19 March 2013

Bede Fraser
Manager
Retail Investor Division
The Treasury
PARKES ACT 2600

Submission by email

Dear Mr Fraser,

Future of Financial Advice – Regulations

The FSC thanks the Government and The Treasury for the opportunity to provide comments on the proposed amendments to the FoFA regulations which includes an additional conflicted remuneration exemption, amendments to the grandfathering provisions (s1528) and a contracts savings provision.

The Financial Services Council represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and Public Trustees. The Council has over 130 members who are responsible for investing more than $1.9 trillion on behalf of 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Principle

We remain of the view that grandfathering of existing clients must apply on a consistent basis for platform operators, product issuers, service providers (e.g. MDA services) across superannuation, managed investments, life insurance policies (e.g. investment linked life insurance policies) deposit products and other securities in relation to 'investment switches' and new investments into 'new investment options' (which may or may not be 'financial products'). The FSC welcomes the proposed regulations which aim to provide competitively neutral grandfathering provisions for all platforms. However, we note that the definitional limit of the platform provisions to a 1012IA platform only grandfathers some platforms and then creates differences in the treatment between the custodial and non-custodial platform.

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We are also concerned that the draft regulations do not currently prevent existing contracts from terminating and resulting in the loss of grandfathering for existing clients as well as new clients, and it is very important that draft regulation 7.7A.17 is amended to fix this issue before released in final form.

This paper aims to assist Treasury meet the government's intent without extending the grandfathering beyond those provided by the Minister in his second reading speech in Parliament on 24 November 2011. These matters are complex matters especially from a drafting perspective. The FSC is happy to assist and discussing the contents of this submission and any drafting concerns Treasury may have with you.

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FSC SUBMISSION

FoFA Regulations

March 2013

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TECHNICAL ISSUES WITH FOFA GRANDFATHERING REGULATION 7.7A.16 AND NEW REGULATIONS

1. BUYER OF LAST RESORT: 7.7A.12EA Application of ban on conflicted remuneration—purchase of financial advice business

We welcome the intended exemption from the conflicted remuneration provisions in respect of financial services registers. The draft regulation currently covers the purchase of registers by licensees from their representatives, under buyer of last resort arrangements. The normal practice when a licensee buys client register rights or the financial services business of a representative is for the licensee to then allocate those register rights to one or more other representatives so that the clients can continue to be serviced. The exemption would need to apply to the buying and the selling of registers, register rights and financial services businesses. The same would apply for licensee to licensee sales and sales to licensees where an owner of a business or register rights is not a representative of the purchasing licensee.

Another key point is the equal weighting of products on the register so that products issued by the purchaser or a related party of the purchaser are not given preferential valuations. We accept this limitation but point out that it is appropriate to compare "in house" products with externally issued products on a like for like basis. In other words, products of the same type and class should be given the same weightings, regardless of brand. Not all products are of the same value when making a decision to buy part or all of a register. This is so, regardless of the brand of the product. Therefore, the wording in relation to the weighting of products needs to be adjusted to read: " in which the weighting attributed to the financial products….. is the same as the weightings attributed to other financial products of the same type and class."

To simplify the regulation but ensure that there are appropriate exemptions to facilitate the functioning of the market for financial planning businesses, we recommend the exemption be worded to include:

- The purchase and sale of financial services registers (the registers are not limited to financial planning but any financial services)
- Reference to 'financial services business' which has recognition in the Corporations Act, rather than financial advice business, as the business of a representative includes advice and dealing
- The ability to differentiate products on inherent value-to-type but not according to brand/issuer. Comparison of products by brand of issuer should be for products of the same type and class.
- Licensee to licensee transactions
- Representative to licensee transactions
- Licensee to representative transactions.

- The transaction could be framed as a sale or surrender of rights in a client register, sale of business or sale of an entity that runs a financial services business.
- Partial or full sales should be accommodated as this is commonplace in the industry.

2. GRANDFATHERING BENEFITS TO BE PERMITTED TO FLOW THROUGH TO THE ADVISER/ REPRESENTATIVE

The proposed grandfathering regulation 7.7A.16A will have a large impact on payments other than those from platform or product providers to dealer groups/advisers. In the short time that we have had to review the draft provision, we have identified the following types of payments as being impacted by the proposed regulations:

- employee remuneration based on sales of financial products relating to new clients – Many such arrangements are currently grandfathered for existing employees for their current performance year but now these employees will need to be transitioned to new bonus and performance arrangements from 1 July 2013 part-way through their current year (see 3D for more discussion on this point);

- the sharing of platform (non-custodial platforms) and product issuer commission by dealer groups with advisers in relation to existing clients. This has a significant impact on thousands of existing practice agreements and planning practice valuations.

- impact the payments by licensees to advisers. This could take the form of an existing remuneration scheme payment, a flow through (non-rem) incentive payment which is grandfathered or an existing non-monetary benefit.

