Australian Government

The Treasury

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the Corporations Amendment (Future of Financial Advice) Bill 2011

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INTRODUCTION

1. Treasury's submission to this Inquiry addresses the measure contained in Corporations Amendment (Future of Financial Advice) Bill 2011 (the Bill).

2. Further, the submission provides an overview of the initiatives the Government has announced in relation to its ***Future of Financial Advice*** (FOFA) reforms.[1]

FINANCIAL ADVICE

The provision of financial advice

3. The Government has announced reforms in relation to the provision of financial advice, focused on enhancing the quality of financial advice.

4. Concerns about the quality of financial advice and in particular the potential for conflicts of interest to result in consumer detriment were considered by the 2009 ***Inquiry into Financial Products and Services in Australia*** (the Ripoll Report)[2] by the Parliamentary Joint Committee on Corporations and Financial Services, which was set up in the wake of collapses such as Storm and Opes Prime.

Future of Financial Advice reforms

5. In response to the recommendations of the Ripoll Report, the Government announced the FOFA reform package, which is focused on improving the quality of advice, strengthening investor protection and underpinning trust and confidence in the financial planning industry.

6. The objectives of the FOFA reforms are twofold:

   - ensuring that financial advice is in the client's best interests – distortions to remuneration, which misalign the best interests of the client and the adviser, should be minimised; and

   - making financial advice accessible to those who would benefit from it.[3]

7. Among the key reforms is a prospective ban on conflicted remuneration structures, including commissions, volume-based payments and soft-dollar benefits of $300 or more, in relation to the distribution of and advice on retail investment products.[4] The prospective ban also extends to up-front and trailing commissions. The reforms will also ensure that percentage-based fees (known as assets under management fees) can only be charged on ungeared products or investment amounts.

8. The reforms will reduce conflicted remuneration structures in relation to advice on, and distribution of, retail financial products and certain risk insurance policies

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1 Further information is available at futureofadvice.treasury.gov.au.

2 Further information is available at www.aph.gov.au.

3 'Overhaul of Financial Advice', media release by the former Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, 26 April 2010, available at futureofadvice.treasury.gov.au

4 There are carve-outs from the ban on soft-dollar benefits for professional development and administrative IT services if set criteria are met.

within superannuation. The measure is targeted at removing the current potential for product providers to influence adviser recommendations, as well as targeting other payments which have similar conflicts to product provider set remuneration and that otherwise do not engender the right behaviour. The measure in relation to percentage-based fees is targeted at conflicts of interest where an adviser is incentivised to recommend leverage to increase funds under management and hence fees.

9. The reforms include other measures to improve the quality of advice, enhance consumer protection and enshrine the focus of the adviser on the best interests of the client.

10. There will be a best interests duty for financial advisers, requiring them to act in the best interests of their clients (when giving personal advice to retail clients). In order to ensure clients understand ongoing fees and to give them an opportunity to consider whether they are receiving value for money, advisers will also be required to get retail clients to opt-in (or renew) their advice agreement every two years.

11. In addition to these changes to enhance consumer protection and improve the quality of financial advice, the Government has committed to ensuring that Australians have greater access to affordable advice. To this end, the reforms include an expansion in the provision of limited or scaled advice, which will be of particular benefit to individuals and families who may only want piece-by-piece advice rather than a complete financial plan.

12. The majority of the reforms, including the prospective ban on conflicted remuneration, compulsory renewal (opt-in), and the statutory fiduciary duty, are intended to apply from 1 July 2012.

Corporations Amendment (Future of Financial Advice) Bill 2011

13. The Bill represents the first of two legislative tranches to implement the FOFA reforms. This Bill (tranche 1) contain two key FOFA measures:

    - A requirement for providers of financial advice to obtain client agreement to ongoing advice fees and enhanced disclosure of fees and services associated with ongoing fees; and

    - Enhancements of the ability of the Australian Securities and Investments Commission (ASIC) to supervise the financial services industry through changes to its licensing and banning powers.

14. The Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (tranche 2), which was introduced into Parliament on 24 November 2011, contains further FOFA measures, including:

    - The imposition of a best interests duty on financial advisers, requiring them to act in the best interests of retail clients when providing personal financial product advice;

    - A ban on financial advisers receiving remuneration which could reasonably be expected to influence the financial product advice provided to retail clients;

- A ban on the charging of asset-based fees (fees calculated as a percentage of client funds under advice or management) on the borrowed monies of retail clients; and

- A ban on volume-based shelf-space fees from funds managers to administration platform operators.

