Burrell Stockbroking and Superannuation

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

Submission

27 January 2012

Introduction

Burrell Stockbroking and Superannuation is a medium sized private firm offering full service stockbroking, superannuation and wealth management advice to both wholesale and retail 'mum and dad' clients. Burrell Stockbroking and Superannuation is a participant of the Australian Securities Exchange (**ASX**) and the National Stock Exchange of Australia (**NSX**).

We are pleased to provide this submission to the Senate Standing Committees on Economics, on the *Corporations Amendment (Future of Financial Advice) Bill* **(First Bill)** and *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* **(Second Bill)**.

In this Submission the focus will be on: From the First Bill:

1. The Opt-in obligation (for Ongoing Fees);
2. Staggered disclosure dates and the detail required by new disclosure provisions.

From the Second Bill:

1. The best interests obligations.
2. Ban on charging asset-based fees on borrowed funds; and
3. Ban on conflicted remuneration.

1. Executive summary

Burrell Stockbroking and Superannuation supports the introduction of the 'statutory best interest obligations' provided the catch all provision s961B(2)(g) is removed. It is our opinion that the best interest obligations will assist in improving the quality of advice throughout the industry as long as the scope is limited. For example, if advisors meet their obligation, clients should not be placed in double or triple gearing arrangements the like of which contributed to the Storm Financial collapse.

Our firm supports the introduction into statute of a client's right to opt-out of ongoing fees at any time. Opt-out encourages a competitive market and is already established as market practice. However, we believe that there should be a one month notice period to deal with administrative processes before termination.

Burrell Stockbroking and Superannuation does not support the other aspects of the Future of Financial Advice (**FOFA**) reform. Opt-in, disclosure, Ban on charging asset-based fees on borrowed funds, and the ban on conflicted remuneration will severely damage the financial services industry and will not achieve FOFA's aims.

2. The Opt-in obligation (for Ongoing Fees)

The purposes of the new opt-in provisions in s962N are explained in the Explanatory Memorandum to the First Bill as protecting 'disengaged clients from paying ongoing financial advice fees where they are receiving little or no service.' [1] Further, the Explanatory Memorandum explains that 'for those clients that are not disengaged, the renewal requirement will provide them with an opportunity to consider whether the service they are receiving equates to value for money.'[2] The focus of the First Bill should be on whether fees are reasonable, not the ongoing nature of the fees. In most instances ongoing fees in relation to advisory services provide clients with value for money. By discriminating against ongoing fees the opt-in provisions will not have the desired effect of ensuring clients obtain the best outcome. Opt-in will disengage clients and discourage business models that are value for money. It is Burrell Stockbroking and Superannuation's opinion that opt-in should be removed. The opt-out provision in the First Bill provides more than adequate protection for clients who feel they are not receiving value for money.[3] The opt-out provision achieves FOFA's aims without interrupting established contracts every two years, a burden that no other industry faces.

2.1. <u>Charging ongoing fees is the leading business model</u>

The stockbroking sector of the financial services industry generally operates on one of two business models. The first model is high turnover commission only. The alternative model is based on lower turnover coupled with an advice fee based on the percentage of total holdings. Burrell Stockbroking and Superannuation operates predominantly by the second model as it provides clients with valued

[1] *Corporations Amendment (Future of Financial Advice) Bill 2011* Explanatory Memorandum cl 1.5.
[2] Ibid.
[3] *Corporations Amendment (Future of Financial Advice) Bill 2011*s 962E.

advice at a low rate. Our Firm offers clients the choice of whether to pay an upfront fee for wealth management advice, or alternatively pay an ongoing retainer. Almost every client has chosen a retainer. For investment advice, clients have a choice of higher brokerage and no asset fee or lower brokerage and a modest asset fee. The second model is preferred as it generates less buy/sell recommendations and is more professional. The First Bill threatens to undermine this business model. It is our belief that charging by way of recurring income is one of the leading business models for the financial services industry when it comes to giving advice. Clients are skeptical of having to pay a time based fee for financial services. Time based fees lead to distrust as clients believe the fees are open-ended. Simply put, stockbroking clients do not want nor do they trust time based fees. Conversely, charging a retainer where the client is not locked in encourages valued advice and does not lead to lower service levels once the upfront costs are paid. As a client incurs no significant upfront cost under a retainer, if they are not satisfied with initial advice provided they can terminate the relationship at far less cost than fee-for-service. As such, the opt-in policy should be removed as it discriminates against one of the leading business models of the industry.

2.2. Opt-out is a better policy

We agree with concerns raised by many others in the industry that clients will inadvertently fail to opt-in, which would leave them exposed to adverse market conditions. Burrell Stockbroking and Superannuation and the industry in general already allow clients the ability to opt-out at any stage or by complying with a short notice period (our Firm currently requires one month's written notice). The Bill should include the option of a notice period before termination to assist in administration.

The opt-out provision in the First Bill provides clients with safeguards while allowing the financial industry to focus on clients and not complying with overly burdensome regulatory conditions. The opt-out provision in conjunction with the best interest obligation achieves FOFA's aim of ensuring clients are engaged and receive value for money without damaging the industry. We, like many in the industry, believe that opt-in should be removed.

