

2010-2011

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

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CORPORATIONS AMENDMENT (FURTHER FUTURE OF FINANCIAL ADVICE  
MEASURES) BILL 2011

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EXPLANATORY MEMORANDUM

(Circulated by the authority of the  
Assistant Treasurer and Minister for Financial Services and Superannuation,  
the Hon Bill Shorten MP.)



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## ***Glossary***

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<b><i>Abbreviation</i></b>	<b><i>Definition</i></b>
ADI	Authorised deposit-taking institutions
ASIC	Australian Securities and Investments Commission
Bill	Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011
Corporations Act	<i>Corporations Act 2001</i>
FOFA	Future of Financial Advice
Licence	Australian Financial Services Licence
Licensee	Holder of an Australian Financial Services License
PJC Inquiry	<i>Inquiry into Financial Products and Services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services (2009)</i>
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>



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## ***General outline and financial impact***

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### **Outline**

On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced the Future of Financial Advice (FOFA) reforms.

The FOFA reforms represent the Government's response to the 2009 *Inquiry into Financial Products and Services in Australia* by the Parliamentary Joint Committee on Corporations and Financial Services (PJC Inquiry), that considered a variety of issues associated with corporate collapses, including Storm Financial and Opes Prime.

The Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (the Bill), along with the Corporations Amendment (Future of Financial Advice) Bill 2011, implements the FOFA reforms. The reforms focus on the framework for the provision of financial advice. The underlying objective of the reforms is to improve the quality of financial advice while building trust and confidence in the financial advice industry through enhanced standards which align the interests of the adviser with the client and reduce conflicts of interest. The reforms also focus on facilitating access to financial advice, through the provision of simple or limited advice. To this end, the Bill sets up a framework with the following features:

- a best interests obligation for financial advisers requiring them to act in the best interests of their clients and to place the interests of their clients ahead of their own when providing personal advice to retail clients (best interests obligation);
- a ban on conflicted remuneration (including product commissions), where licensees or their representatives provide financial product advice to retail consumers;
- a ban on volume-based shelf-space fees from asset managers or product issuers to platform operators; and
- a ban on asset-based fees on borrowed amounts.

The reforms also include a requirement for ongoing advice fees to be actively renewed by retail clients every two years, and an enhancement of ASIC's powers to deal with unscrupulous operators. These measures are

contained in the Corporations Amendment (Future of Financial Advice) Bill 2011.

***Date of effect:*** The reforms commence on 1 July 2012. In some circumstances, under grandfathering arrangements included in the Bill, the proposed provisions in Divisions 4 and 5 of Part 7.7A banning certain kinds of remuneration do not apply to remuneration provided after commencement under arrangements entered into before commencement. Regulations may prescribe circumstances in which the provisions do apply to such remuneration and do not apply to other kinds of remuneration.

***Proposal announced:*** On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced the Future of Financial Advice (FOFA) reforms. On 28 April 2011, further detail on the operation of the FOFA reforms was announced by the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon Bill Shorten MP.

***Financial impact:*** This Bill has no significant financial impact on Commonwealth expenditure or revenue.



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## ***Best interests obligations***

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### **Outline of chapter**

1.1 Schedule 1 to the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (the Bill) amends the *Corporations Act 2001* (Corporations Act) to require persons providing personal advice to retail clients to act in the best interests of the clients and to give priority to the interests of the client. Schedule 1 also amends existing regulatory requirements so they apply more directly to individual advisers.  
*[Schedule 1, item 23, Division 2]*

### **Context of amendments**

1.2 Under the structure of the financial advice industry in Australia, individuals involved in the provision of personal advice to retail clients may receive remuneration from parties other than the client. The most common example of such a form of non-client remuneration is a commission paid from a product provider to a financial adviser, in situations where a client of the adviser acquires a product from the product issuer.

1.3 The Corporations Act does not currently prohibit such non-client remuneration, but it implicitly recognises its ability to influence the provision of financial advice to clients. Given this, the Corporations Act requires licensees to have adequate arrangements in place to manage conflicts of interests (paragraph 912A(1)(aa)) and for information about remuneration and interests that are capable of influencing the advice to be disclosed to clients through the statement of advice (section 947B when the statement of advice is provided by licensees and section 947C when the statement of advice is provided by the authorised representative). In addition, the Corporations Act places an obligation on licensees and authorised representatives to ensure that the advice is appropriate for the client (section 945A).

1.4 However, there are no provisions in the Corporations Act that require a financial adviser to act in the best interests of the client or to give priority to the interests of the client when providing advice. This means that as long as the advice meets the standard of being appropriate and the necessary disclosures have been made, the adviser is not

prohibited by the Act from giving advice that benefits the adviser rather than, and in preference to, the client.

1.5 In its report on Financial Products and Services in Australia, the Parliamentary Joint Committee on Corporations and Financial Services (PJC) recommended a 'duty on financial advisers requiring them to place their clients' interests ahead of their own'. Further, the PJC noted '[t]here is no reason why advisers should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide advice not in their clients' best interests, yet comply with section 945A of the Corporations Act'.

1.6 In response to this recommendation, the Government announced in April 2010 that it would introduce a statutory duty to require financial advisers to act in the best interests of their clients. The duty would also clarify that in no circumstances is it permissible for advisers to place their own interests ahead of their clients' interests.

1.7 In addition, the amendments aim to address concerns that the existing regulatory obligations in relation to the provision of financial advice impose requirements on licensees and authorised representatives rather than on the individual providing the advice. In situations where advice was provided that breached these requirements (for example, the advice was inappropriate contrary to section 945A), while action could be taken against the relevant licensee or authorised representative, it was difficult to take action against the individual adviser.

## **Summary of new law**

1.8 The Bill amends the Corporations Act to require individuals who provide personal advice to retail clients to:

- act in the best interests of the client in relation to that advice, and sets out a number of reasonable steps that may be taken as complying with the duty; and
- give priority to the interests of the client in the event of conflict between the interests of the client and the interests of either the individual providing the advice, the licensee, or the authorised representative (or any associate of these entities).

1.9 In addition, the Bill replaces the existing requirements in the Corporations Act to have a reasonable basis for providing advice (section 945A) and to warn clients if the advice is based on incomplete or inaccurate information (section 945B) with new provisions in order to:

- clarify the relationship between the new best interest obligations and these requirements; and
- impose these requirements on the individual who provides the advice.

1.10 In situations where the obligations imposed have been contravened by an individual adviser, penalties following from that breach will rest with the relevant licensee or authorised representative. The individual adviser who contravened the obligation may face administrative action in the form of a banning order.

1.11 In addition to the obligations directly imposed on individuals who provide personal advice, the amendments impose a direct obligation on the licensee to take reasonable steps to ensure the licensee’s representatives comply with their obligations.

### Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Statutory obligation for individuals who provide personal advice to act in the best interests of client.	There is no existing statutory obligation for individuals who provide personal advice to act in the best interests of clients.
Statutory obligation for individuals who provide personal advice to give priority to the interests of the client in the event of a conflict of interest.	There is no existing statutory obligation for individuals who provide personal advice to give priority to the interests of the clients.
Statutory obligation for <i>individuals</i> who provide personal advice to ensure that the advice is appropriate.	Statutory obligation on the <i>licensee or authorised representative</i> to ensure that the advice is appropriate.
Statutory obligation for <i>individuals</i> who provide personal advice to warn clients if the advice is based on incomplete or inaccurate information.	Statutory obligation on the <i>licensee or authorised representative</i> to warn clients if the advice is based on incomplete or inaccurate information.
Penalties for breaching obligations to give appropriate advice and warn the client are civil penalty provisions.	Penalties for breaching obligations to give appropriate advice and warn the client are criminal in nature.
Statutory obligation on licensees to take reasonable steps to ensure <i>their representatives</i> comply with the obligation to provide appropriate advice only.	Statutory obligation on the licensee to take reasonable steps to ensure compliance with the obligation to provide appropriate advice only.

## **Detailed explanation of new law**

### **Preliminary**

1.12 The obligations imposed under Division 2 of item 23 apply in relation to personal advice as defined under the Corporations Act. In situations where only general advice is being provided, the obligations under Division 2 will not apply. *[Schedule 1, item 23, Division 2, subsection 961(1)]*

1.13 In addition, the application of the obligations is limited to the provision of advice to retail clients. This is consistent with the broader Future of Financial Advice reforms where the focus is on advice to retail clients given the need to ensure a higher standard of consumer protection for retail clients. Financial advice to wholesale clients is not covered by the obligations. *[Schedule 1, item 23, Division 2, subsection 961(1)]*

1.14 The obligations under Division 2 are intended to directly apply to the individual who is to provide the advice. This individual is referred to in the Division as the ‘provider’. *[Schedule 1, item 23, Division 2, subsection 961(2)]* An individual may be a provider even if the individual is a representative of a licensee and is to provide advice on behalf of the licensee. *[Schedule 1, item 23, Division 2, subsection 961(4)]* Placing obligations directly on the individual is a shift from many of the existing provisions in the Corporations Act where obligations have been imposed at the level of the licensee or the authorised representative.

1.15 This shift in focus to the individual facilitates administrative action to stop individual advisers who give poor quality advice from providing advice in the future (for example, by use of banning orders). This outcome is more difficult to achieve in situations where the obligations are imposed only at the level of the licensee or the authorised representative. The shift also gives individual advisers a clear standard for them to meet in providing advice. Any penalties flowing from the breach of an obligation will continue to flow through to the licensee or authorised representative rather than the individual adviser (unless that individual is also the licensee or authorised representative).

1.16 In situations where two or more individuals are to provide the advice, the obligations imposed under Division 2 will apply to both individuals. This is to avoid any uncertainty in how the obligations apply in situations where multiple individuals are to provide the advice. *[Schedule 1, item 23, Division 2, subsection 961(3)]*

1.17 Where it is not reasonably possible to identify the individual who is to provide the advice, the obligations will flow onto the person that

is to provide the advice. This will be a licensee or authorised representative of a licensee who may be structured as a corporate entity. *[Schedule 1, item 23, Division 2, subsection 961(5)]*

1.18 The reforms are also designed to take into account the growing use of computer programs to deliver advice to clients. In such cases, often no person, whether individual or artificial, can be said to provide each individual piece of advice. In this situation, the person that offers the advice through the computer program is subject to the obligations imposed in the Division. This person will need to ensure that the computer program is able to operate in a manner that complies with the obligations imposed through Division 2. *[Schedule 1, item 23, Division 2, subsection 961(6)]*

1.19 In the limited situations where a licensee is to provide advice as an authorised representative of another licensee, for the purposes of Division 2, the licensee that is to provide the advice is considered to do this in its capacity as an authorised representative (not a licensee) and should be treated accordingly. This is aimed at clarifying the situation where the licensee is acting under a binder in accordance with section 916E of the existing Corporations Act. *[Schedule 1, item 23, Division 2, section 961A]*

### **Act in the best interests of the client**

1.20 Subdivision B, Division 2 of Part 7.7A establishes the framework for the obligation to act in the best interests of the client. *[Schedule 1, item 23, Division 2, Subdivision B]*

1.21 There is a general obligation on providers of advice to act in the best interests of the client. *[Schedule 1, item 23, Division 2, subsection 961B(1)]* This general obligation is supplemented by a provision setting out steps that, if the provider can prove they have taken, will be taken to satisfy the general obligation. These steps have been set out based on the specific conditions under which advisers currently operate. This approach is needed given the broad nature of a best interests obligation; it may allow a provider to demonstrate that it has complied with the obligation by proving it took certain steps.

1.22 The principle guiding the application of the best interests obligation is that meeting the objectives, financial situation and needs of the client must be the paramount consideration when going through the process of providing advice. This principle is embedded in the framework for the best interests obligation.

1.23 There are steps that providers may prove they have taken to demonstrate that they have acted in the best interests of the client.

*[Schedule 1, item 23, Division 2, subsection 961B(2)]* These steps recognise that the requirement to act in a client's best interests is intended to be about the process of providing advice, reflecting the notion that good processes will improve the quality of the advice that is provided. The provision is not about justifying the quality of the advice by retrospective testing against financial outcomes.

1.24 Whether a provider has acted in the best interest of the client will be tested according to what would objectively and reasonably be considered appropriate for the client, as outlined in section 961G (as is the case under the existing section 945A of the Corporations Act). Issues around what is expected of providers when faced with a conflict of interest are dealt with under the obligation to give priority in section 961J. To a certain extent, the process of providing advice (as regulated in section 961B), the quality of advice (as regulated in section 961G) and conflicts of interests (as regulated in section 961J) are interrelated issues. Together, the provisions operate to implement the policy framework for ensuring financial advisers act in all circumstances in the best interests of the client.

1.25 The steps set out in subsection 961B(2) are not intended to be an exhaustive and mechanical checklist of what it is to act in the best interests of the client. A provider may be able to demonstrate that it has, in fact, acted in the best interests of the client under subsection (1), without having recourse to subsection (2). However, as a general principle of statutory interpretation, it is expected that the interpretation of the general obligation in subsection (1) will be informed by the steps set out in subsection (2). Those steps provide an indication of what, as a minimum, is expected of providers in order to be considered to have acted in the best interests of the client. *[Schedule 1, item 23, Division 2, subsection 961B(2)]*

1.26 The steps that will be taken to satisfy the best interests obligation have the notion of 'reasonableness' built into them. For example, they require 'reasonable inquiries' to obtain accurate information from the client, and a 'reasonable investigation' into relevant financial products. This reflects the notion that the type of behaviour that is expected of providers in order to comply with the duty is behaviour that is reasonable, given the client's objectives, financial situation and needs.

1.27 The list of steps in subsection (2) that may be taken to satisfy the best interests obligation includes a number of relatively specific steps (paragraphs (a) to (f), several of which incorporate a 'reasonableness' element) as well as a more general step (paragraph (g)) requiring the provider to demonstrate that it has taken any step that would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

1.28 Because subsection 961B(2) affords the provider a means of demonstrating its compliance with the best interests obligation, it requires the provider to prove that it has met the requirements of the subsection. That is, if a provider wishes to rely on subsection (2), the provider must prove on the balance of probabilities that it took each of the steps in paragraphs (a) to (g). It remains for the party taking action against the provider to demonstrate that the provider has failed to satisfy the best interests obligation under subsection (1), and the provider may challenge the party taking action on the basis that it has met the requirements of subsection (2).

1.29 Requiring the provider to demonstrate it has satisfied the steps in subsection (2) reflects the fact that it is the provider, rather than the client or the regulator, that is best placed to prove whether or not the steps were taken. This does not relieve the party taking action for breach of the best interests duty of the onus of proving non-compliance with that duty.

1.30 Below is an outline of the steps that a provider may demonstrate were taken, to satisfy the best interests obligation.

***Steps that may be taken, together, to satisfy the best interests obligation***

1.31 Consistent with the principle outlined above, the starting point is for the provider to identify the objectives, financial situation and needs of the client as disclosed to the provider through the client's instructions. *[Schedule 1, item 23, Division 2, paragraph 961B(2)(a)]* Identifying the objectives, financial situation and needs of the client is core to personal advice as reflected in the definition of personal advice in the Corporations Act.

1.32 From there, the provider must identify the subject matter of the advice sought by the client. *[Schedule 1, item 23, Division 2, paragraph 961B(2)(b)(i)]* This could be a simple process where the client does not have complex needs or objectives, for example, the client is seeking advice from bank teller about which deposit account is suitable given the client's lifestyle.

