COMMONWEALTH OF AUSTRALIA

Royal Commissions Act 1902

ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

INDUSTRY SUPER AUSTRALIA PTY LTD'S SUBMISSIONS IN RESPONSE TO INTERIM REPORT

A. Introduction

1 This submission is made by Industry Super Australia (**ISA**) in response to the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry dated 28 September 2018 (**Interim Report**).

2 The submission draws on ISA's experience with the Future of Financial Advice (**FoFA**) and other law reforms, and the policies ISA has advocated as part of its involvement in those processes.

B. The FoFA reforms

3 The FoFA reforms enacted in 2012 were developed over several years in response to a series of high profile financial collapses, including Great Southern, Westpoint, Opes Prime, Trio and Storm Financial.

4 The objective of the FoFA reforms was simple. All financial advice should be in the best interests of the client, and free from influences that create an incentive to deliver advice other than in the best interests of the client.

5 However, the ultimate form of the FoFA legislation was very complex. This was due significantly to the compromise and accommodation of divergent interests involved in the consultation and legislative process[1], as observed in the Interim Report.[2]

---

[1] See, eg, Industry Super Australia, Submission No 31 to Senate Economics Legislation Committee, Parliament of Australia, *Inquiry into the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014*, 1 May 2014, 1 (**ISA 2014 Senate Committee Submission**) and Australian Institute of Superannuation Trustees and Industry Super Australia, *Joint Submission to Treasury Consultation Paper on the regulatory impact of Future of Financial Advice reforms*, 14 June 2017, 1 (**AIST / ISA 2017 Joint Submission**). Both submissions note the FoFA reforms were the subject of significant compromise with the advice and wealth management industry.

[2] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 2 (**Interim Report**). The Interim Report states at 88–9: "*The content and extent of changes to be made in 2012, and later in 2014 and 2015, were contested … It is, therefore, not surprising that the resulting provisions show signs of compromise and accommodation of widely divergent interests*."

6 The conduct described in the Interim Report demonstrates that the FoFA regime has had only limited success in achieving its objective. ISA recommends the implementation of the further measures outlined in this submission to reduce the misalignment between advisers and consumers, consistent with FoFA's objective.

C. Conflicted remuneration and the "best interests" duty

7 ISA has continually advocated for the banning of all forms of conflicted remuneration for financial advice.[3] ISA's analysis of APRA data in 2014 indicated that conflicted remuneration contributed to a loss of some $97 billion in national savings between 1996 and 2014 as a result of financial advisers recommending poorly performing products.[4] Commissions, in particular, reduce member benefits, distort incentives, and undermine the integrity of the superannuation system.

8 ISA does not consider it appropriate to carve out segments of the financial industry from the "best interests" duty and conflicted remuneration structures.[5] The law should be simplified to remove those carve outs.

Best interests duty

9 The conduct identified in the Interim Report has reinforced that the financial services sector is characterised by a fundamental information asymmetry between advisers and clients, and that without effective and efficient regulation, those information asymmetries can lead to detrimental outcomes.[6]

10 When an adviser provides financial advice, the nature of the relationship, including the differences in knowledge and sophistication, establishes a relationship of trust and confidence between the parties. Clients deserve, and the law should require, advisers to act in a way that respects that trust: advisers should owe their clients unflinching loyalty.

11 Currently, a financial adviser has a statutory duty under section 961B(1) of the *Corporations Act 2001* (Cth) (**Corporations Act**) to act in a client's best interests when providing advice. However, under section 961B(2), the adviser is taken to have satisfied the duty if he or she can prove they have carried out seven listed steps, which act as a "safe harbour".

---

[3] Industry Super Australia, Submission No 143 to Senate Standing Committees on Economics, Parliament of Australia, *Inquiry into the Scrutiny of Financial Advice*, 14 December 2014, 9 (**ISA 2014 Scrutiny of Financial Advice Submission**).
[4] ISA 2014 Senate Committee Submission, 2.
[5] AIST / ISA 2017 Joint Submission, 2.
[6] ISA 2014 Senate Committee Submission, 12.

