Corporations Amendment (Future of Financial Advice) Bill 2011 *Corporations Amendment (Further Future of Financial Advice Measures) Bill* 2011

Submission to the Parliamentary Joint Committee on Corporations and Financial Services

21 December 2011

Please Note: This Submission consolidates the Stockbrokers Association's submissions on both the First Reading versions of the ***Corporations Amendment (Future of Financial Advice) Bill 2011*** *(which was introduced to the Parliament on 13 October 2011), and the* ***Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*** *(which was introduced to the Parliament on 24 November 2011). It supersedes and replaces our previous submissions to the Joint Committee on these Bills.*

Executive Summary

Implementation Timetable

- The timeframe for implementation of the new measures is very short. If the new measures are to come into effect on **1 July 2012**, especially given the current parliamentary inquiries and lack of Regulations which underpin the requirements, Members will not have enough time to make systems, policy and procedural changes which will be necessary for their implementation. We therefore seek a **further transition period** of at least 12-18 months from 1 July 2012.

Best Interests Obligation

- The Stockbrokers Association welcomes the **decriminalising** of the obligation to have a reasonable basis for personal advice to retail clients;
- The removal of the requirements where 'different' subject matter of advice may be appropriate as we had earlier recommended is welcomed as they would have caused serious issues in giving advice;
- The removal of requirements which would have restricted the ability of advisers to rely on expert third parties for product recommendations as we had earlier recommended is also welcomed. Advisers cannot be expected to do all their own

research;
- Compared to the earlier drafts, the Bills will go further to facilitate tailored, scaled, limited advice; and
- Existing obligations of market participants often exceed those proposed, which needs to be acknowledged in the proposed requirements.

Opt-in obligation
- As we had earlier recommended, the narrowing of the opt-in obligation to arrangements for the giving of **personal advice**, and not to other financial services, is welcomed.

Enhancements to ASIC powers
- While the provider (individual or firm) is responsible for their own actions, we fail to see why the new definition of 'provider' is required. ASIC already has sufficient powers against individuals; and
- We fail to see why the power to take action against someone 'likely to breach' requirements is necessary. Once again, the existing ASIC powers are sufficient.

Conflicted Remuneration
- It is most unfortunate that FOFA will see the implementation of the **prohibition model** in relation to **conflicted remuneration**, when in stockbroking the current **disclosure model** has not been proved to be in need of replacement;
- Consistent with the Opt-In proposals, the provisions should only apply to **personal,** not general **advice**;
- We welcome the announcements of the **Stockbrokers Carve-outs**, namely the exclusion from the definition of *conflicted remuneration* of **Stamping Fees** on capital raisings and **Commission Splitting** in remuneration arrangements, but require more information on the Regulations that will implement the carve-outs before we are in a position to make detailed comments; and
- We also welcome the clarification that **Asset-based fees on ungeared portions of portfolios** will not constitute conflicted remuneration, but seek clarification on certain aspects.

Other FOFA Matters
- Finally, we note that it is unfortunate that there is no resolution to the parallel FOFA reforms previously announced by the Government, namely –
  - the **Wholesale/Retail client** definition review, and
  - the review of **Compensation arrangements**.

Introduction

The Stockbrokers Association of Australia is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. Our membership includes stockbroking firms across the spectrum, ranging from the largest wholesale stockbroking firms to medium-sized firms, and down to the smallest firms, having mainly a retail client base.

The Stockbrokers Association is pleased to provide this submission to the Parliamentary Joint Committee on Corporations and Financial Services on the *Corporations Amendment (Future of Financial Advice) Bill* (the **'FOFA Bill'**) and *Corporations Amendment (Further Future of Financial Advice Measures) Bill* (the **'Further Measures Bill'**).

We note that one of the aims of FOFA (as expressed in Minister Shorten's announcement of 29 August 2011[1]) is to restore trust and improve the availability of advice to investors –

> *'It is a concern that only one in five Australians access financial advice. These reforms will restore trust and confidence in the sector following collapses such as Storm, Westpoint and Trio. They also remove the red tape that has prevented low-cost, good quality advice being delivered to millions of Australians.'*

The activities of stockbrokers are far removed from those of Storm, Westpoint and Trio, which led to the wholesale review of financial services in Australia. Stockbrokers would like to think that there is already a relationship of trust and fiduciary duty with their clients. This is borne out by the fact that in Calendar Year 2010 complaints to the **Financial Ombudsman Service** about stockbrokers **fell by 75%**. In figures just released by FOS for the 2011 Financial Year, complaints about stockbrokers **fell by 36%** from the previous financial year[2].

