4 August 2009

Shona Batge
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra, ACT 2600

Dear Shona

Inquiry into Financial Products and Services in Australia

The Accounting Professional & Ethical Standards Board Limited (APESB) welcomes the opportunity to make a submission to the Inquiry into Financial Products and Services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services.

APESB is currently in the process of developing a new standard for members of the accounting profession who provide the services under consideration in your Inquiry. We have not finalised our approach on all areas at this stage but we welcome this Inquiry generally and we also believe it will assist us in our deliberations.

Background of the APESB

APESB was established in February 2006 as an initiative of the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia. In November 2006, the National Institute of Accountants (NIA) was admitted as a member of the APESB.

APESB is an independent standard setter with the primary objective of developing and issuing, in the public interest, appropriate professional and ethical standards which apply to the membership of the three professional accounting bodies. A secondary objective of the APESB is to provide an opportunity or forum for the discussion and consideration of issues relating to professional standards for accountants.

Standards applicable for professional accountants engaged in financial advisory services

Briefly in terms of background, in October 2005 the national councils of ICAA and CPA Australia issued APS 12 *Statement of Financial Advisory Service Standards* (APS 12) to mandate best practice for members of the accounting profession engaged in financial advisory services. When APESB was established in February 2006, ICAA and CPA Australia transferred their intellectual property rights to the existing professional and ethical standards, which include APS 12, to the APESB.

In June 2006, APESB issued APES 110 *Code of Ethics for Professional Accountants* (the Code). The Code articulates the values and principles which are the basis of professional and ethical decision making for members of the accounting profession. These include compliance with the five fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The APESB Code (APES 110) is consistent with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants (IFAC) and is used in over 120 countries.

In October 2008, APESB released a Consultation Paper Review of Miscellaneous Professional Statement APS 12: *Statement of Financial Advisory Services* (Consultation Paper) for public comment. The main objectives of the Consultation Paper were to stimulate discussion and debate on issues affecting accountants who provide financial advisory services as well as to provide information and insights to assist APESB in considering the issue of appropriate standards in the area. One of the key issues of concern identified in the Consultation Paper was that of remuneration practices of financial advisers and how the most prevalent remuneration structures in Australia create conflicts of interest. Clearly this is a matter of concern in the broader commercial and client community.

APESB has addressed the following issues raised in the Terms of Reference by the Parliamentary Joint Committee on Corporations and Financial Services that are relevant to APESB's mandate. The relevant issues and our recommendations in summary are:

- *The role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers*

  The central proposition in the APESB submission is that financial advisers need to transition away from 'product based' remuneration models (commissions, asset-based percentage fees when it is used as the main or only basis of setting the fee and production bonuses attached to particular products) and adopt a 'fee for service' model which minimises conflicts of interest.

  We believe that it is important to have proper disclosure, processes to identify conflicts of interests and transparency of fees and expenses. Fees and expenses must be unbundled so that consumers can clearly evaluate the reasonableness of fee components and the total fee.

  We also recommend that 'other benefits' or 'soft dollar' benefits which are related to product sales be banned. Where financial advisers are effectively employees of the product provider their remuneration should not be unduly determined by sales based bonuses as this creates a conflict of interest in circumstances where they are held out to customers as independent "financial advisers".

- *The appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served.*

  APESB believes that financial advisers need to adopt appropriate procedural prudence (processes) when providing financial advice to clients. We have included in our submission the procedural prudence that we are currently considering to be included in our revised version of APS 12.

- *The general regulatory environment for these products and services*

  We consider that the term 'Financial Adviser' is constructed too narrowly in the existing legislation in that the term focuses primarily on the delivery of investment product advice rather than a more holistic approach required for wealth creation and maintenance. We recommend that the definition of financial adviser be revised in the *Corporations Act* to a more holistic role of wealth creation and preservation of wealth.

  We also consider that as a matter of principle, the Australian Financial Services Legislation should be reviewed and if possible should be written in a manner that the overarching principles are in legislation and the rules relating to particular matters are in regulations.

  Overall we believe that redefining the role of the financial adviser within legislation, removal of conflicts of interest with regard to remuneration models and better procedural prudence may mean that further regulation is not required.

If you would like to discuss further or require any additional information, please do not hesitate to contact me on 0418 836 984 or Channa Wijesinghe, Technical Director on (03) 9642 4372.