12 During the consultation process on the drafting of this obligation, ISA strongly favoured the inclusion only of subsection (1). However, the safe harbour was included because most of the industry wanted greater certainty about the steps needed to satisfy the best interests' obligation.[7]

13 ISA submits that in light of the conduct identified in the Interim Report, the safe harbour in subsection (2) should now be abolished.

14 First, it is unnecessary. The content of a duty to act in a client's "best interests" will not be difficult for advisers to understand. The fiduciary duties owed by persons such as directors, trustees and lawyers are similarly expressed broadly and generally, and persons subject to those duties have no real difficulty in assessing, in the circumstances of each particular case, what they should do.

15 Second, while the steps in subsections (a) to (f) may be important and relevant to the financial planning process, they fall well short of requiring advice in the client's best interests.[8] The steps in (a) to (f) do not even mention a client's best interests. Only step (g) does, and step (g) only requires that the provider take "any other step" that would "reasonably be regarded" as being in the client's best interest. It does not require a provider to act at all times in a client's best interests, or even to form the view (reasonably or otherwise) that it was acting in the client's best interest. This is consistent with the Interim Report's observation that:

> *As amplified in the legislation, and as implemented in practice, the best interests duty and associated obligations are more in the nature of obligations to 'do no harm' to the client than 'do what is best'.*
>
> *The legislative provisions emphasise process rather than outcome. Although the fundamental obligation is cast as a 'best interests duty' there is no explicit reference in the legislation to making comparisons of a kind that would merit the use of the superlative 'best' in the collocation 'best interests'.*[9]

<u>Exceptions to conflicted remuneration</u>

16 There is no good reason to maintain the existing exceptions to conflicted remuneration for general insurance[10], life risk insurance products[11], consumer credit insurance[12], basic

---

[7] ISA 2014 Senate Committee Submission, 21.
[8] Ibid.
[9] Interim Report, 139.
[10] *Corporations Act 2001* (Cth) s 963B(1)(a).
[11] Ibid s 963B(1)(b).
[12] Ibid s 963B(1)(ba).

banking products[13], and non-monetary benefits, commonly known as "soft dollar benefits". ISA agrees with ASIC's submission to the Royal Commission that "*any exception to the ban on conflicted remuneration, by definition, has the ability to create misaligned incentives, which can lead to inappropriate advice*"[14].

17 ISA makes the following specific comments in relation to insurance, basic banking products, soft-dollar benefits and the remuneration of financial advisers generally.

Insurance

18 ISA submits that commissions should be banned from all insurance arrangements. This is supported by the closing address of Counsel Assisting in the round 6 hearings, which identified numerous instances where commission structures in insurance incentivised aggressive and inappropriate sales tactics, and the prioritisation of sales over compliance.[15] It is also supported by the findings of ASIC's 2014 review into Australia's retail life insurance advice industry. As part of that review, ASIC concluded in relation to adviser incentives that:

(a) Commission payments are the predominant remuneration structure in the industry.[16]

(b) Upfront commission models correlated to advice that failed to comply with the law, with 96% of the poor advice given by advisers paid under commission models.[17]

(c) A remuneration arrangement tied to a product sale creates an incentive for the adviser to make a sale, rather than provide non-product-specific advice or strategic advice for which the adviser may not be paid.[18]

(d) In the case of pre-FoFA advice, there was no reasonable basis for much of the advice. In the case of post-FoFA advice, the advice did not comply with the "best interests" duty and related obligations and failed to leave the client in a 'better position'.[19]

---

[13] Ibid s 963D.
[14] ASIC, *Submissions of the Australian Securities and Investments Commission: Round 2: Financial Advice*, 7 May 2018, 31, cited in the Interim Report, 97.
[15] See, eg, T6462 and T6467.
[16] ASIC, *Report 413: Review of retail life insurance advice,* October 2014, 13.
[17] Ibid 42.
[18] Ibid 43.
[19] Ibid.

19 There is no good reason to distinguish insurance products from the ban on commissions being paid to financial advisers.

Basic banking products

20 The rationale for exempting basic banking products from the conflicted remuneration provisions was that the products are relatively homogenous and low risk.[20] Put another way, it is assumed these products are more easily understood, and consumers generally understand that employees of banks sell their employer's product. ISA considers that this assumption is flawed and conflicts with a fundamental goal of the FoFA reforms to produce a uniform approach to the provision of high quality advice.[21]

Soft-dollar benefits

21 Although certain soft-dollar benefits are currently banned, others – such as benefits authorised by the client, or benefits of a small value (under $300[22]) – continue to be allowed. As a matter of principle, all soft dollar benefits should be banned, because by their very nature they can reasonably be expected to influence the advice given. It is illogical to conclude, for example, that client authorisation will somehow prevent that influence.

