6 May 2020

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Dear Mr Glenfield

Thank you for the time you took to meet with us recently. Firstly, I would like to confirm to you that IMAP as an industry body supports the establishment of a profession for financial advisers, endorses the intent of the Code of Ethics and believes that the implementation of the Code will, in the long term, provide better outcomes for retail clients.

We wanted to set out IMAP's position on certain Standards within the Code which we believe relevant providers and their licensees will find problematic.

We have identified a number of structural problems with the Code as it is currently drafted. In summary these are:

i. The conflict between certain Standards and established and tested law and regulatory policy;
ii. Inconsistency between the Code and FASEA's guidance – in particular the concern that where a Code Monitoring Body may adjudicate a matter under the strict terms of Standard 3, in which case the FASEA guidance will be of little evidentiary value;
iii. Inconsistency in the manner in which the Code must be applied as between members of the advice profession; and
iv. The lack of a materiality test.

Separately, we think it appropriate to note the differences between Standard 3 and the way in which conflicts are required to be addressed by other professions, which have had considerably longer experience in addressing this issue.

The Code Structure

i. Conflict with established law and regulatory policy

The Code of Ethics applies only to relevant providers, specifically, those individuals who are authorised by an AFS Licensee to provide *personal advice to retail clients* in relation to more complex products.

- Standard 1 by default requires relevant providers to comply with the law – for example s961B of the Corporations Act which establishes the Best Interest Duty requirement.

- Standard 2 which makes this point explicitly. ASIC's understanding of the obligations of an adviser under this part of the law are set out in RG175, particularly RG175.242 – 175.257. In particular, ASIC note (RG175.256):

"...We expect advice providers to exercise judgement in acting in the best interest of the client."

- Standard 3 requires relevant providers to 'not' advise, refer or act in any other manner where you have a conflict of interest or duty.

S912A (1) (aa) of the Corporations Act states:

A financial services licensee must… have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative

Further, while the conflicted remuneration provisions in Div 4 of Part 7.7A of the Corporations Act prohibits forms of remunerations that create a conflict of interest, it does not prohibit all forms remuneration. For example, if the benefit falls within an exemption or would not reasonably be expected to influence the adviser, then the remuneration is not prohibited.

This is a quite explicit recognition in the law that:

- conflicts may arise between the interests of a relevant provider ("representative") and a client;
- that these can, and must, be managed; and
- that this is a responsibility of the licensee, in addition to the responsibilities of the relevant provider.

Standard 3 of the Code of Ethics is a blanket ban on advising, referring or acting in any other manner where the adviser has a conflict of interest or duty. This blanket prohibition is inconsistent with the established law referred to above in that it does not recognise that an adviser can adequately manage a conflict of interest by instituting various controls to ameliorate the consequences of a conflict of interest or duty e.g. acting in the best interests of a client to name but one, prioritising the interests of the client where a conflict exists etc.

The ban on conflicts of interest and duty imposed by Standard 3 also goes beyond the premise or any recommendations made by Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Hayne Royal Commission**) in its Final Report.

In relation to the underlying premise of dealing with conflicts of interest and duty, the Final Report posed the following question before noting improved education and standards for financial advisers as one potential solution:

Accepting, for the moment, the premise of the FOFA reforms – that conflicts of duty and interest exist and should be 'managed' – the question that presents itself: is there more that could be done to 'manage' those conflicts better?[1]

[1] FSRC Final Report Vol 1 p 170

Importantly, this passage acknowledges the existence of conflicts and interests and duty in the provision of personal advice to retail clients and that dealing with conflicts is found not in prohibiting the conflict from occurring but by ameliorating the consequences of the conflict. For example:

- The Hayne Royal Commission did not recommend the structural separation of product manufacturers and financial advisers despite the "obvious conflicts of interest" which affects the provision of financial product advice in this situation;

- The Hayne Royal Commission did not recommend that all advisers be 'independent' within the meaning of s.923A of the Corporations Act which is another of saying that they must not have a conflict of interest or duty;

- The Hayne Royal Commission did not prohibit an adviser who is not 'independent' within the meaning of s.923A of the Corporations Act from recommending any product manufactured by an entity associated with the adviser AFSL holder.

