Conflicts transcend incentives, ASIC to prove

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Fee arrangements can be conflicted even if they don't directly incentivise the people making the product recommendations, ASIC's enforcement team will argue as part of the civil penalty proceedings it brought against Colonial First State Investments and Commonwealth Bank in the Federal Court on Tuesday.

ASIC's decision to sue CFS Investments and CBA was based on Kenneth Hayne's characterisation that a revenue sharing arrangement to distribute the Essential Super product through CBA branches could reasonably be expected to influence those distributing it even though the arrangement was designed to recoup costs but not incentivise.

"They [CBA] submitted that branch staff were not 'directly' rewarded for sales of Essential Super and their incentives were determined on the basis of a balanced scorecard," Hayne stated in the February 2019 Final Report.

"They also said that the revenue-sharing arrangement was not designed to incentivise CBA to sell Essential Super, but to approximate its share of the costs," Hayne described.

"For these reasons, they submitted that the fee arrangement was not properly characterised as conflicted remuneration," he stated, after reviewing the case study and listening to witness testimony.

However, even though branch staff weren't directly incentivised to recommend the product, Hayne pointed out that CBA was to receive 30 per cent of the revenue earned by the trustee in relation to the fund in the relevant financial year.

"It follows that the greater the volume of sales of the product, the more revenue CBA would receive. In this way, it could reasonably be expected to influence which product branch staff were trained and told to recommend and the financial product advice given to retail clients. Indeed, it would be surprising if it did not have this effect," Hayne stated.

"In my view, the payments to CBA may have contravened the conflicted remuneration provisions of the Act," he said in his concluding remarks in the final report.

Hayne speaks, ASIC litigates

A little more than 16 months on from Hayne's remarks as stated above, ASIC has now commenced civil proceedings alleging that more than $22 million in conflicted remuneration was paid to CBA for the distribution of CFS Investment's Essential Super product.

The Essential Super product was recommended through CBA branches outside of the personal advice framework and as such came with a 'general advice warning', the Hayne royal commission case study described.

But it is not the testing of the definition between general and personal financial product advice that ASIC is pursing as part of its Federal Court case on Tuesday – as it did in the case against Westpac securities late last year, a test case it lost but then successfully litigated on appeal.

It was the fee provided to CBA under its distribution agreement which Hayne highlighted could "reasonably be expected to influence the choice of the product recommended by branch staff" even though branch staff weren't directly incentivised to recommend the product.

"Direct financial incentives to sell product are obviously a big no-no, but non-financial incentives are relevant too – like keeping your job, pleasing your boss, getting a promotion and avoiding criticism. In his final report, Commissioner Hayne noted that staff were trained to 'create an interest in the customer for the product'. What were the consequences for staff who failed to do this effectively?," Simon Carrodus, solicitor director with The Fold Legal, commented.

Carrodus went on to characterise the proceedings as a potential test case for the application of the conflicted remuneration prohibition.

In ASIC's own updated guidance on conflicted and other banned remuneration (RG 246) from December 2017, the regulator defines conflicted remuneration as benefit that "could reasonably be expected to influence" financial product recommendations or advice.

Conflicted remuneration is defined in the Corporations Act as any benefit, whether monetary or non-monetary, given to an Australian financial services licensee who provides financial product advice to persons as retail clients that, because of the nature of the benefit or the circumstances in which it is given could reasonably be expected to influence 1. the choice of financial product recommended by the licensee or representative to retail clients, or 2. the financial product advice given to retail clients by the licensee or representative.

The conflicted and other banned remuneration provisions were introduced in June 2012 as part of the Future of Financial Advice reforms in response to the 2009 Parliamentary Joint Committee on Corporations and Financial Services inquiry into financial products and services.

ASIC Deputy Chair Daniel Crennan (pictured, left, with ASIC chair James Shipton) noted the investigation reflects the regulator's ongoing commitment to bring the Hayne's royal commission referrals and case studies to litigation when appropriate.