ASIC

Australian Securities & Investments Commission

Inquiry into the Future of Financial Advice law reforms

Submission by the Australian Securities and Investments Commission

December 2011

Contents

A Executive summary

1 The Australian Securities and Investments Commission (ASIC) makes this submission to assist the:

(a) Parliamentary Joint Committee on Corporations and Financial Services (Committee); and

(b) Senate Economics Legislation Committee,

with their inquiries into the *Corporations Amendment (Future of Financial Advice) Bill 2011* (FoFA Bill No. 1) and *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* (FoFA Bill No. 2) (together, the FoFA Bills).

2 ASIC has previously provided the Committee with a submission on the FoFA Bill No 1. This submission relates to the FoFA Bill No. 2.

3 ASIC supports measures, such as those contained in the FoFA Bills, which will improve:

(a) the standard of financial adviser conduct;

(b) the quality of financial advice provided to retail clients; and

(c) engagement by retail clients with the financial advice they receive.

4 We also support effective and broad anti-avoidance measures that would ensure that the policy intent of the FoFA reforms, including the ban on conflicted forms of remuneration, are not avoided through emerging industry or transaction restructuring, e.g. via new forms of vertical integration.

5 We have recently released information on our plans for publishing regulatory guidance on the impact of the FoFA reforms. In particular, we plan on publishing in 2012 guidance on the best interests duty, scaled advice, the ban on conflicted forms of remuneration and ASIC's amended licensing and banning powers. The guidance will help industry understand how we will administer the FoFA reforms.

6 We have also announced that we plan on adopting a facilitative compliance approach for the first 12 months of the implementation of the FoFA reforms. That is, provided industry participants are making reasonable efforts to comply with the FoFA reforms, ASIC will adopt a measured approach where inadvertent breaches result from a misunderstanding of requirements or systems issues. However, where ASIC finds deliberate and systemic breaches we will take stronger regulatory action.[1]

[1] See 11-294AD *ASIC's plans for FoFA reforms*, 13 December 2011, available at: http://www.asic.gov.au/asic/asic.nsf/byHeadline/11-294AD%20ASIC%E2%80%99s%20plans%20for%20FoFA%20reforms?opendocument.

ASIC submissions to past Committee inquiries

7 ASIC has previously provided a submission to the Committee as part of its *Inquiry into financial products and services in Australia* (FPS Inquiry). We have also provided a submission in relation to the Committee's *Inquiry into the collapse of Trio Capital and any other related matters* (Trio Inquiry). These two submissions:

(a) examined policy underpinnings of the Australian financial services regulatory (FSR) regime;

(b) set out the key issues raised by the relevant inquiry's terms of reference, including for the FPS Inquiry the role of financial advisers and the role of commission arrangements for product sales and advice;

(c) set out ASIC's forward program to improve performance of its oversight role; and

(d) included an outline of areas for possible reform to address the issues raised by the relevant inquiry.

8 In our submission to the FPS Inquiry, we suggested that the Government should:

(a) consider amending the *Corporations Act 2001* (Corporations Act) to clarify that advisers must act in good faith in the best interests of their clients and, where there is a conflict between their clients' interest and their own interests, give priority to their clients' interests. It should not be possible to contract out of this duty; and

(b) assess changing the policy settings of the Corporations Act so that advisers cannot be remunerated in a way that has the potential to distort the quality of advice given. This would mean that the following forms of remuneration would not be permitted:

(i) up-front commissions;

(ii) trail commissions;

(iii) soft-dollar incentives;

(iv) volume bonuses;

(v) rewards for achieving sales targets; and

(vi) fees based on a percentage of funds under advice.

9 In its report on the FPS Inquiry, the Committee recommended that:

(a) a fiduciary duty for financial advisers requiring them to place their clients' interests ahead of their own be introduced into the Corporations Act;[2] and

[2] In making this recommendation, the Committee commented that: "there is no reason why adviser's should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide

(b) the Government consult with and support industry in developing the most appropriate mechanism by which to cease payments from financial product issuers to financial advisers.

10 The amendments to the Corporations Act proposed in the FoFA Bill No. 2 reflect the Government's implementation of these recommendations.

