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Submission to FASEA: Code of Ethics Guide – comments on consultation draft

November 2020

2 November 2020

Mr Stephen Glenfield
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Financial Adviser Standards and Ethics Authority
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By Email: consultation@fasea.gov.au

Dear Mr Glenfield

FASEA Code of Ethics Guide – comments on consultation draft

The Institute of Public Accountants (IPA) welcomes the opportunity to provide comments on the Code of Ethics Guide. Our comments are from the perspective of our members, including those who hold a full or limited Australian Financial Services Licence and those who work as Authorised Representatives of licence holders. In preparing this submission we have consulted with and are grateful to IPA members, stakeholders and Hall & Wilcox.

The IPA has over 40,000 members across Australia and in over 80 countries. Three-quarters of our members work in or are advisers to small business and the SME sectors.

The Financial Planners and Advisers Code of Ethics 2019 (**Code of Ethics**), issued by the Financial Adviser Standards and Ethics Authority (**FASEA**), came into effect on 1 January 2020. The retail financial advice industry is currently relying on three explanatory documents to assist with navigating the Code of Ethics and to understand their obligations under the Code of Ethics. These three documents, which are referred to in this submission are:

- Financial Planners and Advisers Code of Ethics Explanatory Statement, which was issued with the Code of Ethics Legislative Instrument on 8 February 2019 (**Explanatory Statement**).
- FG002 Financial Planners and Advisers Code of Ethics 2019 Guidance (**2019 Guidance**).
- FASEA's Preliminary Reponses to Submissions on the Code of Ethics Guidance dated December 2019 (**Preliminary Response to Submissions**).

On 5 October 2020, FASEA released the Draft Financial Planners and Advisers 2019 Guide, dated October 2020 (**Draft Guide**) for consultation. We understand the purpose of the Draft Guide is to consolidate the 2019 Guidance and Preliminary Response to Submissions into a single guidance document.

Importantly, the Explanatory Statement, the 2019 Guidance, the Preliminary Response to Submissions, and the Draft Guide are not law. Under section 921U(2)(b) of the *Corporations Act 2001* (Cth) (**Corporations Act**), FASEA is required to make a Code of Ethics via legislative instrument for the purposes of section 921E (the provision that requires relevant providers to comply with the Code of Ethics). It follows that only the Code of Ethics itself has the force under law. The explanatory materials are merely intended to assist advisers to understand the operation of the Code of Ethics. FASEA acknowledges this in the Draft Guide where it states 'this guide is illustrative rather than conclusive regarding application of the Code'.

As other commentators have recognised, FASEA is a 'standards body', not a regulator of the Code of Ethics. It remains to be seen how the provisions of the Code of Ethics will be monitored, investigated and enforced, once the 'monitoring body' is established.

This submission addresses a few key issues raised by our members and across the industry, which could be better addressed in the new Code of Ethics Guide.

Standard 2 - *You must act with integrity and in the best interests of each of your clients*

The Draft Guide states that, consistent with Parliament's intent, the Code of Ethics extends the minimum legal obligations that would otherwise apply to relevant providers under the Corporations Act. The obligation to act in the best interests of one's clients, when giving advice to retail clients, is already enshrined in section 961B(1) of the Corporations Act. The Draft Guide acknowledges that the 'safe harbour' provision in section 961B(2), together with sections 961C, 961D and 961E, provide a framework for how an adviser can satisfy the statutory duty in section 961B(1). However, the Draft Guide states that the duty in Standard 2 of the Code of Ethics is a broader duty than the obligation prescribed by law in section 961B(1), and imposes an ethical duty on advisers that operates in addition to the statutory duty.

Given the Code of Ethics is intended to go beyond the obligations in the Corporations Act, it would appear that the 'safe harbour' provision, which provides advisers with some certainty of application of the statutory best interests duty is largely redundant. An adviser could satisfy all of the requirements under the 'safe harbour', and therefore be deemed to have complied with their statutory best interests duty, but still be in breach of their best interests duty under Standard 2 of the Code of Ethics.

This is particularly problematic in the context of giving qualified advice. The Draft Guide states that Standard 2 is to be interpreted by reference to Standard 6 which states that an adviser 'must take into account the broad effects arising from the client acting on [the] advice and **actively consider the client's broader long-term interests and likely circumstances**'. The Draft Guide states that:

> '*To comply with the ethical duty, it will not be enough for an adviser to limit their inquiries to the information provided by the client. [The adviser] will need to **take reasonable steps** to inquire more widely into the client's circumstances. [The adviser] is not relieved of the ethical duty merely because the client does not provide enough information, even when asked'*.

This suggests that an adviser may be considered to have not taken 'reasonable steps' to inquire about a client's circumstances if the adviser requests relevant information from the client and the client is unwilling, or unable, to provide the information. It is therefore not clear from the Draft Guide what lengths an adviser must go to when investigating the client's relevant circumstances in order to discharge their *ethical* duty to act in the best interests of the client. We therefore have concerns whether an adviser can ever have comfort that they have complied with Standard 2 when giving qualified advice, in circumstances where the adviser has requested further information from the client and the client has either been unwilling, or unable, to provide such information.

