



Investment & Financial Services Association Ltd
ACN 080 744 163

23 June 2006

Mr Jeremy Cooper
Deputy Chairman
Australian Securities and Investments Commission

Att: andrew.fawcett@asic.gov.au

Dear Jeremy

ASIC DISCUSSION PAPER – MANAGING CONFLICTS OF INTEREST IN THE FINANCIAL SERVICES SECTOR

We refer to the discussion paper released by ASIC in April 2006 seeking comments on the draft case studies and specific questions raised. The Board of Directors of IFSA consider that the issue of conflicts of interest and the role of both ASIC and industry participants in this matter is of fundamental importance to the structure of the industry and integrity of industry operations. We, therefore, appreciate the extension of time to make this submission.

We acknowledged that effective conflicts management is fundamental to ensuring the trust of our customers. Indeed, IFSA Standard No.1 Code of Ethics & Code of Conduct requires IFSA members to “at all times safeguard the interests of their clients provided they do not conflict with the duties and loyalties owed to the community and its laws”.

We also acknowledge that ASIC has an important role in providing guidance to industry participants. However, we consider that:

- Guidance is best provided by way of a clear expression of principle, and not case studies as is envisaged by the Discussion Paper;
- Retail and wholesale structures in the financial services industry are sound and generally working well;
- Potential conflicts of interest are addressed in the Corporations Act 2001 (**‘Corporations Act’**) in a systematic way, principally through:
 - A requirement for trustees and responsibility entities to act in the “best interests” of their clients under the Corporations Act in addition to the obligation at common law;
 - A requirement for financial advisers and their representatives to provide “appropriate” advice to their clients;

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- The requirement for financial services to be provided efficiently, honestly and fairly;
 - Disclosure to clients of associations and benefits that may influence any particular recommendation;
 - Disclosure of costs and benefits to the client; and
 - A requirement for conflicts management in the provision of financial services;
- It is the responsibility of management to ensure systems and controls are in place to manage conflicts of interest. Failure to do so is a breach of the law;
 - While disclosure of costs and benefits has improved and can continue to be improved, this should not necessarily mean more disclosure that is potentially confusing to investors;
 - Industry standards and guidance play an important role in generating a culture of compliance in the industry;
 - The case study approach has significant limitations and may adversely impact both customers and industry participants.

While the analysis of the case studies has been completed by IFSA, the IFSA Board of Directors considers that it would be more constructive for IFSA to seek to assist ASIC by focussing primarily on the regulatory approach for providing guidance to industry on conflicts management. We make the following comments on the approach adopted in the Discussion Paper and reasons for our recommendation that a more effective way to facilitate industry efficiency in its conflicts management obligation would be to work with industry to ensure that a clear set of conflicts management principles and a model for better disclosure is developed. Those principles and disclosure model would act, in conjunction with ASIC Policy Statement 181, as a framework within which effective guidance could be provided to industry and by industry to its customers.

1. GENERAL COMMENT

1.1 Australian Regulatory System

IFSA members operate in a highly integrated and competitive industry where funds managers, financial product manufacturers and distributors actively compete and seek to provide efficient services to their clients.

By world standards, Australia has a well regulated, compliance oriented, financial services sector. We believe that the current retail and wholesale structures in our industry are sound and are generally working well. The Corporations Act has addressed potential conflicts of interest in a systematic way, principally through disclosure and the requirement for conflicts management.

If the level of disputes is indicative of customer satisfaction, changes to the law as part of the Financial Services Reforms (FSR) have been a great success. The most recent data released by industry dispute resolution bodies shows that the number of complaints received and actioned by those bodies has decreased significantly since transition to FSR. These outcomes reflect well, overall, on both ASIC and the industry. We believe that this is consistent with industry participants operating

effective internal dispute resolution processes, better compliance and, increased levels of customer trust and satisfaction in the operations of individual industry members.

Our industry operates in a dynamic commercial environment. New players enter and existing participants exit the market. New products and services are continually being offered and regulatory cultures change. IFSA also recognizes that some market participants are less than vigilant in ensuring compliance with the law and are not always compliant with these requirements. For these reasons we support ASIC's endeavors to raise awareness of conflicts of interest and better outcomes. We believe that a soundly based principles approach will stand the test of time and meet the needs of a dynamic financial services market.

We note that the UK Financial Services Authority ('FSA') has itself undertaken considerable research, analysis and consultation in seeking to promote a regulatory system that supports appropriate consumer protection, public awareness and confidence in the financial system. It is our opinion that this work has many parallels to the operation of the Australian system and certain of the issues raised by the ASIC case studies could benefit from that work¹.

1.2 Conflicts management obligation

Section 912A(1)(aa) requires a financial services licensee to 'manage' any conflict arising for its financial services business. The section does not require a licensee to avoid conflicts unless, of course, the conflict would breach another provision of the law. That obligation reflects the commercial reality that business arrangements and behaviour must comply with the law.

