Executive Summary

MLC's submission is informed by its firm belief in the value of financial advice.

The increasing exposure of the household sector to the business cycle and the growing importance of superannuation and insurance to a person's long term financial security make the need for financial advice more compelling than ever before. Working against this imperative is wide spread consumer indifference or distrust of the advice process and its value to investors.

As a broad observation, MLC believes that Australia's investment and advice industry has delivered many benefits to Australians. Regrettably, there are several areas where reform is overdue and investor losses could have been avoided. The Committee is right to make these issues a point of focus of its inquiries.

In an ever changing market place, the regulatory framework can not remain static and must account for developments, positive and negative, particularly in the areas of product design and distribution practices.

All of the recommendations and commentary contained in MLC's submission have a common objective which seek to place the customer at the centre of the investment experience and have the industry move to a more transparent and sustainable operating model.

MLC's recommendations to the committee are captured in three broad themes: ***Trust and Transparency, Financial Advice*** and ***Risk and Regulation***. Central to this reform is a proposal for a new licensing criterion for Australian advice businesses delineated between two categories: the '**affiliated**' advice business and the '**independent**' advice business.

The submission also makes specific recommendations covering the optimal structure of advice businesses, the role and responsibilities of licensees, licensee governance, remuneration practices, financial planner standards, access to advice and a review of the regulatory framework against acceptable levels of conduct and disclosure.

Recommendations

Advice Models

MLC recommends that Australian investors would be better protected in a regulatory regime that oversees two distinct models of advice businesses, each categorised to reflect their operating structure and providing a meaningful descriptor for investors. These businesses should be licensed as either 'affiliated' advice business or 'independent' advice business.

MLC recommends that financial planners operating in Australia be required to operate as either an 'affiliated financial planner' or an 'independent financial planner'; both terms would be designated definitions under the Corporations Act and be federally regulated by Australian Securities and Investments Commissions (ASIC).

Regulatory and legislative changes in this area should have regard for existing industry standards and requirements and should follow consultation with the industry and consumer groups.

Remuneration Models

MLC recommends the Committee require the advice industry, through its representative organisations, to identify alternative distribution remuneration models which do not include volume based criteria.

MLC further recommends the newly proposed models should be free of influences that unduly bias advice recommendations and all payments should be fully disclosed to the customer. The industry should present alternative proposals to the government for its consideration by June 2010.

MLC recommends all financial advice fees, whether relating to the preparation of the initial financial plan or its ongoing management, should be tax deductible. Furthermore, no cap should be applied.

MLC recommends the GST aspects of these fees should also be reviewed. Currently treatments can vary, but generally an individual investor cannot recover GST on financial advice fees; however, some providers may pass a credit back depending on the structure of their product.

Education Standards

MLC recommends that new entrant non Certified Financial Planners (CFP) be obliged to meet minimum requirements of (i) completion of an undergraduate degree, (ii) completion of the Advanced Diploma in Financial Services and (iii) at least 12 months of related industry experience.

Limited Advice Models

MLC endorses the position of the Financial Industry Council of Australia (FICA) with respect to legislative change to the definition of general and personal advice, further, MLC urges the Government to examine limited advice models, beyond superannuation, in consultation with the industry.

Further, MLC recommends greater regulatory clarity around limited advice models in order to better facilitate the provision of low cost, effective advice to customers for whom this is the best solution.

Role of the Licensee

- Each licensee should have a separate board that governs the activities of the licensee for the purposes of the Financial Services Reform Act (FSR) obligations and compliance.

- A licensee board of an affiliated business should comprise a majority of independent directors, thus ensuring a focus on governance rather than product distribution.

- At least one independent director on all Board sub committees (e.g. Approved Product List and Dealer Advice Standards sub committees). Many boards will require sub committees to provide the appropriate level of monitoring on key issues. These sub committees should be independently chaired to ensure arms length decision making.

- Capital requirements for Australian Financial Service Licensees:
  - Capital held by licensees should be sufficient to give clients reasonable protection against inappropriate adviser activity.
- Independent and expert input into product research processes:
  - The construction of Approved Lists and investment guidelines should be the responsibility of licensees. These vital activities should not be placed solely in the hands of research houses. Licensees need to monitor both product and its application. Guidelines on leverage, degree of structure, stage in a client's life, risk profile and diversification are just as important in the research process as product selection.

- No remuneration bias for sale of in-house products.

- A certified and continuous internal audit process to review advice functions.

- Each licensee should have a set of operating standards that advisers in the licensee sign up to and abide by. These standards should be available for viewing by the regulator and the public. The licensee should not only monitor adviser behaviour around legislation but also their own internal standards.

- Consistent breaking of licensee standards should be seen in the same way as breaking legislation. If advisers consistently break standards the licensee should have a cause to remove its authorisation.

FSR

MLC recommends that the Financial Services Reform Act be comprehensively reviewed against its original objectives and current assessments of its operation. The review should be conducted by an independent body comprised of government, industry and consumer representatives

Inquiry into Financial Products and Services in Australia

The Company

MLC & NAB Wealth is the wealth management division of the National Australia Bank (NAB). MLC & NAB Wealth (MLC) provides investment, superannuation, insurance and private wealth solutions to retail and institutional customers.

MLC supports the provision of quality financial advice through its financial planning networks including NAB Financial Planning, Godfrey Pembroke, Garvan Financial Planning, MLC Financial Planning and Apogee Financial Planning, as well as through its institutional advice arms.

MLC uses a 'manager of managers' investment approach. For the most part, MLC does not directly manage investment funds. Instead, MLC's multi-manager options combine the expertise of leading investment managers from around the world.

MLC manages more than $70 billion on behalf of individual investors and corporate customers in Australia (Half Year Report - March 2009).

MLC holds the number one position for personal insurance annual inforce premiums with 14.3% market share *(source: DEXX&R Life Analysis as at March 2009)* and is the second largest provider of superannuation in Australia with 15.7% market share *(source: Plan for Life Quarterly Data System, March 2009).*

MLC's submission

MLC and its subsidiaries are members of the **Financial Planning Association** (FPA) and the **Investment and Financial Services Association** (IFSA). The company has participated in the consultation process of each organisation and is broadly supportive of the final documents.

This submission seeks to provide further comment in areas where MLC has specialised industry experience and provides specific recommendations on potential legislative or regulatory change for the consideration of committee members.

Accordingly, this document will not respond exhaustively to each reference Identified by the Committee, the submission will examine what MLC regards as three important themes for the future sustainability and development of Australian financial services: ***Trust and Transparency, Financial Advice*** and ***Risk and Regulation.***

The submission also includes prefacing information on recent historical and contextual developments in Australian financial services.