Compulsory renewal requirement (opt-in)

15. Financial advisers are traditionally remunerated differently from other occupations. For example, many advisers have traditionally received commissions from product providers for placing clients with particular products, sometimes paid as a percentage of funds under management. Some commissions are ongoing in nature, forming what are known as 'trail' commissions.

16. In situations where the client pays a substantial proportion of the adviser's remuneration directly (known as 'fee for service') it is common for this remuneration to be ongoing in nature. For example, an adviser might charge a client an ongoing annual fee calculated as a percentage of the client's funds under management (known as an asset-based fee) or a flat dollar amount. This annual fee generally covers a range of advisory services provided to (or available to) clients. As opposed to professions or other occupations that tend to charge for transactional, one-off services or advice, advisers' remuneration structure is partly reflective of the notion that the benefits of financial advice tend to be realised over the medium to long-term, and therefore remuneration structures tend to reflect the ongoing nature of the adviser-client relationship.

17. As a result of this unique remuneration structure, in some situations clients of advisers that pay ongoing fees for financial advice receive little or no service. Of the clients that do receive a service for the fees they are paying, some are unaware of the precise magnitude of those fees (or the fees advisers are receiving from third parties) or they continue paying ongoing fees as a result of their own disengagement. This is despite the fact that most ongoing advice contracts allow a client to 'opt-out' at any time.

18. The concept of compulsory renewal of ongoing advice fees, requiring the active renewal by the client to ongoing fees, is designed to protect disengaged clients from paying ongoing financial advice fees where they are receiving little or no service. For those clients that are not disengaged, the renewal requirement will provide them with an opportunity to consider whether the service they are receiving equates to value for money.

19. The Bill contains two legislative requirements on financial advisers that charge ongoing fees to retail clients. Although separate obligations, the compulsory renewal notice and fee disclosure obligations combine to amount to what is commonly referred to as 'opt-in'. In practical terms this means that advisers need to both disclose relevant fee and service information to their clients, and, armed with this information the clients decide whether they wish to continue paying ongoing advice fees to their adviser.

20. These requirements are a variation of an original Government policy of a compulsory annual opt-in requirement. After extensive consultation with stakeholders, and after giving due consideration to the administrative costs to business and balancing this

with the potential benefits to clients, the Government decided to amend the opt-in policy to a two-yearly requirement. A longer period between opt-in requirements is still intended to achieve the policy objective and ensure that advisers are in regular contact with clients. It also provides some flexibility regarding implementation and recognises the concerns advisers have raised about the administrative cost of implementing the opt-in requirement.

21. The compulsory renewal aspect of the policy makes inferences about the intention of the consumer. Specifically, the Bill assumes that by not actively agreeing to paying ongoing fees, the client has chosen through their inaction to discontinue paying those ongoing fees and as a result the advice relationship terminates.

22. The compulsory disclosure and renewal notice obligations will apply to advisers where they provide personal advice to a retail client, and the client pays a fee which does not relate to advice that has already been given (at the time the arrangement is entered into). In other words, these obligations apply to 'ongoing fees', rather than one-off transactional fees. The obligations become relevant to ongoing fees which are charged for 12 months or more (in the case of disclosure) and 24 months or more (in the case of compulsory renewal).

    - If an ongoing fee arrangement is to remain in place for a period longer than 12 months, the adviser is required to provide the client with a fee disclosure statement within a period of 30 days beginning on the 12 month anniversary of the day the arrangement was entered into.[5]

    - If an ongoing fee arrangement is to remain in place for a period longer than 24 months, the adviser is required to provide the client with a renewal notice within a period of 30 days beginning on the 24 month anniversary of the day the arrangement was entered into.

23. Certain arrangements not caught by the obligation include:

    - Where a person is paying an adviser by instalments for advice that has already been provided before the arrangement is entered into (a payment plan);[6]

    - The ongoing payment of an insurance premium; and

    - The ongoing payment of a product fee.

24. The renewal notice and fee disclosure statement will need to contain fee information to assist in informing the client of the value they are receiving from their adviser. This will include fee information for the following 12 months so that the client should be well informed as to the fees they will be paying if the relationship is to continue.

