APES 230 ED Technical Analysis Paper

Purpose

To provide an analysis to the Board of the key issues of the APES 230 project and to obtain the Board's views and directions on the outstanding matters to finalise the drafting of the proposed revised APES 230 ED. The following key areas are addressed in this Technical Analysis Paper:

(i) Scope of APES 230 ED
(ii) Members in Business
(iii) Fundamental principles of the Code
(iv) Remuneration methods in respect of Financial Planning Advice.
(v) Remuneration methods in respect of Insurance and risk products.
(vi) Remuneration methods in respect of mortgage products
(vii) *FoFA* update.
(viii) Legacy products
(ix) Operative date and transitional provisions
(x) Client's choice
(xi) Application of the proposed standard to Investment Management Firms
(xii) Corporate superannuation plans
(xiii) Tax deductibility
(xiv) WRAP accounts

(i) Scope of APES 230 ED

<u>Definitions of Client and Financial Planning Advice</u>

Some respondents to APES 230 ED are concerned that the definition of Client and Financial Advice in APES 230 ED (issued in June 2010) can be read in a manner to inadvertently capture other Professional Services delivered by Members that are not related to financial planning (i.e. independent expert's report).

Technical staff has considered this issue and proposes the following amendments to improve the clarity of the proposed revised APES 230 ED:

- The Board consider amending the title of the proposed standard from "Financial Advisory Services" to "Financial Planning Services";
- Amend the definition of "Financial Planning Advice" to focus on personal financial planning; and
- Exclude from the scope financial, accounting and taxation advice provided to a Client which is not related to a Client's personal financial affairs.
  (*refer to the proposed amendments in the proposed revised APES 230 ED*).

The term Financial Planning is better suited than Financial Advisory Services as:

- The Members who work in this area are known by this term as well as the common use of the term is used by consumers and other stakeholders to describe the work in this specialist area compared to the term "Financial Advisory Services";
- The American Institute of Certified Practising Accountants (AICPA) has issued Professional Standards for "Personal Financial Planning" since 1992 (revised 1996);
- AICPA, ICAA and CPA Australia have specialist financial planning chapters for Members as well as a financial planning specialisation for Members who practice in this area; and
- Firms have service lines that are known as "Financial Advisory Services" that provide services to Clients that are not related to Financial Planning. Further most Members provide *financial advice* to Clients and the vast majority of these services are <u>not</u> related to Financial Planning.

Accordingly, Technical staff believe that the use of the term "Financial Planning" and the proposed revised definition of "Financial Planning Advice" focussing on a Client's personal financial affairs will provide clarity to stakeholders of the scope of the proposed APES 230 ED.

Matters for the Board's consideration

- **Change of the title of the proposed Standard to "Financial Planning Services"; and**
- **Proposed amendments to the definition of "Financial Planning Advice".**

Services covered by APES 230 ED

Some respondents to APES 230 ED have argued that Commissions are commonly used in insurance and mortgage broking and that it is the industry practice to be remunerated in that manner. Accordingly they argue that insurance and mortgage broking should be scoped out of APES 230 ED or alternatively Clients should be given the choice to remunerate the Member on a Commissions or Fee for Service basis. Respondents have also argued that the new credit regime issued by the government will provide adequate protection for consumers.

Respondents who favour a Fee for Service for these services argue that Financial Planning Services should be an integrated professional advice discipline. It should not be "unbundled" in such a manner that certain sub-disciplines are required to reflect the profession's fundamental ethical standards in APES 230 whilst other sub-disciplines are not required to reflect them. These respondents have successfully transformed their practices to a Fee for Service basis and rebate the commissions received from insurance companies and financial institutions to their Clients.

Matters for the Board's consideration

- **Board's views on whether Insurance and risk products and mortgage products are within the scope of APES 230 ED.**

(ii) Members in Business

Respondents to the Exposure Draft noted that Members in Business may not have ultimate authority over their organisations operating policies and thus will have difficulty in implementing APES 230 ED, particularly the provisions dealing with remuneration.

Accordingly, a review of APES 230 ED was preformed to consider the provisions that Members in Business will have difficulty in complying with and appropriate flexibility has now been incorporated in a similar manner to other Professional Standards in the APES 200 series.

Technical Staff Comment
Paragraphs 8.8 and 9.6 were added in respect of this issue and now provide flexibility for Members in Business.

Matters for the Board's consideration

- **Board's views on the proposed amendments to the proposed revised APES 230 ED to address the concerns in respect of Members in Business.**

(iii) Fundamental principles of the Code

The five fundamental ethical principles that Members of the accounting profession must comply with are in APES 110 *Code of Ethics for Professional Accountants:*

Fundamental Principles

100.5 A Member shall comply with the following fundamental principles:

(a) *Integrity* – to be straightforward and honest in all professional and business relationships.

