Stockbrokers
Association of Australia
Incorporating SDIA

Future of Financial Advice (FOFA)
***Corporations Amendment Regulation* 2012 (No.10)**

FOFA – Stockbrokers Carve-outs and Brokerage on Borrowed Amounts

Further Submission

18 December 2012

Executive Summary

For the reasons set out in this Submission, **any ban on charging brokerage on leveraged transactions will not achieve any benefit**. Any perceived risks to the client relate to the establishment of the funding facility, not the subsequent trade. These risks have been dealt with comprehensively through the regulation of margin lending and other consumer credit legislation. These measures, together with the higher standards which apply to market participants generally, should allay any concerns.

Margin lending in particular is transparent and product neutral, and efficient and easily understood by clients. To deal with these risks a second time by banning brokerage over stock market transactions using borrowed funds is an unnecessary over-response, which has the potential to achieve negative policy outcomes, and no benefits.

It would seriously impact on the already low turnover and liquidity on the market. If brokerage either cannot be charged on leveraged trades, or the amount which can be charged cannot be easily determined, then brokers may simply decline to provide advice to clients if borrowed funds are used. This must adversely impact on the level of trading, or, of even more concern, result in clients trading without having obtained professional advice. Moreover, these measures may threaten Australia's efforts to grow as a financial centre.

There is also the concern that the carve-outs have provided a '**regulatory loop-hole**' by extending the benefits of the carve-outs to non-ASX market participants who almost exclusively trade in ASX-listed products.

Introduction

By email of 22 November 2012, Dr Richard Sandlant of Treasury advised that the *Corporations Amendment Regulation 2012 (No.10),* which includes the **stockbrokers carve-outs**, had been made and would be gazetted.

The regulations are the same as the embargoed draft version sent to us on 25 October 2012. In confidential comments on the draft version that we made on 29 October, we raised concerns about the following matters:

- Brokerage on Borrowed Amounts, and
- Extension of Carve-outs to participants of non-ASX Exchanges.

In relation to the first point, Treasury noted in the email of 22 November that -

> *…while [the Regulations]* ***do not*** *exempt brokerage fees from the ban on asset-based fees on borrowed amounts, this is something that the Government would like to consider further. It was decided that further consultation is necessary with both industry and consumer groups to properly assess the* ***consumer risk*** *if these fees were to be exempt and the* ***commercial impact*** *if they were not.*

Having now had the opportunity to consult with our members, the purpose of this further submission is to provide brief further detail on the impact on stockbrokers (and their clients) if brokerage is **not** carved out of the **ban on asset-based fees on borrowed amounts**. This will confirm the points that we made in our meeting with Treasury officers in Canberra on 13 December 2012. We will also reiterate our comments on the extension of the carve-outs to **non-ASX Participants**.

Drafting solutions for both issues are also provided.

A. ISSUE: BROKERAGE FEES ON LEVERAGED PURCHASES

1. Background

In discussions to date, we have provided information about the operation of margin lending in the context of listed equities. While not the only source of funding – home equity loans and other lines of credit being others - it is the one most suited to share purchases, and is widely used. We have noted that margin lending provides a flexible line of credit for clients to draw upon, and is increasingly used as a normal operating account. It is used conservatively by clients, especially in the period post-GFC, with average leverage rates on RBA figures falling from 45% to 30%. Overall margin lending has also fallen considerably over the period from 2007. Total draw-downs have fallen by 67%, from $38bn to $12bn[1]. During the same period, Residential finance, which includes property investment, has increased by 70%.

[1] Reserve Bank of Australia *Margin Lending Data* 15 November 2012 at: http://www.rba.gov.au/statistics/tables/xls/d10hist.xls; *All Lending Data* 31 October 2012 at: http://www.rba.gov.au/statistics/tables/xls/b02hist.xls

As we note further below, Margin lending is transparent, well managed and well regulated.

2. Consumer Risk if brokerage on leverage purchases were exempt

Generally, we submit that the risk to the consumer would be **minimal** if brokerage on leveraged purchases were exempt from the ban on asset-based fees on borrowed amounts.

a. Transparent/Product Neutral: for all share purchases (and sales), brokerage is transparent and product neutral. For example, clients do not pay a different rate to buy BHP Billiton shares v. RIO shares. The only difference with margin lending is the amount that banks will lend against a certain security (usually known as the Loan-to-Value ratio or **LVR**). The LVR will vary according to the bank's assessment of the quality of each stock as security for the loan. If the ban were to continue, there may need to be 3 rates of brokerage: a flat fee (or no fee) for leveraged purchases, a rate for unleveraged purchases and a rate for sales. (As we have noted, it may be impossible to know if a purchase is leveraged, or if so to what extent.) This would be confusing for clients, and goes against transparency.

b. Highly regulated: in response to problems which emerged from matters like *Storm Financial* and *Opes Prime*, margin lending has since 2010 been regulated as a financial product under the *Corporations Act*. This has meant that the same standards of investor protection apply to advising in margin lending as to other products. Accordingly, retail advisers must be accredited, they must have a reasonable basis for their advice (suitability), and complaints and compensation arrangements apply. As well as the specific protections under the *Corporations Act*, Banks are subject to the National Consumer Law, which also offers investor protection.

