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The Manager
Financial System Division
Treasury
By email - FSRCconsultations@treasury.gov.au

Re: Ongoing fee arrangements and disclosure of lack of independence

It is evident from the widespread occurrence of fees-for-no-service that greater safeguards for consumers need to be introduced. CHOICE is strongly supportive of the reforms to ongoing service arrangements. These reforms will help prevent the possibility of advisers having a 'set and forget' mentality in relation to the charging of advice fees.

While these reforms are an important step forward, harmful conflicts will still exist in the industry. The Government must look to ban all ongoing service arrangement, asset-based fees, and life insurance commissions that contribute to advisers providing conflicted advice.

For a number of decades, ASIC investigations have found advisers are providing poor quality advice to people. For example:

- In 2012, an ASIC shadow shop ranked only 3% of financial advice provided to clients as "good'" quality.[1]
- In 2018, ASIC found that 91% of financial advice provided was in breach of the law.[2]

The Banking Royal Commission shone a spotlight on the systemic failings of the industry.

CHOICE remains deeply concerned about the impact of the proposed reform to disclose an adviser's lack of independence. Disclosing a conflict does not remove that conflict. However, in order to overcome this shortcoming, Treasury must mandate performance based disclosure requirements. Advisers must be required to ensure that a specific percentage of financial advice clients clearly understand what it means if an adviser is not independent.

[1] ASIC 2012, REP 279, Shadow shopping study of financial advice
[2] ASIC 2018, REP 575, SMSFs, Improving the quality of advice and members experiences.

Recommendation 2.1 Ongoing fee arrangements

CHOICE is strongly supportive of the proposed reforms to ongoing service arrangements. In particular, we support the proposed requirements for advice fee recipients to:

- seek annual renewal from clients for all ongoing fee arrangements;
- require fee recipients to disclose in writing the total fees that will be charged;
- set out the services that will be provided during the following 12 month period; and
- obtain written consent before fees under an ongoing fee arrangement can be deducted from a client's account.[3]

The current remuneration structure in the industry is poorly positioned to encourage advisers and product issuers to act in the best interests of their clients. CHOICE strongly affirms the Royal Commission's conclusion that 'advisers often treated ongoing service arrangements as though they were nothing but trail commissions for the advice that had already been given'.[4]

These ongoing arrangements contain an inherent and ever present temptation for financial advisers - the less time and effort an adviser spends on a customer, the greater the financial payoff. This is exemplified in evidence from the Royal Commission where for BW Financial Advice Limited, a subsidiary of the Commonwealth Bank, the 'mere offer of an annual review was sufficient for the fee to be charged.'[5]

We recommend the following amendment to strengthen the legislation:

Record keeping requirement should be ten years

The record keeping requirement must be extended to ten years, not five. A recent ASIC investigation found that, on average, it took over four years from when a breach first occurred by a financial institution before the incident was identified.[6] The ongoing fees for no service scandal dates back to 2013, and will likely take a number of years before it is resolved and customers are remediated. Given the industry's widespread poor track record of compliance with the law, a ten year record keeping period is a more appropriate timeframe.

Banning conflicts within the industry

The proposed reforms to ongoing service arrangements are an important step forward in removing conflicts within the financial advice industry.

[3] Financial Sector Reform (Hayne Royal Commission Response - Protecting Consumers (2020 Measures)) Bill 2020, Explanatory Memorandum, p.5
[4] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 2018 Interim Report, p. 122
[5] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 2018 Interim Report, p. 129
[6] ASIC Rep 594, Review of selected financial services group's compliance with the breach reporting obligation

However, asset-based fees, ongoing service arrangements, and life insurance commissions are all conflicted payments and continue to cause widespread consumer harm. While not within the scope of this reform, Treasury must consider future reform that will ban these conflicted payments.

Ongoing fees for financial advice should be replaced with a fixed fee for service. Banning ongoing fees and forcing advisers to prove their worth by having to pitch for repeat customers would remove the conflicts that drive poor outcomes in the sector. This places the power back into the hands of consumers, who can judge the value of the financial advice when it occurs, and are not simply charged for something as vague as an 'offer of a review'. This would greatly improve transparency over fees paid and would likely prompt people to end payments where they no longer believed they were getting appropriate value for money.

CHOICE strongly recommends that asset-based fees are banned. As part of ongoing service arrangements, consumers are often required to pay asset-based fees, which are calculated as a percentage of funds under management. Asset-based fees obscure the true cost of a service and share many of the harmful impacts on consumers as other ongoing service arrangements or commissions. Asset-based fees bear no relationship to the work actually done by the financial adviser or the quality of the work conducted.

Asset-based fees also create conflicts of interests that may encourage the adviser to give poor quality advice. They discourage strategic advice, such as personal debt reduction, like paying down a home loan or credit card, for which the adviser would not earn a fee, towards recommendations that acquire products in which an adviser can extract an asset-based fee.

Once established, asset-based fees do not provide an incentive to provide ongoing services to the client, because the financial adviser is paid regardless. They have consistently been a source of poor consumer outcomes for decades, and have driven disastrous business models.

