

# APESB



Accounting Professional & Ethical Standards Board

## **Technical Analysis Paper: APES 230 *Financial Planning Services***

Executive Summary

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*This Technical Analysis Paper currently represents the views of management and do not represent the views of the Board. The Board will consider and deliberate on the issues raised in this Technical Analysis Paper at its Board meeting on the 16<sup>th</sup> of November 2012.*

## Executive Summary

APESB issued its second Exposure Draft of APES 230 *Financial Planning Services* (APES 230 ED2) in July 2012 with an accompanying Explanatory Memorandum (APES 230 EM) to provide stakeholders with the background to the development process of APES 230 as well as the rationale for the Board's key decisions.

### Submissions

APESB has received 163 submissions from professional accounting bodies, other associations, Members, Dealer groups, financial institutions, consumer groups, the regulator and other stakeholders.

From a review of the respondents' comments Technical Staff have identified ten themes and editorial suggestions. We note that a significant amount of submissions have the same or similar content and information. We have prepared summary spreadsheets to identify the issues raised by respondents and will cross refer to the respondents' comments from this Technical Analysis Paper.

### Scope of APES 230 ED2

APESB standards for a specific practice area are developed from the perspective of a Member practising in that area and to encapsulate all the work performed by the Member. Accordingly, when developing APES 230 the Board considered the different work performed by a Member in a financial planning practice and define 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, it is not appropriate to draft a professional standard in a manner to capture only some services and not others.

The Board considered this issue at the November 2011 Board Meeting and agreed that the proposed APES 230 should address all services carried out by a Member who provides Financial Planning Services to a Client.

Some respondents have argued that taxation advice should be excluded from the definition of Financial Planning Advice due to the existence of APES 220 *Taxation Services*. The definition of Financial Planning Advice only captures taxation advice related to financial planning. The approach adopted in the proposed APES 230 is consistent with the existing standard APS 12.

Further, for the majority of Financial Planning Advice there is a related tax consequence. In these circumstances to exclude taxation advice is inappropriate. If related tax advice is excluded another risk is that a Member may classify a service under APES 220 which does not address conflicted remuneration. A potential way to address this issue would be to exclude a taxation service provided in connection with financial planning from the scope of APES 220.

### Retail vs Wholesale Clients

The Board determined at the November 2011 Board meeting to define Clients in a manner to capture all Clients and not to make the distinction between retail and wholesale Clients.

The definitions of 'wholesale' and 'retail' clients derive from requirements under the AFSL licensing regime which regulates financial advisers selling financial products. APES 230 addresses Members providing Financial Planning Advice, which is more comprehensive than product sales.

At the time of issuing APES 230 ED2 the Board determined to provide the Best Interest Obligation provided for retail clients under the *Corporations Act* to all clients as Members must provide Financial Planning Advice to all clients with the same degree of care and diligence.

### Remuneration requirements

The most controversial aspects of APES 230 ED2 continue to be the remuneration requirements which have been developed based on the application of the fundamental ethical principles in APES 110 *Code of Ethics for Professional Accountants* (the Code).

In the proposed APES 230 ED2, APESB proposed the following remuneration requirements:

- A comprehensive ban on assets based fees regardless of whether the Clients investments are geared or not;
- A ban on receiving commissions from third parties for investment, life insurance and mortgage products;
- A ban on soft dollar benefits subject to a threshold.

As identified in the APES 230 EM the most common remuneration methods prevalent in the financial planning industry is a percentage of FUM and Commissions paid by third parties. These remuneration methods may motivate actions that are not aimed at creating wealth for the Client.

During APESB's consultation process key stakeholders were asked whether there was an effective safeguard against these threats to the fundamental ethical principles of the Code. None was identified. Accordingly at the time APES 230 ED2 was issued in July 2012, the Board concluded the only way to effectively avoid compromising these fundamental ethical principles of the Code is to prohibit conflicted remuneration models such as percentage of asset based fees which are linked to FUM and Commissions.

133 respondents (82%) oppose all of the remuneration requirements in the proposed APES 230 ED2. 16 respondents (10%) are fully supportive of all the remuneration requirements of APES 230 ED2. The remaining respondents (8%) are partly supportive or only have editorial suggestions on APES 230 ED2. It should be noted that 93 (70%) of the submissions that are not supportive are emanating from dealer groups Count and Securitor and their associated firms and institutions.

