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HOUSE OF REPRESENTATIVES

CORPORATIONS AMENDMENT (FURTHER FUTURE OF FINANCIAL ADVICE
MEASURES) BILL 2011

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon
Bill Shorten MP.)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
ADI	Authorised deposit-taking institutions
ASIC	Australian Securities and Investments Commission
Bill	Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011
Corporations Act	<i>Corporations Act 2001</i>
FOFA	Future of Financial Advice
Licence	Australian Financial Services Licence
Licensee	Holder of an Australian Financial Services License
PJC Inquiry	<i>Inquiry into Financial Products and Services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services (2009)</i>

General outline and financial impact

Outline

On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced the Future of Financial Advice (FOFA) reforms.

The FOFA reforms represent the Government's response to the 2009 *Inquiry into Financial Products and Services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services* (PJC Inquiry), which considered a variety of issues associated with corporate collapses, including Storm Financial and Opes Prime.

The Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (the Bill), supplements the Corporations Amendment (Future of Financial Advice) Bill 2011 to implement the FOFA reforms. The reforms focus on the framework for the provision of financial advice. The underlying objective of the reforms is to improve the quality of financial advice while building trust and confidence in the financial planning industry through enhanced standards which align the interests of the adviser with the client and reduce conflicts of interest. The reforms also focus on facilitating access to financial advice, through the provision of simple or limited advice. To this end, the Bill sets up a framework with the following features:

- a ban on conflicted remuneration (including product commissions), where licensees or their representatives provide financial product advice to retail clients;
- a ban on volume-based shelf-space fees from asset managers or product issuers to platform operators; and
- a ban on asset-based fees on geared funds.

The reforms also include a statutory best interests duty, a requirement for ongoing advice fees in excess of two years to be actively renewed by retail clients, and enhancements of ASIC's powers to deal with unscrupulous operators. These are contained in the Corporations Amendment (Future of Financial Advice) Bill 2011

Date of effect: The reforms commence on 1 July 2012.

Proposal announced: On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced the Future of Financial Advice (FOFA) reforms. On 28 April 2011, further detail on the operation of the FOFA reforms was announced by the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon Bill Shorten MP.

Chapter 1

Conflicted remuneration and other banned remuneration

Outline of chapter

1.1 Schedule 1 to the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (the Bill) amends the *Corporations Act 2001* (Corporations Act) to ban the receipt of certain remuneration by licensees which has the potential to conflict the advice they provide to retail clients in respect of certain financial product advice. [*Schedule 1, item 11, divisions 4 - 6*]

Context of amendments

1.2 Australian Financial Services Licensees that provide financial advice to retail clients are traditionally remunerated differently from other occupations. For example, many advisers have traditionally received commissions from product providers for placing clients with particular products, often paid as a percentage of funds under management. Some commissions are ongoing in nature, forming what are known as ‘trail’ commissions.

1.3 Product commissions may encourage advisers to sell products rather than give unbiased advice that is focused on serving the interests of the clients. Financial advisers have potentially competing objectives of maximising revenue from product sales and providing professional advice that serves the client’s interests.

1.4 There is some evidence that these conflicts affect the quality of advice. The 2006 Shadow Shopping exercise of the Australian Securities and Investments Commission (ASIC) found that advice that was clearly or probably non-compliant was around six times more common where the adviser had an actual conflict of interest over remuneration. The conflict may lead to advice that is not compliant and not in the client’s interests.

1.5 In its 2009 report the PJC inquiry noted that the ineffectiveness of current disclosure of conflicts and conduct rules that allow an adviser to favour their own interests over the interests of clients is more likely to lead to sub-optimal investment strategies or excessive fee arrangements than catastrophic outcomes for investors.

1.6 In its report, the PJC noted it received considerable evidence suggesting that the most effective way to improve the quality of financial advice for consumers is to remove conflicts altogether by banning commissions and other conflicted remuneration practices. In responding to the PJC report, the Government decided that product commissions should be banned, the guiding principle being that the interests of advisers and clients should be more closely aligned.