We also have concerns about what circumstances an adviser has to take into account in order to discharge their duty to actively consider the 'broader' long-term interests and likely circumstances of the client. Without any more substantive guidance on what constitutes a client's 'broader' long-term interests and 'likely' circumstances, it is very difficult for advisers to comply with, or to build frameworks to enable compliance with, this duty. The IPA submits that the term 'broad' should be replaced with 'reasonable', that is, the adviser 'must take into account the broad effects arising from the client acting on [the] advice and **actively consider the client's reasonable long-term interests and likely circumstances**'.

Standard 3 -*You must not advise, refer or act in any other manner where you have a conflict of interest or duty*

The Draft Guide states that the intent of Standard 3 is that advisers must not advise, refer or act in any other manner where they have a conflict of interest or duty “that is contrary to the client’s best interests”. However, in relation to Standard 1, the Draft Guide notes that the ‘Corporations Act permits the management of conflicts of interest between the adviser and their client (including by disclosure), however the Code of Ethics requires that the adviser must not act if there is an actual conflict of interest’. Without expressly saying so, the Draft Guide appears to be taking the position that an actual conflict of interest is one which is contrary to the client’s best interests, and only actual conflicts of interest are prohibited under the Code of Ethics.

The ‘standard for judgement’ for determining if an arrangement is conflicted and therefore prohibited is that if:

1. A disinterested person (an unbiased third party with nothing to gain or lose from how the question of conflicts is resolved),

2. who knows all of the facts,

3. would reasonably conclude (that is, has good reasons that other reasonable people would find convincing),

4. that the arrangement could induce the adviser to act other than in the best interests of the client then,

that arrangement gives rise to a conflict and is prohibited**.** Again, without expressly saying so, the Draft Guide appears to be setting out a test for determining whether something is an *actual* conflict of interest, and therefore in breach of the Code of Ethics.

This position on conflicts of interest could be made clear in the Draft Guide by stating that:

- the Code of Ethics only prohibits *actual* conflicts of interest;
- something is only an *actual* conflict of interest if it is contrary to the client’s best interests; and
- the ‘standard of judgment’ for determining whether something is an actual conflict of interest (as opposed, presumably, to a *potential* conflict of interest) is the four-part test referred to above.

In our view, making this distinction apparent in the Draft Guide would be useful for advisers, many of whom have raised concerns that certain remuneration arrangements, or certain product distribution or ‘white label’ arrangements, involve an inherent conflict of interest which breaches Standard 3.

We note here that the position adopted in the Draft Guide focuses on the conflict itself, rather than the actions taken by the adviser as a consequence of the conflict, and determines that any *actual* conflict of interest could cause the adviser to breach the Code of Ethics. The Draft Guide acknowledges that the Code of Ethics goes further than the Corporations Act and the guidance of the Australian Securities and Investments Commission (ASIC) in relation to conflicts of interest. We are of the view that the position taken by ASIC in relation to conflicts, which accepts that some conflicts of interest and duty can be appropriately managed so they have no adverse impact on the services or advice delivered to the client, is a more measured and sensible approach.

We note that ASIC Regulatory Guide 181: *Licensing: Managing conflicts of interest* (which sets out ASIC’s approach to compliance with the statutory obligation to manage conflicts of interest in section 912A(1)(aa) of the Corporations Act) has not been updated since it was issued in 2004. In this regard, we urge FASEA and ASIC to provide a consistent view on the management of conflicts of interest, or provide joint guidance in relation to conflicts of interest where personal advice is provided to retail clients.

Standard 4 - ***You may act for a client only with the client's free, prior and informed consent. If required in the case of an existing client, the consent should be obtained as soon as practicable after the Code Commences***

The Draft Guide acknowledges that there are two components to the consent requirement in Standard 4: if an adviser has already received the client's free, prior and informed consent, Standard 4 will have been met, but if not, the consent should be obtained as soon as practicable.[1]

The prior guidance documents did not clarify when a person ceases to be an 'existing client', but suggested that the person continues to be an 'existing client' for as long as the adviser continues to receive remuneration (particularly commissions) that relate to that person.[2]

Example 2 is clearly aimed at resolving two issues we have raised when posing the following question:

> *'I have a number of existing insurance only clients who I have irregular contact with. These clients received an advice document and signed an authority when I presented the original advice a number of years ago. Do I need to contact them to obtain consent?'*

In response, the Draft Guide clarifies that a client is an 'existing client' where the adviser continues to receive ongoing fees, even if the adviser is not in regular contact with the client. The Draft Guide states that:

> *'If an adviser is receiving an ongoing fee (including insurance commissions) which is directly related to the financial product advice recommendation for their client and has not contacted that client for a number of years, it would be appropriate to do so to confirm there are no changes in their personal circumstances which would impact the financial product advice recommendation and to confirm the clients ongoing consent to act'.*

Further, the Draft Guide explicitly states that if an adviser contacts the client to seek consent multiple times and the client does not respond after the adviser has taken 'all reasonable steps', the adviser should cease receiving the fees.[3]