The conflicts management obligation is predicated on the licensee being best placed to judge:

- when its interests and those of its customers are not aligned;
- the potential negative results that may arise from any misalignment of interest; and,
- how best to prevent any negative results or behaviour occurring.

It is the responsibility of management to ensure systems and controls are in place to manage conflicts of interest. Failure to do so is itself a breach of the law.

In balancing the competing interests of sellers and buyers of financial services the Corporations Act requires disclosure by the licensee of both costs and benefits to ensure that the customer transacts knowing the benefit that will accrue to the provider of the financial product or service. These requirements are part of, and in addition to, the broader duty of care obligations of the financial services licensee.

1.3 Industry Standards/Guidelines

A range of Standards and Guidelines have been developed to assist industry participants to implement practices and procedures that will enable the effective management of conflicts of interest. Those standards and guidelines include:

¹ See in particular FSA Consultation Paper 121: *Reforming Polarisation: Making the market work for consumers* (CP121) and, Consultation Paper 166: *Reforming Polarisation: Removing the barriers to choice* (CP166)

- Financial Planning Association (**FPA**) Principles for Managing Conflicts of Interest (effective 1 July, 2006);
- IFSA Standard No 14 - IFSA/FPA Industry Code of Practice on Alternative Forms of remuneration in the Wealth Management Industry (July 2004);
- IFSA Standard No. 13 - Proxy Voting (October 2004);
- IFSA Bluebook – Corporate Governance: A Guide for Fund Managers and Corporations – IFSA Guidance Note No.2 (October 2004);
- IFSA Standard No 15 - IFSA/FPA Industry Guide on Rebates and Related Payments in the Wealth Management Industry (November 2004);
- IFSA Standard No. 1 - Code of Ethics & Code of Conduct (June 2001) – currently being revised;
- IFSA Guidance Note No. 7.00 on Personal Trading (July 1999);

2. THE ASIC CASE STUDY APPROACH

2.1 Appropriateness

The case studies provide examples of a range of possible fact situations. We agree that a number of the examples do involve the potential for conflicts of interest that can be effectively managed, while others are not conflict situations at all but disclose fundamental breaches of the law. The presumption underpinning the ASIC Discussion Paper appears to be that ‘conflict of interest’ situations in the financial services industry should generally be avoided. While this expectation is unrealistic in a competitive commercial environment, it does reinforce the need for effective conflicts management based on sound principles.

We consider that the case study approach has significant limitations and, may adversely impact both industry participants and their customers. The limitations of the use of case studies include:

- it is not practical to seek to address often highly complex business environments with simple fact situations;
- a number of the case studies confuse actions that breach specific legal requirements with the conflicts management duty of a licensee under section 912A(1)(aa) of the Corporations Act ;
- a number of case studies appear to extend the operation of the law in a manner not intended eg. It is an entirely new (and undesirable) concept for a product provider to be responsible for the actions of advisers that are either acting under their own AFSL or as authorised representatives under another AFSL;
- the ‘loosely based’ (ASIC’s description) case studies used have the potential to become benchmarks for industry imposed by the regulator and effectively mandated by auditors without any recognition of the customer benefits or diversity of arrangements in place. A one size fits all approach will impose significant limitations on diversity, industry innovation and could fundamentally undermine the operation of existing industry structures;

- the case studies assume that the industry is incapable of identifying and managing conflicts and the potential behaviour arising out of conflict situations.

The case studies and ASIC commentary appear to express a bias particularly against conglomerate arrangements and institutional ownership of advisor groups. The fact is that many customers prefer to obtain advice from an adviser who is backed by the financial strength and security of a large financial institution and to invest through a product from the parent institution as long as it is clearly disclosed and they receive choice and appropriate advice regarding their underlying investment and insurance options.

A range of product platforms are provided a major institutions through wrap and master fund arrangements where the consumer has the comfort of knowing that the institution backs the operation of the platform, or is the trustee or responsible entity of the product. Investment platforms also provide customers with a convenient and efficient way of accessing a range of boutique and specialist fund managers that they would otherwise not be able to access. Additionally, available investment options and fund managers available through such platforms are intensively monitored and researched before being made available for selection by a customer. They deliver efficient portfolio and transaction administration services to customers.

2.2 Implications for Industry Structures

The financial services market is characterised by a significant degree of horizontal and vertical business integration in addition to boutique operations. The diversity within our industry is a significant strength and offers investors a wide range of investment choices. Taken to its extreme, avoidance of conflicts would have the effect of undermining existing industry structures and operations. These structures have delivered significant industry efficiencies and benefits. Three of the case studies we would highlight in this regard are A5 – **Poor disclosure of interests**, B11 - **Super funds that don't pay commissions** and C3. – **Related Entities**. The case studies are discussed at **ATTACHMENT A**.