(b) *Objectivity* – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional competence and due care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent Professional Services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

(d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the Member or third parties.

(e) *Professional behaviour* – to comply with relevant laws and regulations and avoid any action that discredits the profession.

Other relevant sections of the Code to consider by Members when providing Professional Services are:

- Section 200 – *Members in Public Practice Introduction*
- Section 220 – *Conflicts of Interest*
- Section 240 – *Fees and Other Types of Remuneration*
- Section 280 – *Objectivity – all services*
- Section 310 – *Potential Conflicts*

Members in Public Practice must comply with the fundamental principles of the Code when they providing Professional Services to Clients. When providing these Professional Services Members need to maintain their objectivity (Section 280 – *Objectivity all Services*) and be also mindful of conflicts of interests (Section 220 – *Conflicts of Interest*) that will or may impact on their ability to deliver Professional Services in an objective and unbiased manner.

The development of the Financial Planning profession

Generally well recognised professions articulate and enforce professional and ethical standards in the public interest and then enforce these high standards on their membership as a condition of entry into the relevant profession.

Respondents to APES 230 ED note that the role performed by financial planners are viewed by many as a link in the financial product manufacturing and distribution chain, rather than a legitimate Professional Service which should be provided to Clients in an objective manner.

Due to the industry’s historical development, the proposed principles in APES 230 ED is commercially inconvenient for some members, particularly where they are currently in receipt of large amounts of trailing income (commissions or asset fees) for which in certain instances little or no work is performed.

Contingent Fees and the Code

The main criticism of APES 230 ED focuses around its proposal to mandate Fee for Service as the recommended remuneration method for financial planners. Some respondents have argued that this is inconsistent with the Code as the Code allows the use of Contingent Fees.

Whilst the Code recognises that Contingent Fees are used in certain types of non-assurance engagements it also states that the use of Contingent Fees may create a self-interest threat to objectivity. The Code then goes on to say that the existence and significance of the threats will depend on factors including (paragraph 240.3):

- The nature of the engagement;
- The range of possible fee amounts;
- The basis of determining the fee;
- Whether the outcome or the result of the transaction is reviewed by an independent third party.

In the case of a typical financial planning engagement the benefit to the Member depending on the use of Commissions, percentage based asset fees and Soft Dollar Benefits as remuneration methods are likely to be quite wide ranging and will depend on the wealth management strategies adopted and the financial products chosen. Further the professional fees are not subject to an independent review by any third party such as a court (For example, in a liquidation a court may review and set the fee for a liquidator).

Further the Code is a minimum requirement and there are instances where APESB has restricted remuneration methods available to Members in circumstances where the remuneration method adopted will create threats to the fundamental principles of the Code for which there are no safeguards available. Accordingly, in these circumstances APESB prohibited the use of Contingent Fees. These circumstances are described in the following APESB Professional Standards:

- APES 215 *Forensic Accounting Services*;
- APES 225 *Valuation Services*;
- APES 330 *Insolvency Services*;
- APES 345 *Reporting on Prospective Financial Information Prepared in Connection with a Disclosure Document*; and
- APES 350 *Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document.*

Accordingly, Technical Staff has revised Section 8 and 9 of the proposed revised APES 230 ED in a manner consistent with fundamental principles of the Code and removed the previous link with fiduciary duties of a Member who is providing financial advice. Some of the remuneration methods noted above create threats to the fundamental principles of Integrity, Objectivity, Professional Competence and Due Care and Professional Behaviour of the Member.

During the Board's consultations with various stakeholders, the stakeholders were unable to identify appropriate safeguards that could adequately address the threats to the fundamental principles of the Code.

(iv) Remuneration methods in respect of Financial Planning Advice

The various remuneration methods adopted by financial planning practices in respect of Financial Planning Advice are:

- Commissions which are paid by product manufacturers;
- Percentage based asset fees which are linked to Funds Under Management (FUM);
- Fee for Service (Flat or fixed fees based on Professional Services provided to Clients which are unrelated to sale of products or FUM); and
- Hybrid Fee for Service (combination of flat/fixed fee up-front for the financial plan and a ongoing % based fee on the portfolio managed. In some cases the initial fee may be rebated if the prospect proceeds and an on-going %-based fee is charged).

Commissions

Due to the *FoFA* reforms to be implemented by the government it is unlikely that this form of remuneration will be used in respect of financial advice post 1 July 2012 (or a later date), except on individual life insurance policies The draft reforms are currently being considered by parliament and have been referred to the PJC inquiry for a review. However, it should be noted that the government reforms will be implemented on a prospective basis which means that existing commission-based arrangements will be allowed to continue in perpetuity, even where it is possible to arrange for the commission to be rebated to the client.