- There will no longer be any grandfathering in relation to conflicted remuneration for financial services such as broking services. For example, payments made for broking services (including significant payments under large institutional white-label arrangements) that are currently grandfathered and which do not fall under an exemption to conflicted remuneration will now need to immediately cease from 1 July 2013.

While the above are just some of the issues that have been identified arising from the proposed regulation, there will undoubtedly be further issues once we have had time to reflect further on the provision.

We submit that a transition period is required in order to be able to comply with these changes to the grandfathering arrangements. Changes will need to be made to employment remuneration systems and policies, distribution agreements, adviser fee payment systems, processes and policies, agreements between products issuers and advisers and brokers and other payment systems and processes in order to comply with these changes. These changes to systems and documentation are

substantial and adequate time is needed to be able to implement these changes. Given the complexity of the amendments required to comply with these provisions, the FSC welcomes the extension of grandfathering to 1 July 2014.

We submit that grandfathering should apply consistently both at the product issuer/dealer group level and at the dealer group/adviser level. Therefore, the regulations should be amended to ensure that payments grandfathered at the product provider level should remain grandfathered when shared with employees or advisers, noting:

- We can see no basis in policy to apply different grandfathering rules at different levels of the payment chain. To do so would impose a significant burden on dealer groups and their representatives.

- There is a considerable administrative advantage to being able to identify a payment at source as either prohibited or not prohibited, and on that basis, being able to pass it through. If payments are acceptable at one level but not at the next, then the next payer in the chain must add a further administrative filter which is unexpected and has not been captured within the scope of regulatory change programs.

Further, to the extent that benefits from platforms to licensees and non-platform (licensee to adviser) are applied inconsistently this will have significant impacts on a dealer group's ability to administer the grandfathered payments it can pass through to advisers compared with what it receives from a platform. Again this creates unnecessary complexity.

We believe that the intention of the Regulations should be to allow equal treatment of payments within the industry and at a minimum we would request that Treasury clarify this via including specific commentary into the Explanatory Statement to this effect.

Our understanding is that regulation 7.7.16A is proposed to captures payments from Licensees to Advisers and ensures that existing payments can continue to flow through from Platform and Product manufacturers to Licensees and Advisers. However, the provision does not provide for the payments to flow from non-platform providers and indeed regulation 7.7A.16 also does not provide for the grandfathered payments to flow to the adviser from a platform.

For both advice businesses and individual advisers, given the complex chain of "arrangements" that may be affected by an adviser move or sale, a much simpler solution would be for a regulation to specify that where conflicted remuneration is grandfathered as between platform operator/product issuer and advice licensee then to the extent that the remuneration is passed on to or forms:

- the basis of a payment from advice licensee to adviser practice, or
- from advice licensee to employee adviser or

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- from adviser practice to individual adviser then the subsequent payment is also grandfathered.

The ban on new clients at the adviser level (of value chain participants) will automatically draw a line in the sand on the payments that flow through to all other (value chain participant) levels.

An important consideration is the enormous challenge of the filtering task for:

- advice licensees in the payments they pass on, and
- thousands of small adviser businesses (and the licensees who supervise them)
- if these parties cannot base their processes to filters that occur at the adviser level.

For the avoidance of doubt Treasury may want to consider further clarifying the ability for equal treatment of payments from Product manufacturers, Platform Operators, Licensees and Advisers by the inclusion of a separate regulation as outlined below. We understand that some industry participants may find comfort with this clarity and certainty.

Recommendation

Proposed draft regulations to provide exemptions from the ban on conflicted remuneration

The drafting on the following page attempts to address the flow of remuneration to representatives with regards to grandfathering. However, we note that this issue is not limited to just grandfathering.

A typical payment flow to an individual authorised representative may involve the following sequence of separate payments: product issuer/platform operator to dealer group/licensee; dealer group/licensee to corporate authorised representative; corporate authorised representative to individual authorised representative. If a grandfathered (therefore permissible) payment is to be allowed to flow through to the individual authorised representative, then wording needs to be broad enough to cover all of these steps.

In terms of Non-monetary benefits, we submit the principle is that a benefit received under the grandfathering regulations can be passed on to a representative and from one representative to another if the benefit was pursuant to a pre FoFA arrangement.

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Drafting Recommendation

Regulation 7.7A. XX

(1) (a) This regulation is made for paragraph 963B(1)(e) of the Act; and
(b) prescribes the circumstances in which a monetary benefit is not conflicted remuneration if given by a financial services licensee or a representative of that licensee, to a representative of the licensee where the representative provides financial product advice to or deals in the financial product on behalf of retail clients.

Note: The definition of financial product advice is in subsection 766B(1) of the Act.

(2) A monetary benefit is not conflicted remuneration to the extent that the amount or value of the benefit is determined by reference to remuneration that is permissible by virtue of the application of Reg 7.7A.16 or 7.7A.16A or both.