1.33 However, in some cases, particularly where the client has complex needs or objectives, it is recognised that clients may not be immediately able to identify the subject matter of the advice they are seeking. In these situations, it may be necessary for the provider to enter into a discussion with the client about what subject matter of advice would be in their best interests. This can take into account considerations like how much the client is willing to spend on the advice. However, the provider cannot enter into a contract to be exempted from this obligation merely by seeking formal agreement from the client that the subject matter of the advice that has been given by the provider is what has been requested by the client and is therefore in the client's best interests. In

identifying the advice that has in effect been sought by the client (including advice implicitly sought by the client), the provider must take into account the client's overall circumstances.

1.34 This process is designed to accommodate the provision of limited advice (also referred to as 'scaled advice') that only looks at a specific issue (for example, single issue advice on retirement planning) and 'holistic' advice that looks at all the financial circumstances of the client. In some situations, the client might prefer to receive more targeted advice on a matter that is particularly concerning them rather than comprehensive advice. As long as the provider acts reasonably in this process and bases the decision to narrow the subject matter of the advice on the interests of the client, the provider will not be in breach of their obligation to act in the client's best interests. The scaling of advice by the provider must itself be in the client's best interests, especially since the client's instructions may at times be unclear or not appropriate for his or her circumstances.

1.35 Once the provider has identified the subject matter of the advice sought by the client, the provider can use this to identify the objectives, financial situation and needs that would reasonably be considered as relevant to the subject matter of the advice. This is referred to as the client's relevant circumstances. *[Schedule 1, item 23, Division 2, paragraph 961B(2)(b)(ii)]*

1.36 The provider cannot solely rely on the instructions from the client, but is also obligated (if it is to demonstrate compliance under subsection (2)) to make further inquiries in situations where it is reasonably apparent that the information provided by the client about their relevant circumstances is incomplete or inaccurate. This is only necessary if the information is considered relevant to the client's relevant circumstances; it is not necessary for providers to ensure every piece of information provided by the client is complete or accurate. *[Schedule 1, item 23, Division 2, paragraph 961B(2)(c)]*

1.37 The test for what is reasonably apparent is determined by reference to what would be apparent to a person with a reasonable level of expertise in the subject matter of the advice. This is an objective test based on the specific subject matter of the advice in question and professional standards in the industry. This means that the test is of a higher standard when the subject matter of the advice is highly complex and technical in nature. *[Schedule 1, item 23, Division 2, section 961C]*

1.38 If, having made reasonable inquiries, it is still reasonably apparent that the information about the client's relevant circumstances is incomplete or inaccurate, the provider can still give the advice; however, the provider is under an obligation to warn the client. *[Schedule 1, item 23,*



*Division 2, section 961H*] If the information provided by the client in relation to their needs and objectives illustrates the client has unrealistic or conflicting expectations (for example, the client wants high returns but is not willing to accept any level of risk), the provider should explain to the client that their expectations cannot be met and seek further information from the client about how the relationship should proceed.

1.39 The next step in subsection 961B(2) requires an assessment of whether the provider has the necessary expertise to provide advice on the subject matter sought by the client. If the provider does not have this expertise, the provider must decline to provide that advice. In most cases, as long as the provider is competent for the purposes of the Corporations Act to provide advice for that class of financial product, the provider would satisfy this requirement. However, in the situation where the client requests advice on a particularly technical or complex aspect of the financial product, the provider may not have the expertise to provide this advice even though they are generally competent to provide advice about that class of product. In this situation, in order to act in the client's best interests, the provider should decline to provide the advice. [*Schedule 1, item 23, Division 2, paragraph 961B(2)(d)*]

1.40 In situations where it is reasonable for a provider to consider recommending a financial product to the client, the provider must conduct a reasonable investigation into the financial products that might achieve those objectives and meet those needs of the client considered relevant to the advice. The provider must assess the information gathered as part of the reasonable investigation. [*Schedule 1, item 23, Division 2, paragraph 961B(2)(e)*]

1.41 A reasonable investigation into financial products does not require an investigation into every product that is available on the market, given that in many cases this would be impractical and costly. The provider is required to scope their product selection based on the needs and objectives of their client. The provider is expected to exercise professional judgement to determine whether this requires going beyond the provider's approved product list (if the provider operates using such a list). This will ultimately depend on the nature and range of products on their approved product list and the needs and objectives of the specific client. Additionally, providers should investigate any specified financial product the client requests be considered. [*Schedule 1, item 23, Division 2, section 961D*]

1.42 The next step requires providers to base all judgements in advising clients on the objectives, financial situation and needs of the client. This is an explicit statement of the guiding principle, identified above, that it is the objectives, financial situation and needs of the client

that is of paramount consideration when acting in the best interests of the client. *[Schedule 1, item 23, Division 2, paragraph 961B(2)(f)]*

1.43 In recognition of the myriad of circumstances that could form the backdrop of the advice, the final step in subsection 961B(2) requires that the provider take any step, additional to those in paragraphs (a) to (f), that would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances at the time of the advice. That is, in satisfying this final step, a provider will need to go further than in the previous more specific steps, and will have to take any step necessary to demonstrate that it has acted in the best interests of the client. For example, where a provider with a conflict of interest has made a financial product recommendation, it should be able to demonstrate that an adviser with a reasonable level of expertise and without a conflict of interest would have considered the steps taken reasonable in the circumstances. This means that, if the provider wishes to rely on subsection (2), it must demonstrate that it did anything else that it would reasonably be regarded as being in the best interests of the client to do. *[Schedule 1, item 23, Division 2, paragraph 961B(2)(g)]*

1.44 This is an objective standard based on the client's relevant circumstances, the provider's relevant expertise and the subject matter of the advice sought. A particular step would reasonably be regarded as being in the best interests of the client if a person with a reasonable level of expertise in the subject matter, exercising care and objectively assessing the client's relevant circumstances would regard it as in the best interests of the client to take that step. This is in keeping with the broad obligation in subsection (1) to act in the best interests of the client. *[Schedule 1, item 23, Division 2, section 961E]*

1.45 Steps that may reasonably be regarded as being in the best interests of the client may also be informed by professional standards and ethics that may be reflected in industry codes and any responses flowing from the work of the Advisory Panel on Standards and Ethics for Financial Advisers (the Advisory Panel). The Advisory Panel was established by the Government in 2010 to provide recommendations to the Government on professional and ethical standards in the financial product advice industry, including the possible development of a best practice guide for persons providing financial product.

1.46 It is important to note that there nothing in the best interests duty that should be interpreted as prohibiting a provider from charging the client for the services that have been performed by the provider. Nor should the best interests duty be interpreted as mandating or prescribing how much the provider can charge the client. The cost of financial advice services is ultimately determined by competitive market forces.

1.47 Further, there is nothing in the best interest obligation that necessarily prohibits a provider from receiving remuneration other than from the client (for example, a commission from an insurance provider). However, a provider in receipt of this remuneration must be able to demonstrate that it is complying with the steps above and is giving paramount consideration to the objectives, financial situation and needs of the client. This Bill also imposes some restrictions on remuneration received by a provider under the new Division 4 of Part 7.7A (see Chapter 2).

### ***Arrangements for particular financial products***

#### *Basic banking products*

1.48 Particular arrangements are established dealing with the provision of advice solely about basic banking products given by an employee or agent of an Australian ADI or someone otherwise acting by arrangement with an ADI under the name of an ADI. *[Schedule 1, item 23, Division 2, subsection 961B(3)]*

1.49 Basic banking products are: a basic deposit product or non-cash payment facility relating to a basic deposit product; a first home saver account; a travellers' cheque facility; and other products prescribed by regulation. This provides flexibility to add additional products in the future if it is considered appropriate for them to fall within this arrangement, given the constant rate of development in the financial product market. *[Schedule 1, item 23, Division 2, section 961F]*

1.50 When an employee or agent of an Australian ADI provides advice in relation to these products, they are deemed to have complied with the best interests duty obligation if they:

- identify the objectives, financial situation and needs of the client;
- identify the subject matter of the advice; and
- make reasonable enquires to obtain further information relevant to the subject matter of advice if it is reasonably apparent the information provided by the client is incomplete or inaccurate.

*[Schedule 1, item 23, Division 2, subsection 961B(3)]*

1.51 These obligations are based on what is already expected of providers under the obligation in the existing section 945A of the Corporations Act to have a reasonable basis for advice. Providers who are

subject to the provision need not demonstrate compliance with the other steps mentioned in subsection 961B(2). In particular, the arrangements do not require a provider to conduct a reasonable investigation. This means that there is no obligation on providers to consider products outside of those offered by the ADI for which they are working.

#### *General insurance products*

1.52 The arrangements that apply in relation to basic banking products also apply in relation to the provision of advice solely about general insurance. The arrangements for general insurance apply regardless of whether the advice is provided by an employee or agent of a general insurer or through another source (like an insurance broker). This is to avoid any regulatory distortion in the provision of advice about general insurance. *[Schedule 1, item 23, Division 2, subsection 961B(4)]*

1.53 Basic banking products and general insurance are recognised as being simple in nature and are more widely understood by consumers. This means that there is a lower risk of consumer detriment in relation to the provision of advice on these products. For this reason, a modified best interests obligation more appropriately balances the benefits to consumers with the compliance costs to providers.

#### *Regulations*

1.54 The regulations can add or remove particular steps, in prescribed circumstances, that the provider must prove to comply with the requirement in subsection 961C(1). The regulations may also prescribe circumstances in which the requirement in subsection 961C(1) does not apply. It is important for there to be this degree of flexibility around the more detailed aspects of the best interests obligation because of the diversity and complexity of the financial services industry. *[Schedule 1, item 23, Division 2, subsection 961B(5)]*

1.55 This regulation-making power will allow the legislation to be updated in a timely manner in the event that the application of a particular step (or steps) is found to result in undesirable consequences in the light of advancements in the financial services industry or the provision of advice in unique and unforeseen circumstances.

### **Appropriate advice**

1.56 The Bill repeals existing section 945A of the Corporations Act *[Schedule 1, item 6]* and introduces provisions dealing with appropriate advice that take account of the best interest obligations. *[Schedule 1, item 23, Division 2, section 961G]*

1.57 In contrast with existing section 945A, the provision does not contain the process-related elements in paragraphs 945A(1)(a) and (b) that have now been incorporated into the steps of the best interest obligation. This has been done to avoid overlap between the provider's best interest obligations and the obligation to give appropriate advice. Incorporating these process elements into the best interest obligation is not intended to lessen the standard of conduct expected of providers. Providers are still expected to follow a 'know your client' and 'know your product' process in providing advice as is currently required by paragraphs 945A(1)(a) and (b). The steps required by the best interests obligations are more expansive than previously required by existing paragraphs 945A(1)(a) and (b) and would be expected to raise the standard of conduct of advisers.

1.58 The obligation in relation to appropriate advice is placed directly on the person that provides the advice rather than the licensee or authorised representative. Currently only licensees and authorised representatives are required to comply with existing section 945A. As noted previously, this change is necessary to ensure that administrative actions may be taken against providers that fail to comply with the obligation. The penalties resulting from any breach will flow to the relevant licensee or authorised representative. *[Schedule 1, item 23, Division 2, section 961G]*

1.59 The obligation to give appropriate advice takes direct account of the best interest obligations. This means that, regardless of whether the provider has actually complied with its best interest obligations, in testing whether the advice is appropriate it is assumed that the provider has all the knowledge that it would have had if it had complied with the best interest obligation. That is, when a court considers whether advice is appropriate it will have regard to what the provider would have known had it fully complied with the best interests obligation. If the appropriate advice obligation did not make this assumption, providers that did not comply with their best interest obligations may be held to a lower standard than providers that do comply. *[Schedule 1, item 23, Division 2, section 961G]*

### **Incomplete or inaccurate information**

1.60 The Bill repeals existing section 945B of the Corporations Act *[Schedule 1, item 6]* and introduces an arrangement for disclosure when the provider has incomplete or inaccurate information. The amendments ensure that the disclosure arrangements for incomplete or inaccurate information are consistent with the best interests obligation. *[Schedule 1, item 23, Division 2, section 961H]*

1.61 As with the other provisions, this obligation is imposed directly on the provider. The provider is required to warn the client in situations when, even following any reasonable inquiries made as part of the best interests obligation, it is reasonably apparent that there is information that is either incomplete or inaccurate. *[Schedule 1, item 23, Division 2, section 961H]*

1.62 For the avoidance of doubt, the provision makes it clear that the arrangements for disclosure do not reduce or diminish a provider's best interest obligations, particularly as they relate to the obligation to make reasonable inquiries to obtain complete and accurate information. *[Schedule 1, item 23, Division 2, subsection 961H(5)]*

### **Priority of interests**

1.63 The provider must give priority to the interests of the client in situations where the provider knows, or reasonably ought to know, there is a conflict between the interests of the client and the interests of the:

- provider; or
- licensee of whom the provider is a representative; or
- authorised representative that authorised the provider (where relevant).

*[Schedule 1, item 23, Division 2, section 961J]*

1.64 The obligation to give priority to the interests of the client also extends to conflicts arising as a result of the interests of an associate (as defined in the Corporations Act) of the provider, licensee or authorised representative. This is designed to prevent the use of related parties as a means of circumventing the obligation. *[Schedule 1, item 23, Division 2, section 961J]*

1.65 However, the obligation is only triggered in situations where the provider knows, or reasonably ought to know, there is a conflict of interests. This means that in situations where the provider has no knowledge of a conflict of interest (for example, because the client did not disclose a particular interest to the provider), the provider will not be in breach if it failed to give priority to the interests of the client unless it can be established that the provider ought to have known about the conflict. *[Schedule 1, item 23, Division 2, section 961J]*

1.66 The obligation to give priority to the interests of the client does not mean that the provider can never pursue its own interests or the interests of another party (for example, the licensee). However, the

provider will breach this obligation if, in pursuing its own interests or the interests of another party, the provider fails to give priority to the interests of the client if there is a conflict.

1.67 Consistent with the best interest obligations, there is nothing in the obligation to give priority to the interests of the client that should be interpreted as prohibiting a provider from charging the client for the services that have been performed by the provider. Nor should the obligation be interpreted as mandating or prescribing how much the provider can charge the client. The cost of financial advice services is ultimately determined by competitive market forces.

1.68 Further, a provider does not breach the obligation to give priority merely by accepting remuneration from a source other than the client (for example, a commission paid by an insurance provider). However, if the provider gives priority to maximising a non-client source of remuneration over the interests of the client, the provider will be in breach of the obligation. This Bill also imposes some restrictions on remuneration received by a provider under the new Division 4 of Part 7.7A (see Chapter 2).

1.69 Providers of advice solely about basic banking products or general insurance are excluded from the obligation to give priority to the interests of the client. [*Schedule 1, item 23, Division 2, subsections 961J(2) and (3)*]

1.70 As outlined in relation to the obligation to act in the best interests of clients, basic banking products and general insurance are recognised as being simple in nature and are more widely understood by consumers. This means that there is a lower risk of consumer detriment in relation to the provision of advice on these products. For this reason, exclusion from the obligation to give priority to the interests of the client more appropriately balances the benefits to consumers with the compliance costs to providers.

