Law Council
OF AUSTRALIA

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

## Submission to Retail Investor Division, The Treasury

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# Law Council of Australia Superannuation Committee - Submission on Exposure Draft of the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011

The Superannuation Committee (Committee) is a committee of the Legal Practice Section of the Law Council of Australia. Its objectives include ensuring that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. It fulfils this objective in part by making submissions and providing comments on the legal aspects of proposed legislation, circulars, policy papers and other regulatory instruments.

In this submission, the Committee provides comments on some legal aspects of the exposure draft of the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (Bill). Our comments focus on issues which are particularly relevant to the superannuation industry and superannuation members.

## 1 Summary

The Bill is intended to prohibit the receipt and payment of conflicted remuneration by Australian financial services licensees and their representatives in order to ensure that retail clients have access to unbiased advice.

The Committee considers that the likely impact of the Bill will be much broader than is necessary to ensure that retail clients have access to unbiased financial product advice. It also thinks that the Bill will, if passed in its present form, have unintended and potentially negative consequences on superannuation funds and their members. In summary the Committee is particularly concerned about:

- the breadth of the definitions of conflicted remuneration, platform operator and volume-based shelf-space fee; and
- the uncertainty of the scope of the bans and the uncertainty about the scope and application of the exceptions to the general bans; and
- the failure of the Bill to address the issue of adviser fees being deducted from members' interests in superannuation funds; and
- the scope of the anti-avoidance provision.

Significant issues for superannuation trustees and their members include:

- the prospect that administration fees paid to fund administrators (who also provide financial product advice, including only general advice) could be both conflicted remuneration and a prohibited benefit provided by a product issuer to a licensee; and
- that members of superannuation funds will not be able to direct a trustee to deduct adviser service fees agreed with their adviser from their interest in the fund.

More detail about the Committee's concerns is provided below.

# 2 Conflicted remuneration

## 2.1 General ban

Section 963D(1) provides that a licensee must not accept "conflicted remuneration" Section 963F(1) provides that an authorised representative must not accept conflicted remuneration. Under section 963E a licensee must also take reasonable steps to ensure that its representatives do not accept conflicted remuneration.

## 2.2 Definition of conflicted remuneration

Conflicted remuneration is defined in very general terms in section 963(1). The Bill then deems certain benefits to be conflicted remuneration in section 963(2) and excludes certain benefits from being conflicted remuneration in sections 963A and 963B.

## 2.3 General definition

The Committee has two key concerns about the general definition of conflicted remuneration:

- it is not limited to remuneration for personal advice, nor even for financial product advice more generally, paid by the product issuer to the adviser; and
- the "might influence" test is extremely broad and gives no certainty to providers.

***Definition not limited to remuneration for personal advice***

Any fee or charge may be conflicted remuneration under the general definition in section 963(1) if the licensee or its representative provides financial product advice to a retail client which might have the necessary influence. For example, a product issuer who provides general financial product advice (for example in the form of a product disclosure statement), could be prohibited by the ban on conflicted remuneration from receiving a management fee as the fee might influence its general advice to investors. It could also prevent trustees of superannuation funds paying fees based on assets under administration or the number of members to fund administrators (who also provide general or personal advice to members). These are both examples of the unintended consequences which will apply if the definition of conflicted remuneration is not amended.

***Might influence test***

The definition of conflicted remuneration focuses on whether or not remuneration "might influence" the choice of financial products recommended by an adviser or "might otherwise influence" the advice given to retail clients. This drafting is particularly broad as there is no materiality threshold, whether in relation to the likelihood of there being any influence, or in relation to the extent of that influence. This means that the legislation will potentially apply to arrangements where there is a very low probability of there being any actual influence or where the extent of the influence is either remote or purely theoretical.

The Committee recommends that consideration be given to alternative wording which incorporates some form of materiality threshold, for example, by focussing on arrangements "which are reasonably likely to have a material influence" on the advice provided.