c. Tightly controlled by lenders: the operation of margin lending is subject to extensive risk management by lenders, including the calculation of buffers and LVR's in real time according to market movements and changes to the client's circumstances. Accordingly, remedial action in terms of margin calls and/or additional capital can be taken rapidly. Similar measures are not possible in other funding mechanisms like home equity loans, because they are not tied to the market value of the shares and market movements generally.

d. No issue with stockbrokers: there is no evidence of increasing problems arising from advice from stockbrokers on margin lending. In fact, on figures released by the Financial Ombudsman Service (**FOS**) the reverse is true. As set out in Appendix 1, in the 2012 Financial Year there were **no complaints** relating to margin lending against Stockbrokers. In FY2011 there were 5 complaints, and in FY2010 there were 20. In part, these figures reflect the general reduction in margin lending over the period. However, it also reflects well on the standard of advice from stockbrokers, which has generally seen the level of complaints to FOS about stockbrokers falling, while other sectors are increasing (see Appendix 1).

e. ***Risk of churning overstated***: if there is a concern that advisers will encourage margin lending in order to earn more income, comfort should be drawn from the same factors that we argued in support of the stockbrokers carve-outs last year. We reiterate that market participants have higher conduct standards, and management & supervision requirements under the ***Market Integrity Rules***, breach of which can lead to fines of up to $1m apply.[2] We also note that margin lending may in a sense even *reduce* the number of transactions for clients e.g. if a client owns Qantas shares and needs money to buy NAB shares, margin lending allows the client to buy the NAB shares and hold both, without the need to sell the Qantas shares in a separate transaction.

f. ***More risks to clients if fees <u>not exempt</u>:*** if brokerage on borrowed amounts is banned it may have the effect of exposing clients to more risks, for example by encouraging clients to do the following:

- unregulated lending like drawing down home loans, putting their residence at risk;
- unregulated advice on investing in property on the advice of real estate agents;
- invest in more structured products with *in-built leverage* like instalment warrants, geared ETF's and property trusts;
- trade in highly leveraged products that are aggressively marketed with no advice or just general advice like Contracts for Difference (CFD's).

The danger is that less sophisticated small clients will suffer and that choice and protections generally will fall.

3. Commercial Impact if brokerage on leveraged purchases were not exempt

a. ***Broker level impact***: as we have previously noted, if the ban is to apply, for brokers it would mean that –

- approximately 30% of brokerage revenue would be lost. This revenue would have to be made up in other ways, e.g. higher fees for everyone, including those who aren't leveraged;
- since stockbrokers do not split brokerage fees between advice and execution, it would be extremely difficult to do so without increasing fees for all clients, whether they are leveraged or not;
- it would be practically impossible for a stockbroker to precisely calculate the amount of leverage used by the client for a purchase, even if it is known that the client has margin lending[3]. If the ban means that *any amount* of leverage means that you can't charge brokerage on the *whole amount* please advise as this would be revolutionary for the whole industry;
- costs of IT system changes if a solution were possible (and we doubt it is) would be very high – this would include the cost of developing a system to separately identify the cost of advice and execution; and

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[2] See attached Submission to Treasury *FOFA – Ban on Commissions - Impact on Stockbrokers* dated 5 August 11 page 6 et seq for more detail on the churning issue

[3] See attached Submission to Treasury *FOFA – Stockbrokers Carve-Outs Regulations Final Draft* dated 29 October 2012 page 6 '**f. how to calculate the unleveraged portion**'

- internal changes to employment contracts, policies and procedures and other costs as set out in our submission of 29 October would also be onerous, expensive and counterproductive in terms of the level of advice available to retail clients.

b. ***Market level impact***: at the market level, if the ban is to apply, then there will be impact on the market generally, in the following ways –

- assuming that 20% of market volume is retail, if the result of the ban is that brokers won't deal on margin accounts (which account for 30% of their revenue), then 30% of the total market's 20% retail purchases, or up to **6% of total market volume** would potentially disappear. We cannot imagine that the Government intended to damage the market in such a way from these changes; and
- further, it would put Australia at a **competitive disadvantage** as a **regional financial centre** since none of our near neighbours has a similar ban.

4. Timing

This issue is effectively **already time critical**. In this Christmas holiday period, industry will not be able to commence any meaningful systems or other changes until February 2013. It is then highly unlikely that all such changes could be achieved in order to achieve full compliance by 1 July 2013. We therefore trust that Government will address the issue of whether the stockbrokers carve-outs will be extended to brokerage on borrowed amounts as a matter of **urgency**.

5. Unintended Consequence

In launching the FOFA package in April 2010, then Minister for Human Services and Minister for Financial Services, Superannuation and Corporate Law the Hon Chris Bowen MP stated that the FOFA legislation would –

> *'…have the capacity to carve out specified payments if* ***unintended payments*** *are captured or* ***unintended consequences*** *occur'*[4].