## **Licensee obligations**

1.71 A licensee must take reasonable steps to ensure that its representatives comply with the obligation to act in the client's best interest, giving appropriate advice, warning clients and giving priority to the interests of the client. [*Schedule 1, item 23, Division 2, section 961L*]

1.72 This is consistent with the general obligation imposed on licensees under existing paragraph 912A(1)(ca) of the Corporations Act to take reasonable steps to ensure that its representatives comply with financial services law. It also reflects the current approach adopted for the obligation to give appropriate advice in existing section 945A of the

Corporations Act (prior to the passage of the Bill), where the licensee is under an obligation to take reasonable steps to ensure an authorised representative complies with the obligation.

1.73 For example, in the context of the best interests obligations, in order to take reasonable steps to ensure compliance a licensee would be expected to explain to providers that they are obligated not to recommend a product from an approved product list if there is no product on the list that would meet the needs and objectives of the client. Further, licensees will need to take positive steps to ensure that providers do comply with this (for example, through periodic audits of advice given to clients).

1.74 Determining whether there is no product on the approved product list that would meet the objectives and needs of the client will be based on the provider's professional judgement, once the provider meets the client and understands the client's needs and objectives. As the licensee often does not have direct contact with the client, the licensee cannot be expected to make this determination. However, the narrower an approved product list constructed by a licensee is, the more likely it is that its providers will not be able to recommend a product from that list. This means that it is in the interests of the licensee to construct approved product lists that are suited to their target clients.

#### ***Penalties and action for loss or damage***

1.75 As previously noted, even though most of the obligations in Division 2 are imposed on the individual that provides the advice, the penalties resulting from any breach flow through to the relevant licensee or authorised representative. *[Schedule 1, item 23, Division 2, Subdivision F]*

1.76 Breaches of any of the obligations in Division 2 may result in a civil penalty. Although criminal penalties are currently available for the existing obligations to give appropriate advice (section 945A) and to warn clients (section 945B), the interrelationship between these obligations and the best interest obligations imposed in this Bill makes it desirable to have consistent penalty arrangements. The enforcement arrangements for the whole of Part 7.7A will be based on civil penalties and provision for compensation for loss or damage.

1.77 The licensee breaches a civil penalty provision if a representative, other than an authorised representative, breaches the obligation to act in the best interests of the client, the obligation to give appropriate advice, the obligation to warn the client or the obligation to give priority to the interests of the client. *[Schedule 1, item 23, Division 2, section 961K]*



1.78 Similar penalty arrangements to those that apply to licensees also apply to authorised representatives. *[Schedule 1, item 23, Division 2, section 961Q]* However, given the degree of control that a licensee is potentially able to exercise over its authorised representative, an authorised representative does not contravene the requirement in situations where the breach resulted from reasonable reliance by the authorised representative on information or material provided by the licensee. The onus is on the authorised representative to establish that the exception applies. This is intended to reflect the existing defence provision available to authorised representatives under subsection 945A(2) of the Corporations Act. *[Schedule 1, item 23, Division 2, subsection 961Q(2)]*

1.79 As noted above, licensees also have a general obligation to take reasonable steps to ensure that their representatives (including authorised representatives) comply with their obligations. The penalty for a licensee that breaches this obligation is the same as the penalty for the obligation that the licensee failed to take reasonable steps to ensure compliance. *[Schedule 1, item 23, Division 2, section 961L]*

1.80 Consistent with the existing section 953B of the Corporations Act, regardless of whether it is the licensee or authorised representative that incurs the penalty for a breach of an obligation, a person that suffers loss or damage resulting from the breach is able to recover that amount from the licensee. This reflects the fact that, under the Corporations Act, it is ultimately the licensee that is accountable for the advice that is provided by one of its representatives, and the Corporation Act imposes an obligation on licensees — not representatives — to have in place arrangements for compensating clients that suffer loss or damage (see existing section 912B). *[Schedule 1, item 23, Division 2, section 961M]*

## Application and transitional provisions

1.81 The obligations in Division 2 apply to personal advice provided to a retail client on or after 1 July 2012, whether or not the request for advice was made before this date. *[Schedule 1, item 33, section 1527]*

## Consequential amendments

1.82 Existing Subdivision B of Division 3 of Part 7.7 (that contains sections 945A and 945B) is repealed, as the requirements are replaced by sections 961G and 961H of Division 2 in item 17. *[Schedule 1, item 6]* As a consequence, references to the existing section 945B in paragraphs 947B(2)(f) and 947C(2)(g) of the Corporations Act are

updated to refer to section 961H (as this will replace section 945B).  
*[Schedule 1, items 7 and 8]*

1.83 In addition, references to sections 945A and 945B in paragraph 953B(1)(c) of the existing Corporations Act are removed. Sections 961G and 961H of Division 2 in item 23 that replace the existing sections 945A and 945B have their own section dealing with actions for loss or damage (in section 961M of Division 2 in item 23), and therefore are not included in section 953B. *[Schedule 1, item 9]*

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## **Chapter 2**

# **Conflicted remuneration and other banned remuneration**

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### **Outline of chapter**

2.1 Schedule 1 to the Bill amends the Corporations Act to ban the payment and receipt of certain remuneration which has the potential to influence the advice licensees provide to retail clients in respect of certain financial product advice. *[Schedule 1, item 24, Divisions 4 and 5]*

### **Context of amendments**

2.2 Australian Financial Services Licensees that provide financial advice to retail clients are traditionally remunerated differently from many other occupations. For example, many advisers have traditionally received commissions from product providers for placing clients with particular products, often paid as a percentage of funds under management. Some commissions are ongoing in nature, forming what are known as ‘trail’ commissions.

2.3 Product commissions may encourage advisers to sell products rather than give unbiased advice that is focused on serving the interests of the clients. Financial advisers have potentially competing objectives of maximising revenue from product sales and providing professional advice that serves the client’s interests.

2.4 There is some evidence that these conflicts affect the quality of advice. The 2006 Shadow Shopping exercise of the Australian Securities and Investments Commission (ASIC) found that advice that was clearly or probably non-compliant was around six times more common where the adviser had an actual conflict of interest over remuneration. The conflict of interest may lead to advice that is not compliant and not in the client’s interests.

2.5 In its 2009 report the PJC noted that the ineffectiveness of current disclosure of conflicts, and conduct rules that allow an adviser to favour their own interests over the interests of clients, are more likely to lead to sub-optimal investment strategies or excessive fee arrangements than to catastrophic outcomes for investors.

2.6 In its report, the PJC noted it received considerable evidence suggesting that the most effective way to improve the quality of financial advice for consumers is to remove conflicts altogether by banning commissions and other conflicted remuneration practices. In responding to the PJC report, the Government decided that product commissions should be banned, the guiding principle being that the interests of advisers and clients should be more closely aligned.

## **Summary of new law**

2.7 The Bill amends the Corporations Act to define ‘conflicted remuneration’ and to ban its receipt and payment in certain circumstances. The Bill establishes the ban on the receipt by licensees and their representatives, and on the payment by product issuers or sellers, of remuneration that could reasonably be expected to influence the financial product advice given to retail clients.

2.8 The ban on conflicted remuneration includes a ban on both monetary and non-monetary (soft-dollar) benefits. In relation to monetary benefits, there are areas that the ban on conflicted remuneration does not apply to:

- general insurance;
- life insurance which is not bundled with a superannuation product;
- individual life policies which are not connected with a default superannuation fund; and
- execution-only (non-advice) services.

2.9 In relation to non-monetary benefits, there are also areas that the ban on conflicted remuneration does not apply to:

- general insurance;
- benefits under the amount prescribed in regulations (proposed to be \$300), so long as those benefits are not identical or similar and provided on a frequent or regular basis;
- benefits for the purposes of genuine professional development or administrative IT services, which meet the criteria prescribed in the regulations; and

- benefits in relation to execution-only (non-advice) services.

2.10 The Bill bans certain product commissions to financial advisers and their dealer groups, as well as volume rebates from platform operators to dealer groups. It also bans volume-based shelf-space fees from funds managers to platform operators, and the charging of asset-based fees to retail clients on borrowed amounts.

### **Comparison of key features of new law and current law**

<i>New law</i>	<i>Current law</i>
Licensees must not accept remuneration which could reasonably be expected to influence the financial product advice or recommendations provided to retail clients (with the exception of certain insurance or execution-only services).	There is no existing statutory prohibition on advisers from receiving conflicted remuneration. Relevant information about advisers' remuneration (including commissions) is required to be disclosed, including in the initial Statement of Advice provided to the retail client.
Licensees must not accept soft-dollar benefits over the prescribed amount that could reasonably be expected to influence the financial product advice or recommendations provided to retail clients (with the exception of certain insurance or execution-only services, and excepting certain benefits for education or training purposes, and certain information technology benefits).	There is no existing statutory prohibition on advisers from receiving soft-dollar benefits. There are disclosure obligations. Various industry codes also self-regulate in this area to some extent.
Employers of financial services licensees (or their representatives) must not pay the licensee or its representatives conflicted remuneration.	There is no existing statutory prohibition on employers paying conflicted remuneration to licensees or their representatives. Employers can currently pay incentives to advisers to sell a certain type or a certain volume of products.
Product issuers or sellers must not provide conflicted remuneration to licensees or their representatives.	There is no existing statutory prohibition on product issuers from paying conflicted remuneration to licensees or their representatives. Various industry codes purport to self-regulate in this area to some extent.

Volume rebates paid by platform operators to licensees will be banned.	There is no existing statutory prohibition on platform-licensee rebates.
Licensees and platform operators must not accept volume-based fees the purpose of securing 'shelf-space' on an adviser's or platform's product list.	There is no existing statutory prohibition on the receipt of volume-based shelf-space fees.
Advisers must not charge asset-based fees (fees dependent upon the amount of funds held or invested) to a retail client to the extent that the amount is borrowed.	There is no existing statutory prohibition on the charging of percentage-based fees to retail clients.

## Detailed explanation of new law

### Preliminary

2.11 Like the obligations to be imposed by the new Division 2 of Part 7.7A, where a licensee is to provide advice as an authorised representative of another licensee, for the purposes of Division 4 the licensee that is to provide the advice is considered to do this in the capacity of an authorised representative (not a licensee) and should be treated accordingly. This is aimed at clarifying the situation where the licensee is acting under a binder in accordance with section 916E of the existing Corporations Act. *[Schedule 1, item 24, Division 4, section 963]*

2.12 Unlike the obligations in Division 2, the provisions in Division 4 apply to both personal and general advice. This reflects the fact that, while it is not in the nature of general advice for the provider to take the kinds of steps envisaged by the best interests duty, the provision of general advice may still be susceptible to influence by conflicted remuneration.

### Conflicted remuneration

2.13 The Bill broadly defines the term 'conflicted remuneration' and proceeds to outline those persons who should not accept or pay conflicted remuneration. *[Schedule 1, item 24, Division 4]*

2.14 Conflicted remuneration means any monetary or non-monetary benefit given to a licensee or representative that could reasonably be expected to influence financial product advice, by either influencing the choice of financial product being recommended or by otherwise influencing the financial product advice more generally. *[Schedule 1,*

*item 24, section 963A]* This means that, even if benefits are product-neutral, if they could reasonably be expected to influence the advice given they will be captured by the ban.

2.15 The concept of conflicted remuneration covers a broad range of monetary and non-monetary benefits, covering both traditional product commissions, volume payments from platform operators to financial advice dealer groups, and ‘soft-dollar’ (non-monetary) benefits.

2.16 Section 963L sets up a statutory presumption that certain kinds of benefits are conflicted remuneration, unless the contrary is proved. The kinds of benefits included in this section relate to the volume of financial products recommended or funds invested. The list of volume-based incentives presumed to be conflicted remuneration includes benefits which are dependent on:

- the value of financial products of a particular class recommended or acquired; and
- the number of financial products of a particular class recommended or acquired.

*[Schedule 1, item 24, Division 4, section 963L]*

2.17 Where a volume-based payment of this kind is made, section 963L requires the party alleged to have paid or accepted conflicted remuneration to prove that the payment is not conflicted remuneration. That is, if that party has paid or received a volume-based benefit of the type described, it will have to demonstrate that, in the circumstances, the benefit was not in fact conflicted remuneration.

2.18 In an industry as complex and fast-evolving as the financial services industry, there are and will always be a wide range of remuneration arrangements. However, volume-based payments of the kind described in section 963L appear on the face of it to be inherently conflicted, since the financial adviser will have a financial incentive to maximise the value of the payments irrespective of the suitability of the products or investments for the client. It would be legislatively impractical to define and categorise all remuneration arrangements precisely, and to prescribe in advance which are conflicted and which are not. Where there are volume-based benefit structures that are not inherently conflicted, this will be peculiarly within the knowledge of those paying and receiving the benefits. It is therefore appropriate that those parties be required to demonstrate that the benefits are not conflicted.

2.19 The structure of the ban on conflicted remuneration recognises that employees in the financial services industry are remunerated in a

variety of different ways. It also recognises that performance pay can be an important part of any remuneration arrangement, and reflects the need to strike a balance between rewarding performance and avoiding inappropriate influence over financial advice. This is why the presumptions in section 963L are linked to the potential influence of the remuneration over the advice. If an employee is remunerated based on a range of performance criteria, one of which is the volume of financial product(s) recommended, the part of the remuneration that is linked to volume is presumed to be conflicted. However, if it can be proved that, in the circumstances, the remuneration could not reasonably be expected to influence the choice of financial product recommended, or the financial product advice given, to retail clients (section 963A), the remuneration is not conflicted and is not banned. This will depend on all of the circumstances at the time the benefit is given or received. Factors that will be relevant in assessing whether a benefit could reasonably be expected to influence the advice will include the weighting of the benefit in the total remuneration of the recipient, how directly involved in the advice giving process the recipient is and how direct the link is between the benefit and the value or number of financial products recommended or acquired. For example, if the benefit was based on the total profitability of the licensee, it was on a small percentage of the total remuneration of the recipient, and the recipient was not involved in providing financial advice to retail clients, it would be less likely of being able to influence the recommendations or advice provided to retail clients. Section 963L provides the industry with the flexibility to maintain broadly based performance-based remuneration arrangements without compromising the advice provided to retail clients.

2.20 The volume-based payments described in section 963L are not an exhaustive definition of what constitutes conflicted remuneration. To the extent that other benefits, by their nature or circumstances in which they are given, could reasonably be expected to influence financial product advice given by the licensee or representative, those benefits will be considered conflicted and be subject to the obligations under Division 4. While the presumptions in section 963L all relate to volume, a benefit need not be volume-based in order to be conflicted remuneration. For example, any flat payment received by a licensee for product distribution would, on its face, be conflicted remuneration. *[Schedule 1, item 24, Division 4, section 963A]*

2.21 It is noteworthy that although most conflicted remuneration will be in the form of ‘payments’, the definition is sufficiently broad and will capture other modes of disseminating ‘benefits’ that conflict advice. In the context of payments from platform operators to financial advice dealer groups, volume-based benefits can take numerous forms without appearing as a discernable payment from one entity to another. For example, some platform-dealer group arrangements involve a bundled fee



which is paid by the client for administration or trusteeship services as well as distribution services which is then split between the platform and dealer group (with distribution to the latter sometimes labelled a 'promoter fee'). To the extent the share of the fee between the platform and dealer group is dependent on volume (which could reasonably be expected to influence financial product advice), any volume-based margin accessed by the dealer group would be treated as conflicted remuneration.

