Association of Financial Advisers

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The Treasury
Financial Services Reform Taskforce
Langton Crescent
Parkes ACT 2600

By email: FOFAGrandfathering@treasury.gov.au

Dear Treasury,

AFA Submission: Ending Grandfathered Conflicted Remuneration for Financial Advisers: Draft Regulations

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are currently practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

1. Summary

The key points that we have set out below in this submission, are as follows:

- There has been a failure to comply with the Terms of Reference for the Royal Commission in terms of the requirement for due consideration of the implications of the recommendations.
- There has been continued misrepresentation of the history of the grandfathered commissions issue.
- There has been a lack of clarity on the implications of the proposed ban on grandfathered commissions as the Corporations Act definition of conflicted remuneration means that there are a range of circumstances where the payment of commissions is not conflicted remuneration.
- There is a great deal of complexity in building a rebate scheme that has not been taken into account, which will make it very costly for product providers.

- The record keeping requirements seem excessive and the purpose is not clearly defined.
- The ultimate objective in terms of the benefit to the consumer has never been identified and therefore there is no guarantee that the simplistic approach to such a complex issue will indeed benefit all of the clients impacted.

2. Introduction

The AFA has been very vocal on the issue of grandfathered commissions, throughout the Royal Commission process and in response to the draft legislation that was released by Treasury for consultation on 22 February 2019. This is not due to some ignorant self-interest, resistance of change or lack of desire to meet consumer expectations. It is about a fair representation of the issue and the implications of the recommendations. We provided a very comprehensive submission to Treasury on 22 March 2019 in response to the draft legislation. We do not intend to repeat everything that we said in that submission, however we do feel that it is necessary to set out our starting position on the issue of grandfathered commissions, which is as follows:

- The AFA acknowledges the recommendation from the Banking Royal Commission to ban grandfathered commissions and that this recommendation has been supported by all sides of politics.
- The AFA does not support arrangements where commissions are being paid and no service is being provided.
- We accept that grandfathered commissions in the main, will and in many cases, should be removed.
- We are deeply concerned that there are unintended consequences playing out right now that impact the financial integrity of financial advice practices and in turn the emotional health and wellbeing of honest hard-working financial advisers, including those younger advisers who have recently acquired businesses with debt, based on the valuation of recurring revenue, including grandfathered commissions.

We continue to argue for a more comprehensive review of the issue, a more pragmatic timeframe and an improved solution for clients who are currently in grandfathered commission products and are receiving services from their financial adviser and are happy with their current arrangements.

We remain concerned as to whether both the policy objective has been clearly defined and whether the winners from this exercise will be the intended winners. It is clear that there is virtually no appetite amongst the politicians or others who implement their decisions, to seek to genuinely understand this issue. We have particular concerns about the extent to which this process will deliver a fair outcome for all.

Key Points and Recommendations from the AFA's 22 March 2019 Submission

We believe that it is appropriate to repeat our primary points from our earlier submission:

- There is a lack of clarity on what the policy objective is.
- There is a complete lack of data and analysis on the issue of grandfathered commissions.
- The Royal Commission misrepresented the assertion that grandfathered commissions was a compromise as a result of lobbying pressure from industry groups during the FoFA process.
- Until the Royal Commission raised the issue, there had been no indication at all with respect to a ban on grandfathering. Grandfathered commissions were not in dispute during the 2012 Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the FoFA legislation and both sides of politics agreed to confirm grandfathered commissions in approving a Regulation in November 2014. Neither Treasury nor ASIC have undertaken or indicated the necessity to undertake any activity in this space over a long period of time,

with the exception of a recent post Royal Commission project by ASIC, that appears to suggest that the level of grandfathered commissions is quite small.

- There are a range of reasons why clients may have remained in grandfathered commission products, despite continuing to receive financial advice, including exit fees, CGT, Centrelink treatment, and insurance. Nothing has been proposed to address these factors.
- Grandfathered benefits exist at many levels and their removal will involve great complexity and have broad consequences.
- There is a complete lack of clarity with respect to how this ban will be implemented.
- It is therefore unreasonable to seek to ban grandfathered commissions in the timeframe that has been proposed.
- The consequences of this policy will have a significant impact on many small business financial advice practices and the re-assessment of business loans based on this policy has already commenced. There will be many people who are unfairly impacted.
- Consideration of the constitutional and property rights issue needs to be undertaken.
- There is no regulatory impact statement.
- There is a lack of consideration of who, if anyone will really benefit from this policy.