This submission

11 This submission focuses on the factors driving the need for the regulatory reform proposed in the FoFA Bill No. 2. These have been highlighted in the collapses of Storm Financial Limited (Storm) and Trio Capital Limited, which were the subject of past Committee inquiries, and other corporate collapses of financial services businesses (e.g. the Westpoint Group). Shadow shopping surveys undertaken by ASIC have also identified the need for change, in particular highlighting concerns about the effect on advice of conflicts of interest over remuneration (e.g. commissions). For example, in Report 69 *Shadow shopping survey on superannuation advice* (REP 69), we found that advice which was clearly or probably non-compliant was about six times more common where the adviser had an actual conflict of interest over remuneration.

12 ASIC has previously provided Treasury with officer-level comments on the drafting of in-progress versions and the exposure drafts of the FoFA Bills. Our main concern in making any drafting suggestions is to ensure any new obligations are enforceable in a practical sense.

advice not in their clients' best interests, yet comply with section 945A of the Corporations Act. A legislative fiduciary duty would address this deficiency.": at p 110.

B Acting in the best interests of the client

13 This section discusses the need for increasing the quality of personal financial advice provided to retail clients through a statutory best interests duty. Specifically, it discusses:

(a) how the structure of the financial advice industry can affect access to good quality advice;

(b) poor quality advice and how this is not often identified by retail clients;

(c) poor consumer confidence in financial advisers; and

(d) the limitations of current obligations on financial advisers.

14 This section also discusses:

(a) accommodating in the law the provision of scaled advice in light of consumer demand for it; and

(b) the changes to the current policy settings contained in the FoFA Bill No. 2 that have arisen from the FPS Inquiry.

Access to quality financial advice

15 As we noted in our submission to the FPS Inquiry, access to good quality advice is crucial because of:

(a) the complexity of financial products and disclosures and the fact that in Australia retail clients have direct access to a wide variety of financial products ranging from low risk to high risk;

(b) the onus on investors to make financial decisions (about superannuation and other investments) to ensure their financial security; and

(c) low levels of financial literacy.

16 Issues that may affect the quality of advice provided to consumers include:

(a) the structure and operation of the advice industry; and

(b) the standard of care currently imposed on advisers under the Corporations Act.

Impact of the structure of the advice industry

17 The financial advice industry has, in part, developed from the product issuing industry (in particular, the life insurance industry) as the means of distribution of products. These historical roots and other customary practices have influenced the structure of the advice industry and can impact on the quality of advice. Factors affecting the quality of advice include:

(a) the role played by many financial advisers in providing advice services to clients, but also selling financial products for product issuers;

(b) restrictions on the range of products financial advisers may advise on, e.g. though approved product lists; and

(c) an adviser's links to product issuers and the practice of re-branding aligned financial advisers so that it is not readily apparent that they are part of the same corporate group as the product issuer. The effect of this is that the link between product issuers and advisers is more opaque.

18 Approximately 85% of financial advisers are associated with a product issuer, so that many advisers effectively act as a product pipeline.[3] Of the remainder, the vast majority receive commissions from product issuers and so have incentives to sell products: see Section C. This structure creates potential conflicts of interest that may be inconsistent with providing good quality advice and these conflicts may not be evident to consumers.

19 The scope of advice provided by an adviser may be restricted. For many reasons licensees restrict the range of products financial advisers can advise on, e.g. through an approved product list. This restriction helps to:

(a) ensure the products recommended meet minimum standards;

(b) ensure that advisers are adequately trained on the products they advise on; and

(c) give professional indemnity insurers comfort that there are controls in place to mitigate the risks of negligent advice being given.

20 However, the range of products on which an adviser is permitted to advise can also be influenced by which products are more profitable to the licensee (e.g. where there is a commission from a product issuer or a relationship with a product issuer). ASIC's Report 251: *Review of financial advice industry practice* (September 2011) (REP 251) revealed a high degree of product concentration in the portion of funds under advice: see paragraphs 61 –64. This is despite most of the licensees having extensive approved product lists.

21 These considerations, namely restrictions in the range of products financial advisers can advise on, and the tendency towards product concentration, restrict the nature of the advice in a way that is often not evident to consumers.

