30 April 2014

To the Senate Standing Committees on Economics,

We write as representatives of Australia's consumer movement. The Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 proposes significant wind backs to essential consumer protections.

The 2012 Future of Financial Advice reforms followed more than two decades of advocacy and investigations from consumer organisations into conflicts of interest in the financial advice industry. The FoFA reforms were critically important because of the catastrophic effects of major financial advice scandals. Numerous studies have shown that poor advice is attributed to the presence of commissions and the failure of an adviser to act in their client's best interests. Financial counsellors deal with the aftermath of financial advice gone wrong, assisting clients who are now in difficulty because of poor advice.

The proposed Bill would undermine the original goals of the FoFA reforms: to improve the quality of financial advice and build trust in the financial planning industry. The attached submission prepared by CHOICE outlines how the proposed Bill would:

- Dilute the best interests obligation;
- Remove the opt-in requirement;
- Limit the consolidated annual statement of fees to new clients; and
- Water down the ban on commissions.

A growing number of Australians will rely on superannuation savings to retire and will need quality, independent financial advice to live comfortably. It makes no sense for the Government to wind back financial advice protections in this climate.

We urge the Committee to recommend that the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 be abandoned.

Kind regards,

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Submission on Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014

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About CHOICE

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

To find out more about CHOICE's campaign work visit www.choice.com.au/campaigns and to support our campaigns, sign up at www.choice.com.au/campaignsupporter choice

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Introduction

CHOICE considers the proposed Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 (the Bill) to be a significant wind back of the Future of Financial Advice (FoFA) reforms introduced in 2012.

CHOICE has spent more than two decades investigating and warning consumers about conflicts of interest in the financial advice industry. In 2012 CHOICE welcomed FoFA as a crucial step towards putting the financial advice industry on a professional footing, promoting consumer trust and engagement. The reforms are critically important given Australia's ageing population and the growing number of consumers becoming first-time investors in their retirement.

The proposed Bill would substantially weaken consumer protections and undermine the original goals of the FoFA reforms: to improve the quality of financial advice and build trust in the financial planning industry.

FoFA was a compromise between the interests of consumer protection and industry, and the proposed Bill tilts the balance further away from consumers. The Government has flagged additional changes to FoFA through regulation, which is likely to reduce consumer protections even further. This submission outlines how the proposed Bill would:

- Dilute the best interests obligation;
- Remove the opt-in requirement;
- Limit the consolidated annual statement of fees to new clients; and
- Water down the ban on commissions.

Because of the cost to consumers CHOICE urges the Committee to recommend that the proposed Bill be abandoned.

> ***Recommendation 1:*** CHOICE recommends that the Government does not proceed with the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014.

> ***Recommendation 2:*** CHOICE recommends that the Government release a full exposure draft for any proposed regulatory changes, with adequate opportunity for consultation and comment.

1. Quantifying the cost to consumers

CHOICE is concerned that the process to justify the Bill has failed to thoroughly assess the cost of proposals to consumers.

The focus of the Bill is to reduce the regulatory burden on the financial advice sector. A reduction in costs to businesses can lead to a reduction in costs to consumers if savings are passed on. However, consumers will not receive benefit if deregulation allows advisers to take advantage of the client-adviser relationship, recommending products that are not in a client's best interests. The balance needs to be in favour of protecting consumers and their retirement income, rather than protecting the income of financial advisers.

Both the options-stage and the details-stage Regulation Impact Statement (RIS) for the Bill did not thoroughly assess the costs and benefits of proposals. Each RIS gives an extensive assessment of cost savings to industry but failed to quantify the cost of proposed reforms to consumers. Analysis by Rice Warner Actuaries found that the original FoFA reforms would cost industry $187.5 million per year but that consumers would receive a benefit of more than twice that cost.[1]

The Explanatory Memorandum for the Bill overstates the benefits of proposed changes. For example, the statement of compatibility with human rights states that the Bill "may advance the right to privacy" as it prevents the need for financial advisers mail out annual fee disclosures to certain clients.[2] It is farcical to claim that removing a provision to send client information through private mail protects privacy - information should not be so private that a client cannot easily receive it.