***Superannuation issue***

Most superannuation trustees appoint an administrator to provide administration services to the fund. The administrator may be a related company or an unrelated company providing administration services to many superannuation funds. In either case, the trustee will usually pay the administrator a fee which is linked to the value of funds-under-administration or the number of members in the fund. These are both reasonable methods of measuring of the value of the service provided. However, in cases where the administrator also provides financial product advice to members, there is a very real risk that the remuneration paid for administration services would fall within the definition of conflicted remuneration and be prohibited by the legislation. Whenever the administrator recommended to a member that they remain a member of the fund, or even where they did not recommend that the member leave the fund, the effect of the advice would be to maintain the value of funds under administration and the number of members, which in turn has the effect of maintaining the value of the remuneration for administration services (and therefore potentially falls within the general definition of "conflicted remuneration").

***Suggested amendment***

In the Committee's opinion, the general definition of conflicted remuneration in section 963(1) should be limited to: "any benefit, whether monetary or non-monetary, given by a product issuer to a licensee or representative which is reasonably likely to materially influence the personal advice provided by the licensee or adviser to a retail client."

## 2.4 Benefits which are deemed to be conflicted remuneration

Section 963(2) will deem certain arrangements to be conflicted remuneration if they are "dependent" on the value or number of the financial products being recommended. The use of the word "dependent" gives rise to a question as to whether remuneration can be dependent on more than one factor, or whether dependency means that there must be no other relevant considerations which affect entitlement to the remuneration. Given the ordinary meaning of the word "dependent", there is a real likelihood that this section might be interpreted as only applying to arrangements where the value or number of financial products is the sole determinant of whether or not a person is entitled to receive remuneration. If the arrangement was subject to any other factor or consideration, then this could well be enough to put the arrangement outside the scope of section 963(2). For example, consider an arrangement which offered the potential for additional payments to be made if particular sales targets were to be achieved, subject to the corporate performance of the relevant company and any other discretionary considerations. In this case, the remuneration is arguably not dependent on the achievement of sales targets because that in itself does not ensure payment of the benefit – in other words, the remuneration in this example is arguably dependent on all the relevant factors (but not on any one factor in isolation).

The draft Explanatory Memorandum to the Exposure draft Bill indicates that this is not the intention of the drafters.

***Suggested amendment***

The Committee notes that it is a policy matter for Government whether the ban should only apply to remuneration which is wholly dependent on the value or number of financial products or whether it should apply when it is one component only. In either case, the Committee is concerned to ensure that the law is certain. Therefore, it recommends that alternative language be used, for example, by expressly stating that a benefit will be conflicted remuneration if it is "wholly or partly dependent upon or calculated with regard to" the value or

number of financial products recommended. However, in this case, the Committee considers that a materiality threshold should be included. In its opinion, the test should focus on whether the benefit is *reasonably likely* to influence the personal advice provided by a licensee or representative to a retail client.

### 2.5 Benefits which are not conflicted remuneration

Section 963A(1)(d) states that benefits given to a licensee or its representatives are not conflicted remuneration if the benefits are given to the licensee by the client.

The Committee has two key concerns about section 963A(1)(d):

- it is not clear that a fee paid by a product issuer, albeit at the direction of a client would be a benefit "given to the licensee or representative *by* a retail client"; and

- the exception will not apply where a retail client wishes to pay their adviser from their interest in a superannuation fund.

***Benefit given "by" a retail client***

Based on the Information Packs released in April 2010 and 2011, the Committee understands that the legislation is intended to allow:

- an adviser and client to agree the adviser's fee, including an asset-based fee; and

- the adviser's fee to be satisfied by the product issuer deducting the fee from the client's product and paying the adviser.

The 2010 Information Pack contained the following statement: "*It is important to note that the adviser charging regime does not prevent client-agreed deductions being allowed from a client's investment to pay for financial advice or flexibility in payment options. The client does not have to pay the advice fee, or ongoing fees, up front, and in full. While these deductions from a client's investment would need to be facilitated by a product provider, this is not a commission, as the remuneration is not set by the product provider. Advisers cannot prefer product providers because this type of service is offered.*"

However, it is not clear that this section 963A(1)(d) (nor any other section) will allow a client/investor to direct the product issuer to deduct an amount from their product and pay it to their adviser. There is a question about whether such a payment would be given to the licensee "by" the client.

