

## ***FUTURE OF FINANCIAL ADVICE - BAN ON COMMISSIONS*** **IMPACT ON STOCKBROKERS**

### **Submission**

#### **EXECUTIVE SUMMARY**

The FOFA reforms include unintended consequences in their application to stockbroking which are detrimental to both investors and the industry. This appears to have arisen because the impact on stockbroking was not fully considered in the framing of the FOFA reforms.

The FOFA ban on commissions should not extend to **direct equities** because the fees that stockbrokers earn for advising on these products – and which may be shared with staff - are paid directly by the client to the broking firm on a transaction-by-transaction basis, not paid by the issuer. They are fully **disclosed** to the client and **product-neutral**. It is essentially a 'fee for service model' which is consistent with the objectives of FOFA.

Our submission is consistent with the approach taken in reforms to the law in the **UK and Europe**, where similar reforms **do not cover direct equities**. The rationale of those reforms is consistent with FOFA, so a similar approach should be adopted in Australia.

The issue of **churning** by stockbrokers has been **grossly overstated**, and shows a lack of understanding of the regulatory structure which applies to stockbrokers. Regulation by ASIC (and formerly ASX) under the ASIC Market Integrity Rules, ASX Operating Rules and the Corporations Act, management and supervision structures, and policies and procedures within stockbroking firms ensure that clients are well protected from churning.

The issue of one-off **stamping fees** for new issues ought to be treated differently to that of fees paid by product providers to advisers. Any proposed ban on **stamping fees** will lead to difficulties for Australian companies in raising capital, and reduced opportunities for investors. It also threatens moves to grow Australia as a financial centre, since capital raising may move overseas.

Where execution, clearing and settlement services are provided by stockbroking firms to clients of **licensed intermediaries**, they ought not to be caught by the FOFA ban because the advisory relationship remains between the client and the intermediary, any fees are charged on a **fee for service** basis, and are **product-neutral** and **transparent**.

We also seek the results of the consultation on the review of the **definition of wholesale and retail clients**, which was part of FOFA but which have not been announced. This definition has a substantial impact on our Members' businesses.

## A. BACKGROUND

We refer to our letter to Dr Sandlant of 30 June 2011, and our recent discussions in Canberra (11&27 July) about the impact of FOFA on Stockbrokers, for which we thank you and your staff.

### ***Support for ban on conflicted remuneration***

Our Members support the move in FOFA to ban conflicted remuneration arrangements. These arrangements are not in the best interests of clients, or indeed the industry. As cases like *Storm Financial* have demonstrated, it is impossible for advice to be in the client's best interests if the advice is guided more by what the adviser will earn by way of commission from the product issuer than what is suitable for the client.

However, in stockbroking the apparent breadth of the ban means that there are a number of areas where such a ban would lead to unintended consequences. This will be of **no benefit** to investors (in fact it may lead to a **reduction** in the availability of professional investment advice to retail clients), and will not only cause substantial detriment to stockbrokers, but as we set out, will have a negative impact on capital raising in Australia and on the operation of the listed securities markets. As we note below, there are **international precedents** for **not** applying the ban to the core aspects of stockbroking such as we are discussing. To do so will place Australia at a competitive disadvantage.

Our Members also support the proposed statutory duty to act in the *best interests of clients*. Indeed, unlike other sectors of the financial services industry, stockbrokers already owe this duty at common law<sup>1</sup>, so we see this more as the codification of an existing duty, rather than the imposition of a new one.

### ***Product focus***

At the outset, we stress that we are not seeking any advantage over other advisers, like financial planners. We only seek relief for market participants advising on **listed products** that are not investment products. In relation to the secondary market, these products do not and never have involved the payment of commissions by the issuer to the adviser. As we will show, the status of the adviser as a market participant serves to further ensure that the advice is not conflicted, that 'churning' does not occur, and that if it does, the implications for the adviser are far more serious than in any other sector.

### ***No proper Consultation***

We appreciate that the new provisions have not been finalized. However, we gather that draft legislation is likely to be released any day. Unlike most significant pieces of law reform (for example, *Financial Services Reform* [2004], *Changes in Market Supervision* [2010]) where there has been a period of time allowed for proper discussion of the detailed policy aspects of the proposals as outlined (usually in Discussion or Consultation Papers), there has been no such policy discussion in this case. There is to be no further guidance or discussion papers issued,

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<sup>1</sup> *Daly v Sydney Stock Exchange* (1986) 160 CLR 371

just draft legislation. We have not had the benefit of 'targeted consultation'<sup>2</sup> on these matters that apparently has been offered to other sectors of the financial advisory industry.

