Stockbrokers Association of Australia
Incorporating SDIA

# ASIC Consultation Paper 189
## *FOFA: Conflicted Remuneration*

## SUBMISSION

9 November 2012

The Stockbrokers Association of Australia is grateful for the opportunity to comment on ASIC's Consultation Paper 189: Future of Financial Advice – Conflicted Remuneration.

At the outset, in our Members' view, we would like to emphasise that it is very difficult to comment on draft ASIC guidance in this area without knowing the full impact of the **stockbrokers carve-outs**. (See further detail at A.1. below.)

Like the other FOFA Consultation Papers 182&183 (updating RG175), the end product of CP189 may not be a constant reference source for retail broking firms, but it will be an important statement of ASIC's views on the conflicted remuneration prohibition. It is likely to be cited by the authorities or **FOS**, etc in any regulatory review or determination of complaints. It is therefore important to consider the impact of the policy in full, including the stockbrokers carve-outs, before it is finalised.

## A. INTRODUCTORY POINTS

### 1. The Stockbrokers Carve-outs

Importantly, we note that CP189 has been issued prior to the detail of the Stockbrokers Carve-Outs from the prohibition on conflicted remuneration[1] being finalised. As noted at CP189.36 and CP189.138, any guidance on this area will need to be considered after the carve-outs are finalised.

[1] See Draft *Corporations Amendment Regulation 2012 (Third Package)* released for comment 14 June 2012; and Submission by Stockbrokers Association dated 29 June 2012

In launching the FOFA package in April 2010, then Minister for Human Services and Minister for Financial Services, Superannuation and Corporate Law the Hon Chris Bowen MP stated that the FOFA legislation would –

> '*…have the capacity to carve out specified payments if unintended payments are captured or unintended consequences occur*'[2].

The *Explanatory Memorandum* to the *Corporations Amendment (Further Future of Financial Advice Measures) Bill* September 2011 refers to the carve-out for Commission Splitting as follows:

> **(Commission Splitting)**
>
> 1.24 The regulations will also ensure that the **traditional remuneration arrangements** of employee brokers (often paid as a percentage of brokerage) are not unduly impacted by the conflicted remuneration measures.

Commenting on the draft Regulations giving effect to the stockbrokers carve-outs in June 2012, in commending the Government, we summarised the arguments in favour of granting the carve-outs as follows:

> *'As we have maintained since our discussions on this subject with Government commenced in early 2011, [the carve-outs] are entirely consistent with the FOFA principles, in particular that the adviser must act in the client's best interests. They will allow advice to continue to be given to investors that is transparent and product-neutral, backed-up by the high standards, and management, supervision and compliance arrangements demanded of market participants.'*[3]

## 2. Timing

Timing is also a key concern. It is now November and we still do not have the final details of the stockbrokers carve-outs, and ASIC will be expecting that members comply with the law on the commencement of FOFA on 1 July 2013. While of course our Members rely on the law and not necessarily ASIC policy in operating their businesses, it will be important to see the final ASIC policy in preparing for FOFA, since that is what ASIC will expect. For example, in several areas of CP189, ASIC makes important concessions or indicates that it will expect to see compliance with the provisions in a manner that may not be strictly as stated in the law. One such area is in

[2] The Hon Chris Bowen MP Minister for Human Services and Minister for Financial Services, Superannuation and Corporate Law *The Future of Financial Advice Information Pack* 26 April 2010, page 5

[3] Submission on Draft *Corporations Amendment Regulation 2012 (Third Package)* released for comment 14 June dated 29 June 2012, page 4

relation to volume-based fees that are received from the Issuer and passed onto clients (Proposal C5, p.29). Here ASIC states that, even though such payments may be Conflicted Remuneration, they may be permissible on certain conditions including that they are passed to the client within one week. The mechanics of the operation of the stockbrokers carve-outs are going to be crucial to our Members, and it is going to be important to see how ASIC views their application in structuring businesses, remuneration models, etc. We would hope that, drawing on matters raised below, ASIC may adopt a facilitative approach. ASIC has indicated that the final policy from CP189 will be finalised in February 2013. This will leave a very short time to prepare for implementation on 1 July 2013. We trust that if the transition cannot be extended, ASIC would at least take a pragmatic approach to the application of FOFA for its first year of operation to allow the necessary systems and other changes to take place. Accordingly, **we request ASIC to outline what its position will be as to timing**, especially as its policy in this area will not be finalised until well into the first quarter of calendar 2013.

