Associate Professor Joanna Bird
Ross Parsons Centre of Commercial Corporate and Taxation Law

24 January 2012

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Email: economics.sen@aph.gov.au

Dear Committee Secretary

Joint Consumer Submission to the Inquiry into the
Corporations Amendment (Future of Financial Advice) Bill 2011 and
Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011

The Australian Investors Association, the Australian Shareholders Association, CHOICE, the Consumer Action Law Centre, COTA, and the National Information Centre on Retirement Investments Inc are pleased to provide to the Senate Economics Legislation Committee, for its consideration, submissions on the Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011.

These submissions have also been submitted to the Parliamentary Joint Committee on Corporations and Financial Services.

If you have any queries about these submissions, please feel free to contact me.

Kind regards

Joanna Bird

Corporations Amendment (Future of Financial Advice) Bill

Joint Consumer Submission

choice

COTA For older Australians

consumer action law centre

asa Australian Shareholders' Association the trusted voice of shareholders

NICRI Consumer Protection for the Small Investor

AUSTRALIAN INVESTORS ASSOCIATION

PREPARED FOR, AND IN CONSULTATION WITH, THE CONSUMER REPRESENTATIVES BY ASSOCIATE PROFESSOR JOANNA BIRD, SYDNEY LAW SCHOOL, UNIVERSITY OF SYDNEY

30 November, 2011

Contact: (02) 9351 0475; joanna.bird@sydney.edu.au

Joint Consumer Submission

1. This is the Joint Consumer Submission to the Inquiry by the Parliamentary Joint Committee on Corporations and Financial Services into the Corporations Amendment (Future of Financial Advice) Bill 2011 (the Bill). A list of individual consumer representatives and consumer organisations (consumer representatives) consulted during the development of this Joint Consumer Submission is set out in paragraphs 68 and 69 below.

Executive Summary

The need for reform

2. The case for reform of the regulation of financial advice is overwhelming. Currently, the conflicts of interest, remuneration models, sales culture and mismatch between supply and demand in the Australian financial advice industry lead to poor consumer outcomes. They have led to incidences of poor quality financial advice and excessive fees for advice, as well as a low demand for financial advice. The current regulation of the financial advice industry is not able to prevent this potent mix of poor consumer outcomes.

3. The consumer representatives strongly support the Future of Financial Advice (FoFA) reforms which they believe will achieve the Government's objectives and lead to better consumer outcomes. In particular, they support the amendments in the Bill, namely:

- the annual disclosure statement requirement;
- the biennial renewal notice requirement;
- the enhancements to the licensing and banning powers of the Australian Securities and Investments Commission (ASIC); and
- the anti-avoidance provision.

Importance of the fee disclosure statement and renewal notice

4. Both the disclosure statement requirement and the renewal notice requirement are essential to the achievement of the objectives of the FoFA reforms. The fee disclosure statement ensures that clients are aware of the ongoing fees they are paying and the services they receive in return for those fees. This information enables clients to make an informed decision about whether they want to continue paying those fees. Importantly, the fee disclosure statement gives clients information that they do not receive from current financial services disclosure documents. The renewal notice requirement ensures that disengaged retail clients do not pay ongoing fees for little or no service. Current remuneration models in the financial advice industry mean that clients often pay for advice on an ongoing basis (that is, indefinitely until they take an active step to stop payment) in a manner which requires them to take no active steps to effect payment. That is, payment is not transparent to the clients. Disengaged clients are very vulnerable to exploitation through such remuneration models. The renewal notice requirement will force clients to take an active step once every two years.

5. Contrary to the arguments made by some industry participants, it is not the case that the best interests duty and the ban on conflicted remuneration are sufficient to achieve the Government's objectives. First, general conduct duties, especially those drafted like the best interests duty in the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011, are not an effective way to change widespread existing business practices. Secondly, and most importantly, the ban on conflicted remuneration in the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 will still allow advisers to charge asset based fees (ie a fee for service calculated as a percentage of funds under advice) that mimic all the undesirable characteristics of commissions. That is, they will give rise to conflicts of interest, be non-transparent to the client and bear no relationship to the services actually provided. In these circumstances, the fee disclosure statement and renewal notice are essential to ensure clients are aware they are paying such fees and make an active decision to continue paying them. The consumer representatives fear that without the disclosure statement and renewal notice requirements the FoFA reforms will fail to effect any real change in the financial advice industry.

6. The consumer representatives also strongly reject the argument that the compliance costs of the disclosure statement and renewal notice requirements are disproportionate to the benefit of the requirements. The most reliable available research indicates that the costs are low. The benefits to consumers, on the other hand, will be significant.

7. Industry stakeholders have made a number of proposals to modify the fee disclosure statement and renewal notice requirements. The consumer representatives believe that, if implemented, all these proposals would severely weaken the effectiveness of the requirements and they strongly object to them.

8. The proposal to limit the disclosure statement to new clients would significantly disadvantage existing clients of financial advisers. As the Bill is currently drafted, the renewal notice requirement already creates two classes of client:

- those who will have the benefit of the renewal notice (because they have not received personal advice from their adviser before the commencing day and first entered into their ongoing fee arrangement after the commencing day); and
- those who do not have the benefit of the renewal notice (because either they received personal advice from their current adviser prior to the commencing day or entered into their ongoing fee arrangement prior to the commencing day.)

Limiting the fee disclosure statement to the first class will exacerbate this problem. The disclosure statement is, in fact, even more important for the second group of clients who, under the Bill, will not receive the renewal notice. The information in the disclosure statement may enable this group of clients to overcome any disengagement and take appropriate action.

9. Amending the Bill so that the fee disclosure statement and/or the renewal notice only has to be provided to clients whose funds under advice are above a certain threshold would disadvantage those most in need of protection. The smaller the amount of funds under advice, the greater the impact of erosion of the value of those funds through ongoing fees.