As we have noted previously, all that has been published about the likely application of FOFA to stockbrokers comes from an FAQ on the FOFA website, and a broad statement from the Minister's *Information Pack* released in April 2011. Both are set out as follows:

**FAQ on the FOFA website<sup>3</sup>:**

*How will the ban on conflicted remuneration structures affect stockbrokers?*

*The ban on conflicted remuneration structures is not designed to target certain industries, or sub-sections of the financial advice industry. The focus of the ban is removing conflicts of interest that may cause bias, or the potential for bias, in financial advice due to payments from product providers to those providing advice. There are various considerations and concerns that will need to be considered in relation to how these reforms may impact the activities of stockbrokers. For example, Treasury is aware that a typical charging model for stockbrokers may involve a payment, commonly referred to as a 'commission', from the client to the broker that is typically charged as a percentage of the value of a certain transaction or a fee per transaction. While these arrangements need to be explored, a **transparent and product neutral** regime with a client-paid fee will not be subject to the ban, unless it is an asset-based fee relating to geared products or investments amounts.*

*Treasury also understands that brokers do not always divide their fees into an advice component and a transaction brokerage component, and there is a need to explore the implications of this in relation to the reforms. The nature of payments between market-linked brokers and 'white label-brokers', as well as any payments between structured product providers and brokers will also need to be considered.*

*Treasury is consulting with industry on what types of payments will be permissible, while having regard to the principles the Government has announced in its reform package. Legislation will have the capacity to carve out specified payments if unintended payments are captured, or unintended consequences occur.*

**Minister's April 2011 release<sup>4</sup> section 2.3, *Ban on Volume Payments*:**

*...there will be a broad comprehensive ban, involving a prohibition of any form of payment relating to volume or sales targets from any financial services business to dealer groups, authorised representatives or advisers. While this broad ban on volume payments will require some adjustment by industry, the measure will enhance competition, with platforms competing with one another purely on price and quality for the client, rather than by distributing their products through volume bonuses to dealer groups or advisers. The ban is intended to prevent any licensee, authorised representative or adviser from receiving a payment from any entity based on volume of product sales. Following the conclusion of formal consultations some industry stakeholders raised the issue of arrangements such as equity share schemes or special purpose vehicles being used to circumvent the ban on volume-based payments. The Government shares these concerns and will consult with consumer and industry groups on anti-avoidance provisions.*

It is clear from recent discussions that **the impact on the stockbroking industry was not considered** in the development of the FOFA proposals. Apparently, this is because it had been assumed that stockbrokers in this country would not be affected, since they only dealt with **wholesale clients**, or if they were retail, only clients that dealt on a **non-advisory**, 'execution-only' basis. We trust that it is now understood that **nothing could be further from the truth**.

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<sup>2</sup> Mentioned on the FOFA website at:

[http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq.htm#Q2\\_4](http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq.htm#Q2_4)

<sup>3</sup> <http://futureofadvice.treasury.gov.au> (emphasis added)

<sup>4</sup> Australian Government *Future of Financial Advice 2011 – Information Pack* 28 April 2011 p.9-10

While business models vary across the industry, the provision of advisory services to retail clients is a significant part of the services offered by our Members. On the ASX market over recent years there has been on average around 600,000 transactions in cash equities - worth around \$6bn - **per day**. Trading by retail clients accounts for around 30% of this trading, or around \$2bn per day, and around **60%** of this is conducted on an advisory basis.

### **UK: The Retail Distribution Review**

In 2006 the UK Financial Services Authority commenced a wide-ranging review into certain serious mis-selling practices that had emerged in several high-profile cases prior to the financial crisis. The review, known as the *Retail Distribution Review (RDR)* examined similar issues to the *Ripoll Review*<sup>5</sup> (and now FOFA), including professional standards and conflicted remuneration. The FSA's response to the RDR aims to:

- i) improve the clarity with which firms describe their services to consumers;*
- ii) address the potential for adviser remuneration to distort consumer outcomes; and*
- iii) increase the professional standards of advisers.*<sup>6</sup>

The RDR is a very similar review to the events leading to FOFA, but on a larger scale, taking into account UK and European markets. The RDR has taken a different approach to FOFA in two of the key areas under discussion which impact on Australian stockbrokers, namely Splitting Commissions and Stamping Fees. As we will expand upon below<sup>7</sup>, we urge the Australian authorities to take the UK/European approach into account.

## **B. AREAS OF IMPACT ON STOCKBROKERS**

The business model of stockbrokers is different to financial planners. In saying this, we note that there are hybrids of these models, so that within some retail stockbroking firms you will find financial planners.

Stockbrokers have a '**fee for service model**'. Brokerage is paid at the time the transaction is completed, at the agreed rate. There is no charge for on-going advice subsequent to that trade. The client often receives free advice. Especially in challenging markets as we have now, clients often need to call to make enquiries, check their portfolio, and seek advice – but if there is no trade there is no charge.

Stockbroking is also different to financial planning in that firms have all the funding costs associated with completing a trade on market, together with far more onerous liquid capital requirements to participate in the market than non-market participants.