Summary of new law

1.7 The Bill amends the Corporations Act to define ‘conflicted remuneration’, and establishes that licensees and their representatives must not receive conflicted remuneration. The Bill establishes the ban on the receipt by licensees and their representatives of remuneration which might influence the financial product advice given to retail clients.

1.8 The ban on conflicted remuneration includes a ban on both monetary and non-monetary (soft-dollar) benefits. In relation to monetary benefits, there are areas that the ban on conflicted remuneration does not apply to:

- General insurance;
- Life insurance which is not bundled with a superannuation product;
- Individual life policies which are not connected with a default superannuation fund; and
- Execution-only (non-advice) services.

1.9 In relation to non-monetary benefits, there are also areas that the ban on conflicted remuneration does not apply to:

- General insurance;
- Benefits under the amount prescribed in regulation (proposed to be \$300), so long as those benefits are not identical or similar and provided on a frequent or regular basis;
- The benefit is for the purposes of genuine professional development or administrative IT services and meets the criteria prescribed in the regulations; and
- Execution-only (non-advice) services.

1.10 The Bill bans product commissions to financial advisers and their dealer groups, as well as volume rebates from platform operators to dealer groups. It also bans volume-based shelf-space fees from funds managers to platform operators, and the charging of asset-based fees to retail clients on geared funds.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Licencees must not accept remuneration which has the potential to influence the financial product advice or recommendations provided to retail clients (with the exception of certain insurance or execution-only services).	There is no existing statutory prohibition on advisers from receiving conflicted remuneration. Relevant information about advisers' remuneration (including commissions) is required to be disclosed, including in the initial Statement of Advice provided to the retail client.
Licencees must not accept soft-dollar benefits over \$300 that have the potential to influence the financial product advice or recommendations provided to retail clients (with the exception of certain insurance, execution-only, certain education or training purposes, and certain information technology benefits).	There is no existing statutory prohibition on advisers from receiving soft-dollar benefits. There are disclosure obligations. Various industry codes also self-regulate in this area to some extent.
Employers of financial services licencees (or their representatives) must not pay the licencee or its representatives conflicted remuneration.	There is no existing statutory prohibition on employers paying conflicted remuneration to licencees or their representatives. Employers can currently pay incentives to advisers to sell a certain type or a certain volume of products.
Product issuers must not provide monetary or non-monetary benefits to licencees or their representatives, regardless of whether it might influence the financial product advice provided to retail clients (with the exception of certain insurance, execution-only, certain education or training purposes, and certain information technology benefits).	There is no existing statutory prohibition on product issuers from paying monetary or non-monetary benefits to licencees or their representatives. Various industry codes purport to self-regulate in this area to some extent.
Volume rebates paid from platform	There is no existing statutory

operators to licensees will be banned.	prohibition platform-licensee rebates.
Licensees and platform operators must not accept volume-based fees the purpose of securing 'shelf-space' on an adviser's or platform's product list.	There is no existing statutory prohibition on the receipt of volume-based shelf-space fees.
Advisers must not charge asset-based fees (fees dependent upon the amount of funds held or invested) to a retail client to the extent that their funds are 'borrowed' or 'geared'.	There is no existing statutory prohibition on the charging of percentage-based fees to retail clients.

Detailed explanation of new law

Conflicted remuneration

1.11 The Bill broadly defines the term 'conflicted remuneration' and proceeds to outline those persons who should not accept or pay conflicted remuneration. *[Schedule 1, item 11, sections 963, 963D, 963F, 963G, 963H]*

1.12 Conflicted remuneration means any monetary or non-monetary benefit given to a licensee or representative that might influence or distort advice, by either influencing the choice of financial product being recommended or by otherwise influencing the financial product advice more generally. *[Schedule 1, item 11, subsection 963(1)]*

1.13 The concept of conflicted remuneration covers a broad range of monetary and non-monetary benefits, covering both traditional product commissions, volume payments from platform operators to financial advice dealer groups, and 'soft-dollar' (non-monetary) benefits.