It is important to remember that both requirements only apply if the adviser has chosen to charge a client an ongoing fee. Advisers can still provide advice to lower value clients without providing a fee disclosure statement or a renewal notice provided they do not charge ongoing fees.

10. The consumer representatives also strongly oppose the proposals to extend the renewal notice period beyond two years. Such a change would dilute the effectiveness of the reform and perpetuate the passive income problem that the reform is designed to address.

Necessary amendments to the Bill

11. The consumer representatives are of the view that the Bill should be amended to strengthen the disclosure statement and renewal notice requirements, as well as the anti-avoidance provision. In particular, the consumer representatives believe that:

- the renewal notice should be provided to all retail clients who are charged ongoing fees. However, if this approach is not adopted the Bill should be amended to apply the renewal notice requirement to all existing clients who enter into new ongoing fee arrangements with their adviser after the commencing day and all ongoing fee arrangements with existing clients that are assigned to a new advisers after the commencing day;
- the fee disclosure statement should be amended to require disclosure of commissions and other non-fee remuneration of advisers;
- clients should be entitled to an automatic refund if their adviser continues to charge them ongoing fees in breach of the provisions in the Bill (subject to the adviser's right to apply for an order that it is not required to give a refund); and
- the anti-avoidance provision should be amended to facilitate preventative enforcement action and to make anti-avoidance schemes legally void and unenforceable.

Background

History of the Bill

12. The Bill forms part of the FoFA reforms. The FoFA reforms represent the Government's response to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into Financial Products and Services in Australia in 2009 (the 2009 Inquiry). The 2009 Inquiry was in turn a response to significant consumer losses. The 2009 Inquiry was prompted by the collapses of Storm Financial and Opes Prime. However, other consumer losses, such as those resulting from the collapse of debenture issuers Westpoint, ACR and Fincorp, were also an important part of the backdrop to the 2009 Inquiry.

13. During the conduct of the 2009 Inquiry the Parliamentary Joint Committee received 398 formal submissions and 37 supplementary submissions. The Parliamentary Joint Committee held nine public hearings and took evidence from about 100 witnesses.

14. On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP announced the FoFA reforms. The reforms included:

- a ban on conflicted remuneration, including commissions, any form of payment relating to volume or sales targets and asset based fees in relation to geared products and investment amounts;
- a product neutral adviser charging regime, including an annual fee disclosure notice and opt-in (ie renewal notice)
- a best interests duty for financial advisers; and
- enhancements to ASIC's licensing and banning powers.

15. Treasury consulted on these reforms, mainly through a peak consultation group (PCG), comprising key stakeholders. The bodies represented on the PCG for the FoFA reforms are:

- Financial Planning Association
- Australian Financial Advisers
- CHOICE
- Consumer Action Law Centre
- ADF Financial Services Consumer Council
- Financial Services Council
- Australian Financial Markets Association
- Australian Finance Conference
- Australian Bankers Association
- ABACUS Australian Mutuals
- Insurance Council of Australia
- National Insurance Brokers Association
- Association of Super Funds of Australia
- Industry Super Network
- SMSF Professionals Association of Australia
- Australian Compliance Institute
- CPA Australia
- Financial Ombudsman
- Financial Sector Union
- Law Council of Australia

ASIC also attends PCG meetings. Treasury also held public information sessions in June/July 2010 and February/March 2011.

16. In April 2011 the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon Bill Shorten MP, released another Information Package on the FoFA reforms. In this Information Package the Minister announced, amongst other things, that:

- the opt-in (renewal notice) would only be required once every two years; and
- there would be a limited carve out from elements of the ban on conflicted remuneration and the best interests duty for basic banking products where employees of an Australian Deposit-taking Institution (ADI) are advising on and selling their employer ADI's basic banking products.

17. Since the release of the April 2011 Information Package, the Government has continued to consult with the PCG and two Exposure Draft Bills have been released for public consultation. The Exposure Draft of the Corporations Amendment (Future of Financial Advice) Bill was released on 29 August 2011 and the Government received 44 public submissions. The Exposure Draft of the Corporations Amendment (Further Future of Financial Advice Measures) Bill was released on 28 September 2011. The submissions on this Exposure Draft have not yet been publicly released by Treasury.

18. As can be seen from the above history, the industry and regulatory issues that give rise to the need for the FoFA reforms and the Bill have been subject to intensive consultation and scrutiny, starting with the 2009 Inquiry. As a result of this process significant concessions have been made to industry, most notably the biennial, rather than annual, renewal notice and the carve-outs for basic banking products. Nevertheless the industry continues to push for concessions. The consumer representatives are very concerned that further concessions will lead to the FoFA reforms being nothing more than window dressing of the status quo.

The case for reform

19. Real and robust reforms are essential because, as highlighted by the Report of the 2009 Inquiry and subsequent ASIC reports[1] a number of features of the Australian financial advice industry lead to poor consumer outcomes. In summary, the features of the financial advice industry that are driving poor consumer outcomes are:

- strong conflicts of interest;
- flawed remuneration models;
- a sales culture; and
- a mismatch between supply and demand.

Conflicts of interest

20. Financial advisers have significant conflicts of interest that shape their Approved Product Lists and inevitably negatively affect the quality of financial advice. The conflicts of interest arise from both the ownership of financial advice businesses and remuneration models:

- (ownership conflicts) At least 85% of advisers are associated with a product manufacturer.[2] There is evidence that the conflicts of interest created by this relationship leads to poor quality advice. For example, ASIC's 2006 Shadow Shopping survey on superannuation advice indicated that unreasonable advice was more common where the recommended product was associated with the adviser's licensee.[3] ASIC Report 251 *Review of financial advice industry practice* points to the conflicts of interest created by the sale of exclusive products.[4]

[1] Report 224 *Access to financial Advice in Australia* (December 2011) and Report 251 *Review of financial advice industry practice* (September 2011).

