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Basis for Conclusions: APES 230 Financial Planning Services (Formerly APS 12)

Prepared by the Technical Staff of the Accounting Professional & Ethical Standards Board

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This basis for conclusions has been prepared by technical staff of Accounting Professional & Ethical Standards Board Limited (“APESB”). It has been reviewed and approved by the Board of Directors of APESB and is provided for the benefit of stakeholders so they may gain an understanding of the background to the development of APES 230 *Financial Planning Services* (the Standard).

The basis for conclusions **does not** form part of APES 230 and is not a substitute for reading the Standard.

Background

APESB has issued APES 230 setting out mandatory requirements and guidance for Members who provide Financial Planning Services. Except for paragraphs 8 and 9, APES 230 is effective from 1 July 2014 with early adoption permitted. The requirements of paragraphs 8 and 9 in respect of professional fees and Third Party Payments are effective from 1 July 2015. APES 230 will replace the existing APS 12 *Statement of Financial Advisory Service Standards* (APS 12).

APES 230 includes mandatory requirements and guidance in respect of:

- Fundamental responsibilities of Members;
- Professional Independence;
- Terms of the Financial Planning Service;
- The basis of preparing and reporting Financial Planning Advice;
- Client’s information, monies and other property;
- Professional fees;
- Third Party Payments;
- Soft Dollar Benefits;
- Documentation and quality control; and
- Transitional provisions.

APESB issued two exposure drafts of the proposed Standard, hereafter referred to as ED1 and ED2 in June 2010 and July 2012 respectively. At the time of issuing ED2, APESB issued an accompanying Explanatory Memorandum (EM) to inform readers of ED2 of the development process undertaken by APESB. The EM also considered the key matters raised by respondents to ED1, the matters considered during APESB’s 2011 public consultations with key stakeholders and the rationale for the APESB’s decisions on the key issues.

Submissions on both ED1 and ED2 were received from the Professional Bodies, Firms, Members, dealer groups, financial institutions, consumer groups, other associations, ASIC and other stakeholders. In response to the comments received, APESB has made a number of changes in the final version of APES 230. The following summarises the significant issues raised by respondents and how APESB addressed them.

Scope of APES 230

The scope of APES 230 was developed from the perspective of a Member who undertakes Financial Planning Services and was drafted to encapsulate all the work that may be performed by such a Member. Accordingly, when developing the Standard APESB considered the different types of engagements performed by a Member in a financial planning practice and defined Financial Planning Advice to capture these different activities. It is acknowledged that some of these activities may also be subject to legislative requirements such as the *Corporations Act 2001*. However, APESB believes it is not appropriate to issue a Professional Standard that only captures some services performed by a Member in a financial planning practice and not others.

Taxation advice

Some respondents expressed the view that taxation advice should be excluded from the definition of Financial Planning Advice due to the existence of APES 220 *Taxation Services* (APES 220). Unlike APES 220, APES 230 is not intended to capture Taxation Services that are not otherwise connected with Financial Planning Advice. The definition of Financial Planning Advice only captures taxation advice which is related to financial planning, as for most Financial Planning Advice provided by a Member there is a related tax consequence. In these circumstances to exclude related taxation advice is inappropriate.

Real Estate and loan procurement

Some respondents expressed the view that advice on the acquisition of real estate and loan procurement should be excluded from the definition of Financial Planning Advice due to the existence of a separate credit licensing regulatory regime. For most individuals, their home and related mortgage are their most significant asset and liability and therefore Clients require advice on how to obtain a cost effective mortgage. Further, a common tax effective investment strategy for an individual is the purchase of an investment property with a mortgage to finance its purchase. In these circumstances the Board determined that it was not appropriate to exclude mortgage broking advice from the definition of Financial Planning Advice.