Refer to the summary analysis tables (Appendix G) which tabulate the aspects of the proposed APES 230 ED2 that respondents have commented on as well as the key concerns that they have raised that will be explored further in this Technical Analysis Paper.

The respondents who are not supportive of the remuneration requirements in APES 230 ED2 include the professional accounting bodies, Dealer Groups, including Count (and 70 Members/Firms aligned with Count) and Securitor (and 21 Members/Firms/Financial Institution aligned with Securitor), large accounting firms (4), Financial Services Council, Association of Financial Advisers, SMSF Professional Association of Australia, firms (28), institutions and other stakeholders.

The position of the three professional accounting bodies is that APES 230 should be aligned with the *FoFA* legislation, allowing the continuity of asset fees (except on gearing) and Commissions on life insurance (except on certain insurance policies in superannuation funds). However, on this occasion, the ICAA and CPA Australia have added that receipt of Commissions on life insurance and mortgages should be accompanied by Members seeking 'informed consent' from Clients as an adequate safeguard to allow the continuity of that form of conflicted remuneration.

The problematical nature of disclosure and subsequent 'informed consent' in the context of the provision of professional financial advice and the ongoing receipt of conflicted remuneration were discussed in some detail in the PJC Inquiry into Storm Financial. For example, ASIC commented in its submission to the PJC Inquiry that disclosure can be ineffective because of: length and complexity of some documents; limited consumer engagement and understanding; and the mixed or competing purposes of disclosure. Similar comments were made by Choice in their comments to the PJC:

CHOICE told the committee that disclosure had in fact been counterproductive:

*The requirement to disclose conflicts is often more of a hindrance than a help. People are poorly equipped to identify, accept and account for the impact of conflicts on advice, mainly because consumers simply do not expect conflicts in the first instance. Disclosures are not sufficient to counteract a Client's own understanding of the role of an adviser. There is also evidence to suggest that disclosing conflicts can perversely increase consumer confidence in the advice rather than act as a stark warning on the quality of advice. (5.63)*

Furthermore, as noted by ISN in its submission on APES 230 ED1:

*ISN is particularly supportive of combining the imposition of a fiduciary standard with regulation of remuneration related conflicts. Unlike a fiduciary duty under general law where remuneration related conflicts can be overcome by gaining the informed consent of the client, in the area of financial advice, it*

*is broadly accepted that clients are generally not capable of providing “informed consent”. The finding of the PJC summarises this view concisely:*

*There are also limits as to the usefulness of disclosure, however clear and concise, in an environment where clients have already committed in their mind to their trusted adviser’s chosen strategy. (P.87)*

It was the failure of disclosure and the impracticality of consent in this environment which was the implicit assumption behind the findings of the PJC Inquiry, and the subsequent *FoFA* provisions banning asset based-fees (on gearing) and Commissions (on investment products and certain life insurance arrangements).

The respondents who are fully supportive of APES230 include Members and Firms that have successfully transitioned their practices to be compliant with the proposed remuneration requirements in APES 230 (6), the Independent Financial Advisers Association of Australia, the Australian Securities and Investments Commission, The Australian Consumers Association (Choice) and Financial Counselling Australia, Industry Super Network and the Australian Institute of Superannuation Trustees, consultants who have assisted with transitioning practices to the proposed remuneration principles and other stakeholders.

The respondents who have provided comments that are not supportive of some elements yet indicate support for other key elements in APES 230 ED2 include Members and Firms whose business models are structured in such a manner that they comply with some of the proposed remuneration requirements in APES 230. These include a large accounting firm, the wealth management division of one major financial institution, Members and Firms aligned with Dealer Groups Count (4) and Securitor (1), as well as other Members and Firms (6).

APESB commenced the APES 230 project in late 2007 prior to the Global Financial Crisis and the controversies associated with financial collapses such as Storm or Westpoint. The primary aim of the APES 230 project is to replace the existing professional standard APS 12 *Statement of Financial Advisory Standards (APS 12)*.

The subsequent *PJC Inquiry into Financial Products and Services in Australia*, held in response to the above named collapses, identified that remuneration driven conflicts played a key role in the suboptimal advice delivered by financial advisers to their Clients. The proposed remuneration requirements in APES 230 will remove (not just manage) the occurrence of such conflicts.

Although the proposed remuneration requirements have proven to be controversial, they are not new. They exist as guidance in APS 12 which was issued in 2005 by the Institute of Chartered Accountants in Australia and CPA Australia prior to the establishment of the APESB.