In this Submission we will comment on the following aspects of the Bills:

a. **Best Interests obligation**,
b. **Opt-in obligation** (for Ongoing Fees)
c. **Enhancements to ASIC powers**
d. **Conflicted Remuneration,** and
e. **Other FOFA Reforms** (Wholesale/Retail Client definitions & Compensation Arrangements).

However, before commenting in detail on the proposals, we would like to comment on the crucial issue of the **Timeframe for Introduction** of the reforms.

[1] Hon Bill Shorten MP Minister for Financial Services and Superannuation *Future of Financial Advice Reforms – Draft Legislation* Media Release 127 29 August 2011
[2] Financial Ombudsman Service *2011 Annual Review* available at http://www.fos.org.au/centric/home_page/publications/annual_review.jsp

Implementation Timetable

As a preliminary matter, we believe strongly that a **further transitional period** for the implementation of FOFA from the planned date of commencement (1 July 2012) should be provided. Both the Bills are the subject of 2 separate Parliamentary Inquiries. Significant Regulations which underpin the operation of the Bills cannot be settled until the Bills are passed, and this won't be until February/March at the earliest. (In addition, several important aspects of the FOFA reforms have not yet been the subject of draft legislation - see Part E below). With the two Bills not likely to be passed by Parliament until the end of first quarter of 2012, and then allowing time for the Regulations to be finalised for important aspects like the stockbrokers carve-outs, it is unrealistic to expect organizations to make the systems, policy, procedural and other changes in order to be compliant with both Bills by 1 July 2012.

We therefore believe strongly that a **further transitional period of at least 12-18 months** from the planned date of commencement (1 July 2012) should be provided for all of the FOFA proposals.

A. BEST INTERESTS OBLIGATION

The new obligations in the FOFA Bill **replace** the old 'know your client/know your product' obligations. Section s945A (requirements to have a reasonable basis for advice) and s945B (limited information warning) are repealed and replaced by s961C and s961J respectively, as well as the other provisions of the new Sub Division B.

We are pleased to see that the new best interests obligation is to be a **civil penalty provision** and is therefore **decriminalised.** As the Association has stated for a number of years[3], it is anomalous and disproportionate that breaches of s945A&B were made serious criminal offences by the financial services reforms which came into effect in 2004.

1. 'Subject Matter' of advice & obligations where different subject matter may be appropriate

We are pleased to see that the issues we had raised earlier with the proposed Section s961C(2)(d) as to the requirement of an adviser to notify the client in writing where another 'subject matter' could better achieve the client's objectives appear to have been taken into account in drafting the *Further Measures Bill*. As we note at 3. below, there is a greater acknowledgement in the Bill that the advice *given* must be tied to the advice that is *sought* by the client. It is hoped that this will facilitate the giving of more 'scaled advice', which is what most stockbroking clients require.

2. Reliance on another individual for product investigation and assessment

We had earlier raised concerns about a proposal which would have required advisers to make their own investigation into product research prepared by another party, either within or outside the firm, for example research reports from a sprecialist research house.

We are therefore pleased that the earlier draft Section 961C(g) that required the 'provider' (i.e. the individual adviser who provides advice) to either:

- conduct a reasonable investigation into the financial products that might achieve the client's objectives and assess the information gathered in the investigation, OR
- if another individual has made such an investigation and the provider has access to the results of the investigation – assess the information gathered in the investigation,

has been removed.

3. Scaled Advice

As we have previously noted, in Stockbroking, clients often seek advice on a limited basis, for example, a brief inquiry as to which stock(s) to buy or sell. Clients don't often require a full financial plan or advice on their entire circumstances or portfolio of investments. We

[3] For example, in our Submission to the Government's *Review of Sanctions for Breaches of Corporate Law* dated 6 June 2007

were therefore pleased to see that the Government in rewriting the *Further Measures Bill* appears to have taken steps to accommodate clients and their limited requirements.