### ***Exceptions from conflicted remuneration***

#### *Monetary benefits*

2.22 Section 963B sets out monetary benefits given in certain circumstances which are not treated as conflicted remuneration. The list contains benefits that would otherwise be caught within the meaning of conflicted remuneration. *[Schedule 1, item 24, Division 4, section 963B]*

2.23 A benefit given to the licensee or representative solely in relation to a general insurance product is not conflicted remuneration. This ensures that the Bill does not prohibit the payment of monetary commissions in the general insurance industry. *[Schedule 1, item 24, Division 4, paragraph 963B(1)(a)]*

2.24 In the case of a benefit from a life insurance company to a licensee or representative, the benefit will not be conflicted remuneration if it is given in relation to a life risk insurance product other than: a group life policy for the benefit of members of a superannuation entity; or a life policy for a member of a default superannuation fund. This ensures that commissions on group risk inside superannuation are prohibited, and commissions are also prohibited on any life insurance policies which are for the benefit of members of a default superannuation fund. Commissions will still be permissible on individual life risk (non-investment-linked) policies within superannuation for non-default ('choice') funds. Commissions will still be permissible on life risk (non-investment-linked) policies sold outside superannuation. *[Schedule 1, item 24, Division 4, paragraph 963B(1)(b)]*

2.25 Monetary commissions or incentive payments in relation to execution-only sales or issues of financial products (that is, where the product is sold with no advice provided to a retail client) are not conflicted remuneration. Where there is advice, but that advice is provided to someone in their capacity as a wholesale client only, a monetary commission is not conflicted remuneration. *[Schedule 1, item 24, Division 4, paragraph 963B(1)(c)]*

2.26 Where the monetary benefit is given by the client in relation to the issue or sale of a product or in relation to financial product advice provided to the client, this is not conflicted remuneration. This ensures

that ‘fee for service’ arrangements — where the client is the person paying the adviser — are not conflicted remuneration (even where the client pays a volume-based fee). The provision is intended to exclude from the definition of conflicted remuneration any fee for service paid by the retail client, whether the benefit is given directly by the retail client or is given by another party at the direction, or with the clear consent, of the retail client. [*Schedule 1, item 24, Division 4, paragraph 963B(1)(d)*]

2.27 Subparagraph 963B(1)(e) creates a regulation-making power to prescribe a benefit, or circumstances in which a benefit is given, that is excluded from the definition of conflicted remuneration. [*Schedule 1, item 24, Division 4, paragraph 963B(1)(e)*]

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

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

#### *Non-monetary (soft-dollar) benefits*

2.30 The Bill includes non-monetary or ‘soft-dollar’ benefits within the definition of conflicted remuneration. To the extent that a soft-dollar benefit could reasonably be expected to influence financial product advice, it will be conflicted remuneration. [*Schedule 1, item 24, Division 4, section 963A*]

2.31 There are a number of soft-dollar benefits which are not regarded as conflicted remuneration. These include:

- benefits given in relation to a general insurance product;
- benefits under the amount prescribed by regulations (proposed to be \$300), so long as those benefits are not

identical or similar and provided on a frequent or regular basis;

- benefits with a genuine education or training purpose that are relevant to the provision of financial advice to retail clients and comply with any other requirements detailed in the regulations (exemption for professional development); and
- benefits that are the provision of information technology (IT) software or support, that are related to the provision of financial product advice and that comply with any other requirements detailed in the regulations (exemption for administrative IT services).

*[Schedule 1, item 24, Division 4, section 963C]*

2.32 Any non-monetary benefits provided by a retail client in relation to the sale of a financial product or provision of financial advice are also excluded from the definition of conflicted remuneration. *[Schedule 1, item 24, Division 4, paragraph 963C(e)]*

#### Professional development

2.33 It is intended that other criteria will be specified in the regulations for the professional development exemption. *[Schedule 1, item 24, Division 4, paragraph 963C(c)]* While it is envisaged that there will be further consultation on the regulations, it is currently intended to prescribe the criteria set out below.

- **Domestic requirement** — the professional development must be conducted in Australia or New Zealand.
- **Majority time requirement** — where 75 per cent of the time (during standard day of 8 hours or equivalent time) is spent on professional development. In a standard 8 hour day, this takes into account a one hour lunch break, as well as another hour that might be applied to other activities such as networking.
- **Expenses** — any travel costs, accommodation and entertainment outside of the professional development activity must be paid for by participants or its employer or licensee.

2.34 It is not generally intended that the ban on conflicted remuneration cover a person who is remunerated for work undertaken at the professional development activity, for example, speaking at a conference or running seminars. It is a question of whether any benefit

received in these circumstances from any entity could reasonably be expected to influence financial product advice; if it could, it would be captured by the ban.

2.35 Further regulations are also proposed (under the general obligations of a licensee in existing paragraph 912A(1)(j) or existing disclosure obligations of the Corporations Act) to set disclosure and record keeping requirements for benefits of this type.

2.36 For exempt non-monetary benefits for both professional development and administrative IT services, it is proposed that:

- any benefit should continue to be disclosed in disclosure documents, in circumstances where they are currently required to be disclosed; and
- recipients should record receipt of these benefits.

2.37 For exempt infrequent or irregular benefits under \$300:

- no disclosure is required in disclosure documents; but
- recipients must record receipt of these benefits.

2.38 The regulations will also require that, on request, the records referred to in paragraphs 2.36 and 2.37 above must be made available to the person who made the request.

2.39 The ban on conflicted remuneration is also not generally intended to cover the services provided by a licensee to its authorised representatives for the purposes of the authorised representative providing financial services on behalf of the licensee. These services would only be captured by the ban if the services were provided in such circumstances that they could reasonably be expected to influence financial product advice.

*Treatment of benefits from employers to employees*

2.40 A monetary or non-monetary benefit given to a licensee or representative by the employer of the licensee or representative is not necessarily conflicted remuneration. If the payment of the benefit is remuneration for work carried out (for example, an employee's salary), then this will not be conflicted remuneration so long as it is not within the definition in section 963A. While this allows the payment of salaries to employee advisers, it means that any proportion of that employee's salary that could reasonably be expected to influence advice is conflicted remuneration. An important consideration in these circumstances would

be the extent to which any volume-based proportion of a salary package is presumed to be conflicted remuneration by virtue of section 963L and whether the recipient could prove that it could not reasonably be expected to influence advice.

### **Example 2.1**

A salaried financial planner receives a base salary of \$80,000 for providing financial product advice to retail clients, with the possibility of a discretionary bonus of up to 20 per cent if certain key performance indicators are achieved. If a component of that bonus is dependent on the adviser recommending or selling a particular number of financial products, that component of the bonus could be considered to be conflicted remuneration, and subject to the prohibitions under section 963J. However, it would be open to the financial planner to prove that, in the circumstances, the bonus could not reasonably be expected to influence the advice.

2.41 The Bill provides an exception from the ban on conflicted remuneration for arrangements where employees of an ADI (or of an agent of an ADI) advise on and sell basic banking products. This entitles an employee to receive sales incentives from their ADI employer, even where it is volume based. However, if the employee provides financial product advice on financial products other than basic banking products, either in combination with or in addition to advice provided on basic banking products, the receipt of a benefit will be considered conflicted remuneration. This will encourage customer service specialists, who wish to continue receiving volume or sales bonuses, to focus on providing advice on basic banking products only. *[Schedule 1, item 18, Division 4, section 963D]*

### **Example 2.2**

A teller employed by an ADI provides advice on and recommends particular banking products to the ADI's customers. The employee is eligible for a performance bonus, in addition to her base salary, if certain key performance indicators are achieved. If a component of the bonus is dependent on the teller recommending or selling a particular number of financial products other than basic banking products, this component would be considered to be conflicted remuneration, and subject to prohibitions under section 963J. The teller cannot receive a sales bonus for recommending a basic banking product (such as a savings account) to a customer if advice on that basic banking product also included advice on a non-basic banking product (such as an investment product).

2.42 Salaried planners or bank tellers can advise retail clients on non-basic banking products, provided they possess the requisite authorisation and competency. However, to the extent they provide

financial product advice on these products, they cannot be remunerated on the basis of volume or sales targets in relation to those products.

***Ban on conflicted remuneration***

2.43 Neither a licensee, a licensee's authorised representative nor any other representative may accept conflicted remuneration. [*Schedule 1, item 24, Division 4, sections 963E, 963G and 963H*]

2.44 The obligation on an authorised representative not to accept conflicted remuneration under subsection 963G(1) does not apply in the situation where the authorised representative received the benefit after reasonably relying on information from their licensee that the benefit was not conflicted remuneration. For example, in the situation where a licensee dealer group collected product commissions on the authorised representative's behalf, and the licensee advised an authorised representative that a particular forthcoming payments was in relation to 'grandfathered' or wholesale commissions, and this turned out not to be true, the authorised representative will not be liable so long as its reliance on that advice was reasonable. Because these matters will all be within the knowledge of the authorised representative, the authorised representative bears the onus of proving that the exception is made out. [*Schedule 1, item 24, Division 4, subsection 963G(2)*]

2.45 A licensee must take reasonable steps to ensure that its representatives do not accept conflicted remuneration. [*Schedule 1, item 24, Division 4, section 963F*]

***Treatment of benefits from employers to employees***

2.46 An employer of a licensee, or of a representative of a licensee, is under an obligation not to pay the employee conflicted remuneration, rather than the employee being under an obligation not to accept conflicted remuneration from the employer. This is appropriate because in the majority of cases it is the employer, rather than the employee, that sets the terms and conditions of an employment contract, as well as being in control of remuneration payments. [*Schedule 1, item 24, Division 4, section 963J*]

2.47 However, a representative (other than an authorised representative) such as an employee is under an obligation not to accept conflicted remuneration unless it is in circumstances in which an employer is liable under section 963J. This means that while an employee will not be under an obligation not to accept conflicted remuneration from their employer, they will be under an obligation not to accept conflicted remuneration from a third party. [*Schedule 1, item 24, Division 4, section 963H*]

*Benefits from product issuers*

2.48 A product issuer must not give conflicted remuneration to a licensee or a licensee's representative. This ensures that, where conflicted remuneration is paid by a product issuer or seller and accepted by a financial services licensee, both parties will be liable to civil penalty. *[Schedule 1, item 18, Division 4, section 963K]*

2.49 The test of whether a product issuer has paid conflicted remuneration is an objective one, based on the perspective of the product issuer. If the product issuer could not reasonably have known that remuneration was conflicted, it is not expected that the product issuer will be caught by this provision. However, this does not allow a product issuer who is wilfully blind to the potentially conflicted nature of remuneration to avoid the application of the ban.

**Volume-based shelf-space fees**

2.50 The Bill establishes a ban on the receipt by platform operators of volume-based benefits to the extent that such incentives are merely a means of product issuers or funds managers 'purchasing' shelf space or preferential positions on administration platforms. However, the Bill does not purport to ban fund managers lowering their fees to platform operators (in the form of scale-based discounts or rebates) where such discounts or rebates represent reasonable value for scale. *[Schedule 1, item 24, Division 5, Subdivision A]*

2.51 A platform operator is defined as a financial services licensee or RSE licensee (as defined in the *Superannuation Industry (Supervision) Act 1993* ('SIS Act')) that offers to be the provider of a custodial arrangement. 'Custodial arrangement' is defined in the existing section 1012IA of the Corporations Act; broadly, it is an arrangement where the client may instruct the platform to acquire certain financial products, and the products are then either held on trust for the client, or the client retains some interest in the product. Under this definition, it is taken to include arrangements where the client may direct the platform to follow an investment strategy of the kind mentioned in the SIS Act. *[Schedule 1, item 24, Division 5, section 964]*

2.52 A platform operator must not accept a volume-based shelf-space fee. *[Schedule 1, item 18, Division 5, subsection 964A(1)]*

2.53 A benefit is presumed to be a volume-based shelf-space fee if the benefit or its value is wholly or partly dependent on the number or value of a funds manager's financial products to which the custodial arrangement relates. This is intended to capture benefits provided in return for a greater number or value of the funds manager's financial

products about which information is to be included on the platform.  
*[Schedule 1, item 24, Division 5, subsection 964A(2)]*

2.54 However, a benefit is presumed not to be a volume-based shelf-space fee if it is proved that all or part of the benefit is:

- a reasonable fee for a service provided to the funds manager by the platform operator or another person; or
- a discount or rebate offered to the platform operator, so long as the value of the benefit does not exceed the reasonable value of scale efficiencies gained by the funds manager because of the volume of funds under management.

*[Schedule 1, item 24, Division 5, subsection 964A(3)]*

2.55 In cases where the scale discount or rebate exceeds the reasonable value of scale efficiencies, it is considered that the benefit is intended to gain a placement on a platform or preferential treatment on a platform (for example, a position on a ‘model portfolio’ or ‘menu selection’).

2.56 Where it is alleged that a volume-based shelf-space fee has been paid, and a platform operator in response wishes to rely on one or both of the exclusions in subsection 964A(3), the platform operator has the onus of proving that the payment is a fee for service or represents the reasonable value of scale efficiencies. In determining whether a payment represents the ‘reasonable’ value of scale efficiencies regard should be had to what might be reasonable in all the circumstances, including, for example, the relative bargaining power between the particular funds manager and the platform operator.

2.57 It is reasonable to expect that the platform operator will be aware of the nature of any discount or rebate it receives, and will therefore be aware of whether a payment is a genuine fee for service, or represents genuine scale efficiencies. It is therefore appropriate that the platform operator bear the onus of proving that the payment ought to be presumed not to be a volume-based shelf-space fee.

### **Ban on asset-based fees on borrowed amounts**

2.58 The Bill establishes a ban on asset-based fees on borrowed amounts, where a licensee or licensee’s representative provides financial product advice to a retail client. *[Schedule 1, item 24, Division 5, Subdivision B]*

2.59 Similarly to proposed sections 961A and 963, where a licensee is to provide advice as an authorised representative of another licensee,



the licensee that is to provide the advice is considered to do this in the capacity of an authorised representative (not a licensee) and should be treated accordingly. *[Schedule 1, item 24, Division 5, section 964C]*

2.60 The Bill provides that an ‘asset-based fee’ is a fee for providing financial product advice that is dependent upon the amount of funds to be used to acquire financial products. If a fee is partly dependent on that amount of funds, then it is an asset-based fee to that extent. *[Schedule 1, item 24, Division 5, section 964F]*

2.61 Licensees or their authorised representatives must not charge asset-based fees to retail clients on borrowed amounts to be used to acquire financial products by or on behalf of the clients. *[Schedule 1, item 24, Division 5, sections 963D and 963E]* A ‘borrowed amount’ can mean an amount borrowed in any form, whether secured or unsecured, including the raising of funds through a credit or margin lending facility. *[Schedule 1, item 24, section 964G]* A licensee contravenes the provision if its representative (other than an authorised representative) charges an asset-based fee on a borrowed amount. *[Schedule 1, item 24, Division 5, subsection 964D(2)]*

2.62 If it is not reasonably apparent that the amounts used to acquire financial products by or on behalf of the client are borrowed, then the prohibition does not apply to the fee. This provides some protection to advisers who have no reason to believe the funds being used by the client are borrowed (in the situation, for example, where the client deliberately conceals the fact that the funds are borrowed). *[Schedule 1, item 24, Division 5, subsections 964D(3) and 964E(2)]* The test for whether something is ‘reasonably apparent’ is an objective one, based on whether it would be apparent to a person with a reasonable level of expertise in the subject matter of the advice, exercising care and assessing the client’s information objectively. It is a question of what would be apparent to a prudent adviser. *[Schedule 1, item 24, Division 5, section 964H]*

2.63 Subdivision B of Division 5 provides that the ban on asset-based fees on borrowed amounts, and the exception for when the borrowing is not reasonably apparent, do not absolve licensees and authorised representatives from the duty in Division 2 to act in the best interests of the clients. To the extent that duty requires licensees and authorised representatives to make reasonable inquiries to obtain complete and accurate information from their clients, this obligation remains in place. This ensures that advisers cannot deliberately or knowingly disregard relevant information or not make reasonable inquiries, merely so that they can charge an asset-based fee on the client’s borrowed amounts. *[Schedule 1, item 24, subsections 964D(5) and 964E(4)]*

2.64 The regulations may prescribe additional exceptions to the ban. *[Schedule 1, item 24, Division 5, subsections 964D(4) and 964E(3)]*

2.65 To the extent that a retail client's funds are not borrowed, licensees or authorised representatives can charge asset-based fees on that non-borrowed component.