If the payment is "by" the client and permitted by section 963A(1)(d), the issue also arises as to whether it could nevertheless be a caught by the ban in section 964(1) on an issuer of a financial product giving a benefit to a licensee or a representative who provides financial product advice to clients. In the Exposure Draft Bill's current form, the fact that a benefit falls within the exception in section 963A(1)(d) does not mean that it could not fall within the ban in section 964(1).

***Suggested amendment***

In the Committee's opinion, section 963A(1)(d) should be amended to expressly provide that the exception is satisfied where a product issuer makes a payment from a product at the direction of the client or otherwise with the consent of the client. In addition, section 964(1) should be amended to provide that a benefit which falls within section 963A can be paid by a product issuer without breach of section 964(1).

***Superannuation issue***

In the Committee's previous submission on tranche 1 of the Future of Financial Advice Exposure draft Bill, it noted that fees paid by superannuation fund members to their advisers require special treatment to recognise the constraints imposed by the *Superannuation Industry (Supervision) Act 1993* and Regulations (SIS). A client and adviser cannot enter into an arrangement under which the client agrees to pay the adviser a fee by directing the trustee of the client's superannuation fund to deduct the fee from their interest in the fund. SIS will prevent the trustee acting on the direction of the client and prevent the cashing of the benefit in many cases.

Currently these arrangements are commonly dealt with by tripartite arrangements between the trustee, member/client and adviser. As between the trustee and adviser, the trustee is liable to pay the adviser's fee.

***Suggested amendment***

In order to ensure that members of superannuation funds are able to pay their advisers a fee for service, including an asset-based fee, in the same way as investors in other investment products, the Bill will need to be amended to specifically allow tripartite arrangements between trustees, members/clients and advisers to provide for adviser remuneration.

# 3 Benefits from product issuers

## 3.1 The scope of the prohibition

Section 964(1) will impose a ban on monetary and non-monetary payments by product issuers or sellers to financial services licensees or their representative, irrespective of whether or not such payments are conflicted remuneration. The Explanatory Memorandum for FOFA Tranche 2 explains that this provision is designed to prevent product issuers from making large payments which, though not volume based, may nevertheless make it hard for ASIC to identify whether the remuneration gives rise to conflict. This provision was not directly contemplated by Treasury's previous FOFA announcements.

There are a number of difficulties with the breadth of the ban. In particular, while the ban in section 964(1) applies to benefits provided to a licensee or representative who provides financial product advice to retail clients, the benefits which are banned do not need to have any connection to the financial product advice provided. If at some point, and in any context, the licensee or representative provides financial product advice to a retail client, a product issuer cannot provide them with a benefit unless they fall within an exception. This prohibition will require product issuers and sellers to undertake a review of the activities and prior activities of all licensees and representatives to whom they provide benefits to determine whether or not they provide or have provided financial product advice to retail clients. In many cases this information may not be available to the product issuer.

If the prohibition in section 964 is intended to target conflicts of interests arising from payments by issuers to advisers, then it should be amended so that the prohibition only applies where the payment might influence the advice which is given.

## 3.2 Fee for service exception

An exception to the blanket ban on monetary and non-monetary benefits by product issuers is provided for in section 964(2)(a) where "the benefit is a fee for service and the fee reasonably represents the market value of the service".

The Committee notes again that the fee for service may be wholly unconnected with the financial product provided by the recipient of the fee. The effect will mean that a fee paid by a product issuer for a service wholly unconnected with financial product advice will need to comply with the section if the recipient happens to provide financial product advice, albeit in another capacity, but a fee paid by a product issuer for the same service will not need to comply with the section if the recipient does not provide financial product advice.

The Committee is also concerned about the difficulty of applying the "market value" test in the section. The market value for certain services, such as marketing and distribution, may be difficult to determine.

