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19 October 2011

The General Manager
Retail Investor Division
The Treasury
Langton Cresent
PARKES ACT 2600

email: futureofadvice@treasury.gov.au

Dear Sir

Submission:
Exposure Draft – Corporations Amendment (Further Future of Financial Advice) Bill 2011

RBS Morgans management team and board of directors support the overall aims of FoFA to improve the availability and quality of advice to retail clients. We have reviewed the Corporations Amendment (Further Future of Financial Advice) Bill 2011 Explanatory Memorandum and the Exposure Draft and considered the practical implications of the proposed changes on the provision of financial advice to retail investors.

This submission should be considered in the context of our earlier submissions dated 22 July 2011 and 16 September 2011.

To avoid any confusion, we believe it is imperative to differentiate between the activities of the Financial Planning Industry (in particular the activities of Storm, Westpoint and Trio, which led to the wholesale review of financial services in Australia) and the Stockbroking Industry. In particular where financial product advice and securities advice (advice from the representatives of Market Participants relating to the buying and selling of securities listed or in the process of being listed on a regulated exchange) is provided to retail investors.

In our opinion, given the extent of regulation and supervision of Market Participants and requirements to hold prescribed amounts of capital, stockbroking activities undertaken by Market Participants should be excluded from the proposed FOFA reforms in order to maintain and improve the availability and affordability of advice for retail investors. The regulation and supervision of market participants far exceeds the requirements for AFSL holders.

In this submission we wish to comment on the following matters, namely:

- the carve outs from the definition of conflicted remuneration for stockbrokers (stamping fees on capital raisings and commission splitting in remuneration);
- asset based fees on geared portfolios; and
- anticipated significant administrative issues for the introduction of the conflicted revenue legislation.

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Proposed Stockbroker carve outs from conflicted remuneration

We note the Bill proposes carve outs from conflicted remuneration, for example:

- execution only trades;
- advice provided to wholesale clients; and
- proposed carve outs to exclude certain stockbroking activities.

We comment on these proposed changes as follows:

Execution only trades (section 963A(1)(c)) must be closely monitored

We are concerned that the exclusion of execution only trades will mean certain advisers may increasingly look for the opportunity to execute and record no advice trades whether or not advice as been provided. This is particularly relevant for advisers within AFSL holders who are not Market Participants (shadow brokers) but clear through Market Participants. This is a significant and unregulated market being access by many direct equities advisors and financial planners.

For Market Participants who provide advice, the proportion of no advice or execution only trades to total trades is closely monitored by ASIC in its surveillance role. A level playing field must be maintained by not allowing the largely non-regulated groups a potential loop-hole for commission sharing.

Wholesale client exclusion will further widen the gap between wholesale and retail investors

We re-iterate the imbalance this proposed legislation creates between the wholesale and retail sectors where providing advice to wholesale clients is excluded where retail clients are not. The added costs and compliance burden will increase the already large gap between investment services offered to wholesale and sophisticated clients compared to the average retail client. The proposed reforms will reduce investment research services available to retail investors with a greater focus on the wholesale sector. This is contrary to the objectives of the proposed FOFA reforms; that is, to maintain and improve the availability and affordability of advice for retail investors.

Stockbroker carve outs – we strongly recommend engaging industry leaders in forming the regulations; and to restrict the benefit of stockbroker carve outs to highly regulated and supervised Market Participants

We note it is proposed to exclude certain stockbroking activities from being considered conflicted remuneration. Our observations on the commentary in paragraphs 1.25 and 1.26 in the Explanatory Memorandum are as follows:

Whilst we welcome and fully endorse the Stockbroker carve outs for the detailed reasons set out in our submission dated 22 July 2011 we note the wording used in paragraphs 1.25 and 1.26 is highly qualified and no substance has been provided on the proposed provisions.

We urge that Treasury undertake an extensive consultation process *by engaging with those stockbrokers directly affected by the provisions* (ie. full service stockbrokers providing advice to retail clients) to ensure the regulations adequately and properly reflect industry best practice. For example, ensuring the regulations recognise the varying employment structures in place between stockbrokers and their employee brokers (authorised representatives), which can be structured as direct employment or engagement on an exclusive contractual basis either with the individual or through a private company.

We strongly believe the proposed Stockbroker carve outs contemplated in paragraphs 1.25 and 1.26 be limited provided to Market Participants (of which there are approximately 45 in Australia) who already operate under a high standard of regulation, supervision, compliance and capital requirements. These carve outs should not be extended to the growing proliferation of ASFL holders who are not Market Participants but advise retail clients in the

buying and selling of listed securities and execute trades through a third party clearing or trading platforms provided by a Market Participant. This group commonly referred to as "shadow brokers" or "non-broker dealers" are not highly regulated, supervised or subject to the stringent capital requirements of Market Participants.