Chapter 1: Recent developments in Australian Financial Services

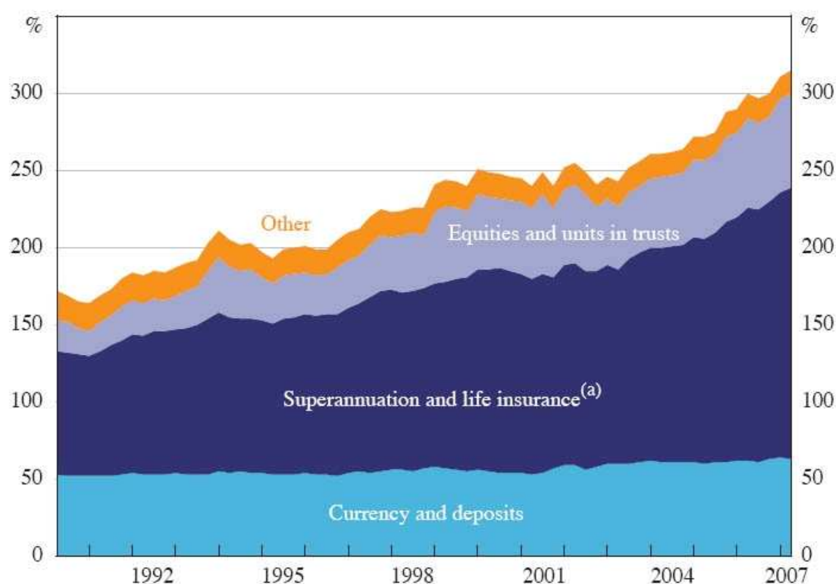
(i) The rise of the household sector

The last quarter of the twentieth century has seen a significant transformation of the Australian economy, notably, the deregulation of the financial services industry. A feature of this development has been the *retailisation* of financial services.

Macroeconomic developments and related financial innovation have had significant flow on effects to household balance sheets. It is now common for households to hold assets linked to daily market movements.

Recent research by the Reserve Bank of Australia has identified two significant features of Australian household balance sheets: the rise in household indebtedness and a larger share of household financial assets being held outside traditional bank assets - typically in products with a higher market risk such as equities and managed investments, including superannuation.

Composition of assets in the household sector



In summary, the RBA's research[1] found:

- *There has been significant participation by retail investors in the markets for some sophisticated financial products in Australia.*

- *The household sector's total holdings of financial assets have risen from the equivalent of 170 per cent of annual household disposable income in 1990 to 315 per cent in 2007.*

- *Direct holdings of equities and units in trusts have risen from 20 per cent to 60 per cent in the same period.*

- *Holdings of cash and deposits have been relatively unchanged as a share of household disposable income, whereas assets held in superannuation (pension) funds and life offices have risen from the equivalent of 80% to nearly 180% of income.*

- *Retail and high net-worth individuals account for about two-thirds of the assets of Australian hedge funds, compared with less than one-half globally; nearly one half of domestic hybrid issues since the mid 1990s were initially taken up by retail investors; and between 2002 and 2005, retail investors purchased around 15% of domestic collateralised debt obligation (CDO) issues.*

Retail participation in these markets has been facilitated by a regulatory regime that does not restrict access to any financial products as long as the provider meets certain disclosure requirements (FSR).

The increased participation by the retail / household sector in more sophisticated investment products has been noted and welcomed by the corporate regulator.

[1] *Risk and the Transformation of the Australian Financial System*, Chris Ryan and Chris Thompson, **Reserve Bank of Australia**, August 2007

In a recent speech entitled '***Helping Retail Investors'***, the former Deputy Chairman of ASIC, Jeremy Cooper remarked:

> "...*the evolution of the Australian financial services market has been characterised by innovation and this is obviously to be encouraged. Wholesale products have been adapted to work in the retail market, generally with positive outcomes for retail investors.*
>
> *An early example of this was the cash management trust; giving retail investors exposure to securities and rates of return that were previously not available to them on a small scale. Another innovation has been the funds management platform where increased scale has allowed access to products and managers previously only available to wholesale investors."*[2]

Notwithstanding the broad acceptance of retail investors participating in more sophisticated product offerings, the Reserve Bank research concluded that the structural changes in household risk profiles require changes to financial literacy programmes, product disclosure practices and the regulation of the financial planning industry in order to better position the household sector.[3]

MLC believes that Australian households and families have on balance, benefited from recent developments in investment offerings; however, it notes with concern that the growth in the retail holdings of non bank products has not been matched by a commensurate growth in Australians seeking professional financial advice.

This was also an issue identified by the Reserve Bank's research, noting that there is a need to better equip '***households with the knowledge and tools they need to manage the increased risk resulting from the transformation of their balance sheets'***[4]**.**

Specifically, according to the RBA, there was a need to '***strengthen standards among professional advisers*'.**[5]

MLC agrees with the findings of the Reserve Bank and believes the most assured way for Australian households to better manage risk and achieve financial security is by seeking qualified, professional and properly regulated financial advice.

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[2] Cooper, J, 'Helping Retail Investors'. SPAA Annual Conference, 11 March 2009
[3] *Risk and the Transformation of the Australian Financial System*, Chris Ryan and Chris Thompson, **Reserve Bank of Australia**, August 2007 pg 71
[4] Ibid pg 64
[5] Ibid, pg 72

(ii) Manufacturer and adviser relationships in the financial advice industry[6]

Over the years, the advice industry has been characterised by a system of complex arrangements that exist, in large part, to manage the tension existing between product manufacturers who wish to gain control of distribution and advisory groups and financial planners who control and guard the exclusive relationship with the customer.

Historically, it has been the manufacturers, in an attempt to achieve higher product sales, which have encouraged the planners to support them. Their support is enlisted in the form of rewarding sales and recommendations favourable to the manufacturer; through various volume related payments and incentives.

The wealth management and investment industries have a history of payment and remuneration practices where margins were shifted between manufacturers and licensees; details of these arrangements and their consequences are discussed in Chapter 2.

(iii) Corporate Collapses in Australia

MLC does not believe that recent corporate collapses in Australia can be adequately explained by a single or limited number of reasons; little is to be gained by assessing competing claims of blame or absolution, such as a failure of regulatory powers versus flawed business models. Accordingly, this submission will not provide input on these matters.

However, MLC does believe that broader issues such as excessive gearing, the provision of lax credit, an over reliance on tax mitigation strategies and a general confusion regarding property rights of securities will feature in the final analysis.

Arguably, these are symptoms and by products of an investment environment where the customer's interests are always not properly considered.

