

13 September 2010

The Chairperson
Accounting Professional & Ethical Standards Board Limited
Level 7, 600 Bourke Street
MELBOURNE VIC 3000
AUSTRALIA
e-mail: sub@apesb.org.au

Dear Ms Spargo,

Proposed Standard: APES 230 - Financial Advisory Services

Thank you for the invitation to comment on the above Proposed Standard.

I make this submission in my capacity as a member of the Institute of Chartered Accountants in Australia. I am also the Chief Executive Officer of a large retail financial services organisation, Colonial First State (CFS), and Deputy Chair of the Financial Services Council (FSC, formerly the Investment and Financial Services Association (IFSA)).

CFS provides investment, superannuation and retirement products to individuals as well as to corporate and superannuation fund investors. CFS is the second largest administrator of retail funds (A\$61 billion¹) in Australia and has the sixth highest number of financial advisers through Commonwealth Financial Planning, Financial Wisdom, Whittaker Macnaught and BW Financial Advice.

Given both my past experience as an accountant and my current role as the head of a number of financial advice businesses, I believe I am uniquely qualified to provide comment on the matters contained in the Proposed Standard.

At the outset I would like to commend the Board for its efforts in support of increasing professional standards in the industry. I have long supported increasing professional standards for financial advisers and accountants alike. Under my stewardship CFS has been a strong supporter of the product and advice remuneration reforms contained in the FSC Member Superannuation Charter and the Financial Planning Association's Remuneration Principles. And whilst I am comfortable with most of the principles within APES 230, there is one important assumption upon which the Proposed Standard is based which I do not support. This relates to the definition of 'Fee for Service' for the provision of Financial Advisory Services. The application of this definition will hinder the future delivery of affordable and accessible financial advice by Members to their clients. Below I have outlined reasons for my concern in relation to the proposed definition.

The Proposed Standard and the definition of Fee for Service

Proposed Standard APES 230 requires that Members of a professional body which adopts the Standard comply with the Standard when providing a 'Financial Advisory Service'. The Standard requires that a member who provides a Financial Advisory Service only charges clients on a 'Fee for Service' basis.

¹ Plan for Life, Mar 2010

'Fee for Service' is not defined by law. In the broader financial advice industry it is broadly understood to refer to an arrangement where the adviser and client explicitly agree to the fee charged. A fee for service arrangement can take a number of different forms. In fact the form of the payment or the payment mechanism is almost irrelevant. It is the explicit agreement to the service delivered, and fee charged for that service, which is crucial in establishing a fee for service arrangement. Often the fee can be explicitly deducted from a client's investment, facilitated by the product provider. However, the Proposed Standard defines Fee for Service arrangements much more narrowly than this:

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."

The Board's stated reason for drafting the Fee for Service definition narrowly is to minimise conflicts of interest. This implies that percentage-based asset fees cause conflicts of interest and are therefore an inappropriate method of remuneration for Members.

In the comments below I outline why I do not agree with this proposition as well as the reasons why I believe percentage based asset fees are an important part of financial advice remuneration in a fee for service environment.

Forms of financial advice remuneration

Financial advice provides considerable benefits to clients and has an important part to play in addressing issues such as retirement adequacy and generational change. Accountants are trusted advisers and are a crucial source of such advice.

The issue of remuneration is important because initial financial advice is expensive. Research conducted by Dealer Group Advisers indicates that the average full financial plan costs \$3,570 to create, present and implement. This is far beyond what the vast majority of consumers are willing to pay. Consequently, it is very difficult for an adviser to recoup the necessary return from upfront advice on an hourly or set fee basis.

The Treasury demonstrated the extent of the problem in their submission to the Parliamentary Joint Committee on Corporations and Financial Services (PJC) as follows:

"The requirement for a fee only structure could contract the advice market and this contraction may fall largely on less affluent clients who are unable to pay up front fees."

As guiding principles, I believe it is important that remuneration is transparent, understandable, agreed by the client and controlled by the client. There are at least three methods of remuneration that meet these guiding principles; hourly rates, set or flat fees and percentage-based asset fees.

All three forms of remuneration have advantages and disadvantages. Hourly rates have been criticised because "clients feel they have no control, that there is no correlation between cost and quality".² Furthermore, a recent AFR article regarding hourly rates and law firms outlined four problems with this method of billing:

"First, it measures efforts, not outputs and results. Second, it "misaligns interests" and encourages law firms to unnecessarily prolong tasks. Third, it requires the constant addition

² "Kill the Billable Hour", Evan R. Chesler, Forbes Magazine, 1 December 2009.

of new lawyers to increase profitability, instead of focusing on efficiency gains. Fourth, it burns people out and destroys innovation.”³

Clearly, the statement applies equally to professions other than law.

The need for percentage based fees for advice

In April this year, Minister Bowen released the Future of Financial Advice report. The suggested reforms are guided by overriding principles that financial advice must be in the client’s best interests and that financial advice should not be put out of reach of those who would benefit from it. The listed benefits of the reforms include “Adviser charging will be clear, product neutral (and) directly related to the services provided”. Following considerable investigation from the PJC the report recommends that percentage based fees be permitted on ungeared products and investment amounts.

There are several reasons that some clients and Members prefer a remuneration method based on percentage-based asset fees. Firstly, such fees align the Member’s remuneration with the client’s interests; the adviser’s fees increase or decrease with the client’s balance.

Second, it should be recognised that accounting work and financial planning work are different, and involve different types of risk. Financial planning involves both advice and the management of investment transactions, carrying substantial operational risk. In this environment it is reasonable to charge a fee based on the proportionate increase in risk. Given the proposed regulatory changes it is likely we will see an increasing trend towards transaction-based or limited scope advice. It will continue to be important for Members to have the flexibility to charge for their services in a manner which recognises the risk associated with the transaction involved in this form of advice. Furthermore, unlike an accounting transaction, the benefits of financial planning are rarely immediate. Most are realised over a long period of time and require constant monitoring. Percentage-based asset fees reflect the ongoing nature of an advice relationship, especially under the fee for service model (‘Adviser charging’) described in the Future of Financial Advice report.

Finally, percentage based asset fees reflect the fact that there is more work for the Member for clients with higher balances. Higher net worth clients will generally have a more complicated financial situation, requiring more detailed analysis, implementation and review.

The implications of introducing the Proposed Standard in its current form

The adoption of this recommendation would bring enormous disruption to thousands of Members. Firms will be forced to implement new systems and procedures and the costs of compliance will be pushed to clients, who already struggle to meet the cost of initial advice. Clients, therefore, will be forced away from a source of trusted advice.

All forms of remuneration risk being abused. In my view, however, the benefits of percentage-based asset fees far outweigh the risks. Banning this form of remuneration may reduce perceptions of a conflict of interest of the Member. The cost, however, is that access to advice is materially reduced for a large number of Australian consumers and a large number of the Institute’s Members would have an immediate and negative impact on their own businesses.

³ “Billing Time”, Brad Hatch, AFR’s BOSS Magazine, September 2009.