Example: A benefit paid to a licensee that is exempt from the ban on conflicted remuneration by virtue of the grandfathering provisions (e.g. an existing commission arrangement), can continue to be the basis of a payment made by the licensee to a representative

3. SYSTEM NEUTRALITY

A. Not all Platforms are 1012IA custodial arrangement: Regulation 7.7A.16 and 7.7A.16A do not give structural neutrality to Platform providers.

The FSC notes that a regulation with regard to grandfathering for Platform providers is required because s1528(b) of the Corporations Act provides that benefits pursuant to an arrangement entered into prior to the application date are grandfathered for the purposes of Division 4 of Part 7.7A unless the benefit is paid by a platform operator.

Critically, we note that the proposed regulations aim to provide (grant) grandfathering to platforms in regulation 7.7A.16. However, 7.7A.16 defines a platform as a custodial arrangement. It is important to note that not all platforms are custodial arrangements despite being a platform. Likewise not all benefit payments payable by a platform fit within the custodial arrangement provision because the Platform provider may also be a Responsible Entity or Registered Superannuation Fund. Therefore some interpret that there is no grandfathering relief available in respect to benefits paid by a platform operator relating to financial products (ie as a responsible entity or Registered Superannuation Entity) it issues that do not constitute a custodial arrangement.

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The exclusion in reg7.7A.16A(2)(a) gives rise to this concern remembering that a platform operator in the market is not limited to a custodial arrangement platform operator as per 1012IA.

The FSC notes that the provisions need amending to provider all platform providers the same level playing field to ensure that Australia's superannuation and managed investments market remains competitive which ultimately benefits the millions of Australians invested in those funds via Platform providers.

Further, the FSC submits that grandfathering of existing clients must apply on a consistent basis across platforms providers and across product providers like superannuation/managed investment funds in relation to 'investment switches' and new investments into 'new investment options'.

In order for grandfathering to operate effectively, flexibly and with certainty for product providers, advisers and investors it must permit existing investors to 'switch' into existing investment option on the platform (that is the Fund/Scheme etc) irrespective of whether they were previously invested in that option or with that specific fund manager. Its important to note that in some structures (for example superannuation) the change in the investment option as a switch by the client is not the purchase of a new financial product and the client is not entering into a new arrangement with a fund manager (because the arrangement is between the fund manager and the trustee of the super fund – the client is still in the same arrangement/relationship with the Fund/product/platform but the legislation is now treating their monies differently. We remain concerned that the current drafting does not achieve a pragmatic consumer orientated solution (which is consistent with the Minister's intent).

We note that the government intends to grandfather platform arrangements (entered into prior to 1 July 2013) for all clients invested on the platform prior to 1 July 2014. However, not all platforms fall within the legal definition of a custodial arrangement under s1012IA. As such, some market participants will operate under regulation 7.7A.16 (those who do operate a custodial arrangement) and the remainder will have to operate under regulation 7.7A.16A. There are substantial legal differences between the two provisions such that at present there is no market neutrality. There is bias toward custodial arrangements.

The same arguments apply to insurance products such as insurance bonds.

To provide for competitive neutrality across platforms and non-platforms/multi-fund MIS, and for the grandfathering limits to apply equally to super and MIS, Treasury may wish to consider the following frameworks to illustrate how to solve for parity between custodial and non-custodial platforms without broadening the intent of the provision.

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Illustration 1:

7.7A.16A Application of ban on conflicted remuneration—person other than platform operator

(1) This regulation:

(a) is made for the purposes of subsection 1528(2) of the Act; and

(b) prescribes a circumstance in which Division 4 of Part 7.7A of Chapter 7 of the Act applies to a benefit.

(2) The circumstance is that the benefit:

(a) is not given by a platform operator[1]; and

(b) is given under an arrangement entered into before the application day, within the meaning of subsection 1528(4) of the Act; and

(c) is given in relation to the acquisition of a financial product by a retail client who immediately before 1 July 2014 did not have an interest in:-

(i) the financial product; or

(ii) another financial product [on the investment menu] of a multi-product offering

(3) "Multi product offering" is where one or more financial products are marketed and offered together with a facility, under the one offer document, which allows a retail client to choose between or acquire, switch or transfer an interest in any one or more of those financial products.

(4) ……

Illustration 2: using managed investment schemes to illustrate the concept

Addition of the following in reg 7.7A.16

Managed investment schemes

(4) For the purposes of sub-regulation (2)(c)(ii), if a retail client:

(a) had an interest in a managed investment scheme before 1 July 2014; and

(b) acquires:

(i) a further interest in the managed investment scheme on or after 1 July 2014; or

(ii) an interest in another managed investment scheme on or after 1 July 2014 which is marketed in conjunction with the first scheme; the acquisition of the further interest or the interest in the other scheme (as applicable) is taken not to be the acquisition of a financial product and, if paragraph (ii) applies, the interest in

[1] See paragraph two of section 3A.

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the other scheme is taken to be a financial product in which the retail client had an interest immediately before 1 July 2014.