[6] References to 'licensee' in this document refer to advice licensees unless otherwise indicated. References to manufacturers includes stand alone fund managers and platform providers as well as integrated fund management – platform models

Recent comments by the Governor of the Reserve Bank, Glenn Stevens are also instructive, the Governor noted an international trend among investors for an ongoing quest for yield:

> *"...end investors consciously (began) to accept more risk in order to find the returns they were seeking. Additionally, the easy availability of credit and benign macroeconomic environment led to an increase in the use of leverage to increase returns further. It also provided the demand side backdrop for the development of new instruments. The innovative financial community obliged and provided ever more sophisticated ways of achieving the returns desired by investors..."*

The Governor concluded that the innate complexity and reduced transparency of investment instruments made their properties hard to assess, and impaired an investor's ability to assess their own risk.[7]

MLC submits that this continues to be the experience for too many Australian retail investors.

Ultimately, Australian retail investors will continue to be subject to unnecessary risk and hidden costs while the financial services industry persists with remuneration arrangements that are not made explicit to the customer or presented in easily understood terms.

(iv) Current Government initiatives

MLC notes several government reform programmes which are currently being pursued in the financial services sector; specifically, reform of consumer credit law and regulation, responsible lending practices, unfair contract terms and the pending regulation of margin lending.

MLC submits that all of these initiatives will contribute to an improved customer experience for Australian retail investors and was broadly supportive of these reforms in the 2008 *Financial Services Green Paper* issued by Senator Sherry.

However, there are some current industry practices that are beyond the scope of these reforms which continue to negatively impact Australian investors, these practices are discussed in Chapters 2 and 3 of the submission and require further review.

[7] RBA Governor, Mr G Stevens, Speech, *Financial Markets Innovation Congress*, Sydney, 27 March 2008

Finally, this submission does not make comment on broader policy matters that are being considered by the Henry Review of the Australian Taxation System and the forthcoming Cooper Review of the Australian Superannuation system. MLC looks forward to participating in those ongoing consultations.

Chapter 2: Trust and Transparency

During the last several years, large licensees have emerged with a business model that brings together large groups of advisers under a single license which offers preferred platform solutions. These groups are growing rapidly and new business structures and payments have emerged to support the aggregation model.

Some of the practices that have emerged include:

- *White Label Platforms*: The manufacturer provides an outsourced administration platform badged as the licensee's own product. This is provided at a wholesale cost with the distributor and the manufacturer entering into a revenue share arrangement; ideally, the revenue share agreement should not be volume based and all payments fully disclosed, under these conditions, this is an effective model.

- *Private Label Platforms*: This is where a licensee becomes the manufacturer and then outsources the administration to a platform provider. Under this model the licensee becomes the responsible entity (RE), but enjoys the extensive support from the platform provider.

'*White label'* and '*Private label'* platforms operating under the 'affiliated' advice (discussed below) model and without volume based payments, are sustainable options with benefits for industry efficiency and customers.

- *Shelf Space Fees*: Investment fund managers pay platform providers for inclusion on the provider's platform. The majority of platforms keep this payment to increase margins.

- *Volume Rebates*: These rebates or commissions typically relate to the volume of business written and are paid to the licensee by the manufacturer. Some licensees are even raising volume commissions from groups that are not even operating under their licence. In some instances these volume rebates are shared with advisers in the form of bonuses or equity arrangements.

Too often, remuneration deals between manufacturers, licensees and planners are opaque and not clearly disclosed to the customer; both shelf space and volume rebate payments can work against the investor receiving unbiased advice; ideally, they should not feature in the future development of the advice industry.

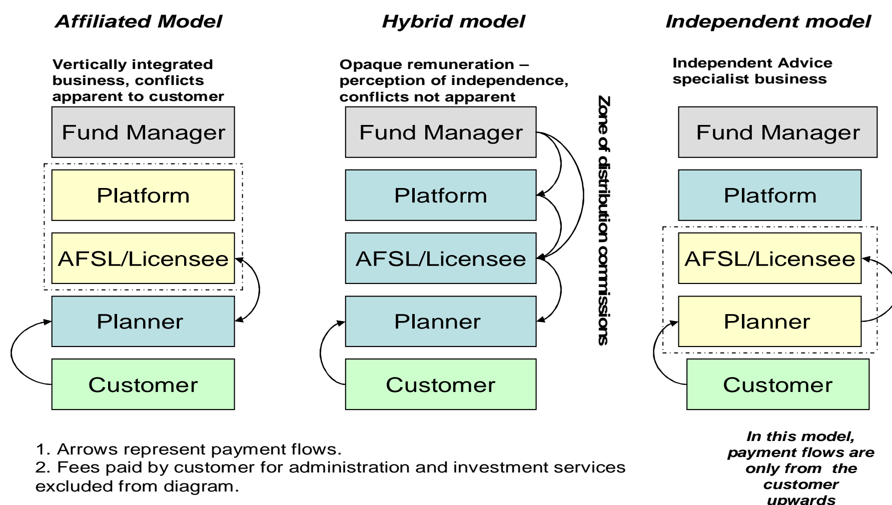
(a) *Advice Industry Structure and Regulation*

There are three different business models that exist in the Australian advice industry:

- **The affiliated model**: This is where the manufacturer and licensee operate within the same legal entity, it is also referred to as a *vertically integrated* model. Governance focuses both on manufacturing and advice functions.

- **The hybrid model**: This is where the manufacturer and the licensee are separate legal entities but remuneration arrangements between them resemble and operate as a *virtual affiliated* model. Typically this approach only focuses on advice licensee governance and controls; the standards and safeguards found in the affiliated model are not in place. This model is the least transparent to investors.

- **The independent model**: This is where the manufacturer and the licensee operate independently with no remuneration or ownership linkages. All licensee remuneration is sourced through the relationship with the customer. This model has the least amount of conflicts.



While it is common for conflicts to be present in various business models, particularly where incentives exist for sales performance, the more important consideration is the avoidance or management of these conflicts; this can be achieved under both the affiliated and independent models shown above.

However, the hybrid model does not facilitate the management of conflicts as it does not acknowledge the financial dependency of the licensee on the product manufacturer or the influence the relationship has with respect to final advice recommendations to investors.

If the conflict is not identified or acknowledged, it can not be managed.

The advice businesses that have failed in recent times, including Storm Financial, operated under the hybrid model.

The Affiliated model

Large integrated financial services organisations are uniquely positioned to provide retail investors with a full suite of products and services to meet their current and future needs.

A global trend in financial services has seen these institutions simultaneously own and operate product manufacturing and distribution / advice businesses.

This structure (also referred to as a vertically integrated model) does contain some conflicts of interests. It is critical for these institutions to have a thorough understanding of the conflicts that reside in their businesses in order for the conflicts to be identified and either removed or addressed by careful management.

MLC submits that the benefits of a properly managed *affiliated* model, significantly outweighs the potential negatives and has proven to deliver a more secure and holistic financial service with superior consumer protection capabilities and a stabilising influence on the broader financial system.