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<sup>5</sup> Parliamentary Joint Committee on Corporations and Financial Services (Cth) *Inquiry into financial products and services* Final Report November 2009

<sup>6</sup> Financial Services Authority Policy Statement 10/6 *Distribution of retail investments: Delivering the RDR* March 2010 page 3 ('**FSA PS 10/6**') [http://www.fsa.gov.uk/pubs/policy/ps10\\_06.pdf](http://www.fsa.gov.uk/pubs/policy/ps10_06.pdf)

<sup>7</sup> See page 9 (commission splitting) and page 12 (stamping fees)

We are grateful for the clarification of the impact of FOFA on several areas of our Members' stockbroking businesses. We would now like to expand on **three** remaining areas of concern, namely –

1. 'Straight' Brokerage and Commission arrangements
2. Capital Raising – Brokers 'Stamping Fees', and
3. Intermediary Arrangements.

## 1. 'Straight' Brokerage and Commission arrangements

By far the most common type of fee in stockbroking involves charging the client a fee for executing market transactions based on a percentage of the value of the consideration, called brokerage. Usually there is a minimum charge, so that brokerage may be for example, 1% of consideration, with a minimum charge of \$100. The service may include advice, or purely execution on-market only. As noted in the FAQ above, typically there is no split in the fee between advice and execution. Accordingly, brokerage may or may not include a charge for advice. To our knowledge, no broker in Australia splits its brokerage charge into a fee for execution and a fee for advice. However, these arrangements are '**transparent and product neutral**', in the sense that the fee is paid directly by the client to the broker on a fully disclosed basis under the agreement with the client. Accordingly, since it is '**transparent and product neutral**' it should not attract the ban or the 'opt-in' requirements.

If there is no transaction, the client pays no fee. In difficult markets when clients need reassurance and 'hand-holding', there may be many communications where advice is given but there is no transaction. Therefore, frequently the client is getting free advice.

**Commission arrangements:** Of immediate concern to our Members is the effect of the following statement in the April Information Pack:

*...there will be a broad comprehensive ban, involving a **prohibition of any form of payment** relating to **volume** or sales targets from any **financial services business** to dealer groups, authorised representatives or advisers.*

The majority of our Member firms that provide advice to retail clients have a remuneration structure for advisers which typically includes both of the following elements:

- a. a retainer (salary), and
- b. a share of the brokerage charged to clients (commission), either paid regularly or as an annual bonus.

This structure allows firms to keep their fixed costs relatively low, which is important especially in difficult markets such as we have today, where turnover is very low. In more favourable times, firms earn more in brokerage, and advisers benefit commensurately from higher commissions. In bad times the adviser earns less. These arrangements are fully disclosed and understood by clients.

We would question the extent to which commission sharing arrangements with staff could give rise to the types of conflicts which the legislation is, understandably, seeking to address in other areas. The same commission sharing arrangement will invariably apply between firm and individual advisers regardless of the particular shares that a client will buy or sell. It is not as if an adviser will benefit from steering a client into, say, buying BHP rather than ANZ, because his or her commission will not differ because of the particular security, nor will BHP or ANZ provide any incentives to the adviser to recommend its shares. Also, clients contact their stockbroker because they want to buy or sell listed securities. This is acknowledged in the work on 'Scaled Advice' in FOFA. Therefore, any perceived 'conflict' of a stockbroker seeking to benefit from steering the client into buying or selling shares, because of the brokerage that they will receive, compared to an alternative investment such as a managed fund, does not realistically arise.

### **Churning**

'Churning' – in the sense of advisers pressuring their clients to trade in excess of what is suitable for them, in order to produce more commission for the adviser - is clearly Treasury's **main concern** here. However, it appears to have been grossly overstated, and we would like to assure Treasury that **churning is not a common practice in stockbroking**. The risk of churning is an issue that was recognized long ago and it is a key focus of rules and internal arrangements for stockbrokers, both in discretionary and non-discretionary trading.

We know of no other sector of the financial services industry that is so strictly or rigorously regulated than stockbroking, and this is reflected in the rules to prevent and the measures to address the risk of churning, discussed as follows:

It is a general obligation of all AFS licensees to have '*adequate resources and supervisory arrangements*' and to act '*efficiently, honestly and fairly*'<sup>8</sup>. All retail advisers must ensure that advice to their clients has a reasonable basis<sup>9</sup>. FSR made breach of this requirement a criminal offence. It is difficult to imagine that churning could ever be suitable for the client.

For **market participants** there are in addition much greater management and supervision requirements, with a much stronger regulatory regime to enforce them. This is reinforced by strong liquid capital requirements which are in excess of those which apply to non-market participants. The capital requirements are strictly enforced by ASIC and ASX, to protect investors and the integrity of the market. The National Guarantee Fund provides further protection for investors. These requirements, together with some specific rules which apply to churning, ensure that this conduct is already treated as a very serious matter, and one that participants take measures to avoid.

