Future of Financial Advice: stocktake, commercial realities, and why we're here
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Introduction

Anyone with even a remote connection to the financial services industry will be aware of "FOFA", whether or not they know what the acronym stands for. That is not to say, however, that one's knowledge of the acronym is indicative of knowledge of its operation, scope, and complexity. The reforms have been the subject of protracted political, industry and consumer discussions, submissions, lobbying, and criticisms, all of which are expected to continue into the future, particularly following the recent election of a Federal Coalition government which not only holds a significant majority, but which has been a staunch critic of aspects of the reforms.

Throughout its long gestation (FOFA was first announced as a substantive reform in April 2010), it is also fair to say that each of the financial services industry's participants (of which there are many) has worked hard to protect its share of the pie. What started out as a timely and necessary policy reform in the wake of a number of high profile collapses during the Global Financial Crisis (**GFC**), has given way to a complicated, complex, and in some respects misunderstood package of legislation and regulatory guidance, which has left more questions than it has answered. In some respects, the reforms are commercially impractical.

Nevertheless, FOFA is well and truly upon us, having gone "live" in full from 1 July 2013. It impacts retail consumers, Australian financial services (**AFS**) licensees, and their representatives.

Purpose

The purpose of this paper is to stocktake where we stand on FOFA, following its commencement in full from 1 July 2013. The paper will focus on some of the commercial, operational and implementation aspects with which AFS licensees and their representatives will need to contend post-1 July 2013. In this regard, I will look to drill below the legislation and deal with how impacted entities should approach FOFA and what procedures need to be in place to ensure not only a timely transition to the new world, but also to prevent inadvertent consequences arising during normal commercial activity.

Why FOFA?

FOFA, ultimately, is a product of the GFC. It follows a number of high profile collapses of public investments, including Trio, Westpoint, Opes Prime, and Storm Financial, in which investors (namely, retail investors) lost vast sums of money.

In the wake of these events, regulators and consumer advocates identified a number of perceived and actual conflicts in the financial services advice model accessible to retail clients. In particular:

- products recommended to retail clients were seen as not being in the clients' best interests: rather, financial advice was being dictated by financial motives (for example, trail commissions).

- it was recognised that, in a number of cases, advisers were essentially "sales staff" for product manufacturers, in which:
    - advisers were remunerated based on the volume of products sold or money invested;
    - clients were sold into products which provided the highest revenue stream for advisers: therefore, clients' interests were perceived to be secondary to advisers' motives. Advisers also encouraged clients to borrow to invest, thus maximising adviser income streams (this was particularly the case with Storm Financial); and
    - revenue sources were often hidden from clients, because they were not paid by clients directly (for example, trail commissions paid by product manufacturers).

The advice model was ultimately held to be inconsistent with consumer expectations that advisers provide a professional service in clients' best interests, where advice is not dictated by other motives. It was also recognised that there was no express statutory duty on advisers to give priority to clients' best interests, and that it was important that investors have the trust and confidence to seek financial advice.

The FOFA reforms were designed to tackle these issues.

Structure of this Paper

This paper will cover five broad areas:

1. Best Interests Duty.
2. "Opt-in" and fee disclosure.
3. Prohibitions on "conflicted remuneration", "volume-based shelf-space fees" and "asset-based fees on borrowed amounts".
4. Meaning of "arrangement" and operation of "grandfathering".
5. Anti-avoidance.

All statutory references throughout this paper are to the Corporations Act 2001 (Cth), unless otherwise stated.

The paper is based on the law as it stands at 1 July 2013. In December 2013, the Coalition announced further changes which are presently under public consultation, and which will be the subject of a separate paper when legislated.

How best to understand and navigate FOFA?

FOFA can essentially be divided into two parts: one dealing with the duties of financial advisers; the other dealing with prohibited payments.

Elaborating:

- the adviser duties include the "best interests duty", and prescriptive disclosure obligations under "opt-in". These obligations apply where *personal advice* is provided to *retail clients*. If merely *general advice* is provided, these obligations do *not* apply.

- prohibited payments refer to the bans on "conflicted remuneration", "volume-based shelf-space fees" and "asset-based fees on borrowed amounts". These bans generally apply where *financial product advice* is provided. "Financial product advice" encompasses both *general advice* and *personal advice*.[1]

PART I - "ADVISER" DUTIES

1 "Best interests duty"

What is the best interests duty?

Section 961B(1) of the Corporations Act states, in relation to an advice *provider* giving *personal* advice, as follows:

> "*(1) The provider must act in the best interests of the [retail] client in relation to the [personal] advice.*"

This is generally referred to as the **best interests duty**.

Section 961B(2) states as follows:

> *(2) The provider satisfies the duty in subsection (1), if the provider proves that the provider has done each of the following:*
>
> *(a) identified the objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions;*
>
> *(b) identified:*
>
> *(i) the subject matter of the advice that has been sought by the client (whether explicitly or implicitly); and*
>
> *(ii) the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the **client's relevant circumstances**);*
>
> *(c) where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information;*
>
> *(d) assessed whether the provider has the expertise required to provide the client advice on the subject matter sought and, if not, declined to provide the advice;*
>
> *(e) if, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product:*

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[1] *Financial product advice* is provided when the advice in question is intended (or could reasonably be regarded as having intended) to induce the client to make a decision in relation to a financial product. Such advice becomes *personal* advice when it is given after taking into account the client's circumstances, needs and objectives.

(i) conducted a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered as relevant to advice on that subject matter; and

(ii) assessed the information gathered in the investigation;

(f) based all judgements in advising the client on the client's relevant circumstances;

(g) taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances."

This is often referred to as the **safe harbour** provision, about which more will be said below.

How does the best interests duty work?

Section 961B(1) is the operative provision, obliging the provider of *personal* advice to a retail client to act in the client's best interests. This will usually be an individual financial adviser who is either an AFS licensee in their own right, or an authorised representative of an AFS licensee. However, under FOFA, it can also include employee representatives.

The Corporations Act expressly provides that a licensee must ensure that their representatives comply with the best interests duty[2], and may be liable for civil penalties if their representatives breach the requirements[3]. A court may also order that a client be compensated by a licensee for loss or damage[4].

Let's go back to the "safe harbour" provision. That provision prescribes a series of steps for the provider to take, which if proven, will *deem* the provider to have met the best interests duty. That is not to say that the prescribed steps in section 961B(2) are the *only* way a provider can meet the best interests duty; rather, it is *one* way.

The benefit of the "safe harbour" provision is that it provides an express statutory regime through which the best interests duty can be met.

Following a Coalition announcement in December 2013, it is proposed to remove sub-section (g) of the "safe harbour" provision, which should give advisers some certainty around the best interests duty. It is also proposed to amend the best interests duty to explicitly allow for "scaled advice". This proposal will allow clients and advisors to agree on the scope of the advice whilst ensuring that the advice remains appropriate.

"Best interests" is itself not defined in the Corporations Act. However, section 961E does provide that:

> "*It would reasonably be regarded as in the best interests of the client to take a step, if a person with a reasonable level of expertise in the subject matter of the advice that has*

[2] Section 961L.
[3] Section 961K.
[4] Section 961M.

been sought by the client, exercising care and objectively assessing the client's relevant circumstances, would regard it as in the best interests of the client, given the client's relevant circumstances, to take that step."