Corporate finance, financial strategies and structures

Some respondents expressed the view that advice on financial strategies and structures should be excluded from the definition of Financial Planning Advice in ED2, since this definition may unintentionally capture much of advice provided by a Member in Public Practice. Respondents were also concerned that advice on appropriate business structures, establishing, running and winding up entities, the buying and selling of businesses, and independent expert's reports will be unintentionally captured by the definition.

APESB considered this issue and in the definition of 'Financial Planning Advice' made an amendment to make it clear that the advice must be in respect of *personal financial affairs* specifically related to wealth management, retirement planning, estate planning, risk management and related advice.

APES 230 is not intended to cover Professional Services provided by corporate finance or corporate financial advisory service lines of Firms, such as Independent Expert's reports, Due Diligence Services or Valuation Services. Members should note that there are other APESB Standards that address these services.

Retail vs. wholesale Clients

Respondents noted that the federal government's *Future of Financial Advice* reforms (*FoFA*) will only apply to retail Clients and that this distinction should be made in the Standard.

APESB determined to define Clients in a manner to capture all Clients and not to make the distinction between retail and wholesale Clients as there should not be two different standards of Professional Service provided to Clients.

The definitions of 'wholesale' and 'retail' Clients derive from requirements under the AFSL licensing regime which regulates financial advisers selling financial products to retail Clients. APES 230 is a Professional Standard which addresses Members providing Financial Planning Services to all Clients.

Definitions – Best Interests of the Client

ED1 referred to fiduciary responsibilities that a Member was required to comply with when providing Financial Planning Services. Some respondents were concerned that there would be confusion between statutory *Best Interests of the Client* as defined in *FoFA* and the professional obligations imposed by the fiduciary responsibilities in ED1.

APESB considered this issue and determined in ED2 that *Best Interests of the Client*, which is aligned with *FoFA*, should be used in preference to reference to fiduciary responsibilities in ED1. Accordingly the provisions dealing with fiduciary responsibilities were amended and APESB resolved to link the *Best Interests of the Client* directly to the *Corporations Act 2001* to remove the possibility of any inconsistency. APES 230 extends the *Best Interests of the Client* test to all Clients, whether they be retail or wholesale and removes the exemptions allowed within the *FoFA* proposal.

Definitions – Fee for Service

ED1 included a definition of Fee for Service and proposed a mandatory requirement for a Member providing a Financial Advisory Service (now Financial Planning Service) to only charge a Client on a Fee for Service basis. Fee for Service is defined in the standard and allows for a wide range of factors to be considered when determining the appropriate fee.

After considering respondents' comments to ED1 and feedback from public stakeholder consultations, the Board removed the defined term, redrafted ED2 and proposed that asset based fees and Commissions should be prohibited for Financial Planning Services.

Subsequent to the issue of ED2 and further concerns raised by respondents and stakeholders, the Board has determined to permit in APES 230 alternative remuneration methods, one being Fee for Service, which is preferred by the Board because it eliminates the threats of conflicted remuneration. Where Fee for Service is not used by Members, the Standard includes additional safeguards, including the requirement of Informed Consent, to reduce to an Acceptable Level the threats to the fundamental principles in APES 110 *Code of Ethics for Professional Accountants* (the Code).

With the introduction of alternative remuneration methods the Board reintroduced in the Standard the definition of Fee for Service.

Definitions – Informed Consent

APESB has introduced in APES 230 the concept of Informed Consent and as a result has included a definition of that term. Informed Consent, when applied in conjunction with other safeguards, is seen as a way of reducing to an Acceptable Level the threats posed by conflicted remuneration. The requirement of Informed Consent is a significant hurdle and represents a substantial safeguard. Informed Consent requires a higher level of disclosure than for a simple consent. It requires that the Client has a clear appreciation and understanding of the relevant facts in relation to the charging for services, as well as the implications of what the Client is agreeing to. The Member must form a view about the level of understanding of his or her Client in the particular circumstances. The view must be objectively based, or in other words it must be able to sustain scrutiny from an objective third party assessment as opposed to simply the subjective view of the Member. This test relating to Informed Consent is widely used in other commercial contexts.