Should the Bill proceed there are two likely types of costs to consumers. First, there will be ongoing costs to consumers who receive advice that fails to maximise or protect their finances. The failings of the financial advice system have been well documented. ASIC has noted "broad systemic problems with the financial advice industry, driven by conflicted remuneration structures and compounded by weaknesses in the regulatory system."[3]

Repeated studies have shown that a significant proportion of advice is of a low standard and that poor advice is strongly linked to the presence of commissions and the failure of an adviser to act in the client's best interests.[4] Even adequate advice is not guaranteed to leave a consumer financially better off. In reviewing retirement advice, ASIC found numerous examples of adequate and even good advice "where a combination of the product fees and advice fees effectively cancelled out the value of the advice."[5]

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[1] Rice Warner (2013) *The financial advice industry post FOFA*, prepared for Industry Super Australia, July 2013.
[2] Explanatory Memorandum, Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014, Statement of Compatibility with Human Rights, pp. 40-41.
[3] ASIC (2013) *Main submission to the Senate inquiry into the performance of the Australian Securities and Investments Commission*, October 2013, p 142.
[4] For example see ASIC (2003) *Report 18 Survey on the quality of financial planning advice*, p. 5-6, ASIC (2012) *Report 279 Shadow shopping study of retirement advice*, p 8.
[5] ASIC, (2012) *Report 279,* p. 43.

A large and growing number of consumers will face costs due to poor or inappropriate advice. The Government estimates that 20 to 40 per cent of Australian adults use or have used a financial adviser, with this figure set to grow with rising superannuation funds.[6]

Secondly, the proposed changes will lead to costs to consumers as they reintroduce measures that encourage sales-driven practices in financial advice. With financial advisers working in boiler-room style sales cultures, consumers are highly likely to lose significant funds through further major market failures like Storm Financial. While no legislation can fully prevent a market failure, the original FoFA reforms aimed to curb the worst practices in the financial advice industry. The effects of recent major financial advice scandals have been catastrophic, resulting in consumers losing $5.7 billion in funds as well as their homes and certainty about retirement.[7]

As well as consumer costs, the Bill is likely to increase costs for government through increased reliance on welfare as retirement savings fail to be maximised and through significant loss of savings in market crashes.

> ***Recommendation 1:*** CHOICE recommends that the Government does not proceed with the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014.

1.1. Status of FoFA regulations

CHOICE is concerned that substantial changes are likely to be made to FoFA via regulation rather than legislation. Draft regulations released in February 2014 contained worrying changes including further carve outs on conflicted remuneration.[8] These changes will impact millions of Australians and should be subject to the full parliamentary scrutiny afforded by the legislative process. Currently, regulations are on hold as the Government has committed to consult with all relevant stakeholders.[9] CHOICE looks forward to further detail about this consultation. Consultation must be conducted publicly, proactively include consumer organisations and allow adequate time for consultation.

> ***Recommendation 2:*** CHOICE recommends that the Government release a full exposure draft for any proposed regulatory changes, with adequate opportunity for consultation and comment.

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[6] Explanatory Memorandum, p 47.
[7] Losses from Opes Prime, Storm Financial, Timbercorp/Great Southern, Bridgecorp, Fincorp, Trio/Astarra, Westpoint and Commonwealth Financial Planning sourced from figures in ASIC (2014), *Submission to the Financial System Inquiry*, pp. 192-193 and Industry Super Australia (2014), *Exposure Draft: Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014, ISA Submission*, pp. 37-38.
[8] See CHOICE (2014), *Submission on Exposure Draft: Future of Financial Advice Amendments* for full comments; Draft proposed regulations available at: http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=consultation/fofa_amendments/default.htm
[9] Finance Minister Senator Mathias Cormann quoted in Martin, Peter and Gareth Huthens (24 March 2014), "Coalition puts financial advice rules on hold", *Sydney Morning Herald* available at: http://www.smh.com.au/business/banking-and-finance/coalition-puts-financial-advice-rule-changes-on-hold-20140324-35dmr.html

2. Substantive concerns

2.1 Changes to the best interests obligation

The best interests obligation was a critical component of the 2012 FoFA reforms. It protects consumers as financial advisers have a legally enforceable obligation to act in the client's best interests.