Amendment of the following to reg 7.7A.16A

Managed investment schemes

(4)For the purposes of sub-regulation (2), if a person:

(a) had an interest in a managed investment scheme immediately before 1 July 2014; and

(b) acquires:

(i) a further interest in the managed investment scheme on or after 1 July 2014; or

(ii) an interest in another managed investment scheme on or after 1 July 2014 which is marketed in conjunction with the first scheme;

the acquisition of the further interest or the interest in the other scheme (as applicable) is taken not to be the acquisition of a financial product and, if paragraph (ii) applies, the interest in the other scheme is taken to be a financial product in which the person had an interest immediately before 1 July 2014.

We note that there are additional drafting amendments required to reg 7.7A.16A which is covered in the remained of section 3 of this paper.

Amendment to the Explanatory Statement:

The FSC also recommends that an inclusion be made to the Explanatory Statement potentially at the top of page 2 (after platform has bee defined as a custodial arrangement) which says that not all platforms are custodial arrangements and as such the intent is to provide platforms (custodial and non-custodial platforms) parity in terms of grandfathering arrangements entered into pre 1 July 2013 for clients accounts held on/via a platform as at 1 July 2014 in regulations 7.7A.16 and 7.7A.16A.

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B. 7.7A.16 Application of ban on conflicted remuneration—platform operator

We note regulation 7.7A.16 only grandfathers:

- “regulated acquisitions”; and
- where a person gave an instruction for a “regulated acquisition” before 1 July 2014.

This is a problem because not all investments by clients through a platform are “regulated acquisitions”.

For example:

- Group insurance arrangements through a super platform (because the insurance is acquired by the trustee not the retail client);

- A platform’s working cash account is effectively a part of the platform and is arguably not a regulated acquisition;

- Listed securities (e.g. shares) acquired by the client through the platform (where acquired by client directly i.e. on a non-custodial basis) (These are not acquired pursuant to a “regulated acquisition”). (The draft explanatory statement states that this regulation is intended to apply “regardless of whether these investments are made through a platform or directly by the client” and so this intention should be reflected in the drafting;

- Margin lending through the platform (these are also not acquired pursuant to a regulated acquisition as the margin loan is acquired directly by the client); and

- Certain cash accounts connected with the platform that are not ‘custodially” held.

This therefore treats custodial platforms unfavourably compared to non-custodial platforms and needs to be remedied. The FSC suggests that a simple solution to this issue is to add a new subsection listing those non-custodial investments held by a custodial platform in essence deeming these holdings as “regulated acquisition” in the following **Recommendation.** We note that the effect of the drafting addition is to bring reg 7.7A.16 into parity with reg 7.7A.16A.

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Recommendation

The FSC recommends the following amendments be included in reg7.7A.16 to provide neutrality to investors:

Non-custodial platform investments and group life insurance through super

(4) For the purposes of sub regulation (2), if:

(a) a retail client gives an instruction to the platform operator of the custodial arrangement for the platform operator to arrange for the retail client to acquire or hold an interest in, or rights and benefits in relation to, one or more of the following:

(i) a particular financial product or a financial product of a particular kind, or

(ii) an interest in a group life policy for members of a superannuation entity (as defined in s.963B(2)); and

(b) the acquisition is contemplated by the offer document for that custodial arrangement,

then the acquisition or the otherwise holding of an interest, or rights and benefits, is taken to be a regulated acquisition under that custodial arrangement.

Note: Examples of such non-custodial platform investments and insurance through super include:

(a) non-custodial share purchases through a platform; and

(b) acquisition of a margin loan through a platform;

(c) acquisition of a cash account; and

(d) acquisition of life insurance through super where that life insurance policy is a group life policy previously acquired by the super trustee and held for the benefit of members.

(5) For the purposes of sub regulation (2), cash held by the platform operator in the cash facility of a custodial arrangement in respect of a retail client is taken to have been a regulated acquisition under that custodial arrangement.

C. Sub-regulations 7.7A.16 (3) and 7.7A.16A (3) Continuity of arrangement

The FSC welcomes the addition of a continuity of arrangement provision to enable the orderly operation of the industry without inadvertent ceases to grandfathering.

The FSC supports that the proposed regulations provide certainty that a change in the parties to an arrangement does not result in a new arrangement in and of itself and therefore does not cease grandfathering.

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However, we submit that the examples in the notes are very restrictive and will not have the intent the government provides in the proposed regulation. We suggest that more fitting examples to give effect to the government's intent include the following which we recommend be included in the Explanatory Statement:

- Changes in trustees as a result of a Successor Fund Transfer;
- Changes in parties as a result of a Part 9 transfer (life companies);
- Changes in custodial arrangements.

And/or any party to arrangements such as the following:

- Agreement between product provider and dealer group;
- Agreement between dealer group and adviser;
- Agreement between client and adviser;
- Assignments, Novation or transfers of revenue streams (property rights).

In essence, the regulations should not operate so as to treat existing clients as new clients after the change in trustee/responsible entity/operator or novation of the relevant arrangements as a consequence of a restructure.