## B. COMMENTS on CP189

**Conflicted Remuneration**

Conflicted Remuneration (s963A) is –

> '…any benefit, whether monetary or non-monetary, given to a financial services licensee, or a representative of a financial services licensee, who provides financial product advice to persons as retail clients that, because of the nature of the benefit or the circumstances in which it is given:
>
> (a) could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to retail clients; or
>
> (b) could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative. '

Conflicted Remuneration cannot be accepted by a Licensee (s963E), given to employees or representatives (s963J), or given by Issuers to licensees or representatives (s963K).

The Stockbrokers Association of Australia would like to provide comments on the following aspects of CP189:

1. Scope
2. Example 1: Market Participant quarter-end trading
3. Low value benefits
4. Intermediary Arrangements and Volume Based Remuneration
5. Volume-Based benefits that may not be conflicted remuneration
6. Performance Pay
7. Fees on Borrowed Amounts
8. Transitional Matters

### 1. Scope: Both Personal and General Advice covered (p.15)

While the Best Interests obligation only applies to personal advice (s961(1)), the Conflicted Remuneration provisions apply to 'financial product advice' which under s766B means personal advice **and** general advice. This has significant consequences which may be unintended, as set out below, particularly at 4.

### 2. Comments on *Example 1*: Market Participant – quarter-end trading (p.17-18)

This example involves an adviser encouraging clients to trade in the last days of the quarter so that the adviser can achieve a higher quarter-end bonus. We make the following suggestions so as to improve the example:

- While variations exist across the industry, most commissions are paid monthly, rather than quarterly;
- There may be higher commissions depending on the levels of brokerage charged e.g. 30% up to $100k brokerage; 40% for $100k-$500k; 50% for over $500k+, etc. While variations do exist, sometimes the brackets apply like tax rates, with the higher rate only applying to the amount in the next bracket, not the first $100,000, etc;
- The bonus is not a practical motivating factor for achieving short-term targets;
- The example appears to be a situation of *Further Advice*[4]. There is no indication of the clients' circumstances having changed, such as would necessitate an investigation of the clients' circumstances and the provision of a new Statement of Advice. Accordingly, it is incorrect and possibly misleading for the ASIC guidance to emphasise that *'…the advice provider does not conduct an investigation into these clients' current relevant circumstances'*. In the situation of Further Advice, this is not normally required; and
- The example also appears to be a good example of *Scaled Advice* which, as discussed in another consultation paper[5] is personal advice where holistic advice on the client's entire investment portfolio is not required, but piece-by-piece advice on certain products is appropriate.

Above all, the example ignores the **stockbrokers carve-outs**, the June draft of which included anti-churning measures. Those measures, together with the existing higher management and supervision standards of market participants, would detect behaviour of concern in any case. If any matters of concern were found, the bonus would be withheld, and possible disciplinary action would be taken by the firm.

## 3. Low Value Benefits not Conflicted Remuneration i.e. less than $300 & not 'frequent or regular' (p.22; s963C(b)(ii))

In Example 5, a Luncheon of $150 per head is provided by an issuer. ASIC takes the view that 'frequent or regular' benefits in s963C(b)(ii) means more than **three times per annum**. The $300 figure and 'frequent or regular' provisions are in the *Act*, but the 'three times per annum' condition appears to be an arbitrary condition placed by ASIC. Would a *quarterly* lunch be necessarily conflicted? Within the bounds of the law, the issue needs to be addressed with more flexibility by ASIC. For example, ASX often serves drinks at its training functions or product presentations. Is this necessarily conflicted, or is it just about being a good host.

[4] Defined in s946B(1) as amended by Reg.7.7.10AE and Reg.7.7.10B

[5] ASIC Consultation Paper 183: *Giving information, general advice and scaled advice* August 2012

## 4. Intermediary Arrangements and Volume Based Remuneration (Pt C p.24; s963L)

Our Members provide services to licensed intermediaries like financial planners or other financial advisers to facilitate stockmarket dealing. These include what are sometimes referred to as 'white label' and/or intermediary arrangements. As well as providing an execution service for completing stockmarket transactions, they may or may not provide the financial planner or adviser with research - i.e. general advice – that they publish on listed securities.