[2] ASIC submission to the 2009 Inquiry, at para 111, citing IBISWorld Industry Report, Financial Planning and Investment Advice in Australia: K7515, 22 May 2009, p. 7. Since 2009 there has been consolidation in the financial advice industry and it is now likely that an even higher percentage of adviser are associated with a product manufacturer.

[3] ASIC submission to the 2009 Inquiry, at para 114

[4] Para 41.

- (remuneration conflicts) The vast bulk of adviser income comes from commissions and asset based fees.[5] Commissions encourage advisers to sell products, rather than give strategic advice (eg advice to pay off debt). They also provide an incentive to recommend products that pay higher commissions (eg Westpoint products), rather than those that pay low or no commissions. Asset based fees drive equally poor consumer outcomes. They also encourage advisers to recommend that clients acquire financial products, rather than pursue other strategies such as debt reduction, and that they increase the value of their investments in financial products by borrowing. It seems reasonable to assume that the Storm Financial remuneration model, which included a combination of asset based fees and commissions, may have encouraged advisers to recommend inappropriate borrowing. Other aspects of adviser remuneration models such as sales targets and volume bonuses also create conflicts of interest and have a similar distorting impact on the financial advice given to consumers. In short conflicted remuneration has driven poor business models, like Storm Financial, which are based on extracting maximum adviser income, not on delivering value to clients. There is frequently limited or no alignment between adviser remuneration and consumer value. In fact, the two often work in opposition.

21. The current regulation of conflicts of interest does not sufficiently deal with these entrenched conflicts. It generally leads to the disclosure of the conflicts of interest.[6] However, disclosure is a particularly ineffective regulatory tool to deal with conflicts of interest in an advice situation. Research shows that, in an advice situation, disclosure of conflicts of interest can lead to perverse outcomes, such as increasing the bias in the advice and inducing clients to place greater trust in the conflicted adviser.[7]

Remuneration models

22. As noted in paragraph 20 above, the dominant remuneration models in the financial advice industry (that is, commissions, asset based fees and volume bonuses) create conflicts of interest which demonstrably increase the likelihood of poor quality advice. There are several other features of the financial advice remuneration models that lead to poor consumer outcomes:

- (Lack of transparency) Adviser remuneration is commonly ongoing in nature and paid out of client assets under the control of the adviser. The consumer is frequently unaware of when, how or how much their adviser is paid because they do

[5] Approximately 71% of adviser revenue comes from commissions (both trail and up-front) and 23 % from fee for service calculated as a percentage of funds of advice: ASIC submission to the 2009 Inquiry, at para 163, citing Investment Trends October 2008 Planner Business Model Report, 27.

[6] Section 912A(1)(aa) *Corporations Act 2001* requires Australian financial services licensees to have adequate arrangements for the management of conflicts of interest. Disclosure is generally considered to be adequate management. Conflicts of interest also have to be disclosed in the Financial Services Guide and the Statement of Advice: ss 942B, 942C, 947B and 947C.

[7] Daylian M. Cain, George Loewenstein and Don A. Moore, 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest' (2005) 34 *Journal of Legal Studies* 1, at 9-12. See also Daylian M. Cain, George Loewenstein and Don A. Moore, 'When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of interest' (2011) *37 Journal of Consumer Research* 836, at 840-841.

not need to take any active steps to pay their adviser. This has led to situations in which consumers are paying advice fees even though they have received little or no ongoing service. The lack of transparency and client control means that even engaged consumers are unlikely to be able to prevent the payment of excessive fees.[8] It is very important to note that the current mandatory disclosure documents do not, and given their nature and timing, probably could not, address this lack of transparency. Retail clients will receive a Financial Services Guide (FSG) before they are first provided with financial advice by their financial adviser. The FSG must set out information about the remuneration or other benefits the adviser and its associates may receive because of the provision of financial advice. However, this prospective information will necessarily be high level and vague. Any Statement of Advice (SOA) given to the retail client at the time advice is provided must include information about remuneration and other benefits that might reasonably be expected to influence the adviser in providing the advice. It is clear that these documents have not led to consumers understanding how their advisers are remunerated and how much they will pay.

- (No link between amount paid and service provided) Currently, in the financial advice industry, the amount of remuneration paid is often not linked to the service provided. Under the dominant remuneration models (that is, commissions, asset based fees and volume bonuses) advisers are paid regardless of the number of hours spent preparing the advice or regardless of how beneficial the advice is from the consumer's perspective. Many advisers are receiving trail commissions for product acquisition advice given many years ago to clients whom they currently have no contact with. In this situation, the adviser's remuneration is dependent on how much the client spent acquiring the asset and how long the client holds the asset. Asset based fees also ensure that the financial adviser is paid a certain proportion of the client's assets regardless of the amount of work done by the financial adviser or the quality of that work. Research conducted by Rice Warner Actuaries in May 2011 showed that when an adviser used a commission or asset based fee remuneration model the cost of advice was 3 to 18 times the cost of similar advice provided by an adviser that used a fee-for-service remuneration model.[9] The higher fees from these remuneration models will obviously erode consumer wealth. Moreover, these remuneration models do not provide an incentive to provide high quality, ongoing advice.

Sales culture

23. There is a sales culture in the Australian financial advice industry, with financial advisers primarily acting as the sales force of product manufacturers. This culture derives from the historical roots of the industry. As noted in ASIC's submission to the 2009 Inquiry[10], 'the financial advice industry has developed from the product manufacturing industry (in particular, the life insurance industry) as the means of distribution of products.' The sales

[8] Explanatory Memorandum to the Bill, paras 1.4 and 3.33.

[9] Rice Warner Actuaries, *Value of IFFP Advice – Industry Super Network* (May 2011) available at http://www.industrysupernetwork.com/wp-content/uploads/2011/05/ValueofAdvice-ReportMay2011.pdf

[10] Para 110

culture has been reinforced by both the ownership links between financial advisers and product manufacturers and the traditional remuneration models in the industry (referred to in paragraph 20 above).