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<sup>8</sup> Corporations Act s.912A(1) [General Obligations]

<sup>9</sup> Corporations Act s.945A

## a. Management and Supervision Requirements of Market Participants

Market Participants must have appropriate supervisory policies and procedures to ensure compliance with the **ASIC Market Integrity Rules, ASX Operating Rules** and the **Corporations Act**<sup>10</sup>. Failure to do so can incur a penalty from ASIC of up to **\$1m**. This does not apply to non-market participants. As well as the management requirements set out in ASIC policy<sup>11</sup>, ASIC has stated<sup>12</sup> that it won't vary significantly from the previous ASX approach to regulating market participants. In particular, ASIC will '*take into consideration*' the following standards (which were prescribed by ASX for compliance):

- AS3806 2006 *Compliance*
- ASNZ 4360 2004 *Risk Management*
- AS ISO 10002 2006 *Customer Satisfaction*
- ASIC RG104&105
- SDIA/SIA *Best Practice Guidelines for Research Integrity*

Market Participants' management and supervision requirements are reinforced by the **Responsible Executive (RE)** regime. RE requirements only apply to market participants, not to other licensees like financial planners. The Regulatory Objectives of RE Regime are that they:

- complement the firm's obligation to be responsible for acts and omissions of employees
- ensure 'identifiable people' are responsible for supervision
- ensure those responsible for supervision and control are 'competent' and of 'good fame and character', and
- reinforce personal responsibility for the firm's operations and compliance with rules by making them accountable and bound by the rules<sup>13</sup>.

Responsible Executives must pass a compulsory examination<sup>14</sup>, comply with continuing education requirements and sign an annual declaration to their firm<sup>15</sup> that they have -

- maintained their currency of knowledge of the Market Integrity and ASX Rules, and the Corporations Act
- reviewed supervision & control procedures
- controls over their allocated areas that are functioning and achieving compliance, and
- documentation which proves the above.

The firm must in turn make an annual declaration to ASIC that its RE's have complied with their obligations<sup>16</sup>.

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<sup>10</sup> ASIC Market Integrity Rule ('MI Rule') 2.1.3; ASX Clear Operating Rule 3.5.1 (for Clearing Participants)

<sup>11</sup> ASIC Regulatory Guides 104&105

<sup>12</sup> ASIC Regulatory Guide 214.76

<sup>13</sup> ASX Market Rule Guidance Note 27, adopted by ASIC in RG214

<sup>14</sup> ASIC MI Rule 2.3.1(2)(c)

<sup>15</sup> ASIC MI Rule 2.3.3; ASXC Rule 4.22.1(l)

RE's are a key part of the management structure that market participants must have to ensure that it has operations and processes to ensure compliance with the Market Integrity Rules, ASX Operating Rules and the Corporations Act. Breach of this Market Integrity rule carries a maximum penalty for the firm of \$1m.<sup>17</sup> Management failures are also likely to attract a charge of 'unprofessional conduct'<sup>18</sup> which under ASIC Market Integrity Rules (and the former ASX rules), is a **very serious matter**, and which also carries a \$1m maximum penalty.

A record of the firm's management structure must be lodged with ASIC, and the structure is subject to review and scrutiny by the regulator<sup>19</sup>. Any significant changes must be notified to ASIC.

Failures in management and supervision attract substantial fines. While there are no published decisions of the ASIC Markets Disciplinary Panel yet, there are a number of decisions of the ASX Disciplinary Tribunal which include high penalties in respect of management failures.

For example,

- the highest ever total penalty imposed by ASX was a fine of \$1.35m on *Tricom Securities* in 2009<sup>20</sup>. As well as covering breaches of the settlement, capital liquidity, and market manipulation rules, the total included a fine of \$250,000 (the maximum at the time) for failure to have appropriate management structures to ensure compliance,
- in 2010, *Findlays* was fined a total of \$280,000<sup>21</sup>, including a fine of \$150,000 for unprofessional conduct in failing to have management structures in place to ensure compliance with the rules, and
- in 2009, *StateOne stockbroking* was fined a total of \$235,000<sup>22</sup>, including \$100,000 for unprofessional conduct in failing to have management structures to ensure compliance.

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<sup>16</sup> ASIC MI Rule 2.3.5

<sup>17</sup> ASIC MI Rule 2.1.1; ASXC Rule 4.8.1

<sup>18</sup> ASIC MI Rule 2.1.5; Defined in MI Rule 1.4.3, 'Unprofessional Conduct' includes:

(a) conduct which amounts to impropriety affecting professional character and which is indicative of a failure either to understand or to practise the precepts of honesty or fair dealing in relation to other Market Participants, clients or the public;

(b) unsatisfactory professional conduct, where the conduct involves a substantial or consistent failure to reach reasonable standards of competence and diligence; and

(c) conduct which is, or could reasonably be considered as likely to be, prejudicial to the interests of the Market Operator or Market Participants,

by a Market Participant, or an Employee, whether in the conduct of the Market Participant's business as a Market Participant or in the conduct of any other business, and need not involve a contravention of these Rules or any law.

