HENRY DAVIS YORK
LAWYERS

19 October 2011

Our Ref EAG/JAI000

**BY EMAIL futureofadvice@treasury.gov.au**
The General Manager
Retail Investor Division
The Treasury
Langton Crescent
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Dear Treasury

**Exposure Draft - Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011**

Henry Davis York is grateful for the opportunity to comment on the Exposure Draft of the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011. Our submission is set out in the attachment to this letter.

We would be happy to elaborate on our comments if that would be of further assistance.

Yours faithfully
Henry Davis York

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

**Submission on Exposure Draft**

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## 1 Background

A key reference point for this second tranche of the Future of Financial Advice reforms is the 2009 Inquiry into Financial Products and Services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services (**PJC Inquiry**). The PJC Inquiry was a response to financial product and service provider collapses which produced devastating results for many retail clients. In particular, the PJC Inquiry focussed on the current regulation of the provision of financial advice, remuneration practices among financial planners and the sales-advice conflict.

A key recommendation of the PJC Inquiry was:

> "*... that the government consult with and support industry in developing the most appropriate mechanism by which to cease payments from product manufacturers to financial advisers.*"

We support the Federal Government's continued efforts in seeking to improve standards in the financial planning industry. In particular, we support appropriate steps being taken to remove incentives for financial planners to favour their own interests over their clients and which can lead to sub-optimal investment strategies for their clients. These incentives can include product sales commissions and trail fees. We note that the industry itself has taken significant steps towards improving professionalism among industry participants and removing conflicted remuneration structures since the PJC Inquiry.

However, we note that the amendments to the Corporations Act 2001 (**Corporations Act**) set out in the Exposure Draft Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (**Draft Bill**) extend well beyond the financial planning context. The proposed ban on conflicted remuneration is currently framed in such a way that other industry participants and remuneration practices will be inadvertently captured by the prohibition in ways not contemplated by the policy objective or the PJC Inquiry.

Our submission identifies two particular areas of concern regarding the way the Draft Bill has been formulated. Firstly, there will be unintended consequences for financial product issuers, platform providers and investment managers by virtue of the conflicted remuneration prohibitions not being limited to personal advice situations. Secondly, the conflicted remuneration prohibition in respect of group life insurance inside superannuation would appear to be based on a premise that group insurance will not be individually advised on or available in Choice superannuation products.

## 2 Unintended consequences for product issuers, platform providers and investment managers

The proposed conflicted remuneration definitions in sections 963(1) and (2) are not limited to personal advice situations. We submit that they should be.

In our view, not restricting the proposed conflicted remuneration definitions in sections 963(1) and (2) to personal advice situations could lead to unintended consequences for product issuers such as responsible entities of registered managed investment schemes and superannuation trustees, platform providers and investment managers.

Sub-section 963(2)(c) defines conflicted remuneration to include a benefit, access to which or the value of which is dependant on the total value of investments made by retail clients to whom the licensee provides financial product advice.

Responsible entities, superannuation trustees, platform providers and investment managers often receive investment management and/or administration fees for the management and administration of their retail clients' investments in a fund (or funds). These fees are often dependant on the total value of investments made by the retail client in the fund (or funds). These same responsible entities, superannuation trustees, platform providers and investment managers often produce investor-directed educational and investment related information containing general financial product advice to these clients at no cost.

The investment management and administration fees would, therefore, fall within the definition of conflicted remuneration in section 963(2)(c).

The likely consequence of this is responsible entities, superannuation trustees, platform providers and investment managers ceasing to provide investor-directed educational and investment related information containing general financial product advice to their clients.

This would appear contrary to industry, regulatory and Government initiatives to promote financial literacy and understanding amongst retail investors and an unintended consequence of sub-section 963(2)(c).

Similar comments can be made in relation to sub-section 963(1)(b) of the Draft Bill.

It appears to us that the policy intent of the Draft Bill can be achieved and the potential consequences outlined above avoided, by limiting the proposed conflicted remuneration definitions in sections 963(1) and (2) to personal advice situations only.

Set out below are example scenarios and the potential consequences:

### Scenario 1 - Website and scheme-related materials

(**Scenario**) Responsible entities typically receive investment management fees for operating a registered scheme, calculated as a percentage of assets under management. For the purposes of the section 963(2)(c) definition:

- these fees constitute monetary benefits dependent on the total value of investments made by retail clients in the scheme; and
- the responsible entity is likely to also provide general financial product advice to the same retail clients through various media, including the responsible entity's website and other scheme-related materials e.g brochures and newsletters.

(**Consequences**) In order to continue to be able to receive investment management fees without any potential argument that it is breaching the prohibition in section 963D, the responsible entity would have to block retail clients from accessing its website, or reduce its website information so that no general financial produce advice is given. The responsible entity would also be likely to have to discontinue or substantially limit scheme-related information provided to its clients, regardless of whether the content had an educational benefit.