24. This sales culture is inconsistent with the provision of independent, high-quality professional advice, in the best interests of clients. It has created supply-side competition where the product manufacturers are competing for the business of the advisers (ie their product distributors), not for the consumers who eventually buy the products. That is, the competition in the financial advice industry is primarily for the financial advisers, who deliver consumers and market share to product manufacturers. This supply-side competition has driven up costs for consumers. It has driven remuneration models such as trail commissions and soft dollar benefits which enable product manufacturers to compete for and retain financial advisers.

Mismatch between supply and demand

25. ASIC Report 224 *Access to financial advice in Australia* shows that there is a mismatch between what consumers generally want (which is scaled or piece-by-piece advice) and what advisers generally provide (comprehensive financial advice).[11] There is also a significant gap between the amount consumers are prepared to pay for financial advice and the cost of providing financial advice. For example, the cost of providing comprehensive financial advice ranges between $2500 – $3500,[12] whereas, on average, consumers believe that initial advice should cost $310 and ongoing advice should cost $298 per annum.[13] This mismatch may, in part, be created by the existing remuneration models which have hidden the cost of advice and led consumers to believe that advice is either free or low cost. The disparity between the cost of providing advice and the amount consumers are prepared to pay, creates strong incentives to maintain remuneration models that hide the true cost of advice from consumers and that allow product manufacturers, who are willing to pay adviser to distribute their product, to subsidise advice (and increase costs for all consumers of financial products).

26. Finally, Report 224 also states that less than 40% of the Australian adult population has ever used a financial planner,[14] even though quality financial advice leads to real benefits for individuals and the economy.[15] The reasons for low access to financial advice include lack of engagement with financial matters, low levels of financial literacy and distrust of financial advisers.[16]

[11] Paras 75 – 79.

[12] ASIC Report 224, para 171

[13] ASIC Report 224, para 87

[14] ASIC Report 224, para 2. Statistics on the percentage of Australians accessing advice vary. The Explanatory Memorandum to the Bill states that between 22% and 34% of adult Australians access financial advice: para 3.21,

[15] ASIC Report 224, paras 17 – 26.

[16] ASIC Report 224, para 95.

Poor consumer outcomes

27. In summary, the Australian financial advice industry, as currently structured, leads to the following poor outcomes for consumers:

- Poor quality advice leading to consumer losses. As noted in the Report of the 2009 Inquiry[17], this poor quality advice may lead to catastrophic losses (such as in Storm Financial where a number of clients were left with 'great challenges in meeting living expenses, repaying debts and, in some cases, keeping their homes')[18] or, as is more likely, sub-optimal investment strategies which erode consumers' wealth in less dramatic, but nevertheless significant, ways. ASIC Report 240 *Compensation for retail investors: the social impact of monetary loss* (May 2011) shows that consumer loss through financial service provider misconduct can lead to severe financial and emotional stress. It also has a corrosive effect on trust in the financial system;
- Excessive fees. Consumers are seeing their wealth eroded unnecessarily over time, through payment of excessive fees for financial advice. (See the research referred to in paragraph 22 above); and
- Low access to advice. Relatively few consumers obtain advice even though they are likely to benefit from good quality advice. (See ASIC Report 224 referred to in paragraph 26 above.)

Need for regulatory change

28. The above summary shows that the case for reform is overwhelming. Given existing industry practices and structures, the current regulation of the financial advice industry is not achieving good outcomes for the consumers it is intended to protect.

29. The FoFA reforms are designed to address this problem. The consumer representatives strongly support the Government's desire to deal with this problem through implementation of the FoFA reforms. If properly drafted and implemented the consumer groups believe the FoFA reforms will achieve their objectives of:

- improving the quality of financial advice;
- building trust and confidence in the financial planning industry; and
- facilitating access to financial advice through the provision of simple or limited advice. [19]

The consumer representatives strongly support these objectives.

Importance of the fee disclosure statement and renewal notice

Purpose of the disclosure statement and renewal notice

30. The consumer representatives believe that the disclosure statement and renewal notice requirements are essential components of the FoFA reforms. It is important to remember that both requirements only apply where the adviser has entered into an ongoing fee

[17] Para 5.12

[18] Report of the 2009 Inquiry. para 3.1.

[19] See Explanatory Statement to the Bill, p.3.

arrangement, that is, an arrangement under which the client will pay a fee to the adviser during a period of more than a year. This fee will often be paid by the adviser deducting a fee from the client's assets (which are under the control of the adviser). It will generally not be paid by the client taking an active step each year to pay the adviser eg by writing a cheque. In this content, the renewal notice requirement ensures that disengaged retail clients do not pay ongoing fees for little or no service. These disengaged clients are very vulnerable to exploitation through remuneration models which involve the payment of ongoing fees out of assets under the control of the adviser. The fee disclosure statement ensures that clients are aware of the fees they are paying and the services they receive in return for those fees and are able to make an informed decision about whether they want to continue paying those fees.

31. As stated above in paragraph 22, it is important to realise that the fee disclosure statement provides clients with information they do not receive from the 'up-front' provision of an FSG or SOA. Firstly, the fee disclosure statement provides clients with information about the fees they have actually paid and the benefits they have actually received in return for those fees. The FSG, on the other hand, is a forward looking document. It is provided at the beginning of the relationship between the retail client and the financial adviser and necessarily only provides very general information about prospective remuneration. In general, this is also true of an SOA. An SOA is only given intermittently during an ongoing advice relationship (and possibly only once), only contains forward-looking, general information about remuneration and does not need to include disclosure of fees to be paid by the client, such as hourly fees, that are payable irrespective of whether the client acts on the advice. Secondly, the prospective remuneration information in the fee disclosure statement is likely to be more precise and meaningful for clients, than any prospective information in the FSG and SOA, because it relates only to the coming year.