22 The banning of soft dollar benefits is supported by the conclusions in Steven Sedgwick AO's *Retail Banking Remuneration Review Report*[23] and ASIC Report 516, Review of mortgage broker remuneration.[24]

Remuneration of financial advisers

23 For the reasons set out above, remuneration of financial advisers should not be tied, to any extent, to the volume or value of sales made.[25] Performance assessments of advisers should be based on matters such as consumer satisfaction, values and risk and compliance standards. Any incentives or bonuses based on product sales should be prohibited.

D. Grandfathered commissions and ongoing service arrangements

24 Following the commencement of the FoFA reforms, payment and receipt of some forms of conflicted remuneration for financial advice was permitted to continue by

[20] See, eg, AIST / ISA 2017 Joint Submission, 16.
[21] Ibid 9.
[22] See *Corporations Regulations 2001* (Cth) r 7.7A.13.
[23]. Stephen Sedgwick, 'Retail Banking Remuneration Review' (Final Report, Retail Banking Remuneration Review, 2017) 34.
[24] ASIC, *Report 516: Review of mortgage broker remuneration,* March 2017, 13, [46].
[25] See also Interim Report, 98.

'grandfathering' provisions.[26] The grandfathering of commissions was lobbied for extensively by the banks, and remains a major source of industry revenue.[27]

25 The Interim Report observes that the grandfathering provisions were "*temporary and exceptional measures*" and asks: "*If the premise for the conflicted remuneration provisions is accepted (and no one suggested that it should not be) how can the grandfathering provisions be justified today?*"

26 In ISA's view, the short answer is that grandfathered commissions cannot be justified today, and should be prohibited immediately. They were introduced as a transitional arrangement following the introduction of FoFA reforms. It has been over five years since those reforms were introduced. Transitional arrangements are no longer required.

27 Ongoing service arrangements should also be prohibited, due to the significant potential for ongoing service fees to substantially erode retirement savings. ISA's previous research has demonstrated that:

(a) Ongoing fees in superannuation can reduce the average Australian's retirement savings by around $46,000 over their working life (as at 2014).[28]

(b) Ongoing asset-based fees are up to 17 times more costly than fee for service alternatives (as at 2014).[29]

(c) In 2011, almost three million Australians were paying commissions despite not receiving ongoing advice.[30]

28 The above research and outcomes are consistent with the conduct and outcomes described in section 7 of the Interim Report titled "*Fees for no service*".

29 ISA considers that proper fee-for-service arrangements – such as those which typically operate in other industries including legal, medical, accounting, architectural and engineering – will facilitate a professional and product-neutral advice industry that

---

[26] Ibid 93.
[27] See, eg, Interim Report, 94, citing ASIC, *Report 407: Review of the Financial Advice Industry's Implementation of the FoFA Reforms*, September 2014, 30, [96].The Interim Report observes that in 2014, when ASIC looked at the value of grandfathered benefits, it found that, *'[o]n average, licensees indicated that grandfathered benefits were worth around one-third of their total income (though substantially more or less than the average in some cases).*'
[28] ISA calculations using ASIC Moneysmart superannuation calculator (Inputs: AWOTE, .5%, 40 year time span, starting balance $10k). See ISA 2014 Senate Committee Submission, 3.
[29] ISA 2014 Senate Committee Submission, 18, citing research by Rice Warner Actuaries, May 2011, accessible at <http://www.industrysuperaustralia.com/rice-warner-research-value-of-advice>
[30] ISA 2014 Senate Committee Submission, 18, citing Industry Super Network, 'Estimating super members paying for advice which they don't receive', August 2011, accessible at <http://www.industrysuperaustralia.com/roy-morgan-research-supports-need-for-opt-in-provisions>

provides consumers with greater transparency of the value of the advice and the associated fees.[31]

30 In particular, fee-for-service arrangements will help address the cause of many of the poor consumer outcomes described in section 7 of the Interim Report, including:

(a) Fees being charged for no service;

(b) Advisers being incentivised to do as little as possible in return for annual fees;

(c) Services not being well defined and having little substantive content;

(d) Fees being "invisibly" deducted from investment accounts; and

(e) Clients forgetting they have signed up for ongoing fees.