1.14 Subsection 963(2) provides examples of benefits which are conflicted remuneration. It includes examples of benefits relating to volume of financial products recommended or funds invested. The list of incentives based on volume includes benefits which are dependent on:

- the value of financial products recommended;
- the number of financial products recommended; or
- the value of investments by clients to whom the licensee or representative provides financial product advice.

1.15 While this is more than an illustrative list, it is not intended to be exhaustive. To the extent that other benefits, by their nature or circumstances in which they are given, might influence financial product

advice given by the licensee or representative, those benefits will be considered ‘conflicted remuneration’ and subject to the obligations under this division. While the examples provided all relate to volume, a benefit need not be volume-based in order to be conflicted remuneration. For example, any flat payment received by a licensee for product distribution would on its face be conflicted remuneration. *[Schedule 1, item 11, section 963]*

1.16 A licensee and their authorised representatives must not accept conflicted remuneration. *[Schedule 1, item 11, sections 963D and 963F]*

1.17 The obligation on an authorised representative not to accept conflicted remuneration under section 963F(1) does not apply in the situation where the authorised representative received the benefit after reasonably relying on information from their licensee that the benefit was not conflicted remuneration. For example, in the situation where a licensee dealer group collected product commissions on the authorised representative’s behalf, and the licensee advised an authorised representative that a particular forthcoming payments was in relation to ‘grandfathered’ or wholesale commissions and the payment later turned out to be illicit, the authorised representative will not be liable so long as its reliance on that advice was reasonable. *[Schedule 1, item 11, subsection 963F(2)]*

1.18 A licensee must take reasonable steps to ensure that its representatives do not accept conflicted remuneration. *[Schedule 1, item 11, section 963E]*

Carve-outs from conflicted remuneration

1.19 Section 963A sets out monetary benefits given in certain circumstances which are not treated as conflicted remuneration. The list contains benefits that would otherwise be caught within the meaning of conflicted remuneration. *[Schedule 1, item 11, section 963A]*

1.20 A benefit given to the licensee or representative by a general insurer in relation to a general insurance product is not conflicted remuneration. This ensures that the Bill does not prohibit the payment of monetary commissions in the general insurance industry. *[Schedule 1, item 11, subparagraph 963A(1)(a)]*

1.21 In the case of a benefit from a life insurance company to a licensee or representative, the benefit will not be conflicted remuneration if it is given in relation to a life risk insurance product other than a group life policy for the benefit of members of a superannuation entity, or a life policy for a member of a default superannuation fund. This ensures that commissions on group risk inside superannuation are prohibited, and

commissions are also prohibited on any life insurance policies which are for the benefit of members of a default superannuation fund.

Commissions will still be permissible on individual life risk (non-investment-linked) policies within superannuation for non-default ('choice') funds. Commissions will still be permissible on life risk (non-investment-linked) policies sold outside superannuation. [*Schedule 1, item 11, subparagraph 963A(1)(b)*]

1.22 Subparagraph 963A(1)(c) establishes that monetary commissions or incentive payments in relation to execution-only sales or issues of financial products (that is, where the product is sold with no advice provided to a retail client) are not conflicted remuneration. Where there is advice, but that advice is provided to someone in their capacity as a wholesale client only, a monetary commission is not conflicted remuneration. [*Schedule 1, item 11, subparagraph 963A(1)(c)*]

1.23 Where the monetary benefit is given by the client in relation to the issue or sale of a product or in relation to financial product advice provided to the client, this is not conflicted remuneration. This ensures that 'fee for service' arrangements – where the client is the person paying the adviser – are not conflicted remuneration (even where the client pays a volume-based fee). [*Schedule 1, item 11, subparagraph 963A(1)(d)*]

1.24 Subparagraph 963A(1)(e) creates a regulation-making power to exclude prescribed benefits or prescribed circumstances in which a benefit is given from the definition of conflicted remuneration. [*Schedule 1, item 11, subparagraph 963A(1)(e)*]