Percentage based asset fees which are linked to FUM

<u>Arguments for percentage based asset fees</u>

Respondents who are supportive of percentage based asset fees which are linked to FUM argue that:

- A percentage of FUM is easily understood by the Client;
- Allows Clients to access Financial Planning Advice;
- This method is widely used and consumers are familiar with it;
- Platform fees are asset based and therefore efficiency and consistency will be achieved if the adviser also gets remunerated on an asset based structure; and
- Provides an incentive for a Member to grow FUM as then they will also get a higher remuneration and thus are rewarded if the invested funds perform well.

<u>Arguments against percentage based asset fees</u>

Respondents who do not favour percentage based asset fees argue that

- Whilst there is an upside opportunity there is also a downside risk in having the Members remuneration linked to the performance of the market. The wealth management industry was one of the industries that suffered the most during the Global Financial Crisis (GFC).
- This approach has the potential to skew the behaviour of a Member to recommend investment strategies that accumulate FUM to the detriment of considering other financial strategies on which a percentage cannot be earned (eg. Investment

properties, lowering debt of a Client, salary sacrificing into a company/industry superannuation fund, investments in cash in falling markets.).

- Accordingly, there will be a lack of objectivity and potential conflicts of interests in making recommendations to invest in FUM or to be invested in FUM as otherwise Members may not be able to earn remuneration (i.e. obtain a percentage of FUM).
- Another issue is transparency. “1% of FUM” may be transparent in a conceptual sense, but it may not be clear in an absolute dollar sense. To accurately predict the final fee of the proposed “1% of FUM” at the start of the year may not be possible.

Key Advantages	**Key Disadvantages**
• In a sense easy to understand. • Upside opportunity for Member if FUM grows. • Alignment of Client’s interest to grow FUM and FUM performance with the Member’s interest of earning a higher remuneration. • Easy to implement.	• Actual dollar amount may not be clear to a Client. • Risks Member’s objectivity and creates conflicts of interests. • Downside risks of the market. • Rewards FUM growth not whether the Client’s best interests are served. • Biased towards asset-rich clients. • Smaller clients (with little/no FUM) are of minimal interest, unless there is potential for gearing/margin loans (eg Storm). • Dollar amount may not reflect a reasonable reward for the Member’s effort. • Allows members to appear “independent” without actually being so.

Please see Appendix 1 for Advantages and Disadvantages of percentage based asset fees which are linked to FUM and Fee for Service remuneration comparison table.

Fee for Service (Flat or fixed fees based on services provided to Clients which are unrelated to sale of products or FUM)

Arguments for Fee for Service

Respondents who favour Fee for Service argue that:

- When a Fee for Service remuneration approach is adopted the Member’s commercial interest are not linked with the sale of products or accumulation of FUM;
- This remuneration method complies with the fundamental principles of the Code and removes conflicts of interest (which are present in the Commissions and percentage based asset fee remuneration methods);
- Allows the Member to provide objective unbiased and strategic Financial Planning Advice which is in the best interests of the Client without the imperative to sell products/accumulate FUM;
- Creates a relationship of trust between Members/Clients;
- Allows Members to charge Fee for Service to Clients of all sizes, large and small., thus widening the availability of financial planning services; and

- Transparent to Clients and provides them with an actual dollar amount upon which they can evaluate whether the benefits of the intended purchase outweighs the cost.

Arguments against Fee for Service

- It is difficult to implement;
- It is difficult to price fees as more complex advice may have higher variability in outcomes; and
- Adoption of Fee for service will mean higher fees which may make it difficult for ordinary Australians to access Financial Planning Advice.

Key Advantages	Key Disadvantages
• Transparent • Simple to understand and it is clear to the Client what the cost of the service is. • Allows for modular / piecemeal approaches. • Encourages efficiency. • Does not create conflicts with the Member's commercial interests and the best interests of the Client. • Scalable (with the right set up)	• Performance risk • Some respondents note that it is difficult to implement Fee for Service.

Please see Appendix 1 for Advantages and Disadvantages of percentage based asset fees which are linked to FUM and Fee for Service remuneration comparison table.

Technical staff note

Some respondents incorrectly interpreted Fee for Service to mean **hourly rates** and argued that **hourly rates** are inappropriate and will lead to inefficiencies. Please note that the definition of Fee for Service should not be read to mean **hourly rates**.