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5 Alternatively, if a fee disclosure statement has been given to the client since the arrangement was entered into, the adviser is required to provide the fee disclosure statement to the client within a period of 30 days beginning on the 12 month anniversary of the day on which a disclosure statement was last given. The same principle applies in relation to the relevant anniversary dates for the compulsory renewal notice.

6 However, the arrangement which purports to be a payment plan must resemble a payment plan. For example, if the client has the right to opt-out any time, or if the fee is charged as a percentage of funds under management, then those fees are unlikely to represent instalment payments for advice or services that have already been provided.

25. The key difference between the renewal notice and fee disclosure obligations is that the renewal obligation requires an active response from the client for the ongoing fee arrangement to continue, whereas the disclosure notice does not.

    - If, after receiving the renewal notice, the client does not notify the adviser in writing that they wish to renew the ongoing fee arrangement, the arrangement terminates at the end of an additional 30 days after the renewal period.[7]

    - The Bill infers a client's failure to respond to a renewal notice to mean that the client does not wish to renew the ongoing fee arrangement. This might be due either to the client's disengagement or to a conscious decision by the client not to actively renew because, for example, they considered they were not receiving value for the fees they were paying.

26. The fee disclosure statement and renewal notice could take simple forms. Provided the required information is contained in those notices, advisers have flexibility in how they present these documents. We anticipate that product and platform manufacturers will play a role in facilitating the opt-in process for advisers, including by producing templates which are user-friendly for both the adviser and consumer.

27. There are implications for advisers that do not provide the renewal notice or fee disclosure notice by the relevant date.

    - The client is not liable to continue paying the ongoing fee (whether or not it is the previous or current adviser that failed to comply with the requirement);

    - The client is not taken to have waived their rights or to have entered into a new ongoing fee arrangement by merely continuing to pay an ongoing fee after a breach of the renewal obligation;

    - While not endowed with absolute statutory right of a full refund in this circumstance, the client (or ASIC) has the right to apply to the Court for a refund where an adviser has knowingly or recklessly continued to charge a client ongoing fees after an arrangement has terminated as a result of breaching the disclosure or renewal obligations.

28. Although the fee disclosure statement and the renewal notice are required to be provided within a period of 30 days beginning on the relevant anniversary date (12 months since the arrangement began in respect of the disclosure obligation, and 24 months since the arrangement began in respect of the renewal notice obligation), nothing prevents an adviser from providing these notices in advance of the prescribed time periods in order to satisfy the obligations sooner than is actually required if it is convenient to do so.

    - To the extent these obligations are fulfilled by advisers in advance of the prescribed periods, the time within which these obligations need to be fulfilled in the future will 'reset', with the creation of new disclosure and renewal notice days.

    - Because the anniversary date 'resets', discharging this obligation ahead of schedule will not afford the adviser any additional time before the next notice or

7 The renewal period is a period of 30 days beginning on the day on which the adviser gives the client a renewal notice and a fee disclosure statement.

statement must be sent. However, it does provide additional flexibility for the adviser to discharge the obligations at times when it is most convenient for the them and their client.

29. There are also applicable civil penalties should an adviser continues charging a client after the arrangement has terminated (if, for example, a client chooses to opt-out).

- Maximum civil penalties for such a breach are $50,000 for an individual and $250,000 for a body corporate. These are smaller maximums than apply for other breaches of the corporations Act which attract maximum penalties of $200,000 for an individual and $1 million for a body corporate.

- It is expected that maximum penalties would apply only in the most serious of breaches of these provisions.

- In most cases such a breach would be considered relatively minor, particularly if the breach was due to an administrative error and unintentional. In most cases it is envisaged that the situation would be remedied by the adviser returning the client's money in a prompt fashion, negating the need for any further action to be taken.

30. The compulsory renewal and disclosure obligations apply to ongoing fee arrangements entered into on or after the commencing day and where the client has not received financial advice from the licensee prior to the commencing day. This ensures that the key components of opt-in – those that can result in termination of ongoing fee arrangements – apply prospectively (that is, to new clients).