A best interests obligation is necessary as consumers are not experts in the areas they are seeking advice. Repeated shadow shopping exercises have shown a large gap between the quality of advice and consumer perception of the quality of advice. In 2011 ASIC found that only 3% of retirement advice was good quality yet 86% of consumers receiving advice perceived it to be good quality.[10]

CHOICE is a strong supporter of the best interests obligation in its current form. Should the Bill proceed the following changes will render the best interests obligation largely ineffective.

What is the problem?

2.1.1 Removal of 961B(2)(g)

961B(2)(g) requires advisers to take any other step that would be reasonably regarded as being in the best interests of the client. Without 961B(2)(g), clauses 961B(2)(a)-(f) function as a 'tick-a-box' checklist to assess if the best interests obligation has been met. It leaves a test that contains no mention of protecting the client's best interest.

Some stakeholders have expressed concerns that 961B(2)(g) is too open ended, creating uncertainty as to how advisers can satisfy the obligation. However, 961B(2)(g) is further defined in legislation and through regulatory guidance. 961E (which the Bill also proposes to remove) defines the best interests of the client as any step that a person with a reasonable level of expertise who exercises care and objectively assesses the client's relevant circumstances would require.[11] This definition addresses the information asymmetry inherent in the client-adviser relationship by linking the best interests obligation to subject matter expertise. Further, ASIC has provided detailed regulatory guidance about the best interests obligation.[12]

2.1.2 Removal of 961B(2)(a) and scoping of advice

By removing section 961B(2)(a) and replacing it with 961B(2)(ba) the Bill reorders the process a financial adviser can take to meet the best interests obligation. Specifically, an adviser would be

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[10] ASIC (2012), *Report 279*, good advice complied with the law, met the clients' needs, improved their situation and clearly explained recommendations.
[11] s961E states that "It would be reasonably regarded as in the best interest of the client to take a step, if a person with a reasonable level of expertise in the subject matter of the advice that has been sought by the client, exercising care and objectively assessing the client's relevant circumstances, would regard it as in the best interests of the client, given the client's relevant circumstances, to take that step."
[12] See ASIC (2014), *Regulatory Guide 175, Licensing: Financial product advisers – Conduct and disclosure (RG175).*

able to investigate a client's circumstances *after* agreeing on the scope of the advice. This change is extremely disadvantageous to consumers.

Limited or scoped advice can be an affordable and appropriate option for some clients but the scope of advice must be built on a professional investigation of a client's relevant circumstances. Inadequate investigation of a client's circumstances is highly likely to lead to poor advice.[13] CHOICE agrees with ASIC's assessment that "Even for very limited advice, there are some topics that cannot reasonably be excluded from scope" such as income levels or existing debt.[14]

The addition of subsection 961B(4A) will allow advisers to effectively 'contract out' of their duties to consumers by bypassing the full best interests obligation in defining the scope of advice.[15] Rather than addressing the information asymmetry in the client-adviser relationship, this change would allow the lack of knowledge a consumer has about finance to be exploited.

Should the Bill pass in its current form, advisers will be able to scope advice in a manner that is not in their client's best interest. This is illustrated in the examples below:

> *Client X, a twenty-seven year old man, has a modest income, a small amount of savings and superannuation and relatively large personal debts. The client's objective in seeking financial advice is to generate funds for a house deposit. Adviser A agrees with Client X to limit the scope of advice to loan products to invest in the share market to generate funds even though the Client would be better off paying existing high-interest debt.*
>
> *Client Y, a forty-year old woman, seeks advice from Adviser B for financial advice about her superannuation savings. Adviser B agrees with Client Y that the advice will be limited to certain products. Adviser B recommends that Client Y should switch superannuation funds into one of these products. Adviser B has no obligation to inform Client Y of any detriment that may be caused by this switch, despite the fact that it may not be in her best interests.*
>
> *Client Z, a 60-year-old male, seeks advice from Adviser C about investing in the share market. Adviser C agrees with Client Z that the advice will be limited to investing in shares. Adviser C has no obligation to inform Client Z of any detriment that may be caused by investing in a single asset class, despite the fact that it may not be in his best interests particularly light of his age and the risk profile of shares.*

In financial advice scandals like Storm Financial, a number of dealer groups have followed a "cookie cutter" approach to advice. Proposed changes to scoping of advice risks legalising these sales-driven strategies and the one-size-fits all approaches to financial advice.