### **Penalties and action for loss or damage**

2.66 The Bill sets out the provisions in Part 7.7A which are subject to civil penalties (if breached). With respect to the civil penalty provisions in Divisions 2, 4, 5 and 6 of Part 7.7A, the Bill establishes maximum civil penalties of \$200,000 for an individual or \$1,000,000 for a body corporate. *[Schedule 1, items 28 and 30, sections 1317E and 1317G]*

2.67 The Bill also amends existing section 1317DA of the Corporations Act to include the civil penalty provisions for Part 7.7A within the definition of a 'financial services civil penalty provision'. This means that compensation orders under section 1317HA of the Corporations Act will be available for contraventions of the civil penalty provisions in Divisions 4, 5 and 6. (Division 2 has its own arrangements; see Chapter 1.) *[Schedule 1, item 27, section 1317DA]*

### **Anti-avoidance**

2.68 The Corporations Amendment (Future of Financial Advice) Bill 2011, introduced into the House of Representatives on 13 October 2011, includes a provision (new section 965) to prohibit schemes to avoid the application of Part 7.7A. The purpose and application of this provision are explained in the Explanatory Memorandum to that Bill.

2.69 The current Bill amends the new section 965, to change part of the test for whether a scheme is an avoidance scheme from whether 'the sole or dominant purpose' of the scheme is avoidance, to whether avoidance is the sole or a non-incidental purpose of the scheme. This is intended to capture a broader range of schemes designed to avoid the application of the FOFA reforms. *[Schedule 1, item 25, section 965]*

### **Application and transitional provisions**

2.70 Item 33 of Schedule 1 to the Bill sets out the transitional and application arrangements for the provisions of Part 7.7A established by the Bill. Arrangements for the best interests obligations are discussed in Chapter 1.

#### ***Conflicted remuneration***

2.71 The obligations in Division 4 (conflicted remuneration) generally apply from the date of commencement, 1 July 2012. However,

they do not apply to benefits given to a licensee or representative if the benefit is given under an arrangement entered into before the day of commencement. The regulations may prescribe circumstances in which the conflicted remuneration obligations will apply to benefits given under an arrangement that pre-dates commencement. These arrangements do not apply to conflicted remuneration given by a platform operator; the provisions of Division 4 apply to these payments from the date of commencement. *[Schedule 1, item 33, subsections 1528(1) and (2)]* Regulations will not apply to the extent that their operation would result in an acquisition of property otherwise than on just terms. *[Schedule 1, item 33, section 1530]*

2.72 The regulations may prescribe other circumstances in which Division 4 applies or does not apply. It is intended to provide for payments made by platform operators under this provision. It is also intended that the regulations will provide for conflicted remuneration with respect to both individual and group risk insurance products within superannuation to be banned from 1 July 2013, to align with the start date of the MySuper reforms. *[Schedule 1, item 33, subsection 1528(3)]*

#### ***Volume-based shelf-space fees***

2.73 The ban on volume-based shelf-space fees in Subdivision A of Division 5 of Part 7.7A applies from the day of commencement, but does not apply to benefits given to a licensee under an arrangement entered into before the day of commencement. The regulations may prescribe circumstances in which the ban will apply to benefits given under an arrangement entered into before the day of commencement. *[Schedule 1, item 33, section 1529]* Regulations would not apply to the extent that their operation would result in an acquisition of property otherwise than on just terms. *[Schedule 1, item 33, section 1530]*

#### ***Asset-based fees on borrowed amounts***

2.74 The ban on asset-based fees on borrowed amounts in Subdivision B of Division 5 of Part 7.7A applies to fees charged from the day of commencement, but only to the extent that the borrowed amounts are to be used to acquire financial products on or after the day of commencement. However, the ban would not apply to fees charged after that date to the extent that the operation of the ban would result in an acquisition of property otherwise than on just terms. *[Schedule 1, item 33, section 1531]*



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## ***Regulation impact statement***

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### **Background and problem identification**

3.1 This regulation impact statement represents certain policies announced by the Government in April 2010. Further related policy was developed and announced by Government in April 2011.

3.2 The *Corporations Act 2001* (the Corporations Act) regulates financial products and services in Australia. One way in which an investor acquires a financial product is as a result of following financial product advice. There are relevant conduct rules around the giving of financial product advice and rules to ensure participants behave fairly and honestly. There are also disclosure requirements designed to overcome information asymmetry between industry participants and investors where disclosure assists investors to make informed decisions.

3.3 Currently, the Corporations Act requires that conflicts of interest be managed and disclosed. The law requires that fees or remuneration (including commissions and other payments) are disclosed clearly to retail investors. It does not set limits on what can be charged or how it can be charged. The Corporations Act also requires that advisers have a reasonable basis for financial product personal advice (that is the advice must be suitable). Under equitable principles, there are some duties owed by persons providing advice to their clients arising out of the adviser/client relationship. However, there is a lack of clarity around when those duties apply and precisely what is required to comply with them.

3.4 Under the Corporations Act, generally before the financial service is provided, a retail client must be provided with a Financial Services Guide (FSG) that contains information about remuneration, including commissions or other benefits to be received by an adviser. If personal advice is provided, the retail client also generally receives a Statement of Advice (SOA) from an adviser which includes information about the advice and remuneration and commissions that might reasonably influence the adviser in providing advice. Before a product is provided, a retail client must further receive a Product Disclosure Statement which must also include information about the cost of the product and information about commissions or other payments that may impact on returns.

### ***Retail investments***

3.5 Retail investors hold a variety of financial products. In the main this includes superannuation, life insurance, deposit products, shares, debt securities (including debentures) and managed funds (other than superannuation). The total value of household investment in these investment products is around \$350 billion or 5.5 per cent of total household wealth.<sup>1</sup>

3.6 Retail investors can purchase products in different ways. This includes products:

- distributed without advice, that is directly from a product provider or third party broker or dealer;
- distributed with some advice, but not by a financial planner<sup>2</sup> (that is, representative of the product provider who provides some general or personal advice about the product); and
- distributed by a financial planner who provides personal advice to retail clients. The planner may or may not be associated with a product provider but is likely to receive commissions from them. Financial planners also may use platforms<sup>3</sup> to invest in financial products on behalf of clients.

### ***Fees***

3.7 Investors pay fees when they acquire financial products. In some circumstances, and generally for managed funds, investors tend to pay the same total in product fees whether the product is distributed through a financial planner or not.

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1 Australian Bureau of Statistics, Cat No 5204, Australian System of National Accounts, 2007-08. Household investment in debt securities at 30 June 2008 was \$11.9 billion or 0.2 per cent of total household assets. The ABS data do not provide information on specific investments in shares and managed funds other than superannuation. However, the total amount of wealth invested in shares and other equity, including investment in shares and managed funds other than superannuation, at 30 June 2008, was \$338.6 billion, or 5.4 per cent of total household assets. (ASIC's Submission to PJC, August 2009, 101).

2 There is no legislative definition of the term financial planner.

3 A platform is an administration facility that simplifies acquisition and management of a portfolio of investments. Platforms allow retail investors to purchase a range of investments through the one facility. In one sense platforms are like a department store where you can choose from different brand names and products in the one place, rather than having to visit a number of specialty stores.

3.8 An investor purchasing a managed fund will generally make a substantial initial investment in the fund, and may well make additional contributions. Fees are then deducted from this investment, including entry and contribution fees, administration/account fees, transaction fees and fund management fees (investment and performance fees). Fees are generally set by the product manufacturer and built into the product.

3.9 Each financial service provider receives a payment from the product fees the investor pays. That is:

- the product provider pays its fund manager fees for managing the investment;
- where there is a financial planner, the planner and dealer group are also paid for advice/sale of the product;
- the product provider may pay a commission for the sale of the product, generally to the dealer group. The dealer group then passes on part of the commission to an individual planner. Where there is an employee adviser, they may not receive part of the commission but rather a salary. However often the sale counts towards sales targets that may earn the planner a bonus; and
- the dealer group or planner is paid an ongoing commission (trail commission) and this is paid out of administration fees from the retail investor's account.<sup>4</sup>

### ***Financial Planning Industry***

3.10 Financial advice comes from many sources including financial planners, brokers and accountants.<sup>5</sup>

3.11 In the Australian market, there are 700-1,000 adviser dealer groups operating more than 8,000 financial planning practices and employing around 18,200 people. Industry revenue for the 2008-09 financial year is expected to be \$4.36 billion, an estimated fall of 18.1 per cent compared with 2007-08. The average financial planner has

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4 ASIC Submission to the PJC Inquiry, August 2009, 107-8.

5 There are some differences between the common usage of the term 'financial planner' and legal concept of 'provider for financial product advice'. A broad range of people may provide 'financial product advice'. The data under 'financial planning industry' relates to the industry as the term is more commonly understood.

380 clients, of whom 40 per cent are advised regularly and on a face-to-face basis.<sup>6</sup>

3.12 Approximately 85 per cent of advisers are associated with a product provider. Of the remainder, the vast majority receive commissions from product providers.<sup>7</sup>

### ***Remuneration models***

3.13 Financial planners receive a mix of salaries, 'fee for services', bonuses and commissions. The Financial Planning Association (FPA) identified the most common remuneration types to be hourly rate/time based charging; service based charging; asset based charging; commission and subsidised advice.

3.14 Many planners tend to charge zero or minimal advice fees and instead receive their remuneration from product providers. Product providers recover these charges from the charges levied within products.

3.15 Trailing commissions (usually 0.6 per cent of account balances) are the main remuneration method for financial planners, with seven in ten planners citing them as a form of remuneration. Other forms of remuneration include initial commission on new investment/contribution (up to 4-5 per cent of contributions), volume bonuses (that is, additional commission of up to 0.25 per cent of account balances), and fee for service charged to the client (up to 1 per cent of account balance, or a flat fee, perhaps related to the hours involved). These amounts would not all be paid at the maximum level.

3.16 Trailing commissions are more common among aligned independent and aligned planners<sup>8</sup>, while bank-based planners favour up-front commissions.

3.17 Remuneration models vary across organisations and according to the market segment to which a client belongs. Low to mid-wealth clients tend to pay initial and trail commissions, while 'high net worth'

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6 ASIC submission to the PJC Inquiry on Financial Products and Services in Australia, 109, per Rainmaker, Financial Planning. Rainmaker considers there are 749 advisory groups. The above figure reflects alternative estimates.

7 Ibid, 110.

8 An aligned planner is a planner who works for a financial planning firm, which is owned by a product manufacturer. That is, the licensee/dealer group and the planners within are aligned to the product manufacturer (AMP Financial Planning is an example). An aligned independent is an employee of a financial planning firm, which is owned by a product manufacturer but the firm is independently branded (for example, Hillross (owned by AMP)). The independence refers to the level of influence the product manufacturer has over the planners within the firm regarding what they sell/advise on and who owns the clients.



and 'affluent' clients tend to pay a greater proportion of service fees as a percentage of assets invested, or flat dollar adviser fees. This is most likely because wealthy clients are more sophisticated about how much the advice is costing, and more able to negotiate fees than less-wealthy clients. Wealthy clients tend to receive sophisticated treatment and periodic reviews from their advisers, while smaller customers tend to be offered simple strategies, packaged products and one-off sales. Again, this segmentation is likely based on both customers' needs and ability to pay.

3.18 Revenue from fixed-rate and hourly-rate fee for service was 16 per cent of total planner revenue in 2008. Independent planners have a higher proportion of fee for service arrangements than bank planners, with around 13 per cent of independent planners deriving over half of their revenue from pure fee for service in 2008, compared to 6 per cent of aligned planners and 1 per cent of bank planners. Forty eight per cent of bank planners did not derive any revenue from pure 'fee for service' in 2008 (and 9 per cent of all practices).

3.19 Planners deriving most of their revenue from pure fee for service spend almost half (47 per cent) of their time with clients planning for financial and lifestyle goals, and put less of their client portfolios into managed funds and more into direct equities. Planners deriving no revenue from pure for fee service were more risk-oriented.<sup>9</sup>

3.20 Advisers derive revenue from:

- trail commissions (per cent of assets) (estimated at 35 per cent of adviser revenue);
- initial or up-front commission (per cent of initial investment) (estimated at 26 per cent of adviser revenue);
- fee for service as a per cent of assets under management (called an asset based fee) (estimated at 23 per cent of adviser revenue); and
- fee for service as a fixed dollar amount or an hourly rate paid up-front or out of the product (estimated at 16 per cent of adviser revenue).<sup>10</sup>

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<sup>9</sup> Ibid, 110-11.

<sup>10</sup> ASIC submission to the PJC Inquiry on Financial Products and Services in Australia, 48-49 per Investment Trends October 2008 Planner Business Model Report, 27.

### ***Access to advice***

3.21 Not all investors obtain financial advice. Available figures indicated that between 22 per cent and 34 per cent of adult Australians access financial advice. Use of a financial adviser increases with age.<sup>11</sup>

### **Conflicts of interest**

3.22 Remuneration structures in the financial services industry must be disclosed as they can create real and potential conflicts of interest that may distort the quality of advice. While all remuneration structures may create some form of conflict, there is some evidence that certain structures are creating strong conflicts which are not being sufficiently addressed through current regulation that requires conflicts to be managed and disclosed.

3.23 Problems have been identified with commission-based remuneration arrangements, sales and volume incentives and the use of asset based fees. The issues are outlined below.

### ***Commission based remuneration arrangements — product provider influence over adviser recommendations***

3.24 Typically a commission is an arrangement between a product provider and the adviser or the adviser's licensee and is built into a financial product.

3.25 Upfront and ongoing (trail) commissions paid from product providers to licensees are built into product charges (for example entry and administration fees). For ease of reference, commissions also refer to other product provider payments, including those based on volume or funds under management (other than soft-dollar benefits)<sup>12</sup>, as these are payments that come from product providers and may also influence adviser recommendations.

3.26 Where commissions are used, the income of a financial advice business is linked to which products are recommended (for example, industry superannuation funds do not pay commissions, whereas retail superannuation funds do). Advisers earn income according to the type

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11 Ibid, 114.

12 A soft-dollar benefit is a benefit received by a financial adviser (or its associates) other than a basic cash or direct client fee. Examples include subsidised business equipment and luxury overseas conferences.

and volume of products sold. There are many incentives to meet volume-based or sales-driven targets.