Recommendation

The FSC recommends the examples included in the notes to sub-reg 7.7A.16(3) and sub-reg 7.7A.16A(3) are too narrow and restrictive to give effect to the government's intent and should therefore be deleted.

We would recommend the following examples be included in the Explanatory Statement:

- Changes in trustees as a result of a Successor Fund Transfer;
- Changes in parties as a result of a Part 9 transfer (life companies);
- Changes in custodial arrangements.

And/or any party to arrangements such as the following:

- Agreement between product provider and dealer group;
- Agreement between dealer group and adviser;
- Agreement between client and adviser;
- Assignments, Novation or transfers of revenue streams (property rights).

The Note for the Explanatory Statement could read as follows:

- *Where an arrangement is grandfathered, the mere transfer or novation of that same arrangement does not affect grandfathering. This would apply to contractual and statutory transfers or novations. For example, any grandfathering applying to an arrangement would not be affected in the following circumstances: the mere transfer of a financial services business, the transfer of life insurance business under Part 9 of the Life Insurance Act 1995; transfers under the successor fund transfer provisions of the Superannuation (Industry Supervision) Act 1993; change of trustee of a trust, responsible entity of a scheme, platform operator and/or custodian.*

Importantly we also note that the intent of sub-reg 7.7A.16A(3) is to provide the same continuity of arrangement grandfathering to non-platform providers. However, because 7.7A.16A prescribes limitations of the Grandfathering provision to non-platform providers, the provision does not work. That is, it does not actually grant grandfather of continuity of arrangements for non-platform providers.

Recommendation

The FSC recommends that the subsection needs to be under a new subsection (or regulation) that makes it clear that it prescribes circumstances in which Division 4 of Part 7.7A does **not** apply (and so distinguish it from the current (1)(b) which says the opposite).

D. The employment contract issue: new employees/advisers come onto existing arrangements until 1/7/2014

The proposed sub-regulation 7.7A.16A(2) also provides for the grandfathering of employee incentive arrangements ("Arrangements") which existed before 1 July 2013 in circumstances where the benefit payable under the Arrangement is given in relation to the acquisition of a financial product by a person had an interest in the financial product immediately before 1 July 2014. Where the Arrangement is entered into at the Licensee level (and assuming the benefits payable under the Arrangement only relate to the acquisition of financial products prior to 1 July 2014), there is uncertainty as to whether the relief in sub-regulation 7.7A.16A(2) will apply to "new employees" who commence employment with the Licensee – including advisers after 1 July 2013 and participate under the Arrangement.

For the purposes of determining how grandfathering applies to employment contracts and adviser incentive schemes, it is difficult to identify what is considered the “arrangement”. For example, the “arrangement” may consist of one or more of the following:

(i) the employment contract;
(ii) the enterprise agreement;
(iii) the terms of the incentive scheme;
(iv) the bonus scheme; or
(v) the annual performance review period.

As a result, there is a lack of clarity regarding whether new employees /advisers can participate in any grandfathered arrangements. For example, it is not clear if new employees /advisers who commence under an arrangement (e.g. commence employment or join a licensee) post 1 July 2013 can fall under an existing employment / adviser remuneration scheme that was in place prior to 1 July 2013 (noting that anti-avoidance provisions have been in place since 1 July 2012).

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If new employees / advisers who come on board between 1 July 2013 and 30 June 2014 cannot participate in existing arrangements, but are able to write business that contributes to volume based payments that can continue under the regulations until 1 July 2014, this creates significant complexity and also means that the regulations do not give employers or licensees enough time to develop new schemes for new employees / advisers. As a result, licensees and employers will most likely need to run two schemes during that 12 month period and will have less than 3 months to develop a new scheme for new employees / advisers. It also creates inequity amongst those new and existing employees and advisers during that 12 month period. It also requires employers/licensee to implement appropriate frameworks for dealing with different remuneration schemes. The alternative may be to move existing employees /advisers to new arrangements part way through their performance year. This is an undesirable outcome as it has the potential to raise employee relations issues for employers/licensees.

It is our understanding that Treasury intended for the proposed grandfathering regulation to apply to "new employees" participating in employment incentive arrangements which existed before 1 July 2013 as grandfathered arrangements until 1 July 2014.

As a result we believe the simplest way of dealing with this is to insert a new regulation which provides that employee remuneration arrangements will not have to change for new or transferring employees until the existing employees move provided that occurs on or before 1 July 2014. For the avoidance of doubt, we request that Treasury include a note in the draft regulation after sub-regulation 7.7A.16A(2) to clarify this matter.

Recommendation

The FSC recommends a new regulation which clarifies that both new employees/advisers, and any existing employees who transfer into new roles on or after 1 July 2013, can remain under the grandfathered pre 1 July 2013 arrangement. However the arrangement will not be grandfathered after 1 July 2014 for these or any employees.

E. Sub-regulation.7.7A.16A(5) Super contributions grandfathering provision for non-platforms

Sub-regulation (5) provides that super tops ups (contributions) can be made to an existing client's (pre 1 July 2014) account and remain grandfathered. However, whilst we appreciate the provision's inclusion to avoid any doubt of the government's intent we believe the provision is not required because the issue of subsequent superannuation contributions is addressed in section 761E of the Corporations Act.