<sup>19</sup> ASIC MI Rule 2.1.2

<sup>20</sup> ASX Circular to Participants 230/09 *Disciplinary Matters*

<sup>21</sup> ASX Circular to Participants 111/10 *Disciplinary Matters*

<sup>22</sup> ASX Circular to Participants 172/09 *Disciplinary Matters*

## b. Specific Rules on Churning

As well as the management and supervision requirements of the Market Integrity Rules, and the common law duty to act in the client's best interests, there are also some specific rules which prevent churning, in both the discretionary and non-discretionary context.

*Discretionary Accounts:* Largely as a result of some high profile legal actions<sup>23</sup>, the operation of Managed Discretionary Accounts (**MDAs**) is a very highly regulated activity, covered by the ASIC Market Integrity Rules and Class Orders<sup>24</sup>. The 'classic' form of Churning occurs when an adviser deals excessively for a client on a discretionary account, in order to earn more brokerage. This conduct is specifically prohibited under the market integrity rules<sup>25</sup>, which prohibit '**excessive trading**' on an MDA, having regard to the client's circumstances, investment objectives and needs. Brokers are required to issue quarterly reports to MDA clients, update the clients profile and issue annual statements. Like any transaction for a retail client, Confirmations are sent out to the client independent of the Adviser for every transaction. Management reviews trading for signs of churning, and the client can make a complaint if they believe transactions to be excessive or out of order. MDA's are monitored both internally and by way of an annual external audit, and churning is always an issue that is checked.

*Non-Discretionary Advice:* In the non-discretionary area, the rules also prevent churning. Unless properly set up as an MDA, advisers must not execute transactions for a client (or allocate securities to a client) unless the client has given prior instructions<sup>26</sup>. Again, breach of this rule carries a maximum penalty of \$1m.<sup>27</sup>

Unauthorised discretionary trading and churning have long been recognised as a key risk area for stockbrokers. It is often the focus of regulatory attention, both in compliance reviews and in specific enforcement action. Part of a firm's management and supervision arrangements includes checking for unusually frequent trading. Management receives trading reports on a daily basis and always checks for any sign of churning. If unusually frequent trading is detected, it is investigated. This investigation may include management contacting clients directly, to ensure that they are aware of the trading and happy with the service being offered. Churning will NOT be eliminated because of the proposed ban. Indeed, as a result of the higher salaries to be paid, the firm is going to want more business to be written so that it can cover its increased fixed costs, which may possibly encourage churning.

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<sup>23</sup> For example, *Ali v. Hartley Poynton Ltd* [2002] VSC 113

<sup>24</sup> ASIC MI Rule 3.3.2 & ASIC RG179/CO04/194 Dec04

<sup>25</sup> ASIC MI Rule 3.3.2

<sup>26</sup> ASIC MI Rule 3.3.1

<sup>27</sup> A broking firm was recently fined \$20,000 for breaching the former ASX equivalent of this rule, and \$80,000 for Unprofessional Conduct in not preventing this conduct: ASX Circular 122/11 *Disciplinary Matters*.

### **UK Position**

Splitting commission with advisers in the UK is not banned. It is important to note that the emphasis of the UK's RDR is on investment products, like managed funds and investment trusts. **Direct equities are not within its scope.**

The UK FSA has adopted a 'disclosure and agreement' model in the RDR<sup>28</sup>. Under this model, advisory firms can be paid by charges they have set out up-front and agreed with their clients.<sup>29</sup> Like FOFA, 'product-neutral' advice is an important element of the FSA rules:

*'The charges should reflect the services being provided to the client, not the particular product being recommended'*<sup>30</sup>.

Accordingly, the RDR only applies to 'retail investment products', which are defined as:

*retail investment product*

- (a) a *life policy*; or
  - (b) a *unit*<sup>31</sup>; or
  - (c) a stakeholder pension scheme; or
  - (d) a personal pension scheme; or
  - (e) an interest in an *investment trust savings scheme*; or
  - (f) a *security* in an *investment trust*; or
  - (g) any other *designated investment* which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in the financial asset; or
  - (h) a *structured capital-at-risk product*;
- whether or not any of (a) to (h) are held within an *ISA* or a *CTF*.<sup>32</sup>

The RDR was a UK initiative and therefore does not have to take account the 2006 EU Directive known as **MiFID** (Markets in Financial Instruments Directive)<sup>33</sup>. However, since it must ensure that none of its measures are *inconsistent* with MiFID, the FSA is participating in the European Commission's review of MiFID and its 'packaged retail investment products' (PRIIPs) initiative<sup>34</sup>. Accordingly, the FSA's definition of 'retail investment product' is based on the likely definition of the European 'packaged retail investment product'.