1.25 It is proposed to exclude certain stockbroking activities from being considered conflicted remuneration, by allowing persons undertaking these stockbroking activities to receive third party 'commission' payments from companies where those payments relate to capital raising. The precise breadth of the carve-out would be subject to further consultation, but it is proposed that the receipt of 'stamping fees' from companies for raising capital on those companies' behalf not be considered 'conflicted remuneration' where the broker is advising on and/or selling certain capital-raising products to the extent that they are (or will be) traded on a financial market. It is proposed that the carve-out would apply to any person authorised to undertake the relevant stockbroking activities pursuant to the capital raising carve-out, including both direct and indirect market participants.

1.26 The regulations will also ensure that the traditional remuneration arrangements of employee brokers (often paid as a percentage of brokerage) are not unduly impacted by the conflicted remuneration measures.

Treatment of benefits from employers to employees

1.27 A monetary or non-monetary benefit given to a licensee or representative by their employer is not necessarily conflicted remuneration. If the payment of the benefit is remuneration for work carried out (for example, an employee's salary), then this will not be conflicted remuneration so long as it is not the kind mentioned in subsection 963(2). While this allows the payment of salaries to employee advisers, it means that no proportion of that employee's salary should comprise of the types of volume incentives as outlined in subsection 963(2). *[Schedule 1, item 11, subparagraph 963C(a)]*

Example 1.1

A salaried financial planner receives a base salary of \$80,000 for providing financial product advice to retail clients, with the possibility of a discretionary bonus of up to 20 percent if certain key performance indicators are achieved. If a component of that bonus is dependent on the adviser recommending or selling a particular number of financial products, that component of the bonus would be considered to be conflicted remuneration, and subject to the prohibitions under section 963H.

1.28 The Bill provides a carve-out from the ban on conflicted remuneration for arrangements where employees of an ADI advise on and sell basic banking products. This entitles an employee to receive sales incentives from their ADI employer even where it is volume based. However, if the employee provides financial product advice on financial products other than basic banking products, either in combination with or in addition to advice provided on basic banking products, the receipt of a benefit will be considered conflicted remuneration. This will encourage customer service specialists, who wish to continue receiving volume or sales bonuses, to focus on providing advice on basic banking products only. *[Schedule 1, item 11, subparagraph 963C(b)]*

Example 1.2

A teller employed by an ADI provides advice on and recommends particular banking products to the ADI's customers. The employee is eligible for a performance bonus in addition to their base salary, if certain key performance indicators are achieved. If a component of the bonus is dependent on the teller recommending or selling a particular number of financial products other than basic banking products, this component would be considered to be conflicted remuneration, and subject to prohibitions under section 963H. The teller cannot receive a sales bonus for recommending a basic banking product (such as a savings account) to a customer if advice on that basic banking product

also included advice on a non-basic banking product (such as an investment product).

1.29 A salaried planner or bank teller can advise retail clients on non-basic banking products, provided they possess the requisite authorisation and competency. However, to the extent they provide financial product advice on these products, they cannot be remunerated on the basis of volume or sales targets in relation to those products.

1.30 The employer is under an obligation not to pay a licensee or representative conflicted remuneration, rather than the employee being under an obligation not to receive conflicted remuneration from their employer. This is appropriate, because in the majority of cases it is the employer, rather than the employee, that sets the terms and conditions of an employment contract, as well as being in control of remuneration payments. *[Schedule 1, item 11, sections 963G and 963H]*

1.31 However, a representative (other than an authorised representative) such as an employee is under an obligation not to receive conflicted remuneration unless it is in circumstances in which an employer is liable under section 963H. This means that while an employee will not be under an obligation not to receive conflicted remuneration from their employer, they will be under an obligation not to receive conflicted remuneration from a third party. *[Schedule 1, item 11, section 963G]*