# 4 Volume-based shelf-space fees

## 4.1 Superannuation trustees will be platform operators

Sections 964A and 964B introduce a broad conceptual definition of a "platform operator" and "volume-based shelf-space fees" and sections 964C and 964D prohibit the payment of such fees to a platform operator (who may be a financial services licensee or an RSE licensee).

The definition of "platform operator" includes an RSE licensee and the ban will apply to an RSE which offers a facility within the meaning of section 964A(1)(b) and which satisfies section 964A(1)(c). These paragraphs are extremely broadly drafted. They will include a licensed trustee of a superannuation fund which offers members access to particular managed funds that are managed by particular investment managers. A PDS which discloses member investment choice is likely to be a "facility" with the result that the trustee is a "platform operator" caught by Subdivision B of Division 5. On this basis, the vast majority of trustees of large superannuation funds will be prohibited from accepting a volume-based shelf-space fee under section 964D.

The effect will be that the superannuation funds and their members may lose the benefit of any favourable fee arrangements that have been negotiated by the trustee for the benefit of members with the issuers of the pooled products in which those funds invest, resulting in higher costs for members.

More details of the Committee's concerns are set out below.

## 4.2 Rebates and discounts

The definition of volume-based shelf-space fee in section 964B provides that discounts and rebates of amounts payable by a platform operator to a fund manager for services provided by the fund manager to the platform operator are volume based shelf space fees unless the value of the discount or rebate is justifiable by the reasonable value of scaled efficiencies in the fund manager's costs. The Explanatory Memorandum states: "*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.*" It therefore appears that fund managers are not able to offer wholesale asset management fees to platform operators unless the difference between the wholesale rate and the 'rack' rate paid by other investors can be justified as a reasonable assessment of the costs the fund manager will save by offering its product through the platform.

As a consequence, this means that any rebates which have been negotiated by these superannuation trustees would be prohibited under the new legislation, especially if the amount of the rebate exceeds any efficiency savings of the kind referred to in section 964B(2)(b). In this regard, it is critical to note that some large superannuation funds are able to negotiate very favourable rebate

arrangements which in some cases will far exceed mere efficiency savings. The crucial distinguishing factor in the context of superannuation funds (as opposed to other platform operators) is that superannuation trustees are required by law to hold all rebates for the benefit of their members and cannot retain those rebates for their personal benefit.

### 4.3 Suggested amendment

The Committee considers that this would be an unintended and undesirable consequence of the legislation. In the Committee's view, a better result for investors/members would not be to prohibit such discounts or rebates but, instead, to require any discount or rebate to be passed on to the investors/members.

The Committee therefore suggests that the legislation be amended:

- to exclude trustees of superannuation funds from the definition of "platform operators" (this would involve removing the ban on RSE licensees accepting a volume-based shelf-space fee, and providing that the ban on AFS licensees accepting a volume-based shelf-space fee does not apply where the licensee is also an RSE licensee); and/or

- to introduce an additional exception that applies in cases where volume-based shelf-space fees are not received for the benefit of the platform operator but are instead received for the benefit of the retail clients who have accessed the relevant financial products through the facility operated by the platform operator.

If these changes are not made, there is a real risk that superannuation funds and their members will lose the benefit of existing rebate arrangements (especially the more favourable of those arrangements), with the result that members of superannuation funds will suffer an increase in their superannuation fund's investment fees.

## 5 Benefits provided where arms-length transactions involving superannuation trustees

### 5.1 Potential breaches by superannuation trustees

In addition to the comments about the application of specific sections of the Exposure draft Bill, the Committee is concerned that trustees of superannuation funds will be specially impacted by the proposed prohibitions in a manner which is unintended and unnecessary.

Superannuation fund trustees who provide advice to members may breach the legislation in cases where:

- they co-incidentally receive benefits from the same investment managers who manage products in which their members invest; or

- their financial advisers are employed by the same company that provides general administration services to the trustee, especially if the administration fees are calculated with regard to the level of funds under administration,

unless an exception is created for benefits received pursuant to arms-length arrangements that are genuinely unconnected with any financial product advice.