The definition of Fee for Service from the proposed revised APES 230 ED is reproduced below:

Fee for Service *means fees determined by taking into consideration factors such as the complexity of the Financial Planning Service, the required skills and knowledge, the level of training and experience of the Member and the Member's staff, the degree of responsibility applicable to the work such as risk and the time spent on the Financial Planning Service.*

Fee for Service does not include Commissions*, percentage based asset fees, production bonuses, or other forms of fees or remuneration that are calculated by reference to product sales or the accumulation of funds under management, whether paid by the Client or a third party such as a product manufacturer.*

Hybrid Fee for Service structure

Some respondents advocated the use of a Hybrid Fee for Service whereby a Fee for Service as defined in APES 230 ED is charged on the initial strategy advice and thereafter an asset based fee/commission is charged on the portfolio that will be managed by the Member on an ongoing basis. Some of the Members who adopt this approach also uses a sliding scale or percentage whereby as the amount of FUM increases the percentage charged decreases.

The issue with this approach is that it still does not adequately address the risk of whether the Member considers other investment options (reducing debt, investment property etc) that are in the best interests of the Client and appropriate to the financial objectives of the Client as it does not result in increasing FUM.

Technical Staff comments

With the use of percentage based asset fees in essence the value of the financial advice is linked to the relevant products or FUM.

A similar example in the accounting profession is if auditors started charging a “Fee for Service” based on a percentage of the value of a company’s assets. Then it would be in the auditor’s interest to allow the company to overstate its asset base as the auditors’ fee would be higher. However, APES 110 prohibits the use of commissions or similar fee arrangements in respect of audit engagements.

Another example raised by a respondent is if medical practitioners started charging fees based on a on a percentage of the value of the drugs prescribed by them. If this practice was adopted then patients and the general public would not trust the advice received from Doctors. Doctors and other true professions are remunerated on a professional basis based on the value of the service provided rather than the products that are given as part of that service.

Fee for Service will lead to the public’s trust of the financial planning industry because Clients will be comfortable that they are buying objective professional advice, and that it is not a product sale disguised as a service.

Matters for the Board’s consideration

- **The Board’s views on the different remuneration methods adopted in the Financial Planning industry and which methods should be permissible in the proposed revised APES 230 ED.**

(v) Remuneration methods in respect of Insurance and risk products

The most common remuneration method in respect of insurance and risk products is Commissions. However, Members who have adopted a Fee for Service approach are charging their clients on a Fee for Service basis and rebating the Commissions they receive from the insurance companies.

Arguments for Commission*s based remuneration*

Respondents who want to maintain a Commission based remuneration structure for insurance and risk products argue that:

- The insurance company sets the Commission based remuneration structure and therefore, Members have no say in the remuneration methods;
- A similar set of Commission rates are applied to all advisers;
- In Australia there is an under insurance problem and by charging Clients an upfront Fee for Service it will only exacerbate the underinsurance problem as Clients will not pay a fee for initial advice, implementation and annual review of their insurance needs;
- Insurance is a product that needs to be sold and therefore, the sale of this product grants Commission payments from the manufacturer to the adviser that sold the product;
- Clients should be offered a choice to pay the adviser either via Commissions or Fee for Service; and
- Clients undergo a traumatic and stressful time when claiming life insurance. Fee for Service remuneration structure will require a payment from the Client for the service done by the adviser to claim their insurance. Whereas, Commission based payment will cater for such a situation and not cause any more stress to the Clients at a delicate and stressful time.

Arguments for Fee for Service based remuneration

Key stakeholders who argue for a Fee for Service approach for insurance and risk products argue that:

- the current embedded Commission based remuneration actually contributes to the ongoing problem of underinsurance in Australia by adding to the cost of insurance and removing trust in advice offered (by embedding conflicts of interest).
- Commissions on these products are very similar to %-based asset fees/trailing commissions in investments with ongoing trails received over the years the policy is held.
- A stakeholder points out that one of the major factors in determining how insurance premiums are priced is the embedded, up-front advisor Commissions where the Commission payment is factored into the cost of the premium charged to consumers. A Survey of initial Commissions reveals that they can be in the range of 100-130% for the first year and around 11% on an ongoing basis. These Commissions are paid by the insurer to financial advisers which are then factored into the amount of premium charged to the consumer. When an insurance company pays a financial advisor these Commissions, it will mean that the Client will have to stay with the insurance company for at least five to six years to make it sustainable for the insurance company. However, if there is a high churn rate then this will lead to the

insurance companies pushing the cost of premiums higher. This in turn contributes to higher insurance premiums and potentially contributing to the under insurance problem in Australia.

- In response to the above argument, another stakeholder argues that there are four different types of Commissions. The most dangerous is the Upfront (noted above) and Stepped Commission method as both results in a high upfront Commission payment and minimal ongoing Commission payments. These two methods of Commissions have the potential to encourage churning to obtain the high initial payment. However, the Hybrid and Level Commission methods have stable Commission payments and the churning rate is significantly lower than the Upfront and Stepped Commissions. This stakeholder only uses either the Hybrid or Level Commission method for all of his Clients.

