Stockbrokers
Association of Australia
Incorporating SDIA

30 June 2011

Dr Richard Sandlant
Manager, Future of Financial Advice Unit
Department of the Treasury
Langton Crescent
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Dear Dr Sandlant

FUTURE OF FINANCIAL ADVICE - BAN ON COMMISSIONS – IMPACT ON STOCKBROKERS

We refer to recent discussions about the impact of FOFA on Stockbrokers, and wish to raise our Members' concerns as a matter of urgency.

A. BACKGROUND

Generally, our Members support the move to ban conflicted remuneration arrangements, especially where those arrangements may not be in the best interests of clients. However, there are a number of scenarios where such a ban would lead to unintended consequences. This will not be of any benefit to investors, and cause substantial detriment to stockbrokers.

We appreciate that the new provisions have not been finalized. However, 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), we understand that there is to be no such policy discussion in this case. There is to be no further guidance or discussion papers issued, just draft legislation in July/August. Moreover, we have not had the benefit of 'targeted consultation'[1] on these matters that apparently has been offered to other sectors of the financial advisory industry.

Recently, we have endeavoured to raise these matters directly with Treasury. While we have raised some of these matters in telephone discussions, many matters are outstanding. Hence,

[1] Mentioned on the FOFA website at: http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq.htm#Q2_4

it is important that we formally raise these matters ahead of implementation. If the legislation (once released) effects these arrangements as seems possible, it may be that we will be seeking a waiver or exemption as a matter of urgency. Therefore, as well as raising the issues themselves, one of the main purposes of this letter is to foreshadow applications for waivers or exemptions from the forthcoming legislation that is expected to be released in July/August. (Obviously though, this is done without the benefit of knowing the precise detail of the draft legislation.)

B. AREAS OF IMPACT ON STOCKBROKERS

The likely impact of FOFA is of particular concern in the following areas:

1. **'Straight' Brokerage and Commission arrangements**
2. **Portfolio Administration Fees**
3. **Capital Raising – Brokers 'Stamping Fees', and**
4. **Intermediary Arrangements**
5. **Cash Management Account fee sharing**

The application (if any) of the ban to these scenarios is not clear from the materials published to date. The main information on the likely application to stockbrokers comes from an FAQ on the FOFA website, and from the Minister's *Information Pack* released in April 2011. Both are set out as follows:

> **FAQ on the FOFA website[2]:**
> *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.*
>
> There are two questions raised in the FAQ itself for further consideration:

[2] http://futureofadvice.treasury.gov.au (emphasis added)

a. whether there will be the need for brokers to split 'commissions' (normally referred to as 'brokerage' in stockbroking i.e. a % fee for execution of a trade on-market, with or without advice)
b. whether fee rebates between brokers and other licensed advisers will be caught.

Information Pack - April 2011
We note the following extract from the Minister's April 2011 release[3] 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.*

From the above, the focus of the ban seems to be:
1. the connection of the fee with **advice**, and
2. whether the percentage fee applies to assets which include a **leveraged proportion**.

We would now like to expand on the five areas of concern mentioned above. We stress that across the industry, there are variations on the models we wish to discuss depending on the business models of the stockbroker. However, we will endeavour to present 'typical' models for consideration.

1. 'Straight' Brokerage and Commission arrangements

This is the most common type of fee in stockbroking. It involves charging the client a fee for executing market transactions based on a percentage of the value of the consideration. Usually there is a minimum charge, so that the fee 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. (If there is no advice given – sometimes referred to as 'execution-only' - the rate will be lower.) 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

[3] Australian Government *Future of Financial Advice 2011 – Information Pack* 28 April 2011 p.9-10

agreement with the client. Accordingly, since it is 'transparent and product neutral' it should not attract the ban or the 'opt-in' requirements. We seek formal confirmation of this.

Commission arrangements: of more immediate concern to our Members is the effect of the following statement in the April Information Pack (set out in full above):

> *…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 as we have today. In more favourable times, firms earn more in brokerage, and advisers benefit commensurately from higher commissions. These arrangements are fully disclosed and understood by clients.

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. 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.

Our Members fail the see the efficacy or public benefit in banning broking firms from sharing brokerage with their own staff. This is the time-honoured model in stockbroking, and unlike other sectors, is transparent and fully-disclosed. It is also product-neutral in the sense that the client pays the same rate of brokerage regardless of the product.

We sincerely trust that these arrangements will not be effected by the proposed ban. Please confirm.

2. Portfolio Administration Fees

These arrangements involve a broker providing an administrative service to clients including consolidated reporting (for example, monthly/quarterly/annually) on transactions, portfolio values, capital gains, dividends, etc for which the client pays an annual fee usually based on a percentage of the value of the portfolio. Individual Transactions (with or without advice) are separately charged a (usually discounted) brokerage rate. Variations can include a higher annual fee and very low or no brokerage on transactions. They can also include the Managed

Discretionary Accounts, which attract greater regulatory requirements in terms of conduct, disclosure and consumer protection[4].

a. ***No Advice***: If the annual administration fee does not include any charge for advice, it would appear that neither the ban on conflicted volume based advice fees nor the 'opt-in' requirement would apply. Please confirm.
b. ***Advice****:* If the annual administration fee does include a charge for advice, it would appear that it would not be caught by the ban on commissions, but it would be subject to the 'opt-in' requirements. Please confirm.
c. ***Leverage:*** regardless of advice, earlier indications suggested that if the annual administration fee were to apply to any leveraged portion of a portfolio, the fee on the entire portfolio would banned. However, it would now appear that it is possible that the fee could still be charged on the unleveraged portion of the portfolio. We see no reason why the latter type of arrangement ought to be banned. Please confirm.