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<sup>28</sup> The RDR measures applying to adviser remuneration are set out in Chapter 4 of FSA PS 10/6 *Adviser Charging and inducements*. See also the *FSA Factsheet* at

[http://www.fsa.gov.uk/smallfirms/your\\_firm\\_type/financial/pdf/rdr\\_adviser.pdf](http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/rdr_adviser.pdf)

<sup>29</sup> FSA PS 10/6 page 25

<sup>30</sup> FSA PS10/6 page 25

<sup>31</sup> i.e. a 'unit' in collective investment, not a direct equity

<sup>32</sup> FSA PS10/6 Appendix 1 (Handbook text) page 2 of 69

<sup>33</sup> EU Directive 2004/39/EC effective 1 November 2007 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF> ; <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0026:0058:EN:PDF>

<sup>34</sup> *Communication from the Commission to the European Parliament and the Council: Packaged Retail Investment Products* (April 2009) [http://ec.europa.eu/internal\\_market/financeservices-retail/investment\\_products\\_en.htm#communication](http://ec.europa.eu/internal_market/financeservices-retail/investment_products_en.htm#communication); *Consultation Paper on Packaged Retail Investment Products* (November 2010) [http://ec.europa.eu/internal\\_market/consultations/docs/2010/priips/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/priips/consultation_paper_en.pdf)

The focus of the MiFID **Packaged Retail Investment Product** review is therefore on 'manufactured' or structured investments - not direct equities - because this is where the most serious problems in terms of conflicted advice have emerged:

*These issues [i.e. conflicted remuneration and disclosure] are particularly significant for what can be termed packaged retail investment products (PRIPs), which offer exposure to underlying financial assets, but in packaged forms which modify that exposure compared with direct holdings. They are typically 'manufactured', by which they combine different assets into a single proposition, or introduce some element of financial engineering.<sup>35</sup>*

Therefore, the measures being taken against conflicted remuneration in the UK and Europe **do not apply to advising and dealing in direct equities**. With direct equities there is no element of 'packaging', 'structuring' or 'manufacturing' and no sales incentives passing from the issuer to the adviser. There is simply a fee (brokerage) payable by the client to the stockbroking firm covering execution and advice. **We strongly submit that the same approach ought to be taken in Australia.**

Our Members fail to see the efficacy or public benefit in banning broking firms from sharing brokerage with their own staff. This is an established model in stockbroking, and unlike other sectors, is transparent and disclosed in Statements of Advice, Financial Services Guides and/or Client Agreements. It is also **product-neutral** in the sense that the client pays the same rate of brokerage regardless. Therefore, the ban should not be extended to advice on direct equities.

If these arrangements were banned, it would mean that firms would have to pay much higher salaries to their staff (the advisers) thus significantly increasing their fixed costs. This would lead to severe financial pressure on broking firms. In these difficult times for brokers, such a ban would almost certainly lead to more closures and consolidations of firms, which are already under pressure due to low market turnover. This would inconvenience clients, for whom the ban on commissions would have no practical effect or advantage: they would still pay the same rate of brokerage to their broking firm.

Regulation by ASIC (and formerly ASX) under the **ASIC Market Integrity Rules, ASX Operating Rules** and the **Corporations Act**, management and supervision structures, and policies and procedures within stockbroking firms ensure that clients are well protected from churning. This is much more rigorous in market participants (who are subject to the ASIC Market Integrity Rules) than to firms that merely hold an AFSL. There is no evidence that there is a problem that needs to be addressed, as shown by low complaints to FOS and NGF claims<sup>36</sup>. We strongly submit that these arrangements be allowed to continue. This would be best achieved by adopting the UK approach where **direct equities are not subject to the ban on commissions**.

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<sup>35</sup> EU Consultation Paper *Legislative Steps for the Packaged Retail Investment Products initiative* Nov 2010 page 3

<sup>36</sup> See FOS figures on page 14 below

## 2. Capital Raising - Brokers 'Stamping Fees' and Underwriting Fees

From our discussions to date:

- the ban will apply when personal or general advice on new issues is given to retail clients. It will not apply where no advice is given, or the client is wholesale.
- Stamping Fees from issuer companies to brokers will be banned, except for wholesale clients or non-advisory retail business.
- However, Brokers will be able to charge normal brokerage to clients directly, which clients never have had to pay before.

If Stamping fees were banned, it would have a serious impact on the ability of listed companies to raise capital effectively and efficiently. Moreover, it may even threaten the viability of many listed companies in Australia. It would also deny Australian investors investment opportunities.

In terms of efficient distribution, it may also threaten the ability of Australian companies to achieve the minimum spread of shareholders as required by the listing rules. Faced with these difficulties, companies may pursue other avenues, including raising capital overseas, which may threaten Australia's position as a regional financial centre.

The success and efficiency of the Australian capital markets is impressive, particularly the successful recapitalization of companies post-GFC. There was criticism through that period that retail clients missed out on opportunities. The better performance of those clients able to access wholesale offerings compared to retail has continued to be significant since the GFC. This ban will only increase that effect, as retail clients will be further 'shut-out' of new issues.

Compared to fund managers selling products and paying incentives to advisers which may be conflicted, there is a strong public policy argument here in favour of allowing the status quo (stamping fees) to continue. This is both in terms of facilitating capital raising by companies, and in terms of providing investment opportunities for retail clients who are encouraged to save and build wealth for retirement. We have already noted the low rate of complaints against stockbrokers. Very few of these complaints relate to capital raisings. This ban will deter clients from obtaining the advice from qualified advisers that they need.