22 Advisers also place a substantial amount of retail investment through platforms.[4] Platforms are administration services that facilitate the acquisition and holding of assets by enabling investors to bundle or 'wrap'

[3] IBISWorld Industry Report, Financial Planning and Investment Advice in Australia: K7515, 22 May 2009, p. 7.
[4] In 2008, approximately 72% of new investments placed by financial planners was through platforms (Investment Trends, July 2011 Planner Technology Report (released August 2011), based on a survey of 1,394 financial planners).

services, including custody of assets, execution of financial transactions and consolidated reporting. Putting all clients on the same platform creates business management efficiencies for an adviser and it is easier to monitor the client's portfolio and generally administer a business that uses a single platform. The use of platforms, however, may also restrict the range of products that advisers will recommend to their clients. This is because fees paid to platform providers ('shelf fees') have the potential to influence the range of products to which a client has access on a platform. Similarly, volume rebates paid to dealer groups by platform providers have the potential to influence product recommendations through the platform.

23 There is considerable evidence that the quality of advice is affected by conflicts of interest, such as those created by links to product issuers. For example, ASIC's 2006 Shadow Shopping survey on superannuation advice, which covered 102 Australian financial services (AFS) licensees and 259 individual advisers found that unreasonable advice was about six times more common where the recommended product was associated with the adviser's licensee.[5]

24 While conflicts of interest are required to be disclosed to clients, this is generally not sufficient to counteract the clients' own understanding of the role of an adviser. Disclosure is an important regulatory tool to help consumers understand what they are paying however our experience has shown that it is a poor tool for helping consumers to understand the impact of a conflict of interest. Retail clients do not know how to discount the objectivity of the advice they are receiving based on the size of the conflicted remuneration disclosed. For example, one recent survey found that of the respondents who had chosen a financial adviser □40% said they do not consider the possibility of conflict when their planner made investment recommendations.[6]

25 We consider there is significant scope for the interests of advisers and their clients to be more closely aligned. We consider that disclosure alone is unlikely to achieve this. Disclosure may inform the client but it does not actually align the interests of the adviser and their client.

Poor quality advice

26 Our 2006 Shadow Shopping survey revealed a high number of instances where there was not a reasonable basis for personal advice provided to a retail client: 16% of the advice clearly did not have a reasonable basis in

[5] Report 69 *Shadow shopping survey on superannuation advice* (REP 69).
[6] ANZ, *Adult Financial Literacy in Australia*, December 2011.

some respect and a further 3% probably did not have a reasonable basis based on the information ASIC received.[7]

27 Despite this, of the advice by AFS licence representatives where ASIC judged the advice to clearly lack a reasonable basis, 85% of retail clients were satisfied with the advice they received. This suggests that most clients do not have the ability to assess the merits of the advice they receive, and take the advice on trust. For example, we are aware of a case, where a retail client accepted the advice they received in circumstances where it was disclosed in the Statement of Advice that they would be significantly worse off financially as a result. These matters demonstrate why disclosure alone is unlikely to resolve these issues and supports the case for enacting measures which more closely align the interests of the adviser and the client and improve the quality of advice clients receive.

28 ASIC is currently conducting a shadow shop of financial advice related to people retiring. While the shadow shop is yet to be completed, the current indications are that we will be reporting a significant level of poor advice. The full results will be publicly available in March 2012. In the mean time, the Committee may wish to approach ASIC for a confidential briefing about our preliminary findings in February 2012.

29 Poor quality advice is also a focus of ASIC's enforcement work. We regularly accept enforceable undertakings from AFS licensees or look to amend licence conditions where we have identified instances of poor quality advice.

Poor consumer confidence in financial advisers

30 ANZ's Adult Financial Literacy in Australia survey found that 42% of respondents would not trust financial professionals nor accept what they recommend.[8]

31 ASIC' Report 224: *Access to financial advice in Australia* (REP 224) also identified consumer mistrust of financial planners as a barrier to consumers seeking financial advice. The report noted that among some consumers, notably those who have never used a financial planner or those who have had a negative experience with a financial planner, one of the main reasons for not seeking advice is the lack of trust they have in financial planners.[9]

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[7] REP 69.
[8] ANZ, *Adult Financial Literacy in Australia*, December 2011. Respondents to this survey were 3,502 randomly selected Australian adults.
[9] Page 60.