ASIC has also stated that it is working to facilitate tailored or scaled advice. In a recent Consultation Paper[4], ASIC sought to provide additional guidance on how to 'scale' advice. By way of background to the guidance, ASIC noted that a recent survey found that **one-third** of Australians prefer scaled or 'piece-by-piece' financial advice rather than comprehensive or 'holistic' advice.[5] (Our Members would suggest that if this survey were solely conducted in **stockbroking**, the figure would be significantly **higher** than one-third.)

It is therefore encouraging to see that the Government has made the following improvements to the proposals (and ASIC is taking measures to facilitate the type of service that a growing number of clients want):

a. Restoration of a concept akin to 'Relevant Personal Circumstances': 'Client's Relevant Circumstances'

Earlier, we commented that the Exposure Draft of the Bill removed the concept of *Relevant Personal Circumstances* from the process of giving advice and noted the issues such removal raised. We were therefore pleased to see that Section 961B(2)(b)(ii) restores the concept of the ***client's relevant circumstances***, namely

> *...the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter*

This concept is important to ensure that the advice is given in context of the subject matter of advice that is being sought by the client. It restores a concept that has been known to the law since the 1980s, namely the requirement to inquire about the ***relevant personal circumstances*** of a client in providing personal advice[6].

b. Further steps to tie Advice to the Client's Circumstances

We have also previously raised concerns that there was a drift in emphasis away from what the client *is requesting*, to what the client *may need* in terms of advice. Inherent in the latest 'know your client / know your product' obligation are concepts which tie the advice sought to the client's circumstances and needs, which is a connection we had recommended be reintroduced into the law. This is seen in the concepts of -

- ***client's relevant circumstances*** under Section 961B(2), those circumstances that are relevant in the context of the advice sought,
- ***reasonable investigations*** into financial products under Section 961D, which specifically do not require investigations into *all* financial products available, and
- ***reasonably apparent*** under Section 961C which is judged in the context of the advice being sought by the client.

[4] ASIC Consultation Paper 164 *Additional guidance on how to scale advice* July 2011 ('CP164'). ASIC has announced that it will redraw this guidance to take FOFA into account: ASIC Advisory AD11-294 *ASIC's plans for FOFA Reforms* 13 December 2011.
[5] CP164.1
[6] See Section 945A (Requirement to have a Reasonable Basis for Advice), which will be repealed by the Bill.

It is also pleasing to see the removal of obligations which were proposed which imposed a 'negative' duty to advise and warn on other products that may have been appropriate (s961C2d&f), or special provisions where a product was being recommended in substitution for a product s961C2h.

This should foster scaled advice.

4. Professional Indemnity Insurance – ASIC RG 126 (Compensation Arrangements)

Given the introduction of the concept of 'Provider', even though Civil Liability is to remain with AFS Licensees and Authorised Representatives, the regulatory risk (in terms of the possibility of Banning) faced by Representatives providing Retail Personal Advice will increase. This may lead to higher premiums if there is the need to review Retail Compensation/PI Insurance arrangements to cover Representatives.

5. Incentive to revert to 'representatives' model

In stockbroking, two models apply in relation to representatives: some Market Participants have appointed all their Advisers as Authorised Representatives, while most have taken best advantage of Section 910A(a)(iv) and appointed very few or no Authorised Representatives.

Those who have networks of Authorised Representatives may face requests from Authorised Representatives to revert to 'Representative' status. This would remove the need for tailored FSG/SoA formats for the Authorised Representative, and importantly, would mean that the former Authorised Representatives avoid the new civil penalty provisions that would have applied to them personally.

The potential ramifications should be considered. ASIC would be likely to be forced to take a hard-line on the interpretation of Section 910A(a)(iv), in order to protect the utility (to ASIC) of having Authorised Representatives providing Retail Services.

6. Relevance of other Market Participant Obligations

Proposed Section 960B states that the new provisions apply -

> *'...in addition to any other requirements imposed by the Corporations Act or any other law'*.

Our Members, who are Market Participants, are already subject to a number of obligations which already carry Best Interests obligations. The new obligation should be made subject to other existing obligations, or the result will be uncertainty confusion, and also an inequitable outcome for our Members compared to other financial services provided. For example, our Members could already face action by ASIC for failure to act in the client's best interests and penalties of up to $1m. No other sector of the financial advice industry faces this level of regulation.

Under the AFS licence (e.g. general obligations under s912A), and the special obligations under the *ASIC (ASX Markets) Market Integrity Rules* enacted by ASIC under s798G of the *Act* (and the common law[7]), our Members are already under the obligation to ensure that they act in the client's best interests.