We submit that all capital raising fees paid to stockbrokers must be carved out from the proposed FOFA reforms to ensure the sound functioning and international competitiveness of Australia's capital markets and, in particular, the ability of smaller listed companies to access capital in Australia largely from retail investors. We refer you to our submission of 22 July 2011 which detailed the role the stockbroker plays in introducing capital from retail investors to Australia's smaller listed companies and the potential adverse impact to this sector and the Australian economy if stockbrokers are not able to facilitate this role.

RBS Morgans would welcome the opportunity to engage with Treasury in the development of the regulations, in particular the consideration of the appropriate circumstances of the carve outs to ensure the objectives of ensuring quality and affordable advice for retail investors is available and enhanced, and listed companies (in particular the smaller listed companies) have a vibrant and viable way of accessing new capital to grow as previously submitted.

Implementation & development of systems to identify and manage conflicted remuneration poses significant industry changes – we recommend a 12 month extension to the proposed launch date of 1 July 2012

The proposed reforms will increase the risks faced – and the ongoing expenses incurred – by AFSL holders with employed advisors (Authorised Representatives). In its current form, the Bill makes the AFSL holder responsible for determining whether each receipt, in the hands of the advisor, satisfies the grandfathering and allowable remuneration definitions.

In order to properly implement a robust system that assesses and flags receipts as grandfathered or potentially conflicted, each AFSL holder will be reliant on each external product provider from whom they receive commission revenue to provide them with adequate (and accurate) information. Post 1 July, 2012 each receipt will need to be assessed by the AFSL holder to determine whether it represents:

- revenue which can be considered to be grandfathered (vs not grandfathered); or
- a lump sum of revenue, a portion of which is grandfathered and a portion which is not considered grandfathered; and/or
- revenue which, if paid to the advisor, could be considered conflicted remuneration.

Whilst the responsibility for determining compliance with the grandfathering and conflicted remuneration tests lies with the AFSL holder, the external product providers control the level of detail provided with each receipt. Our existing revenue receipt system is not configured to assess receipt information for the purposes of flagging whether it is grandfathered or not grandfathered and / or potentially conflicted. With incoming information from multiple product providers, the non-standard provision of information across the industry increases the risk for the AFSL holder that a receipt will be incorrectly assessed.

Further, significant investment in back office systems will be required to manage this process. Given the level of interdependency with external providers and the quality of information they provide, it is not realistic for AFSL holders to be in a position to comply with new rules from 1 July 2012. We propose that the new rules governing the treatment of revenue receipts which place the burden of responsibility on the AFSL holder to assess each receipt be deferred to 1 July 2013. This would serve to provide AFSL holders with the opportunity to engage with product providers – and then design, build, test and implement changes to their systems and processes.

Given the significant work and investment the entire industry is required to undertake to comply with the proposed legislation (not just AFSL holders), we strongly recommend a transition period of at least 12 months to 1 July 2013 be allowed.

Asset based fees on geared funds

We acknowledge concerns arising from the highly geared investment structures promoted by a small group of investment advisory firms such as Storm Financial.

However, a vast majority of the advisory industry did not promote these forms of geared investment structures. In fact, many advisors guided clients away from highly geared structures and products aggressively promoted by groups such as Storm, in many cases charging no fees.

For many investors, gearing in an investment portfolio is an effective, efficient and sensible strategy for investment. The role of investment advice provided by a financial advisor is to ensure the level and structure of gearing or borrowings for investment is appropriate having regard to the investors personal circumstances and investment objectives.

The very wide definition of borrowing in the proposed reforms in our view will further increase the gap between sophisticated investors and retail investors. The effect will be an average retail investor will have less opportunity to benefit from gearing structures which are well advised and appropriate for their individual circumstances relative to the sophisticated investor reducing the availability of appropriate investment options and ultimately further increasing the wealth divide.

We have a number of concerns on the propose amendments referred to in paragraph 1.49 to 1.53 in the Explanatory Memorandum.

a) *What constitutes 'geared funds'? – the proposed definition is very broad and has a number of unintended consequences*

   It is obvious the target of these reforms are activities undertaken by certain financial advisors placing inappropriate gearing structures on retail investors and to discourage this practice by way of the removal of fees on the geared portion. We support the discouragement of this form of behaviour.