Current obligations on financial advisers

32 The Corporations Act does not require advisers to act in the best interests of their clients.[10] Under the Corporations Act providers of personal advice are, however, required to ensure any advice provided is appropriate.[11] Section 945A of the Corporations Act currently contains the appropriate advice rule. In order to give appropriate advice, the adviser must:

(a) know their client—this means determining the relevant personal circumstances in relation to giving the advice and making reasonable inquiries about those personal circumstances;

(b) know their product—having regard to information obtained from the client about their personal circumstances, and considering and conducting an investigation of the subject matter of the advice as is reasonable in all of the circumstances; and

(c) ensure the advice is appropriate to the client—having regard to the consideration and investigation of the subject matter of the advice: s945A(1).

33 Additionally, AFS licensees are required to manage their conflicts of interest.[12]

34 We do not consider that s945A sets a high standard as there may be products and strategies that are broadly appropriate for the client, but not necessarily in their best interests. Consider the following example: a client approaches an adviser wanting advice on consolidating their superannuation. They have superannuation in three accounts: a public sector accumulation fund and two retail funds. It may be appropriate under s945A for an adviser to recommend that the client rationalise their accounts and reduce fees by transferring their superannuation from the three accounts into a single account with another fund. However, the adviser may be motivated to recommend a fund with higher fees than the public sector fund because the trustee of the recommended fund is a related company to the adviser's licensee. This advice may not, however, be in the client's best interests. It may be in their best interests to consolidate all of their superannuation into the public sector accumulation fund.

35 It appears to us that there is a mismatch between the client's expectation that the adviser is providing an impartial service (e.g. advice that is in their best interests) and the obligations of the adviser under the s945A. Investors may see advisers as similar to lawyers and accountants in terms of duties and professionalism.

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[10] At common law, if financial advisers put themselves in a relationship of trust with their client, they may be fiduciaries and therefore may owe fiduciary duties to the client.

[11] There is no appropriate advice obligation on providers of general advice.

[12] See paragraph 67 for more information on this obligation.

36 There is no duty currently on advisers to prioritise the interests of the client when providing them with personal advice. Under current law, an adviser may have a reasonable basis to recommend a client invest in any of three different products. Of the three products, the adviser could recommend the product that delivers the adviser the greatest fee revenue, provided that this conflict of interest and the amount of the fee is clearly disclosed to the client.

Increasing access to scaled advice

37 Increasing access to scaled advice is consistent with the policy intent of the FoFA reforms. ASIC believes that scaled advice can be given in a way that meets the best interests duty for advisers. ASIC research has found that many Australians would like more information and advice about investment issues. An ASIC report released in December 2010 found that one third of Australians 'are now expressing a preference for piece-by-piece advice rather than holistic or comprehensive advice': see REP 224.62 and REP 224.75 – REP 224.77.

38 In July 2009, ASIC released Regulatory Guide 200 *Access to advice for super fund members* (RG 200). RG 200 gives guidance on the differences between factual information, general advice and personal advice, and how to scale advice to members of superannuation funds.

39 Other ASIC regulatory guidance also discuss how to scale advice, including:

(a) Regulatory Guide 84 *Super switching advice: Questions and answers* (RG 84); and

(b) Regulatory Guide *175 Licensing: Financial product advisers—Conduct and disclosure* (RG 175).

40 In July 2011, ASIC released Consultation Paper 164 *Additional guidance about how to scale advice* (CP 164). The proposals in CP 164 are aimed at increasing access to advice for Australians by facilitating the provision of scaled or limited advice, where appropriate and practical. We will finalise our guidance in 2012, taking into account the best interests duty proposed in the FoFA Bill No. 2.