Whilst the Draft Guide provides some clarity as to the proposed operation of the consent requirement, it appears to be misaligned with the corresponding provisions of the Corporations Act, which, in effect, provide that a person with whom an adviser does not have an Ongoing Fee Arrangement for the purposes of the fee charging provisions in Part 7.7A of the Corporations Act is no longer an 'existing client' of the adviser. The intention of requiring advisers to have an Ongoing Fee Arrangement with a client was to ensure that a client could actively determine whether the client wishes to continue to engage the adviser's services. The Draft Guide instead determines whether a person is an 'existing client' of the adviser by reference to whether the adviser continues to receive remuneration in respect of that client, even where there is no longer an Ongoing Fee Arrangement in place. This appears to impose an unnecessary burden on advisers to make active contact with people who have already determined that they do not wish to continue to engage the services of the adviser under an Ongoing Fee Arrangement. We recommend the Draft Guide provides more clarity around what constitutes an 'existing client', in line with the corresponding position under the Corporations Act, so advisers have greater certainty about their obligations under Standard 4.

[1] Financial Planners and Advisers Code of Ethics 2019 Guide (Draft), page 21.
[2] Preliminary Response to Submissions, page 11.
[3] Financial Planners and Advisers Code of Ethics 2019 Guide (Draft), page 22.

Standard 7 - ***Except where expressly permitted by the Corporations Act, you may not receive any benefits, in connection with acting for a client, that derive from a third party other than your principal***

The Draft Guide provides some clarity and appropriate guidance in relation to circumstances where referral fees may be acceptable, particularly where remuneration is received via a corporate structure.

However, the Draft Guidance does not address the issue of remuneration arrangements which are 'not prohibited' under the Corporations Act, such as the 'mere referral'[4] exemption which is explicitly carved out of Chapter 7 of the Corporations Act. It would appear that a referral fee received by an adviser under the mere referral exemption would contravene the Code of Ethics, even though it has deliberately been excluded from the financial services regulatory regime and arguably has no application to the obligations on advisers as relevant providers under Chapter 7 of the Corporations Act.

Standard 7 allows an adviser to receive benefits from third parties where that benefit is 'expressly permitted by the Corporations Act'. The use of this term in Standard 7 is problematic, as there are few, if any, circumstances where relevant benefits are 'expressly permitted' by the Corporations Act. Instead, the relevant legislation, such as the provisions regarding conflicted remuneration in Part 7.7A of the Corporations Act, operate in a way that certain conduct is prohibited but then there are specific exclusions to the prohibition. It is therefore not clear whether receipt of a benefit that would not be prohibited because of particular statutory provisions would also be permissible for the purposes of Standard 7.

We therefore recommend that greater clarity is provided as to whether benefits that are permitted under the Corporations Act by implication (ie, because they are subject to an exclusion from provisions that would otherwise prohibit their receipt) fall within the ambit of benefits that are 'expressly permitted' for the purposes of Standard 7.

Standard 9 - ***All advice you give, and all products you recommend must be offered in good faith and with competence and be neither misleading or deceptive (linked with other provisions of the Code of Ethics)***

The Draft Guide states that the Code of Ethics should be read and applied as a whole. Noting this, we query whether an adviser can ever meet their obligations under the Code of Ethics if they recommend an in-house product, where they receive greater remuneration (whether directly or indirectly) to the remuneration they would receive for recommending third party products. The Draft Guide suggests that an adviser can, provided that:

- the product recommendation is in the best interests of the client (Standard 2 and Standard 5);
- the client understands the advice including the benefits, costs and risks (Standard 5);
- the advice, product recommendation and fee structure are in the best interests of the client (Standard 7);
- the fee paid by the client is fair and reasonable and represents value to the client and is fully understood by the client (Standard 7); and
- a disinterested or unbiased person, in possession of all the facts, would reasonably conclude that:

[4] *Corporations Regulations 2001* (Cth) reg 7.6.01(1)(e) and 7.6.01(ea).

- the fee paid by the client is fair and reasonable and represents value to the client; and
- the remuneration could not lead the adviser to prefer the interests of someone (including their own or their Licensee) over the client's best interests.

The guidance provided in the Draft Guide on the last element of the test is problematic in the context of in-house products. We are concerned that a 'disinterested or unbiased' person, having knowledge of the adviser's remuneration arrangements for recommending the in-house product, would conclude that those arrangements have led the adviser to prefer their interests over the client's interests, irrespective of whether the advice given is demonstrably in the client's best interests.

In our view, the test in Standard 9 should focus on whether a 'disinterested or unbiased' person **without** knowledge of the associated remuneration would still determine that the advice being given is in the best interests of the adviser. The test should be focused on an objective assessment of the benefits of the advice for the client, not the manner in which the adviser is remunerated. The client will achieve a favourable outcome where the advice is in their best interests, the fees paid are fair and reasonable and represent value, and the client understands the advice, including the benefits, costs and risks: the manner in which the adviser is remunerated for providing such advice should not be a relevant circumstance in making this assessment.

If you have any queries with respect to our comments please don't hesitate to contact Vicki Stylianou at vicki.stylianou@publicaccountants.org.au or on mobile +61 419 942 733.

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