What else does the best interests duty cover?

The Corporations Act also prescribes that advice providers also have an obligation to:

- only provide appropriate advice[5]; and
- prioritise the interests of the client where there is a conflict with their own interests, or those of one of their related parties[6].

Issues for consideration

The best interests duty raises a number of issues which AFS licensees and their representatives will need to consider:

1. How has the best interests duty changed existing obligations when giving personal advice?
2. What does the best interests duty mean for Approved Product Lists (**APLs**), in terms of both use and selection?
3. What does the best interests duty mean for existing client advice templates (eg Statements of Advice (**SoAs**); fact finders etc…)?

Each of these questions will be addressed below. In doing so, we will also survey ASIC's position in detail.

How has the best interests duty changed existing obligations when giving personal advice?

In theory, not much should change, however it is instructive to note that the best interests duty (like much of FOFA) has its genesis in regulatory concerns that retail clients would have been better off had they *not* obtained financial advice in relation to investments in failed ventures such as Trio, Storm Financial and Westpoint. The concerns largely stem from the position that retail clients were given personal advice that was not in their best interests; rather, the advice was dictated by other conflicting motives.

These principles appear to govern ASIC's approach to the best interests duty. In particular, ASIC states in its updated Regulatory Guide 175 (**RG 175**) that:[7]

"*When assessing whether an advice provider has complied with the best interests duty, we will consider whether a reasonable advice provider would believe that the client is likely to be in a better position if the client follows the advice*."

[5] Section 961G.
[6] Section 961J.
[7] RG 175.229.

Much of the commentary in RG 175 centres around this basic proposition. Therefore, it is instructive to use this as a starting point.

Following from the above, ASIC has indicated that it will assess:

> "*the position the client would have been in if they did not follow the advice, which is to be assessed at the time the advice is provided*".[8]

In particular, ASIC:

> "*will not examine investment performance retrospectively, with the benefit of hindsight*".[9]

ASIC gives the example of a subsequent fall in unit prices in a case where the advice (at the time it was provided) was appropriate to the client: in that case, the best interests duty was met.

To use ASIC's wording:[10]

> "*The best interests duty is concerned with what occurred at the time the advice was provided*".

ASIC gives another example as follows, which is instructive:[11]

> "*A client holds a portfolio of products through a platform. They have told their advice provider that they believe their current platform is providing an acceptable service and they can understand the reporting provided but they are concerned about the fees they are paying for using the platform.*
>
> *The advice provider discusses the reports with the client and believes that the client understands them, even though they are presented in a complex manner.*
>
> *The advice provider recommends that the client switch to another platform because the format of its consolidated reports on the client's holdings will be easier for the client to follow. Compared with the fees the client is currently paying, the fees for this other platform are higher by 0.1% of the value of the client's assets administered by the platform.*
>
> ***Commentary***
>
> *In this scenario, we would not consider that a reasonable advice provider would believe that the client is likely to be in a better position if the client follows the advice. This is because the client was concerned about costs but was switched to a platform with higher costs.*
>
> *The advice provider has not complied with the best interests duty*."

[8] RG 175.230.
[9] RG 175.230.
[10] RG 175.235.
[11] RG 175.235.

The above example may seem simplistic, however when coupled with the starting proposition that ASIC, in assessing whether an advice provider has complied with the best interests duty, will consider whether a reasonable advice provider would believe that the client is likely to be in a better position if the client follows the advice, it becomes clear that the key deliverable to discharging the best interests duty, is a proper understanding of the client's objectives and motives for seeking advice and the transactions proposed in relation thereto. The advice provider, after having undertaken reasonable investigations, must then assess whether the advice he/she is about to give, is likely to leave the client in a better position, having regard to the client's objectives/motives.

Elaborating on the above example, if the client has expressed concerns about fees, and is given advice about a product which – whilst having better features – is actually more expensive than the incumbent product, ASIC will consider the adviser to have fallen foul of the best interests duty.

In some respects, this may lead to unintended outcomes, in that the new product better may objectively be better suited to the client, but by sheer virtue of the fact that the new product is more expensive, the client is seen by the regulator as being "worse off": thus, the best interests duty is not met.

On a literal interpretation of RG 175, the best interests duty would still not be met even if the new product generated significantly higher returns than the client's incumbent product.

On the flip side, and disappointingly, ASIC's position probably leaves open the conclusion that the best interests duty is met in a case where a client invested in a cheaper option simply because fees were his/her primary concern, but with the result that the client was left worse off overall in terms of net financial returns.

What this appears to make clear, in any event, is that the best interests duty (at least in ASIC's view) is all about properly scoping from the outset what the client's objectives and motives are for seeking personal advice. Putting it another way, the advice needs to be consistent with the subject matter of the advice sought by the client, and their particular requirements. This should not be difficult to achieve if the initial client dialogue/engagement is properly scoped and documented.

It could almost be said that the significant majority of the obligations dictated by the best interests duty, are imposed as part of the initial client engagement/dialogue. If these aspects are properly defined and scoped from the outset, then it is likely that the best interests duty is going to be met, because the adviser will understand what the client seeks. If not done properly at the outset, then it is equally likely that there is very little that the adviser can do going forward to cause the best interests duty to be met.

What does the best interests duty mean for APLs, in terms of both use and selection?

Use

ASIC provides some useful guidance in relation to the use of APLs.

What is clear from RG 175 is that being limited to products within an existing APL of itself does not infringe the best interests duty. ASIC's focus appears to be whether a reasonable advice

provider would believe that the client is likely to be in a better position if the client follows the advice.

Specifically, ASIC comments that:[12]

> "*The best interests duty does not prevent or require the use of approved product lists.*
>
> *In some cases, an advice provider can conduct a reasonable investigation into financial products under section 961B(2)(e) by investigating the products on their AFS licensee's approved product list.*
>
> *In other cases, an advice provider will need to investigate and consider a product that is not on their AFS licensee's approved product list to show that they have acted in the best interests of the client when providing them with personal advice - for example:*
>
> *(a) if the client's existing products are not on the approved product list of the advice provider's licensee and these products might be able to meet the client's relevant circumstances;*
>
> *(b) if an approved product list used by an advice provider is restricted to one class of product and there are products that are not in that class that would better meet the client's relevant circumstances, considering the subject matter of the advice sought by the client; or*
>
> *(c) if the client requests the advice provider to consider a specified financial product that is not on the approved product list of the advice provider's licensee*."

The above is very instructive, and consistent with ASIC's proposition that, in assessing whether an advice provider has complied with the best interests duty, ASIC will consider whether a reasonable advice provider would believe that the client is likely to be in a better position if the client follows the advice.

To the extent that *product-specific* advice is sought, the adviser, in discharging his/her duty to undertake reasonable investigations, will more than likely need to consider that particular product or class of products, even if they are not on the adviser's APL.

If, however, product-specific advice is *not* sought, and based on what the adviser understands as being the client's requirements/objectives/motives (after making reasonable enquiries), considers that products on the adviser's APL will meet those requirements/objectives/motives and leave the client better off, the best interests duty will likely be met if advice is given based on the existing APL.

