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

Submission

20 October 2011

Executive Summary

The Stockbrokers Association of Australia notes that it is most unfortunate that the second FOFA Bill will see the implementation of the **prohibition model** in relation to **conflicted remuneration**, when in this industry the current **disclosure model** has not been proved to be in need of replacement.

The **timeframe** for implementation of the new measures is very short. If the new measures are to come into effect on **1 July 2012**, and much detail will not be known until the Regulations are finalized in early 2012, Members will not have enough time to make systems and other changes which may be necessary for their implementation. We therefore seek a **further transition period** of at least 12-18 months from 1 July 2012

The provisions should only apply to **personal, not general advice**.

We welcome the announcements of the **Stockbrokers Carve-outs**, namely the exclusion from the definition of *conflicted remuneration* of **Stamping Fees** on capital raisings and **Commission Splitting** in remuneration arrangements, but require more information on the Regulations that will implement the carve-outs before we are in a position to make detailed comments.

We also welcome the clarification that **Asset-based fees on ungeared portions of portfolios** will not constitute conflicted remuneration, but seek clarification on certain aspects.

Finally, we inquire as to the progress of other aspects of the FOFA reforms, namely the **Wholesale/Retail client** definition review, and the review of **compensation arrangements**.

Introduction

The Stockbrokers Association of Australia is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. Our membership includes stockbroking firms across the spectrum, ranging from the largest wholesale stockbroking firms to medium-sized firms, and down to the smallest firms, having mainly a retail client base.

The Stockbrokers Association is pleased to provide this submission to the Government on the *Corporations Amendment (Further Future of Financial Advice Measures) Bill*.

We note that one of the aims of FOFA (as expressed in Minister Shorten's announcement of 29 August) is to restore trust and improve the availability of advice to investors –

> *'It is a concern that only one in five Australians access financial advice. These reforms will restore trust and confidence in the sector following collapses such as Storm, Westpoint and Trio. They also remove the red tape that has prevented low-cost, good quality advice being delivered to millions of Australians.'*

The activities of stockbrokers are far removed from those of Storm, Westpoint and Trio, which led to the wholesale review of financial services in Australia. Stockbrokers would like to think that there is already a relationship of trust with their clients. This is borne out by the fact that in 2010 complaints to the **Financial Ombudsman Service** about stockbrokers **fell** by **75%**.

In this Submission, after some introductory comments on timing, the advent of the prohibition model and the scope of the definition, we will concentrate on the following matters, which have already been the subject of detailed correspondence with Treasury during this year[1], namely the **carve-outs** from definition of **Conflicted Remuneration** of the following:

1. **Stockbrokers Carve-outs: Stamping Fees** on capital raisings and **Commission Splitting** in remuneration; and
2. **Asset-based fees on ungeared portfolios.**

Finally, we would like to inquire as to the progress of other aspects of the FOFA reforms.

Timeframe

As a preliminary matter, we believe strongly that a transitional period of at least 12-18 months from the planned date of commencement (1 July 2012) should be provided for all of the FOFA proposals. Given the range of issues raised during the public consultation process of both FOFA Bills, and the significant regulations that are yet to be drafted that are critical to ensuring reforms operate appropriately, the FOFA reforms are realistically some time away from being

[1] For example, Submission to Treasury *Future of Financial Advice – Ban on Commissions – Impact on Stockbrokers* 8 August 2011 which can be found at http://www.stockbrokers.org.au/PolicyRegulatoryIssues/RecentFOFASubmissions/tabid/363/Default.aspx

settled. With the final FOFA legislation not likely be passed through Parliament until the end of first quarter of 2012, and then allowing time for the regulations to be finalised, it is unrealistic to expect organizations to make the systems, procedural and other changes in order to be compliant with the FOFA reforms by 1 July 2012.