### Scenario 2 - Investor education services

(**Scenario**) Many funds management companies structure their employee incentive arrangements to include bonus payments. The size of the bonus pools and payments to the employees may partly depend on the financial performance of the company, which is a function of investments in the products managed by the company. For the purposes of the section 963(2)(c)) definition:

- these bonus payments constitute monetary benefits which may be dependent on the total value of investments made by retail clients; and
- the funds management company may offer free investor education services. Such services include the issuing of periodical investor magazines as well as guides and tools on the company's website which can be accessed by retail clients. Such services can incorporate tools such as investment returns calculators and search functions for locating a financial planner. Aspects of the provision of the investor education service will constitute providing general financial product advice to retail clients.

(**Consequences**) In order for the funds management company to continue to pay bonuses to its employees without any potential argument that it is breaching the prohibition in section 963H, the company would have to discontinue providing the investor education service, regardless of the potential benefits to the investors in terms of improved financial literacy and, in the case of the planner locator, being able to access professional advice.

In our view, it is an inappropriate and, we assume, an unintended consequence of the drafting of the definition that these scenarios should be captured. Improved education and knowledge among investors should be encouraged and, in our view, will itself drive improved professionalism among industry participants as investors' expectations increase regarding the quality of service they expect to receive.

For completeness, we note that the exception in proposed section 963A(1)(d) only applies to benefits given by a retail client and in relation to the issue or sale of a financial product. There is a strong argument that investment management fees and administration fees as described above are not fees relating to the issue or

sale of a financial product. In addition, it is also worth noting that these fees are not always paid directly by the retail client as required to be able to rely on proposed section 963A(1)(d).

Finally, in our view it adds unnecessary complexity to the Draft Bill to provide for a separate prohibition on product issuers and sellers in section 964 but in different terms. Section 964 should be aligned with section 963D, with the prohibition applying to the more narrowly defined context of conflicted remuneration rather than monetary and non-monetary benefits generally. Again, this prohibition would need to be clarified as applying only to personal advice situations to avoid the types of unintended consequences identified above.

## 3 Group Life Insurance Issue

The Draft Bill (section 963A(1)(b)) proposes that benefits given by an APRA authorised life company to a licensee or representative will be conflicted remuneration where the payments relate to the provision of financial advice given to a retail client in relation to:

(a) a group life policy for members of a superannuation fund; or

(b) a life policy for a member of a default superannuation fund.

The Explanatory Memorandum provides that in addition to commissions being permissible for life risk insurance products sold outside of superannuation, "commissions will still be permissible on individual life risk (non-investment linked) policies within superannuation for non-default (choice) funds".

In our view the distinction made in the Draft Bill between a group life policy and an individual life policy, particularly when applied in the context of insurance sold through non-default funds is problematic and has unintended consequence. We believe that this distinction may be based on erroneous assumptions made about the nature of group life cover in superannuation.

Group life policy is a term of art that is familiar to those operating within the life and superannuation industries. In simple terms, a group life policy means a life policy that is issued for the benefit of two members or more of a fund as distinct from an individual policy which will be for the benefit of a single or individual member of a fund. However, the fact that a policy is a group policy does not preclude an individual member seeking to tailor their insurance cover, if the cover so permits. In our experience, the option to individualise life cover for an individual member under a group policy is commonly available.

Further, an individual member under a group policy will usually have the benefit of a lower premium rate (because of the scale of the purchasing power of a trustee on behalf of its members) that may otherwise be available if the policy was issued on an individual basis.

The Draft Bill will preclude the payment of commissions in respect of group life policies sold via Choice funds even where the insurance cover has been tailored by the individual member following receipt of advice. In our view there is no reason why as a matter of policy, a distinction should be drawn between an individual and a group life policy sold in a Choice (non-default) fund where an individual has

received advice about their insurance cover and has elected to change it from an automatic acceptance level available under the group policy.

We would suggest that if section 963A(1)(b) is passed unamended in this respect, a potential unintended consequence may be a shift in industry practice so that only a default level cover may be offered on a group policy platform. In our view, this will only contribute to the significant underinsurance problem in Australia with an insurance gap continuing to grow between the level of default insurance provided and what the individual requires given their particular life circumstances.

## 4 Transitional provisions

We understand that transitional provisions for the conflicted remuneration prohibitions will be made available by Treasury in separate draft legislation. As indicated in our submission, the issues generated by the Draft Bill are complex and broad in nature. The transitional measures will in our view raise similarly complex issues which will be interrelated with those arising from the Draft Bill. We submit that industry needs to see the detail on how transition to the new regime is to be introduced before it can form a final view on the Draft Bill. We therefore request that the transitional measures be released for public review and comment before the Draft Bill is settled and passed through Parliament.

**Henry Davis York**

19 October 2011

Please contact either Liz Gray, Claire Machin or Jon Ireland if you wish to discuss any aspect of this submission.

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