3.27 Commissions may encourage advisers to sell products rather than give unbiased advice that is focused on serving the interest of the clients. Financial advisers have potentially competing objectives of maximising revenue from product sales and providing professional advice that serves the client's interests.

3.28 There is some evidence that these conflicts affect the quality of advice. The 2006 Shadow Shopping exercise of the Australian Securities and Investments Commission (ASIC) found that advice that was clearly or probably non-compliant was around six times more common where the adviser had an actual conflict of interest over remuneration. The conflict may lead to advice that is not compliant and not in the client's interests. There is anecdotal evidence that high commissions motivated the mis-selling of Westpoint products.

3.29 In its 2009 report on Financial Products and Services in Australia<sup>13</sup>, the Parliamentary Joint Committee (PJC) noted that the ineffectiveness of current disclosure of conflicts and conduct rules that allow an adviser to favour their own interests over the interests of clients is more likely to lead to sub-optimal investment strategies or excessive fee arrangements than catastrophic outcomes for investors.

3.30 The issue of conflicted remuneration structures has been debated for many years. It more broadly reflects the ongoing debate about the sales focus of the financial advice industry and mismatch with consumer expectations about receiving a professional unbiased advice service.

3.31 In its report, the PJC noted it received considerable evidence suggesting that the most effective way to improve the quality of financial advice for consumers is to remove conflicts altogether by banning commissions and other conflicted remuneration practices. The PJC recommended, among other things, that the Government consult and support industry in developing the most appropriate mechanisms to cease payments from product providers to financial advisers.<sup>14</sup>

3.32 The significance of this issue has been recognised both locally and internationally. Locally, important industry associations, including the Financial Planning Association (FPA) and Investment and Financial

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13 Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services into Australia, November 2009.

14 Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services into Australia, November 2009.

Services Association (IFSA), have adopted policies to transition away from commission-based payments. The United Kingdom's Financial Services Authority (FSA) is introducing 'Adviser Charging' which will remove commission bias from advice on retail investment products. The United States Treasury is proposing to give the Securities and Exchange Commission (SEC) the power to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to them, but are not in the investors' best interest.

3.33 Although not conflict related, other issues arise with commissions. After the investor has invested in the product, they cannot control the commission payments to advisers unless they leave the product or nominate another adviser (who receives the ongoing commission payments). Also, ongoing commissions are often paid even if no ongoing advice is being received (only around 40 per cent are clients are advised regularly and on a face-to-face basis). There are also clear transparency issues where investors may not know what they pay for advice or what service they are entitled to in relation to the payment of ongoing commissions.

#### ***Other volume based and sales incentives***

3.34 A variety of payments throughout the financial services industry are based on volume or sales targets. Some volume based payments are noted above, as they are payments from product providers. However, there are other volume based payments in the financial services value chain that do not flow directly from a product provider, for example that flow to and from platforms (in the form of shelf fees), as well as incentives provided by licensees to its employees or authorised representatives to meet sales or volume targets.

3.35 In relation to platforms<sup>15</sup>, there are ongoing payments from platforms to licensees based on volume (relating to funds under management), which also may create conflicts and distort advice. This payment could be characterised as a commission in another guise. There are also Fund Manager Payments, which are ongoing payments that are volume based from the fund manager to the platform. These fees are interrelated, where generally the fund manager pays the platform to sit on the investment menu and the platform pays the licensee to be on the

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15 A platform is an administration facility that simplifies acquisition and management of a portfolio of investments. Platforms allow retail investors to purchase a range of investments through the one facility. In one sense platforms are like a department store where a customer can choose from different brand names and products in the one place, rather than having to visit a number of specialty stores.

approved product list and the licensee pays the planner for the recommendation of the platform.

3.36 In relation to adviser employees, the very nature of volume based payments and sales incentives encourages the sale of products, rather than the giving of unbiased advice. The indirect conflicts through employee remuneration operate in a similar fashion to conflicts in product provider set remuneration. While it is noted that many employee remuneration bonus arrangements are supplemented by other criteria, such as quality and compliance, often sales targets in some shape or form are the primary determinant of the bonus. Licensees may indicate that quality advice or compliance requirements appropriately manage the conflicts created by sales incentives, so that planners who fall short of required compliance standards will not be eligible for a bonus. However, there are concerns about the effectiveness of these controls in some circumstances and sometimes there will be enormous pressure internally to allow the planner to receive a bonus, notwithstanding shortfalls in terms of compliance.

#### *Asset based fees*

3.37 An asset based fee is a fee agreed between a client and adviser. The fee is calculated as a percentage of funds under management. The fee changes with any changes to funds under management.

- Given the transition away from commission based arrangements, there is an expectation that advisers will more heavily rely on the use of asset based fees for remuneration.

3.38 Asset based fees can also create conflicts of interest that can distort the quality of advice. It is important to note that the conflicts related to commissions and asset based fees are different in origin but can present the same type of issues.

3.39 Advisers who are remunerated by the quantity of funds under management can also have conflicts of interest. They have more of an interest in selling investment products to their clients and encouraging their clients to borrow to invest, or use other strategies to maximise funds under management (such as recommending that a client sell other assets, such as real estate and/or property, to invest in products that will expand available funds under management). The conflicts arise most notably where leverage is recommended or where leverage is included in the product.

#### *Storm and asset based fees*

3.40 The recent collapse of Storm Financial received close attention by the PJC.

3.41 Storm's remuneration model involved the use of asset based fees and commissions. For geared clients, Storm had a fee for service model (plus trail commissions) equating to roughly 7.5 per cent on all new money invested by clients. This covered the initial advice and ongoing regular servicing of the portfolio. Any additional money invested by the client also attracted this upfront fee for service. Also the product manufacturers would pay Storm annual trail commissions of between 0.2 per cent and 0.385 per cent on the value of that client's investment at the time (including the margin loan).

3.42 Under the Storm model, the fact that fees were generated based on the amount of funds invested and the amount of funds under management created an inevitable conflict of interest between the adviser/licensee's interests in increasing revenue on the one hand and the interests of the client in receiving appropriate advice. Asset based fees create a conflict of interest that encourages advisers to recommend aggressive gearing to increase the upfront fee generated when the borrowed money is invested and to increase the balance of funds under management and thereby the ongoing fees generated. It also acts as a disincentive for advisers to build into the client's strategy an exit plan whereby investors can realise gains as a result of market increases to reduce overall debt, as this would reduce the fees earned by the adviser and licensee.

3.43 In addition, in the case of Storm the overall financial viability of the licensee relied heavily on these asset based fees, which meant that when the global financial crisis occurred, and the value of the clients funds dropped, and clients also stopped investing new monies, the income of the licensee effectively disappeared. By relying on bull market inflows for revenue, Storm was highly susceptible to collapse.

3.44 ASIC noted in its PJC submission that "Storm may be an example of the potential impact on clients of failure to manage conflicts of interest created by commissions and remuneration based on funds under advice".

3.45 There are also transparency concerns with the use of asset based fees. The fee can mask the cost of advice, both up-front and in the case of ongoing fees — where the fee rises with normal asset appreciation. There may or may not be a higher level of service when the fee rises due to greater funds under management. This reflects the potential for ongoing fees that do not match the service provided.

## Objectives of Government action

- 3.46 The objective of Government is to:
- minimise or eliminate the use of remuneration practices that distort the quality of advice and adversely affect consumer outcomes;
  - encourage the provision of professional unbiased financial advice;
  - enable consumers to understand the fees they are paying for advice and the services that they are paying for; and
  - facilitate better market outcomes.

## Options that may achieve objective(s)

### *Option A: Status Quo (including simplified fee disclosure)*

3.47 This option would maintain the status quo. Current obligations for licensees to manage and disclose conflicts of interest (including remuneration and other payments) would continue. Various disclosure documents would continue to be provided to investors, designed to assist them to understand the potential impact of remuneration based and other conflicts on the advice they receive from financial advisers.

3.48 The Government has already committed to shortening lengthy, complex and unreadable financial services disclosure documentation. Based on current government action to simplify disclosure of financial products and services (which is currently underway), the option would also involve simplified one or two page fee disclosure in the short PDS, supplemented by additional detailed information made available via incorporation by reference (IBR). The disclosure about advice fees is achieved through summary information in the short PDS and more detail provided in the Financial Services Guide (FSG) and the Statement of Advice (SOA).

3.49 This option would see more effective disclosure of financial advice services offered to investors. This includes simplified fee disclosure such that consumers are able to understand the remuneration costs, separate product and advice fees and that those costs are comparable and clear.

***Option B: Prospective legislative ban on conflicted remuneration structures.  
Introduction of new adviser charging rules***

3.50 This option would involve a direct ban on conflicted remuneration structures for new contracts (that is, existing contracts are grandfathered such that the ban does not apply to them) from 1 July 2012. As a consequence of the ban on conflicted remuneration structures, the option would also introduce new rules on adviser charging. This includes:

***Removing product provider influence over adviser recommendations***

3.51 Ban any form of commission from any financial services business in relation to the distribution and provision of advice for retail financial products (excluding risk insurance).

- It would allow adviser charges to be deducted from a client's investments.

3.52 Product providers must distinguish the cost of the product from advice.

***Removing the influence of sales incentives and/or other volume based payment***

3.53 This would prevent payments throughout the financial services industry that are based on volume or sales targets in relation to the distribution and provision of advice for retail financial products (excluding risk insurance).

***Removing adviser incentives to sell and gear clients — ban on the use of asset based fee***

3.54 This would prevent an adviser from charging an asset based fee in relation to services provided to a retail client where the adviser recommends their clients borrow to invest or leverage is included in the product (an asset based fee is a fee calculated based on a percentage of funds under management). For example, where a client is advised to borrow funds to invest the adviser would be prohibited from charging an asset-based fee based on both the original equity and the additional leverage.

***Introduction of adviser charging rules***

3.55 This would require advisers to agree their fees directly with clients and disclose the charging structure to clients in a clear manner, including as far as practicable, total adviser charges payable. Ongoing adviser charges could also only be levied if it relates to the provision of an



ongoing service, which clients must renew annually, or if a payment plan is agreed up-front for advice.

***Option C: Industry led action to address conflicted remuneration structures, with Government support***

3.56 In Australia, there have been some recent moves to adopt fee for service models instead of commission based payments. While views are not unified across industry, the Financial Planning Association (FPA) and the Investment and Financial Services Association (IFSA) have led action in this regard. Some product providers and/or financial advice firms have, or are in the process of, transitioning away from commission based payments. This includes some of the larger adviser groups.

3.57 This option would involve government and industry developing the most appropriate mechanism to address conflicted remuneration structures. This option was supported by the PJC, although the PJC recommendation involved the government consulting with and supporting industry to develop an appropriate mechanism to cease payments from product providers to financial advisers (that is, this would not cover, for example, asset based fees or employee sales incentives from the licensee).

***Option D: Introduce a statutory duty to prefer the client's interests over the interests of the advisor (Client first rule)***

3.58 Under this option, a new statutory duty would prohibit advisers, in the event of a conflict, to prefer their own interests over those of the client. This option would clarify for all parties that in no circumstances is it permissible for advisers to put their own interests ahead of those of their client. There would be no possibility of avoiding that duty through disclosure or by obtaining consent of clients to breach it.

3.59 The proposed duty recognises that conflicts do exist in many cases, but will require that advisers ensure that they do not prefer their own interests over those of their clients, thereby compromising the quality of advice. The duty would overlay the existing duties of disclosure and giving appropriate advice. Breaches would be enforceable by clients and the regulator in the same manner as the existing duties and would include civil (including compensation claims) and criminal action, and action by the regulator regarding the financial services licence.

***Option E: Introduce a rule banning advisers who have a conflict of interest from providing advice (No conflicts rule)***

3.60 Under this option, advisers would be prohibited from providing financial advice in the event that they had a conflict of interest that might compromise the quality of the advice. There would be no possibility of

avoiding that rule through disclosure or obtaining the consent of clients to breach it.

3.61 The proposed rule would prohibit all conflicts of interest. It would overlay the existing duties of disclosure and giving appropriate advice. Breaches would be enforceable by clients and the regulator in the same manner as the existing duties and would include civil (including compensation claims) and criminal action, and action by the regulator regarding the financial services licence.

***Option F: Introduce a fiduciary-like statutory duty to act in the best interests of clients, subject to a ‘reasonable steps’ qualification and to place client’s best interests ahead of their own***

3.62 Under this option, advisers must act in the best interests of their clients and must place the best interests of their clients ahead of their own when providing personal advice. Advisers must already provide advice that is appropriate. Overall, this is supplemented by a requirement that advisers act in the client’s best interest in giving personal advice.

3.63 The duty will include a ‘reasonable steps’ qualification, so that advisers must take ‘reasonable steps’ to discharge the duty but are not expected to base their recommendations on an assessment of every single product available in the market. If an adviser cannot recommend a product that is in the best interests of the client from their own ‘approved product list’ (APL) (a list of products that their licensee has authorised them to sell), then the duty may require them to search beyond the APL or recommend that the client should see another adviser. There would be no possibility of avoiding that duty through disclosure or by obtaining consent of clients to breach it.

3.64 Breaches would be enforceable by clients and the regulator in the same manner as the existing duties and would include civil (including compensation claims) and criminal action, and action by the regulator regarding the financial services licence.

**Impact analysis**

***Option A: Status Quo (including simplified fee disclosure)***

3.65 This option would preserve the status quo. Conduct and disclosure rules would continue to regulate conflicts of interest, which is that conflicts of interest must be managed and disclosed.

3.66 This means that fees or remuneration (including commissions and other payments) must be disclosed clearly to retail investors and there would be no limits on what can be charged or how it can be charged. The

requirement that advisers have a reasonable basis for financial product personal advice (that is the advice must be suitable) would continue to operate as is.

3.67 Current government work also means that this option would involve the simplification of information provided to consumers on fees and commissions in disclosure documents, such as Product Disclosure Statements (PDSs) and Financial Services Guides (FSGs). It involves developing 'short form' disclosure documents in an attempt to summarise and simplify complex fee information for consumers in a way that is meaningful to them, with further detail available using Incorporation by Reference (IBR) mechanisms.

3.68 The benefit of this option is that it facilitates choice of remuneration which suits the client and particular adviser. Consumers may also benefit from more understandable fee disclosure. Further market forces may continue to drive a transition to a fee for service environment for adviser remuneration to reflect broader community concerns. The approach is also consistent with existing regulatory measures which to some extent does minimise the compliance burden for industry. There would be no substantive compliance burden on industry, other than a broad impact that, in some circumstances, consumers may continue to not seek financial advice based on the perception of conflicts (noting that consumers may not seek advice for a variety of different reasons). A NewsPoll/Industry Super Network survey in February 2010 indicated that most respondents would prefer a fee-for-service model. 79 per cent of those surveyed believed commissions and other inducements compromised the quality of advice received.

3.69 While not quantifiable, there are costs to consumers in maintaining the status quo. The costs relate to the continued conflicts of interest and its potential adverse impact on the quality of advice. In general, the level of trust that consumers place in their adviser, and the strength of that conflict, often means they are unable to assess the impact of the conflict on the advice received. Further, the inherent sales versus advice conflict may continue to misalign the interests of the consumer and adviser.

3.70 Further, from a consumer perspective, there are also serious questions about whether complex fee arrangements, in particular the way advice fees can be remunerated through the product provider via commission structures and/or calculated as a percentage of funds under management (FUM), can be communicated in a simple and meaningful manner to consumers. The complexity in which advice fees can be incurred pose a significant challenge to achieving 'simplified fee disclosure'.