Banning the deduction of advice fees in superannuation

CHOICE endorses Super Consumers Australia's position that Treasury must prohibit the deduction of advice fees from all superannuation accounts. We acknowledge that the Government has released draft legislation that will ban the deduction of advice from MySuper products. This prohibition needs to be extended to all choice superannuation products.

We endorse Super Consumer's submission, that states:

> "*there is consumer research that indicates there is psychological 'pain' associated with paying for something, and that consumers place a higher value on products that are purchased with a more 'painful' payment method. Payment methods that are less visible (eg. credit card) are likely to be*

less painful.[7] This suggests that people may be more likely to value advice if they have to actively pay for it from their own pocket, rather than have fees deducted from their super account."[8]

People have a cognitive bias where they disproportionately underestimate the value of fees deducted from less visible superannuation accounts. Further, the incentive will exist for advisers to recommend people switch from safer MySuper accounts into choice products in order to receive advice fees. Given the industry's track record of providing poor quality retirement advice, people's superannuation should not be subject to the deduction of any financial advice fees. Failing this prohibition, the Federal Government must amend the legislation to require that fees can only be deducted from a choice superannuation account for one-off advice.

Recommendation 1.
Treasury extend the record-keeping obligations to ten years.

Recommendation 2.
Treasury bans all harmful conflicts within the financial advice sector, including:

- replacing ongoing service arrangements with a fixed fee for service;
- banning life insurance commissions; and
- banning asset-based fees.

Recommendation 3
Treasury prohibits payment deduction for personal advice from superannuation. Failing this, the Federal Government must amend the legislation to require that fees can only be deducted from a choice superannuation account for one-off advice.

[7] Shah, A.M., Eisenkraft, N., Bettman, J.R., & Chartrand, T.L., 2015, '"Paper or Plastic?" How We Pay Influences Post-Consumer Connections', Journal of Consumer Research, 42(5), pp688-708; Ariely, D., & Silva, J., 2002, 'Payment method design: Psychological and economic aspects of payments', Center for e-Business MIT, Paper 196, pp68-73; Prelec, D., & Simester, D, (2001), Marketing Letters, 12(1), 5–12. doi:10.1023/a:1008196717017.
[8] Super Consumers Australia, 2020, submission to the Treasury, Financial Services Royal Commission – Enhancing consumer protections and strengthening regulators

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Recommendation 2.2 - Disclosure of a lack of independence

CHOICE remains deeply concerned about this reform. Disclosing an adviser's lack of independence will not solve the deep, structural conflicts within the industry. Without the removal of conflicts, such as asset-based fees and life insurance commissions, this change to disclosure will likely have a negligible effect on both consumer outcomes and curbing misconduct. However, to mitigate the chance this reform will be ineffective, we recommend that Treasury amend the legislation to mandate performance-based disclosure.

Disclosure of a conflict does not remove the conflict. This was recognised by a joint research project by ASIC and the Dutch Authority for Financial Markets.[9] The report isolated 33 specific case studies where disclosure either harmed consumers or had major shortcomings. Further, research by the Federal Trade Commission found that disclosure of conflicts of interest actually increases trust in a broker, when it should have led customers to be more critical about the advice.[10]

CHOICE recommends that Treasury mandate performance-based disclosure requirements to overcome the shortcomings of prescriptive based disclosure.[11]

Prescriptive regulations, such as mandating that an adviser discloses a lack of independence in the Financial Services Guides, give specific instructions about what firms must and must not do. Performance-based regulations, on the other hand, give goals toward which firms must work, but are less prescriptive in how those goals must be met. Prescriptive regulations require only that certain actions be taken, whereas, performance-based regulation demands that outcomes be achieved.

Advice licensees should be required to ensure that a certain proportion of customers met a comprehension threshold. Treasury should prescribe in legislation that a specific percentage of financial advice clients clearly understand what it means if an adviser is not 'independent', 'impartial' and 'unbiased'. Advice licensees would be regularly tested to ensure they are on track to meet the percentage goal, but the model otherwise allows firms latitude in how they achieve this target.

Under the proposed law, ASIC will be granted the powers to create a legislative instrument that determines the nature of this disclosure. We recommend that the Treasury amend the legislation to explicitly state that:

[9] AFM and ASIC 2019, REP632, Disclosure: Why it shouldn't be the default, https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf

[10] James Lacko and Janis Pappalardo, 2004, 'The effect of mortgage broker compensation disclosures on consumers and competition: a controlled experiment", Federal Trade Commission, https://www.ftc.gov/reports/effectmortgage-broker-compensation-disclosures-consumers-competition-controlled-experiment

[11] See Lauren Willis, 2015, 'Performance-Based Consumer Law', University of Chicago Law Review, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2485667

Recommendation 4:

The Treasury should include the following amendment to the *Corporations Act* 2001 s942(7C):

The instrument must include the following:

- *a requirement that a threshold of a percentage of retail clients, as defined by ASIC, understand whether their adviser contravenes 923(A)(5)*

This legislation is a litmus test for both Treasury and ASIC. Policymakers must take seriously the overwhelming evidence that prescriptive disclosure is at best ineffective and at worst, harmful to people. A failure to move beyond a prescriptive disclosure based regime is an opportunity lost and will perpetuate consumer harm.

For further information please contact CHOICE on pveyret@choice.com.au

Yours sincerely,

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