Current obligations

41 As noted at paragraph 32, advisers are required to comply with the appropriate advice rule in s945A. Currently, many AFS licensees are providing scaled or limited advice that complies with s945A. ASIC has stated in a number of regulatory guides that the requirement to give appropriate advice in s945A is scalable. For example we have stated that:

> "The requirement that personal advice must be suitable is scalable according to the nature of the advice. This means that you can limit your

inquiries to the agreed subject matter of the advice. Where the subject matter of the advice is relatively simple, less extensive member inquiries are required to reflect the level of complexity, and the advice can be presented simply”.[13]

Changes to policy settings

42 The best interests duty, and also the other reforms proposed in the FoFA Bills, will improve the quality of personal financial advice provided in Australia by more closely aligning the interests of advisers with their clients. This is important considering the structure of the financial advice industry (discussed above).

43 More closely aligning the interests of the adviser with those of their client is likely to improve trust and confidence in the financial advice industry over time. Flowing from this, the number of Australians that seek financial advice should increase.

44 At paragraph 36, we noted that there is no duty currently on advisers to prioritise the interests of the client when providing personal advice.

45 Once the new obligations are in place, ASIC will continue to provide guidance with the aim of increasing access to advice by facilitating industry to provide scaled advice while complying with the relevant advice obligations (as we have in the past with RG 200 and CP 164). This guidance will discuss a range of topics, including how the fact find process in giving advice can be either limited or expanded, depending on the complexity of the advice being provided. For example, when a client’s circumstances relevant to the scope of the advice are straightforward, the scale of the advice provider’s inquiries may be quite limited. As the complexity of a client’s circumstances relevant to the scope of the advice increases, the advice provider will need to expand the scale of their inquiries.

46 The Explanatory Memorandum to the FoFA Bill No. 2 helpfully provides some direction as to how the best interests duty is intended to apply when providing scaled advice to a client. It states that the process the adviser is required to follow to satisfy the best interests duty “is designed to accommodate the provision of limited advice (also referred to as “scaled advice”) that only looks at a specific issue (for example, single issue advice on retirement planning)”: paragraph 1.34. This commentary is useful, and will assist ASIC in giving guidance to industry about how they can give scaled advice in a way that complies with the new obligations.

[13] At RG 200.14.

47 We are clearly of the view that advice providers can give scaled advice and concurrently satisfy the best interests duty. While we are of this view, we are aware that some parts of industry are interpreting the draft legislation more conservatively. In order to provide these stakeholders with further comfort about the intention of the FoFA Bill No. 2, it may be helpful to include a note in the legislation that states specifically that the best interests duty is intended to accommodate the provision of scaled advice.

C Minimising conflicts of interests relating to remuneration

48 Remuneration structures currently used in the financial advice industry create significant real and potential conflicts of interest that can distort the quality of advice. ASIC believes reforms that seek to address these conflicts will help improve the quality of financial advice.

49 This section discusses:

(a) remuneration structures in the financial advice industry;

(b) the conflicts of interest that arise from these remuneration structures;

(c) current obligations imposed on financial advisers in relation to managing conflicts of interest (including through disclosure); and

(d) briefly the changes to the current policy settings contained in the FoFA Bill No. 2 and that have arisen from the FPS Inquiry.

Remuneration structures in the financial advice industry

50 Remuneration of distributors of financial products was historically set by the product issuer. It was based on the value of products sold and deducted from the amount paid by the consumer for the product. These remuneration settings encouraged product distributors to sell certain products and to prioritise selling products over other potential strategies to improve the client's financial affairs.

51 As the market for financial advice services has grown, the historic connection with product issuers and this remuneration structure has conflicted with investors' needs for quality impartial advice and their perception that this is what financial advisers provide.

Current remuneration structures

52 There are a variety of ways in which investors pay advisers (directly or indirectly via product issuers):

(a) trail commission (% of assets) (this is estimated to provide 31% of adviser revenue);

(b) initial (or upfront) commission (% of initial investment) (this is estimated to provide 24% of adviser revenue);

(c) fee for service as a % of assets under advice (this is estimated to provide 22% of adviser revenue); and

(d) fee for service as a fixed dollar amount or on an hourly rate paid upfront or out of the product (this is estimated to provide 14% of adviser revenue).[14]

53 An investor might be paying one, two or three types of remuneration to a single adviser.

Features of commissions

54 The distinguishing feature of commissions is that they are an arrangement between the product issuer and the adviser or the adviser's licensee and they are built into the product. That is, the commissions are incorporated into the fees paid by the client to acquire or hold the product. After the investor has invested in the product, the investor cannot control the commission.