This has been the case for MLC, a wholly owned subsidiary of the National Australia Bank. MLC owns several financial advisory businesses which are licensed to provide advice to retail clients, including: NAB Financial Planning, Godfrey Pembroke Limited, Apogee Financial Planning Limited, Garvan Financial Planning and MLC Financial Planning.

At MLC, conflicts are managed through its board structures, stringent product selection processes, compliance processes and monitoring of the quality advice delivered by our advisers *(MLC's suggested model for best practice governance of Australian Financial Services Licensees (AFSLs) is discussed in Chapter 3 of this document).*

Further, an integrated financial services company is distinguished in the advice industry by its access to capital to remedy investor losses arising from maladministration or malfeasance on the part of a company's representative.

At MLC, we have had a small number of incidents where authorised representatives have carried out fraudulent activity resulting in losses for clients. The interests of our clients are paramount and our response to these issues has been to quickly engage the regulator, undertake a thorough investigation of events, compensate affected investors for their losses and undertake a review of our compliance systems and processes.

With respect to compensatory matters, integrated financial companies are much better placed to discharge the statutory requirements and meet the legitimate expectations of affected investors. In this context it is important to note that professional indemnity insurance (PI) is not a substitute for capital in compensation matters.

Recently, ASIC noted in Regulatory Guide 126 (Compensation and insurance arrangements for AFSLs), the limitations of current PI requirements as a consumer protection mechanism.

In its 27 November 2007 press release, ASIC stated:

> *"PI insurance is not designed to protect consumers directly and is not a guarantee that compensation will be paid. It is designed to protect the insured (i.e. the licensee) against the risk of financial losses arising from poor quality services (e.g. poor advice or execution of services) and other misconduct by a financial services provider (e.g. fraud by its representatives)…*
>
> *Currently available insurance is unlikely to provide a source of funds where a licensee has become insolvent before the claim was brought. Ideally insurance policies would continue to cover the licensee after it has become insolvent or otherwise ceased business, but we understand this insurance cover is generally not available in the current market to the average licensee. We also recognise that insurers may exclude some areas of cover in currently available policies for risk management reasons."*

Further, when a licensee needs to rely on PI insurance to compensate retail clients, they effectively have competing duties to discharge. Under the licence, they have a duty to the client to act efficiently, honestly and fairly when administering the client's claim for compensation.

However, under the PI insurance contract, they have a duty of utmost good faith to the PI insurer. The PI insurer has no direct responsibility to the retail client in the process. The interests of the client and the insurer are not aligned. If the licensee and the PI insurer don't agree, the client will lose out unless the licensee has the financial backing to compensate clients independent of whether the PI insurer meets all or any part of the claims.

The Hybrid model

The hybrid model is commonly used by licensees who aggregate advisers and utilise white labelled platforms sourced from large integrated providers; on appearance, it does not substantially differ from the affiliated model. The licensee operates both as a product provider *and* a licensee.

However, the illusion of licensee independence from the manufacturer is held out as a superior proposition for customers as they are often told the company is '*independent*'.

Such claims belie the near total dependency on revenue generated from manufacturer payments to the licensee, typically based on volume.

The complex system of rebates and volume bonuses that are paid to non- institutionally owned licensees create inherent conflicts and bias. In effect, the advisers use the platform promoted by the licensee and the licensee and adviser are financially rewarded for doing so.

The customer's visibility of these arrangements is minimal, worse still, the customer is not aware of how these payments can determine what products the adviser recommends.

The high profile failures in the investment and advice industry of the last 18 months operated under the hybrid model; it is a model with too few safeguards and too many influences running counter to investor interests.

MLC **has no** objection to the use of white labelled platforms or the outsourcing of manufacturing. MLC **does** object to the system of distribution commissions paid to licensees and advisers which create bias in the advice process.

The Australian advice industry would be better served if those businesses operating under the hybrid model adopted the suggested governance standards of the affiliated model.

The Independent model

The independent model separates advice from manufacturing and is 'indifferent' as to where monies are placed. Independent models can be readily differentiated from the 'hybrid' model as the licensee / adviser does not receive any payments from product manufacturers.

Payments flow upwards from the customer to the adviser and to the fund manager and platform provider. Independent licensees do not receive payments from manufacturers in order to sell that manufacturers product. This model has the least amount of conflicts and the proposition to the customer is specialised advice.

> ***MLC recommends that Australian investors would be better protected in a regulatory regime that oversees two distinct models of advice businesses, each categorised to reflect their operating structure and providing a meaningful descriptor for investors. These businesses should be licensed as either 'affiliated' advice business or 'independent' advice business.***

b) Commissions and Advice Fees:

Introduction

Competition for control of distribution and the customer relationship has been a central feature of the advice industry's evolution and this has resulted in changes to product commission structures over the years.

For example, investment products in the late 1980's and early 1990's tended to have either high upfront commissions or exit fees which were used by product manufacturers to pay advisers. Typically, these commissions were not negotiable by the customer.

By the late 1990's customers regularly negotiated upfront fees down to zero and products with exit fees waned. In response, flexible trail commissions were introduced and 'dial up/dial down' commissions became the norm.
More recently, products have been developed without any in-built commission – led by MLC with the launch of *MasterKey Fundamentals* in 2006; the introduction of these products was a pre-cursor to the full separation of advice fees from product administration and investment fees.

Product administration and investment fees have also become more transparent and have reduced. Estimates suggest that these charges have been reduced by approximately 20% over the last ten years.

Advice Commissions

For several years, MLC has publicly identified commission based remuneration models as being an issue for the industry and consumers.

MLC believes that commissions paid on the sale of investment products do not deliver the value to the industry they once did - in fact, the time of commissions as an ongoing feature of remuneration models for investment products has passed.

MLC **does not** favour an absolutist regulatory response such as the banning of advice commissions; however, it believes the industry should migrate to a remuneration model, more befitting of a profession and more acceptable to the customer: a true fee-for-service arrangement.

The industry has largely recognised this need to create a more acceptable remuneration structure and industry bodies have now indicated their intention to move from commissions to advice fees. In particular, the release of the *Super Charter* by IFSA (July 2009) and the FPA's *Remuneration Consultation Paper* (May 2009) are both commendable initiatives and have received early government and industry support.

Product manufacturers have an important role in assisting the industry to migrate away from commission payments with the creation of commission free products.

MasterKey Fundamentals, MLC's superannuation, pension and investments offer which does not have commissions built into the products supports advisers who charge a separate fee for advice. This initiative was undertaken by MLC to support advisers in the transition to fee based advice models.

There has been some poorly informed debate around the difference between a fee and a commission; these definitional issues are at times (intentionally) confusing and MLC urges the Committee to fully appraise itself of what are the acceptable preconditions for a payment to be regarded as a 'fee'.

For its part, MLC has had a consistent view on this matter.