What the best interests duty therefore means, going forward, is that an adviser cannot simply narrow the scope of his/her advice to products on the APL if it is reasonably clear that the client seeks advice on products (or product types) not covered by the APL. Also, if it is clear that the client's requirements/objectives/motives cannot be satisfied by products on the APL (for example, the client seeks lower fees and all the products on the APL are more expensive than the client's existing product(s)), advice should not be given in relation to products on the APL: in this latter case, the adviser would be required to undertake reasonable investigations into other

[12] RG 175.328 - 175.330.

suitable products if he/she is going to provide personal advice to that client and in relation to that client's requirements/objectives/motives.

Selection

What the above also makes clear, is that the best interests duty itself does not speak to the APL product *selection* process. From ASIC's perspective, the best interests duty is all about identifying the client's requirements/objectives/motives, and assessing whether the client is likely to be better off: if the existing APL can be utilised to answer those tests in the affirmative, then the existing APL can be used; otherwise, the advice provider will need to undertake reasonable investigations of products not on the APL.

Commercially, product providers may (and should) look to tailor their APLs based on an identification of clients' needs over time, but this is not dictated by the best interests duty.

What does the best interests duty mean for existing client advice templates (eg SoAs; fact finders etc…)?

As indicated above, the significant majority of the obligations dictated by the best interests duty appear to be imposed as part of the initial client engagement/dialogue. If these aspects are properly defined and scoped from the outset, then it is likely that the best interests duty is going to be met, because the adviser will understand what the client seeks. If not done properly at the outset, then it is equally likely that there is very little that the adviser can do going forward to cause the best interests duty to be met.

The most transparent way of establishing compliance with the best interests duty is to meet the "safe harbour" requirements discussed above. As mentioned, section 961B(2) of the Corporations Act prescribes a series of steps for the provider can take, which if proven, will *deem* the provider to have met the best interests duty. Ultimately, then, advice templates should be written having regard to these prescribed requirements, and it should be manifestly evident from the advice documents that the advice provider has had regard to the "safe harbour" requirements when providing his/her advice.

2 "Opt-in" and fee disclosure

What is "opt-in"?

Section 962K of the Corporations Act provides that an AFS licensee, or its representative, who enters into an "ongoing fee arrangement" with a retail client must give the client a written *renewal notice* every 2 years which requires the client to "opt in" to renew that fee arrangement.

If the retail client does not respond to the renewal notice, or opts out at a later time, then the ongoing fee arrangement terminates. Once the arrangement is terminated, the fee recipient must cease charging the ongoing fee.

The licensee/representative which enters into the ongoing fee arrangement with the retail client is referred to as the fee recipient. All express obligations under "opt-in" fall on the fee recipient. Accordingly, it is imperative that the fee recipient be properly identified, especially where payments flow between entities.

Before I discuss "opt-in" in full, I should note that the Coalition proposes to remove it in full, following its announcement in December 2013. Again, the Coalition's proposals will be the subject of a separate paper when they are legislated.

What is an "ongoing fee arrangement"?

An "ongoing fee arrangement" is defined in section 962A as an arrangement under which an AFS licensee, or its representative, gives personal advice to a retail client and where fees are to be paid for *more than* 12 months.

It is a condition of the ongoing fee arrangement that the client may terminate the arrangement at any time.[13]

Section 962D provides that the opt-in requirements apply to an ongoing fee arrangement entered into on or after 1 July 2013 where the client has not been provided with personal advice before that date by the adviser. This is the "grandfathering" provision.

Is there an exemption from "opt-in"?

Section 962CA introduces a new power for ASIC to exempt a person or class of persons from complying with the opt-in requirements if ASIC is satisfied that the person, or class of persons, is bound by a code of conduct approved by ASIC.

What is the renewal notice?

For those arrangements to which "opt-in" applies (ie they are not grandfathered), the fee recipient must, within a period of 30 days beginning on the "renewal notice day", give the retail client a renewal notice[14]. For the ongoing fee arrangement to continue, *the client must notify the fee recipient in writing, within the "renewal period", that the arrangement is to continue.*

For the purposes of the above:

- The "renewal notice day" is – for the first renewal of the arrangement – the second anniversary of the day on which the arrangement was entered into[15]. Given that the renewal notice does not need to be given in relation to grandfathered arrangements, and hence can only apply in relation to ongoing fee arrangements commencing on or after 1 July 2013 for the AFS licensee, this means that no renewal notice day for any of the AFS licensee's retail clients will be earlier than *1 July 2015*.

  For subsequent renewals, the renewal notice day will be the second anniversary of the last day on which the arrangement was previously renewed.

- The "renewal period" is 30 days beginning on the day on which the renewal notice is given by the fee recipient.[16]

[13] Section 962E.
[14] Section 962K.
[15] Section 962L.
[16] Section 962L.

If the client notifies the fee recipient in writing within the renewal period that they do not wish to renew the arrangement, the arrangement terminates on the day the notification is given.[17]

If the client does *not* notify the fee recipient in writing within the renewal period that they wish to renew the arrangement, the arrangement terminates 30 days after the end of the renewal period[18]. This effectively allows the ongoing fee arrangement to continue for 90 days after the second anniversary date.

Section 962K(2) outlines the content requirements for a renewal notice.

What else needs to be given to retail clients?

Even where:

- an "ongoing fee arrangement" is grandfathered (meaning there is no obligation to give a renewal notice); and/or
- the fee recipient is exempt from having to comply with the "opt-in" requirements,

the fee recipient still needs to give the retail client a "fee disclosure statement".[19]

Timing of fee disclosure statements

Section 962G of the Corporations Act provides that the fee disclosure statement needs to be given before the end of a period of 30 days beginning on the "disclosure day" for the ongoing fee arrangement.

The "disclosure day" is one of the following:[20]

- if no fee disclosure statement has previously been given – the anniversary of the day on which the arrangement was entered into; or
- otherwise – 12 months from the period to which the previous fee disclosure statement related.

Section 962H(2) outlines the content requirements for a fee disclosure statement.

Issues for consideration

The "opt-in" regime raises a number of issues. Some immediate questions include the following:

Does there need to be a connection between the ongoing fee and the personal advice provided?

The ongoing fee does not have to be connected to the personal advice provided by the fee recipient.

[17] Section 962M.
[18] Section 962N.
[19] Section 962S.
[20] Section 962J.

In view of the above, does this mean that any ongoing fees charged by a fee recipient (including product fees), are subject to "opt-in"?

A number of concerns were raised by the Industry that the drafting of the "ongoing fee arrangement" provisions was such that most fees charged by an AFS licensee (including product fees) were caught, meaning that the retail client needed to "opt-in" to paying, say, account fees or management fees.

Section 962A(5) of the Corporations Act excludes from an "ongoing fee arrangement" those arrangements which "*[relate] to a fee that is prescribed as a product fee*".

Regulation 7.7A.10(2) of the Corporations Regulations 2001 (Cth) provides that, for the purposes of section 962A(5):

> "*a product fee is a fee that the issuer of a financial product charges a retail client in relation to the administration of a financial product issued to the client*."

On the basis of the above, fees such as product fees, account-keeping fees, management fees, administration fees etc… charged by the *product issuer*, will not be caught. This is in keeping with the legislative intent of the "opt-in" regime, which was to target ongoing *adviser* service fees.

What else is exempt from being an "ongoing fee"?