A key rationale for not prohibiting such conflicts of interests was the impact on the industry:

Adopting any of these approaches would be likely to reduce the conflicts of interest that affect the financial advice industry. So much may be accepted. But, adopting any of these approaches would also involve significant disruption to that industry, and the financial services industry more broadly.[2]

Instead, the Final Report:

- referred to the improved education and standards for financial advisers;
- referred to the design and distribution obligations and product intervention powers;
- recommended better disclosure (which the Government has accepted) when an adviser or licensee is not be independent – i.e. the FSG contain a statement to this effect;
- considered potentially amending the best interest duty in the future; and
- recommended a ban on grandfathered conflicted remuneration (which the government has accepted),

to manage or ameliorate the consequences of the conflicts of interest and duty that exist in the financial services industry.

To simply ban an individual relevant provider from having any conflict of interest or duty via a standard of the Code of Ethics without regard to the controls the adviser or licensee may have in place to manage the conflict not only goes beyond what the current legal settings but is also contrary to the principles and recommendations of the Hayne Royal Commission.

ii. Inconsistency With and Lack of Relevance of FASEA Explanatory Material

In our meeting with you in March, we noted your comments as to the intent of Standard 3. That provided an adviser acted in the best interests of the client and in compliance with the other standards of the Code, the adviser would not be in breach of Standard 3 notwithstanding

[2] FSRC Final Report Vol 1 p 191

any conflicts the adviser may have. If we understood you correctly, the rationale for this interpretation is that the controls put in place by the adviser or their licensee operated to remove the conflicts of interest. While we agree that this should be the policy objective of the Code, we disagree that this would be the normal meaning likely to be given by a Court or CMB when interpreting Standard 3.

First, at a principle level, any controls that are implemented by way of complying with the other standards of the Code do not remove the conflict, it ameliorates the affects or consequences of the conflict.

Second, the words of the FG002 Financial Planners and Advisers Code of Ethics 2019 Guidance (**FASEA Guide**) are inconsistent with the plain reading of the text of Standard 3.

Standard 3 uses the language of prohibition to ban or forbid an adviser from acting where any conflict of interest or duty exists. The Code contain no exemptions from this prohibition.

However, the FASEA Guide goes on to state that certain forms or remuneration, profit-sharing, income from ancillary products or services or other sources of variable income would be a conflict of interest in breach of standard 3 provided other conditions were satisfied. The rationale being that in such circumstances the conflict of interest is not an actual conflict of interest.

Further, The FASEA Guide states:

The Code of Ethics must be read and applied as a whole. Therefore, Standard 3 operates in combination with the values and other standards prescribed in the Code of Ethics in order to strengthen and inspire good practice.[3]

However, this is not consistent with the actual wording of Standard 3. Standard 3 does not contain any phrase which modifies the ban on acting if a conflict exists by reference to other Standards. Standard 3, like each other Standard, and indeed each other requirement of all laws is to be read in isolation.

Also, section 4(2) of the Code states that each provision of the Code is to be given its full effect, and is not to be "read down" by reference to other provisions, unless the Code itself says so.

Thirdly, we turn now to the issue of whether the Explanatory Material would have any relevance in the event a matter comes before a court or the Code Monitoring Body (CMB), when established.

The Code, and each individual Standard within it, has the force of law. The consequences for not complying with the Code are serious. An adviser may be excluded from the from the coverage of the monitoring body's compliance scheme. In addition, ASIC can take action again a licensee for breaches of the Code by its representatives. Finally, breaches of the Code can give rise to injunctive relief and compensation or damages.

[3] FG0002 p17

It is a principle of statutory interpretation that the proper construction of a legislative provision, regulation or legislative instrument starts with the actual wording of the text[4].

This principle was also discussed at length in Justice Michael Kirby's paper on judicial interpretation.