2.3 Danger of prescription

The problem with the use of limited fact case studies is that they can ultimately be used by field officers as a substitute for the law and this can cause considerable dislocation to a fair and efficient regulatory system. Rather than offering guidance, the use of case studies can potentially create uncertainty.

3. SECTION D OF THE DISCUSSION PAPER

Section D: Observations and conclusions does provide an outline and a start to a principles based summary to underpin the conflicts management obligation in the Corporations Act. While we agree with the majority of the obligations and observations listed, we believe that items 2, 3, 4 and 5 should be amended. Our comments on these items are provided at **ATTACHMENT B**.

4. CONCLUSION AND RECOMMENDATION

A diversity of business models operate in the Australian financial services industry. A prescriptive approach to regulation, particularly in the field of conflicts of interest,

has significant cost implications for how businesses operate. Any increase in industry costs or reduction in industry efficiency will impact customer interests.

Recent Government initiatives have been directed at addressing the regulatory burden on industry by overly prescriptive law that has the effect of increasing operational costs without a commensurate consumer benefit. We consider the approach of the current Discussion Paper is in conflict with achieving efficient regulatory outcomes in so far as it moves away from clearly expressed principles.

We look forward to the adoption of the Government's proposals for further refinements of the Financial Services Reform measures, including the proposal for incorporation by reference. This measure alone will greatly assist in improving disclosure, shortening the length of core documents, and allowing customers to focus on core product features and financial service issues relevant to them. This is an area where both ASIC and industry can collaborate to refine the disclosure to customers to ensure better outcomes for both customers and the industry.

In relation to conflicts management, it is our view that the list of observations and conclusions set out at Section D of the Discussion Paper should be considered as a basis for the development of Conflicts of Interests Principles. It is on this basis that we recommend that the case study approach to providing guidance should be replaced by a principles based approach.

We recommend that ASIC work with industry to develop a clear set of Conflicts Principles and would welcome the opportunity to work more closely with ASIC on these matters.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Richard Gilbert', is written over a thin vertical red line.

Richard Gilbert
Chief Executive Officer

ATTACHMENT A**CASE STUDY A5 Poor disclosure of interests**

This example gives rise to a general comment that a prescriptive approach to conflicts management will lead to lengthier and less helpful disclosures. We share ASIC's concern about the length and readability of some existing disclaimers which have resulted from a range of contributing factors including the law, ASIC's policy making and interpretations, legal advice and the desire of in-house compliance and risk management teams to be thorough. It is simply prudent for risk management professionals to seek to manage risk through disclosure, and it is unfortunate that disclaimers become less effective as a result.

The ASIC commentary on example A5.1.1 suggests that there should be full disclosure of actual relationships and fees. There are concerns over this approach:

- for some licensees, the disclosure of these details would lead to very long disclaimers as there may be many relationships to be disclosed;
- it is impractical to disclose actual fee amounts, and in some cases the fact of a relationship, where confidentiality obligations exist;
- the resulting disclosures will, in all likelihood not be read by clients, based on the empirical research ASIC refers to in its paper.
- to require licensees' compliance teams to gather the necessary relationship and fee data and to require use by their businesses of constantly changing forms of disclosure would impose a considerable additional cost burden on the licensees and ultimately on the fees payable by clients.

CASE STUDY B11 - Super funds that don't pay commissions

In its commentary at B11.2.1 ASIC states that:

“the remuneration model forces AdviceNetwork to prefer commission paying products over products that do not pay commissions. Ideally, this conflict **should be avoided** and is only partly addressed by disclosure and control mechanisms”.

Generalised, the comment is not consistent with legal requirements nor does it reflect client payment or selection preferences. It should be recognised that, in the process of making a purchase decision, customers are influenced by a range of factors such as brand, reputation, utility, efficiency, reliability, risk as well as current and past relationships. The fact that a providing entity's fees are based on commission means that while there is a potential conflict of interest that must be appropriately disclosed, it doesn't necessarily mean that the client is disadvantaged. In fact, the very opposite may be true.

The example provided suggests that the licensee does not permit its advisers to charge fees for service. IFSA is not aware of any licensees within its membership that do not provide advisers the choice to operate on a fee for service basis where the client pays directly for the advice. In all likelihood, the example is not relevant because it does

not reflect current industry practice. However, if this were to be the case, the adviser could elect to change licensee and/or, the client could choose an adviser that could provide such a facility. To our knowledge, under the current law these two options operate in a highly contestable market (ie. no fetters on member choice and competitive adviser market). Advisers and clients have the right to determine what is in their own interest and to make the choice accordingly.