55 Commissions as a 'built in' feature of products also distort the cost of advice. Retail clients are unaware of the true cost of receiving personal financial advice as this is often bundled into the overall fees they pay for financial products.

56 Because the commission is built into the product, it is often difficult to draw a link between the commission and the advice service provided. For example, industry argues that trail commissions are in effect payment for ongoing advice services provided to the client or ongoing administrative costs, for example, the costs of monitoring the client's portfolio. However, trail commissions are often paid regardless of whether there is any ongoing advice or service.

Developments in the industry

57 An Investment Trends study has found that fee for service remuneration models are starting to play a more significant role in the industry. At the same time, there has been a reduction in the amount of trail and upfront commissions received, which has fallen from 69% of total practice revenue in 2006 to 55% in 2010. Many financial planners expect to move away from commissions to a fee for service based remuneration structure in the future.[15]

[14] Investment Trends, *October 2010 Planner Business Model Report*, February 2011. This report is based on a survey of 1,662 financial planners.
[15] Investment Trends, *October 2010 Planner Business Model Report*, February 2011. This report is based on a survey of 1,662 financial planners.

Figure 1: Current and projected sources of remuneration

	2006	2007	2008	2009	2010	2011*	2012*	2013*
% from fee for service	15%	35% ↑	39% ↑	43% ↑	40%	48%	62%	58%
% from commissions	69%	65% ↓	61% ↓	55% ↓	55% ↓	52%	37%	39%

Source: Investment Trends, *October 2010 Planner Business Model Report*, February 2011.

Conflicts of interest

58 Commission payments and other volume based remuneration payments can create real and potential conflicts of interest for advisers. These conflicts include:

(a) **making product sales rather than providing strategic advice:** commissions encourage advisers to sell products rather than give strategic advice (e.g. advice to the client that they should pay off their mortgage), even if this advice is in the best interests of the client and low risk. Commissions also provide an incentive to recommend products that may be less appropriate but are linked to higher commissions. Higher commissions might be provided for selling higher-risk products, perhaps because other advisers are unwilling to sell these products due to the high risk (e.g. Westpoint);

(b) **not recommending products that generate a low commission:** products that might be better for the client but do not generate a high commission return might not be recommended to clients. Moreover, because many advice businesses are remunerated through product sales, the businesses need to continue to bring in new clients to invest in products. Further, because commissions are paid irrespective of whether or not ongoing services are provided there is little incentive to service existing clients;

(c) **remuneration based on the volume of funds under advice and product sales:** remuneration based on the amount of funds under advice can also create conflicts of interest. Advisers who are remunerated by reference to funds under advice have an interest in selling investment products to their clients (including via gearing) rather than providing strategic advice, e.g. to pay down debts.

(d) **the relationship between licensee revenue and adviser remuneration:** REP 251 found that there were a number of conflicts of interest around licensee revenue and adviser remuneration. REP 251 was based on the results of a questionnaire filled out by the 20 largest

AFS licensees that provide financial product advice to retail clients. The majority of licensees filling out the questionnaire indicated that they remunerated their advisers based on the volume of financial products sold. This remuneration included ongoing commissions, up-front commissions and volume rebates. Similarly, the top three revenue streams for licensees are linked to volume sales paid by the fund manager or product provider to the licensee;[16]

(e) **recommending products issued by a related party:** ASIC's Report 50 *Superannuation switching surveillance* (August 2005) (REP 50), found that of 4,900 superannuation switching recommendations given by advisers, 90% recommended a switch to a related fund. This does not necessarily mean that the advice was inappropriate, but it does highlight the prevalence of real or potential conflicts of interest and their impact.

Conflicts of interest and the quality of advice

59 There is strong evidence that conflicts of interest arising from how advisers are remunerated can affect the quality of advice. ASIC's 2006 Shadow Shopping exercise suggested that unreasonable advice was more common where the adviser stood to get higher remuneration if the recommendation was followed. In particular, we found that advice that was clearly or probably non-compliant with the Corporations Act requirements was about six times more common where the adviser had an actual conflict of interest over remuneration. Earlier shadowing shopping surveys conducted by ASIC also demonstrated this effect: see REP 50.