Section 962A(3) of the Corporations Act excludes from an "ongoing fee arrangement" those fees *the total of which are known, except that they are being paid over a period of more than 12 months*. If the total fees to be paid under the arrangement are known in advance, and the client cannot "opt out" of paying them, then they will be exempt from "opt-in".

Separately, section 962A(4) of the Corporations Act excludes insurance premiums from an "ongoing fee arrangement", so long as the insurance premiums are the only fees payable under the arrangement.

What is the scope of "grandfathering"? Are all ongoing fee arrangements grandfathered in relation to a retail client once that client has received advice prior to 1 July 2013?

The "opt-in" provisions are expressly clear that they only apply where the retail client has not been provided with personal advice prior to the commencing day (which for the AFS licensee is 1 July 2013), and in relation to "ongoing fee arrangements" entered into on or after 1 July 2013.[21]

Accordingly:

- All pre-1 July 2013 "ongoing fee arrangements" will be grandfathered.
- All post-1 July 2013 "ongoing fee arrangements" will be grandfathered in relation to a retail client who has received personal advice from the fee recipient pre-1 July 2013.

[21] Section 962D.

The second point above widens the scope of grandfathering considerably, given - as indicated above – that there does not need to be a connection between the personal advice given and the ongoing fees charged. Accordingly, so long as the retail client received personal advice prior to 1 July 2013, all future ongoing fee arrangements between the client and the fee recipient will be grandfathered.

When do fee disclosure statements need to be given in respect of grandfathered arrangements?

The definition of "disclosure day" (discussed above) raises the question of when the first fee disclosure statement needs to be given to an existing retail client with whom the fee recipient has an ongoing fee arrangement (ie grandfathered arrangements). What if the arrangement commenced, say, on 1 July 2005? Does this mean that a fee disclosure statement should have been given before 31 July 2006? In other words, does section 962G have retrospective effect?

Regulations have not been made to date to expressly deal with this position. It is accepted, however, that:

- in what is known as the "golden rule" of statutory interpretation, the literal meaning of words used in legislation should not be adopted if they lead to absurd or unreasonable results[22]; and

- a legislative provision should not have retrospective effect unless it is expressly or impliedly designed to be of retrospective effect. There is also a general principle of law which creates a *presumption* against retrospectivity.[23]

Does this mean that we can proceed on the basis that the "disclosure day" for the provision of the first fee disclosure statement in respect of grandfathered arrangements, cannot be earlier than the *anniversary date which first occurs from 1 July 2013*? Either way, the anniversary date for all existing arrangements needs to be determined. This may prove tricky for legacy clients.

The industry expects legislative change to deal with these issues, following the Coalition's announcement in December 2013.

How do we know when an "ongoing fee arrangement" has commenced?

There is no exact science in determining when an ongoing fee arrangement commenced. This is because it must by definition be determined on a case-by-case basis: in some cases, it will be the date on which the client's account was opened; in other cases, the arrangement may have commenced well after the opening of the client's account. Also, does "commencement" mean the date of receipt of the first ongoing payment, or is it the date on which the fee recipient's *right* to be paid first arises?

ASIC appears to understand the concerns around determining "disclosure days" for grandfathered clients. In ASIC Regulatory Guide 245 (**RG 245**), ASIC provides as follows:[24]

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[22] *Sakhuja v Allen* [1973] AC 152.
[23] *Fisher v Hebburn Ltd* (1960) 105 CLR 188.
[24] RG 245.60 - 245.62.

"*We expect fee recipients to document the approach taken to identify the date that ongoing fee arrangements were entered into with existing clients and to apply that approach consistently across their client book. We accept that they might take different approaches for different categories of client.*

Where it is impossible or unreasonably difficult to identify the actual date that an ongoing fee arrangement was entered into with an existing client, we think fee recipients should adopt a common sense approach. For example, they could give the first [fee disclosure statement] to all existing clients within 30 days of 1 July 2013.

Alternatively, if it is impossible or unreasonably onerous to determine the day an ongoing fee arrangement was entered into with an existing client, we will not take enforcement action against a fee recipient (for failing to provide the [fee disclosure statement] to an existing client within a period of 30 days beginning on the first disclosure day) if the fee recipient:

(a) notifies the client in writing of the date (between 1 July 2013 and 31 January 2014) they will treat as the anniversary of the day on which the ongoing fee arrangement was entered into;

(b) explains to the client the significance of that date for the purposes of the [fee disclosure statement] obligations; and

(c) provides the client with [a fee disclosure statement] within 30 days of the first anniversary of that date."

When do payments need to be switched off?

Payments need to be switched off immediately upon the *termination* of the ongoing fee arrangement. Analysing the above, we can see that there are essentially 5 possible termination dates of an ongoing fee arrangement. These are as follows. Note these apply only in relation to *non-grandfathered* arrangements.

- If the client notifies the fee recipient in writing within the renewal period that they do not wish to renew the arrangement, the arrangement terminates *on the day the notification is given*.

- If the client does *not* notify the fee recipient in writing within the renewal period that they wish to renew the arrangement, the arrangement terminates *30 days after the end of the renewal period*. This effectively allows the ongoing fee arrangement to continue for 90 days after the second anniversary date.

- Consistent with the above, if the client "opts-in" to the ongoing fee arrangement *outside* the renewal period (for example, 40 days after receiving the renewal notice), the arrangement will still terminate *30 days after the end of the renewal period*: this is because the legislation strictly requires "opt-in" to occur *within the renewal period*. Effectively, this means that the fee recipient will need to commence a new ongoing fee arrangement with the client.

- If the client notifies the fee recipient in writing outside the renewal notice period that they do not wish to renew the arrangement, the arrangement terminates *on the day the notification is given*.

- If the fee recipient does not comply with the requirements for the giving of a renewal notice and a fee disclosure statement to the retail client (ie both the obligation to give the documents the content of which accord with the requirements of the Corporations Act, and to give them within the prescribed time), the arrangement terminates *on the day which follows the end of the prescribed period for giving the documents*.

Note that the legislation does *not* expressly provide that the failure to give a fee disclosure statement in relation to *grandfathered* arrangements, causes the arrangement to terminate. However, it does provide that the failure to do so for grandfathered arrangements, is a civil penalty provision. This means the fee recipient is liable to pay a penalty.

Is the fee recipient entitled to pro-rata payments?

Where an arrangement is terminated, the fee recipient is entitled to be paid its accrued entitlements. To given an example, if an arrangement was such that monthly fees were payable, the termination of the arrangement half-way through that monthly cycle would mean the fee recipient was entitled to 50% of that monthly fee.

PART II - PROHIBITED PAYMENTS

3 Conflicted remuneration and volume-based shelf-space fees

AFS licensees participate in one way or another in arrangements with other licensees and/or their representatives. Invariably, some of these arrangements will provide for payments or receipts which from 1 July 2013 are prohibited under FOFA, either because they represent the payment/receipt of "conflicted remuneration", and/or the receipt of "volume-based shelf-space fees".