All the matters above, were set out in our 22 March 2019 submission and we encourage any reader to give due consideration to that submission as part of this process.

Our key recommendations in our 22 March 2019 submission were as follows:

- Assuming that there is a ban on Grandfathered commissions, that it be implemented after a three-year transition period, subject to the following further conditions:
    - Certain legacy products such as lifetime annuities and whole of life are exempted.
    - Clients have the option to opt-in, in order to continue a grandfathered commission arrangement, where they can continue to access financial advice.
    - Government to provide CGT rollover relief and Centrelink rollover relief to relevant clients.

Royal Commission Terms of Reference

At the conclusion of an exercise as significant as the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, it is appropriate to go back and assess the outcome, relative to the original Terms of Reference. We particularly think that this is appropriate with reference to any recommended changes to the law relating to the provision of financial services. The key sections of the Terms of Reference that apply with respect to the Royal Commission's authority to inquire, include the following matters:

(f) *the adequacy of:*

(i) *existing laws and policies of the Commonwealth (taking into account law reforms announced by the Commonwealth Government) relating to the provision of banking, superannuation and financial services; and*

(ii) *the internal systems of financial services entities; and*

(iii) *forms of industry self- regulation, including industry codes of conduct:*

To identify, regulate and address misconduct in the relevant industry, to meet community standards and expectations and to provide appropriate redress to consumers;

(h) *whether any further changes to any of the following are necessary to minimize the likelihood of misconduct by financial services entities in future (taking into account any law reforms announced by the Commonwealth Government:*

(i) *the legal framework;*

(ii) *Practices within financial services entities;*

(iii) the financial regulators;

AND, without limiting the scope of your inquiry or the scope of any recommendations arising out of your inquiry that you may consider appropriate, for the purposes of your inquiry and recommendations in relation to the matter mentioned in paragraph (f):

(k) <u>We direct you to have regard to the implications of any changes to laws</u>, that you propose to recommend, for the economy generally, <u>for access to and the cost of financial services for consumers</u>, for competition in the financial sector and for financial system stability; and

(l) We authorize you to have regard to <u>comparable international experience</u>, practices and reforms.

We believe a few points need to be made with respect to the Royal Commission Terms of Reference:

- There were no case studies with respect to misconduct by financial advisers as a result of the existence of grandfathered commissions. There was merely the suspicion that grandfathered commissions might contribute to misconduct as it was possible that it could incentivize an adviser to avoid recommending a client move to a more modern product. This is an assumption, which we would accept may be correct in some cases, however not as a general rule.
- Therefore in the absence of the Royal Commission demonstrating misconduct with respect to grandfathered commissions, we question whether paragraph (h) is triggered to consider any changes to the legal framework.
- In terms of paragraph (k), there has been no assessment by either the Royal Commission or the Government as to the implications of this change in the law.
- There has been no consideration of any international experience with respect to grandfathered commissions.

The ban on grandfathered commissions will disturb the financial advice relationship for many clients and will result in many no longer having access to financial advice. The ban on volume bonuses will also push up the cost of running a financial advice business and therefore will ultimately increase the cost of accessing financial advice. These implications have not even been considered. This recommendation and the draft legislation and draft regulations have been put forward in a policy and information vacuum. There will be substantial consequences as a result of the proposal to ban grandfathered commissions, which will be much greater, dependent upon the timeframe that is made available to do this. The mere existence of a Royal Commission and the resultant media attention, does not justify the avoidance of any focus upon the implications of this change. This represents a failure of democratic processes.

Continued Misrepresentation of the Grandfathered Commissions Issue

The payment of grandfathered commissions is not a breach of the law as the law currently stands. It may well be the case that grandfathered commissions are now considered to be below community standards. We would argue that this is an outcome of the Royal Commission and the media and other stakeholder response to the Royal Commission. For the reasons set out below we believe that it is neither fair nor correct to suggest that grandfathered commissions were, in the eye of the community who are consumers of financial advice, below their standard, prior to the Royal Commission:

- We are not aware of a single parliamentary inquiry calling for a ban on grandfathered commissions.
- We are not aware of any report from ASIC that has identified the continuing extent of grandfathered commissions and any detrimental impact on clients.
- There had been no media coverage with respect to banning grandfathered commissions.
- We are not aware of a single financial adviser who was prosecuted or banned as a result of

providing financial advice to stay in a grandfathered commission product that was no longer suitable for the client.