3. Capital Raising - Brokers 'Stamping Fees' and Underwriting Fees

Where a broker sells stock in a new issue to clients as agent for the issuer (either in an IPO or additional securities e.g. a rights issue or placement) brokers typically earn no brokerage from the client. However they will earn a fee from the Company floating or offering the new shares, commonly called a 'stamping fee'. Typically this is based on a percentage of the amount subscribed for by the investor. It is usually a relatively low rate, covering the processing costs of the broker in handling funds and organizing the registration of stock through CHESS. These arrangements are fully disclosed to clients. It may or may not be related to advice to the client. As it relates only to the one transaction that is, the subscription for new stock by the client, it resembles 'straight' brokerage. The only difference is that it is paid by the Company, not the client, on a fully disclosed basis. There is no continuing or trailing fee. We would appreciate any clarification on the application if any of the ban on commissions to this arrangement. Like brokerage, this is would appear to be a 'transparent and product neutral' fee. Please confirm.

It is unlikely that Stamping fees on capital raisings for listed companies have been the cause of client losses or complaints. Stamping fees are by far the most practical way of giving advisers an incentive to raise funds for a company. Charging a flat fee instead is not a practical solution, and may lead to higher charges to clients. For example a charge akin to brokerage on subscriptions which traditionally has not applied, may need to be applied.

Underwriting: The same principles apply to Underwriting Arrangements, except that the Stockbroker is taking on the risk that if the new issue is not taken up, the firm will be obliged to purchase the shortfall. These arrangements are always fully disclosed to clients.

[4] as outlined in ASIC Regulatory Guide 179 *Managed Discretionary Account Services*

If the above 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.

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.

4. Intermediary Arrangements

Often, stockbrokers have arrangements with other financial advisors or planners that are not market participants to execute transactions on-market for the other advisor's clients. In these arrangements, the intermediary (e.g. a financial planner/non market participant) gives advice to its client, and the client then decides to buy or sell listed securities. Not being a market participant, the planner relays the order to buy/sell securities to a stockbroker for execution on-market. The stockbroker executes the trade and settles direct with the end client, charging the client brokerage on the trade. The client settles direct with the stockbroker, paying the stockbroker brokerage. This is done directly with the client, to enable the client to obtain the advantage of share registration and transfer under the ASX CHESS system. (The intermediary could not offer this service because it is not a market or CHESS participant.) The stockbroker collects a portion of the fee payable to the intermediary by the client. Since settlement occurs directly with the stockbroker, for convenience the stockbroker pays a portion of the brokerage to the intermediary. The fee collection and reimbursement arrangement is fully disclosed. Assuming that there is no advisory relationship between the client and the stockbroker - the client is only getting advice from the intermediary - it would appear that neither the ban on commissions nor the opt-in would apply to the stockbroker. Please confirm.

5. Cash Management Trusts

Investments in Cash Management Trusts (CMT's) generally form part of the cash component of a client's investment portfolio. Indeed, with concerns over the equities markets, the cash portion of investment portfolios is generally growing[5].

CMT's also offer an efficient way of handling cash, giving the client good interest rates for money at call. Often clients give access to their stockbrokers to these funds for the purpose of settlement of market transactions, so that funds can be made available for settlement of transactions on T+3. Otherwise, clients would have to send cheques or make other arrangements that may take longer, creating settlement issues for the broker in the T+3 environment.

[5] Wilson Asset Management now holds 40% of its biggest fund in cash: *Investors play safe with cash* Australian Financial Review 27 June 2011 page 19

It is common for CMT providers to pay a commission to the stockbroker for the client's CMT. This is a variable amount. If there is little in the CMT, no commission will be earned. It is fully disclosed to the client.

Like brokerage sharing arrangements, commissions from CMT providers are part and parcel to brokers' business models. The removal of these commissions will not necessarily benefit clients. They would not receive more interest, for example.

CMT fee sharing arrangements like these should be seen more in terms of brokerage on an investment than conflicted remuneration. We do not see why these arrangements should be banned.

C. CONCLUDING COMMENTS

It is unfortunate that the actions of several licensees in the lead-up to the GFC have lead to excessive regulation effecting the whole financial services industry, when the justification for those wholesale measures has not been made out. 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.[6] 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.)[7]

The most recent figures for complaints against stockbrokers to FOS for the calendar year ended **31 December 2010** are remarkable[8]. During 2010, **53 complaints** were received against stockbrokers, a reduction of over **55%** on the previous year 2009, when **120 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 the National Guarantee Fund for that matter), Stockbrokers have attracted a very low rate of client complaints and unrecoverable losses.

[6] Financial Ombudsman Service *Media Release* 30 September 2009

[7] Financial Ombudsman Service 2009-2010 *Annual Review*

[8] Address by Alison Maynard, Ombudsman, Financial Ombudsman Service to the Stockbrokers Association of Australia Annual Conference, Sydney, 27 May 2011

Prior to the release of the Minister's *Information Pack* in April, we were not consulted on any of these proposals, or their application to stockbroking. 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 that no policy consultation took place ahead of the release of draft legislation enacting the proposals set out in the Information Pack, which we understand is due occur in July/August.

These changes will mean significant burden and expense in changes to remuneration arrangements, legal agreements and even the business models of our Members, together with major disruption to client relationships. We therefore wish to formally raise these matters, which may need to be addressed by some form of exemption or carve-out from the substantive prohibitions to be included in the Bill.

We are grateful for your time in considering these matters which we have recently drawn to your attention and trust that they may be addressed now as a matter of urgency.

Yours sincerely,

David W Horsfield
Managing Director/CEO

cc. James Chisholm, Geoff Miller & Jim Murphy, Department of the Treasury