31. For all other ongoing fee arrangements to which the key compulsory renewal and disclosure obligations do not apply, there is a separate obligation for advisers to provide fee disclosure statements in relation to those other arrangements. This ensures that for arrangements that are already in place prior to the commencement date that the opt-in policy cannot result in termination of those arrangements, but still ensures that the client remains informed of the fees they are paying and the services they are receiving or entitled to access from their adviser.

32. The opt-in measures are intended to commence on 1 July 2012.

Enhancements of ASIC's powers

33. The Bill also contains measures relevant to enhancing ASIC's powers to better enforce the financial services law and to be able to intervene more proactively when it believes a breach of the law is likely or imminent. ASIC outlined what it saw as the limitations in its regulatory powers before this same committee in 2009.[8]

34. During this committee's 2009 Ripoll Report, ASIC raised concern with its ability to protect investors by restricting or removing industry participants who might cause or contribute to adverse investor outcomes. ASIC consider this issue arises as:

- the threshold for entry into the licensing regime is 'low' while the threshold for cancelling a licence is 'relatively high'; and

8 PJC Inquiry into financial products and services in Australia, Submission by the Australian Securities and Investments Commission, August 2009

- the regime focuses on entities rather than its agents (such as employees or directors) which means ASIC cannot prevent persons from entering the industry and can have difficulty removing them.[9]

35. In its submission to this committee in 2009, ASIC noted that licensing decisions can be appealed to the Administrative Appeals Tribunal (AAT). ASIC has had difficulty establishing before the AAT that a licensee 'will not' comply with its obligations in the future. Further, when considering whether a licence should be granted, it has been difficult for ASIC to assess whether an applicant 'will not' comply with their obligations and meet their licence conditions before they have commenced business.[10]

36. ASIC has experienced problems when trying to exercise its powers to ban persons from providing financial services. It has had difficulty in establishing that it has a reasonable belief that the person 'will not' comply with their obligations under financial services law: see ***Re Howarth and ASIC*** [2008] AATA 278.

37. ASIC found it difficult to prove that a broader range of conduct (aside from convictions for fraud) can establish a belief that the individual 'will not' comply with their obligations under financial services law in the future. For example, ASIC has been unable to establish that certain conduct should give rise to a banning order based on a finding under paragraph 920A(1)(f) of the Corporations Act, including:

    - failure to comply with the principal's internal guidelines and procedures;
    - failure to comply with the relevant ASX business rules; or
    - conduct which may amount to a serious conflict of interest.[11]

38. ASIC has also argued that, under its powers, it cannot ban individuals on the basis that they are not 'fit and proper' (for example, not competent or of good fame or character).[12]

39. ASIC has experienced difficulty in relation to the banning of individuals because of the focus on entities in the Corporations Act. Licensing generally occurs at the entity level and ASIC does not approve the agents or representatives of that entity. Further the obligations in the Corporations Act are largely imposed on the licensee (the entity), not the representatives who work for that entity.[13] For example, the requirement to have a reasonable basis for advice under section 945A of the Corporations Act applies to a providing entity, which includes the licensee and authorised representative. The provision does not directly apply to an employee or director.[14]

40. Further to ASIC's experience in using its powers, broader concerns have been raised about the effectiveness of licensees being responsible for the actions of their

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9 Ibid, 24.
10 Ibid, 26, 31.
11 Ibid, 33.
12 Ibid, 32.
13 Under the Corporations Act, some of the Chapter 7 conduct and disclosure obligations are also imposed on an authorised representative, in addition to the licensee. However obligations are not generally imposed on other representatives, such as employees and directors.
14 Ibid, 26.

representatives, with implications for the professionalism of the industry, as well as investor protection. This issue was considered in the Ripoll Report.

41. It is recognised that while there are important reasons for the current formulation of ASIC's powers (around, for example, natural justice for licensees and their representatives), current evidentiary thresholds make it very difficult for a regulator to be proactive in protecting consumers before an adverse outcome takes place. Under current arrangements, it is relatively easier to be reactive by enforcing the law after it has been breached and after potential adverse outcomes have already taken place.

42. In light of the above concerns, in the Ripoll Report recommended that the Corporations Act should be amended to provide extended powers for ASIC to ban people from the financial services industry under section 920A (recommendation 6). It also recommended that ASIC be able to deny a licence application or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with its obligations under sections 913B and 915C of the Corporations Act (recommendation 8).[15]

43. As a result of this recommendation, the Bill clarifies the operation of ASIC's banning power and sets out new tests under which ASIC can exercise its discretion to remove persons from the financial services industry. Details around the precise amendments are available in the explanatory memorandum, or at attachment A to this submission.

