Ending Grandfathered Conflicted Remuneration for Financial Advisers

Submission to Treasury

22/3/19

FSC FINANCIAL SERVICES COUNCIL

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FINANCIAL SERVICES COUNCIL

1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2. Response to Draft Bill

2.1. Background

On 28 September 2018, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**RC**) released its Interim Report. In his Interim Report, the Commissioner asked the following questions:

> "*Should the grandfathering exceptions to the conflicted remuneration provisions now be changed? How far should they be changed? If they should be changed, when should the change or changes take effect?"*

In our submission in response to the Interim Report, on 26 October 2019, we stated our position as follows:

> *"The FSC supports:*
> - *the ceasing of the grandfathering of conflicted remuneration payments (apart from payments made under the LIF grandfathering regime[1]) and, so far as is possible and practicable, issuers redirecting these payments to consumers; and*
> - *the ceasing of the grandfathering of volume-based shelf space fees,*
>
> *via legislated change.*
>
> *We support the cessation of these payments as soon as practicable (to enable implementation). We recommend that there be consultation on this aspect.*
>
> *The FSC would like to reinforce that it strongly supports the LIF Reforms and reiterates its comments in this regard in its submission in relation to the Round 6 Insurance Hearings, responding to policy question number 8."*
>
> (***FSC's Position***)

In the RC's Final Report, the Commissioner recommended that the grandfathering provisions for conflicted remuneration should be repealed as soon as is reasonably practicable.[2]

On 4 February 2019, the Government released its response to the RC's recommendations[3]. The Government agreed to end grandfathering of conflicted remuneration, effective from 1 January 2021. In fact, it went further than the RC, and committed to ensuring that the benefits of removing grandfathering would be passed on to clients (**Government Position**).

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[1] "LIF grandfathering regime" is a reference to the grandfathering regime that was introduced by the *Corporations Amendment (Life Insurance Remuneration Arrangements) Act* 2017 (Cth) and the *Corporations Amendment (Life Insurance Regulation Arrangements) Regulations (2017)* (Cth).

[2] Recommendation 2.4 of the RC's Final Report

[3] See: https://treasury.gov.au/publication/p2019-fsrc-final-report

The draft Bill upon which Treasury has sought consultation seeks to bring into effect the Government Position. As can be seen from our previous submission, the FSC wholly supports the Government Position. However, we consider that parts of the draft Bill require further clarification in order to achieve the Government Position. This response seeks to highlight the key areas of concern for our members. It then provides some detail as to the changes to the Bill (and proposed Regulations) that we consider necessary.

2.2. Key Issues

The key issues we seek to raise with the current drafting of the Bill are as follows.

A. LIF Reforms not to be included

The RC's recommendation regarding grandfathered conflicted remuneration was contained in Recommendation 2.4. Recommendation 2.5 related solely to the exception to the ban on conflicted remuneration for life risk insurance products. The Commissioner recommended that, when ASIC conducts its review of life risk insurance products, it should consider further reducing the cap on commissions in respect of life risk insurance products. In response, the Government stated that it supports ASIC conducting its review of the reforms to life insurance remuneration in 2021, and taking into account the factors identified by the RC in its Final Report. There has been no indication by the RC or the Government that the cessation of grandfathering should in any way affect the LIF Reforms. We are pleased to see that the drafting of the Bill does not appear to affect the LIF Reforms (however we have sought some clarification regarding Treasury's intention with respect to the proposed Regulations).

B. Legacy Products

The cost of grandfathered conflicted remuneration payments is often incorporated into a bundled administration fee. In many cases, the manufacturer cannot cease paying these commissions without making substantial changes to the product administration systems and/or redesigning the product pricing model.

Rather than restructuring old products, it may be more efficient for the product manufacturer to transfer customers to more contemporary, non-commission paying products, ensuring at all times that any such transfer is in the best interests of customers.

