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Royal Commission Confusion - Conflicted Remuneration, Intermediaries and Grandfathering
(By Phil Anderson – General Manager, Policy and Professionalism at the AFA)

The Royal Commission final report has set down what the Commissioner considers to be six general rules or what he describes as six norms of conduct. These six rules include the following two:

- Intermediaries should act only on behalf of, and in the interests of the party who pays the intermediary; and
- Exceptions to the ban on conflicted remuneration should be eliminated.

I have a problem with the term intermediary being used to describe a financial adviser as they are primarily providers of a service called financial advice. Financial advice is a service that the Royal Commission just didn't seem to have properly understood. Whilst financial advice may include the recommendation of financial products, I simply do not believe that financial advisers are intermediaries for product providers.

Financial advisers are also subject to stringent rules that are designed to ensure that they operate in the best interests of their clients. There is the Best Interests Duty (Section 961B) and also the obligation to prioritise the interests of the client when there is any conflict between the interests of the adviser (or related/associated entities) and the client (Section 961J).

Let's be very clear here, the Commissioner is suggesting that intermediaries (and he is referring to financial advisers) should act in the interests of product providers and not their clients. This cannot be correct.

In the context of the knowledge that financial advisers and mortgage brokers do receive payments from product providers for life insurance and mortgages, it just seems such a confused proposition to suggest that they need to act in the best interests of the product provider. This intermediary rule would only work if conflicted remuneration was fully banned, however the Commissioner has acknowledged the continuation of commissions for life insurance and mortgage broking, at least for some time. How can these rules therefore apply universally?

We also ponder to what extent this ideological determination to eliminate conflicted remuneration is just an ideological preference that in many cases is disconnected from the real world. This is demonstrated in a few obvious examples:

- In recommendation 1.3, the Royal Commission has recommended a ban on paying trail commission to mortgage brokers on **new** loans. The important thing to note here is the fact that it is a reference to new loans. That clearly means that trail commission on existing loans will be excluded, or in effect 'grandfathered'. This is confirmed in the final report although there is no detailed discussion on the issue of 'grandfathering' existing loans. The application to new loans only is supported in the recommendations of both the Government and the Opposition. Despite all this disgust over financial services grandfathering arrangements, why is a grandfathering approach being proposed with respect to mortgage broking?
- The Government have not supported the ban on upfront commissions for mortgage broking at this stage and the Opposition have suggested the application of a cap on upfront commissions for mortgage broking (much like what applies with life insurance). Labor have gone on to suggest in their 22 February 2019 media release, that the use of these caps "will still achieve the objective of ending conflicted remuneration in mortgage broking, but we will do so in a manner that does not harm competition in the mortgage market." This statement seems to suggest that Labor have a very different and more pragmatic definition of conflicted remuneration that might serve to support the argument for the future of life insurance commissions, where a cap now applies.
- In Recommendation 4.4, the Commissioner has recommended a cap on commissions for vehicle dealers in relation to the sale of add-on insurance products. Both the Government and Labor have

agreed to support this recommendation to retain another example of conflicted remuneration. Does this also suggest that commissions are OK, provided that they have a cap?

It seems that the final report got unfortunately tied up, as a result of an ideological opposition to conflicted remuneration, and then when faced with some practicalities, accepted that there may be grounds where conflicted remuneration is actually in the best interests of consumers and provides for an efficient market.

It is unfortunate that there has been no genuine debate on the issue of conflicted remuneration and who an intermediary owes a duty to in either the media or the political arena, however it is apparent that what the Royal Commission has argued, has holes in it, and will not work in the interests of consumers in all cases. It is obvious that the most sensible position on conflicted remuneration is that it should be eliminated in cases where it is not in the best interests of consumers. It is clear that the Commissioner wants simplicity and the avoidance of exemptions, however where such exemptions are in the best interests of consumers, then they should be allowed to continue.

Let me go back to the point on grandfathering existing trail commissions on mortgages. It is very interesting that this has been proposed and accepted without any reference to why this is being grandfathered. Sure, there are very genuine arguments that it will serve to protect the mortgage broking industry (and their clients) and this is an argument that we would strongly support. Interestingly, there has been no statement on whether this grandfathering should be for a limited period of time and if so, how long this grandfathering arrangement should continue. Is it also possible that there might be constitutional issues involved in such an action? For mortgage brokers, we would not want this turned around on them in five years' time, to suggest that this was always expected to be a transitional arrangement that should have rapidly disappeared. This expectation of a rapid transition is the exact same argument that has been used by some in the financial advice context, despite there being no statement as part of FoFA, to set any expectation on a transition timeframe. This transition expectation has routinely been incorrectly put forward as part of the Royal Commission process.