*Global Consistency:* Global consistency is also an issue here. No other country to our knowledge treats advice to retail clients in this manner. Australia is already a difficult place to raise capital. Issuers will just go overseas, harming the Government's aim to build Australia as a regional financial centre. Again, the more this happens, the more Australian retail investors will miss out on opportunities.

### **UK approach to Stamping Fees**

In the UK, the general principle of receiving payment from third parties (such as an issuer for capital raising) is governed by the Financial Services Authority *Conduct of Business Sourcebook*

which took effect in 2007. The relevant rule concerning *inducements*<sup>37</sup> requires that such payments must be in the client's best interests, be properly disclosed and 'designed to enhance the quality of the service'. The result is that such stamping fees are **permissible**, so long as the firm can show that the payment is to cover the cost of providing a service that otherwise might not be economically viable (for example, because of the extra work incurred by the firm).

Once again, the UK approach is **useful and relevant**, and one that we trust will be adopted in Australia.

### 3. Intermediary Arrangements

As we have described before, often stockbrokers have arrangements with other financial advisers or planners that are not market participants which we'll refer to as '**intermediaries**', to execute, clear and settle transactions on-market for the intermediary's clients. The nature of the services provided to the intermediaries can best be characterised as the provision of **infrastructure**, where the broker collects the total fee (brokerage), deducts a fee for execution and/or clearing and settlement services and remits the balance to the intermediary.

We would like to discuss the two common industry models, Dealer Groups/Financial Advisers, and White Label arrangements. (*In the following examples 'ABC Corp' is the market participant who provides share trading technology services to an intermediary.*)

#### **i) Dealer Groups and Financial Advisers**

Dealer groups and financial advisers may have agreements with stockbrokers (ABC Corp in this example), to execute transactions on-market for their clients. Most financial advisers are not market or CHESS participants, so rely on these arrangements with brokers to efficiently relay orders to buy/sell securities for execution on-market.

In these arrangements, the financial adviser may provide personal advice to their client, and the client then decides to buy or sell listed securities. ABC Corp executes the trade and settles direct with the end client, charging the client brokerage on the trade. This enables the client to obtain the advantage of share registration and transfer under the ASX CHESS system.

The brokerage is collected by ABC Corp on each trade on behalf of each adviser in the dealer group and remitted to the dealer group, usually on a monthly basis. ABC Corp retains a proportion of the overall brokerage charged to the client, for provision of the underlying share trading execution clearing and settlement services. The fee collection and reimbursement arrangement is fully disclosed in the Financial Services Guide which the client acknowledges they have read and understood, when they sign the agreement to begin using the service. As outlined earlier in this paper, there are robust governance obligations and oversight of market participants. There are no volume-related payments made by ABC Corp to the financial adviser or dealer group which encourage higher trading volume. Any payments are purely fee for service. In remitting fees to the intermediary collected on its behalf, ABC Corp deducts a fee for the infrastructure services it has provided. It would appear that neither the proposed i)

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<sup>37</sup> See FSA COBS Rule 2.3 <http://fsahandbook.info/FSA/html/handbook/COBS/2/3>

ban on commissions, or ii) prohibition on volume related payments, would apply to this scenario. **Please confirm.**

**ii) White label arrangements – direct to customer**

White label arrangements involve **licensed advisers** who are not market participants but who want to provide share-trading and associated services to their end-clients under their own brand, without becoming a market participant. These advisers outsource to ABC Corp to leverage their economies of scale in technology, ability to meet regulatory capital and licensing requirements, support services and experience. In the case of a white label partnership, ABC Corp provides the adviser with a fully branded standalone website and trading platform – including branded forms and agreements.

ABC Corp registers a trading name (ABN), maintains an AFSL, Full Licence and Participation with the Australian Stock Exchange (ASX) and is a member of the Financial Ombudsmen Service (FOS). While the white label partner is able to retain the relationship they have with the client, the adviser bears no credit risk or market risk for trading, as the client is contracting with a trading name of ABC Corp. End clients can be directed to the white label platform from the adviser's website in order to open an account online and access ABC Corp's platform.

The adviser does not provide personal financial advice to its clients. General advice may be provided and Market data and company information is sourced from independent third party providers, such as the ASX or Research Houses (e.g. Morningstar, Thomson Reuters, etc) and displayed on ABC Corp's website.

When a client lodges a request online to buy or sell shares, brokerage is debited by ABC Corp directly from the customer bank account. Brokerage rates and all fees and charges are disclosed in the Financial Services Guide which the client acknowledges they have read and understood when they sign the agreement before using the service. Revenue is generally calculated by ABC Corp, and a portion paid to the partner usually on a monthly basis – fees deducted/retained by ABC Corp are either calculated on a revenue share or fees for discrete service basis. This arrangement remunerates both parties as both contribute to the overall service to the end client.