Conflicted Remuneration

Conflicted remuneration is any benefit (monetary or soft-dollar), given to a licensee/representative who provides financial product advice to a retail client, that could reasonably be expected to influence the choice of financial product recommended or the advice given to the retail client.[25]

FOFA imposes a prohibition on both a licensee/representative *accepting* conflicted remuneration, and an issuer/seller *providing* conflicted remuneration.[26] In addition, FOFA expresses a presumption that a volume-based benefit is conflicted remuneration.[27]

The prohibition is primarily targeting adviser trail commissions and rebates.
Exceptions to the prohibition include the following:[28]

[25] Section 963A.
[26] Sections 963E - 963K.
[27] Section 963L.
[28] Sections 963B and 963C.

- benefits given solely in relation to insurance products, *except* group life policies and life policies for default members (ie these last items are caught by the prohibition).

- benefits given by the retail client.

- soft-dollar benefits less than $300 and which are infrequent.

- soft-dollar benefits for genuine training/education purposes or for IT support, and which are relevant to the provision of financial services.

Note the ban on conflicted remuneration currently applies where "financial product advice" is provided: that is, it applies even when merely *general* advice is provided. The Coalition proposes, however, to limit the ban on conflicted remuneration to *personal* advice.

Volume-based shelf-space fees

Where an AFS licensee (referred to as a *platform operator* for the purposes of the prohibition) provides a *custodial arrangement*, a benefit is given by a fund manager to the *platform operator*, and a financial product to which the custodial arrangement relates is a product in which the fund manager deals, then that benefit is prohibited if it is a *volume-based shelf-space fee*.[29]

FOFA prohibits the platform operator from accepting the volume-based shelf-space fee.[30]

Section 964 is a complicated provision on its face. In simple terms, however, it is attempting to deal with the situation comparable to where food distributors pay more to have their products on preferential shelving in supermarkets (ie they buy "shelf space"). In the financial services context, it is referring to the situation where product manufacturers pay more to have their products listed on platforms or APLs.

Flat fees are not volume-based, and so are not caught by the prohibition.

There are some exceptions to the prohibition, however, as follows:[31]

- reasonable fees for service provided to the fund manager by the platform operator. The scope of this exception appears clear on its face.

- discounts/rebates paid to the fund manager, the value of which do not exceed an amount that may reasonably be attributed to efficiencies gained by the fund manager because of the number or value of financial products in relation to which the fund manager provides services to the platform operator.

Note the prohibition makes reference to a "custodial arrangement", which is defined for these purposes to have "*the same meaning as it has in [section] 1012IA [of the Corporations Act]…*".[32]

[29] Section 964.
[30] Section 964A(1).
[31] Section 964A(3).
[32] Section 964(2).

"Custodial arrangement" is defined in section 1012IA to mean "*an arrangement between a person (the provider) and another person (the client) (whether or not there are also other parties to the arrangement) under which:*

(a) the client is, or is entitled, to give an instruction that a particular financial product, or a financial product of a particular kind, is to be acquired; and

(b) if the client gives such an instruction, a person (the acquirer), being the provider or a person with whom the provider has or will have an arrangement, must (subject to any discretion they have to refuse) acquire the financial product, or a financial product of that kind; and

(c) if the acquirer acquires the financial product, or a financial product of that kind, pursuant to an instruction given by the client, either:

(i) the product is to be held on trust for the client or another person nominated by the client; or

(ii) the client, or another person nominated by the client, is to have rights or benefits in relation to the product or a beneficial interest in the product, or in relation to, or calculated by reference to, dividends or other benefits derived from the product."

In simple terms, a custodial arrangement arises where a client is entitled to give instructions to a provider to acquire a particular financial product, and the provider must acquire that product, subject to any discretion they have to refuse to acquire that product. It typically encompasses "wrap"-style products and Investor Directed Portfolio Services (often referred to as "IDPSs").

Grandfathering

FOFA, however, grandfathers to some extent the provision/receipt of conflicted remuneration and volume-based shelf-space fees which would otherwise be prohibited, if they are given under an "arrangement" entered into *before* 1 July 2013.[33]

What is an "arrangement"?

"Arrangement" is defined in section 761A of the Corporations Act to mean:

"*…a contract, agreement, understanding, scheme or other arrangement (as existing from time to time):*

(a) whether formal or informal, or partly formal and partly informal; and

(b) whether written or oral, or partly written and partly oral; and

(c) whether or not enforceable, or intended to be enforceable, by legal proceedings and whether or not based on legal or equitable rights."

This definition is very broad, with the consequence that it can be satisfied in a broad range of circumstances. The words "*(as existing from time to time)*" suggest that changes can be made

[33] Sections 1528 and 1529.

to an existing arrangement with the effect that a *new* arrangement is formed. This leads to the question as to what type of changes are required in order for a new arrangement to be formed.

With this in mind, one can already see that it is crucial that an analysis of all existing payment arrangements in which an AFS licensee participates with other licensees and/or representatives is undertaken to determine which of those falls within the meaning of an "arrangement" under the Corporations Act. Once those arrangements are determined, it is necessary to assess which payments/receipts under those arrangements are at risk of losing grandfathering in the event that changes are made on and from 1 July 2013 such that it could be said that a *new* arrangement then arises. Where this occurs, all prohibited payments/receipts must cease in relation to that *new* arrangement.

What is the scope of the grandfathering concession for pre-1 July 2013 arrangements?

The proposed legislation governing the grandfathering of existing arrangements has taken many forms, and has been extremely confusing in a number of respects. Accordingly, it is helpful to survey how the grandfathering provisions have evolved to where they sit today.

Prior to March 2013, the legislation operated to widen the scope of the grandfathering concession considerably. For example:

- Industry was advised in late 2012 that draft regulations released in July 2012, which had the effect of removing grandfathering protection for conflicted remuneration paid in relation to *new* financial products acquired post-1 July 2013, would *not* be proceeded with. On this basis, all payments made pursuant to pre-1 July 2013 arrangements - even where they relate to a new financial interest acquired post-1 July 2013 - could continue to be grandfathered.

- draft regulations, which were issued in September 2012, would allow "platform operators" to grandfather existing arrangements under which conflicted remuneration is paid. Prior to these draft regulations, the legislation as it then stood prevented a platform operator from being able to grandfather existing arrangements, meaning that *all* payments of conflicted remuneration to a platform operator and receipts from a platform operator would need to cease on and from 1 July 2013.

On the basis of the above, all prohibited payments/receipts of conflicted remuneration and volume-based shelf-space fees pursuant to existing arrangements could continue post-1 July 2013, for so long as those *existing arrangements* continued on foot.

So what's changed?

In March 2013, further draft regulations were released for consultation, which operated to narrow the scope of the grandfathering concession in relation to *conflicted remuneration*.

The draft regulations proposed the following:

- where benefits are given by a "platform operator", grandfathering will only apply to the extent that the payment is made under a pre-1 July 2013 arrangement, and which relate to a "custodial arrangement" provided by the platform operator on the instruction of a person, who had given the instruction prior to 1 July 2014.

- where benefits are given by someone other than a platform operator, grandfathering will only apply to the extent that the payment is made under an existing (ie pre-1 July 2013) arrangement, and in relation to the acquisition of a financial product by a retail client who did not have an interest in the product immediately before 1 July 2014.

In simple terms, the draft regulations aimed to apply the ban on conflicted remuneration to new financial products acquired by retail clients post-1 July 2014. To the extent that conflicted remuneration is to be paid in relation to a pre-1 July 2013 arrangement, those payments can only continue to be made to the extent that they relate to financial products held by retail clients as at 30 June 2014.