In order to satisfy AML/CTF requirements, the adviser's client normally opens an account with the market participant and provides written authority to deal. This also facilitates execution and settlement, since the adviser is not 'connected' to the trading platform or CHESS. While the principal advisory relationship is between the client and the adviser, this arrangement ensures that listed products can be bought and sold in the client's name. Settlement is also more efficient than if the adviser were interposed in the transaction.

There are a number of different remuneration models in the industry. Normally, the remuneration arrangements involve the client paying the market participant the transaction consideration plus brokerage (or receiving consideration *less* brokerage for sales). After the client has settled with the broker, the market participant will then passes an amount to the adviser, which represents among other things, a payment to the adviser for advice. However, there are other models in existence, such as where the adviser is paid a flat fee rather than a proportion of brokerage.

The issue here for our Members is where they provide general advice to the planner, and pay the planner a portion of the brokerage. Normally this is a percentage, therefore volume based. It is not usual in Australia for brokerage to be separated as a fee for execution and a fee for advice. However, the end-client is aware of the arrangement, which is **transparent, product neutral, and fully disclosed** by the adviser and ties-in with the confirmation that the client receives directly from the market participant.

Since the conflicted remuneration provisions apply to *financial product advice* it means that they apply equally to personal and general advice, such as the general advice provided to the adviser by the market participant: s766B(2).

We submit that intermediary arrangements like this should be treated as if it were 2 licensees dealing with each other. If general advice is given by a market participant to a licensed adviser as part of a share dealing service, it should not be caught by the prohibition on volume-based remuneration in making payments to the adviser.

In effect, because the adviser has no role in the execution and settlement of market transactions, the market participant is collecting the fee from the client on behalf of the adviser.

This approach is consistent with another area in CP189. In ASIC's view, benefits from Issuers that are paid to Advisers and then passed onto clients are **not** volume based fees and therefore presumed to be Conflicted Remuneration under s963L, so long as they are paid within a week, and as part of the arrangement with the Issuer: Para.60-62. As noted in our meeting on 1 November, this is really a 'no-action' position taken by ASIC in relation to conduct which would otherwise be presumed to be Conflicted Remuneration and prohibited under s963E.

We would submit that the same no-action position should be taken by ASIC in the situation of dealing services offered by market participants to licensed advisers. Where only general advice is given to the adviser, the market participant ought to be able to rebate a proportion of brokerage paid it by the client to the adviser. This could be made on appropriate conditions, for example limiting additional fees that the adviser could charge in respect of advice.

## 5. Volume-Based benefits that may not be conflicted remuneration (Proposal C5; p.29)

ASIC proposes to adopt the position that, notwithstanding s.963L (volume-based benefits presumed to be conflicted remuneration) volume-based benefits *can* be received by advisers from issuers if:

(a) the benefit is passed onto the client within one week, and
(b) it is a condition of receiving the benefit that it will be passed onto the client.

Our Members are concerned about the efficacy and practicality of ASIC's position. The suggestion that Brokers receive volume based fees and then pass them onto clients within a week would be difficult to achieve. The administration and cost to the broker would be out of all proportion to the benefit. The timeframe is certainly not workable. Fund Managers generally say that such fees are not part of their fee structure and are paid to the licensee from their own funds. Perhaps such fees should be credited back directly to the clients by the Funds.

However, the likelihood is that Fund managers would prefer to keep such fees so that there is certainty rather than give the benefit to some but not all licensees. Further, it has to be appreciated that advice will not be provided for no cost. If income is not being generated from the issuer the Broker may then raise an invoice payable by the client to compensate them for the time involved in advising and / or facilitating the investment in the Fund. On this basis the cost to the client has increased.

## 6. Performance Pay for Employees (Pt D p.32)

We presume that the Stockbrokers Carve-outs (though they are not final) will allow transactional brokerage that is paid by clients to continue to be shared with representatives. This is the traditional remuneration model of stockbrokers. However, there are a number of remuneration models other than these, including remuneration based on the value of a portfolio.

Under FOFA any remuneration based on volume of business written is presumed to be Conflicted Remuneration: s963L. However, ASIC's proposal is that up to 7% of remuneration can be performance based and not amount to Conflicted Remuneration: Proposal D3 p.37. (Apparently this figure comes from data on bank employees' remuneration.) This is somewhat arbitrary by ASIC, but at least it acknowledges that some volume based remuneration can be paid.