The FSC has for many years strongly supported and advocated for appropriate regulatory frameworks to facilitate rationalisation of legacy financial products.[4] Rationalisation should remove outdated and often more expensive products (often due to attached commissions), while providing a fair outcome for consumers. The FSC urges Treasury to ensure appropriate options are available to the product manufacturer to respond to the ending of the grandfathering provisions in a manner which benefits customers.

[4] Please read: https://consult.treasury.gov.au/budget-policy-division/2018-19-pre-budget-submissions/consultation/view_respondent?sort=excerpt&order=ascending&_b_index=120&uuId=596571344 for full details of the FSC's policy position regarding legacy products.

While the design of modern products may provide better consumer outcomes, current mechanisms for moving clients from legacy products to new products can create costs for consumers, including:

- tax consequences such as CGT and stamp duty;
- clients may be charged exit fees (noting that these fees will be banned for superannuation products from 1 July 2019); and
- clients may require financial advice on the replacement of products.

Addressing these issues will substantially reduce costs to members and enable them to move into more up to date products with better customer benefits where it is in their best interests to do so.

The FSC proposes a common rationalisation regime that could be applied to any financial product. The rationalisation scheme would have the following components:

- a consumer interest test which would apply at the group level to assess whether moving clients into the new product is in the best interests of clients as a group[5];

- ASIC would have a role to play to ensure that, on balance, customers are better off as a result of the rationalisation; and

- the tax attributes of the legacy product should be able to be rolled over to the destination product, meaning the product transfer should not trigger a tax event.[6]

Where clients are moved out of legacy products and into new products (where it is in their best interest to do so), the obligation to rebate commissions to clients would not arise as product manufacturers do not have arrangements to pay commissions with respect to these new products.

C. Entity responsible for rebating clients

We consider that the product manufacturer (namely the issuer of the product) generally is better placed to rebate the client for the following reasons:

- allowing the holder of an Australian Financial Services Licence (**Advice Licensee**) to rebate the conflicted remuneration means that it would be lawful for the product manufacturer to pay the conflicted remuneration to the Advice Licensee, which would be inconsistent with the Government Position of terminating grandfathered commission arrangements;
- a product manufacturer would generally be better equipped to implement, manage, control and monitor processes to equitably pass back potentially hundreds or thousands of individual payments to customers through centralised systems than for

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[5] For further information on the consumer interest test, please see pages 9 – 10 of the FSC's 2019-2020 Federal Budget Submission to Treasury.
[6] We appreciate that stamp duties are within the remit of State and Territory Governments. However, we are hopeful that the Commonwealth could facilitate dialogue in this context.

Advice Licensees or their representatives, given Advice Licensees and representatives often operate as small businesses;

- it would be easier for ASIC to verify whether the payments are being passed back to customers if the obligation was managed by a large corporate entity rather than hundreds of individual businesses;
- it would be more efficient and quicker for the product manufacturer to pay the client directly rather than having the product manufacturer pay the Advice Licensee and then for the Advice Licensee to on forward the payment the client;
- subject to system limitations, the product manufacturer is the entity that controls pricing of a product and could give the client a reduction in a product fee instead of paying the clients small amounts of cash (paragraph 1.17 of the draft Explanatory Materials (**EM**) refers to the reduction of a fee as a possible way to rebate a client which it is envisaged will be contained in the proposed Regulations). The Advice Licensee cannot control pricing of the product; and
- if the Advice Licensee was permitted to refund cash deposits to their customers, superannuation members could effectively receive early release payments from preserved funds.

While the Bill does not name the product manufacturer as being responsible for rebating, we think the better reading of the Bill would mean that the product manufacturer was responsible, in most instances. As a general principle, the person originating the payment should be responsible for rebating the client. We believe in the majority of cases that this would be the product manufacturer, but the EM should include guidance that, in some instances, it may instead be the Advice Licensee or employer.