Some of the respondents who responded to the original APES 230 ED in 2010 noted that it is too difficult to implement the proposed APES 230 due to systems issues. However, with the development of *FoFA* there is already a legislative requirement for appropriate systems to be developed for:

- Financial Advisers to charge a Fee for Service when a Clients’ investment funds are geared (i.e. as asset based fees are prohibited); and
- Financial Advisers to charge a Fee for Service when they provide risk advice in respect of group life insurance policies within superannuation funds, including within ‘default’ superannuation funds (i.e. commissions prohibited).

Therefore, the *FoFA* legislation (which is due to commence on 1 July 2013) has in effect legislatively mandated the creation of APES 230 compliant systems for certain retail client segments (as defined in *FoFA*). Accordingly, for financial advice and advice on insurance and risk products, all that APES 230 is proposing is to comprehensively apply the same systems to all Clients rather than segments of the Client population.

It is acknowledged that transitioning to a *FoFA*/APES 230 compliant environment will be a challenging time and those Members and Firms will require significant support from their professional accounting body as well as other service providers, however, the benefits of such a transition are:

- Members will provide professionally independent and trusted advice (without real or perceived conflicts);
- Members will be remunerated for the advice provided rather than quantity of products sold;
- Members will move from a sales mindset to a professional mindset; and

- Members will be able to differentiate in the market place with a new and truly professional value proposition.

Further, based on responses to APES 230 ED1 & 2 and a few days' desk research we have identified over 50 firms/practices who are already APES 230 compliant or substantially APES 230 compliant. The existence of these firms in the market place provides evidence that there must be systems and processes already developed and the transition to APES 230 compliant remuneration methods is possible.

All of these firms differentiating their service offering on the basis of Fee for Service are recognising the issues created by remuneration driven conflicts. These firms/practices have moved early (early adopters) to differentiate their firms in the marketplace. Refer to appendix F for Firms/practices that have APES 230 remuneration methods and relevant information from their websites.

Based on final outcomes of the Board's deliberations, the proposed remuneration requirements will be finalised in the coming months. Thereafter the professional accounting bodies, dealer groups, and other service providers should assist Members and Firms to transition to an APES 230 compliant environment. Support could also be obtained from consultants who assist firms to transition to APES 230 compliant Fee for Service mode of operation.

Respondent 92, which represent one such consulting firm, states that they have assisted over 300 Australian financial advice firms make the progression to business models that are APES 230 compliant. The respondent acknowledges that the transitioning is not without obstacles and challenges. However, the initial requirement is to develop a professional mindset.

As stated by respondent 92 some aspects of a professional mindset that would benefit Members include:

- The desire to deliver ethical and 'professionally correct' financial advice;
- The desire to build trust between themselves and their Clients;
- Dedication to demonstrating consistent and methodical value creating activities for their Clients; and
- Seeking to develop relationships and networks with other like-minded professionals.

Respondent 145, states that professional accountants should strive for the highest level of professionalism, above the minimum standards required by the *FoFA* legislation and apart from the vested interests of the financial services industry.

While the majority of the respondents view APES 230 (not to mention *FoFA*) as onerous and unachievable, as noted in Appendix (F) there are other firms/practices who have transitioned to an APES 230 mode of operation. Accordingly, if there is appropriate support provided with change management programs, access to experts, lessons learned from firms who have already done the transition, templates etc., then the transition will not be as insurmountable task as many respondents are suggesting.

Fee for Service (as defined in APES 230) compliant firms clearly differentiate themselves in the market place as providing independent financial advice which is not influenced (or has the perception of being influenced) by remuneration driven conflicts. This is due to the fact that the nexus and control between the financial advice and financial product will not exist.

The proposed APES 230 will improve the transparency of the fees charged to Clients as well as focus on the quality of advice delivered. It will lead to the development of trusted professional adviser relationships where the key person in the relationship is the Client and not the product provider or platform operator. These APES 230 compliant firms price their advice based on complexity and quality of their advice rather than the quantity of products sold.

One of the difficulties that will be experienced by Members who need to transition is that in previous Client conversations fees were in a sense opaque to the Client. It was either a percentage of FUM or collected by way of Commissions where the Client did not have to directly pay the Member. Thus some Members may find it difficult to openly discuss fees and the value delivered by the financial advice. These Members will require training to enable them to confidently have conversations about the value of their fees as they develop trusted professional adviser relationships.