In the event that the Member is not able to obtain Informed Consent or the Client does not have the capacity to provide Informed Consent, the Member cannot be remunerated by asset based fees or Third Party Payments. In these circumstances the Member must use Fee for Service.

Definitions – Soft Dollar Benefits

Respondents to ED2 noted that the proposed definition in ED2 of Soft Dollar Benefits will prevent a Member from receiving free or subsidised professional development which is allowed under *FoFA*, subject to certain restrictions. Accordingly APESB determined that the definition should be amended to enable the provision of free or subsidised professional development as specified in the *Corporations Act 2001*.

Best Interests of the Client obligations in *FoFA* to apply to all Clients

Respondents to ED2 raised concerns in respect of the Board's intention to apply the Best Interests obligations in *FoFA* to all Financial Planning Services. *FoFA* is only applicable to activities carried out pursuant to an AFSL Licence and in respect of retail Clients. The primary concern of these respondents was that Members will be subject to professional obligations which they are not otherwise legally required to comply with.

APESB has determined that these requirements are what the Board expects of Members providing all Financial Planning Services, including those outside *FoFA*. *FoFA's Best Interests of the Client* obligations assist in reducing the threats to the fundamental principles of the Code arising from conflicted remuneration. These obligations are appropriate for all Clients. Furthermore, the Code mandates similar professional obligations in respect of putting the Client's interests first and acting with appropriate care and diligence when performing Professional Services.

Accordingly, APESB has determined that the *Best Interests of the Client* obligations in *FoFA* should apply to all Financial Planning Services, including those services provided under the *National Consumer Credit Protection Act 2009* or services provided under any other legislation or regulations such as the Private Health Insurance. All Clients are entitled to the same standards from Members who provide Financial Planning Services.

Members are advised to refer to ASIC's Regulation Impact Statement (RIS) *Future of Financial Advice: Best interests duty and related obligations* issued in December 2012. This RIS provides ASIC's final guidance on the new obligations for financial advice providers to act in the *Best Interests of the Client* and the related obligations in Div 2 of Pt 7.7A in the *Corporations Act 2001*.

Terms of Engagement

APESB has determined to include in this section appropriate reference to provisions relating to a Member's obligations to obtain a Client's written agreement to terms of engagement including the basis for charging fees; and appropriate reference to the requirement to obtain written Informed Consent from the Client where a Member is to be remunerated other than on a Fee for Service basis.

Members in Business

A number of respondents to ED1 expressed concern over the application of the Standard to Members in Business due to the fact that such Members may not be in a position to determine or change the policies and procedures of their employer. APESB has made amendments to the Standard to allow for such circumstances for Members in Business.

Basis for the Financial Planning Advice

APESB has made minor editorial amendments in this section to align a Client's relevant circumstances with *FoFA*.

Remuneration requirements

The most debated aspect of the Standard and the area of greatest focus for respondents and stakeholders in both ED1 and ED2 was the remuneration requirements. Requirements in the exposure drafts were developed based on the application of the fundamental ethical principles in the Code and intended to eliminate the threats created by the conflicted remuneration methods of asset based fees and Third Party Payments. Providing for adequate safeguards in relation to conflicted remuneration was seen to be very challenging. The Board's preferred approach was to remove the opportunity for such conflicts by not allowing fees to be charged solely with reference to the volume of assets managed by the Member and by not allowing Third Party Payments.

From submissions received on ED2, the majority of respondents opposed all of the remuneration requirements included in it. Many felt that adequate safeguards could be utilised. It should be noted that around 70% of the submissions that were not supportive emanated from two dealer groups and their associated firms and institutions. Only a small minority was fully supportive of all the remuneration requirements of ED2 with the remaining respondents being partly supportive.