- No institutions moved to ban or limit grandfathered commissions until after the conclusion of Round 2 of the Royal Commission.

If anything, grandfathered commissions might now be considered to be below community standards, principally because it is assumed that no ongoing service is being provided and that clients should already have been moved to a better product. There just seems to have been no consideration given to the fact that many advisers are continuing to service their clients in grandfathered commission products and there are many clients who cannot be moved out of grandfathered commission products. There has been a complete failure of process to even consider these situations.

It is one thing for community standards to have changed, however it is a totally different thing for history to be re-written on the back of a Royal Commission and a media driven change of community standards. It is not acceptable for the history to be ignored and for it to be misrepresented. Neither is it acceptable for so many to change their long-held views, simply because it has become politically expedient. With any form of change of this scale, there are going to be winners and losers, and there are a large number of financial advisers who will be materially disadvantaged, and the impact will flow on to their clients, staff and suppliers. We are forced to accept that community standards have changed as a result of the Royal Commission, however we do not have to accept that financial advisers should be condemned and unfairly treated as a result of this change. Now is the time for greater equity to be introduced into this process.

As an example of this, Matt Thistlethwaite MP made the following statements with respect to the PJC Inquiry on FoFA in 2012 and with respect to the impact of the ban on financial advisers, during a House of Representatives Economics Committee hearing on 27 March 2019:

> *"At the time {2012}, a parliamentary committee and the parliament agreed to provide a carve-out for grandfathered commissions. But, in the report by the Parliamentary Joint Committee on Corporations and Financial Services that looked at FOFA, there was, very much, an indication that these things wouldn't last forever and that a carve-out was being provided at that point in time, but <u>the industry was on notice to look at phasing those sorts of things out</u>."*

> *"I recently had a financial planner come up to me at an event and say: 'You guys have got it wrong with grandfathered commissions. In a lot of financial-planning businesses, people had borrowed money to buy the business on the basis that the grandfathered commissions were part of the profits of the business, the structure of the business, and the reason why they bought into that particular business.' Obviously I said to the person: <u>'Look, I've got little sympathy for you. You've been on notice about this, and, if you'd done your due diligence, you should have known about this.'</u>"*

We contest this and believe that the misrepresentation in this is clearly demonstrated by the conclusion from the 29 February 2012 PJC majority final report that Matt Thistlethwaite was actually a member of. The majority final report's concluding Committee Comment on grandfathering, rather than putting the industry on notice, was making a point about the need for greater certainty of the treatment of grandfathered commissions that applied with respect to platform operators:

> *"The committee has requested a response from Treasury as to why section 1528(1)(b) has been included where grandfathering is not given when 'the benefit is not given by a platform operator'. The committee asked Treasury to comment on this issue in light of arguments that this does not align with the government's policy intention. Although the committee had not received a response before finalising its report, it is important that Treasury does explain this*

issue on the public record."

With respect to the point about the adviser failing to do their due diligence, we would make the point that the lender has made the loan on the basis of their due diligence and their understanding of the law, where prior to the Royal Commission, no one expected a sudden banning of grandfathered commissions. If this was not apparent to a large bank, with the huge resources that they have, then why was it reasonable to assume that a financial adviser would have known better? If this was any other group of borrowers, would the banks be held responsible for inappropriate lending?

As we have said above, it is not fair or reasonable to re-write history and then blame financial advisers for decisions that they made on the basis of the law that applied at the time, particularly where their lender was equally in support of the valuation methodology being used at that time and was required to do their own due diligence before providing the loan. This is a matter of fairness and equity and the extent of discrimination against financial advisers is becoming an increasing concern.

The Use by the Minister of the Power to Direct ASIC

Section 14 of the ASIC Act gives the Minister the power to direct ASIC to undertake an inquiry or investigation. It may come as a surprise to many, to learn that this power has only ever been used twice and only once since the start of this century. During the Global Financial Crisis, and despite many corporate collapses and a huge threat to the entire economy, this power was not used. However on 21 February 2019, the Treasurer used this power to instruct ASIC, from 1 July 2019, to do the following:

"Under section 14 of the Act, the Australian Securities and Investments Commission is directed to investigate the extent to which persons who are giving or accepting grandfathered conflicted remuneration, as at the commencement of this instrument, are:

a) Changing their arrangements to end the payment of grandfathered conflicted remuneration prior to 1 January 2021; and
b) Passing the benefit of ending the payment of grandfathered conflicted remuneration on to clients, whether through direct rebates or otherwise."