This is a 'direct to client' model and as neither ABC Corp nor the adviser firm are providing personal advice to the end client, we do not see any material possibility of conflicts which disadvantage the customer. In terms of the FOFA principals referred to in section A of this submission we submit that:

- This model is product neutral (does not encourage trading in any particular security), and
- The model is transparent in that all charging and revenue arrangements are disclosed to the client
- There are no volume bonuses or payments related to sales targets to the adviser in this example

For these reasons we do not believe this model should be subject to the proposed FOFA prohibitions on volume related payments or commissions. **Please confirm.**

## C. CONCLUDING COMMENTS

It is unfortunate that the actions of several licensees in the lead-up to the GFC have led to excessive regulation affecting the whole financial services industry, when the justification for those wholesale measures has not been made out.

### ***FOS Complaints***

In stockbroking, this is exemplified by the very low (and reducing) rate of complaints against stockbrokers.

For the financial year **2008-09** (the year of the *Storm Inquiry*) the Financial Ombudsman Service (**FOS**) recorded an overall increase of 33% in new disputes. For this year FOS did not publish complaints by service provider, but by product group, so stockbrokers were included in the figures for securities, derivatives, managed funds, margin loans, etc, together with other providers like financial planners.<sup>38</sup>

For the financial year **2009-10** FOS recorded an overall increase of 6% in new disputes, to 17,352. This total included 1639 complaints in relation to Investments, of which **134** (or 8%) were complaints against stockbrokers. (By comparison, 58% of all investment complaints were made against financial planners.)<sup>39</sup>

The most recent figures for complaints against stockbrokers to FOS for the **calendar year** ended **31 December 2010** are remarkable<sup>40</sup>. During 2010, **53 complaints** were received against stockbrokers, a reduction of over **75%** on the previous calendar year 2009, when **216 complaints** were received.

These figures are even more impressive when you consider that over recent years on ASX there have been on average around 600,000 transactions in cash equities - worth around \$6bn – **per day**, or around 120 million trades worth around \$1.2 trillion per annum. (While trading by retail clients accounts for around 20-30% of these figures, it is still significant.)

Therefore, on the data published by FOS (and SEGC, the trustee of the National Guarantee Fund), Stockbrokers have attracted a very low rate of client complaints and unrecoverable losses.

The proposals will have a significant and possibly detrimental effect on our Members, their clients and also on capital raising by companies in Australia. It is therefore surprising and disappointing that no policy consultation took place ahead of the release of draft legislation

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<sup>38</sup> Financial Ombudsman Service *Media Release* 30 September 2009

<sup>39</sup> Financial Ombudsman Service 2009-2010 *Annual Review*

<sup>40</sup> Address by Alison Maynard, Ombudsman, Financial Ombudsman Service to the Stockbrokers Association of Australia Annual Conference, Sydney, 27 May 2011; Figures for 2009 supplied by FOS 4 July 2011

enacting the proposals set out in the Information Pack, which we understand is due occur in August.

These proposals will only achieve a negative outcome should the bill pass in its current form because they will lessen the protection to retail clients as those small to medium retail brokers are forced to shut their doors due to the increased overheads and compressed commission rates. Participants who have provided personal advice to retail clients over the last 100 years will simply cease to provide advice to those retail clients who need it the most and push them into industry funds and online brokers.

These changes will mean significant burden and expense in changes to remuneration arrangements, legal agreements with clients and even the business models of our Members, together with major disruption to client relationships and potentially to the markets generally. One of the flow-on effects of these changes will be that retail clients will be pushed to dealing execution-only, without advice. One of the stated objectives of the Government is to increase the degree to which retail investors obtain advice in relation to their investments, which we support. These proposals will tend to undermine that objective. This will lead to a less efficient and less informed market. Most importantly, investor protection will be lost – and the most disturbing thing is that those most in need of advice are the ones who are going to miss out.

Good regulation is grounded in evidence based issues. In the areas of stockbroking that we have outlined, there is no evidence of a problem which requires a regulatory solution, especially one as revolutionary as the ban being considered.

***Wholesale/retail definition review***

Our Members' businesses are modeled according to the clients that are serviced, particularly whether they are categorized as 'wholesale' or 'retail' under the Corporations Act. Accordingly, our Members are anxiously awaiting the results of the review of these definitions<sup>41</sup>, which was concluded in February this year. We therefore seek your advice as to the likely outcomes of the review and when those results are likely.

We are grateful for your time in considering these matters which we have recently drawn to your attention and look forward to continuing the dialogue. Should you require further information or wish to discuss these matters further, please contact me or Doug Clark, Policy Executive on [dclark@stockbrokers.org.au](mailto:dclark@stockbrokers.org.au).



**David W Horsfield**  
**Managing Director/CEO**

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<sup>41</sup> Wholesale and Retail Clients – Future of Financial Advice *Options Paper* January 2011; *Submission* by the Stockbrokers Association of Australia 28 February 2011