The regulations were formally enacted on 28 June 2013, but with some technical changes.

The regulations *as they now stand* provide the following:[34]

- where a "platform operator" acts *in that capacity* and gives a benefit which relates to an acquisition of a financial product on the instructions of a client, the benefit will be grandfathered only if the client has given the platform operator an instruction to open *an* account on the platform before 1 July 2014. In other words, grandfathering will apply only in relation to existing clients or clients who apply to open an account on the platform before 1 July 2014.

- where a benefit is given by someone not acting in the capacity of a platform operator, and it is given in relation to the acquisition of a financial product for the benefit of a retail client, the benefit will be grandfathered only where the product is acquired before 1 July 2014.

In very general terms, the regulations appear to provide that grandfathering:

- will *apply* in relation to pre-1 July 2014 financial products acquired by pre-1 July 2014 clients;

- will *not* apply in relation to post-1 July 2014 financial products acquired by *post*-1 July 2014 clients;

- will *apply* in respect of post-1 July 2014 financial products acquired by *pre*-1 July 2014 clients, but only where the benefit in question is provided by a platform operator.

In all cases, for any form of grandfathering to apply, the arrangement in question (ie under which the benefits are provided) must be a *pre*-1 July 2013 arrangement.

The regulations also clarify that the following will not be treated as an acquisition of a financial product post-1 July 2014:

- a retail client has an interest in a managed investment scheme pre-1 July 2014 and acquires a further interest in it post-1 July 2014;

[34] Part 7.7A of the *Corporations Regulations 2001* (Cth).

- a "multi-product offering" offers interests in more than one financial product under one offer document, and a retail client opened an account on the multi-product offering pre-1 July 2014 and acquires an interest or a further interest under the facility post-1 July 2014.

There are some further rules, dealing with provision of benefits to employees under enterprise agreements, and separate rules which clarify other technical aspects of the reforms.

The new regulations also appear to suggest that benefits given by a platform operator but which do not relate to the licensee acting as a platform operator for the acquisition of financial products (for example, marketing or sponsorship payments), will not have any grandfathering protection.

What is the scope of an "arrangement"?

Refer to the following by way of a simple example:

The above represents a set of relationships commonly found in the industry, in which the product issuer pays a volume-based rebate to a dealer group, which in turn remunerates its financial advisers. Each of the product issuer and the dealer group is an AFS licensee. The financial advisers would either be authorised representatives of the dealer group, or AFS licensees in their own right.

A number of "arrangement" scenarios can arise above. For example:

- The most common (or likely) scenario is that there are two separate groups of "arrangements" in place here for FOFA purposes: there is one "arrangement" between the product issuer and the dealer group; separately, there are individual "arrangements" between the dealer group and each financial adviser under the dealer group's coverage.

- It could also be the case that the above encapsulates one global "arrangement", involving the product issuer, dealer group and financial adviser. This could be the case even if there were separate agreements between the product issuer and the dealer group, and between the dealer group and a financial adviser: the terms of the agreement themselves do not necessarily limit the scope of an "arrangement", particularly if, for example, the one agreement expressly contemplates the same payment flowing between the product issuer and the financial advisers and provides a regime for the flow of monies between the three groups of entities.

- Also, it could be the case that the product issuer and the dealer group have multiple arrangements between them: for example, if there were separate contractual agreements between them, *each of them dealing with a specified product or class of products*. Alternatively, there may be one agreement encapsulating every product issued by the product issuer (and all future products).

In considering the potential breadth of an "arrangement", it is useful to consider the entity to which benefits are being provided. This will more often than not assist in determining the participants in an arrangement, and the payments underpinning it. However, we should be mindful of the following:

1. A does not give a benefit to C merely because A gives a benefit to B who, in turn, gives the benefit or a benefit to C. In such a case, it is likely that there are two separate groups of "arrangements" in place here for FOFA purposes: one between A and B; the other between B and C.

2. A's mere awareness that B may or does distribute the benefit it receives to C does not mean that A itself gives a benefit to C.

3. If A positively participates in the broader distribution of the benefit it gives, for example by making payments to C at the direction or request of B, the outcome could well be different. This may well be an example of the global "arrangement" referred to above, involving the product issuer, dealer group and financial adviser. This could be the case even if there were separate agreements between the product issuer and the dealer group, and between the dealer group and a financial adviser: the terms of the agreement themselves do not necessarily limit the scope of an "arrangement".

Following the above, can we develop a simple proposition of law?

Putting the analysis simply, a proposition of law could be adopted to provide that an "arrangement" for FOFA purposes may be scoped by reference to the relevant agreement/document (for example, a contract or client application form), series of agreements/documents, set of circumstances or courses of dealing (particularly where there is no oral or written contract) under which a licensee's or authorised representative's entitlements

to conflicted remuneration or volume-based shelf-space fees are derived, and under which those entitlements are expressly or impliedly contemplated.

Ultimately, and as can be seen from the above analysis, it is question of fact as to what arrangements are in place at any given time. These need to be assessed on a case-by-case basis.

What are examples of "arrangements"?

At a high level, "arrangements" would include at least the following:

- Rebate agreements
- Service agreements
- Client application forms
- SoAs
- Employment contracts.

What gives rise to a "new" arrangement?

Any proposed changes to existing arrangements on and from 1 July 2013, such that it could be said that a *new* arrangement then arises, will cause existing grandfathering to be lost, meaning all prohibited payments/receipts under that arrangement must cease.

The relevant question, then, is the scope to which an existing arrangement can be modified without causing a new arrangement to arise. Of course, and by necessity, this will need to be assessed on a case-by-case basis, which makes it difficult to develop broad guidelines which can be applied against every fact scenario.

In undertaking such an assessment, we would need to consider elements such as:

- contractual obligations;
- contractual rights;
- course of dealing / patterns of conduct;
- performance;
- flows of payments/benefits etc…

In view of the above, query whether, when and how a *new* arrangement might arise in any of the following circumstances:

Adding a new product or class of products

Does adding a new product to an existing contractual arrangement, without other amendments, and where that arrangement contemplates more than one product, give rise to a *new* arrangement? Alternatively, is it possible that a new arrangement might arise solely in relation to the new product?

New clients

Will a *new* arrangement between the following entities in any of the following scenarios arise:

- Between a product issuer and a dealer group in relation to the payment of conflicted remuneration when a client is signed up by the dealer group post-1 July 2013, when the arrangement extends to all clients of the dealer group?

- Between a product issuer and a financial adviser / representative, in relation to the payment of conflicted remuneration when a client is signed up by the adviser/representative post-1 July 2013, when the arrangement extends to all clients of the adviser/representative?

- Between a dealer group and an individual adviser/representative in relation to the payment of conflicted remuneration when a client is signed up by the adviser/representative post-1 July 2013, when the arrangement extends to all clients of the adviser/representative?

Amending rebate amounts

Will amending the amount of a fee/rebate payable under an arrangement, without other amendments, give rise to a *new* arrangement? What if the quantum of the change is from 25 basis points (**bps**) to 30 bps? What about where the change is from 25 bps to 200 bps? What if the change is a *decrease* in fees?

Mergers/takeovers by licensees

Does a *new* arrangement arise in the event that an AFS licensee merges with, or is taken over by, another AFS licensee? What about the case where – following a merger/takeover – the licensee in question either ceases to exist as an entity or ceases to hold a financial services license?