2.3. At a minimum, the scope of opt-in should be restricted

If opt-in is to continue we believe that the scope of the concept should be limited. The definition of 'ongoing fee arrangement' in s962A is too broad. The current definition includes all 'financial services'. It is our opinion that the definition should be restricted to ongoing fees from third party providers that are incurred as a result of application under a Product Disclosure Statement. This restriction would engage clients with respect to on-going fees where no ongoing advice is provided. However, advisory services, such as traditional stockbroking and wealth management under the retainer model could continue in the most cost effective manner.

2.4. Cost of opt-in

In *Media Release 127* dated 29 August 2011 the Hon Bill Shorten MP stated that 'Rice Warner have estimated the cost of opt-in to be around $11 per client. This includes set-up costs and the cost of chasing up clients who are charged on-going fees but who advisers may not be in regular contact with.' It is our opinion that this cost has been grossly underestimated. If the legislature believe that all opt-in will require is sending a notice to clients they are mistaken. Opt-in will require meeting with the client to renegotiate contracts and costs. We calculate the time of such a meeting, including

preparation, to be more than two hours. As such, the cost of opt-in per client will be around $650 per client. Further, even in the unlikely event that a meeting is not conducted the cost of compliance with opt-in alone would be between $100 and $200. The cost of opt-in is likely to push many independent financial advisers out of the industry. This will lead to less independent advice which is counterintuitive to FOFA's aims.

2.5. Where a client is silent on opt-in

The legislation is not clear on the duties owed by advisers where a client is silent on opt-in. Clients are notorious for not returning paperwork. It is our and the industry's opinion that many clients would inadvertently fail to opt-in, and many would become disengaged and lose trust in their adviser through the opt-in process. As such, if opt-in is implemented the legislation should be more robust on the fact that no liability attaches, and there are no continuing duties, such as to warn about adverse market conditions, once the date for renewal passes. Further, the fact that opt-in will lead to clients being exposed to adverse market conditions emphasises the need for its removal.

2.6. Automatic termination of established contracts

Regardless of the agreed term, opt-in automatically terminates a contract where one party unilaterally does not agree to continue the contract after two years. If the legislature were to apply the opt-in provision to general commercial contracts there would be outrage. The cost and uncertainty of renegotiating contracts every two years would destablise the Australian economy. The financial services industry faces the same outcome if opt-in is retained. FOFA assumes that there is a power imbalance between the financial adviser and the client. Burrell Stockbroking and Superannuation's clients are highly engaged and intelligent. A large power imbalance does not exist. Clients understand the contractual obligations they enter into and this should be respected. Further, we query if opt-in is constitutionally valid considering trade and commerce is meant to be free. Opt-in is bad law and should be removed.

3. Staggered disclosure dates and the detail required by new disclosure provisions

3.1. Scope of the disclosure provisions

The disclosure provisions proposed by FOFA are retrospective. As a result the disclosure requirements can potentially apply to any product that a client holds, no matter how old the product. The administrative cost to establish the fees for all products held by a client will be overly burdensome. If the disclosure provisions are retained in any form they should only apply to new clients.

3.2. Staggered disclosure dates

It is our opinion that s962J is unclear as to whether providers can set a particular date each year for disclosure to occur. The Stockbroking and Wealth Management industries do not operated like fund providers or the insurance industry. Many participants in our industry do not have automated processes that can track when a client entered into an agreement. Tracking the date a client entered

into an agreement has little benefit for our industry. Further, we can not comprehend any reason why having the ability to set a standardised date would not achieve the same outcomes.

3.3. Avoid duplication with current disclosure requirements

As a market participant Burrell Stockbroking and Superannuation already complies with a high standard of fee disclosure. Our Firm conducts, at minimum, yearly reviews with wealth management and most other classes of clients. Fees are disclosed to all new clients via the Firm's Financial Services Guide. Further, for managed discretionary accounts we are required to comply with disclosure requirements in the *Corporations Act* and under the ASIC market integrity rules. The standard date for compliance is 30 June each year. The First Bill should reflect this standard date and ensure that there is no duplication of disclosure between the various legislative instruments.

3.4. Level of detail required by disclosure

Burrell Stockbroking and Superannuation has no concerns about disclosing fees to clients, the concern is the detail that FOFA will require. The law already requires financial services providers to comply with rigorous fee disclosure. Many of these fees are continuously available to clients. For example, clients who subscribe to our portfolio service can view their portfolio and year to date fees live each day. Going beyond the established disclosure requirements is overly burdensome. In our opinion, the level of detail proposed by FOFA as to services provided and to be provided is unjustified. Our firm operates a retainer model for wealth management clients. Clients pay 0.4% for the first $500,000 of their portfolio for all wealth management and superannuation advice. One of the reasons we can provide this service at such a low cost is that detailed records of services by client are not kept and are not desired by clients.