Conflicted Remuneration: Prohibition v. Disclosure

The Bill contains a general prohibition on financial services licensees or advisers receiving **'conflicted remuneration'**. Conflicted remuneration is defined broadly as being any benefit that may influence the advice that is given. As stated in the *Explanatory Memorandum* to the Bill:

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

Placing an absolute **ban** on the **receipt** of conflicted remuneration is a different approach to the current law, which merely requires **disclosure** of any interests or benefits which may influence advice: section 947B(2)(d) and (e). This is complemented by other duties, for example the duty to act *efficiently, honestly and fairly*[2], and the proposed *best interests* duty in the first FOFA Bill. We are not convinced that the '*disclosure model*' needs to be replaced with prohibition. Once again we note that it appears that the law is being changed for the thousands of financial services licensees in Australia because of the misconduct of a few recalcitrant organizations in the lead up to the Global Financial Crisis. We are not convinced that in the stockbroking industry there has been such a systemic failure in the disclosure model that it requires its replacement with prohibition.

Prohibition needs narrowing

We submit that section 964 and the whole prohibition on *conflicted remuneration* need to be reconsidered and redrafted so that they are more aligned to the *actual objectives* of FOFA. Rather than prohibiting the movement of funds between financial product issuers or sellers, the section needs to be redrafted so that it has some **nexus** to the actual definition of *conflicted remuneration* i.e. where a benefit is given to a licensee or their representative in respect of *advice* provided to a client that might influence the financial product recommended or the financial advice given. (As discussed below, one way to achieve this would be to narrow the prohibition to **personal advice**.)

[2] Section 912A(1)(a)

Carve-outs from conflicted remuneration

There are various carve-outs in the Bill from *conflicted remuneration* for certain benefits in certain circumstances set-out in section 963A. For example, one area where the prohibition does not apply is for benefits received for **execution-only** transactions where no advice is given: section 963A(1)(c).

As with the existing law, none of these provisions apply to dealings or advice given to **wholesale clients**.

Prohibition should apply to Personal, not General advice

One of the primary concerns we have with the conflicted remuneration provisions is the fact that they apply to the provision of **both general and personal advice**. Expanding the scope of FOFA to general advice unnecessarily complicates the implementation and administration of the regime and results in a number of what we believe are unintended consequences. We believe including general advice in the FOFA provisions makes the scope so broad that it is virtually unworkable as a reform package and will be incredibly difficult to implement into business operations.

In our opinion, the inclusion of general advice goes well beyond the original intention behind FOFA i.e. removing the risk of retail clients receiving conflicted advice that may be inappropriate for them due to the fact that the adviser/financial planner is paid a commission. By definition, **general advice does not take into account a person's needs or objectives so it is not appropriate to apply a conflicted remuneration regime when a recommendation is not being made based on the person's individual circumstances**.

The scope of FOFA needs to be narrowed back to its original intent. Financial advisers that are paid commissions in respect of the advice that they provide to their clients are generally (if not always) providing personal advice and in our opinion it is this type of advice that was intended to be addressed by FOFA. We understand that the Government is concerned that if it was only personal advice that was captured, then parties providing financial advice would rely on general advice as a business model. With respect, we contend that this is an unlikely scenario because the fundamental value proposition of any party that provides personal advice (including stockbrokers and financial planners) is that they provide advice that it **tailored** to the needs of their clients. This value proposition is not possible within the framework where only general advice is provided.

For these reasons, our view is that the FOFA reforms should only apply to the provision of **personal advice.**

Stockbrokers Carve-outs

The two carve-outs of particular interest to our Members are of course those relating to **Stamping Fees** and **Commission Splitting**. **Stamping Fees** are fees earned by brokers in the sale of new securities to clients on behalf of a company in order to raise capital. **Commission Splitting** refers to the traditional and widespread stockbroker's remuneration model in which the adviser is paid a proportion of the brokerage paid by the client to the firm.[3] These carve-outs are not outlined in detail in the Bill. However, they will be set out in later Regulations to be made after the passage of the Bill, under the regulation-making power to exempt '*prescribed benefits…given in prescribed circumstances*' in section 963A(1)(e) and section 963B(f).