Please see below table for the different Commission methods and average payout percentages.

Commission Type	**Initial Commission**	**Ongoing Commission**
Upfront	105%	9%
Stepped	90%	10, 15, 17.5, 20 then 21% onwards
Hybrid	63%	20%
Level	30%	27%

Furthermore, in the media release dated 29 August, 2011 issued by the government, Mr. Bill Shorten states, *'High upfront* Commission*s have the potential to increase churn. Level* Commission*s on replacement polices are an effective way of addressing this issue. The Government will work with industry and consumer groups on the most effective way of implementing this reform.'*

- As price is a determinant factor for consumers when choosing an insurance policy, if the cost of premiums is lower then it may lead to more consumers being attracted to insurance. Fee for Service advisers state that they can save Clients up to 30% of annual insurance premium costs.

- Every person will have a different insurance need. For instance, as an individual moves through life and their debts are repaid their adviser should consider reducing their insurance cover, but often this creates a conflict of interest for the advisor as it reduces the commissions on the insured amount

- The underinsurance problem has existed in Australia for several decades and the existing commission-based remuneration practices have not solved it.

Matters for the Board's consideration

- **The Board's views on the different remuneration methods adopted (Commissions vs Fee for Service) and the methods that should be permissible in the proposed revised APES 230 ED.**

(vi) Remuneration methods in respect of mortgage products

Some respondents have argued to exclude mortgage broking from the scope of APES 230 ED as the new credit regime issued by the government will provide protection for consumers. Respondents argue that all brokers receive the same rebate rate from the banks and the brokers therefore are not incentivised to put Clients in to more risky products due to rebate differences which applied previously. Furthermore, respondents argue that the Commission percentage relating to a mortgage is very minor at only 0.24-0.4% p.a.

Technical staff comment

Technical staff has performed a calculation that on an average loan of $500K and a Commission rate of 0.34% p.a., at 7.81% standard variable rate over 30 years of the loan, a financial adviser will receive $28,600 in trailing Commission payments.

However, a typical Fee for Service advisor will charge approximately $1,600 for the initial loan evaluation and will rebate the full upfront Commission of approximately $1,800 to the Client. Thus at the initial point itself the Client is better off by $ 200 and thereafter over the life of the loan a Fee for Service adviser will rebate to the Client the Commission payments which is estimated at $ 28,600 in the example noted above. However, if the Client requires any further advice during the life of the Loan then a Fee for Service would be applicable.

Technical staff note that there is a lack of transparency in disclosing the small percentage which is applied to the outstanding capital balance and it is difficult for a consumer to estimate the $ value of the trailing Commission without doing a detailed calculation.

Matters for the Board's consideration

- **The Board's views on the different remuneration methods adopted (Commission, trailing income and Fee for Service) and the methods that should be permissible in the proposed revised APES 230 ED.**

(vii) *FoFA* Update

The Australian government has released the *Future of Financial Advice* Draft Bills on the 29 August 2011 and 29 September 2011. The Draft Bills includes a number of key measures that impact the financial planning industry. Please refer below to a summary of the proposed *FoFA* reforms:

New law	*Current law*
Conflicted remuneration and other remuneration	
Licensees must not accept remuneration which has the potential to influence the financial product advice or recommendations provided to retail clients (with the exception of certain insurance or execution-only services).	There is no existing statutory prohibition on advisers from receiving conflicted remuneration. Relevant information about advisers' remuneration (including Commissions) is required to be disclosed, including in the initial Statement of Advice provided to the retail client.
Licensees must not accept soft-dollar benefits over $300 that have the potential to influence the financial product advice or recommendations provided to retail clients (with the exception of certain insurance, execution-only, certain education or training purposes, and certain information technology benefits).	There is no existing statutory prohibition on advisers from receiving soft-dollar benefits. There are disclosure obligations. Various industry codes also self-regulate in this area to some extent.
Employers of financial services licensees (or their representatives) must not pay the licensee or its representatives conflicted remuneration.	There is no existing statutory prohibition on employers paying conflicted remuneration to licensees or their representatives. Employers can currently pay incentives to advisers to sell a certain type or a certain volume of products.
Product issuers must not provide monetary or non-monetary benefits to licensees or their representatives, regardless of whether it might influence the financial product advice provided to retail clients (with the exception of certain insurance, execution-only, certain education or training purposes, and certain information technology benefits).	There is no existing statutory prohibition on product issuers from paying monetary or non-monetary benefits to licensees or their representatives. Various industry codes purport to self-regulate in this area to some extent.
Volume rebates paid from platform operators to licensees will be banned.	There is no existing statutory prohibition platform-licensee rebates.
Licensees and platform operators must not accept volume-based fees the purpose of securing 'shelf-space' on an adviser's or platform's product list.	There is no existing statutory prohibition on the receipt of volume-based shelf-space fees.
Advisers must not charge asset-based fees (fees dependent upon the amount of funds held or invested) to a retail client to the extent that their funds are 'borrowed' or 'geared'.	There is no existing statutory prohibition on the charging of percentage-based fees to retail clients.
Charging ongoing fees to Clients	
In order to charge an ongoing advice fee to a retail client for a period of longer than 12 months, the fee recipient will be required to provide a fee disclosure statement to the client detailing advice fee and service	There is no requirement under the current law for advisers/fee recipients to provide ongoing disclosure of advice fees to retail clients.