32. Given the limitations of the existing disclosure documents and the remuneration practices of many financial advisers, without the disclosure statement and renewal notice, fees, especially asset-based fees, paid to financial advisers will continue to be non-transparent and retail clients will not be able to make informed decisions about whether they want to continue paying for financial advice. Moreover, some retail clients are likely to be totally unaware they are paying ongoing fees, while receiving little or no services for those fees. These disengaged clients are particularly vulnerable to erosion of their assets through payment of fees in this manner. Without the disclosure statement and renewal notice requirements, advisers will also have insufficient incentives to create new remuneration models which link fees to services provided and represent value for money for clients.

33. In short, the consumer representatives believe that the disclosure statement and renewal notice requirements are essential to prevent asset based fees acting exactly like commissions (that is providing hidden, passive income for advisers and eroding consumers' hard-earned savings). The disclosure statement and renewal notice requirements will ensure that retail clients do not pay excess fees, have trust and confidence in the financial advice industry and, consequently, use financial advisers. Furthermore, these requirements will further foster the continuing development of a truly professional financial advice industry.

Argument that the requirements are unnecessary

34. The consumer representatives strongly reject the argument made in a number of submissions on the Exposure Draft of the Bill[20] that the disclosure statement and renewal notice requirements are unnecessary because, together, the best interests duty and the ban on commission payments are sufficient to address the problems created by the current remuneration models.

35. First, general conduct duties, like the proposed best interests duty for providers of financial advice, are not an effective way to change widespread existing business practices. They are not frequently the subject of compliance action. Regulators and private litigants find vague and uncertain duties, such as the best interests duty, time-consuming and expensive to enforce. The evidence required to prove breach is uncertain and much more complex than, for example, proving failure to include certain information in a disclosure document. Hence, duties such as the best interests duty are seldom the subject of high-visibility enforcement actions and, therefore, their impact on industry practice tends to be gradual. Moreover, it will be particularly difficult to establish that an adviser who has adopted a remuneration model that is common in the industry has breached the best interests duty, as currently drafted. This is because the best interests duty in the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011[21] indicates that the focus of the best interests duty is the advice provided and the steps the adviser takes when developing the advice, not the remuneration charged for that advice. Further, the proposed duty makes numerous references to 'reasonable' conduct, suggesting that what is in the best interests of the client is to be judged by reference to the conduct of a reasonable adviser acting in accordance with standard industry practice.

36. Secondly, as currently drafted[22] the proposed ban on conflicted remuneration will still allow advisers to have non-transparent remuneration models and charge fees that are unrelated to the service provided. In particular, advisers will be able to take ongoing asset based fees out of unleveraged client funds under their control. Given the current disparity between the amount that consumers are willing to pay for advice and the cost of providing advice services (referred to in paragraph 25 above), advisers have strong incentives to recreate the key features of current commission remuneration models (ie passive income, unrelated to the services provided and hidden from the consumer) by, for example, moving to ongoing asset based fees. The consumer representatives are particularly concerned to prevent asset based fees and poor disclosure and consent requirements having the exactly the same impact on consumers' savings as commissions. If this were to happen the FoFA reforms will not achieve their objectives.

[20] See, for example, submissions of the Association of financial Advisers Limited, the AMP Group and the Financial Services Council (available at http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=consultation/corporations_amend/default.htm).

[21] See s961B, item 23, schedule 1.

[22] See Division 3, Part 7.7A, item 23 Corporations Amendment (Further Future of Financial Advice Measures) Bill..

Argument that the requirements will create disproportionate compliance costs

37. The consumer representatives also strongly reject any argument that the disclosure statement and renewal notice requirements will impose disproportionate compliance costs on advisers. The issuing of a fee disclosure statement will, in effect, be equivalent to the rendering of an annual account, as frequently done by other professionals or service providers. It is extraordinary that, currently, the financial advice industry regularly charges ongoing fees but does not render an annual statement of account. The cost of issuing such a statement should not be considered an unreasonable cost of business. Research conducted by Rice Warner Actuaries shows that the compliance costs of issuing an annual statement are no more than $11 per client per annum.[23] Even if one were to accept the industry's inflated and unreliable[24] estimates of $50 to $150 a client, consumers will be significantly better off given the impact that ongoing hidden fees have on client savings.

38. The consumer representatives accept that, for those advisers who are currently charging ongoing fees that do not represent value for money, the proposed requirements are likely to mean that their new clients will not be as profitable as their old clients. However, this loss is not a disproportionate compliance cost. It flows from the positive effect of the requirements, which is to empower retail clients to make informed choices about whether they want to receive financial advice and to ensure disengaged clients are not unknowingly paying fees.

Proposals to further restrict the requirements

39. Since the introduction of the Bill into Parliament, there have been further proposals to limit the disclosure statement and renewal notice requirements. The consumer representatives wish to express their strongest opposition to these proposals.

Limiting the disclosure statement to new clients

40. There have been proposals to limit the disclosure statement requirement to new clients.[25] The consumer representatives already object to the existing limitation of the renewal notice requirement to new clients; this limitation creates two classes of retail clients, one which has the benefit of the renewal notice and one which is denied this benefit: see the discussion in paragraphs 50 and 51 below. The proposal to also limit the disclosure statement requirement to new clients would further exacerbate this problem.

41. The annual disclosure statement is an important reform. As stated above in paragraphs 22 and 31 above, it provides clients who are paying ongoing fees with information they do not

[23] Letter to The Hon MP Bill Shorten from Rice Warner Actuaries, dated 15 September 2011 and available at http://www.ricewarner.com/images/newsroom/1316044106_The%20Cost%20of%20Opt-in_Government%20Submission.pdf. As noted in that letter the Rice Warner estimate of the compliance costs is likely to be more accurate that the estimate published by Money Management which is based on a survey of financial advisers who were asked to estimate the cost of the renewal notice.

[24] As noted in the letter from Rice Warner to the Minister the estimate of the compliance published by Money Management which is based on a survey of financial advisers who were asked to estimate the cost of the renewal notice is likely to be unreliable.