Definition of Fee and Commission

Commission	Fee
• **A commission is an amount paid by a product manufacturer to an adviser.** • **A commission is a cost borne by the customer, often embedded in the price paid for the product.** • **A commission usually continues for the life of the investment.** • **Commission amounts are not clearly identified on the client's statement.**	• **A fee is an amount agreed by the client and the adviser for the advice provided.** • **A fee is an amount of money paid by the customer to the adviser.** • **A fee can be stopped by the client at any time.** • **Fees can be collected from the client's account. When this is the case, they are clearly shown on the client's statement.**

Distribution commissions

As previously discussed, the introduction of shelf space fees and volume bonuses / rebates are relatively new forms of payments in the industry and are arguably the most concerning; they are opaque, largely unidentifiable by the customer and can result in preferential product selections.

Shelf space fees

Shelf space fees are paid by fund managers to platform providers. These payments are used by fund managers to gain preferential access to platforms and favourable recommendations from advisers.

It should be noted that MLC has no objection to platforms charging modest fees to a fund to recoup genuine administrative costs for the maintenance of the fund on the platform. However, when the fees become large and volume dependent, questions need to be asked around what the fees are actually paying for.

Where a platform is white labelled, shelf space fees are paid to an Australian Financial Service Licence (AFSL) for access to the platform, again, in order to gain favourable recommendations from advisers who operate under the licence.

Paying for access to a platform raises the obvious question of whether customers will have access to the best funds if the best funds have not paid a shelf space fee and are therefore not on the platform.

These payments are a potential abuse of market power by the platform provider.

MLC refers the Committee to its own 2007 inquiry into the *Operation and Structure of the Superannuation Industry*; shelf space fees were discussed extensively; not only their detrimental impact on investors, but also the possible anti-competitive nature of shelf space fee arrangements.

One of the recommendations in the 2007 report supported by all Committee members called for ASIC to work with industry to provide investors with more effective and detailed disclosure of shelf space fees.[8]

Volume bonuses/rebates

Volume bonuses or rebates are payments made to the licensee by product manufacturers for the volume of product sold. Typically, the product provider will "share margin" for volume written and for preferential access to the licensee's advisers. These payments can vary between 10-50 basis points.

The problem with these payments is that the current disclosure requirements, usually met in the financial services guide, are not sufficient to give the customer a clear understanding of the incidence or amount of these payments or their capacity to bias the advice received from a planner. In some cases, these payments are shared with advisers through bonuses or through equity arrangements.

By virtue of their design, these payments substantially influence the flow of retail investment dollars and, as such, run counter to the spirit and requirements of the FSR regime. They neither benefit customers, nor are they transparently disclosed.

MLC recommends the Committee require the advice industry, through its representative organisations, to identify alternative distribution remuneration models which do not include volume based criteria. Further, newly proposed models should be free of influences that unduly bias advice recommendations and all payments should be fully disclosed to the customer. The industry should present alternative proposals to the government for its consideration by June 2010.

[8] PJC of Corporations and Financial Services. *Inquiry into the operation and structure of the superannuation industry*, 2007. Recommendation 21.

Insurance Products

MLC notes that the sales and distribution of insurance products has not been a focus of this inquiry but recognises that there will be closer examination of these products in the future.

The role of insurance and risk protection forms an important part of an individual's financial plan and also has a significant role in addressing many social policy considerations associated with Australia's underinsurance problem and the related issue of government dependency.

There are significant differences between the structure and design of insurance and investment products, accordingly financial services regulation should account for these differences.

MLC believes that it is appropriate for advice commission based remuneration models, with full disclosure requirements, to continue for insurance product distribution.

However, MLC believes that aspects of distribution remuneration models which work against the consumer, including the consideration of volume criteria should be removed.

MLC looks forward to providing further information and commentary on insurance related matters at the appropriate opportunity.

Chapter 3: Financial Advice in Australia

(a) The role and value of Financial Advice

Financial intermediation in the economy is a core function of the Australian financial system and represents a critical role performed by financial institutions, specifically: matching investors with those that seek capital.

Professional financial advice can better allocate capital across the financial system; this broader economic benefit is not a feature of sales focussed models.

The advice and transactional relationship between a financial planner and a client is an important form of financial intermediation and should be regarded and regulated accordingly.

That is, regulatory oversight of the adviser – client relationship should not be designed to merely regulate sales distribution activities.

At MLC, we believe in the value of professional financial advice and the difference it can make to our customers' lives.

We have a strongly held belief that an individual or family can greatly benefit from a good financial plan prepared by a qualified, professional planner.

Providing value to clients

Much of the value of advice comes from providing a disciplined approach to customers' financial planning needs, these include: goal setting, budgeting, superannuation and retirement savings, insurance and risk needs, taxation considerations, entitlement to government benefits, gearing, investment diversification and estate planning.

The strategic aspects of financial planning are usually more important than the selection of products to the final outcome.

If delivered widely and properly, financial advice can play an important role in addressing several major economic challenges confronting Australia, particularly those outlined in the Commonwealth Treasury's Inter-Generational reports relating to dependency on government for retirement income and health care needs.

(b) <u>Advice structure: the role of the advice licensee</u>

MLC submits that the role and position of licensees in the Australian advice industry is critically important to its proper functioning and believes the Committee should fully examine licensees' roles, functions and responsibilities.

Enhanced legislative or regulatory clarity in relation to licensee obligations, particularly their obligation to have a reasonable basis for advice and to ensure the advice provided is appropriate, will act as an ongoing point of reference for standards and services within the licensee and for the adviser – client and licensee – client relationships.

The role of the licensee in the advice process is critical and should not be confused or conflated with the traditional responsibilities of the company owning the licence.

Ideally, licensees should be primarily concerned with mandating high professional standards and guidelines for the activities of their advisers. No licensee or entity can totally eliminate all risks; however, with a robust review and compliance structures, the potential of risk can be minimised.

Licensees should be committed to objective and superior quality research which will inform the compilation of approved product lists. For its part, MLC's research process resulted in companies such as Westpoint and Great Southern being excluded from its approved product list.

Further, the licensee needs to ensure its own standards and guidelines are being met by its advisers by way of a comprehensive monitoring and review capability. This is an essential function that will help ensure the client's needs are being properly serviced.

The evidence received by the Committee to date suggests that not all licensees share this view of their role and responsibilities.
In recent years the number of advice AFSL holders has increased significantly and the importance of adequate regulatory oversight has never been more important.

In view of recent investor losses and growth in licensee numbers, MLC believes the Committee should examine issues relating to the following: minimum requirements for obtaining an AFSL, the ongoing training and accreditation standards for licence retention and the role of the responsible officer and directors.

