by virtue of section 963L and whether the recipient could prove that it could not reasonably be expected to influence advice.

42. The Bill provides an exception from the ban on conflicted remuneration for arrangements where employees of an ADI (or of an agent of an ADI) advise on and sell basic banking products. This entitles an employee to receive sales incentives from their ADI employer, even where it is volume based. However, if the employee provides financial product advice on financial products other than basic banking products, either in combination with or in addition to advice provided on basic banking products, the receipt of a benefit will be considered conflicted remuneration.

Volume-based shelf-space fees

43. The Bill also proposes to ban certain payments in exchange for 'shelf-space' on platform operators' menus. There is a ban on the receipt by platform operators of volume-based benefits to the extent that such incentives are merely a means of product issuers or funds managers 'purchasing' shelf space or preferential positions on administration platforms. However, the Bill does not purport to ban fund managers lowering their fees to platform operators (in the form of scale-based discounts or rebates) where such discounts or rebates represent reasonable value for scale.

44. A platform operator is defined as a financial services licensee or RSE licensee (as defined in the Superannuation Industry (Supervision) Act 1993 ('SIS Act')) that offers to be the provider of a custodial arrangement. 'Custodial arrangement' is defined in the existing section 1012IA of the Corporations Act; broadly, it is an arrangement where the client may instruct the platform to acquire certain financial products, and the products are then either held on trust for the client, or the client retains some interest in the product. Under this definition, it is taken to include arrangements

where the client may direct the platform to follow an investment strategy of the kind mentioned in the SIS Act.

45. A benefit is presumed to be a volume-based shelf-space fee if the benefit or its value is wholly or partly dependent on the number or value of a funds manager's financial products to which the custodial arrangement relates. This is intended to capture benefits provided in return for a greater number or value of the funds manager's financial products about which information is to be included on the platform.

46. However, a benefit is presumed not to be a volume-based shelf-space fee (and therefore permissible) if it is proved that all or part of the benefit is:

- a reasonable fee for a service provided to the funds manager by the platform operator or another person; or
- a discount or rebate offered to the platform operator, so long as the value of the benefit does not exceed the reasonable value of scale efficiencies gained by the funds manager because of the volume of funds under management.

47. In cases where the scale discount or rebate exceeds the reasonable value of scale efficiencies, it is considered that the benefit is intended to gain a placement on a platform or preferential treatment on a platform (for example, a position on a 'model portfolio' or 'menu selection').

48. The Bill assumes that the platform operator will be aware of the nature of any discount or rebate it receives, and will therefore be aware of whether a payment is a genuine fee for service, or represents genuine scale efficiencies. It is therefore appropriate that the platform operator bear the onus of proving that the payment ought to be presumed not to be a volume-based shelf-space fee.

Ban on asset-based fees on borrowed amounts

49. The Bill establishes a ban on asset-based fees (that is, a fee calculated as a percentage of a client's funds under advice) on borrowed amounts, where a licensee or licensee's representative provides financial product advice to a retail client.

50. The policy rationale for this measure is to prevent advisers from artificially inflating their advice fee by recommending a client borrow additional funds (inappropriate borrowing strategies were a key concern arising out of the collapse of Storm Financial). The measure does not prevent advisers from recommending borrowing strategies to clients, especially if such a strategy is in a client's best interests. However, the adviser would need to find an alternative method to charge for advice on the borrowed component. For example, the adviser could charge an hourly rate or a flat fee which is not percentage-based.

51. Licensees or their authorised representatives must not charge asset-based fees to retail clients on borrowed amounts to be used to acquire financial products by or on behalf of the clients. A 'borrowed amount' can mean an amount borrowed in any form, whether secured or unsecured, including the raising of funds through a credit or margin lending facility. A licensee contravenes the provision if its representative (other than an authorised representative) charges an asset-based fee on a borrowed amount.

52. If it is not reasonably apparent that the amounts used to acquire financial products by or on behalf of the client are borrowed, then the prohibition does not apply to the fee. This provides some protection to advisers who have no reason to believe the funds being used by the client are borrowed (in the situation, for example, where the client deliberately conceals the fact that the funds are borrowed). The test for whether something is 'reasonably apparent' is an objective one, based on whether it would be apparent to a person with a reasonable level of expertise in the subject matter of the advice, exercising care and assessing the client's information objectively. It is a question of what would be apparent to a prudent adviser.

53. To the extent that a retail client's funds are not borrowed, licensees or authorised representatives can charge asset-based fees on that non-borrowed component.