Some of the existing obligations under the Market Integrity Rules relevant to acting in a client's best interests are as follows[8] -

- restrictions and special disclosures on giving advice in particular situations,
  - when acting for offeror in Buy-Back or Takeover (Rule 6.3.1), and
  - when in possession of price sensitive information which may prejudice another client (Rule 3.6); and
  - when selling an underwriting shortfall (Rule 5.10.5)
- Client Order priority (Rule 5.1);
- Principal trading (Rule 3.2);
- Staff Trading (Rule 5.4);
- Unprofessional Conduct (Rule 2.1.5); and
- Good fame and character requirements (Rule 2.1.4).

Importantly, the concept of **Unprofessional Conduct** is one that already sets high standards of conduct for market participants and their advisers in their dealings with clients. Under Market Integrity 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.* (emphasis added)

Findings of Unprofessional Conduct are very serious matters and carry a maximum penalty of **$1,000,000** together with other licensing, banning or criminal action by ASIC.

Stockbrokers are already under comprehensive common law and regulatory duties to act in the client's best interests. We seek **clarification** as to how these existing provisions will fall within the new regime, particularly where there is **duplication of requirements** between the *Corporations Act* (once amended by the FOFA *Bills*) and the *Market Integrity Rules***.**

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[7] *Daly* v *Sydney Stock Exchange* (1986) 160 CLR 371; (1986) 65 ALR 193; (1986) 60 ALJR 371; (1986) 4 ACLC 283

[8] In setting out these Market Integrity Rules, we note that certain of these obligations are also found in the *Corporations Act*, e.g. client order priority (s991B), principal trading (s991E), and staff trading (s991F).

B. OPT-IN FOR ONGOING FEES

In our earlier submissions, we raised concerns about the breadth of fees to which these provisions would apply, namely, that they should only apply to fees for personal advice to retail clients. We also noted the uncertainty as to the consequences of a client failing to opt-in to a new arrangement every 2 years.

We are therefore pleased that both the above issues have been addressed:

1. **Breadth of Application:** one of the cornerstones of the FOFA reforms is the removal of conflicted remuneration for advice. The earlier draft of the new provisions in s962A(1) which applied the opt-in and disclosure requirements for ongoing fees for 'financial services' was too broad.

   We are pleased to see that the new version of s962A(1) only applies to arrangements where fees are charged for 'personal advice' to retail clients.

2. **Failure by Client to agree to Opt-In**: the earlier draft Bill did not address the consequences of the Client not agreeing to Opt-In. We raised concerns as to the duties of the Provider if a material 'portfolio' event occurs at around the time the Provider is no longer able to charge on-going Personal Advice fees, for example
   a. Is the Provider expected to contact the client to 'Warn' of developments, and to charge an 'episodic' fee?
   b. Would the client have recourse to the Provider/AFS Licensee if reasonable service expectations are not met?

   We are pleased to see that the new version of s962M and s962N addresses this scenario by providing that a failure by the client to opt-in will lead to termination of the arrangement. As stated in the *Explanatory Memorandum* to the Bill,

> **Opt-out process**
> 1.43 The renewal notice requirement establishes a framework by which clients are asked by the fee recipient if they wish to renew the ongoing fee arrangement. **If the client does not actively renew that agreement within the renewal period, the client is assumed to have opted out of the ongoing fee arrangement**.
> 1.44 If the client communicates to the fee recipient in writing within the renewal period that they do not wish to renew the ongoing fee arrangement, the arrangement terminates on the day on which the notification is given. ***[Schedule 1, item 10, division 3, section 962M]***
> 1.45 **If the client does not notify the fee recipient in writing that they wish to renew the ongoing fee arrangement, the arrangement terminates at the end of an additional 30 days after the renewal period.** The Bill infers a client's failure to respond to a renewal notice to mean that the client does not wish to renew the ongoing fee arrangement. This might be due either to the client's disengagement or to a conscious decision by the client not to actively renew because, for example, they considered they were not receiving value for the fees they were paying. ***[Schedule 1, item 10, division 3, section 962N]***
> *(emphasis added)*

We commend the Government for making both the above changes.