Treatment of non-monetary (soft-dollar) benefits

1.32 The Bill prohibits the payment of ‘soft-dollar benefits’ to licensees. It does this by banning the receipt of non-monetary benefits by licensees from any entity where this might conflict financial product advice. *[Schedule 1, item 11, section 963]* Product issuers are also prohibited from giving non-monetary benefits to licensees or their representatives, even where the payment of such benefits do not directly conflict advice. *[Schedule 1, item 11, section 964]*

1.33 There are a number of soft-dollar benefits which, if received by the licensee or representative, are not regarded as conflicted remuneration. These include:

- Benefits given by a general insurer in relation to a general insurance product;
- Benefits under the amount prescribed (proposed to be \$300), so long as those benefits are not identical or similar and provided on a frequent or regular basis;

- The benefit has a genuine education or training purpose, is relevant to the provision of financial advice to retail clients (and complies with any other requirements detailed in the regulations) (exemption for professional development); and
- The benefit is the provision of IT software or support, related to the provision of financial product advice (and complies with any other requirements detailed in the regulations) (exemption for administrative IT services).

[Schedule 1, item 11, section 963B]

1.34 It is intended that other criteria will be specified in the regulations for the professional development exemption. While it is envisaged that there will be further consultation on the regulations, the current criteria to be set in regulations is below for which comments are sought. *[Schedule 1, item 11, section 963B]*

Professional development

- Domestic requirement – the professional development must be conducted in Australia or New Zealand.
- Majority time requirement – where 75 per cent of the time (during standard day of 8 hours or equivalent time) is spent on professional development. In a standard 8 hour day, this takes into account a one hour lunch break, as well as another hour that might be applied to other activities such as networking.
- Expenses – any travel costs, accommodation and entertainment outside of the professional development activity must be paid for by participants or its employer or licensee.

1.35 It is not generally intended that this ban covers a person who is remunerated for work undertaken at the professional development activity, for example, speaking at a conference or running seminars. It is a question of whether any benefit received in these circumstances from any entity might conflict financial product advice, and in which case it would be captured by the ban.

1.36 Further regulations are also proposed (under the general obligations of a licensee in existing paragraph 912A(1)(j) or existing disclosure obligations of the Corporations Act) to set disclosure and record keeping requirements.

1.37 For exempt non-monetary benefits for professional development and administrative IT services, the approach is:

- any benefit should continue to be disclosed in disclosure documents, in circumstances where they are currently required to be disclosed; and
- recipients should record receipt of these benefits.

1.38 For exempt infrequent or irregular benefits under \$300:

- no disclosure is required in disclosure documents; but
- recipients must record receipt of these benefits.

1.39 The regulations will also require that on request, the records under paragraphs 1.37 and 1.38 above must be made available to the person who made the request.

1.40 The ban on non-monetary benefits is also not generally intended to cover the services provided by a licensee to its authorised representatives for the purposes of the authorised representative providing financial services on behalf of the licensee. These services would only be captured by the ban if the services were provided in such circumstances where it might conflict financial product advice.

Benefits from product issuers

1.41 A product issuer must not give monetary or non-monetary benefits to a licensee or representative. Unlike sections such as 963D and 963F, section 964 prohibits the giving of any benefit to a licensee by a product issuer, whether or not it is conflicted remuneration. [*Schedule 1, item 11, section 964*]

1.42 Without section 964, a product issuer could make a large payment in kind to a licensee which is not based on volume and for which it might be hard to establish that the payment might conflict financial product advice. A comprehensive prohibition on payments in kind from product issuers to licensees ensures that ASIC can easily identify payments which have the potential to distort financial product advice, or undermine the professionalism and independence of the advice industry.

1.43 The ban on a product issuer or seller of a financial product from giving benefits to a licensee does not apply in certain circumstances, including where:

- Benefits are given by a general insurer in relation to a general insurance product;
- Soft-dollar benefits under the amount prescribed (proposed to be \$300), so long as those benefits are not identical or similar and provided on a frequent or regular basis;
- The benefit has a genuine education or training purpose, is relevant to the provision of financial advice to retail clients (and complies with any other requirements detailed in the regulations) (see paragraph 1.34); and
- The benefit is the provision of IT software or support, related to the provision of financial product advice (and complies with any other requirements detailed in the regulations).