15 Ibid, 151.

ATTACHMENT A

Details on the amendments to enhance ASIC's powers

44. ASIC may ban a person if either statutory tests under paragraphs 920A(1)(ba) and 920A(1)(f) of the Corporations Act are satisfied.

45. The amendment to the statutory tests is whether the person is likely to contravene its obligations under section 912A or financial services law, rather than they will contravene the obligations (that is, the person will not comply with its obligations or financial services law). In the 10 years since the introduction of the Financial Services Reform Act, interpretation of this provision has tended to a view that ASIC is required to believe, as a matter of certainty, that the person will contravene the obligations in future. Such a standard would be so onerous that it could result, in practice, in ASIC never being able to ban a person using these tests. This new formulation is designed to ensure that ASIC can more appropriately account for the likelihood or probability of a future contravention.

46. There is no policy change relating to the replacement of 'comply' with 'contravene' in both amendments. It brings consistency with similar provisions ASIC also administers under the National Consumer Credit Protection Act 2009.

47. The Bill includes new tests for when ASIC can make a banning order against a person. The tests relate to a person's fame and character and competence. In essence, this introduces a 'fit and proper' test however the limbs of good fame and character and competence are adopted for consistency with the rest of the Corporations Act which uses the good fame and character test.

48. ASIC can ban a person if their conduct gives ASIC reason to believe they are not of good fame and character. In determining whether a person is not of good fame and character ASIC must take into account (subject to Part VIIC of the Crimes Act relating to spent convictions):

    - any conviction of the person, within 10 years before that time, for an offence that involves dishonesty and is punishable by imprisonment for at least three months; and
    - whether the person has held a licence that was suspended or cancelled; and
    - whether a banning order or disqualification order under Division 8 has previously been made against the person; and
    - any other matter ASIC considers relevant.

49. The factors that ASIC must take into account in considering whether a person is not of good fame and character is consistent with the factors used in its decisions on licensing.

50. Given that it can be expected that ASIC will principally use this power to ban individuals, this would enable ASIC to take into account conduct such as where:

    - ASIC believes the individual has committed a fraud, but the individual has not been prosecuted or there is a delay or uncertainty in prosecution;

- the individual has engaged in conduct causing serious detriment or financial loss to consumers, so that there is a need to protect the public;
- the individual has been subject to adverse findings in relevant criminal or civil proceedings, reflecting on their character;
- the individual has demonstrated a consistent failure to comply with the law, or with directions from any licensee or employer; or
- the individual has been a director or senior manager of a licensee that has had its licence suspended or cancelled.

51. Further, the amendment also introduces a statutory test that ASIC can ban a person if their conduct gives ASIC reason to believe they are not adequately trained or competent to provide financial services. It is expected that ASIC will principally use this power to ban individuals where the person lacks appropriate skills, knowledge and experience to provide financial services.

52. The Bill also clarifies ASIC's ability to ban individuals, given the focus of obligations on the entity or licensee. The Bill extends the grounds of banning to whether the person is involved in (or likely to be involved in) a contravention of a financial services law, which enables ASIC to take into account conduct where the person is not under a legal responsibility to comply with the legislation themselves but they contributed or caused another person to breach the legislation. Where the licensee is, for example a body corporate, then any contravention of the law will necessarily be the result of an act or omission of a natural person, such as a director or employee. The amendments clarify that ASIC can take into account conduct of these persons where they have been involved in a contravention of the financial services law, in deciding whether or not these individuals should be banned. The amendment also applies in circumstances where the licensee is a natural person, but an employee of the licensee was involved in a contravention of the licensee's obligations under law.

53. Under existing section 79 of the Corporations Act, a person is 'involved in' a contravention of a financial services law if the person:

- has aided, abetted, counselled or procured the contravention; or
- has been induced, whether by threats or promises or otherwise, the contravention; or
- has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or
- has conspired with others to effect the contravention.

54. To avoid doubt, the Bill also clarifies that a person contravenes a financial services law if a person fails to with comply with the duty, even if the provisions which impose the duty is not an offence or civil penalty provision.

55. The amendments are intended to commence on 1 July 2012.