C. ENHANCEMENTS TO ASIC POWERS

We wish to raise concerns in two areas:

1. ***Provider***: the new definition of 'provider' makes the individual who gave the advice responsible for the advice. Legally, while the Licensee or the Authorised Representative is still legally liable for the advice, the expanded 'Provider' definition is designed to make it clear that ASIC can take action against the individual (e.g. by way of banning order), as well as civil penalty action (or civil recovery by the client) against the Licensee or Authorised Representative. In seeking these powers, ASIC appears to want absolutely no doubt about its ability to take action. We fail to see why ASIC's existing powers are not sufficient in this regard.

2. ***Likely to breach***: ASIC's powers are to be expanded so that it can ban people if they are *likely to breach* requirements. As with the addition power over providers above, we fail to see why this is really needed, and would argue that ASIC's existing powers are sufficient.

3. ***Good fame and character***: we would also note that a good fame and character requirement already exists for our Members and their staff as market participants. This does not exist for other sectors, like financial planning. Market Integrity Rule 2.1.4 requires every person in the firm to be of good fame and character and high business integrity[9]. The maximum penalty for a contravention of this Rule is a fine of $1m. Good fame and character is already a stronger requirement for stockbrokers than other sectors.

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[9] **2.1.4 Persons involved in the business—Good fame and character requirement**
(1) A Market Participant must ensure that any Employee or other person who is or will be involved in the business of the Market Participant in connection with the Market and, in the case of a body corporate, each director or Controller, is of good fame and character and high business integrity having regard to subrule (2).
(2) In assessing whether a person is of good fame and character and high business integrity for the purpose of subrule (1):
(a) a person will not be of good fame and character if he or she is disqualified from managing a corporation under the Corporations Act or under the law of another country, or is an insolvent under administration or its equivalent in another country; and
(b) a person may not be of good fame and character or high business integrity if the person has been:
(i) charged with or convicted of any offence;
(ii) disciplined or adversely mentioned in a report made by, or at the request of, any government or governmental authority or agency;
(iii) adversely mentioned in a report made by, or at the request of, the Market Operator, a Clearing Facility, a Settlement Facility or any other exchange, market operator or clearing and settlement facility; or
(iv) disciplined by the Market Operator, a Clearing Facility, a Settlement Facility or any other exchange, market operator or clearing and settlement facility.
Maximum penalty: $1,000,000

D. CONFLICTED REMUNERATION

In this Part, after some introductory comments on the advent of the prohibition model and the scope of the definition of *conflicted remuneration*, we will concentrate on the following matters, which have already been the subject of detailed correspondence with Treasury during this year[10], namely the **carve-outs** from definition of **Conflicted Remuneration** of the following:

1. **Stockbrokers Carve-outs: Stamping Fees** on capital raisings and **Commission Splitting** in remuneration; and
2. **Asset-based fees on ungeared portfolios.**

Conflicted Remuneration: Prohibition v. Disclosure

The Bill contains a general prohibition on financial services licensees or advisers receiving **'conflicted remuneration'**. Conflicted remuneration is defined broadly as being any benefit that may influence the advice that is given. As stated in the *Explanatory Memorandum* to the Bill:

- 1.12 Conflicted remuneration means any monetary or non-monetary benefit given to a licensee or representative that might influence or distort advice, by either influencing the choice of financial product being recommended or by otherwise influencing the financial product advice more generally. ***[Schedule 1, item 11, subsection 963(1)]***

Placing an absolute **ban** on the **receipt** of conflicted remuneration is a different approach to the current law, which merely requires **disclosure** of any interests or benefits which may influence advice: section 947B(2)(d) and (e). This is complemented by other duties, for example the duty to act *efficiently, honestly and fairly*[11], and the proposed *best interests* duty in the first FOFA Bill. We are not convinced that the '*disclosure model*' needs to be replaced with prohibition. Once again we note that it appears that the law is being changed for the thousands of financial services licensees in Australia because of the misconduct of a few recalcitrant organizations in the lead up to the Global Financial Crisis. We are not convinced that in the stockbroking industry there has been such a systemic failure in the disclosure model that it requires its replacement with prohibition.