[25] Clients can be described as 'new clients if they satisfy the conditions in s962D(1), item 10, Schedule 1 of the Bill.

receive from the FSG or the SOA. This information enables clients to make an informed decision about whether they want to continue to pay ongoing fees. This additional information will benefit retail clients, regardless of whether they receive the renewal notice or not; the renewal notice and the disclosure statement should not be linked, as they perform complementary, but separate, functions. In fact, access to the fee disclosure statement may be even more important for that class of clients who, under the Bill, do not receive the renewal notice, because the information in the fee disclosure statement may enable such clients to overcome any disengagement and take appropriate positive action to ensure they do not pay fees for little or no service.

42. It is important to realise that the group of clients who would not receive the disclosure statement if it were limited to new clients is significant in size. ASIC Report 251 states that the 20 largest licensees that provide financial product advice to retail clients had, in the period covered by the ASIC research, 4.6 million clients. These clients, plus existing clients of smaller licensees,[26] will not have access to the renewal notice and, if the fee disclosure statement requirement is limited to new clients, they will not get the benefit of the annual fee disclosure statement. Without the fee disclosure statement, there is a significant likelihood that a reasonable proportion of this group will pay ongoing advice fees for little or no advice service. Interestingly, ASIC Report 251 shows that, of the 4.6 million existing clients of the top 20 licensees, almost 1.5 million were identified as active. The remaining approximately 3.1 million clients of these top 20 licensees may have ongoing fee arrangements and may be paying for no service. If the disclosure statement requirements are restricted to new clients, these clients will receive neither a renewal notice nor a fee disclosure statement setting out the fees their adviser receives. Without access to the fee disclosure statement they will not be able to make informed decisions about whether they want to continue to pay such ongoing fees. In fact, they may be totally uninformed that they are currently paying ongoing fees.

43. The consumer representatives also note that there can be no objection to and, in fact, there are many precedents for, the imposition of new disclosure obligations in relation to existing clients.

Limiting the disclosure statement and renewal notice by reference to amount of funds under advice

44. There have also been proposals to limit the disclosure statement and renewal notice requirements to clients who have above a minimum threshold of funds under advice. The consumer representatives would strongly object to such a proposal. Clients with low amounts of funds under advice who are paying ongoing fees deserve the protection of the fee disclosure statement and the renewal notice. In fact, this group of clients are even more in need of the protection offered by these reforms because, the smaller the amount of funds under advice, the greater the impact of the erosion of the value of the funds under advice through non-transparent fees deducted from these funds under advice.

[26] This analysis assumes these clients stay with their existing licensee. If they change they will become 'new clients' and will receive renewal notices.

45. Additionally, proposals such as this, which require advisers to segment their client base, adopt different compliance practices in relation to different segments, and monitor when an individual client moves from one segment to another, are likely to increase advisers' compliance costs.

Extending the renewal notice periods

46. In general the consumer representatives are of the view that renewal notices should be given to clients annually. The consumer representatives believe clients should have the right to decide on an annual basis whether they want advice and how much they will pay for it. However, the consumer representatives recognise that the extension of the renewal notice period to two years is a concession to industry, already made by Government.

47. However, given the importance of renewal notices in helping to protect retail clients, all consumer representatives would strongly object to the renewal notice period being extended beyond two years. For example, extending the period to three years would significantly dilute the effectiveness of this reform and perpetuate the passive income problem this key reform is aimed at addressing. The only reason to extend the renewal notice period to three years would be to shore up advisers' incomes at the expense of consumers' savings (which, in the case of compulsory superannuation savings, represent foregone wages). For these reasons, it would be unacceptable and unfair to consumers to extend the renewal notice period any further.

Necessary amendments to the Bill

48. The following paragraphs set out amendments which the consumer representatives believe should be made to the disclosure statement and renewal notice requirements and the anti-avoidance provision to ensure that the Bill fully achieves its objectives.

49. The consumer representatives fully support the enhancements to ASIC's licensing and banning powers and have no comments on the drafting of the relevant provisions in the Bill.

Limitation to 'new clients'

50. Under the Bill the requirement to provide renewal notices only applies to new clients. 'New client' is narrowly defined in new s962D(1)[27] as a client who:

- has never been provided with personal advice as a retail client by the relevant licensee or representative before the commencing day (ie the day on which the reforms commence); **and**
- enters into an ongoing fee arrangement with the relevant licensee or representative on or after the commencing day.

51. As stated above in paragraphs 30 – 33, the renewal notice requirement is crucial for the protection of retail clients. It ensures that disengaged clients do not pay fees for little or no service. Given the capacity of fees to erode savings, the renewal notice requirement has the potential to significantly enhance the wealth of those who have the benefit of it. However,

[27] Unless otherwise indicated, all section references are references to the new sections in item 10, Schedule 1 of the Bill.

under the Bill a significant number of retail clients will not have the benefit of this important requirement because they will not meet the restrictive definition of new client. There will be two classes of clients:

- those who do not have the benefit of the requirement because they received some personal advice from the licensee or representative prior to the commencing day and are still with the same licensee or representative (or its assignee); and
- those who do have the benefit of the requirements because they receive personal advice for the first time on or after the commencing day or are wise enough to terminate any existing arrangement and go to a new adviser on or after the commencing day. (Interestingly, even if a client wants to stay with their existing licensee or representative they will have to change to a new licensee or representative if they want to be in this class. Consumer organisations may have to inform clients that they will need to change advisers if they want a legal right to receive a renewal notice after the commencing day.)

As the data in Report 251, referred to in paragraph 42 above, indicates the first class of clients is likely to be significant in size. Further a reasonable proportion of these clients are likely to be disengaged and receiving no ongoing services.

What amendments should be made?

52. The consumer representatives consider that, because of the importance of the renewal notice requirement for retail client protection, it should apply to all retail clients.