Currently, the licensee is subject to specific sections of the Corporations Act. *Section 912A – General Licensee obligations* requires a licensee to do all things necessary to ensure that financial services are provided efficiently, honestly and fairly, including the appropriate arrangements in place for the management of conflicts of interest and to take reasonable measures to ensure that its representatives comply with the financial services laws.

Section 912B – Compensation arrangements for retail clients requires a licensee to have arrangements for compensating those persons for loss or damage suffered because of breaches of its obligations under Chapter 7 of the Corporations Act.

These requirements are an important element of the existing legislative framework and should be retained and would benefit from a further promotion by the corporate regulator to existing and future licensees.

MLC submits that the licensee framework can be further strengthened with the adoption of the following additional requirements and standards by those licensees operating under the *affiliated* model:

Proposed Advice Licensee Governance

- **Each licensee should have a separate board that governs the activities of the licensee for the purposes of FSR obligations and compliance.**

- **A licensee board of an affiliated business should comprise a majority of independent directors, thus ensuring a focus on governance rather than product distribution.**

- **At least one independent director should be required on all Board sub committees (e.g. Approved Product List and Dealer Advice Standards sub committees). Many boards will require sub committees to provide the appropriate level of monitoring on key issues. These sub committees should be independently chaired to ensure arms length decision making.**

- **Capital requirements for Australian Financial Service Licensees:**

  Capital held by licensees should be sufficient to give clients reasonable protection against inappropriate adviser activity.

- **Independent and expert input into product research processes:**

  The construction of Approved Lists and investment guidelines should be the responsibility of licensees. These vital activities should not be placed solely in the hands of research houses. Licensees need to monitor both product and its application. Guidelines on leverage, degree of structure, stage in a client's life, risk profile and diversification are just as important in the research process as product selection.

- **No remuneration bias for sale of in house products.**

- **A certified and continuous internal audit process to review advice functions.**

- **Each licensee should have a set of operating standards that advisers in the licensee sign up to and abide by. These standards should be available for viewing by the regulator and the public. The licensee should not only monitor adviser behaviour around legislation but also their own internal standards.**

  Consistent breaking of licensee standards should be seen in the same way as breaking legislation. If advisers consistently break standards the licensee should have a cause to remove its authorisation.

*(c) **Education and Accreditation of Financial Planners***

(i) Moves towards professionalism

Over the last few decades, the Australian financial planning industry has been evolving from a product selling and sales culture to a professional advisory offering for retail investors. A recent feature of this evolution has been the growing trend of planners choosing to move away from commission based remuneration models to fee for service arrangements.

MLC acknowledges that there is still residual resistance amongst some planners to transition away from commission based payments; however, the company believes the basis of a planner's remuneration is a critical element in distinguishing a sales function from a professional advisory service.

The interests of the client and the planner are best served when a planner has a single source of income: the client. Payments to planners in various forms from other parties, such as product manufacturers, can compromise planners' claims to professionalism.

MLC notes with approval that there is now a clearly discernible (and perhaps irreversible) trend among planners to fee for service remuneration payments; this is a good example of the industry self regulating in response to consumer and regulatory concerns.

(ii) Official requirements for planners

Currently, ASIC has responsibility for mandating minimum requirements for the accreditation of financial planners, specifically, ***Regulatory Guide 146 Licensing: Training of Financial Product Advisers****.* ASIC states that by setting and enforcing training standards it seeks to *'protect consumers of financial advice by ensuring those who provide the advice are competent to do so'*.[9]

ASIC maintains a training register of educational courses that meet the requirements of RG146, a common option is the Diploma of Financial Services; ongoing training and courses by a planner are required to maintain eligibility to be an AFSL representative.

MLC believes that ASIC's base minima criteria for financial planners is a useful starting point for new entrants to the industry and should be considered in conjunction with ASIC *Regulatory Guide 36 – Licensing: Financial Product advice and dealing* and *Regulatory Guide 175 – Licensing: Financial Product advisers – conduct and disclosure.*

[9] ASIC RG 146.1 (a), May 2008

Together, these standards have combined to provide an adequate framework for the industry; however, MLC acknowledges that there is capacity to further improve standards in this area, accordingly:

MLC recommends that new entrant non Certified Financial Planners be obliged to meet minimum requirements of (i) completion of an undergraduate degree, (ii) completion of the Advanced Diploma in Financial Services and (iii) at least 12 months of related industry experience.

In a further example of industry self regulation, Australian planners, through their representative body the FPA can apply to become a Certified Financial Planner (CFP), an internationally recognised accreditation for the financial planning profession.

In Australia, a university degree is a prerequisite for admission as a CFP in conjunction with extensive industry specific courses and training.

While not all planners in the industry are CFPs; the CFP standard does represent a significant advancement by the industry to lift standards and practices and is deserving of regulatory and industry endorsement.

Meaningful role designations and descriptors

MLC acknowledges that the nomenclature surrounding 'financial planner' is confusing and related terms are used interchangeably by planners and others (investment advisers, brokers); in many instances, this can be confusing and misleading to customers.

Clarification and certainty around the definition and function of a 'financial planner' would remove this doubt from the market and bring an accountability to the planning industry that is currently lacking.

MLC believes that the descriptors used by the advice industry should be meaningful to the customer and should reflect the licence of the business represented by the planner, that is, a representative of either an '*affiliated*' advice company or an *independent*' advice company, accordingly:

MLC recommends that financial planners operating in Australia be required to operate as either an** 'affiliated financial planner'* ***or an** 'independent financial planner'**; both terms would be designated definitions under the Corporations Act and be federally regulated by ASIC.

Regulatory and legislative changes in this area should have regard for existing industry standards and requirements and should follow consultation with the industry and consumer groups.

There is to be no educational or qualification differential between the two categories, the purpose is to better inform the consumer of the nature and service the planner provides.

(d) ***Access to advice***

As discussed, MLC strongly supports the value of financial advice for Australians, regrettably, too few people access financial advice and do not experience its benefits in delivering a more secure financial outcome for themselves and families.

There are many reasons for the relatively low uptake of financial advice in Australia and MLC is supportive of measures which seek to make advice more accessible.

It is our view that consumers could benefit from an additional advice service that is more limited in scope but still provides tangible value to the consumer.

The recent work of the Financial Services Working Group (FSWG) and the subsequent release of ASIC Regulatory Guide 200 *Advice to Super Fund Members* is a welcome initiative in this area, particularly its stated intention to improve investors' access to important information for the purposes of making better informed decisions.

The same principle holds for investments outside of superannuation as well as advice on an individual's risk needs. Many Australians would benefit from limited advice offerings, allowing them to access advice in a more cost effective way. By making advice more incremental, price barriers become less prohibitive.