Prohibition needs narrowing

We submit that section 964 and the whole prohibition on *conflicted remuneration* need to be reconsidered and redrafted so that they are more aligned to the *actual objectives* of FOFA. Rather than prohibiting the movement of funds between financial product issuers or sellers, the section needs to be redrafted so that it has some **nexus** to the actual definition of *conflicted remuneration* i.e. where a benefit is given to a licensee or their representative in respect of *advice* provided to a client that might influence the financial product

[10] For example, Submission to Treasury *Future of Financial Advice – Ban on Commissions – Impact on Stockbrokers* 8 August 2011 which can be found at http://www.stockbrokers.org.au/PolicyRegulatoryIssues/RecentFOFASubmissions/tabid/363/Default.aspx

[11] Section 912A(1)(a)

recommended or the financial advice given. (As discussed below, one way to achieve this would be to narrow the prohibition to **personal advice**.)

Carve-outs from conflicted remuneration

There are various carve-outs in the Bill from *conflicted remuneration* for certain benefits in certain circumstances set-out in section 963A. For example, one area where the prohibition does not apply is for benefits received for **execution-only** transactions where no advice is given: section 963A(1)(c).

As with the existing law, none of these provisions apply to dealings or advice given to **wholesale clients**.

Prohibition should apply to Personal, not General advice

One of the primary concerns we have with the conflicted remuneration provisions is the fact that they apply to the provision of **both general and personal advice**. Expanding the scope of FOFA to general advice unnecessarily complicates the implementation and administration of the regime and results in a number of what we believe are unintended consequences. We believe including general advice in the FOFA provisions makes the scope so broad that it is virtually unworkable as a reform package and will be incredibly difficult to implement into business operations.

In our opinion, the inclusion of general advice goes well beyond the original intention behind FOFA i.e. removing the risk of retail clients receiving conflicted advice that may be inappropriate for them due to the fact that the adviser/financial planner is paid a commission. By definition, **general advice does not take into account a person's needs or objectives so it is not appropriate to apply a conflicted remuneration regime when a recommendation is not being made based on the person's individual circumstances**.

The scope of FOFA needs to be narrowed back to its original intent. Financial advisers that are paid commissions in respect of the advice that they provide to their clients are generally (if not always) providing personal advice and in our opinion it is this type of advice that was intended to be addressed by FOFA. We understand that the Government is concerned that if it was only personal advice that was captured, then parties providing financial advice would rely on general advice as a business model. With respect, we contend that this is an unlikely scenario because the fundamental value proposition of any party that provides personal advice (including stockbrokers and financial planners) is that they provide advice that it **tailored** to the needs of their clients. This value proposition is not possible within the framework where only general advice is provided.

For these reasons, our view is that the FOFA reforms should only apply to the provision of **personal advice.**

Stockbrokers Carve-outs

The two carve-outs of particular interest to our Members are of course those relating to **Stamping Fees** and **Commission Splitting**. **Stamping Fees** are fees earned by brokers in the sale of new securities to clients on behalf of a company in order to raise capital. **Commission Splitting** refers to the traditional and widespread stockbroker's remuneration model in which the adviser is paid a proportion of the brokerage paid by the client to the firm.[12] These carve-outs are not outlined in detail in the Bill. However, they will be set out in later Regulations to be made after the passage of the Bill, under the regulation-making power to exempt '*prescribed benefits…given in prescribed circumstances*' in section 963A(1)(e) and section 963B(f).

The *Explanatory Memorandum* to the Bill refers to the carve-outs for Stamping Fees and Commission Splitting as follows:

(Stamping Fees)

- 1.25 It is proposed to exclude certain stockbroking activities from being considered conflicted remuneration, by allowing persons undertaking these stockbroking activities to receive third party 'commission' payments from companies where those payments relate to capital raising. The precise breadth of the carve-out would be subject to further consultation, but it is proposed that the receipt of '**stamping fees'** from companies for raising capital on those companies' behalf not be considered 'conflicted remuneration' where the broker is advising on and/or selling certain capital-raising products to the extent that they are (or will be) traded on a financial market. It is proposed that the carve-out would apply to any person authorised to undertake the relevant stockbroking activities pursuant to the capital raising carve-out, including both direct and indirect market participants.