We note that the *Balanced Scorecard* approach is favoured by ASIC, whereby factors other than revenue are taken into account in calculating remuneration. The problem with this approach is that in a **commercial enterprise**, the overall assessment must take into account **revenue**. While we note ASIC's view that a bonus that is based on the performance of the Total Business or Unit, rather than an individual's performance, is not Conflicted Remuneration, in practice it is a very difficult system to implement, especially where traditionally a significant part of the remuneration has been based on revenue.

One of the reasons that the stockbroking industry has survived and been able to serve its clients through this difficult period post-GFC is the variable nature of remuneration costs. This means that remuneration costs keep pace with the market.

As borne out by the relatively low number of complaints to FOS against stockbrokers since 2008, this sector was not the cause of the problems which led to FOFA, like Storm Financial. To move those <u>not</u> remunerated by transactional brokerage to a salary plus small bonus model will

significantly increase the fixed costs of doing business. Inevitably this will lead to a reduction in the availability of advice to retail clients.

## 7. Fees on Borrowed Amounts (Pt F p.48; s964D)

Charging an *asset-based fee*[6] on financial products acquired with *borrowed amounts*[7] is prohibited: s964D. This prohibition covers borrowings that are *reasonably apparent*[8] to the adviser. In CP189, ASIC states that advisers cannot ignore any information about any borrowings made known during the investigation of the client's relevant circumstances conducted as part of fulfilling the best interests obligation: Proposal F2 p.50.

While the fact of the client having borrowed in the past is noted, it should not mean that the adviser is deemed to have knowledge of all future borrowing by the client, at every point in time. Moreover, there are some very difficult and often insurmountable issues that our Members would need to address in order to comply with the law as ASIC is suggesting.

It would appear that as the law stands,

- Brokerage is an *asset-based fee* under s964F;
- Under s.964D, licensees must *not* charge an *asset-based fee* on a *borrowed amount* used or to be used to acquire financial products by or on behalf of a client;

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[6] s964F sets out the meaning of ***asset-based fee***:

> 'A fee for providing financial product advice to a person as a retail client is an ***asset-based fee*** to the extent that it is dependent upon the amount of funds used or to be used to acquire financial products by or on behalf of the person.'

[7] s964G sets out the meaning of ***borrowed*** for the purposes of borrowed amounts:

> "borrowed" means borrowed in any form, whether secured or unsecured, including through:
> (a) a credit facility within the meaning of the regulations; and
> (b) a margin lending facility.

[8] s964H sets out the meaning of ***reasonably apparent***:

> *Something is **reasonably apparent** if it would be apparent to a person with a reasonable level of expertise in the subject matter of the advice that has been sought by the client, were that person exercising care and objectively assessing the information given to the financial services licensee, or the representative of the financial services licensee, by the client.*

- The exception to this is where it is not *reasonably apparent* that the amount was borrowed: s964D(3).

This means that Stockbrokers can't charge brokerage on purchases where it is reasonably apparent that the client is using margin lending (or other funding).

By way of background, in terms of margin and other funding, there are several types of client:

**A. Designated Margin Lending Client**
This client's account is designated as being financed by a margin loan e.g. '*D Smith <ANZ Margin Lending>'*. From time to time the client may fund his own purchases, but the account will be set-up so that all purchases are to be financed by margin lending unless otherwise advised.

**B. Non-Designated Margin Lending Client**
Here the client may have margin lending, but the account is not set-up as such.

**C. Client with other Funding**
Here the client funds share purchases from other sources, e.g. by drawing down a home loan.

Variations on the above will exist. For example, the Client may have more than one portfolio and **more than one margin lender**, though usually the shares will only serve as security for one margin loan. In addition, the broker may not know it is a leveraged account until the client instructs *after* the transaction that e.g. *'ANZ Margin Lending will be settling this'*