It should be noted that this directive applies only with respect to grandfathered arrangements that are in force as at 1 July 2019 (the commencement date). Presumably any grandfathered arrangements that are removed before 30 June 2019, will not be subject to any oversight by ASIC and therefore not subject to scrutiny with respect to passing any rebate to clients. Does this create an inappropriate incentive for product providers to move rapidly, even if this might involve a breach of contract with the licensees and financial advisers and no benefit to the consumer?

The accompanying explanatory statement makes the point that "Public consultation was not considered necessary as the Direction is of a minor or machinery nature and does not substantially alter existing arrangements."

This is a most remarkable statement, entirely misrepresenting the extent of this change, particularly when this directive has been issued before the law has been passed and to have effect before the law was intended to come into force.

Impacted financial advisers have been given less than two years to resolve this issue in a manner that addresses the best interests of all their clients and for them to restructure their business models accordingly, yet the Government wants ASIC to investigate in order to make sure that it is happening sooner. This is a form of unreasonable manipulation, seeking to use ASIC to pressure financial product providers to make changes before the law even comes into force. This is surely

unprecedented conduct by a Government, with no consideration of the consequences for the financial adviser community or their impacted clients. This is simply signaling to product providers to get this process under way and that they have the full support of the Government, even if this involves actions that may breach their existing contractual obligations to licensees and financial advisers. This is an extremely concerning precedent for any organization or individual.

We are still trying to fathom why grandfathered commissions have been elevated to be such an important issue that the Treasurer should use this power to direct ASIC to investigate. As we said previously, where are the Royal Commission case studies to demonstrate consumer detriment? How is it possible that the political process has decided that something that was not even the subject of a case study during the Royal Commission, should be the highest priority as an outcome of the Royal Commission? Something is very wrong with this, and it is very unfortunate that, simply because it is being targeted at the financial advice community, and politically popular, that no one is standing up to say that this is wrong and unfair.

The Impact of this Change on Financial Advice Businesses

This recommendation and the response of the political parties has already had a very material impact upon the financial advice sector. We are aware of some banks who are already telling their financial advice lending clients that they are placing no value on grandfathered commission revenue. The outcome in this change of business valuation methodology is that it may put a material number of financial advice businesses in breach of their loan to value ratio obligations and therefore put their loan in default. This is happening even before the law has been passed. We are hearing more and more stories of financial advisers in financial and emotional distress.

Since the time of our earlier submission, we have spoken to the Treasury Royal Commission Implementation Taskforce and the Australian Banking Association about the important need to consider the implications of this change on the existing loans of small business financial advisers. Treasury showed no interest in pursuing this, however the ABA have agreed to investigate this. In our previous submission we recommended investigative work into the following:

- Information on the amount of bank debt in the financial advice space and the number of advice practices and financial advisers involved.
- Understanding the extent to which this debt is backed by security over grandfathered commission business.
- Understanding the number of businesses where the re-assessment of the value of the business on the basis of the Royal Commission recommendations, including the banning of grandfathered commission, will put the practice in default of their loan agreement.

We have sought the support of the banks involved in the financial advice sector to ensure that they offer support to financial advisers during any transition process, particularly given that they have agreed to lend money in the recent past, on the basis of the valuation attributed to grandfathered commission business.

The Constitutional Implications of the Banning of Grandfathered Commissions

We have previously raised our concerns about the lack of transparency with respect to the issue of the acquisition of property on other than just terms. It is very clear from the media releases at the time of the FoFA legislation, that both the Government, Treasury and the Australian Government Solicitor felt that the banning of existing trail commissions was a Constitutional issue back in 2011 and 2012 in the lead up to the passing of the FoFA legislation. We have called upon the Government to set out their views on why they might believe that this no longer applies.

There is some suggestion that the 2012 cases of JT International SA v Commonwealth of Australia;

British American Tobacco Australasia Limited & ORS v Commonwealth of Australia [2012] HCA 43 was the basis for a change of position, however these matters related to the packaging of cigarette packets and was a very different issue.