3.71 A key objective of simplified fee disclosure is to clearly separate product fees from advice fees. Advice fees, however, can be charged in many different ways, including being deducted from the consumer's account in such a way that the advice may appear to the consumer to be 'free'. Advice fees can also be paid as volume bonuses and soft dollar benefits. Disclosure that includes information on advice fees under current remuneration structures becomes, by its very nature, no longer 'simple'.

3.72 While it is possible that simplified disclosure may improve consumer understanding and engagement, this measure alone may not be sufficient to address the conflicts created by conflicted remuneration structures. The conflicts created are strong and consumers may continue to have difficulty understanding the impact of the remuneration on advice.

	<b>Benefits</b>	<b>Costs</b>
<b>Consumers</b>	<p>Consumers can choose the method by which they pay for advice.</p> <p>Some consumers may benefit from simpler disclosure to enable them to understand the fees they are paying.</p>	<p>There is some evidence that conflicted remuneration structures may lead to advice that is not legally compliant or otherwise comprises the client's interest. This can have a wide range of impacts for the investor ranging from possible catastrophic consequences (noting these are more atypical) to sub-optimal investment outcomes (for example even a small difference in a fund's fees and costs can have a significant impact on long term investment returns).</p> <p>Even with simpler disclosure of remuneration, this may not alone be sufficient to address the conflicts created by conflicted remuneration structures.</p> <p>Simplified disclosure is unlikely to improve the quality of advice; as it will not remove conflicted structures.</p> <p>No changes to current arrangements would permit continued potential for misalignment of the interests of consumers in receiving professional unbiased advice and the interests of the adviser.</p> <p>Consumers may also continue to pay for advice services they do not receive.</p>
<b>Industry</b>	<p>Industry can choose the remuneration methods which suits them and their clients.</p>	<p>In relation to simplified disclosure, there would be some minimal compliance impact on product providers, platform providers, licensees and advisers. This would involve one-off compliance costs in adapting new disclosure requirements (for example, structuring and amendments to existing documents). However given a reasonable transitional period, these costs would be relatively minor (and part of normal business</p>

costs) given that disclosure documents must be renewed after a certain period.

Potential for 'first mover disadvantage' — that is those who have adopted fee for service arrangements may face some competitive disadvantage (it is a highly competitive market for experienced advisers and advisers may move to ensure they can continue to receive commissions).

**Government**

The existence of conflicts may continue to adversely the quality of advice and consumer outcomes.

***Option B: Prospective legislative ban on conflicted remuneration structures.  
Introduction of new adviser charging rules***

3.73 This option would involve a direct ban on conflicted remuneration structures, generally in relation to the distribution and provision of advice for retail financial products (excluding risk insurance).

3.74 Retail investors will benefit from this option because it will reduce the incidence of investors being directed to products as a result of incentives offered to advisers, rather than because investment in the products is in the investors' interests. This may reduce instances of sub-optimal advice, may help to prevent and address the rarer instance of major failures affected by high commissions and result in an overall improvement in advice quality, particularly product recommendations. Further the changes clearly align the interests of the adviser and client, and may build trust in an industry where some consumers may not seek advice because of the perceived conflicts within the industry.

3.75 There have been suggestions that retail investors will no longer be able to afford advice if commission are removed. Some investors may consider that they can no longer obtain 'free' (that is, commission based) advice, notwithstanding that investors indirectly pay for the advice (for example through product charges) and in some instances these payments may cost them more over the long term. This may be a difficult perception change for these clients and may impact on demand for full advice. However retail investors will not be restricted to having to pay a large fee up-front. The ban on commissions and asset-based fees (where leverage is used) will still allow investors to be able to pay for advice using flexible payment mechanisms, such as adviser charges being

deducted from a client's investments over time<sup>16</sup> or through a payment plan.

- The available research, undertaken by Rice Warner Actuaries (Rice Warner) on behalf of Industry Super Network (ISN), suggests that clients receiving full advice are likely to pay the same or less in fees after the change. More so, most clients will see the value of the advice provided, even when the cost is transparent. The research also suggests that clients will assess that they often need simple advice and demand for this need will be met.

3.76 The ban on asset based fees only applies to recommendations that include leverage and where leverage is built into the product. There is some potential for consumer detriment in that it does not address a potential issue where advisers can use other strategies to increase funds under management. However under proposed adviser charging rules, there will be requirements for advisers to agree the fee with the client, as well as the adviser making dollar disclosure and only charging an ongoing fee if it relates to ongoing service. This addresses concerns about transparency and clients paying more than the value of the service.

3.77 The ban does not initially apply to risk insurance. Insurance has different features than general investment products. Unlike investments, there are no investment funds from which clients can often draw from to pay for financial advice. Therefore there are concerns about the affordability of advice in a fee for service environment and the potential for under-insurance should be explored in this context. In addition, more work needs to be done at a product level to facilitate a move away from commissions to fees for risk products. Further consultation with stakeholders on these issues will be undertaken before a decision is made about the ban and its application to risk insurance.

3.78 There are costs to the industry to implement this option, and the option will also have broader longer-term implications.

3.79 The option is likely to drive structural reform in the industry. It has implications for the way in which products are distributed and businesses are structured. It is a new model for the industry where fees paid for a product must be transparently distinct from the fees paid for advice. This will alter the financial services industry over the long term. However, the grandfathering of existing contracts means that changes to the industry will be more gradual and will occur over time. The

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16 This mechanism allows product providers to remit adviser payments but as an administrative facility only.

grandfathering of existing contracts means that existing fee arrangements (prior to the commencement of the ban) can continue. For example, this means where a person is already invested in a product (prior to the ban) and the adviser is remunerated by commissions; the product provider can continue to pay the adviser the ongoing trail commission and the adviser can continue to receive it.

3.80 There is an expectation that some persons will exit the industry, as with any major reform. The number of persons who may exit the industry is unknown. It is further expected that there will be consolidation of the industry, with larger institutionally owned dealer groups (licensees) acquiring a number of smaller dealer groups to grow their adviser numbers and achieve economies of scale. While this means there will be fewer participants in the market, it does not necessarily represent a reduction in competition and will drive overall efficiency improvements of financial advisory groups.

- The available research from Rice Warner notes that many full service advisers rely on substantial trail commissions and platform rebates to sustain their businesses and, after the regulatory change, advisers will be compelled to demonstrate the value of their services to retain and attract clients. The research notes that as advice is a growth industry, and coupled with overall efficiency improvements, there is still significant scope for financial planners to maintain and develop viable businesses (even if product provider payments are banned for new business).

3.81 These changes may impact on the demand and supply of advice.

- The available research from Rice Warner suggests that demand will be broadly stable and even though adviser numbers will reduce over time, more efficient delivery models for simple advice and efficiency improvements means that demand will be met.

3.82 It is expected that adviser remuneration, as well as the number of advisers, will reduce over the long term.

- The available research from Rice Warner suggests that adviser remuneration will still increase in real terms, although by significantly less than under the current regulatory environment. The reduction in overall adviser remuneration will be \$2.5 billion (in 2009 dollars) in 2024 representing 0.23 per cent of GDP. The report also suggests

that adviser numbers will reduce<sup>17</sup> and the characteristics of advisers will change.

3.83 There will be a reasonable change management process for participants adopting the proposals. There will be one-off costs to implement the ban on payments and adviser charging, some additional ongoing compliance costs and costs involved with getting across new regulatory requirements.

- Product providers will need to implement ‘factory gate pricing’ (a UK term for separating the cost of the product from the cost of advice). For investment type products, there are current products in the market which separate product and advice costs, and in those circumstances the system changes required should be less than where the provider has no products of this kind. The extent to which product providers already have these systems is not known. Product providers will also need to put procedures and mechanisms in place so they can comply with the ban and associated requirements, such as remitting adviser service fees from the client’s investment.
- The immediate impact for financial planning practices will be to set up alternative cash-flow mechanisms. Currently the value of a financial advice business is calculated on a valuation which is based on the income stream from trail commissions times a multiplier (generally between 1.9 and 2.9). The client book becomes the businesses’ primary asset. The valuation on this basis is also used by lenders in providing finance to the business secured against the income stream coming from the trail commissions, so there may be a need for advisers to re-negotiate loan arrangements with their financiers based on some other valuation of the business (for example, good will). It should be noted that grandfathering of existing contracts will mean that remuneration that comes from existing arrangements will largely be unaffected.
- Advisers and its licensees will need to devise and introduce an adviser charging structure and make relevant disclosures (noting there are some current disclosure requirements). They will need to cost their services, articulate what and how they provide their services and demonstrate a clear value proposition to their clients.

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17 Rice Warner research estimates there are around 15,400 advisers which will remain broadly stable over the next five years and decline to around 8,600 in 2024.



- Advisers will need to make substantial changes to its disclosure documentation. There would also be changes required to policy documents and employment contracts and so forth. However, the transitional period would likely allow for documentation to be updated according to normal roll-over schedules, which would reduce the impact by spreading it out and making it a part of normal business practice.
- Financial planning practices will have to renegotiate fees with their clients and set up new payment mechanisms. Advisers will also need to change systems and procedures to adopt the new charging structure and are expected to spend more time with clients explaining the fee structure, to demonstrate the value of advice.
- There may be cost saving with regard to the systems and staff that are currently needed to manage commission payments. This can be a complicated and time-consuming process involving calculating commissions and doing manual ‘clawbacks’, for example, where the clients exercise a cooling off period and the commissions need to be repaid to the product provider. These systems and staff add extra cost, and would no longer be required, so there is likely to be a cost saving to business in this regard.
- Advisers who will be most impacted will be the businesses that rely substantially on ongoing trail commissions and do not maintain an existing ongoing client relationship. There is no available data on the number of businesses who might fall into this category.
- Advisers will also incur ongoing annual costs in that they must have clients opt-in each year to continue to provide ongoing service.
- Advisers and licensees may need to re-negotiate their fee-sharing arrangements and may need to adjust other elements of the commercial relationship, such as key performance indicators.
- The overall costs depend on the extent to which participants are already structured to adopt this model, for which there is no available data. Some businesses have made these at least some of the changes. The costs to industry have not been quantified, and were not considered in detail in the PJC Inquiry.

	<b>Benefits</b>	<b>Costs</b>
<b>Consumers</b>	<p>Consumers will benefit from improved quality of advice that is not distorted by conflicted remuneration structures.</p> <p>Consumers will benefit from an alignment of adviser interests through remuneration practices that support the clients' interests in receiving professional unbiased advice.</p> <p>The removal of conflicted remuneration structures may enhance trust in the industry and encourage some consumers to seek advice.</p> <p>Consumers will benefit from adviser charging that is clear and directly related to the services provided.</p>	<p>Consumers may continue under the apprehension that commission based advice is 'free' advice and they may perceive an increase in the cost of advice. This may impact of some consumers' willingness to seek advice.</p> <p>There may be some compliance costs passed on to consumers.</p>
<b>Industry</b>	<p>The removal of conflicted remuneration structures may improve the level of generalised trust in the industry and encourage some consumers to seek advice.</p> <p>It is an opportunity for industry to develop more efficient adviser delivery models.</p> <p>No first mover disadvantage.</p>	<p>The ban on conflicted remuneration structures will change the way in which products are distributed and businesses are structured.</p> <p>It is a new model for the industry where fees paid for a product must be transparently distinct from the fees paid for advice. This will alter the financial services industry over the long term. However the grandfathering of existing contracts means that changes to the industry will be more gradual.</p> <p>There will be one-off costs to industry (product providers, platforms, licences and advisers) to implement the ban. There will be some ongoing costs to industry, as a result of new rules (such as opt-in annual renewal notices).</p> <p>Some businesses are expected to exit the industry.</p>
<b>Government</b>	<p>Consumers will benefit from better quality of advice and outcomes.</p>	

***Option C: Industry led action to address conflicted remuneration structures, with Government support***

3.84 Option C would build upon existing industry measures to transition away from commission based payments. The Government would work with industry to develop the most appropriate mechanism to cease these payments.

3.85 To date, not all of industry support a transition away from commission based payments. Further the moves by some parts of industry to transition away from commissions are limited in some way. For

example, the policies only apply to certain products or to certain types of payments.

3.86 The benefit of this option, is that in some instances, it will benefit consumers by reducing the incidence of investors being directed to products as a result of incentives offered to advisers, rather than because investment in the products is in the investors' interests. This may result in an overall improvement in advice quality, particularly product recommendations.

3.87 However the key limitation of this option is that those benefits will only ensue where the initiatives apply. As the initiatives will not apply to all products and payments that create conflicts, the costs to consumers will continue in those circumstances. Further if certain payments continue (as per current industry initiatives) there is a real risk that removed benefits will flow through those mechanisms and in fact there will no substantive change to current arrangements.

	<b>Benefits</b>	<b>Costs</b>
<b>Consumers</b>	<p>Consumers will benefit from improved quality of advice that is not distorted by conflicted remuneration structures, but only to the extent that the initiatives apply.</p> <p>The removal of some conflicted remuneration structures may enhance trust in the industry and encourage some consumers to seek advice.</p> <p>To the extent that the initiatives apply, consumers will benefit from adviser charging that is clear and directly related to the services provided.</p>	<p>To the extent that the initiatives apply, consumers may continue under the apprehension that commission based advice is 'free' advice and they may perceive an increase in the cost of advice. This may impact of some consumers' willingness to seek advice.</p> <p>To the extent that the initiatives apply, there may be some compliance costs passed on to consumers.</p> <p>Where the initiatives do not apply, consumer detriment will continue (as described under costs of maintaining the status quo).</p>
<b>Industry</b>	<p>To the extent that the initiatives apply, the removal of conflicted remuneration structures may improve the level of generalised trust in the industry and encourage some consumers to seek advice.</p> <p>It is an opportunity for industry to develop more efficient adviser delivery models.</p>	<p>To some extent, the initiatives will change the way in which products are distributed and businesses are structured.</p> <p>There will be one-off costs to industry (product providers, platforms, licences and advisers) to implement the relevant initiative.</p> <p>The implications and costs relate solely to the scope of initiatives which have been developed by industry associations or companies.</p>
<b>Government</b>	<p>To the extent that the initiatives apply, consumers will benefit from better quality of advice and outcomes.</p>	<p>The measures are not comprehensive and this allows certain consumer detriment to continue.</p>

***Option D: Introduce a fiduciary-like statutory duty to prefer the client's interests over the interests of the advisor (Client first rule)***

3.88 Option D will not necessarily ban any particular form of remuneration. The proposed duty is a more generic standard that will address issues that might arise from all types of conflicts — for example, ownership-based conflicts.

3.89 It would be able to operate in connection with future provision of advice connected to an existing arrangement with a client. In contrast, the proposal to ban particular remuneration structures can only operate prospectively, due to constitutional restrictions concerning acquisition of property.

3.90 The rule would benefit consumers by reducing the incidence of advice being compromised through conflicts, resulting in sub-optimal outcomes for consumers of financial advice.

3.91 A further possible result of the proposal for the new duty to place the client's interests first is that it would serve to strengthen, from the perspective of potential enforcement, the existing duties of intermediaries to ensure the advice has a reasonable basis and is appropriate for the client's need. When that test is paired together a statutory duty to place the interests of the client first when there is a conflict, there is a clearer message in the statute about unacceptable conduct which would be of benefit to the regulator in its enforcement efforts.