Establishing new platforms or restructuring existing platforms

Does the establishment of a new platform, or the restructure of an existing platform, give rise to a *new* arrangement?

New licensees/representatives

Will a *new* arrangement arise when relationships with new licensees/representatives are formed (whether in writing or otherwise)? For example:

- A dealer group enters into an arrangement with a new adviser/representative for the payment of trail commissions.

- A fund manager enters into a rebate contract with a new dealer group.

Greater contractual obligations

Will a *new* arrangement arise when an existing contract is amended to insert new provisions which have the effect of imposing greater obligations on a party than was previously the case?

New payment regime

Will a *new* arrangement arise when an existing contract is amended to insert a new payment regime which alters the nature and form of the payment obligations under the existing contract (ie goes beyond merely changing the *amount* of a payment), and which was not contemplated by the existing contract?

In view of the above, it is important for AFS licensees to have adequate guidelines in place against which changes to existing arrangements, or the entry into new arrangements, can be assessed to determine whether they give rise to adverse FOFA impacts (for example, the loss of grandfathering).

Legal advice should be obtained on the FOFA risks of proposed changes to existing arrangements, or the entry into new arrangements. Existing processes will need to be updated to incorporate a legal review of proposed changes to existing arrangements, or the entry into new arrangements.

4 Asset-based fees on borrowed amounts

Section 964D(1) of the Corporations Act provides that an AFS licensee:

> "*must not charge an asset-based fee on a borrowed amount used or to be used to acquire financial products by or on behalf of a retail client.*"

Section 964E(1) imposes the same prohibition on representatives of licensees.

The prohibition applies where an AFS licensee (or a representative) provides *financial product advice* to a *retail client.*[35] Therefore, it applies where *general advice* and/or *personal advice* is provided (ie not just personal advice).

An "asset-based fee" is defined as follows:[36]

> "*A fee for providing financial product advice to a person as a retail client is an* ***asset-based fee*** *to the extent that it is dependent upon the amount of funds used or to be used to acquire financial products by or on behalf of the person*."

The other relevant term is "borrowed", which is defined to mean:[37]

[35] Section 964B.
[36] Section 964F.
[37] Section 964G.

"*borrowed in any form, whether secured or unsecured, including through…a credit facility…and…a margin lending facility*".

It also provides that an amount is no longer "borrowed" to the extent that it has been repaid.

What is the prohibition trying to target?

Any fees charged by a licensee/representative (as applicable), which has provided financial product advice to a retail client, on borrowed amounts used by the client to acquire financial products, are banned from 1 July 2013.

In short, the ban is targeting fees such as contribution fees and adviser service fees / member advice fees, to the extent that they are charged on the *borrowed/geared portion of funds used to acquire financial products.*

The ban applies to both upfront fees (eg contribution fees), and ongoing fees (eg annual member advice fees).

The ban does *not* apply to such fees charged on ungeared portions of funds used to acquire financial products.

The ban also does *not* apply:

- to wholesale clients;
- if it is not "reasonably apparent" that the amount has been borrowed.[38] Note, however, there is an express provision which states that none of the rules affect the duty of the licensee/representative to make reasonable enquiries to obtain complete and accurate information.[39] This suggests some overlap with the "best interests" duty; and
- to the extent that the borrowed amount has been repaid.[40]

Is grandfathering available?

Section 1531(1) of the Corporations Act provides that the prohibition only applies to the extent that the borrowed amounts (on which the asset-based fees are charged) are used to acquire financial products *on or after the "commencing day"* (which is **1 July 2013** for the AFS licensee). In other words, to the extent that the asset-based fees are charged on borrowed amounts used to acquire financial products *prior to 1 July 2013*, the ban will *not* apply. This is so even if the fees are charged post-1 July 2013.

PART III - ANTI-AVOIDANCE

5 What is the "anti-avoidance" regime?

Section 965 of the Corporations Act provides as follows:

[38] Section 964D(3)
[39] Section 964D(5).
[40] Section 964G(2).

"*(1) Subject to subsection (2), a person must not, either alone or together with one or more other people, enter into, begin to carry out or carry out a scheme if:*

(a) it would be concluded that the person, or any of the people, who entered into, began to carry out or carried out the scheme or any part of the scheme did so for the sole purpose or for a purpose (that is not incidental) of avoiding the application of any provision of Part 7.7A (which includes the conflicted remuneration provisions) in relation to any person or people; and

(b) the scheme or the part of the scheme has achieved, or apart from this section, would achieve, that purpose.

This will be referred to as **anti-avoidance**.

Anti-avoidance came into effect *on and from* **1 July 2012**. That is, it is not subject to any transitional arrangements (which apply, for example, in relation to the prohibitions on payment/receipt of conflicted remuneration and receipt of volume-based shelf-space fees).

What if anti-avoidance is breached?

Anti-avoidance is a civil penalty provision[41]. Breaching anti-avoidance can expose an AFS licensee and its authorised representatives to one of more the following:

1. "Declaration of contravention" by a Court.

2. Following the above, ASIC can seek pecuniary penalty orders of up to $200,000 per offence.

3. ASIC can also order "disqualification orders" against, say, directors of an AFS licensee.

Operation of anti-avoidance

Anti-avoidance is very broad in its operation. It has three main elements:

1. "scheme";

2. "purpose"; and

3. "*avoiding the application of any provision of Part 7.7A*".

Anti-avoidance, and the elements above, raises the following issues:

1. What is a "scheme"?

2. What is meant by "purpose"?

3. What does it mean to "*avoid the application of any provision of Part 7.7A*"?

[41] Section 1317E.

4. Are schemes carried out between 1 July 2012 and 1 July 2013 subject to "anti-avoidance"?

5. Are schemes carried out *before* 1 July 2012 subject to anti-avoidance? How can far back can anti-avoidance apply? Does anti-avoidance therefore have retrospective effect?

6. What is ASIC's position on anti-avoidance?

An analysis of each of these issues is provided as follows.

What is a "scheme"?

"Scheme" is not defined in the Corporations Act. However, it is generally accepted that "scheme" has a very broad application, in that it will encompass any transaction, event, or course of conduct designed to bring about a particular outcome.

What is meant by "purpose"?

"Purpose" can essentially be equated with motive. For anti-avoidance to apply, the "purpose" of the "scheme" has to be the avoidance of the FOFA prohibitions, however that avoidance must be more than "incidental". This last part is crucial: without it, every transaction which has the effect of avoiding a FOFA prohibition would be caught by anti-avoidance. This is not the intention of the provision, however. Rather, anti-avoidance looks to the motive of a transaction, and whether the outcome (ie avoidance of a prohibition) was driven by that motive. More will be said about this below.

What does it mean to "avoid the application of any provision of Part 7.7A"?

This appears straight-forward on its face. Clearly, a scheme which has the effect of avoiding the application of the ban on say, conflicted remuneration, would be an example of avoiding the application of a provision of Part 7.7A.

What if a scheme was entered into for the purposes of, say, falling within an *exception* to a prohibition? Would this be seen as "avoiding the application of Part 7.7A"? The industry position appears to be that the answer should be "No". That is, entering into a scheme for the purposes of falling within an *exception* to a prohibition, would not fall foul of anti-avoidance. This is on the basis, presumably, that an express *exception* to a prohibition is of itself within Part 7.7A.