60 The collapse of Storm may be an example of the potential impact on clients of a failure to manage conflicts of interest created by commissions and remuneration based on funds under advice. While our investigations are continuing, we understand that Storm advisers remunerated on the basis of total invested funds may have counted loan funds as funds under advice and took a percentage of funds under advice as remuneration, creating an incentive to recommend clients take out loans or increase the size of existing loans.

Product concentration

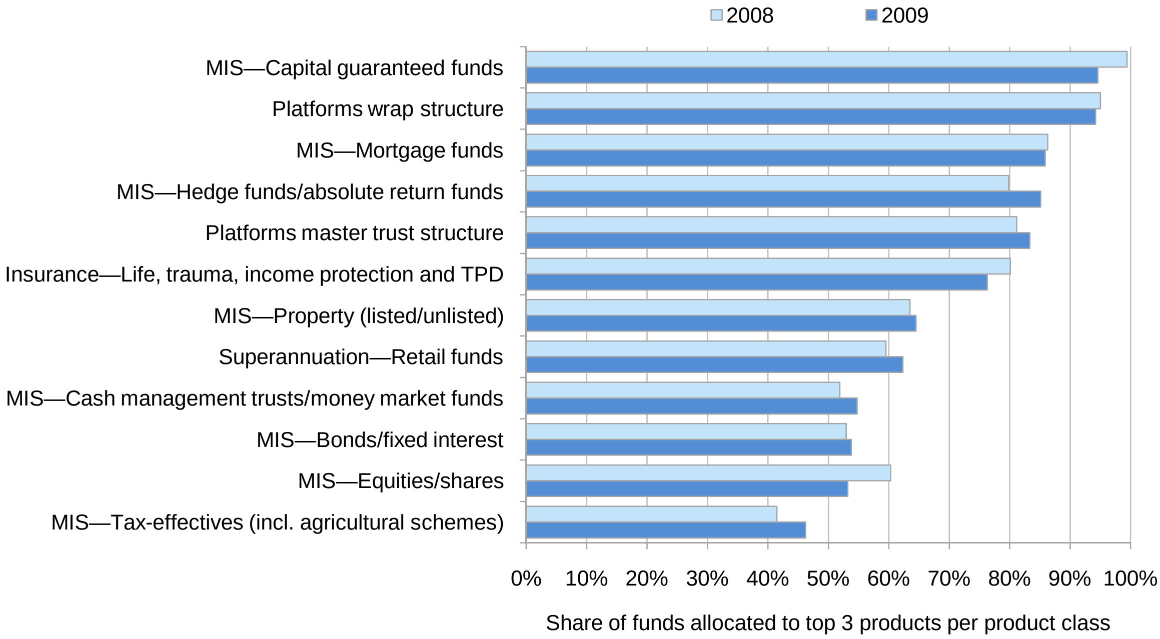
61 The results of REP 251 also revealed a high degree of product concentration in the portion of funds under advice.

62 Figure 2 shows the proportion of funds under advice flowing from each licensee into the top three products (by total funds invested) for each product class (e.g. managed investment schemes, platforms, superannuation).[17] For

[16] See pages 10 – 12.
[17] Data for insurance products refers to premiums rather than investment amount.

example, in platforms with wrap structures, around 95% of funds are held in the top three products, while around 60% of all funds are in the top three retail superannuation products.

Figure 2: Percentage of funds under advice per product allocated to the top three products/providers



Note 1: MIS = managed investment schemes; TPD = total and permanent disability.

Note 2: Figures are based on information provided by the top 20 licensees.

Source: ASIC

63 Product concentration needs to be managed and risk-mitigated by licensees because, if the majority of their clients' funds are held in one or two products, there is significant concentration risk. Failure in one product could be very serious for the licensee (as well as its clients). As Figure 2 shows, the top three products for most licensee groups received a high share of total funds for that product class.

64 Removing incentives for advisers to place clients in particular products is likely to lead to a reduction in these levels of product concentration.

Current obligations on financial advisers

Disclosure and its limitations

65 The law requires that fees or remuneration (including commissions) are disclosed clearly to investors, for example through Financial Services Guides and Statements of Advice. However, it does not set limits on what can be charged or how it can be charged.