1.44 In the case of a benefit from a life insurance company to a licensee or representative, the benefit will not be conflicted remuneration if it is given in relation to a life risk insurance product other than a group life policy for the benefit of members of a superannuation entity, or a life policy for a member of a default superannuation fund. This mirrors the exclusion outlined in the definition of conflicted remuneration.

Volume-based shelf-space fees

1.45 The Bill establishes a ban on the receipt by platform operators of volume-based benefits to the extent that such incentives are merely a means of product issuers or funds managers ‘purchasing’ shelf space or preferential positions on administration platforms. However, the Bill does not purport to ban fund managers lowering their fees to platform operators (in the form of scale-based discounts or rebates) where such discounts or rebates represent reasonable value for scale. [*Schedule 1, item 11, sections 964A, 964B, 964C and 964D*]

1.46 A benefit is a volume-based shelf-space fee if access to the benefit is dependent on the number or value of a funds manager’s financial products about which information is included on the facility, and where the benefit exceeds the reasonable value of scale efficiencies obtained by the funds manager because of the volume of funds under management. It is because the scale discount or rebate exceeds reasonable value that it can be considered a benefit intended to gain a placement on a platform or preferential treatment on a platform (for example, a position on a ‘model portfolio’ or ‘menu selection’). [*Schedule 1, item 11, section 964B*]

1.47 Where a platform operator bargains down the asset-management fee with a funds manager due to the volume of funds the platform operator holds, and this asset-management fee discount is reflected in the form of a rebate to a platform operator, it is not considered a shelf-space fee so long as the scale rebate or discount does not exceed reasonable value of scale efficiencies.

1.48 Section 964A sets out the situations in which Subdivision B applies. *[Schedule 1, item 11, section 964A]*

Ban on asset-based fees on geared funds

1.49 The Bill defines an ‘asset-based fee’ as a fee that is dependent upon the amount of funds used or to be used to acquire financial products by or on behalf of a client. Licensees or their authorised representatives cannot charge asset-based fees on geared funds to retail clients. *[Schedule 1, item 11, sections 964F and 964G]* ‘Geared funds’ is defined as borrowed funds. ‘Borrowed’ means borrowed in any form, whether secured or unsecured, including the raising of funds through a credit or margin lending facility. *[Schedule 1, item 11, sections 964H and 964J]*

1.50 If it is not reasonably apparent that funds used to acquire financial products by or on behalf of the client are geared, then subsections 964F(1) and 964G(1) do not apply. This provides some protection to advisers who have no reason to believe the funds being used are geared (in the situation, for example, where the client deliberately conceals the fact that the funds are borrowed). *[Schedule 1, item 11, subsections 964F(2) and 964G(2)]*

1.51 Subsections 964F(4) and 964G(4) and section 964K clarify that the licensee or authorised representative cannot use subsections 964F(2) or 964G(2) to absolve them of their duty under section 961C to make reasonable inquiries to obtain complete and accurate information. This ensures that the adviser cannot deliberately or knowingly disregard relevant information or not make reasonable inquiries, merely so that they can charge an asset-based fee on the client’s geared funds. *[Schedule 1, item 11, subsections 964F(4) and 964G(4), section 964K]*

1.52 To the extent that a retail client’s funds are not geared, the licensee and or their authorised representatives can charge an asset-based fee on that ‘ungeared’ component.

1.53 This ban applies where a licensee or their representative provides financial product advice to a person as a retail client. *[Schedule 1, item 11, section 963E]*

Anti-avoidance

1.54 A person must not, either alone or together with one or more other persons enter into a scheme if it would be concluded that the person entered into the scheme for the sole or dominant purpose of avoiding the application of any provision in the Bill, provided the scheme has or would achieve that purpose. *[Schedule 1, item 11, section 965]*