Section 761E(3) provides that a superannuation product is issued when a person becomes a member of the relevant superannuation fund. Section 761E(1)(a) provides that a person acquires a product

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when it is issued. Section 761E(3A) goes on to provide that a further contribution made by a client or their employer is not take to be the issue of a financial product. Consequently, further superannuation contributions do not give rise to a financial product acquisition. Draft regulation 7.7A.16A(2)(c) will not therefore mean that grandfathering does not apply to such further superannuation contributions. It would however be useful for the Explanatory Statement to explain this.

Recommendation

The FSC recommends that the existing proposed sub-regulation 7.7A.16A(5) can be deleted as S761E of the Corporations Act and sub-reg 7.7A.16A(2)(c) provides the grandfathering required.

However, the FSC suggests that an addition be made to the Explanatory Memorandum (referencing sub-reg 7.7a.16A(2)(c)) to explain that super contributions (including rollovers) from a member or their employer can be made to a pre existing 1 July 2014 account and be grandfathered.

Replacing the super top up provision with the ability to move from super to pension within the same fund.

Whilst sub-regulation (5) may not be necessary because of s761E, we note that there is a need to provide clarity of treatment (grandfathering) when a client is transitioned from a super to a pension account (within the same scheme/fund) and back (some people transition to a pension and then go back to work seeing them roll back to super).

Regulation 7.7A.16 facilitates the transition from super to pension for custodial platforms as both the super and pension account would be held via the platform and so grandfathered commission could remain payable for a pre 1 July 2014 super member that transitions to pension after 1 July 2014.

However, the same grandfathering treatment is not afforded non custodial platforms (multi-fund offerings) by regulation 7.7A.16A as this regulation requires the client to have held the interest in the product (i.e the pension fund) before 1 July 2014.

Under Corporations Regulation 7.1.04E a super member is deemed to have been issued a new separate financial product when they move from accumulation phase to receive a pension or when they are moved to a new sub-plan (i.e. usually means a move from one accumulation product in a fund to a different accumulation product in the same fund). This over-rides the general rule that a person is issued with a super interest when they join the fund (regardless of how many products they take out within the fund).

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Accordingly, this may mean that transition of a super member from accumulation to pension phase may lead to loss of grandfathering for non-custodial platforms, only for custodial platforms which is not system neutral.

For the avoidance of doubt and to ensure market neutrality is preserved so as not to bias one structure over another (which are identical in intent just operate under different legal means), we recommend that a sub-regulation like that following may solve this gap.

The timing questions could be phrased as at 30 June 2013 or prior to 1 July 2013 – we reiterate our concerns with the word "immediately" see section 6 of this submission.

Recommendation

The FSC recommends the addition of the following to the regulations pertaining to the non-custodial platform arrangements under regulation 7.7A.16A:

Superannuation Schemes

(5) For the purposes of sub-regulation (2), if a member of a superannuation fund

(a) had an interest in the growth phase of that superannuation fund prior to 1 July 2014; and

(b) elects to receive a pension from that superannuation fund in relation to that or part of that interest after 1 July 2014;

then, for the purposes of this regulation, the person is taken not to have been issued with a new financial product.

F. New switching provision to be added to regulation 7.7A.16A

This section expands on one of the parity concern raised in section 3A of this submission – regarding switching.

Under a multi-fund investment product, under which many managed investment schemes or other financial products are marketed and governed under the same rules and offered in one offer document switching investments (from one financial product to another within the scheme, operates in the same way as for investment platforms/custodial arrangements. Indeed, irrespective of the operation of section 1012IA the financial advice market (including researchers) considers multi-fund products to be administrative 'platforms'.

Further, conflicted remuneration arrangements have traditionally been designed to operate in the same way across both platform and non-platform. For system neutrality purposes, it is essential that switching within a multi-fund product (or other investment fund product) is permitted to the same extent under these grandfathering regulations as for platform products under 7.7A.16.

For the absence of any doubt and to ensure system neutrality, its imperative that:

- non-custodial platforms (which fall under regulation 7.7A.16A) also permit switching within the constraints of the "scheme" as provided to the consumer in the offer document. We would also recommend that the last sentence of paragraph six on page 3 of the Explanatory Statement be amended; and

- that the Explanatory Statement reflect that clients invested (holding an interest/benefit) as at 30 June 2014 on a non-custodial platforms may be able to switch to any investment option available on their fund/scheme eg from a Balance fund to Investment Manager X's Australian equities fund and grandfathering be preserved. As such, the use of the word "generic" should be deleted as there may be no such offering available to the client. That is all investment options will carry some label informing the client of the manager the monies may be invested with and in what asset class.

Recommendation

The FSC Recommends that, to avoid doubt, a client invested in a non-custodial platform prior to 1 July 2014, can switch investment options without ceasing grandfathering.