31 In short, there must be a fundamental shift in an industry culture that currently relies on automatic periodic payments from customers for a substantial proportion of its revenue.[32] There is no reliable evidence that the costs of doing away with payment by commission will outweigh the benefits of improving the overall quality of advice that is given.[33]

Opt-in

32 Currently, where an adviser charges ongoing fees, they are required to provide an annual fee disclosure statement and give clients the option to opt-in to the ongoing fee arrangement every two years.[34] The Interim Report asks whether this two year period should be reduced, and in particular whether the adviser and client should have to renegotiate an ongoing service arrangement annually.

33 As noted above, ISA considers that ongoing service arrangements should be prohibited altogether. This would make such an opt-in requirement redundant. However, if ongoing service arrangements are retained, the opt-in requirement should be an annual requirement. There is no good reason why advisers, in collecting an annual fee, cannot also confirm the on-going fee arrangements annually.

[31] AIST / ISA 2017 Joint Submission, 6.
[32] See Interim Report, 130, citing ASIC, *Report 499: Financial Advice: Fees for No Service*, October 2016, 8.
[33] See Interim Report, 98.
[34] Ibid 99, citing generally *Corporations Act 2001* (Cth) ch 7 pt 7.7A div 3 (Charging ongoing fees to clients).

E. Intra-fund advice

34 Intra-fund advice enables simple advice to be provided by a super fund to its existing members about their super account. Given that superannuation is a compulsory investment for most working Australians, it is good public policy to permit super funds to provide basic advice to members to assist them in maximising their benefits in superannuation and increasing their retirement savings.

35 Intra-fund advice should therefore be retained, provided it remains subject to stringent controls to ensure the advice is of high quality, cannot be used as a means of selling superannuation products, is not remunerated based on sales, and is limited to one off and simple advice inquiries. This is presently achieved through a number of mechanisms, including the FoFA legislation and the specific obligations imposed upon trustees of superannuation funds by the *Superannuation Industry (Supervision) Act 1993*.

F. The Wallis Inquiry framework is outmoded in general and inappropriately applied to superannuation

36 As observed in the Interim Report, current financial services policy reflects the influence of the Wallis Inquiry.[35]

37 The touchstone of the Wallis Inquiry was the belief that competition would discipline providers and ensure optimal outcomes for consumers. The Wallis Inquiry assumed that consumers have the capacity to obtain and process information, negotiate with institutions and make informed and rational decisions about which financial services and products to acquire.

38 Contrary to this assumption, the evidence in the Royal Commission has shown that in reality, many consumers lack this capacity (particularly when selecting superannuation products[36]). This vulnerability, combined with shift in the balance of responsibility for ensuring good outcomes in superannuation from institutions (trustees) to consumers arising from the Wallis framework,[37] arguably contributed to the improper conduct.

39 The Wallis Inquiry's approach to superannuation was also problematic because it sought to treat superannuation as a financial product and align its regulation closely with managed investment schemes and other wealth vehicles. Superannuation is not, in its dominant character, a financial product and its purpose is not to assist with "broader

[35] See Interim Report, 77–9.
[36] See, eg, T5267 4–18.
[37] See M Scott Donald, 'The prudent eunuch: Superannuation trusteeship and member investment choice', (2008) 28 *Journal of Banking and Finance Law and Practice* 33.

wealth management" or tax minimisation.[38] It is an employment entitlement and a social policy instrument designed to improve living standards in retirement.

40 The Commission's final report may wish to give consideration to whether the existing regulatory arrangements in respect of superannuation appropriately reflect its nature as an employment benefit and social policy instrument.

40 The Commission's final report may also wish to give consideration to not just the substance of the law reforms, but also how the reform process should proceed, having regard to how the accommodation of divergent interests has impacted the nature and complexity of previous financial services legislation (such as FoFA).

[38] Commonwealth, Financial System Inquiry, *Final Report* (2014) 86.