   The explanatory notes go some way to providing some guidance, but provides the "catch all" phrase *'Borrowed' means* ***borrowing in any form****, whether secured or unsecured, including the raising of funds through a credit or margin lending facility* (our emphasis).

   This is a very broad definition and may catch investment structures that are not the prime target of the reforms.

   Many investors for personal reasons structure their investments in ways that may involve loans between entities (eg. private companies, family trusts, estate planning (testitory trusts)). We believe it is not the intention of the proposed reforms to capture this type of lending and this will be an unintended consequence of the proposed reforms.

   In fact the reforms may have the opposite effect and may encourage investors to structure their investments in such a way to avoid being charged a fee.

b) *Proposed ban on asset-based fees on geared funds will likely lead to higher charges on ungeared component*

   All portfolio management structures have a fixed cost structure and the ban on any ability to charge asset based fees on geared components will cause platform providers significant cost in system development to identify, record and manage geared and

ungeared funds and higher ongoing administrative costs to manage these allocations. Investors will likely see increased costs as providers seek to recover these costs over a lower asset base.

c) *"**Reasonable Inquiries**" requirement - further transfer of risk from client to advisor*

In our previous submission on Tranche 1 reforms, we submitted that *"the proposed section 961C(2)(c) imposes significant obligations on providers to make enquiry of clients. Clients decide what information they provide to their financial adviser leaving the financial adviser exposed to subsequent claims.*

Similarly we are concerned about how the requirement to make "*reasonable inquiries*" to determine what is "*reasonably apparent*" will work in a practical sense. It is a very wide and subjective test. Often it will only become apparent whether reasonable inquiry has been made with the benefit of hindsight. It is not reasonable that a financial adviser be required to "second guess" what has or has not been provided by a client and this places the financial adviser and AFSL holder in a position of significant professional risk.

Asset based fees have been designed over time to reflect the holistic approach to growing "total funds under management" which provides a straightforward alignment of interest between the advisor and the client.

A vast majority of gearing within investment portfolios and asset based structures are appropriate structured and individually tailored for each client, further reinforced by current requirement for licensed adviser's *to act honestly, efficiently and fairly* and the proposed *best interests duty* proposed in Tranche 1 of the proposed reforms.

When used responsibly and structured appropriately, gearing is a useful and practical tool to enhancing investment returns and growing wealth.

Recommendation - We submit the proposed ban on asset based fees on geared funds should only apply to the extent that "advice on gearing" has been provided to the client on their portfolio by the Licenced Dealer or its representatives. This will remove the perceived conflict where an advisor may encourage a client to gear to receive a higher asset based fee.

An observation - Conflicted Remuneration : Prohibition vs. Disclosure

With the benefit of now reading the Explanatory Memorandums for Tranche 1 and Tranche 2 reforms, we believe there is an inconsistency in the approach of the proposed b*an on receipt of conflicted remuneration* along with the current law requiring *disclosure of any interests of benefits which may influence advice* and the *duty to act honestly, efficiently and fairly* and the proposed *best interests duty* proposed in Tranche 1 of the proposed reforms. This seems to be a highly complex way of achieving the same result, which we believe is already being achieved by the stockbroking industry. We do not see a systemic problem within the stockbroking industry that replaces *disclosure of any interests of benefits which may influence advice* and the *duty to act honestly, efficiently and fairly* with a prohibition. Hence we re-iterate our view that market participants should not be included in these proposals put forward in the proposed FOFA reforms.

Conclusion

We recognise it is crucial that the outcomes of the proposed reforms deliver on their key aims. However, as proposed, there are a number of aspects that will have a severe impact on the quality, cost and availability of advice to retail investors.

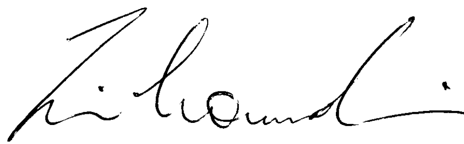
There are clear differences between Financial Planners and Market Participants in terms of regulation, supervision, capital requirements and the type of advice provided – financial product advice versus securities advice. The proposed legislation must take account of this difference to be effective.

RBS Morgans are committed to ensuring the regulations governing the Stockbroker carve outs, when drafted are appropriate and achieve the desired result across the range of business models utilised by the stockbroking industry.

We are keen to offer our input to provide assistance at each stage of this process.

We trust this submission clearly sets out our observations and explains our concerns. We would welcome any engagement should you require any further clarification.

Yours faithfully
RBS MORGANS LIMITED



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