Are schemes carried out between 1 July 2012 and 1 July 2013 subject to anti-avoidance? Are schemes carried out before 1 July 2012 subject to anti-avoidance? How can far back can anti-avoidance apply? Does anti-avoidance therefore have retrospective effect?

Each of the above questions raises similar issues, so they will be considered together.

FOFA is (deliberately) silent on the commencement period from when a new arrangement is at risk of breaching anti-avoidance. In one of the last series of iterations to the FOFA Bills (mid 2012), the Coalition (whilst in opposition) proposed an express amendment that only arrangements entered into *on and from 1 July 2012* should be subject to anti-avoidance, however this was rejected in the final reforms.

In theory, then, any new arrangement entered into from when the FOFA reforms were first announced (around 2009-2010) could constitute anti-avoidance if it meets the threshold requirements outlined above.[42]

It needs to be asked, however, whether anti-avoidance will be applied so strictly. What about transactions such as entering into a new dealer agreement, or varying existing agreements, which are within the normal commercial operations of a platform operator / fund manager etc...? Query whether such transactions of themselves would fall under the microscope of anti-avoidance. This of course needs to be assessed on a case-by-case basis. Other, more radical, transactions such as product restructures would likely be scrutinised in any event.

What is ASIC's position on anti-avoidance?

ASIC, in its Regulatory Guide 246 (**RG 246**), provides some examples of schemes which would give rise to anti-avoidance risks.

As a broad proposition, ASIC comments that:[43]

> "*The anti-avoidance provision is designed to ensure that the policy intent of the FOFA Acts, including the conflicted remuneration provisions, is not avoided through industry or transaction restructuring*."

It also provides that:[44]

> "*In administering the anti-avoidance provision, we are less likely to scrutinise schemes that are normal commercial transactions conducted in the ordinary course of business*."

On one view, it might be suggested that ASIC will only scrutinise *restructures* as such for anti-avoidance, meaning that transactions such as entering into new agreements or amending existing agreements will be less likely to be scrutinised by ASIC. AFS licensees, however, should caution against adopting this position.

What is clear from the above is that any changes to existing arrangements, or the entry into new arrangements, which have the outcome of avoiding the application of any FOFA provision, must be assessed from an anti-avoidance perspective.

PART IV - OTHER MATTERS

6 Unjust acquisition in breach of the Commonwealth Constitution

The prohibitions in relation to conflicted remuneration, volume-based shelf-space fees, and asset-based fees on borrowed amounts, the corresponding grandfathering provisions, and the anti-avoidance regime, each do *not* apply to extent that they would constitute the acquisition of property in breach of the Article 51(xxxi) Commonwealth Constitution.

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[42] "Anti-avoidance" would only kick in from 1 July 2012 however, as this is when the regime came into effect. Putting it another way, "anti-avoidance" does not have retrospective effect.

[43] RG 246.17.

[44] RG 246.227.

Article 51(xxxi) provides that the Commonwealth can make laws with respect to the acquisition of property on *just* terms from any state or person for any purpose in respect of which the Commonwealth has power to make laws.

The legal and academic question, thus, is whether the imposition of any or all of the above-mentioned provisions, constitutes an acquisition by the Commonwealth of property of those impacted (namely, AFS licensees and their representatives) on *unjust* terms, meaning they infringe the Commonwealth Constitution.

Indeed, the grandfathering provisions were inserted because of Treasury's concern that the prohibitions on conflicted remuneration, volume-based shelf-space fees, and asset-based fees on borrowed amounts - *without any grandfathering* - would amount to an unjust acquisition of property in breach of Article 51(xxxi) of the Commonwealth Constitution. The "property" in these cases was identified to be *existing contractual rights of licensees/representatives* to otherwise prohibited payments.

One can see that the grandfathering provisions do undermine the impact of the FOFA reforms.

It will be interesting to see if an AFS licensee is prepared to test the application of Article 51(xxxii) to FOFA. Being in relation to the Commonwealth Constitution, the High Court of Australia would need to hear any such case in its original jurisdiction.

Whilst there is case law on the meaning, scope and operation of Article 51(xxxi), I am not aware of any cases which, on their facts, could directly apply to FOFA. What we do have, however, is a very recent decision of the High Court - being the tobacco "plain packaging legislation" case (**Plain Packaging Case**)[45] - which discussed Article 51(xxxi) in significant detail in the context of intellectual property rights, and which appeared to apply a very strict and literal interpretation to the words used in Article 51(xxxi): specifically (and somewhat obviously), that there had to be an *acquisition* by the *Commonwealth* of existing *property*.

A discussion of the meaning, scope and operation of Article 51(xxxi) is beyond the scope of this paper, however given the High Court's position on Article 51(xxxi) as provided in the Plain Packaging Case, it would be difficult to conclude that the High Court would determine that the FOFA prohibitions constitute an unjust acquisition of property in breach of the Commonwealth Constitution, as it is difficult to see how the "property" in question (if any) has been *acquired by the Commonwealth*.

7 Conclusion: FOFA Checklists

In view of the complexities of the FOFA reforms, and their breadth and scope, AFS licensees and their representatives will need to take steps to ensure that:

- Where the AFS licensee or its authorised representatives provide *personal* advice to retail clients:
    - policies/procedures and client documents (fact finders; SoAs etc…) are amended to demonstrate compliance with the best interests duty and enable reliance on the "safe harbour";

[45] *JT International SA v Commonwealth of Australia* and *British American Tobacco Australasia Limited v The Commonwealth* [2012] HCA 43.

- APLs are reviewed and policies regarding use of APLs and selection of investments for retail clients are amended;
- grandfathered clients have been identified;
- an assessment of whether an ASIC exemption from the "opt-in" obligations is required, has been undertaken; and
- the form, content and timing requirements of the fee disclosure statements required to be sent to clients annually, have been met.

- The AFS licensee has determined whether it is a "platform operator" for FOFA purposes, and whether it acts in that capacity with regard to the acquisition of financial products by retail clients.

- It is satisfied that other licensees with whom it has an "arrangement", have been appropriately classified as either a "platform operator" or a non-"platform operator".

- The AFS licensee has reviewed all existing and proposed payment arrangements in which it participates with other licensees or their authorised representatives, to determine which of those would constitute an "arrangement" for FOFA purposes.

- The AFS licensee has documented written guidelines on the meaning of "arrangement" and the scope of grandfathering for the purposes of the bans on conflicted remuneration and volume-based shelf-space fees, and on when a "new" arrangement arises.

- The AFS licensee has procedures in place to ensure that any changes to existing arrangements, or the entry into new arrangements, are assessed against those guidelines from a legal and commercial perspective to determine whether they give rise to adverse FOFA impacts (for example, loss of grandfathering).

- The AFS licensee has documented written guidelines on the meaning and scope of the application of the "anti-avoidance" regime.

- The AFS licensee has procedures in place to ensure that any changes to existing arrangements, the entry into new arrangements, or other business decisions, which have the outcome of avoiding the application of any FOFA provision, are assessed against the anti-avoidance guidelines.

- The AFS licensee is informed of ASIC's position on the substantive aspects of the reforms.