- **(Commission Splitting)**
  - 1.26 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. *(emphasis added)*

We welcome the Stockbrokers Carve-Outs, but are unable to provide detailed comments at this stage without further detail of the substance of the provisions, which we understand will not be available until consultation commences on the draft Regulations. Until that time, we look forward to further assisting in the consideration of the appropriate circumstances of the carve-outs, or any other matter which you may wish to discuss. However, at this time we would like to mention four aspects of the stockbrokers carve-outs, namely **employment arrangements**, **intermediary arrangements**, **stamping fees** and **cash management trusts**.

a. Stockbrokers Employment Arrangements

It is common in stockbroking for advisers to be engaged on an exclusive contractual basis, rather than a normal employee arrangement. In terms of their dealings with clients, these contractors operate in the same way as all the other employed advisers. We trust that the

[12] Further details of these arrangements are set out in our Submission of 8 August 2011, referred to in Note 1 above.

Commission Splitting carve-out will be flexible enough to encompass these **alternative employment arrangements**.

b. Intermediary arrangements

Despite some indications from Treasury that certain carve outs from the conflicted remuneration provisions under FOFA would be provided in relation to 'intermediary share broking' arrangements, we remain concerned that a number of our Members' business models could be adversely impacted by the FOFA reforms, particularly –

- Execution arrangements between stockbrokers and financial advisers who are not market participants, and
- White label arrangements.

There appears to be minimal risk to customers of receiving conflicted advice in these arrangements, which are transparent and product neutral and no evidence of any historical market failure that needs to be corrected.

c. Stamping Fees

As it is currently drafted, it appears that sections 963 and/or 964 could prohibit 'subunderwriting' or 'firm allocation' fees paid by a lead or joint lead manager to an IPO or placement of securities to licensees which provide financial product advice to retail clients, as consideration for that licensee undertaking to subscribe for, or procure others to subscribe for, an agreed quantity of financial products. These payments would arguably be caught by the draft provisions on the basis that they are either payments which 'might otherwise influence the financial product advice given to retail clients by the licensee' (s963(1)), or payments made by an issuer or seller of a financial product (s964(1)) – although in relation to s964, it is not clear whether an 'issuer or seller' would include a lead manager in this situation.

In addition, it appears the current drafting of section 963 would prohibit payments made by licensees to their representatives that are determined according to the level of brokerage and other capital market related fee revenue generated for the firm by the adviser's efforts. Brokerage fees themselves are arguably carved out of the current draft (on the basis that they are a benefit given by the client to the licensee in connection with financial product advice given by the licensee under s963A(d)), but incentive payments made by the licensee to its representatives that are based on brokerage levels or other capital market related fee activity would currently be banned by section 963(2) of the draft legislation. Such a result would be counter to all the indications from the Minister and our related discussions that made it clear that 'traditional remuneration arrangements' of stockbrokers, and 'stamping fees' would not be affected. **It is essential for the continued sound functioning of Australian capital markets that the proposed regulations are sufficiently broadly drafted to enable the continued payment of fees of the nature described above, and to enable licensees to continue to pay their representatives incentives that are based on the amount of those fees.**

d. Cash Management Trusts

CMT's are commonly used by clients as a bank account facility that earns better interest than normal bank deposits, but with just as much flexibility, so that cash is readily accessible

for settlement of market transactions. It is common for banks to pay a commission to stockbrokers and other financial services providers in respect of their clients' cash management trust balances. We note earlier discussions, which are now reflected in the proposed law, that if purely factual information about CMT's is provided to clients – i.e. no advice is given - then the conflicted remuneration provisions will not apply to CMT's. Indeed, the treatment of CMT's as bank facilities is consistent with other existing *Corporations Act* provisions which do not require Statements of Advice to be provided in respect of personal advice on CMT's[13].

Asset-based fees on Ungeared portfolios

Earlier in the FOFA process, it appeared that if **any portion** of a client's investments were funded by borrowings (i.e. 'geared'), asset-based fees could not be charged on the **entire portfolio**. Our members therefore welcome the provisions in the Bill which clarify that the ban only applies to the **ungeared portion** of the client's investments: section 964F. The *Explanatory Memorandum* states:

- 1.52 To the extent that a retail client's funds are not geared, the licensee and or their authorised representatives can charge an asset-based fee on that 'ungeared' component.

The exception in the Bill applies where it is not *reasonably apparent* that the investments are geared. Section 964F(2) states -

> Subsection (1) *[i.e. the prohibition on charging asset-based fees on geared funds]* does not apply if it is not reasonably apparent that the funds used or to be used to acquire financial products by or on behalf of the client are geared funds.