2.1.3 Reduced best interests obligation for banks and insurers in certain circumstances

The Bill would add clauses to 961B(3)(b) to allow an agent or employee (from financial adviser to retail bank teller) of an Authorised Deposit-taking Institution (ADI) to follow a reduced best

[13] ASIC (2012), *Report* 279, p. 35.
[14] Ibid, p. 13.
[15] See Explanatory Memorandum, para 1.32,"best interests obligations apply to the advice ultimately sought."

interests obligation for personal advice in certain circumstances. Originally the exemption only applied to basic banking products but this has been extended to general insurance products. The agent or employee will not need to:

- Assess whether they have the expertise to advise the client;
- Conduct a reasonable investigation into whether the financial products being recommended meet the objectives of the client;
- Base all judgements on the client's relevant circumstances; or,
- Take any other steps that would be reasonably regarded as being in the client's best interests.[16]

The agent or employee would be able to meet the reduced best interests obligation when selling Consumer Credit Insurance (CCI) alongside general insurance or basic banking products.

Additionally, proposed changes to 961J(2) and (3) would allow an agent or employee to prioritise their own or their employer's interests ahead of the clients for the sale of basic banking products, general insurance, CCI or any combination of those products.

CHOICE maintains that a reduced best interests obligation is inappropriate for any type of personal advice. Changes to CCI are particularly concerning as numerous studies have shown persistent and significant mis-selling.[17]

What is the solution?

CHOICE recommends no change to the best interests obligation or to scoping of advice

2.2 Relaxing the ban on conflicted remuneration

The 2012 FoFA reforms granted numerous concessions to industry for conflicted remuneration. The Bill proposes additional exemptions creating further situations where conflicted remuneration is likely to impact on the quality of financial advice.

What is the problem?

2.2.1 Reducing the scope of the ban on volume-based shelf-space fees

In restricting the definition of a volume-based shelf space fee, the proposed Bill creates exemptions that are likely to significantly influence the range of products that are recommended by financial advisers.

Currently, platform operators are prohibited from receiving volume-based shelf space fees. Prior to 2012, these fees were paid by product manufacturers to purchase preferential treatment for

[16] This is a summary of s961B(2)(d)-(f).
[17] See ASIC (2011) *Report 256 Consumer credit insurance: A review of sales practices by authorised deposit-taking institutions.*

groups of products. Volume-based shelf space fees lead to distorted financial advice by creating an environment where advisers are more likely to recommend a particular fund manager or platform's product.[18] Roy Morgan Research found that 73% of superannuation recommendations were being directed by the six largest institutionally owned advice groups to their own products.[19]

2.2.2 Allowing conflicted remuneration if the client consents

A series of changes would allow conflicted remuneration if the client consents (the client-pays exemption).[20] This amendment enables advisers to contract out of the ban on commissions, and in doing so undermines one of the key premises of the FoFA reforms.

2.2.3 Allowing conflicted remuneration for general advice

CHOICE commends the Government for acknowledging that the December 2013 proposal to allow conflicted remuneration on all general advice was too broad.[21] However, revised proposals in the Bill still undermine the original FoFA reforms and place consumers at risk.[22]

Under the proposed Bill, an adviser or employee of an ADI will be able to receive a benefit if it is in relation to general advice, the employee has not given personal advice to the client in the last twelve months and the financial product is issued or sold by the licensee. For example, a bank teller could receive a bonus for selling a complex product like superannuation if it was one of his or her employer's products.

CHOICE does not believe these protections are adequate. The twelve-month rule could be easily circumvented if one staff member provides advice and another sells the product. Additionally, consumers are still not likely to note a distinction between general and personal advice and may incorrectly believe that the advice provided is appropriate to them.