MLC provides the following information for the consideration of the committee:

(i) Limited advice inquires

In the majority of cases client inquiries relate to a specific advice area or financial product. This need has generally been triggered by a particular event which is driving them to seek resolution on a pressing issue. Whilst MLC does seek to help clients recognise additional needs during our general advice conversations, often it is the 'trigger' event that needs immediate attention.

This is regularly seen during turbulent markets when a client is, for example, looking *solely* for *direction* on where they should invest their superannuation.

Limited advice would be a solution to this problem as the provider could give the client specific direction on the right investment choice tailored to their investor profile. This is an enhancement to providing general advice because the client is given a recommendation that takes into account their specific situation and expands the general advice (educational) provided.

(ii) Client preferences

Some clients are simply not comfortable with being referred to a financial adviser. This could be due to the type of investor they are (eg DIY) or because they do not see value in a relationship with an adviser.

Depending on the nature of a client's clients enquiry, limited advice would meet a client's needs in lieu of referring them a to financial adviser for personal advice involving the preparation of a full financial plan.

(iii) Value of the client

It is widely acknowledged that providing full personal advice is costly under the current regulatory framework. In order for financial advisers to operate sustainable advice businesses that meet the immediate and ongoing needs of their clients and be fully compliant with the law, planners need to be able to derive sufficient revenue from each client.

Limited advice would help the industry service the advice needs of these customers in a cost effective way so that advice is accessible to more people.

Some key principles relating to limited advice include: limiting the scope of the advice to a maximum number of areas at any one time, limiting the scope of fact finds and the use of alternative interaction channels such as phone or on-line communication.

MLC notes that the definitional issues regarding 'advice' remain problematic in this area and will also need to be reviewed; in short, the legislative definition of general advice is too limiting and the definition of personal advice is too broad.

MLC endorses the position of the Financial Industry Council of Australia (FICA) with respect to legislative change to the definition of general and personal advice, further, it urges the Government to examine limited advice models, beyond superannuation, in consultation with the industry.

Further, MLC recommends greater regulatory clarity around limited advice models in order to better facilitate the provision of low cost, effective advice to customers for whom this is the best solution.

(e) *Tax treatment of Advice payments*

MLC urges the committee to separately consider the issue of the taxation treatment of advice related payments for investments. Properly regulated, professional financial advice can materially improve the financial security of Australians; moreover, such advice can assist with the Government's broader policy objectives of higher national savings and better retirement planning.

Previous rulings from the Australian Taxation Office (ATO) have been in response to a commission oriented remuneration model for the financial advice industry; given recent industry trends to fee for service models, it is appropriate that this issue be revisited.

To date, the courts and the ATO have drawn the rather subtle distinction between fees/payments 'incurred in 'the course' of gaining or producing assessable income' i.e., amounts that are incidental and relevant to this end; rather than fees/payments that are not incidental or incurred in the course of gaining or producing assessable income.

As a consequence, the distinction has been made between fees incurred for drawing up the initial financial plan, which are not deductible, on the grounds that it is not expenditure incurred in the course of gaining or producing assessable income from the investments. That is, it is too early in time to be an expense which is part of the income producing process.

This is a similar treatment afforded to investments with an entry fee, which is non-deductible as it has an insufficient connection with the earning of any income.

These costs are considered to be more incidental to the drawing up of the plan and the outlay of the price of acquiring the investment and are capitalised as part of the cost base of the assets acquired

This can be contrasted with on-going management fees or retainers which are considered to be deductible on the grounds that they relate to the 'servicing' of the portfolio or the management of the income producing investments rather than their actual selection and acquisition.

Fees for reviewing the plan and making investment changes would normally be regarded as management of the investment mix. On these grounds it would generally be an allowable deduction. However, where significant investments are added (as a result of say a superannuation payment being received), the fee flips over to being more of a capital nature. Where and how the fee moves from being on revenue account to one of a capital nature is very subjective and varies from plan to plan.

As a comparison, where commissions are paid by manufacturers, they are fully deductible to the manufacturer as the commissions are clearly being paid to generate taxable income for the manufacturer.

There is therefore a tax bias in favour of commissions paid by manufacturers against fees paid by customers.

Clearer rules around the tax deductibility status of all such fees especially the difference between fees paid by investors and commissions paid by companies would simplify the seeking of advice and not lead to particular structures and payment methods being used that are not in the best interests of the investor.

For example, an adviser could forgo the upfront service fee for setting up the portfolio (which would be non-deductible to the investor) and opt instead to be paid by commission from the product issuers when the actual financial products/investments are bought. The commission is effectively tax deductible, but may prove to be more costly to the investor in the longer-term.

MLC recommends all financial advice fees, whether relating to the preparation of the initial financial plan or its ongoing management, should be tax deductible. Furthermore, no cap should be applied.

MLC recommends that the GST aspects of these fees should also be reviewed. Currently treatments can vary, but generally an individual investor cannot recover GST on financial advice fees; however, some providers may pass a credit back depending on the particular structure of their product.

Chapter 4: Risk and Regulation

Government intervention and self regulation by market participants are essential features, and often partners, in ensuring the financial services market operates efficiently and fairly. The combination of 'risk' and 'uncertainty' need to be accounted for in proper measure without interfering with otherwise acceptable market functions.

The Committee is right to review the regulatory framework for financial services products and distribution; MLC believes that in recent times, the customer's interests have not been given proper consideration in the retail investor experience; examples of this have been discussed above.

Central to this problem has been access to meaningful and easily understood information covering all aspects of investment transactions.

Information asymmetry is a fundamental justification for regulation. Retail investors in particular, cannot be reasonably expected to adequately assess the risk profile or soundness of banks, life offices or investment companies.

Nor are customers expected to judge with sufficient expertise the standard of service they are receiving as investors, depositors or policy holders. The asymmetrical nature of the relationship is underscored when one considers the ability of financial institutions to readily change their own risk exposures *vis a vis* the investor's.

While MLC acknowledges (and in some cases supports) that regulatory or legislative action might be required to address some of the issues before the Committee, MLC would urge the Committee to consider the progress that has been made via industry self regulation and the value of industry standards and practices that carry the imprimatur of regulator approval.

The recent launch of the *'Super Charter'* by the IFSA which, *inter alia*, provides for an industry wide removal of commissions from superannuation investments, is a good example of industry self regulating and responding to consumer and regulatory expectations. In the same field, the FPA's consultation paper on remuneration supports the strength of self regulation.

Absolutist responses while initially appealing to those seeking a solution to market and other failures, can have unintended consequences which present larger problems for all parties at a later time, such action should be reserved for cases when a clear and unequivocal benefit will follow a targeted response.

Well intentioned attempts to eliminate all forms of potential risk or possibility of loss are ultimately misguided and can result in perverse outcomes.

A disproportionate attitude to risk levels which fosters a belief that risk can be regulated away or individuals relieved of the proper self assessment obligations by way of a new law are ultimately self defeating.