With the advent of *FoFA*, the movement away from asset based pricing and commission has continued a process which was foreshadowed by the Accounting profession in APS 12 in 2005 and developed further with APES 230. The requirements in APES 230 will mean that Members of the three professional accounting bodies will be in an ethical and market leadership position and will have moved ahead of the minimum legislative requirement to a position which will not be impacted by the acknowledged complexities of *FoFA*.

One such professional association whose members comply with remuneration requirements equivalent to APES 230 is the Independent Financial Advisers Association of Australia Limited. Members of the IFAAA:

- Have no ownership links with any product manufacturer;
- Receive no payments from any third parties (Commissions); and
- Do not charge fees based on how much money the investor has.

As financial advisers have to now change some systems to be compliant with *FoFA*, a comprehensive change such as that proposed by APES 230 will mean that when there are extensions of the *FoFA* requirements in respect of remuneration, then Members will have already made the changes. In fact, the biggest benefit from a business point of view to the Firms who have already transitioned to an APES 230 compliant Fee for Service mode of operation, is that the impact on their businesses due to *FoFA* has been minimal as they are already operating at a higher level than *FoFA* requirements.

### **FoFA and potential APES 230 options**

A brief summary of the key elements of *FoFA* compared to APES 230 ED2 is tabulated below.

#### **FoFA and APES 230 ED**

<b>Key aspects</b>	<b>FoFA</b>	<b>APES 230 ED2</b>
Scope	New Retail Clients	All Clients
Commencement date for new services for Financial Advice	1-Jul-2013	1-Jul-2013
Commencement date for new services for Insurance	1-Jul-2013	1-Jul-2013
Commencement date for new services for Mortgages	Not applicable	1-Jul-2013
Commencement date for existing Clients	Grandfathered	1-Jul-2015
Best Interest Duty	New Retail Clients	All Clients - subject to commencement dates
Asset based Fees for Financial Advice	Prohibited with gearing	Prohibited
Commissions on Insurance	Prohibited within group life and default superfunds	Prohibited
Commissions on mortgage products	Not applicable	Prohibited
Annual Fee Disclosure and opt-in (i.e. if a Code of Conduct is not approved by ASIC)	All Retail Clients (Existing and New)	All Clients

Given that it is now November 2012, the commencement date 1 July 2013 for the proposed APES 230 is not likely.

*FoFA* sets out legislative requirements, which are subject to interpretation, and those requirements came about as a result of a political process. This political process has resulted in compromise in order to get the reforms through Parliament and therefore *FoFA* is internally inconsistent. For example, it bans asset-based fees on geared products but not when it is ungeared, bans insurance commissions within group life and default superannuation funds but not when it is outside of these financial products, although they all represent forms of conflicted remuneration.

### **Asset based Fees**

We acknowledge that the development of the Best Interest Obligation is an improvement on the existing regulatory landscape. However whether it is an effective safeguard is yet to be proven. The issue is in most instances in order for a financial adviser to derive remuneration they must place the Clients funds on a platform. Thereafter, their incentive is to grow FUM to the detriment of consideration of other financial strategies such as reducing the debt of the Client.

## Commissions

In a trusted professional relationship, a third party should not be paying the remuneration of the Member. If a third party is paying the remuneration of the Member then there is a conflict as the perception would be that the financial adviser is more likely to be influenced by the remuneration provided by product provider (Commissions, volume bonuses etc.) than what is in the best interests of the Client.

We note that ICAA and CPA Australia have proposed to the APESB to use "informed consent" as an additional safeguard to overcome the threats to the fundamental ethical principles of the Code.

Given the comments noted above by ASIC, Choice and ISN at the PJC inquiry this safeguard may not be effective in an environment where the financial adviser will generally have more knowledge than a Client.

## APES 230 Options

Technical Staff have also prepared a few potential options for the Board's consideration.