The submitted position of many of the respondents was that APES 230 should be aligned with *FoFA*, allowing the continuation of asset based fees and Commissions, as *FoFA* provides certain legislative safeguards such as the Best Interests obligations and opt-in measures to address threats created by conflicted remuneration methods.

A few respondents made the suggestion that receipt of asset based fees and Commissions should be accompanied by a requirement for Members to obtain written 'Informed Consent' from Clients. These respondents were of the view that the use of 'Informed Consent' combined with other safeguards and *FoFA* are sufficient to reduce the threats to the fundamental principles of the Code to an Acceptable Level.

Following consideration of all submissions, the current industry structure and the need to address threats to the fundamental principles of the Code, the Board determined to permit alternative remuneration methods in respect of Financial Planning Services. Primarily it is the inclusion of the requirement for Informed Consent, combined with the new *FoFA*

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framework, which persuaded the Board to amend the proposed Standard in this way. These requirements are new and untried in the financial planning area and it will be important for the Board to review how well they work as safeguards in practice. Refer below to professional fees and Third Party Payments for a detailed explanation of these alternative remuneration methods.

Members are advised to refer to Section 964F(1) of the *Corporations Act 2001* which prohibits Australian Financial Services Licensees from charging an asset based fee on geared funds used or to be used to acquire financial products by or on behalf of a Client to which the advice relates. While APES 230 does not specifically deal with this situation, Members will of course be required to comply with the relevant provisions in the *Corporations Act 2001*.

Members are also advised to refer to ASIC's Regulatory Guides RG 245 *Fee Disclosure Statements* (RG 245) and RG 246 *Conflicted remuneration* (RG 246) which provides ASIC's final guidance to help industry understand the practical operation of fee disclosures and the ban on conflicted remuneration, and how ASIC intends to administer it.

Practical issues of implementing Fee for Service and FoFA

Some respondents who responded to ED1 and ED 2 considered it too difficult to implement a Fee for Service approach due to systems issues. However the introduction of *FoFA* will make it essential that appropriate systems are developed for financial advisers to charge a Fee for Service:

- when a Client's investment funds are geared (as asset based fees are prohibited in that situation); and
- when they provide risk advice in respect of group life insurance policies within superannuation funds, including within 'default' superannuation funds (as Commissions are prohibited in that situation).

Therefore, *FoFA* (which is due to commence on 1 July 2013) has in effect mandated the creation of Fee for Service systems for certain retail Client products and services.

Further, based on responses to ED1 and ED2 and desktop research, over 50 Firms/practices are already using Fee for Service for Financial Planning Services. These Firms provide evidence that there are systems and processes already developed and the transition to Fee for Service is possible for Members who want to adopt this remuneration method.

The Board acknowledge that some members of dealer groups would face practical issues in implementing Fee for Service, particularly in the area of insurance, but were encouraged that over time these impediments were likely to be lessened. In the meantime, the allowance of alternative remuneration methods, backed by appropriate safeguards, is considered sufficient to mitigate the actual or perceived threat of self-interest to an Acceptable Level. The Board will continue to monitor the implementation of the Standard and if the safeguards prove to be inadequate, the Board will readdress the issue of conflicted remuneration in the future.

Professional fees

When a Member who is providing a Financial Planning Service is remunerated by asset based fees, that remuneration is based on the quantity of product sold or funds under management (FUM). This results in an actual or perceived conflict since it is in the Member's own financial interest to sell more of such product to a Client or to increase FUM, when the

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best option for the Client may be another option such as using surplus funds to repay existing debt. These volume or quantity based sales incentives may influence a Member to increase the Client's funds on a product platform so that FUM is increased which in turn will provide the maximum remuneration to the Member without due consideration of the Client's financial objectives and the risks associated with increasing FUM.

The critical consideration is whether safeguards can be put in place which give adequate protection to the Client in the face of the inherent conflict of interest in this type of fee calculation.