Further, we recommend that:

- the word "generic" in paragraph 2 on page 3 of the Explanatory Statement be deleted and

- the last sentence of paragraph 6 on page 3 of the Explanatory Statement be amended to read "However, switching within a non-custodial platform (like a multi-fund offering) will not cease grandfathering (as outlined above)".

G. Grandfathering dates

We note that the government's intention is to grandfather client's monies (accounts) as at 30 June 2014 pursuant to arrangements in place prior to 30 June 2013.

However, there are discrepancies between the provisions as follows:

- s7.7A.16(2)(c) grandfathers client's accounts as at 30 June 2014 by referencing that a person had given regulation acquisition instruction under the custodial arrangement before 1 July 2014.

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- S7.7A.16A(4) and (5) applies the Conflicted Remuneration provisions of Division 4 of Part 7.7A after the 'application date' – that is this provision will only grandfathers those retail client who had an interest (an account) before 30 June 2013.

There is no policy rationale for a difference in the application of the grandfathering provisions between custodial arrangements and other product providers. On this basis we recommend s7.7A.16(4) be amended to refer to 1 July 2014 (noting we recommend s7.7A.16A(5) be deleted above unless a new switching provision is added at s7.7A.16A(5) in which case that provision also needs to reference 1 July 2014).

Recommendation

The FSC recommends the existing proposed regulation 7.7A.16A(4) be amended to read as follows:

Managed investment schemes

(4) For the purposes of sub regulation (2), if a retail client:

(a) had an interest in a managed investment scheme before the application day; and

(b) acquires a further interest in the managed investment scheme ~~on or after the application day;~~ before 1 July 2014;

the acquisition of the further interest is taken not to be the acquisition of a financial product.

H. "Rollovers" of term deposits (on the platform) will trigger a loss of grandfathering

A rollover[2] of a term deposit will constitute the replacement of one financial product with another. As drafted, the regulations will result in the loss of grandfathering despite the fact the client's account is still active and the client is still 'invested" in the Fund/platform. A specific exemption is required to ensure grandfathering is not lost in this situation.

Recommendation

The FSC recommends that a new provision be included in the regulations to provide that "rollovers" or "reinvestment" into Term Deposits (on maturity) held via a custodial, non-custodial or other fund structure is not an acquisition of a new financial product provided the client is still invested in the same "fund".

[2] Retail investors may invest in bank Term deposits via their custodial and non-custodial platforms. When the Term Deposit matures, a retail client may be reinvested into a new Term Deposit – this is called a rollover.

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5. STATUTORY SAFEGUARD: 7.7A.17 Application of Division 4 of Part 7.7A of Chapter 7 of the Act—effect on terms and conditions of arrangement

Many existing distribution arrangements will apply both to payments in respect of existing clients (which will be grandfathered and can continue to be paid) as well as to payments which would have otherwise been paid in respect of new clients (which will be prohibited from the application day). In order to ensure that the prohibition on conflicted payments does not void the entire distribution arrangement, the FSC submits that the grandfathering regulations need to include a saving provision to the effect that the prohibition does not affect payments in respect of existing clients under pre-application day arrangements.

There is a presumption at common law that parties do not intend a contract to continue if there is a material alteration to the rights or obligations of a party. The draft regulations will likely materially reduce the consideration paid by one party and as the consideration is typically expressed by reference to the totality of funds under administration, that consideration would likely be ineffective and fail. This would represent a material alteration to the rights and obligations of the parties, giving rise to the common law presumption that the parties do not intend the contract to continue.
Section 1101H of the Corporations Act does not address this common law presumption.

Section 1101H addresses enforceability of obligations where a Chapter 7 requirement is not met, by providing that a failure to comply with such a requirement does not affect the validity or enforceability of a contract. Payment of remuneration under a grandfathered arrangement is not a failure to comply with a Chapter 7 requirement, nor is cessation of payment of prohibited conflicted remuneration. Both actions are in compliance with Chapter 7 and therefore s1101H does not apply.

As such, the FSC submits that the grandfathering regulations should include a saving provision such that *To the extent that a provision of this part would have the effect of otherwise rendering invalid:*

- *the payment or receipt of benefits other than conflicted remuneration under an arrangement; or*
- *an arrangement in its entirety which provides for the payment or receipt of benefits other than conflicted remuneration,*

the provision of this part will not have the above effect but such payments or receipts of benefits or arrangements in their entirety will be valid in accordance with the terms of the arrangement.

In addition, we suggest that where an arrangement would have become unenforceable at common law, the saving provision should provide that either party has the right, by written notice to the other party, to nominate that the common law position will apply (and the saving provision will not). This is to ensure that where a party considers the arrangement should cease as a result of the material change to the arrangement, this can still occur.

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We note that an appropriately drafted severance clause in the distribution arrangement may extend modify the common law position. However, severance clauses in existing agreements are unlikely to be broad enough to achieve this (i.e. the severance clause would likely need to contemplate severance even where there has been a material impact on the rights or obligations of one or both parties before it will be effective to save the agreement from terminating – such severance clauses are extremely rare).