Many clients prefer to pay their adviser through a commission or through a fee for service negotiated with their adviser. For adviser and client convenience the payment is often collected through the product platform. If some superannuation funds choose not to provide this choice to their clients or to restrict the arrangement to a limited number of advisers, then that is a matter for a highly contested market to determine.

In many cases, funds that do not provide this choice also do not provide the opportunity for members to benefit from financial advice and accordingly do not offer a mechanism to allow clients to pay for advice. Some funds do provide access to advice through salaried advisers paid by a related entity. In some instances, not all of the costs of advice are borne by the client through the fee for service. The fee for service payment, or part thereof, is indirectly drawn from the client account in the relevant fund thereby lowering the overall returns to the client through that fund. Other funds might provide the advice via a subsidy from the whole of the fund. All of these various arrangements possible involve conflicts of interest and should be clearly disclosed.

CASE STUDY C3 - Related Entities

Global conglomerates issuing products in the Australian market can provide investors with the opportunity to access offshore investment expertise and products not otherwise available in the local market. Due to the differing regulatory regimes applicably globally, it is usually necessary for the local responsible entity to structure these products through outsourcing agreements with offshore related party investment management entities.

The Product Disclosure Statements for this type of product make it clear that the investor is acquiring the investment capabilities of the specific global conglomerate rather than a fund of fund product where the product issuer selects and appoints a range of external investment managers. Investors are, therefore, making their decisions based on the capability of that specific global conglomerate.

In appointing any external investment manager, including related party entities, the responsible entity has a fiduciary obligation to ensure that the service provider carries out their duties appropriately and needs to take appropriate action where this is not the case.

The commentary in C3 appears to suggest that due to the existence of a conflict of interest, the local responsible entity should replace the related party investment manager with another, unrelated investment manager, in cases where the related party manager was performing poorly. In doing so, however, this would significantly change the nature of the product that was originally sold to investors. Where the investment management function is not outsourced and performance is poor the decision to continue to be invested in this product rests with the investor, not withstanding any related party outsourcing arrangement, this should also be the case

where the investor has made the decision to invest in the investment capability of a particular global conglomerate.

PS181 covers both retail and wholesale licensees. To take the ASIC commentary in C3 to its ultimate conclusion in the wholesale context, would mean that an investment manager who had received a wholesale mandate from a client and whose investment performance was poor would have to terminate the mandate itself or transfer it to a competitor who was currently had first quartile performance. A managers' performance is to a large extent cyclical and dependant upon their investment style. The decision to terminate the mandate or transfer it should rest with the client.

ATTACHMENT B**IFSA comments on selected ASIC Principles**

2. *Conflicts of interest impact the quality of financial services provided. In our experience, poorly managed conflicts of interest tend to result in poor service to consumers and a market that is not fair and transparent.*

While we agree with the comment that poorly managed conflicts tend to result in poor service to consumers and market transparency, conflicts of interest where properly managed should not effect the quality of services being provided. In fact, many arrangements where there is a potential for conflicts to arise will give consumers efficient and superior services.

3. *Disclosure alone will rarely be sufficient to manage a conflict of interest. Accompanying internal controls are generally always needed to ensure that the quality of the underlying service is not compromised.*

The law requires that a licensee have in place adequate arrangements for the management of conflicts of interest. Those arrangements would generally address the issues listed in the Schedule to ASIC Policy Statement 181 (PS 181). However, there are instances where the Corporations Act requires disclosure – products disclosure statements, financial services guides and statements of advice – where potential conflicts of interest are addressed. Such disclosure is mandated by the law and can of itself be an adequate response to a conflict situation.

4. *Some conflicts of interest are so serious that they cannot be managed by internal controls and disclosure, and must be avoided. Whether a conflict should be avoided will be determined by both the nature of the conflict and the nature of the firm.*

The law requires conflicts to be managed. As stated in PS 181.20 the three mechanisms that licensees would generally use to manage conflicts are to control, disclose or to avoid the conflict. The only circumstance where a conflict must be avoided is where it would result in a contravention of the law.

5. *Serious conflicts need to be avoided, not because they will always lead to actual harm to clients or to the market, but because allowing such conflicts to continue creates a high risk of that harm occurring. Firms need to take a risk management approach and ask themselves what level of risk their conflicts of interest expose them to. With some conflicts, the risk of an adverse consumer or market integrity outcome is too high—and these conflicts need to be avoided. Prudent firms will avoid such ‘high-risk’ conflicts.*

The statement fails to recognise that the effective management of conflicts can and do deliver significant opportunities and benefits to customers. Case Studies B11 and C3 examined in this submission provide examples of the positive benefits that can accrue to customers where potential conflicts may exist. While avoidance is an option available to the licensee proper management is more appropriate in the majority of instances, unless failure to address the conflict would result in a breach of the law.