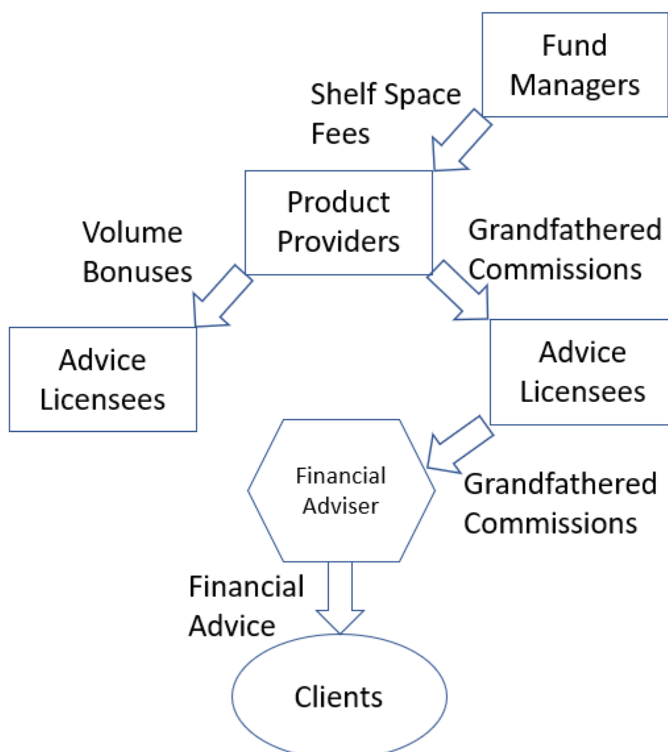
The Royal Commission argued that the banning of grandfathered commissions did not result in the acquisition of anything. We would argue that these regulations result in a scheme where the property of financial advisers (grandfathered commissions rights) are being given to a third party (the clients) through a rebate. We would therefore argue that these proposed regulations are serving to demonstrate that there has been an acquisition of property, and that due consideration needs to be given to whether there is an issue with respect to Section 51xxxi of the Constitution.

3. Complexity of Grandfathered Benefits

In our 22 March 2019 submission, we included the following explanation and diagram, which we believe remains relevant to the discussion about a rebate scheme as proposed in the draft regulations. The following historical benefit types are applicable:

- **Shelf space fees.** These are payments from fund managers to product providers and typically platform operators that had a range of investment options available on their platform. Other than where this is on a cost recovery basis, or a fee for service basis, it is considered to be conflicted, although potentially subject to grandfathering.
- **Volume bonuses.** These payments are from product providers to advice licensees and were typically paid on the basis of the level of business that was in place. These arrangements may have applied to some licensees, but not all licensees. These payments might have been in the range of 0.10% to 0.25% of assets invested and they vary between licensees.
- **Grandfathered commissions.** These are payments from the product provider that are paid via the licensee to the adviser. This is typically in the range of 0.25% to 0.5% of the value of the account.

These payments are set out in the following diagram:



With respect to shelf space fees and volume bonuses, it is anticipated that many different models will apply, with some based upon the average balance during the month, some based upon the balance at the end of the month, and others based upon the balance above a certain threshold. It is clear that more work needs to be done to understand how this works in practice. It is also important to understand how the complexity in the calculation of a shelf space fee or a volume bonus will impact the calculation of the rebate paid to the end client.

4. Feedback on the Draft Regulations

Understanding the Definition of Conflicted Remuneration

Conflicted remuneration is defined in Section 963A of the Corporations Act as follows:

> *Conflicted remuneration means 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.*

Exemptions to monetary conflicted remuneration are set out in Section 963B, and throught the grandfathering arrangements in Section 1528 to 1531.

Section 963B(c) sets out an exemption for what is known as execution only services, where no advice is provided. Importantly, this excludes any situation where financial advice has been provided on that product or class of product to a retail client in the last 12 months.

> *(c) each of the following is satisfied in relation to a financial product other than a life risk insurance product:*
>
> *i. the benefit is given to the licensee or representative in relation to the issue or sale of the financial product to a person;*
>
> *ii. financial product advice in relation to the product, or products of that class, has not been given to the person as a retail client by the licensee or representative in the 12 months immediately before the benefit is given;*

It is important to recognise that a benefit that is characterised as a commission is not automatically classified as conflicted remuneration. There are a number of clear exemptions, including the fact that it is with respect to a wholesale client or an execution only situation.

More importantly, however, is the fact that the definition requires that it could reasonably be expected to influence the choice of financial product or the financial advice provided to the client. Where a client is in a product where they cannot be moved, due to all the factors that we have previously stated, such as exit fees, capital gains tax, Centrelink treatment, insurance or the cost to get advice to move to another product, then it can clearly be argued that it is not conflicted remuneration. In addition, where the client refuses to move to a new product, then it can equally be argued that the payment of a trail commission is not conflicted remuneration. Where it can be argued that it is not conflicted remuneration, because the client did not have the option to move to another product, or they refused to move, then we assert that the proposed ban on Grandfathered commissions will have no impact. We nonetheless think that the context above, with respect to the

definition of conflicted remuneration, is very important in the consideration of these draft regulations.