66 As noted at paragraph 24, disclosure alone is an inadequate regulatory tool to overcome the conflicts of interest created by commissions. While disclosure can help consumers understand what they are paying it is a poor tool for helping consumers to understand the impact of a conflict of interest. There is already evidence to suggest that many retail clients do not consider the effect any conflicts of interest of the adviser may have on the advice the client receives.[18] Further, research demonstrates that disclosure as a response to conflicts of interest can fail because although it may encourage the audience to discount conflicted advice, such discounting tends to be insufficient and indeed disclosure can lead advisers to provide even more biased advice than they otherwise would.[19] As discussed earlier, disclosure itself is unable to align the interests of the client and the adviser.

General obligation to manage conflicts of interest

67 All AFS licensees must have in place adequate arrangements for the management of conflicts of interest: see s912A(1)(aa) of the Corporations Act. One way of managing conflicts of interests is to avoid them. For example, avoiding remuneration structures that could potentially distort the quality of advice. However, this is not the only way conflicts can be managed under s912A(1)(aa). Other conflict management strategies include controlling the conflict of interest or disclosing it.[20] However, given the potential strength of conflicts of interests arising from remuneration, these strategies may not be sufficient to effectively overcome the conflict. This view is supported by the findings of our 2006 Shadow Shopping exercise: see paragraph 59.

Changes to policy settings

68 As discussed above, commission remuneration can encourage advisers to sell products rather than give strategic advice and to recommend products that may be less appropriate but are linked to higher commissions. Remuneration based on funds under advice also encourages sales. Disclosure alone appears to be an ineffective tool to overcome these conflicts of interests.

69 To the extent that the FoFA Bill No. 2 bans conflicted forms of remuneration paid to those that provide financial advice, the Bill is likely to have a

[18] See paragraph 24.
[19] Daylian M Cain, George Loewenstein, and Don A Moore, ‘Coming Clean but Playing Dirtier: The Shortcomings of Disclosure as a Solution to Conflicts of Interest’ in *Conflicts of Interest: Challenges and Solutions in Business, Law, Medicine and Public Policy*, Moore, Cain, Loewenstein and Bazerman (eds), Cambridge University Press, 2005.
[20] Regulatory Guide 181: *Licensing: Managing conflicts of interest* contains guidance on and ASIC’s general approach to how the obligation to manage conflicts of interest in s912A(1)(aa) should be complied with.

significant impact on removing conflicts of interest which can distort the quality of advice.

70 The broader the ban, the more effective it will be in removing remuneration structures that have the potential to distort the quality of advice. 'Conflicted remuneration' may not always be received by a licensee or their representative. They could be received by an associate of one of these entities and still have the potential to influence the advice provided to retail clients. Conflicted remuneration may also not necessarily be 'given' or 'accepted' by a licensee or their representative, which is the language used in the FoFA Bill No. 2. In some cases there may be an argument as to whether conflicted remuneration is 'given' or 'accepted'. A broad definition will also have a greater ability to adapt to changing industry practice.

71 The drafting of the ban on conflicted forms of remuneration contains novel concepts that have not been previously considered by the courts. For example, the concept of a volume-based shelf-space fee and how this has been defined (s964A). ASIC will need to assess the effectiveness of these new provisions over time and in light of regulatory experience.

72 However, to assist industry in adopting measures to comply with the FoFA reforms, ASIC will provide guidance on how we interpret this provision in 2012.

D Anti-avoidance

73 ASIC supports effective and broad anti-avoidance measures that would ensure that the policy intent of the FoFA reforms, including the ban on conflicted forms of remuneration, are not avoided through emerging industry or transaction restructuring, e.g. via new forms of vertical integration.

74 To best promote the objects of the FoFA reforms we consider that the anti-avoidance provision should apply from the earliest possible time.

75 We also think that if anti-avoidance schemes were declared by the Corporations Act to be void (rather than only subject to civil penalty provisions), this would have a powerful deterrent effect. For example, a client would not need to pay what would otherwise be banned remuneration.

76 An anti-avoidance provision that allows ASIC to act pre-emptively and prevent an anti-avoidance scheme from being carried out would also provide increased benefits to retail clients.