information for both the previous and forthcoming 12 months.	
In order to charge an ongoing advice fee to a retail client for a period of longer than 24 months, the fee recipient will be required to provide a renewal notice and a fee disclosure statement to the client, which will detail advice fee and service information for both the previous and forthcoming 12 months. If the client opts not to renew the advice arrangement with the fee recipient, or does not respond to the renewal notice, the arrangement ceases and an ongoing advice fee can no longer be charged to the retail client.	There is no requirement under the current law for advisers/fee recipients to obtain the agreement of retail clients to continue charging ongoing advice fees.
For ongoing fee arrangements, the client can ‘opt-out’ or terminate the arrangement at any time.	There is no implied term under the current law that retail clients have the right to opt-out of ongoing financial advice arrangements at any time (however, it is a common practice in the industry to allow clients to opt-out at any time).
Best Interest Duty	
Statutory obligation for individuals who provide personal advice to act in the best interests of client.	There is no existing statutory obligation for individuals who provide personal advice to act in the best interests of clients.
Statutory obligation for individuals who provide personal advice to give priority to the interests of the client in the event of a conflict of interest	There is no existing statutory obligation for individuals who provide personal advice to give priority to the interests of the clients.
Statutory obligation for individuals who provide personal advice to ensure that the advice is appropriate.	Statutory obligation on the licensee or authorised representative to ensure who advice is appropriate.
Statutory obligation for individuals who provide personal advice to warn clients if the advice is based on incomplete or inaccurate information.	Statutory obligation on the licensee or authorised representative to warn clients if the advice is based on incomplete or inaccurate information.
Penalties for breaching obligations to give appropriate advice and warn client rest with the licensee or the authorised representative and are civil in nature.	Penalties for breaching obligations to give appropriate advice and warn client rest with the licensee or the authorised representative and are criminal in nature.
Statutory obligation on licensees to take reasonable steps to ensure their representatives comply with the obligations outlined above.	Statutory obligation on the licensee to take reasonable steps to ensure compliance with the obligation to provide appropriate advice only.

Source: Future of Financial Advice 2011 – Draft Bills

(viii) Legacy Products

The issue with Legacy Products is that in certain circumstances the Commission payments cannot be turned off and renegotiation of the contract may have a detrimental impact to the Client. Further the new product may not be the most suitable to meet the Client's financial objectives.

<u>*Technical Staff Comment*</u>

Generally the two types of legacy products are those where the Commission can be rebated (refunded) by the product provider to the Client within the product and those that either pay the adviser the Commission or the product provider will retain the Commission. To switch off the Commission the financial adviser would need to remove themselves as the servicing adviser and normally the Client would not receive the rebated Commission. This is not ideal for any party except the product provider.

If a longer transition period is adopted for Legacy products with Commissions that cannot be switched off, then this will allow further time for Members to transition. However, Members should keep a register of all Legacy Products and in instances where Commissions cannot be switched off there should be evidence that the Commission received by the Member has been rebated to the Client.

Technical staff have incorporated amendments to the proposed revised APES 230 ED to address Legacy Products.

Matters for the Board's consideration

- **Does the Board believe that the amendments made in respect of Legacy Products in the proposed revised APES 230 ED adequately address the concerns raised by stakeholders?**

(ix) Operative Date and Transitional Provisions

FoFA has proposed the following operative dates in the draft bills. The transitional provisions contained in APES 230 have been aligned with current drafts of the *FoFA* bills as a minimum or provides additional time:

Issue	*FoFA*	Revised APES 230 ED
Application	New Clients **Implementation commences 1/7/2012*	General provisions **Implementation commences 1 July 2013* *New Clients* **implementation commences 1 July 2013 (fees)* *Existing clients* **implementation*

		commences 1 July 2014 (fees) **Subject to Board Review**
Remuneration: Advice	Fee for Service – when geared **Implementation commences 1/7/2012*	**Subject to Board Review**
Remuneration: Advice	Asset based allowable if no gearing **Implementation commences 1/7/2012*	**Subject to Board Review**
Remuneration: Advice	Commission allowed in certain circumstances: - General Insurance; - Life Insurance; - Individual life policies not connected with a default super fund; and - Execution only (non-advice) services. **Implementation commences 1/7/2012*	**Subject to Board Review**
Remuneration: Product	Initial/upfront Commission – not permitted Trail Commission – not permitted Volume based – not permitted Shelf space fee that are not based on volume (e.g. product access payment)– permitted **Implementation commences 1/7/2013*	**Subject to Board Review**
Soft Dollar Benefit	Banned for anything over $300 (exceptions included): - Benefits given by general insurer in relation to a general insurance product; - Benefits under $300 so long as those benefits are not identical or similar and provided on a regular basis; - Benefits in relation to education or training purpose with nexus to providing financial advice to retail clients; and - Benefit is the provision of IT software or support, related to the provision of financial product advice. **Implementation commences 1/7/2012*	Banned for anything over $300. Must keep a register of Soft Dollar Benefits.
Distinction between retail and wholesale clients	Yes	No
Fiduciary Duty	Best interest duty will be introduced.	Fiduciary duty included in

	FoFA also includes a 'reasonable steps' qualification and 'best interest' formulation. **Implementation commences 1/7/2012*	section 3 of the proposed exposure draft.
Opt In	*FoFA* includes a requirement for retail clients to agree to the fees and to renew (by opting in) every two years for an adviser's continued services. *Implementation commences 1/7/2012*	As per paragraph 5.3, need to notify Clients annually details of fees.

**Implementation date subject to change. The PJC will deliver its findings on February 29, 2012. There may be a delay in the government's proposed reforms, although the government maintains that the current timetable will be adopted.*

(x) Client's Choice

A number of respondents argued that Members should not be restricted by the remuneration method and that they should offer this choice to Clients to allow the Clients to make a private decision on how they want to remunerate the Member. They further state that conflicts do not exist if a Client has made a decision based on full disclosure of information and provided their consent to use either a percentage based asset fee or Fee for Service to remunerate a Member.

Respondents argue that some Clients would prefer to tie the fee of the adviser with the market rather than to have to pay a flat/fixed/hourly and as they believe, that this will enable Members to make better decisions when evaluating financial strategies and financial products.

Furthermore, respondents argue that many Clients in need of financial advice may not be able to afford the upfront payment to the Member and therefore, the proposed Standard is likely to make financial planning not affordable to Australians who need it most.

Respondents opposed to the above views maintain that remuneration models are fundamental to influencing behaviour of Members, and that allowing %-based methodologies in any area of financial planning practice leads to conflicted advice, a lack of trust and poor advice which is not in clients' interests (e.g. Storm).

Furthermore, they argue that a Fee for Service will encourage Members to advise ordinary Australians and will encourage such people to approach Members for advice in the confidence that they can be trusted to act without conflicts and without the imperative to sell a product or to accumulate FUM.

(xi) Application of the Standard to Investment/Portfolio Management Firms.

Pitcher Partners raised the issue of the proposed Standard's affect on Firms that are investment/portfolio management firms rather than financial planning firms. The argument is that investment/portfolio management firms do not perform the traditional holistic financial planning advice to Clients. These firms focus on high net worth clients' investment strategy and related advice. Generally as investment manager does not deal directly with a Client whilst in this case Pitcher Partners as the investment manager is dealing directly with the Client.

Technical staff comment

Based on our understanding of the respondent's service charter, the respondent provides many services that are similar to a traditional financial planning firm. Namely, in the areas of investment, financial services and superannuation. Furthermore, the respondent's Firm uses the same financial planning platform and products used by other financial planning firms and hold an AFSL Licence. Pitcher Partners also has a financial service and credit guide which contains the services they provide and the relevant fee structure. The proposed revised APES 230 ED will capture the services that are provided within the financial services and credit guide.

The respondent uses percentage based asset fees on a sliding scale in their practice and acknowledged that they do have time records to monitor the time their staff spends on various activities. During the Global Financial Crisis they acknowledged that they reduced their exposure to the stock markets and put approximately 50% of their portfolio in cash products and thus took a big hit to their revenue as they do not charge clients on cash products.

Pitcher Partners advice fee structure is as follows:

- Greater than $1m 1.2% plus GST
- Greater than $2m 1.1% plus GST
- Greater than $3m 1.0% plus GST
- Greater than $5m 0.9% plus GST
- Greater than $7.5m 0.8% plus GST
- Greater than $10m 0.7% plus GST
- Greater than $20m 0.6% plus GST
- Greater than $30m 0.5% plus GST

A minimum annual fee of $12,000 plus GST applies to the Portfolio Management Services.
Source: http://www.pitcher.com.au/page-363/Our-Fees

Given the financial planning and investment advisory activities of Pitcher Partners are similar in nature to a financial planning practice and they hold an AFSL Technical Staff are of the view that the services offered by Pitcher Partners are within the scope of the proposed APES 230 ED.