The *Explanatory Memorandum* to the Bill refers to the carve-outs for Stamping Fees and Commission Splitting as follows:

(Stamping Fees)

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

(Commission Splitting)

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

We welcome the Stockbrokers Carve-Outs, but are unable to provide detailed comments at this stage without further detail of the substance of the provisions, which we understand will not be available until consultation commences on the draft Regulations. Until that time, we look forward to further assisting in the consideration of the appropriate circumstances of the carve-outs, or any other matter which you may wish to discuss. However, at this time we would like to mention four aspects of the stockbrokers carve-outs, namely employment arrangements, intermediary arrangements, stamping fees and cash management trusts.

[3] Further details of these arrangements are set out in our Submission of 8 August 2011, referred to in Note 1 above.

a. Stockbrokers Employment Arrangements

It is common in stockbroking for advisers to engaged on an exclusive contractual basis, rather than a normal employee arrangement. This is merely for tax or other purposes: in every other respect the adviser is an employee of the firm just like any other. We trust that the **Commission Splitting** carve-out will be flexible enough to encompass these **alternative employment arrangements**.

b. Intermediary arrangements

Despite some indications from Treasury that certain carve outs from the conflicted remuneration provisions under FOFA would be provided in relation to 'intermediary share broking' arrangements, we remain concerned that a number of our Members' business models could be adversely impacted by the FOFA reforms, particularly –

- Execution arrangements between stockbrokers and financial advisers who are not market participants, and
- White label arrangements.

There appears to be minimal risk to customers of receiving conflicted advice in these arrangements, which are transparent and product neutral and no evidence of any historical market failure that needs to be corrected.

c. Stamping Fees

As it is currently drafted, it appears that sections 963 and/or 964 could prohibit 'subunderwriting' or 'firm allocation' fees paid by a lead or joint lead manager to an IPO or placement of securities to licensees which provide financial product advice to retail clients, as consideration for that licensee undertaking to subscribe for, or procure others to subscribe for, an agreed quantity of financial products. These payments would arguably be caught by the draft provisions on the basis that they are either payments which 'might otherwise influence the financial product advice given to retail clients by the licensee' (s963(1)), or payments made by an issuer or seller of a financial product (s964(1)) – although in relation to s964, it is not clear whether an 'issuer or seller' would include a lead manager in this situation.

In addition, it appears the current drafting of section 963 would prohibit payments made by licensees to their representatives that are determined according to the level of brokerage and other capital market related fee revenue generated for the firm by the adviser's efforts. Brokerage fees themselves are arguably carved out of the current draft (on the basis that they are a benefit given by the client to the licensee in connection with financial product advice given by the licensee under s963A(d)), but incentive payments made by the licensee to its

representatives that are based on brokerage levels or other capital market related fee activity would currently be banned by section 963(2) of the draft legislation. Such a result would be counter to all the indications from the Minister and our related discussions that made it clear that 'traditional remuneration arrangements' of stockbrokers, and 'stamping fees' would not be affected. **It is essential for the continued sound functioning of Australian capital markets that the proposed regulations are sufficiently broadly drafted to enable the continued payment of fees of the nature described above, and to enable licensees to continue to pay their representatives incentives that are based on the amount of those fees.**

d. Cash Management Trusts

CMT's are commonly used by clients as a bank account facility that earns better interest than normal bank deposits, but with just as much flexibility, so that cash is readily accessible for settlement of market transactions. It is common for banks to pay a commission to stockbrokers and other financial services providers in respect of their clients' cash management trust balances. We note earlier discussions, which are now reflected in the proposed law, that if purely factual information about CMT's is provided to clients – i.e. no advice is given - then the conflicted remuneration provisions will not apply to CMT's. Indeed, the treatment of CMT's as bank facilities is consistent with other existing *Corporations Act* provisions which do not require Statements of Advice to be provided in respect of personal advice on CMT's[4].