### 5.2 The activities of superannuation trustees

Trustees of many superannuation funds are involved in providing financial product advice to their members, either directly or through a related body corporate of the trustee. This advice may relate to:

- investment options within the superannuation fund that are managed (either entirely or partly) by particular investment managers;
- particular investment products that can be accessed through the superannuation fund that are managed by particular investment managers;
- non-superannuation assets, which might include investment products managed by particular investment managers.

In many cases, trustees of superannuation funds will have broader arrangements with the same investment managers in relation to the general investments of the superannuation fund (for example, investment management arrangements or brokerage arrangements). In these cases, it is conceivable that superannuation trustees will receive certain benefits from those investment managers and brokers (i.e. which relate to the fund's general investment arrangements) which are genuinely unconnected with any financial product advice that might be given by the trustee to its members in relation to their own personal investment choices. Consider the following example:

ABC Superannuation Fund has appointed XYZ Funds Management to provide investment management services. In connection with this appointment, XYZ Funds Management provides access to information technology and investment research for superannuation fund purposes (but which is not used for the purposes of advising retail clients and therefore is outside the scope of the exceptions in section 963B). Separately, financial advisers employed by the trustee of ABC Superannuation Fund provide financial product advice to its members in relation to products managed by XYZ Funds Management.

Arrangements along the above lines would be restricted by the proposed provisions, notwithstanding that the benefits provided concern an arms-length transaction which is genuinely unrelated to any financial product advice being provided.

In section 2.3 above the Committee has provided another common example of a superannuation fund trustee paying a fee to an administrator who also provides advice to members of the fund.

Arrangements along these lines could also be restricted by the proposed provisions, again notwithstanding that (as with the preceding example) the relevant remuneration concerns an arms-length transaction which is genuinely unrelated to any financial product advice being provided.

***Suggested amendment***

In the Committee's opinion, these issues could be addressed by including, as suggested above in the context of volume-based shelf-space fees, an exception for benefits provided in the course of an arms-length transaction involving superannuation trustees that are unrelated to financial product advice being provided to a retail client.

# 6 Anti-avoidance and existing contractual rights

## 6.1 Anti-avoidance

Proposed section 965 addresses schemes to avoid the operation of Part 7.7A. Section 965 was included in the Exposure draft Bill but has since been included in the Corporations Amendment (Future of Financial Advice) Bill 2011 which was introduced into Parliament on 13 October.

The Committee's key concern is that, as currently drafted, section 965 would not apply just to a scheme entered into on or after 1 July 2012, but also to a scheme entered into before 1 July 2012 but only carried out on or after that date. This begs the question, how far in advance of 1 July 2012 could a scheme be entered into and still run the risk of contravening section 965? Before the Bill receives Royal Assent? Before it is passed by Parliament? Before it was introduced into Parliament? This uncertainty in relation to the commencement of the anti-avoidance measure is, in our view, something which needs to be resolved.

Compare the position with what was clearly the model (at least in part) for section 965 – Part IVA of the Income Tax Assessment Act 1936. Section 177D expressly states that Part IVA does not apply to a scheme that was entered into on or before 27 May 1981. In a similar way, section 965 should expressly state that it does not apply if the scheme was entered into on or before a specified date. In the Committee's opinion, a start date should be clearly identified.

## 6.2 Existing contractual rights

In its August 2011 media release, Treasury stated that the conflicted remuneration provisions would not apply to existing contractual rights of an adviser to receive ongoing product commissions from product issuers and it is proposed that FOFA Tranche 2 will grandfather future payments to licensees or their representatives in respect of investments made prior to 1 July 2012. Whilst the Explanatory Memorandum refers to grandfathered commissions, grandfathering provisions do not appear in the draft legislation. Further, as currently drafted, existing arrangements entered into following the first announcements of the ban on conflicted remuneration may well breach the anti-avoidance provision discussed above. The Committee assumes that the Government will provide grandfathering in a transitional act or regulations and that these provisions will ensure that existing arrangements do not fall within the scope of the anti-avoidance provision.

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