Key aspects	APES 230 - option 1	APES 230 - option 2	APES 230 - option 3
Scope	All Clients	All Clients	All Clients
Commencement date for new services for Financial Advice	1-Jan-2014	1-Jan-2014	1-Jan-2014
Commencement date for new services for Insurance	1-Jan-2014	1-Jan-2015	1-Jan-2014*
Commencement date for new services for Mortgages	1-Jan-2014	1-Jan-2015	1-Jan-2014*
Commencement date for existing Clients	1-Jan-2016	1-Jan-2016	1-Jan-2016
Best Interest Duty	All Clients - subject to commencement dates	All Clients - subject to commencement dates	All Clients - subject to commencement dates
Asset based Fees for Financial Advice	Prohibited	Prohibited	Prohibited
Commissions on Insurance	Prohibited	Prohibited	Transition phase*
Commissions on mortgage products	Prohibited	Prohibited	Transition phase*
Annual Fee Disclosure and opt-in (i.e. Code not approved by ASIC)	All Clients	All Clients	All Clients

\*subsequent to the transition phase all existing and new Clients will be on a Fee for Service basis

### APES 230 Option 1

APES 230 Option 1 retains all of the requirements of APES 230 ED2 with the concession of an additional six months' timeframe. We note that ICAA and CPA Australia have requested that the start date be delayed until 1 July 2014.

However, it should be noted that a significant amount of the changes in the proposed APES 230 overlap with *FoFA* and need to be in place by 1 July 2013. The first exposure draft of APES 230 was issued in June 2010. The second exposure draft of APES 230 was issued in July 2012. Accordingly subject to the Board approving the final form of APES 230 before 1 January 2013, we believe a commencement date of 1 January 2014 (i.e. a 12 month) period is appropriate.

### APES 230 Option 2

APES 230 Option 2 retains the requirements of APES 230 ED2. However, makes concessions in terms:

- Additional period of six months to implement Fee for Service for Financial Advice keeping in mind that legislatively Members will have to implement Fee for Service when Client funds are geared from 1 July 2013;
- Additional period of eighteen months for prohibition on Insurances and Mortgages. This will allow Members additional time to review their systems and processes and to also obtain support from their professional body, dealer group or other service provider.

- Additional six months to transition existing Clients. This is in effect a period of three years from the time of writing where they will continue to receive trailing income from advice and products sold to Clients. Thus if as some respondents argue that they are still in the process of recovering fees from services provided to Clients then this time will be sufficient for them recover these amounts (if any).

### **APES 230 Option 3**

APES 230 Option 3 retains the requirements of APES 230 ED2 and incorporates a transition phase for commissions on insurance and mortgage products between 1 January 2014 and 1 January 2016.

- Provides additional 6 months for new services for financial advice, insurance and mortgage broking;
- During the transition phase a Member may provide risk or mortgage broking on a Fee for Service basis or a Commissions basis. However the Member who is providing services on a Commissions basis will be subject to additional stringent disclosure and “informed consent” during the transition phase.
- Additional period of thirty months for before the prohibition on Insurances and Mortgages commences. This will allow Members additional time to review their systems and processes and to also obtain support from their professional body, dealer group or other service provider.
- From 1 January 2016 all existing and new Clients will be under Fee for Service.

#### Grandfathering

It should be noted that all the options above have “grandfathering” of existing arrangements over a 3 year time frame. This period will allow Members to earn trailing income for services they have performed in the past. We do not recommend indefinite grandfathering as that will create more conflicts for the Member when giving advice to the “grandfathered” Clients in the future.

Where Members are providing ongoing advice to Clients it will not be difficult for the Members to demonstrate the value provided to the Client. The difficulty will be if the Member is earning trailing income and providing no services to the Client.

#### **Recommendation**

That the Board consider and deliberate on Options 1 to 3 or variations thereof. Variations to consider include:

- Revising the timeline to provide additional transition time for any combination of specific requirements;
- Use of ‘informed consent’ to mitigate specific threats identified through APES 230;
- The use of ‘informed consent’ plus a ‘de minimis’ threshold of \$50 per client per annum to allow the continued receipt of trailing commissions. The adviser would be required to explain to the Client the calculation of the ongoing commissions trails and obtain the Client’s informed consent to continue receiving them; and
- The use of a ‘de minimis’ threshold that must be surpassed in order to trigger the recording soft dollar benefits. \$300 total per annum is recommended as per ASIC guidance in CP 189.

In so doing, the Board should note that the financial planning industry is required by law to develop systems that will satisfy *FoFA* (and thereby APES 230), that there are numerous financial planning firms that are currently providing Fee for Service financial advice (refer to Appendix F).

Further that there are a number of resources available to assist practitioners to make the transition to Fee for Service, including Jim Stackpool’s *What Price Advice?*, E+W Strategic Partners, *The Fee-for-Service Handbook*, the FPA’s *Fee-for-Service Toolkit*. Consulting firms such as Strategic Consulting and Training, and Elixir Consulting offer consulting services for practices to transition to Fee for Service.