3.92 For persons conducting the business of financial advice, despite the existing of equitable principles that have similar elements, there would be some transitional costs associated with ensuring that their business structure and practice does not violate the rule. On some occasions on an ongoing basis, the rule would require advisors to, for example, change recommendations to a product that offers less benefits to the advisor in order to ensure the client's interest is preferred over their own.

	<b>Benefits</b>	<b>Costs</b>
<b>Consumers</b>	Consumers will benefit from improved quality of advice that is not distorted by conflicted remuneration structures.  Consumers will benefit from an alignment of adviser interests through remuneration practices that support the clients' interests in receiving professional unbiased advice.	There may be some compliance costs passed on to consumers.

<b>Industry</b>	Clarification of the duty may offer some savings in the longer terms as the conduct that is permitted and not permitted is certain.	Transitional costs for some financial advice providers in ensuring that business structures and practices do not violate the client first rule.  Lesser ongoing costs resulting from the need to prefer the client's interest over their own.  A degree of complication and uncertainty due to the limitation of the duty to circumstances where the client and the adviser's interests are in conflict.
<b>Government</b>	Supplementation of existing rules will clarify required behaviours and assist regulators to enforce requirements against advisors engaging in practices detrimental to consumers.	

***Option E: Introduce a rule banning advisers who have a conflict of interest from providing advice (No conflicts rule)***

3.93 Option E would effectively prohibit many forms of remuneration currently used. Commission payments would violate the rule. There may also be significant impact on the structure of vertically integrated business (where a product provider owns a financial advice business).

3.94 The benefit of the rule for consumers would be that all advice would be free of any 'skewing' as a result of a conflict. However, a no conflict rule would require large scale restructuring of a large proportion of the financial advice industry. Many market participants are likely to leave the industry, and those that are left would need to operate on a fee for service basis. This would result in some serious risks that access and affordability of advice for most consumers would be detrimentally affected.

3.95 For industry, the majority of participants in the financial advice industry may not be able do business as usual without violating the no-conflict rule and/or that carve outs would be required (for example the position of conflict an employee adviser of the Commonwealth Bank may find themselves in). There would need to be a major shift to a fee for service model and the costs of doing so is likely to result in a significant number of market exits.

3.96 For Government, there are likely to be some costs involved with supporting industry participants (including employees) of advice

businesses unwilling or unable to make the transition to a no-conflict environment.

	<b>Benefits</b>	<b>Costs</b>
<b>Consumers</b>	<p>Consumers will benefit from improved quality of advice that is not distorted by conflicted remuneration structures or other conflicts.</p> <p>Consumers will benefit from an alignment of adviser interests through remuneration practices that support the clients' interests in receiving professional unbiased advice.</p>	<p>Cost of advice would increase significantly and availability of advice would decrease significantly.</p>
<b>Industry</b>	<p>Clarification of the duty may offer some savings in the longer terms as the conduct that is permitted and not permitted is certain.</p>	<p>Significant transitional costs for some financial advice providers — which in some cases would be high enough to provoke market exit.</p> <p>Ongoing costs resulting from the need to withhold services in cases where conflict exists.</p>
<b>Government</b>		<p>Possible need for government support of exiting advisors.</p>

***Option F: Introduce a fiduciary-like statutory duty to act in the best interests of clients, subject to a 'reasonable steps' qualification and to place client's best interests ahead of their own (best interest's formulation)***

3.97 Option F may preclude advisers from receiving commission payments in many circumstances but not in all cases. For example, there may be cases where it could be argued that the advisers' interests coincided with those of the client and the commission could be payable in those circumstances.

3.98 The benefit of the rule for consumers is that it encompasses the benefits of the client first rule (option D), including that it reduces the incidence of advice being compromised through conflicts, resulting in sub-optimal outcomes for consumers of financial advice. More generally, consumers will also benefit from advice that is in their best interests, as advice may be compromised by remuneration and other conflicts. The option strengthens the existing duties of intermediaries to ensure the advice has a reasonable basis and is appropriate for the client's need.

3.99 For persons conducting the business of financial advice, despite the existence of equitable principles that have similar elements, there would be transitional costs associated with ensuring that their business structure and practice does not violate the rule. The costs include a review

of and/or changes to processes supporting the giving of advice, including product selection, the scope of the approved product lists and training of advisers. It is expected to increase the requirements for research and due diligence before products are approved for sale, as they will need to be in the client's best interest.

- The quantum of these changes, and costs involved, depend on the extent to which businesses are structured to implement the best interest's formulation, which is unknown.

3.100 While Option D requires that in the event of a conflict, an adviser must not prefer their own interests over those of the client, it does not require advisers to act in the client's best interest generally. However Option F has the effect that an adviser must act in the client's best interest. For example, if an adviser cannot recommend a product that is in the best interests of the client from their own 'approved product list' (APL) (a list of products that their licensee has authorised them to sell), then the duty may require them to search beyond the APL or recommend that the client should see another adviser.

- Given this, there would likely be some rationalisation of investment products, including the development of simpler investment products for 'approved product lists' (for example, investment products based on standard age/asset mixes).

3.101 The option does not propose an impractical standard on industry. The duty will include a 'reasonable steps' qualification, so that advisers must take 'reasonable steps' to discharge the duty but are not expected to base their recommendations on an assessment of every single product available in the market.

3.102 Industry already complies with a best interest test in relation to obligations placed on responsible entities of managed investment schemes. This means that there is already some understanding and application of these principles within the Corporations Law.

The option will provide greater scope to the regulator to address consumer detriment arising from sub-optimal product recommendations.

	<b>Benefits</b>	<b>Costs</b>
<b>Consumers</b>	<p>Consumers will benefit from advice that is in their best interests, including more appropriate product recommendations.</p> <p>Consumers will benefit from advice that is not distorted by conflicts.</p> <p>Potential for development of simpler investment products for retail clients</p>	<p>There may be compliance costs passed to consumers. Particularly in the short term, the cost of advice may increase.</p>
<b>Industry</b>	<p>Clarification of the duty may offer some savings in the longer terms as the conduct that is permitted and not permitted is certain.</p> <p>It is broadly consistent with other obligations in the Corporations Act.</p> <p>Reasonable care qualification clarifies the scope of the duty, in that it does not impose an impractical standard on advisers to base their recommendations on an assessment of every single product in the market.</p>	<p>Transitional costs for some financial advice providers, including a review and or changes to procedures relating to the giving of personal advice to retail clients. This includes costs for research and due diligence requirements, scope of approved product lists and training requirements for advisers.</p>
<b>Government</b>	<p>Consumers will benefit from better quality of advice and consumer outcomes.</p> <p>The regulator is given greater scope to address consumer detriment.</p>	

## **Consultation**

3.103 The PJC undertook an extensive public consultation process in developing its recommendations. During the inquiry, the PJC received and considered evidence from a broad range of sources, including investors, banks, industry bodies, advisers, product providers, consumer groups, law firms and regulatory bodies. In addition, the PJC conducted public hearings on the issues raised by the PJC.

3.104 Following the PJC inquiry, no further consultation was undertaken by Treasury.

3.105 There will be further consultation with stakeholders on whether the ban on conflicted remuneration structures should apply to risk insurance (including group insurance).



*Views on conflicted remuneration structures*

3.106 In its report, the PJC noted it received considerable evidence suggesting that the most effective way to improve the quality of financial advice for consumers is to remove conflicts altogether by banning commissions and other conflicted remuneration practices. The PJC recommended, among other things, that the Government consult and support industry in developing the most appropriate mechanisms to cease payments from product providers to financial advisers.

3.107 ASIC recommended, that in addition to banning commissions and other incentives, asset-based fees also be banned, due to the equivalent conflicts. Many other submitters indicated they favoured fee for advice models: ANZ supports fee-for-service arrangements for the provision of holistic advice, the Accounting Professional and Ethical Standards Board consider advisers should adopt fee-for-service models, The Institute of Actuaries of Australia think that commissions should not be payable for advice, and the Institute of Chartered Accountants in Australia consider that advisers should be remunerated based on 'genuine fee for service arrangements (that is, an asset based fee is not a genuine fee for service), with an industry led solution. The Australian Investors Association (AIA) supports an outright ban on commissions and asset based fees. CHOICE supports a ban on 'remuneration incentives that are inconsistent with fiduciary duties an adviser owes a client'. CHOICE further suggests that ASIC should be given the power to outlaw particular conflicts of interest where it is satisfied that disclosure and management will not prevent inappropriate or biased advice. The Industry Super Network (ISN) recommends a ban on commissions and other forms of conflicted remuneration structures.

3.108 MLC favour a transition to fee for service models, which includes the use of asset based fees but suggest an outright ban on commissions is not appropriate.

3.109 The FPA gave evidence to the PJC that a client directed fee for service model was the most important measure and that asset based fees should be allowed under this model. The FPA stated that asset based fees support the affordability of advice.

3.110 Some do not support a transition away from commission based payments. The Stockbrokers Association of Australia (formerly the Securities and Derivates Industry Association) think disclosure deals with conflicts created by commissions. The Association of Financial Advisers (AFA) and Millenium3 think that consumers and business should be able to choose the remuneration structure that suits them and that the removal

of commissions will affect the affordability of comprehensive financial advice. The Commonwealth Bank of Australia (CBA) note that comprehensive advice is expensive and existing subsidies through commissions make it affordable. Further that any regulation should be industry based. APT Strategy argue that banning commissions would ultimately have negative impacts on consumers through increased advice costs. In its evidence to the PJC, the Investment and Financial Services Association (IFSA) noted that removing existing fee structures would increase the cost to consumers.

3.111 The Australian Compliance Institute acknowledge the remuneration based conflicts but consider that alternatives other than fee for service may be required, given concerns about affordability and access to advice.

3.112 Some other submissions from adviser groups also did not support an outright ban on commissions, some arguing that clients should be able to choose remuneration methods and others argued the method of payment for advisers is not important in addressing poor quality/conflicted advice. There were a few submissions that suggest that many planners would go out of business as a result of the changes.

3.113 The submissions did not address the direct implementation costs to industry.

### ***Fiduciary duty***

3.114 A number of witnesses appearing before the committee supported the imposition of an explicit fiduciary duty on financial advisers, requiring them to give priority to their clients' interests ahead of their own. ASIC's submission to the PJC inquiry supported a fiduciary like duty.

3.115 Professional Investment Services did not oppose the introduction of a statutory fiduciary duty, indicating that such a duty already exists. The Trustee Corporations Association of Australia argued that advisers should always place their clients' interests first. The Australasian Compliance Institute (ACI) supported a fiduciary duty being imposed on individual advisers.

3.116 ANZ's submission to the PJC noted that the obligation of financial planners [those who provide holistic advice] to put the client's interests first should be legislatively enshrined in order to formally establish that financial advisers owe fiduciary duties to their clients.

3.117 Many submissions raise the possibility of introducing a fiduciary duty and indicate their general support for this option. The submitters below provided detail on how they saw the formulation of the duty.

3.118 ISN proposes that all advisers be required to act in their client's best interest, and this obligation would replace the need for advice to have a reasonable basis. The obligation would require the planner to give clients their undivided loyalty, which means the financial planner must strive to avoid any actual or perceived conflict of interest. Where a conflict is unavoidable, a fiduciary must obtain 'informed consent' of the client which they say goes beyond the type of disclosure typically provided in financial services. ISN say this duty does not lead to an obligation to predict the best or highest performing products but state that this requirement would require licensees to include a variety of product types on its approved product list and would preclude volume based payments.

3.119 Choice proposes to establish a legal fiduciary duty on advisers, either similar to options being considered in the US, or like that of the UK where advisers are required to act in the best interests of clients, rather current requirements to provide a 'reasonable basis' for advice. Choice also considers that the fiduciary duty would facilitate the removal of commissions from the industry.

3.120 The FPA acknowledge and willingly accept the fiduciary obligation and propose that a fiduciary relationship based on an obligation to put the 'Client's interest first'. Placing 'Client's interests first' is consistent with the fiduciary duty of loyalty and trust, which suggests that a planner who undertakes to act on the client's behalf must not misuse the position to their own or a third party's possible advantage. The FPA has several concerns with the application of a 'best interests' style requirement for financial planners, one being that it would result in a requirement for advisers to provide the best possible advice.

3.121 AMP supports the recommendation that financial planners act in the best interests of their clients, however AMP considers that under the general law, financial advisers already have a fiduciary obligation to their clients in many aspects of their relationship. It is argued that section 945A of the Corporations Act (requirement to have a reasonable basis for advice) contains a stricter application than a fiduciary duty as it imposes an objective standard that an adviser must meet in preparing and giving advice. AMP believes this extends beyond a fiduciary duty which would require planners to act honestly, for a proper purpose, and to obtain consent to any collateral benefits. AMP thinks it is important that the duties applying to advisers are consistent with other professions.

3.122 The Association of Financial Advisers (AFA) told the committee that the category 'financial adviser' should be legislatively defined before a fiduciary duty could be imposed by legislation.

## **Conclusion and recommended option**

3.123 Option A does not sufficiently address the objectives of Government action, notwithstanding that there may be some benefits to consumers from simplified fee disclosure, which is consistent with other current (or planned) regulation and would offer a much relatively lower compliance burden than the other options.

3.124 Further, Option C does not sufficiently address the objectives of Government action, as industry moves to transition away from commission based payments are limited in scope (both in terms of the types of payments covered and which products they apply to). This limits the effectiveness of industry led action.

3.125 While Option D is attractive, it is not preferred because it would introduce a degree of complication and uncertainty due to the limitation of the duty to circumstances where the client and the adviser's interests are in conflict. Further, the duty would not, however, be strong enough to require the adviser (or authorised representative) to ensure that products recommended from their 'approved product list' were not only appropriate but also in the best interests of the client.

3.126 Option E is also not preferred, because notwithstanding its benefits in addressing Government objectives, the costs and potential industry impact are too prohibitive.

3.127 The preferred option is a combination of options B (legislative ban on conflicted remuneration structures) and F (best interest's formulation). The options impose a ban on conflicted remuneration structures and also introduce a fiduciary-like best interests formulation (which supports the ban on conflicted remuneration structures). The best interests formulation recognises that many conflicts exist but places additional obligations on advisers which reflect the possible detriment to consumers arising from these conflicts and imposes a general requirement for advisers to act in the best interests of their clients when giving personal advice. The best interest's formulation also encompasses the benefits of Option D.

3.128 A combination of Options B and F was found, on balance of the potential costs, benefits and risks considered for each option, to yield the greatest net benefit to the community. The analysis of impacts however,

was limited because there was insufficient quantitative evidence about the costs and benefits associated with each option. The impact analysis and recommendations is largely based on a high level assessment of the potential qualitative impacts. The recommended options are however expected to have a very significant impact in this market.

## **Implementation and review**

3.129 Treasury and ASIC will work closely with industry to devise an implementation strategy. There will be an appropriate implementation period. The ban on conflicted remuneration structures may be progressed in phases.

3.130 Further public consultation on any draft legislation implementing the recommendations is also envisaged prior to introduction of the Bill into Parliament.

3.131 ASIC will need to closely monitor and enforce the ban, in particular to monitor for developments that may see these payments be progressed through alternative mechanisms. The Government will also continue to monitor the application of the regime to ensure that it is operating effectively.