Subsequent to the issue of ED2 and following consideration of concerns raised by respondents and stakeholders, the Board determined to permit alternative remuneration methods. Members may either:

- (a) charge Clients on a Fee for Service basis; or
- (b) charge Clients a fee based on FUM provided that the following safeguards are applied:
 - obtaining written Informed Consent from the Client prior to commencement of the Financial Planning Service;
 - making an annual disclosure to the Client; and
 - thereafter obtaining written consent from the Client on a biannual basis.

Members may choose to charge Clients on a Fee for Service basis which is the most effective method to eliminate threats from conflicted remuneration and is simpler to comply with from an APES 230 perspective. Alternatively, Members may charge Clients an asset based fee provided the additional safeguards described in APES 230 are applied to reduce threats to the fundamental principles of the Code to an Acceptable Level.

Third Party Payments

When developing ED1, the Board considered the threats to the fundamental ethical principles of the Code created by Members receiving Commissions. Third party paid Commissions are not transparent payments as they are not paid by the Client. The receipt of Commissions paid by a financial services company to a Member for selling a product creates a self-interest threat for the Member, since the advice to the Client may be influenced (or be seen to be influenced) by the Commissions. Accordingly, ED1 and ED 2 proposed that Members must only charge a Client on a Fee for Service basis and must rebate any Commissions received from product providers.

A large number of respondents raised concerns with this proposed approach. Much of the concern was based on what is considered current industry practice and the suggested difficulty of restructuring the payment of such Commissions. The Board reconsidered the issues including the long standing industry practice and determined to permit in APES 230 alternative remuneration methods. Members may either:

- (a) charge Clients on a Fee for Service basis; or
- (b) when the Member is to receive Third Party Payments, apply the following safeguards:
 - obtaining written Informed Consent from the Client prior to commencement of the Financial Planning Service;
 - disclosing three comparative quotes where available;
 - making annual disclosures to the Client on the estimated and actual amount of Third Party Payments received; and

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- where applicable, disclosing to the Client the impact of any proposed changes to existing life insurance and other risk contracts and loans.

A Member may choose to charge Clients on a Fee for Service basis, which is preferred by the Board because it eliminates the threats of conflicted remuneration. Alternatively, a Member may continue to receive Commissions provided the additional safeguards described in APES 230 are applied to reduce threats to the fundamental principles of the Code to an Acceptable Level.

Members are advised to refer to Section 963B(1)(b) of the *Corporations Act 2001* which prohibits Australian Financial Services Licensees from accepting conflicted remuneration for the sale of a life risk insurance product that is:

- (a) a group life policy for members of a superannuation entity; or
- (b) a life policy for a member of a default superannuation fund.

Commissions on life insurance and mortgages on existing contracts (trailing income)

Respondents have queried whether Members will be able to continue to receive Third Party Payments from existing contracts. To clarify this issue APESB has included paragraph 9.4 in the Standard which allows Members to continue to receive Third Party Payments for contracts and loans entered into prior to 1 July 2014, provided they do not subsequently provide any further Financial Planning Services in respect of those contracts and loans.

The Board accepted the argument put forward that in many cases Financial Planning Advice had been provided to Clients on the understanding of lower upfront costs offset by trails and that it would be inequitable to ban trails on these pre-existing contracts.

Effective date and transitional provisions

APESB determined to allow an additional year for Members to implement the remuneration requirements in paragraphs 8 and 9 of the Standard (i.e. 1 July 2015). The commencement date for the rest of the Standard remains 1 July 2014, which is one year after *FoFA* commences (i.e. 1 July 2013).

This timeframe should allow Members sufficient time to adapt their business practices and for the Professional Bodies to conduct training for their Members. The primary reason for there being no change from ED2 to the commencement date of the requirements of paragraphs 1 -7 and 10-11 of the Standard is that similar requirements in respect of Terms of Engagement, Reporting and Quality Control are in *FoFA* and are present in existing Professional Standards such as the Code (APES 110), Quality Control (APES 320) and the predecessor standard APS 12.