Our firm and the industry in general do not have the systems in place to comply with the disclosure requirements. We agree with the general sentiment across the industry that the 'data does not exist' in order to be able to comply with the standard of disclosure expected.[4] The cost of installing and implementing the systems to provide the required disclosure information will be taxing on our business and increase the cost of advice and services provided. Further, a major issue is that the information required to calculate client fees to the proposed FOFA standards would be contained across various platforms, which will not always be under our control. It is our opinion that the current disclosure requirements be reviewed to ensure annual disclosure of the dollar value of all fees, but not the level of detail in FOFA. The proposed FOFA requirements will be a burden on our business and the industry. Ultimately, this will increase the cost and decrease access to financial services.

4. The Best Interests Obligation

Burrell Stockbroking and Superannuation support the majority of the changes to the best interest obligation from the draft Bill to the current version. We do not however support the introduction of the catch all provision (s961B(2)(g)). This section goes far beyond the general equitable fiduciary duty to act in the best interests of the client. Further, the section creates a high degree of

[4] Mike Taylor, 'FOFA: Living life by ava-tranche' 25(43) *Money Management* 12.

uncertainty regarding what is necessary to comply with the obligation. This uncertainty also means that there is no finality from claims. For these reasons s961B(2)(g) should be removed.

Apart from the catch all provision the changes to the best interest obligation have addressed concerns in the industry about scalability of advice and advisors having to go outside their specific practice areas to meet the obligation. We believe the obligation addresses the Storm Financial scenario by ensuring clients are not placed into financial products that are not suited to their interests. As such, provided s 961B(2)(g) is removed the best interest obligation should be retained.

5. Ban on charging asset-based fees on borrowed funds

5.1. Achieving the objective of stopping over-gearing

In order to manage risk, clients who use borrowed funds for investment purposes need a higher level of advice than clients who invest their own funds. We advise clients who borrow funds for investment to operate a low risk strategy, such as investing only in blue chip stocks. Removing the ability to charge asset-based fees on borrowed funds will diminish the level of advice provided to clients who borrow. It is essential that clients who borrow continue to access professional advice to manage their risk. The legislature should reconsider the ban on charging asset-based fees on borrowed funds.

Placing a ban on asset-based fees on borrowed funds is not the way to stop over gearing, the like of which lead to the Storm Financial collapse. With the introduction of the best interest obligation a ban of this sort is not needed. To comply with the obligation an adviser will correctly and diligently obtained a client's information and objectives, then give appropriate advice ensuring a client is not over geared. For example, our Firm cautions margin loan clients to keep the LVR under 40%. We specifically advise *against* double gearing. Further, being able to charge on the total value of the portfolio reflects the value of the advice given. Accordingly, the ban on asset based fees on borrowed funds should be removed. It is our opinion that the 'best interest duty' would be sufficient to ensure gearing is controlled.

The ban is uncertain in its application as some clients borrow on their home loan and simply forward the funds for investment. If fees are to be banned, it should only be upfront and trail fees on the loan itself from banks or financial institutions.

6. Ban on receiving third party fees

6.1. Ban on conflicted remuneration

Burrell Stockbroking and Superannuation does not support the ban on conflicted remuneration. The current law concerning conflicts of interests is well established. Conflicted relationships are a major problem in the financial services industry. It is the relationship that is conflicted, not the remuneration. As a first step the relationship should be determined. If found to be conflicted then issues of disclosure should be raised. A blanket ban on this new concept of conflicted remuneration

will severely impact on the financial services industry. The ban will lead to costs being passed onto the client. Many advisors will be forced out of the industry as their businesses will no longer be viable. This will lead to a reduction in the amount of valued advice available to clients, especially retail clients. One of FOFA's main aims is to provide affordable advice to consumers, the ban on conflicted remuneration will achieve the opposite.

Service fee exemption

The removal of the service fee exemption from the Second Bill (s964(2)(a) in the draft bill) will increase costs for clients. Many financial service providers are remunerated for compliance and administration costs from product issuers. For example, our firm is paid by product issuers for the cost incurred in complying with client identification obligations under the *Anti-Money Laundering and Counter-Terrorism Financing* legislation. If service fees are included in the ban the cost will past directly onto clients. This cost will be charged at a much higher rate by product issuers than what financial service providers currently receive. Further, the exemption should not be limited to one-off fees. The compliance and administration costs are on-going; the service fee exemption should reflect this. If the ban on conflicted remuneration is to continue in any form, service fees should be exempt regardless of whether they are on-going.

7. Conclusion

In their current form the Future of Financial Advice Bills will not achieve the aims of the reform. The introduction of the statutory best interest obligation is a positive for the industry. However, the catch all provision in s 961B(2)(g) needs to be removed. The recognition of a clients right to opt-out of ongoing fees at anytime is another positive. However, the opt-out provision (s962E) should have a notice period of one month to assist in administration. All other aspects of the reforms should be discarded, especially the discriminatory disclosure of on-going fee details (but not fees as such), opt-in, ban on assets based fees for borrowed funds, and the ban on commissions as they will cause severe detriment to the financial services industry.