Deficiencies in the Draft Legislation

In our 22 March 2019 submission in response to the draft legislation, we highlighted a number of issues, including the following deficiencies in the way that it would operate:

- The legislation does not guarantee that the benefits of the cancellation of grandfathered commissions would be passed onto individual clients, where the contracts are cancelled prior to 1 January 2021.
- There is no specific explanation of how volume bonus payments will be treated in order to benefit clients.
- The rebate scheme does not apply where no advice has been provided, including discount brokerage arrangements and situations where the clients were transferred to a new adviser, who has not yet provided any financial advice. How will product providers know if advice has been provided or not? How is this beneficial to clients who have received no advice and will therefore not receive any benefit from the rebate scheme?
- There is no discussion on what measures are available to protect the interests of clients, where they are seeking to continue to receive the advice that they are currently enjoying in return for grandfathered commissions.

Complications for Product Providers

Given the various exclusions and exemptions discussed above, where the continuation of trail commissions remain permissible, product providers will need to know if one of the following applies to any and every client:

- The product was provided to the client as a wholesale client, or at least part of the product holding was provided to the client as a wholesale client;
- The product or some of the product holding was provided to the client as an execution only transaction. Presumably the execution only exemption will apply to any distribution re-investment for an execution only product holding;
- The client is unable to be moved to another product as a result of one of the previously stated obstacles; and
- The client has refused to be moved to a new product.

Since product providers do not know the client's full circumstances or the nature under which the product was placed, they have no ability to make this assessment. They equally have no ability to turn off trail commission where one of the above circumstances applies. Thus, this draft legislation and draft regulations would require the product providers to determine if any of the above situations apply to each client. They could do this by contacting the client directly, although the client may not understand the full implications of this or the definition of execution only for example. Alternatively, they could seek to rely upon the licensee or financial adviser to provide this information.

Where one of these exemptions applies, then trail commissions could continue to be paid. It is subject to argument that if the continuation of trail commissions remained valid, then what impact might this have on the continuation of volume bonuses and shelf space fees in relation to these clients? This has not been addressed in the draft legislation or the draft regulations and needs to be. Presumably the clients in the groups discussed above would therefore not stand to benefit from any rebate for the trail commission, and also possibly volume bonuses or shelf space fees, although this depends upon whether they received advice and whether any directly relevant volume bonus or shelf space fee was treated as conflicted remuneration.

The Cost of Implementing a Rebating Scheme

There is no doubt that the cost of developing a rebating solutions will be significant. We have discussed above the initial exercise of understanding to which clients it will apply. The calculation engine and the record keeping requirements will also take some time to build and will be expensive to run. It should be understood that grandfathered commissions are typically paid on a monthly basis, as are volume bonuses and shelf space fees.

For those products that are run on outdated computer systems, it will not be easy to update them to reflect these obligations.

What is unclear is the extent to which the costs of running these rebating solutions can be recovered from clients out of the rebate payment. It seems reasonable that if the Government is legislating the introduction of a rebating solutions that product providers can recover the cost of this from those clients who benefit. Nonetheless, if this was the case, then controls would need to be put in place to ensure that this is purely a cost recovery outcome. There has been no mention of cost recovery, which we believe is essential to have addressed.

Subdivision 4A – Ban on Conflicted Remuneration (Rebates)

It is apparent that Regulation 7.7A.15AJ only covers clients who received advice as retail clients and where the payment of a conflicted remuneration benefit would have applied to them. This sounds straight forward, however with most circumstances in financial services, it is always somewhat more complicated.

Where a client has previously received advice, but has chosen to turn off the grandfathered commissions and has disconnected themselves from the advice provider, they will not be entitled to a rebate. It might also be possible that they have turned off the grandfathered commissions, but remained with their adviser, or the grandfathered commission is already being rebated to them, in which case they will not get any benefit from the grandfathered commission, but may stand to benefit from a share of the volume bonus payments (and also possibly the shelf space fees payment).

We also ask for clarity on whether a client who is an orphan client with the licensee, who previously received advice from an authorised representative of the licensee, but never directly from the licensee, is intended to be covered by this definition.