D. Payments that are not referable to individual clients

Section 963N (Regulations may provide for rebate of conflicted remuneration) of the draft Bill envisages that a scheme will be set up under the Regulations to provide for a person who paid conflicted remuneration to rebate that amount to the relevant person to whom the Advice Licensee gave advice as a retail client. It does not refer specifically to the situation where product manufacturers pay Advice Licensees a benefit based upon the volume of a financial product acquired by the Advice Licensees' clients over a certain period. In this situation, the benefit could not be attributable to particular retail clients, only to the acquisition of certain products by a group of clients in respect of whom the Advice Licensee provides advice or other financial services. Therefore, a mechanism is required for product manufacturers to rebate these clients as a cohort. In keeping with the drafting of the Bill, such a mechanism could be contained in the Regulations. The FSC asks that industry be consulted on the Regulations to ensure rebating of volume-based payments is fair and equitable to clients, while at the same time, efficient to providers.

2.3. Detailed Suggested Amendments

We deal with the specific changes we seek to the Bill (or suggested inclusions to the proposed Regulations) below.

Reference	Issue	Suggested Solution
Ban on conflicted remuneration S1528	In order to achieve the Government Position, certain Regulations need to be repealed. Item 1.6 of the EM stipulates that the Government will repeal a number of grandfathering arrangements which are continued in Part 7.7A of the Corporations Regulations. We set out in the next column the Regulations which we believe need to be repealed or changed to give full effect to the Government Position. In accordance with the Government's response to the RC's Recommendation 2.5, Regulations regarding the treatment of life risk insurance products (other than a group life policy for members of a superannuation entity or a life policy for a member of a default superannuation fund) should not be repealed.	Repeal Regulations (note: this may not be an exhaustive list) 7.7A.15B, 7.7A.16; Amend Regulations 7.7A.16A and 7.7A.16B. Do not repeal Regulations 7.7A.11B, 7.7A.11C, 7.7A.11D, 7.7A.12EB, 7.7A.12EC, 7.7A.16G and 7.7A.16H
Rebate of conflicted remuneration S963M	We understand that S963M and S963N were drafted to bring into effect the Government Position, which is: *"The Government is committed to ensuring that the benefits of removing grandfathering flow to clients.* ***From 1 January 2021****, payments of any previously* ***grandfathered conflicted remuneration still in contracts will instead be required to be rebated to applicable clients*** *where the applicable client can reasonably be identified"* The Government's Position itself is not without ambiguity. Most commercial contracts have, as an express term, provision that a contracting party would not be obliged to undertake an act if, during	

	the term of the contract, that act becomes unlawful. Further, there are general law rules impacting the ability to enforce a contract where doing so would require an unlawful act to be performed. Therefore, the phrase “still in contracts” we submit may be unnecessary. We are keen to understand whether it is the intention of the draft legislation that contracts remain on foot and that the grandfathered arrangements do not terminate (that is, payments are still made under these contracts, but are redirected to the client). If so, this should be made clearer in the Bill. Further, there ought to be express recognition in the Bill that if payments are made in compliance with S963 M and S963N, the person making the payments does not breach Division 4 of Part 7.7A of the Corporations Act.	
Rebate of conflicted remuneration 963N	We consider that the product manufacturer, should in most instances, be better placed to rebate the client for the reasons stated in Section 2.2C above. However, there will be some situations where the grandfathered payment originates from an entity other than the product manufacturer (for example, the Advice Licensee or an employer). While this is likely to be rare, the law should contemplate these scenarios. We consider the current wording of the draft Bill covers the fact that it will be the product manufacturer who makes the rebate in most instances, however the EM should clarify this, and indicate that in some situations, the obligation to rebate will fall on others. Where the benefit cannot be attributable to individual retail clients, for example, because it is a benefit that is based upon the volume of a financial product acquired over a certain period by a group of the Advice Licensee’s clients, a mechanism is required for product manufacturers to rebate these clients as a cohort.	No change – however provide clarity in the EM that, in most situations, the obligation to rebate will typically fall on the product manufacturer, and, in rare cases it will fall on the employer or Advice Licensee. We note the power to make Regulations under this section is broad. Therefore, no change is required, however, given the detail of the scheme will be contained in the Regulations, we consider that detailed consultation with industry on the Regulations is appropriate.