CHOICE recently conducted research into consumer sentiment on these changes. 81% of consumers were concerned that bank tellers would be able to sell complex financial products without assessing their personal needs and that they would earn a commission for doing so.[23]

2.2.4 Further changes through regulation

The Bill would also allow regulations to further define existing exemptions to conflicted remuneration.[24] As mentioned, the Government has placed regulations on hold to undertake

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[18] For further information on the structure of the financial services industry see Explanatory Memorandum, Graphic Three, p. 46.
[19] Roy Morgan research report (December 2011), *Superannuation & wealth management in Australia*, quoted in ASIC Report 279 p. 45.
[20] Relevant proposals are the notes at 963A, 963B(1).
[21] See Explanatory Memorandum, paras 3.3-3.5.
[22] Relevant proposals are to s963B to s963D.
[23] In March 2014 CHOICE commissioned a nationally representative survey of more than one thousand consumers. When asked "Bank tellers in branches will be able to sell complex financial products such as superannuation without assessing your personal needs or situation and earn a commission for doing so. How concerned are you with the following change?" 81% of consumers said they were concerned. For further information about the survey see CHOICE (2014) *CHOICE submission: Financial System Inquiry*, p.10.
[24] See changes to regulation making powers s963B, s963C and s963D.

additional consultation. The regulations proposed in February 2014 contained concerning exemptions to grandfathered arrangements, bundling advice with commissions and commissions in the banking sector.

What is the solution?

CHOICE recommends no change to the ban on commissions.

2.3 Removal of the renewal notice requirement (opt-in requirement)

What is the problem?

The Bill proposes a series of amendments that would remove the renewal notice, also known as the opt-in requirement.[25] The renewal notice ensures that clients avoid paying fees for little or no service by requiring advisers to obtain a client's approval at least every two years to continue ongoing fee arrangements.

The opt-in requirement is necessary because of significant levels of disengagement amongst consumers who, under a trailing commissions or ongoing fees model, continue to pay for services they do not use and may not even know about. ASIC's survey of the top 20 financial services licensees found that 3.1 million or two thirds of clients were inactive.[26] In other words, they were paying commissions and ongoing advice fees but not receiving any benefit.

Removing the requirement ignores a significant consumer cost - millions of dollars of advice fees are being charged but no advice is provided. This erodes individual and national savings for no tangible benefit. CHOICE remains of the view that opt-in is not unreasonably burdensome for providers and its costs are far outweighed by the benefits to consumers. Arguments in favour of removing this requirement emphasise that consumers will benefit from cheaper advice through lower compliance costs.[27] Advice would be cheaper still if consumers had greater opportunity to stop paying for it when not receiving any benefit.

What is the solution?

CHOICE recommends no change to the renewal notice requirement.

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[25] Specifically Amendments to s962F and the repeal of s962CA, s962K, s962L, s962M, s962N and Subdivision C of Division 3.
[26] See ASIC (2011), *Report 251: Review of financial advice industry practice,* p. 4.
[27] For example, see 'CBA banks on Abbott's opt-in promise', accessed at http://www.ifa.com.au/news/12368-cba-banks-on-fofa-opt-in-removal

2.4 Limiting consolidated statement of ongoing fees to new clients

What is the problem?

The Bill proposes removing the obligation for financial advisers to provide fee disclosure statements to consumers who have entered into a contract before 1 July 2013.[28] This would formalise poor practice across the financial services industry.

It is reasonable for a consumer to receive a summary of fees charged for an ongoing service. Failure to provide a summary of fees charged would be unacceptable for other industries that offer ongoing services such as telecommunications or electricity. Providing a summary of charges is a necessary cost of doing business rather than a burdensome compliance cost.

Combined with the removal of the opt-in provision, the removal of the requirement for regular statements increases the likelihood that existing clients, many of whom are likely unaware of 'passive fees' currently being paid on investments including superannuation, continue to pay for services they don't use or need.

What is the solution?

CHOICE recommends no change to the consolidated statement of ongoing fees to existing clients.

[28] The relevant clauses being removed are Schedule 1, items 22, 39 and 40, Subdivision C of Division 3 of Part 7.7A, table item 22 of s1317E(1) and s1317G(1E)(b)(v).