(xii) Corporate superannuation plans

Some respondent are concerned with the timeframe to structure the proposed new fee structure for corporate superannuation plans as they are cross-subsidising fees across the structure of a corporate superannuation plan.

Technical staff comment

Technical staff acknowledges the complexity that exists within some corporate superannuation plans. The practical issue in this scenario could be potentially resolved by negotiating with the relevant corporate superfund to convert the pre-existing Commissions and percentage based asset fees to a fixed fee structure. However, subject to the Board's views on the remuneration principles to be adopted in the proposed APES 230 ED, a longer transition can be considered for financial planners with corporate superannuation plans due to its complexity.

(xiii) Tax deductibility

Respondents have raised the issue that by removing Clients from their existing remuneration structure will cause tax inefficiency particularly within superannuation investments. The reason behind removing the Clients from existing remuneration structure is due to certain limitations as some platforms may not cater for a Fee for Service arrangement.

Another issue on tax inefficiency relates to insurance. Currently Commissions that form part of a tax deductible income protection insurance is in affect tax deductible to the Client. If this is changed over to Fee for Service and is part of the initial Financial Planning Advice, then the payment will become non deductible.

Technical staff comment

Deductible	**Non Deductible**
Reviews Investments and loans Ongoing portfolio maintenance	Initial structuring advice New product recommendations

According to discussions with a senior financial planning practitioner, examples of allowable deductible and non deductible items are listed above. New product recommendation advice or initial structuring advice is not tax deductible. Currently, many platforms are quite comfortable with transitioning to a Fee for Service arrangement.

Technical staff notes that there is a tax inefficiency issue in relation to income protection insurance if it is part of the initial Financial Planning Advice. It should also be noted that the industry is lobbying strongly to gain full tax deductibility of for this initial advice.

(xiv) WRAP Accounts

Some respondents argue that WRAP accounts are not conflicted on percentage based asset fees, because they are able to select underlying funds which have no entry fees, no trailing fees and are acting as administration systems which is different to a product.

Another respondent argues that if the "platform" is providing a valuable administration service to dealer groups/planners, why is the payment **from** the platform provider, and not in the opposite direction? Accordingly this respondents notes that these payments are in nature of an incentive to encourage the placement of funds in the "platform product". In that sense, it does give rise to conflicts of interest, and is similar to any other Commission or incentive payment from a product manufacturer.

Technical staff comment

WRAP accounts are another form of platform product. Therefore the same conflicts will still occur in WRAP accounts as it would on any platform products. Advisers will not get paid unless they put products on to the Client's WRAP account.

Appendix 1 – Comparing Advantages and disadvantages of assets-based fees and Fee for Service

<table>
<tr><th>Fee Model</th><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>Fee for Service</td><td>Transparent – Fees can be easily broken down and compared.
Simple to understand – Fixed fees are easily understood by the lay consumer.
Client certainty - Certainty of price instils confidence in clients.
Piecemeal – Fixed pricing allows smaller increments of work to be conducted for the client.
Encourages efficiency – Fixed pricing encourages planners and practices to innovate and improve the efficiency and effectiveness of the delivery of their services to ensure profitability on fixed price arrangements.
Not conflicted with the best interests of the clients – Fees are paid purely by the client, with services delivered purely at the request and in the interest of the client.
Scalable – Given the appropriate services and an efficient mechanism for delivering specified services, fixed pricing is a significantly more scalable approach taking into consideration time, expertise and complexity versus time-based models.</td><td>Performance risk - Planner and practice carries the risk of delivering advice services in a non-profitable fashion, i.e. with minimal variances, delays, inefficiencies, etc.
Challenging to implement - Some respondents note that it is challenging and not possible to implement Fee for Service.</td></tr>
</table>

Fee Model	Advantages	Disadvantages
Asset-based fees which are linked to FUM	• **Explicit –** An explicitly agreed alternative to Commissions that is opt-ed "in" to by the client. • **Market-linked –** Planner shares in upside or downside asset performance.	• **Moderately opaque –** with asset-based fees it may be difficult for clients to determine the true, underlying cost of advice. • **Risk of conflicts** – Requires a focus on "investable assets", and a bias towards placing clients in products or platforms which generate revenue for the planner but which may not be appropriate for the client. The temptation to "upsell" to a client. • **"FUM Chasing**" **–** Rewards business performance based on the building up of FUM, as opposed to client service. • **Market-Linked -** Revenue is linked to asset performance resulting in revenue loss in adverse markets. • **Misalignment of expectations –** Creates an expectation that the planner is responsible for asset performance.