We therefore welcome the inclusion of a savings provision in these regulations. However, we see a number of problems with the proposed provision:

1) Regulation 7.7A.17 is made under s1101H(3) of the Corporations Act which we consider is the wrong head of power.

   Section 1101H(3) gives power to make Regulations which specify the effect of a failure to comply with a specified provision of Chapter 7 of the Corporations Act. In the case of a contractual term providing for payment of remuneration, some of which is conflicted remuneration under FOFA (and therefore banned) and some of which is grandfathered (and therefore permitted) there will not be a failure to comply with Ch 7 as the only payments that will continue will be grandfathered payments. As such there will not be a failure to comply with a provision of Chapter 7. For this reason we do not think the power under 1101H is appropriate;

2) The drafting in Regulation 7.7A.17 does not achieve the desired saving outcome. The Regulation states that where a term provides for payment of conflicted remuneration, a failure to comply with Ch 7 will not affect the validity of the term. However, merely having a contractual term that covers payment of conflicted remuneration does not breach Ch 7; a breach will only occur at payment/receipt of conflicted remuneration that is not grandfathered. That is, simply having a remuneration clause does not trigger a "failure to comply". As explained in 1) above, provided no conflicted remuneration is paid, there will not be a failure to comply and so Regulation 7.7A.17 will not be activated;

3) We are concerned that the drafting does not override the common law presumption that the parties intend an agreement to terminate where there has been a material change in its terms as a result of a change of law. The fact that future remuneration is significantly affected could still constitute a material alteration to the parties' rights and obligations, which would activate the common law presumption that the parties would not have intended the contract to continue in these circumstances and so it will terminate. If that occurs, then any ongoing payments are no longer made under an existing arrangement, so it may be argued that they have lost their grandfathered status, although the intention was that these payments would be grandfathered.

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Suggested solution

We need a regulation which provides that either:

- The conflicted remuneration in relation to new clients is severed but the contract otherwise remains on foot and is enforceable; or
- we can keep paying what would have been grandfathered benefits in relation to existing clients even where by operation of common law the original arrangement may have terminated and so any continued payment may be under a new post 1 July 2013 arrangement.

Recommendation

The FSC recommends the second option above provides the most succinct drafting and may be easiest to implement could be along the following lines.

Additional Grandfathering of Certain Arrangements

7.7A.17 Extension of grandfathering to new arrangements replacing existing arrangements terminated as a result of FOFA

(1) This regulation:

(a) is made for the purposes of subsection 1528(2) of the Act; and

(b) prescribes a circumstance in which Division 4 of Part 7.7A of Chapter 7 of the Act does not apply to a benefit.

(2) The circumstance is that the benefit:

(a) is paid by one party to another party under an arrangement entered into on or after 1 July 2013; and

(b) subject to (3), the arrangement is on the same terms as an arrangement entered into before 1 July 2013 except that the arrangement does not provide for the giving of any remuneration not permissible under sections 1528 or regulations made for the purposes of subsection 1528(2) (assuming the arrangement had been entered into before 1 July 2013.

(3) Variations can be made to the new arrangement referred to in (2) and it will still be regarded as an arrangement on the same terms for the purposes of (2)(b) provided those variations do not exceed variations on and after 1 July 2013 that could be made to an arrangement referred to in 7.7A.16 and 7.7A.16A without those variations leading to a loss of grandfathering under those regulations.

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6. Use of the word “immediately” in sub-regulation 7.7A.16A(2)(c)

Sub-regulation 7.7A.16A(2)(c) applies to a retail client who:

- had made an acquisition of a financial product
- immediately before the 1 July 2014.

The use of the term “immediately” implies that a retail client’s monies are only grandfathered if the client (still) held the investment “immediately” prior to the date 1 July 2014 which implies the client must still be invested in the platform the day before (immediately implies recency).

The phrasing could be interpreted such that a retail client who held a financial product but redeemed (withdrew) say on 1 March 2014 may result in a breach of the grandfathering provision – because 1 March is not “immediately” prior to 1 July 2014. We do not believe that it is the government’s intent that the client still be invested in the financial product on the 30 June 2014 for the grandfathering provision to apply to payments made to and from parties to an arrangement during the 2013/2014 year.

Whilst the use of the word “immediately” produces the possibility of a breach, we highlight that the language the drafting consider not only address the 2013/2014 year in question, but also generally address grandfathering in the sense that all benefits paid/given to a person prior to 1 July 2014 in relation to a retail client’s investment prior to 1 July 2014 even if the client exited the fund prior to 1 July 2014 is also not a breach of the grandfathering nor Division 4 of Part 7.7A as they were lawful payments.

Recommendation

The FSC submits that provided the retail client held the investment (the account) in a period prior to the 1 July 2014 but in particular during the 2013/2014 year, any remuneration paid pursuant to that investment is a grandfathered payment and not conflicted remuneration.

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