In reality this is a very complex model, and we believe that more clarity is required.

We do not believe that the explanation of whether conflicted remuneration can be attributed to a particular client, has been made sufficiently clear. Obviously it would be attributed to a particular client in the case of a trail commission. It could arguably be attributed to the client for volume bonuses and even shelf space fees, where they are included in the Assets Under Management (AUM) that are used in the calculation of that volume bonus or shelf space fee. The Explanatory Statement does not provide sufficient explanation, and this will lead to unnecessary confusion. We suggest that greater clarity is required.

It is our view that the deadline of 10 days to pass on any benefit to impacted clients is unreasonable. This deadline will apply from day one and in the first cycle of making these payments, we would anticipate that most product providers will be unable to deliver to this timeframe. We can see no reason why this should not be extended to 30 days.

At a high level, the calculation of benefits paid with respect to grandfathered commissions is more straight forward, when compared to the payment of any benefits that relate to either shelf space fees or volume bonuses.

In terms of Regulation 7.7A.15AM, we would like to ensure that shelf space fees are taken into account. Shelf space fees are fees paid by a fund manager to a platform with respect typically to the amount of Funds Under Management attributable to that fund manager. If the fund manager was required, as a result of the ban on grandfathered benefits to pay this money to the relevant retail clients instead of the platform operator, then the obvious question arises as to how they can make this payment as they do not have any details on the end clients. If they were to ask the platform operator to make this payment on their behalf, then they would need to pay the money to the platform operator in order to make the payment, however this would be a breach of the law. There was no discussion of shelf space fees in the explanatory statement. We do not believe that it is an appropriate outcome, if all other grandfathered payments need to be passed on to retail clients. We will limit our discussion on shelf space fees as we cannot see how this can practically be undertaken.

Regulation 7.7A.15AM refers to a group of clients. In our view some explanation of the meaning of a group of clients is required.

Whilst it would be technically possible for product providers to calculate how much to pay each client in lieu of the payment of volume bonuses, we think that this would be extremely complex as it would depend upon the following:

- Understanding which clients are excluded.
- Understanding which part of a client's holding might be excluded (partial retail/wholesale clients and partial advised/execution only product holdings).
- Understanding if some of the volume bonus still needs to be paid to a licensee, where the trail commission related to the end client, is not classified as conflicted remuneration.
- Understanding which costs can be deducted from the payment.
- Allowing for client transactions during the period and whether they impacted the balance that the volume bonus was based upon. This would be the case, particularly if the volume bonus was based upon the daily or average AUM during the month.

Another important consideration is whether they should make the payment for the grandfathered commission and the volume bonus payment as a single monthly payment or to process them as separate payments. For simplicity for the client, it would be better for them to be made as one payment. It should be kept in mind that a rebate might be treated as taxable income for the client, or also in the case of superannuation, could be treated as a contribution. This needs to be clarified.

In terms of the situation of a monetary benefit other than a payment, the requirement to apply the benefit only once a year, rather than as monthly payments, might appear to offer an advantage to the product provider, in terms of the delay in the application of the benefit and the administrative advantage of only processing it once. However, in reality this is also expected to involve a great deal of complexity, and if it was achieved by a fee reduction to an AUM fee, then how can this be applied across all clients in a fashion that is consistent with the rules. Based upon different eligibility criteria, different amounts will need to be paid to each client, and therefore this cannot be achieved by the application of a reduction in asset-based fees. We are unsure how this option will work when there is no fixed fee that applies to the product.

Regulation 7.7A.15AM(3) refers to the requirement that the amount being 'just and equitable' in the circumstances. This is further explained in theory in Regulation 7.7A.15AM(4). What this does not refer to is the ability to take into account the cost of the calculation, which we would assume needed to be taken into account in determining 'just and equitable'. Otherwise with respect to the requirements of Regulation 7.7A.15AM(4), to the extent that they take into account what we have discussed, they seem reasonable, however we are not sure what the intent of Regulation 7.7A.15AM(4)(e) is. We also believe that greater clarity is required as to whether this calculation is one that is done at the end of the year, on a monthly basis or on a daily basis throughout the year. How do you guarantee a 'just and equitable' outcome if the balance of the account for each client moves materially during the course of the year? If this exercise needed to be completed on the basis of the daily balance of the client account, then this would be particularly challenging. What might seem straight forward to those who are removed from the reality of the financial services industry, is often quite different for those who are forced to implement these solutions. However, in the current political climate, there are very few who seek to question the practicality of what has been proposed.