In a widely received speech in 2005 on risk and compensation, the then British Prime Minister Tony Blair, reflected on the limitations of well intentioned responses to market ailments; though not the Australian experience, this perspective from the United Kingdom rewards close reflection:

> *"..But something is seriously awry...when (for example) the Financial Services Authority that was established to provide clear guidelines and rules for the financial services sector and to protect the consumer against the fraudulent, is seen as hugely inhibiting of efficient business by perfectly respectable companies that have never defrauded anyone; when pensions protection inflates dramatically the cost of selling pensions to middle-income people.*
>
> *The response of the US Congress to the Enron and Worldcom scandals shows what governments can do wrong. In 2002 the Sarbanes-Oxley Act was, in the words of the Economist, "designed in a panic and rushed through in a blinding fervour of moral indignation". The point about Sarbanes-Oxley was not that the underlying problems it was addressing were not real.*
>
> *The problem was that the Act was not limited to the remedy of that specific defect. Inspired by the need for Congress to be seen to do something dramatic, Sarbanes-Oxley has imposed the threat of criminal penalties on managers and substantial new costs on American business.*
>
> *There is a delicious irony in this which illustrates the unintended consequences of regulation. Sarbanes-Oxley has provided a bonanza for accountants and auditors, the very professions thought to be at fault in the original scandals.*

A natural but wrong response is to retreat in the face of this change. To regulate to eliminate risk. To restrict rather than enable. But we pay a price if we react like this.

We cannot guarantee a risk-free life. So what to do? First, recognise the problem. Some public discussion of it helps engender a more sensible debate. Instead of the "something must be done" cry that goes up every time there is a problem or a "scandal", we make it clear we will reflect first and regulate only after reflection."

The role of the Financial Services Reform Act

An early policy response to the change in Australia's retail investment markets was the *Financial Services Reform Act (2001)*, which mandated uniform licensing for financial product and service providers and a disclosure and conduct regime for licensees.

While broadly supported as a regulatory concept, FSR has been subject to widespread criticism since its inception, particularly its reliance on the current disclosure provisions and its failure to meet its objective of providing meaningful information to retail investors.

In general terms, MLC notes that the financial services industry has largely persisted with sales based distribution models inside a regulatory framework that was working in the opposite direction.

The FSR was originally intended to give greater importance to the delivery of sound and professional advice.

However, with the benefit of seven years of operation, it is fair to say that FSR has been interpreted and enforced as a product regulating regime; its efficacy on this front is also doubtful with recent experiences highlighting the failure of disclosure regarding risks, such as those associated with mortgage trusts.

Nearly a decade has passed since the drafting of the FSR legislation, since that time there have been extensive changes in product innovation, distribution, investor behaviour and the structure of investment markets; its suitability for the coming years is not widely accepted.

There is now strong evidence that the requirements of FSR have added to the cost of advice and works against its original goals of proper conduct and meaningful disclosure for investors.

MLC recommends that the Financial Services Reform Act be comprehensively reviewed against its original objectives and current assessments of its operation. The review should be conducted by an independent body comprised of government, industry and consumer representatives.

Conclusion

MLC is appreciative of the opportunity to participate in this inquiry of the Parliamentary Joint Committee on Corporations and Financial Services. We commend the document for your consideration.

GLOSSARY

AFSL: Australian Financial Services Licence. Any person who wishes to carry on a financial services business (such as advising on financial products, dealing in financial products or operating a registered scheme) must hold an Australian financial services licence. ASIC regulates the provision of licences and the conduct of licensees (See also Licensees).

Approved Product List: The products that a licensee's financial planners may recommend.

Basis Point: One one-hundredth of a percentage point (0.01%).

Commission: a payment from a manufacturer to an adviser in return for business being placed with the manufacturer.

Distribution Commission: an undisclosed payment from a manufacturer to a licensee. These could be described as volume bonuses, shelf space fees, access fees and rebates.

Equity Payments: Where financial planners are given equity in a licensee in return for meeting volume targets.

Fee (for advice): a payment from a customer to an adviser that is agreed between them. Ongoing advice fees can be terminated at the customer's option.

Fund Manager: engaged in investing monies on behalf of both retail and wholesale investors.

Fund Manager Rebate: A payment from a fund manager to a platform to reduce its effective cost, usually to reflect scale benefits arising from a platform's aggregation of funds. Many platforms pass these rebates back to customers.

General Advice: Advice that does not take into account a person's personal objectives, financial situation or needs. This should be made clear through the use of a disclaimer.

Licensee: The holder of an Australian Financial Services License, the business is primarily the provision of financial advice.

*Manufacturer: P*roduct platform providers and fund managers may combine to be an integrated business or stand alone entities.

MasterKey Fundamentals: An MLC product where the fees charged do not include payment for advice. Fees to financial planners are agreed and paid outside the product's standard fees.

Personal Advice: Financial advice that takes into account a person's personal objectives, financial situation or needs.

Platform: Investment platforms allow investors to hold and manage a portfolio of investments. Platforms provide investors with consolidated reporting of both asset valuations and tax. Investors pay an administration fee to the platform provider. Retail investors who move between platforms will generally incur a capital gains tax liability.

The two most common types of investment platforms are master funds and wrap accounts.

> *Master funds:* Investment funds which allow retail investors, without a large investment balance, to hold and manage a portfolio of wholesale managed fund assets through a master trust structure (in which the trustee is the legal owner of the investments and the investors are allocated units in the trust).
>
> *Wrap accounts:* Wraps are effectively platforms except that the units are held in the retail investor's name as legal and beneficial owner. Investors who change platforms do not incur capital gains tax if the assets are transferred *in-specie*.

Advantages of a platform:

1. The management of investments is centralised.

2. Investments can usually be acquired or changed more cheaply or more conveniently.

3. Investors may have access to some investments on better terms that are only available through the platform.

Private Label: where a licensee offers its own version of a product and outsources the administration to a platform provider. The licensee takes on the primary responsibility for the product although the manufacturer will provide extensive support.

Shelf Space Fee: a payment by fund managers to platform providers. These payments are used by fund managers to gain preferential access to platforms.

Vertical Integration: An organisation that operates over the whole spectrum of the wealth management industry. That is both a manufacturer and a distributor.

Volume bonuses: Bonuses paid to financial planners where the bonus rate increases with the volume of business placed with a particular manufacturer. This creates an increasing incentive for a planner to place more business with a single manufacturer.

Volume overrides: Additional commission paid to financial planners where the bonus rate increases with the volume of business placed with a particular manufacturer. This creates an increasing incentive for a planner to place more business with a single manufacturer.

White Label: where licensees put their own badge on a platform provided by a product manufacturer. The product manufacturer retains the primary responsibility for the product.