The *Explanatory Memorandum* to the *Corporations Amendment (Further Future of Financial Advice Measures) Bill* September 2011 refers to the carve-out for Commission Splitting as follows:

> **(Commission Splitting)**
>
> 1.24 The regulations will also ensure that the **traditional remuneration arrangements** of employee brokers (often paid as a percentage of brokerage) are not unduly impacted by the conflicted remuneration measures.

Throughout the FOFA consultations, the ban on asset-based fees on borrowed amounts was always seen in the context of charging on-going fees on assets under management or advice. While not without practical difficulty, industry has generally accepted that such on-going fees should only be charged on the unleveraged portion of a portfolio.

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[4] The Hon Chris Bowen MP Minister for Human Services and Minister for Financial Services, Superannuation and Corporate Law *The Future of Financial Advice Information Pack* 26 April 2010 page 5

We would therefore submit that the ban was **never intended** to apply to **transactional brokerage** on borrowed amounts. Accordingly, this is a clear case of an unintended consequence that the Government should now remedy.

B. ISSUE: NON-ASX MARKET PARTICIPANTS

We maintain that a loop-hole remains in the regulations, that is, that no connection is required between the exchange of which you are a participant, and the exchange on which the relevant stock is traded: Reg 7.7A.12D(1)(a) & (2). Since the overwhelming majority of trading in this country is in ASX-listed securities, this means that participants of the lesser exchanges will receive the benefit of having the same status as an ASX participant.

There are already indications that non-ASX exchanges are actively promoting firms to become participants on their exchanges on the basis of this carve-out.

We note that ASIC may consider using anti-avoidance measures against conflicted remuneration (s965) if there is a sudden flood of participant applications to the lesser regulated Exchanges, but the process may be difficult to reverse.

C. DRAFTING SOLUTIONS

1. Brokerage Fees on Leveraged Purchases

We would like to suggest the following **drafting** solution. For simplicity, we have approached this from the definition of 'brokerage fee' which is defined in Reg.7.7A.12D(2). The aim is to make it clear that 'brokerage fee' as defined in Reg.7.7A.12D(2) is <u>not</u> an 'asset-based fee' as defined in section 964F. Once that change is made, all the issues surrounding 'borrowed amounts' fall away. Accordingly, we suggest the following marked-up change:

> **7.7A.12D Brokerage fees given to representatives**
>
> …
>
> (2) In this regulation:
>
> ***brokerage fee*** means a fee that a retail client pays to a provider in relation to a transaction in which the provider, on behalf of the retail client, deals in a financial product that is traded on:
>
> (a) a prescribed financial market; or
>
> (b) a prescribed foreign financial market.
>
> <u>To avoid doubt, a brokerage fee is not an asset-based fee.</u>

2. Non-ASX Market Participants

To restrict the carve-out in Regulation 7.7A.12D to participants of the market on which a stock is listed would be relatively simple. We suggest the following marked-up changes:

7.7A.12D Brokerage fees given to representatives
(1) A monetary benefit is not conflicted remuneration if:
(a) the benefit consists of a percentage, of no more than 100%, of a brokerage fee that is given to a provider who is a trading participant of the~~a~~ prescribed financial market upon which the transaction took place; and
(b) the provider, directly or indirectly, gives the benefit to a representative of the provider.
Note The definition of ***prescribed financial market*** is in regulation 1.0.02A.

One of the main reasons for granting the Stockbrokers Carve-outs in the first place was the superior management and supervision requirements that apply to market participants. We have previously provided extensive detail of these requirements, and in particular the measures to address and prevent churning. This remains the case, and measures to prevent churning are particularly sensitive to excessive trading on *margined* accounts.

The proposed ban on charging brokerage on borrowed amounts will unduly impact stockbrokers' remuneration arrangements in an already difficult market environment where turnover is low. We fear that these limits will have unintended consequences, especially the reduction in the availability of advice to retail clients in listed equities. Moreover, it may even lead to lower market turnover and impede measures to grow Australia as a regional financial centre.

Thank-you for the opportunity to provide further comment on the final regulations. We are particularly grateful for your senior officers' time in Canberra last week to discuss these matters.

Once again, we cannot overstate the impact that the limit on brokerage for leveraged purchases will have on the industry, clients and the market generally. Should you require any further information, please contact me or Doug Clark, Policy Executive on dclark@stockbrokers.org.au .

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Stockbrokers Association of Australia
18 December 2012

Appendix 1

FINANCIAL OMBUDSMAN SERVICE
Statistics FY2010-2012 - Stockbrokers

OVERALL DISPUTES

Financial Year	**2010**	**2011**	**2012**
Total Disputes received (all categories)	23,845	30,283 (↑27%)	36,099 (↑19%)
Total Investments Disputes received	1639	1886 (↑15%)	1626 (↓14%)
Total Stockbroker Disputes received	103	66 (↓36%)	63 (↓5%)

FOS MARGIN LENDING DISPUTES

Financial Year	**2010**	**2011**	**2012**
Total Margin Lending Disputes (all Providers)	116	68	23
Total Margin Lending Disputes (Stockbrokers)	20	5	0

Source: FOS *Annual Reviews*, 2010, 2011, 2012