**Problems**

The **practical impact** of banning brokerage on leveraged purchases of financial products would be **dramatic**. Various aspects of the impact are set out below:

a. ***Client agreements***: having to change the agreements with the client so that a set fee is charged on margined purchases (and if so, what fee? and, how would such a fee be arrived at?), but normal brokerage is charged on everything else (unmargined purchases and all sales). This would be a huge legal, systems and logistical task (see f. below). It would also be confusing for the client, who is used to paying standard brokerage on all transactions;

b. ***Systems changes***: changes to IT systems to achieve the different charging models would be **expensive, burdensome and time consuming**, if indeed they were possible (see f. below);

c. ***Employment contracts and arrangements***: contract and systems changes with advisers so that they are no longer entitled to a split of brokerage on margined purchases would be required;

d. ***Personal/General Advice caught***: In terms of advice, Brokers provide personal advice, general advice, or no advice (execution-only) or a combination of the three. Often even execution-only Brokers will provide access to research on companies, which constitutes general advice. As mentioned above, General Advice is included in the prohibition on leveraged assets-based fees (brokerage) because it is *financial product advice*. Brokers don't often treat brokerage differently between advisory and execution-only trades. They will need separate system for execution-only v. advisory trades that are margined, because you can still charge brokerage on the execution-only trades if margined. However, as the prohibition applies to personal and general advice, even general advice will need to be covered by systems to prevent normal brokerage being charged on margin purchases. In practice, this will be incredibly difficult.

e. ***Reasonably apparent***?: Brokers don't often have access to the balance of the client's margin loan at any given time, so while it might be *reasonably apparent* under s964D(3) that the client is a margin lending client – e.g. the Designated Margin Lending Client described above, or where client profiling has disclosed it - the amount of the client's portfolio that is funded by margin loan and/or whether the specific purchase is being funded by a margin or other loan may not be known.

f. ***How to calculate the unleveraged portion***: under these provisions, the Broker would be able to charge brokerage on the unleveraged portion of a transaction, just as you can charge a continuing fee for portfolio advice and management. However, achieving this would be huge problem and is easier said than done. For example, in assessing the unleveraged portion of a margin-funded transaction, even if you have access to current margin loan details, do you assess leverage in terms of the client's portfolio or just the relevant transaction? For example, say Client A's portfolio is worth $1m. Currently Client A's portfolio is 50% leveraged (i.e. he has drawn-down his margin lending facility to the extent of $500k). Client A then buys another $100,000 worth of BHP shares, settled by drawing-down another $100,000 on the margin loan. In determining what if any (asset-based) brokerage can be charged, is the whole $100,000 deemed to be a '*borrowed amount*' and therefore no brokerage can be charged? Or is it just 60% leveraged (or $60,000) since as Client A's overall portfolio gearing becomes 60%, meaning brokerage can be charged on the remaining 40% (or $40,000)? Either way, the situation is probably unworkable because the broker needs real time access to the client's margin loan balance and overall leverage and new systems to achieve it; and

g. ***More than one broker***: even if all the above information about the client's funding position were available to the broker, another complicating factor is that clients may have more than one broker. There is no way of knowing what business the client does

with the other broker(s) and what information the client has or hasn't given to the other broker(s).

The practical, legal and logistical issues set out above mean that charging brokerage only on unleveraged portions of purchases would be effectively **impossible**. ASIC's view (as expressed in our meeting on 1 November) would presumably be that, if you can't work out the leveraged portion, then no brokerage ***at all*** can be charged. We do not believe that this is the regulatory objective of FOFA. The stockbrokers carve-outs acknowledge that normal, product-neutral brokerage is not conflicted remuneration. Accordingly, brokerage should be able to be charged on *all* purchases, notwithstanding that a portion of the consideration may be funded from borrowings.

## 8. Transitional Matters (Pt G)

***Change in portfolio a new arrangement?*** There are serious concerns with ASIC's interpretation of the law (at CP189.121) to the effect that in a portfolio management arrangement where ongoing fees are charged and trailing commissions earned, if there is a change in the portfolio post 1 July 13 - e.g. switching stocks or replacing products – this constitutes a new arrangement. Therefore, any trailing commissions from 1 July 13 will be Conflicted Remuneration. We cannot see how a change to a portfolio provided for and contemplated in an arrangement entered into prior to 1 July 13 can bring about a new arrangement. The crucial date should be date that the original contract or arrangement was entered into.

Once again we are grateful for the opportunity to provide these comments to ASIC on CP189. Thank-you also for the opportunity for our Members to discuss the proposals with senior officials recently. Should you require further information please do not hesitate to contact me or Doug Clark, Policy Executive dclark@stockbrokers.org.au .

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