During the past decade or so, the High Court of Australia has unanimously endorsed other principles as necessary to the accurate reading of legislation. Amongst the most important of these principles have been:

that where the applicable law is expressed in legislation the correct starting point for analysis is the text of the legislation and not judicial statements of the common law or even judicial elaborations of the statute…[5]

We may assume Justice Kirby intended even less weight to be placed on material such as the explanatory material than "judicial interpretations". Further on Justice Kirby notes:

The task of a judge in interpreting statutory, constitutional or subordinate legislation is fundamentally a textual one. It is impermissible to stray too far from the text by importing considerations of context and policy.[6]

In regard to financial services law more generally, legal rights, obligations and prohibitions are created for or imposed on Licensees and Representatives by the Corporations Act, Corporations Regulations and Legislative Instruments. It is these legislative materials which create the law.

Unlike the above legislative material, guidance notes are not law. For example, while industry considers carefully ASIC's view of the law, as set out in its numerous Regulatory Guides (RGs), these do not constitute the law and nor are they a recognised aide to statutory interpretation. Likewise, the FASEA Guide.

Therefore, it is not unlikely that, given the clear and unambiguous language used in the text of Standard 3, that a CMB or a court would not need to consider the FASEA Guide, and even if it did, would not be under any obligation to follow the guidance when interpreting the Standard.

In our view, the present situation is that the purpose of Standard 3 as described in the FASEA Guide does not reflect the actual text of Standard 3 and is contrary to its normal meaning. This is an unsatisfactory position.

Not only does this cause confusion and uncertainty, it leads to the very real possibility that a relevant provider that follows the FASEA Guide may breach Standard 3.

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[4] See Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (2009) 239 CLR 27 in which the majority said at 47, "Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text".

[5] Kirby, Michael --- "Statutory Interpretation: The Meaning of Meaning" [2011] MelbULawRw 3; (2011) 35(1) Melbourne University Law Review 113

6 Ibid

iii. Differences Arising in the Treatment of Advisers Based on their Position Rather than the Effect of the Recommendations

The Code applies to “relevant providers”, that is those people who provide personal advice to retail clients. Consider the following case study.

An adviser makes a recommendation to a client, having regard to the client’s goals, circumstances and likely future situation to invest in a portfolio under a managed account structure in which the Licensee acts as portfolio manager. The Licensee may or may not charge a fee for portfolio management services. The portfolio performs in accordance with expectations. Given the advice provided to the client is identical and the outcomes are identical, is there a breach of Standard 3 in each of the following circumstances?:

	Situation
A	The adviser is a salaried employee of a privately held licensee whose income is not affected by any financial product recommendation but whose continued employment is dependent on the continuing success of the business.
B	The adviser is an authorised representative of a privately held licensees who receives a share of advice fees charged but no revenue based on any financial product recommendation but who is able to service more clients if they are invested through managed account services than if each transaction is subject to separate ROAs and manually executed.
C	The adviser is a director and shareholder of a privately owned licensee whose income is not affected by any financial product recommendation but who may benefit by way of dividends or capital value of the business and who is able to service more clients if they are invested through managed account services than if each transaction is subject to separate ROAs and manually executed.
D	The adviser is an employee of a large, widely held publicly listed financial services business paid on a “balanced scorecard” approach which does not reward any particular financial product recommendation and who is able to service more clients if they are invested through managed account services than if each transaction is subject to separate ROAs and manually executed.
E	As in D above but the adviser is, in addition, a shareholder who receives dividends based on the overall financial performance of the organisation and who is able to service more clients if they are invested through managed account services than if each transaction is subject to separate ROAs and manually executed.

Each scenario above identifies, in an identical set of client circumstances, a set of conflicts, more or less direct and in only one case directly financial. The outcome of this is that the conduct in relation to advice provided which would be both legal and in the client’s best interest if issued by one adviser, however is banned if issued by another.

A strict interpretation of Standard 3 would prevent each adviser from “advising, referring or acting in any other manner”. In other words, the client could never receive advice, even if every other Standard in the Code was complied with in full. Every adviser obtains some form of benefit if the client follows the recommendation which is always a conflict.

A looser interpretation of Standard 3, which only considered financial benefit as giving rise to conflict, would likely strike out C and conceivably E.