53. However, if this approach is not adopted, the Bill should be amended to:

- apply the renewal notice requirements to all clients who enter into a new ongoing fee arrangement on or after the commencing day. That is, proposed s962D(1)(a) should be deleted. This would at least reduce the class of retail clients who will not have the benefit of the renewal notice provision. The consumer representatives note that there can be no objection to the application of new statutory requirements to new contractual arrangements. Further, this amendment would avoid the absurd situation that a retail client will have to move to a new adviser if they wish to have the benefit of these important reforms; and
- apply the renewal notice requirement to all clients who have a new licensee or representative after the commencing day because their ongoing fee arrangements are assigned to a new licensee or representative. That is, a new paragraph should be added to proposed s962D so that it is clear that the requirements in Division 3, Subdivision B apply where the rights of the licensee or representative under the ongoing fee arrangement are assigned to another person on or after the commencing day. Again, this change would further reduce the class of clients who are denied the benefits of the renewal notice requirements.

Disclosure of commissions

54. The fee disclosure statement will not disclose commissions (or other forms of remuneration not paid by the client) that the adviser has received or will receive because of the advice given to the client: s962H.

55. Even after the proposed ban on conflicted remuneration is implemented, commissions (and other non-client forms of remuneration) will still feature in the remuneration of advisers for many years both because the proposed ban will only apply to new clients and because commissions will still be payable on most risk insurance products.[28] These forms of remuneration will still potentially distort advice and should be disclosed to retail clients so that they are fully informed and empowered to take action to protect their own interests. The Government has indicated that disclosure of remuneration, commissions and product fees should be unbundled so that retail clients can see the impact of commissions. It will be efficient for industry if this unbundled disclosure occurs in the fee disclosure statement.

What amendments should be made?

56. Section 962H should be amended to require disclosure of:

- commissions and other remuneration the fee recipient (its representatives, licensee or other related parties) received in the previous 12 months because of the advice provided to the client; and
- commissions and other remuneration the fee recipient anticipates the fee recipient (its representatives, licensee or other related parties) will receive in the next 12 months because of the advice provided to the client,

as well as the fee paid by the client in the previous 12 months and the fee the fee recipient anticipates the client will pay in the next 12 months.

Restrictions on right to a refund

57. If a client makes a payment of an ongoing fee after a breach of the fee disclosure statement or renewal notice requirements by the fee recipient, the fee recipient is not obliged to refund the payment: s962F(3). Instead the client (or ASIC) has the right to apply to the court for a refund where a fee recipient has knowingly or recklessly continued to charge a client ongoing fees after an arrangement has terminated as a result of breaching the disclosure statement or renewal notice requirements. The court can make an order that the fee recipient refund the money where it is reasonable in the circumstances to do so: s1317GA in item 13, Schedule 1 of the Bill.

58. According to the Explanatory Memorandum for the Bill the Bill provides that the fee recipient is not obliged to refund the payment because:

> '[a] statutory right of a client to a full refund of any ongoing fee ... would ... potentially result in a disproportionate and unjust result at the expense of the fee recipient. For example, such a statutory right would mean that one single accidental breach by a fee recipient could result in the forced refund of advice fees over a number of years, regardless whether the client continued to engage and access the services of the fee recipient.'[29]

[28] See s963B(1)(a) and (b), item 23, schedule 1, Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011.

[29] Paras 1.27 and 1.37.

59. The consumer representatives accept that the potential problem created by an unqualified right to a refund is real. However, requiring retail clients to apply to court and prove knowing or reckless breach before the client is entitled to a refund is a totally inappropriate and disproportionate solution to this problem. A central plank of Chapter 7 of the Corporations Act is that it is unreasonable to expect retail clients to enforce their rights through the court system and, hence, all Australian financial services licensees who deal with retail clients are required to be members of an external dispute resolution scheme, such as the Financial Ombudsman Service and the Credit Ombudsman Service.[30]

60. The onus and cost of fixing this problem should fall on the fee recipient, who has failed to comply with the law and who is likely to have more resources and capability to fix the problem than the retail client. Moreover, retail clients should have a clear right to a refund which, if the fee recipient refuses to honour, can be easily enforced by the affected client through the relevant external dispute resolution scheme.

What amendments should be made?

61. Section 962F(3) should be amended to provide that 'Any ongoing fee that the client has paid to a fee recipient after failure to comply with s962G or s962K in relation to the ongoing fee arrangement (whether by that or another fee recipient) must be refunded by that fee recipient to the client if the client requests the fee recipient to do so.'

62. However, the fee recipient should have a right to apply to the court for an order that it is not required to refund the ongoing fee if the court is satisfied that the breach of s962G or s962K was due to inadvertence and in all the circumstances the fee recipient ought not be required to refund the ongoing fee. In determining whether the court should grant such an order it should take into account whether the client has received reasonable services in return for the ongoing fees paid. The legislation should also provide that ASIC should be notified of such an application by the fee recipient so that, if appropriate, ASIC can intervene to protect the interests of clients.

Flaws in the anti-avoidance provision

63. The consumer representatives believe that the anti-avoidance provision in the Bill is a crucial component of the FoFA reforms. There is evidence that fringe sectors of the financial advice industry will try to avoid the clear intent of the reforms through creative anti-avoidance schemes.

64. Unfortunately, as currently drafted the anti-avoidance provision in s965 has flaws which will inhibit its effectiveness.

[30] Section 912A(2) and ASIC Regulatory Guide 165 *Licensing: Internal and External Dispute Resolution* and ASIC Guide 139 *Approval and Oversight of External Dispute Resolution Schemes*. Note, that licensees will not need to be members of an external dispute resolution service if the Superannuation Complaints Tribunal can deal with all retail client complaints relating to their business. The importance of external dispute resolution for retail clients was stressed in the Wallis Report: see Commonwealth of Australia, *Financial System Inquiry Report* (1997), p 189

What amendments should be made?