Asset-based fees on Ungeared portfolios

Earlier in the FOFA process, it appeared that if **any portion** of a client's investments were funded by borrowings (i.e. 'geared'), asset-based fees could not be charged on the **entire portfolio**. Our members therefore welcome the provisions in the Bill which clarify that the ban only applies to the **ungeared portion** of the client's investments: section 964F. The *Explanatory Memorandum* states:

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

The exception in the Bill applies where it is not *reasonably apparent* that the investments are geared. Section 964F(2) states -

[4] Section 946B(5), as modified by Regulation 7.7.10AE (Dec.2005)

> Subsection (1) *[i.e. the prohibition on charging asset-based fees on geared funds]* does not apply if it is not reasonably apparent that the funds used or to be used to acquire financial products by or on behalf of the client are geared funds.

We trust that the provisions of the Bill achieve the aim as expressed in the *Explanatory Memorandum* above, as there is some ambiguity in the language of the Bill. For example, it would assist if the prohibition more clearly applied only to the geared component, not the ungeared component.

a. Definition of 'asset based fee'

The draft definition of 'asset based fee defines the fee as one that is based on the size of the client's (initial?) contribution to the portfolio. However, the most common fee arrangement (and the commonly accepted definition of the term "asset based fee") is a fee which is determined according to the size of the client's portfolio from time to time, not the amount of money they may have initially invested in the portfolio.

We therefore **recommend** that the definition of 'asset based fee' is amended to refer to a fee that is **based on the size of a client's portfolio at or around the time the relevant fee is calculated**.

b. Description of the prohibition

The prohibition applies to charging an asset based fee on geared funds used or to be used to acquire financial products. As noted above, asset based fees are typically based on the size of the client portfolio at the relevant time. Accordingly, we **recommend** that, rather than banning a fee on 'geared funds', the prohibition might be more effectively formulated as a prohibition on **charging an asset based fee on the portion of a client's portfolio that represents the amount of the borrowings incurred by the client in order to acquire that portfolio that are outstanding at the time the relevant fee is calculated.**

c. Application of the prohibition only when gearing was recommended

The prohibition applies whether or not the client's adviser actually advised them to borrow to invest. As a result, it unfairly penalises advisers who 'inherit' clients with an existing loan arrangement, and advisers whose clients make their **own decisions** regarding how they will fund their portfolios. It goes beyond the objective behind the provisions of ensuring that advisers who recommend gearing to their clients appropriately manage the conflict that may be created by an asset based fee. We therefore **recommend** that the prohibition should **only apply** in situations where the **client took out a loan on the advice of their adviser**.

d. Obligation on advisers to enquire about client's borrowings

In order to ensure that they are not charging a prohibited asset based fee, advisers will need to make additional enquiries to confirm the client's source of funding. This is inconsistent with the Government's initiatives to support the provision of scaled advice. We therefore **recommend** that the prohibition should **only apply** in situations where the **client took out a loan on the advice of their adviser**.

Other FOFA matters and consultations

Finally, we look forward to further detail about other aspects of the wider FOFA project, in particular –

- the review of the **definitions of 'retail' and 'wholesale'** investors[5], and
- the results of Mr St John's inquiry into **compensation arrangements**[6].

We are once again grateful for the opportunity to raise these matters with the Government in the process of the enactment of these important matters of policy and law reform, and for the continuing dialogue with Treasury and ASIC officers.

We would of course be happy to discuss further any of the matters raised in this Submission, and look forward to working with Treasury in the drafting of the Regulations which will give effect to many of the reforms.

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[5] FOFA Options Paper *Wholesale and Retail Clients* 26 January 2011
[6] FOFA Consultation Paper *Review of compensation arrangements for consumers of financial services* April 2011