The term "grandfathering" or "grandfathered" was used 47 times in the main body of Volume 1 of the Royal Commission final report. It was clearly a high priority issue for the Royal Commission. They even stated on page 182 that the conflicted remuneration exemption for grandfathered commissions was the one that received the most attention during the hearings. In reality it was only discussed as part of the concessions put forward by the big institutions in the final policy round, however there were no examples of poor advice given as a result of grandfathered commissions. It was certainly very notable to hear ASIC make statements at the Senate Economics Estimates hearing on 20 February 2019 that they do not have any reliable estimate of the extent of grandfathered commissions and that a recent sample that they had taken, suggested that it was now quite small. They had previously indicated that they had not undertaken work to assess the extent or impact of grandfathered commissions. If this was such an important issue, then surely ASIC would have been closely monitoring it since the commencement of FoFA. The topic of grandfathered commissions has become a very convenient political football for everyone to kick around, but there has been no evidence of resulting client detriment.

Despite what the Commissioner said on page 18 of the final report, about not accepting that there is any basis to argue that there is a constitutional issue in the Government legislating to ban grandfathered commissions, there is clearly evidence to suggest that other legal minds have a different view. In Bill Shorten's 29 August 2011 FoFA media release, he included the following statement:

"Following legal advice from the Australian Government Solicitor, the Government has determined that the ban on conflicted remuneration (including the ban on commissions) will not apply to existing contractual rights of an adviser to receive ongoing product commissions."

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The FoFA legislation is littered with references to Paragraph 51 of the Constitution and the issue with the acquisition of property rights on other than just terms (e.g. Sections 1528, 1530 and 1531). As further proof that this is still considered to be a relevant issue, this reference to Paragraph 51 of the Constitution was included three times in the Centre Alliance Party's recently proposed amendments that were seeking to ban grandfathered commissions from 1 July 2020.

As we pointed out in our response to the Interim Report, there is clearly evidence to suggest that the banning of grandfathered commissions would create a constitutional issue, yet despite all the direct evidence that we provided in our interim report submission, the Commissioner still proceeded in the final report to simply deny that it is an issue.

On 22 February 2019, Treasury issued for consultation, draft legislation on banning grandfathered commissions. The most interesting part of this draft legislation is the inclusion of four new subsections that state that Section 1350 of the Corporations Act would not apply in particular cases. Why is that important? Well Section 1350 states that compensation needs to be paid where property is acquired on other than just terms. It does seem remarkable that Treasury is proposing legislation that would seek to remove constitutional rights from financial advisers.

The fact that within the course of two weeks, the Centre Alliance, Labor and Treasury have all brought forward different versions of proposed legislation to deal with grandfathered commissions, highlights the extent to which this issue is entirely out of proportion with reality and the available evidence. The political momentum behind an issue that ASIC cannot provide guidance on the extent of and the evidence does not demonstrate any client detriment is truly illustrative of a hunt for scapegoats and quick wins. We can only ponder as to why this has not been subject to appropriate scrutiny.

There was another statement that was made in the interim report that was repeated on page 18 of the final report, where the Commissioner was discussing why he didn't accept the constitutional issue for grandfathering:

"Second, if the point is good {acquisition of property on other than just terms}, it was good at the time when most forms of conflicted remuneration were prohibited. Yet no-one sought then to challenge the validity of the relevant provisions and the Future of Financial Advice (FoFA) ban on conflicted remuneration has now operated for more than five years without challenge."

He seems to be putting forward the proposition that if the argument about acquisition of property rights on other than just terms applied with respect to grandfathered commissions, then it should have applied with respect to the ban on other forms of conflicted remuneration as well. This demonstrates a complete misunderstanding of FoFA. Put simply, the FoFA ban on conflicted remuneration applied prospectively. Applying a ban on future business was not retrospective and did not involve the acquisition of anything. We made this exact point in our interim submission, however, once again, this was not addressed and the mistake was repeated in the final report.

The financial advice community and the many small businesses and their teams deserve some clear answers on these issues on conflicted remuneration, intermediaries and grandfathered commissions. If grandfathered commissions is as big an issue as the Royal Commission has suggested, then why wasn't ASIC looking at it over the last five years and how is it going to be solved in a way that benefits clients and treats financial advisers fairly. There are too many unanswered questions and this is being pushed forward by all parties at a disturbing rate.

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