Record Keeping Obligations

The requirements for record keeping appear to be extremely onerous. The only reference to an explanation of the purpose of this record keeping is a statement in the Explanatory Statement about enabling compliance to be monitored. Who is proposed to undertake this monitoring? In the context that record keeping is costly, it would be necessary to demonstrate that there is a justifiable client benefit in keeping records to the extent that has been proposed. It is apparent to us that the record keeping requirements have not given due consideration to the complexity of this overall model as we have set out above.

It is not clear the extent to which these requirements can be automated, however that appears somewhat questionable, in the context of the known level of complexity. It is noted that the obligations with respect to Regulation 7.8.11B, relate to every single payment. This would typically be at least 12 per year, however if the grandfathered commission payment and the volume bonus payment were to be processed separately, then this would be at least 24 payments per year.

It is our view that a full rebate model will be particularly challenging to design and implement and likely lead to a significant cost to build. The examples shown above suggest that this will be very confusing to clients and will bestow greater benefits on some clients as opposed to others, in large part based upon chance.

Other Implications of the Rebating Solution

What happens if a client changes his/her adviser (and licensee) after the commencement of this rebating model? If the volume bonus rate that applied to the new licensee is different to the old licensee, then will the rebate amount change?

If the product provider is not able to recover the cost of operating the rebating model from the rebate payment, then they will need to recover the costs through other charges. This might involve an increase in fees or alternatively the loss of a fee reduction that might have otherwise eventuated.

When financial advisers provide advice to move from one product to another product, they have obligations to compare the old product against the newly recommended product. This includes comparing the costs of the product. A multi-layered rebating model will make it very difficult to understand the actual ongoing cost of a financial product, which could impact the cost of providing advice and make it more difficult to prepare advice to move out of older products that are subject to rebating arrangements. This will also increase the costs of operating the financial planning software.

5. Additional Feedback on the Draft Explanatory Statement

In the discussion about Subregulation 7.7A.15AM(2) on page 4 of the explanatory statement, there is a statement that "This 1 year limit allows a non-monetary benefit to be provided by means of a reduction in a product-based fee, which are frequently charged on an annual basis (paragraph 7.7A.15AM(2)(b), item 1, Schedule 1)."

Firstly, we assume that it is a mistake to describe this as a non-monetary benefit. Secondly, we make the point that only a limited number of products and typically superannuation funds have an annual product-based fee. Where no such fee applies, then this option does not exist. Where the fee is an asset-based fee, which is typically taken out as part of the unit price calculation, then, since the rate of the rebate will differ from client to client, this is not a realistic solution. In other cases, what is the solution if the amount of the rebate for a particular client, such as one with a larger balance, exceeds the amount of any annual product-based fee?

6. What is the Outcome for Clients?

We have already expressed our serious concerns with respect to the risk that clients will either end up paying more to retain an ongoing advice relationship or will end up without access to financial advice. We are also very concerned about the implications for clients who are prevented from moving products, although noting that the benefits paid to their adviser, with respect to them, would potentially be excluded from being classified as conflicted remuneration. Putting those higher level issues to one side, in terms of the specifics of this rebate model, we have the following key concerns for impacted clients:

- Complete confusion as to what they are entitled to and what they have received.
- Receipt of payments that they might need to treat as taxable payments or superannuation contributions.
- Uncertainty about the impact these changes might have on whether they should remain in these products.

7. Concluding Remarks

As keen participants in this debate, we have included some new information and insight into this issue.

We believe that the point about the definition of conflicted remuneration is an important new insight into this issue, which has impacted our thinking about our previous recommendations. On the basis of the law, we think that there are grounds for quite a bit of what has previously been considered to be grandfathered commission payments to be treated as non conflicted remuneration.

We remain concerned about the lack of clarity in what has been proposed and lack of appreciation of the complexity that what has been proposed will require. As we have said previously, we are happy to support a transition away from grandfathered commissions, however this needs to allow for obvious problem areas and where clients will be detrimentally impacted. We also believe that more time is required to fully understand the implications and allow the financial services industry and the financial advice profession to prepare for the practicalities of the change.

We support measures to meet and exceed consumer expectations, but we also reserve the right to defend fairness and equity for all.

The AFA welcomes further consultation with Treasury should it require clarification of any points raised in this submission. If required, please contact us on (02) 9267 4003.

Yours faithfully,

Philip Kewin
Chief Executive Officer
Association of Financial Advisers Ltd