	Further, our members foresee situations where clients to whom a rebate is owed, for one reason or another, cannot be identified. The Regulations ought to make provision for how product manufacturers should rebate clients in these circumstances.	No change required, however, given the detail of the scheme will be contained in the Regulations, we consider that detailed consultation with industry on the Regulations is appropriate.
	Under S963N, entities who have paid conflicted remuneration are only obliged to rebate clients who have received advice as a retail client. We foresee numerous situations where the product manufacturer would pay conflicted remuneration to an Advice Licensee in circumstances where the client has not received advice, for example: • the financial adviser deals on behalf of the client without providing the client with any financial advice; and • a client book of business has been sold to another financial adviser and the second financial adviser is not obliged to provide financial advice to the clients within that book. We consider that the rebating of conflicted remuneration should not be limited to only those clients who have received advice.	Amend the relevant part of S963N to read: "gave advice as a retail client or the retail client's initial advice provider was obliged, at a particular point in time, to give the retail client financial advice or another financial service"
	There should there be a mechanism to allow other ways to pass the benefit back to the retail client other than rebating an amount of money, for example, a reduction in fees or a credit to the cost of the product. Such methods should be determined through consultation with industry to ensure they are feasible from a product and IT system perspective. This is consistent with Section 1.17 of the EM.	No change required, however, given the detail of the scheme will be contained in the Regulations, we consider that detailed consultation with industry on the Regulations is appropriate.
Rebate to clients – annuities S963N	The concept of rebating clients creates issues particular to annuity and pension providers. This is because SIS Regulations 1.05(11A)(b)(ii)(E) and 1.06(9A) (b)(ii)(D) prohibit providers from changing the amount of an annuity or pension payment from year to year unless the change is as a result of an indexation arrangement or the transfer of the annuity or pension to another person.	We note the power to make Regulations under this section is broad. Therefore, no change to the Bill is required, however we consider that changes to the SIS Regulations are necessary. We believe that detailed consultation on the Regulations is appropriate to ensure that they clearly and specifically facilitate these payments in relation to annuities as soon as the Bill becomes law.

Rebate to clients – potential cost to clients	The concept of rebating amounts could have income and social security implications, however, this has not yet been considered in detail.	We recommend that the Government consider what amendments are required to these and other laws to ensure that retail clients are not adversely affected by rebating arrangements.
Non-monetary benefits S963N	While we support the cessation of grandfathering of non-monetary benefits, we consider that, in many instances it would simply not be feasible to rebate a non-monetary benefit to a client.	No change required, however, given the detail of the scheme will be contained in the Regulations, there ought to be appropriate mechanisms in the Regulations related to rebates to ensure there is clear direction as to how providers should deal with non-monetary benefits.
Ban on Asset- based fees on borrowed amounts S1531(2)	We do not agree that the current grandfathering arrangements relating to this ban (that is, that the ban does not apply to borrowed amounts used to acquire financial products before 1 July 2013) should be removed. We understand the intention of S1531 in the draft Bill is to ban, from 1 January 2021, the charging of asset-based fees on borrowed amounts used to acquire products at any time. That is, the ban would, for the first time, apply to products acquired before 1 July 2013. We do not consider this provision to be desirable or necessary for the following reasons: • the mischief which the ban was designed to address is no longer at issue. That is, there is no longer an inducement for advisers to increase the size of a client's borrowing in order to increase their fees. • product manufacturer and Advice Licensees often do not know whether or not a client has used borrowed amounts to acquire a financial product. It would be even more difficult to determine this for products a customer purchased before 1 July 2013; • product manufacturers would not know how much of the funds used to purchase the financial products before 1 July 2013 were still borrowed (that is, the client may have paid	Delete Items 6 and 7 from the Bill.

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	back a sizeable portion of the loan since 2013, meaning much of the fees would no longer be banned under S964D of the Corporations Act). Therefore, we submit that ceasing grandfathering on this ban will not result in clients being better off than they are presently.	