Further, there is internal conflict within the Code itself. Standard 3 contains the blanket ban and yet Standard 7 acknowledges that either or both the adviser and their licensee may receive benefits from the client. Standard 7 requires that these are “fair and reasonable and represent value”. These considerations are in effect a requirement for the adviser to exercise judgement about “fairness”, “reasonableness” and “value” which is consistent with legislation noted above, but inconsistent with Standard 3.

In practice, the application of Standard 3 is likely to advantage large vertically integrated financial services organisations whose directors and shareholders are not personally involved in giving advice.

iv. Lack of a Materiality Test

In the way in which the Code is currently drafted, there is no materiality test, either relating to the type of conflict which is banned or when an adviser may provide a service.

While this may be resolved in the way the CMB is finally constituted and its adjudications, as presently set out, Standard 3 is a blanket ban on any type of conflict. As we note above, this is in conflict with the concept of Standard 7.

Professional Standards in Australia

In making financial advising a ‘profession’ we think it is reasonable to compare the FASEA Code of Ethics to other codes of similar professions in Australia such as lawyers and accountants.

A useful point of comparison is the documented standard of the legal profession. We reference the Legal Profession Uniform Law Australian Solicitors’ Conduct Rules 2015. The objective of these is “… to assist solicitors to act ethically and in accordance with the principles of professional conduct…”

Like the Code of Ethics, the Rules require that

4.1 A solicitor must also:

4.1.1	act in the best interests of a client in any matter in which the solicitor represents the client;
4.1.2	be honest and courteous in all dealings in the course of legal practice;
4.1.3	deliver legal services competently, diligently and as promptly as reasonably possible;
4.1.4	avoid any compromise to their integrity and professional independence; and
4.1.5	comply with these Rules and the law

The Rules contemplate that conflict may arise in several ways including:

- In respect of former clients where the solicitor is in possession of information which is confidential to the former client;
- where the solicitor is requested to act for two or more clients in the same matter;
- where the best interests of the client conflict with the solicitor's own interests.

The fundamental premise of the Rules is that conflicts must be disclosed, may be managed and if management is not possible, avoided. This three-pronged approach to the treatment of conflict has been generally accepted by financial services law as being appropriate for the provision of financial advice.

For example, Rule 11.3 prescribes, in respect of a solicitor acting for two or more clients

11.3 Where a solicitor or law practice seeks to act in the circumstances specified in Rule 11.2, the solicitor or law practice may, subject always to each solicitor discharging their duty to act in the best interests of their client, only act if each client:

11.3.1	is aware that the solicitor or law practice is also acting for another client; and
11.3.2	has given informed consent to the solicitor or law practice so acting.

Recommendation

We propose that the impracticality of Standard 3 must be resolved through legislative amendment. This amendment should ensure that Standard 3 is drafted so as to be consistent with the general legal principles which apply to the operation of the Best Interest test. Standard 7, for example, operates by reference to obligations and rights created in the Corporations Act and a redrafted Standard 3 should be worded in a similar way.

We propose two alternative amendments which would be consistent with the principles of law and would achieve the outcome intended by the Hayne Royal Commission:

Option 1

"Where a relevant provider has a conflict of interest or duty, they must:

a. Disclose the conflict;
b. Implement appropriate measures to manage the conflict;
c. Explain clearly why the conflict will <u>not</u> result in a breach of the best interests duty; and
d. Obtain the client's express consent to the adviser's handling of the conflict, or alternatively
e. Avoid the conflict by refusing to provide the services.

Option 2

You must not advise, refer or act in any other manner where you have a conflict of interest or duty, **unless the conflict of interest or duty can be adequately managed and the client is not disadvantaged by the conflict of interest or duty**

Yours faithfully

Jenny Mulders	Toby Potter
Chair	Chair
IMAP Regulatory Group	IMAP

The IMAP Regulatory Group membership is
Chair: Jenny Mulders QRC Consulting
Simon Carrodus The Fold Legal
Katie Gill Implemented Portfolios
Eylem Kamerakkas Macquarie
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