65. Section 965(b) should be deleted. The effect of this provision is that a breach of s965 will only be committed when the avoidance scheme has achieved its purpose. This provision will make it difficult for ASIC to take appropriate action to prevent an avoidance scheme being carried out. (The second part of s965(b) (ie 'apart from this section, would achieve, that purpose') is, as the provision is currently drafted, otiose because the anti-avoidance provision has no effect on validity or effectiveness of an avoidance scheme. Even if the amendment in paragraph 66 below is made and s965 does affect the validity of an avoidance scheme, s965(b) should still be deleted because it assumes that a breach does not occur until that point in time when the purpose of the avoidance scheme has been or (subject to the effect of the anti-avoidance provision) would have been achieved.)

66. Proposed s965 should, subject to necessary protections for innocent third parties, render void schemes entered into for the purpose of avoiding the FoFA reforms. This amendment would prevent parties to such schemes enforcing them.

67. Given the novelty of this provision in financial services regulation, industry should be given clear guidance on what might constitute a breach of the anti-avoidance provision. At a minimum, ASIC should publish regulatory guidance on its approach to enforcement of the anti-avoidance provision and examples of conduct it considers will breach the anti-avoidance provision. This guidance is likely to have a significant impact on industry behaviour.

Organisations and representatives consulted

68. The following consumer organisations have been consulted in the development of this Joint Consumer Submission and endorse its contents:

- Australian Investors Association
- Australian Shareholders' Association
- CHOICE
- Consumer Action Law Centre
- COTA
- National Information Centre on Retirement Investments Inc

Information about each of these consumer organisations is set out in Table 1 at the end of this submission

69. The following individuals have contributed to the content of the submission:

- Stephen Duffield, Consumer representative FOS (Panel)
- Jenni Eason, Member ASIC's Consumer Advisory Panel, Australian Investors Association
- David Leermakers, Policy Officer, Consumer Action Law Centre
- Catriona Lowe, Chief Executive Officer, Consumer Action Law Centre
- Jenni Mack, Chair ASIC's Consumer Advisory Panel, Chair CHOICE

- Wendy Schilg, Member ASIC's Consumer Advisory Panel, Chief Executive Officer, National Information Centre on Retirement Investments Inc

Table 1: Consumer Organisations endorsing the Joint Consumer Submission

No	Consumer Organisation	Description
1	Australian Investors Association (**AIA**)	The AIA was formed by a small group of investors in 1991. It is an independent not-for profit organisation focused on delivering investor education so Australian individuals can become better long-term investors. The AIA offers a range of education services to its members including investment conferences, seminars, information email bulletins, discussion groups and website information covering a diverse range of topics (i.e. equities, derivatives, managed funds, property and self-managed superannuation funds. The AIA is also involved in policy work and campaigns through its engagement with the media, Government and other regulatory bodies. For more information about the AIA see: http://www.investors.asn.au
2	Australian Shareholders' Association	The Australian Shareholders' Association (ASA) was established as a not-for-profit organisation in 1960 to protect and advance the interests of investors. It is a membership-based organisation, funded by member subscriptions. The ASA continues to press for improvements in transparency and accountability in relation to company performance, executive remuneration, treatment of minority shareholders, risk management and dividend policy. The ASA liaises with other bodies such as regulators, lawmakers, industry groups and accounting bodies and represents member views on a number of accounting and financial industry bodies. The ASA holds regular members' meetings all across the country, and also conducts adult education workshops aimed at improving members' financial literacy. For more information about the ASA see: http://australianshareholders.com.au
3	CHOICE	CHOICE first began in 1959 when the first female member of the WA Parliament's upper house, Ruby Hutchison, and her husband ran informal meetings on ways for consumers to protect themselves. CHOICE is the public face of the Australian Consumers' Association (**ACA**). It is an independent, not-for profit organisation, with over 200,000 subscribers.

		CHOICE, as part of its core work: • provides independent consumer information, advocacy and advice to consumers on a diverse range of consumer goods and services; • conducts scientific product reviews; and • is an active advocacy group that is constantly agitating government and industry groups to ensure consumer rights are protected and running campaigns against unjust consumer policies and practices. For more information about CHOICE see: http://www.choice.com.au
4	Consumer Action Law Centre (**CALC**)	CALC is a campaign-focused consumer advocacy, litigation and policy organisation. It was formed in 2006 by the merger of the Consumer Law Centre Victoria and the Consumer Credit Legal Service and is jointly funded by Victoria Legal Aid and Consumer Affairs Victoria. It provides a range of services including: • as a community legal centre - free legal advice and representation to vulnerable and disadvantaged consumers across Victoria; • legal assistance and professional training to community workers who advocate on behalf of consumers; and • as a policy and research body – input to law reform agendas and Government bodies across a range of consumer issues, and also through the media, and community. For more information about CALC see: http://www.consumeraction.org.au
5	COTA Australia	COTA Australia was established in 1951 to protect and promote the well-being of Australian seniors. It is an independent consumer organization with both individual and senior organizational members Australia-wide. COTA Australia has particular regard for the vulnerable or disadvantaged and seeks to give a voice to senior Australians. COTA Australia 's main focus includes: • developing and formulating policy positions to assist Government and regulators; • promoting active ageing and a positive image of ageing; • representing the interests of all older people; • provide assistance to seniors who seek re-employment; and • collecting, interpreting and providing information to individuals. For more information about COTA Australia see: http://www.cota.org.au
6	National Information Centre	NICRI is a free, independent, confidential service which aims to improve the level and quality of investment information provided to

	on Retirement Investments Inc (**NICRI**)	people with modest savings who are investing for retirement or facing redundancy. NICRI gives general information on investing and how to complain, information about the financial planning industry (e.g. how to find an adviser, their fee structures, etc) and provides a telephone information service for consumers wishing to know about investment products, how to improve their financial situation and where else to go to get assistance. NICRI also has a role in government policy making with respect to investment issues. For more information about NICRI see: http://www.nicri.org.au