We trust that the provisions of the Bill achieve the aim as expressed in the *Explanatory Memorandum* above, as there is some ambiguity in the language of the Bill. For example, it would assist if the prohibition more clearly applied only to the geared component, not the ungeared component.

a. Definition of 'asset based fee'

The draft definition of 'asset based fee defines the fee as one that is based on the size of the client's (initial?) contribution to the portfolio. However, the most common fee arrangement (and the commonly accepted definition of the term "asset based fee") is a fee which is determined according to the size of the client's portfolio from time to time, not the amount of money they may have initially invested in the portfolio. We therefore **recommend** that the definition of 'asset based fee' is amended to refer to a fee that is **based on the size of a client's portfolio at or around the time the relevant fee is calculated**.

b. Description of the prohibition

The prohibition applies to charging an asset based fee on geared funds used or to be used to acquire financial products. As noted above, asset based fees are typically based on the size of the client portfolio at the relevant time. Accordingly, we **recommend** that, rather than

[13] Section 946B(5), as modified by Regulation 7.7.10AE (Dec.2005)

banning a fee on 'geared funds', the prohibition might be more effectively formulated as a prohibition on **charging an asset based fee on the portion of a client's portfolio that represents the amount of the borrowings incurred by the client in order to acquire that portfolio that are outstanding at the time the relevant fee is calculated.**

c. Application of the prohibition only when gearing was recommended

The prohibition applies whether or not the client's adviser actually advised them to borrow to invest. As a result, it unfairly penalises advisers who 'inherit' clients with an existing loan arrangement, and advisers whose clients make their **own decisions** regarding how they will fund their portfolios. It goes beyond the objective behind the provisions of ensuring that advisers who recommend gearing to their clients appropriately manage the conflict that may be created by an asset based fee. We therefore **recommend** that the prohibition should **only apply** in situations where the **client took out a loan on the advice of their adviser**.

d. Obligation on advisers to enquire about client's borrowings

In order to ensure that they are not charging a prohibited asset based fee, advisers will need to make additional enquiries to confirm the client's source of funding. This is inconsistent with the Government's initiatives to support the provision of scaled advice. We therefore **recommend** that the prohibition should **only apply** in situations where the **client took out a loan on the advice of their adviser**.

e. Derivatives Collateral and 'gearing'

Under the ASX Clear and other rules on the clearing and settlement of derivatives, clients may be required to lodge collateral in order to secure the exercise of certain derivatives contracts. To give a simplistic example: if a client were to sell 1 call option over BHP shares on the ASX Options Market, the client would need to lodge 100 BHP shares in order to ensure that those shares are delivered to the buyer if the option were exercised. As these lodged shares are 'geared' to the extent that they may not be sold by the holder, and secure the possible exercise of the option, **we seek clarification** as to whether they would need to be **excluded** from the net value of a portfolio for the purpose of calculating the 'ungeared portion' over which fees may be charged. There is a strong argument that they should not, since even if the option were exercised, the client will receive the exercise price in consideration for the shares. Apart from any difference between the market price and the exercise price, the client will retain the value of the shares (plus the premium already earned when the option was sold) even if the option is exercised. This is one of the reasons why Margin Lenders already allow shares purchased with margin loans to be lodged as collateral for options positions. For the purpose of valuing the portfolio therefore, the value of the shares *less* the margin loan should continue to be the relevant amount, with no further reduction required for the fact that the shares have been lodged as options collateral. **To avoid uncertainty, we seek confirmation of this.** One **solution** would be for the Regulations to specifically exclude shares lodged under the rules of a central clearing house from the definition of **'gearing'** for these purposes.

E. OTHER FOFA MATTERS AND CONSULTATIONS

Finally, we look forward to further detail about other aspects of the wider FOFA project, in particular –

- the review of the **definitions of 'retail' and 'wholesale'** investors[14], and
- the results of Mr St John's inquiry into **compensation arrangements**[15].

We are once again grateful for the opportunity to raise these matters with the Joint Committee in the process of the enactment of these important matters of law reform.

We look forward to addressing the Joint Committee further on these matters.

David W Horsfield
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STOCKBROKERS ASSOCIATION OF AUSTRALIA
21 December 2011

[14] FOFA Options Paper *Wholesale and Retail Clients* 26 January 2011
[15] FOFA Consultation Paper *Review of compensation arrangements for consumers of financial services* April 2011