Yours sincerely,

Kate Spargo
Chairperson

1. THE ROLE PLAYED BY COMMISSION ARRANGEMENTS RELATING TO PRODUCT SALES AND ADVICE, INCLUDING THE POTENTIAL FOR CONFLICTS OF INTEREST, THE NEED FOR APPROPRIATE DISCLOSURE, AND REMUNERATION MODELS FOR FINANCIAL ADVISERS

Remuneration models for providing financial advisory services in Australia commonly distinguish between[1]:

- *Commission:* The financial adviser receives percentage-based remuneration from third party product providers in respect of the sale/placement of a product, and/or retention of clients' funds (referred to as a trailing commission);
- *Percentage-based fee for service*: The financial adviser receives a percentage-based fee for service from the client in respect of the sale/placement of a product and/or retention of clients' funds (referred to as a trailing fee);
- *Non-product specific fee for service*: The financial adviser receives a fee for service from the client, the calculation of which is unrelated to the sale of a product or to the retention of clients' funds; or
- Performance remuneration models for employees that drive revenue of the employer.

However, the predominant remuneration models existing currently in the financial planning industry in Australia rely on the sale of products and the accumulation of funds under management (by way of commissions, asset-based percentage fees for service, trails and production bonuses).

The commission-based remuneration models prevalent in the industry create conflicts of interest at three levels:

- The remuneration of the financial adviser is paid by a third party product provider and not the client;
- A product must be sold to receive the remuneration;
- A financial adviser has an interest in recommending a product that pays the highest level of remuneration.

Some financial advisers charge an annual amount pursuant to a so-called 'asset-based percentage fee for service' that is based on a percentage of Funds Under Management (FUM). While appearing preferable to a commission, asset-based percentage fees still requires products to be sold. Accordingly, at the retail level it is not appropriate for FUM to be used as the only or main basis for financial advisers to determine the fee.

As recent examples have demonstrated, some financial advisers have recommended aggressive leveraging models to clients not only against investments purchased but also against other assets (such as the family home), increasing the FUM and hence the asset-based percentage fees that the financial adviser receives. However, in a falling market, the losses to the client are multiplied by leverage. This then creates the situation where the client not only loses on the investments but may also lose assets which has been given as collateral for the borrowings.

At the other end of the spectrum there is a non-product specific 'fee for service', where clients pay for a service that is calculated on the basis of an hourly rate, a task based scale of fees, an annual retainer, a negotiated fee or a combination thereof. **This form of fee is unrelated to the sale of a product or the accumulation/retention of client's funds and the client receives a full rebate (refund) of any commissions flowing from product manufacturers.**

A recent report by Rice Warner Actuaries state that advice provided by a financial adviser recommending retail personal super or retirement income products which include average annual fees and trail commission, costs the client 2 to13 times more than the remuneration charged by a 'fee for service' financial adviser[2].

There is evidence of a trend towards a fee for service model (usually percentage based) and away from commission based models[3]. This trend has coincided with statements by some professional associations to indicate a preference for fee for service models[4], to ensure that fees for advice are separately identified from other fees[5], to ban access to certain alternative remuneration payments and benefits, and to insist on the adviser and client negotiating fees for service and the mechanism for the collection of payment, prior to any service being provided[6].

Internationally, remuneration practices and associated regulations for financial advisers vary[7]. There appears to be no clear preference for fee for service models except in Japan and at the higher service end in the USA[8]. For example, in the USA brokers registered under the Securities Exchange Act may offer financial advice and charge commissions. Financial advisers registered under the Investment Advisers Act mostly (90%) avoid the use of commissions[9]. Only India appears to have banned the receipt of certain commissions such as commissions associated with mutual funds and insurance sales[10].

Additional issues:

- Clients do not have the right to 'turn off' advice related to commission and fees (trail commissions) that the product providers are paying to financial advisers. The client should be able to cease paying their ongoing fees if they feel they are not getting adequate ongoing advice.
- Disclosure of annual fees in percentage terms rather than dollar term is problematic. Research in behavioural economics indicates that people do not necessarily comprehend the impact of 1 or 2 per cent over time. So an equivalent dollar impact should be disclosed for all fees including administration, funds under management, advice etc[11]. Further, by way of example, a 2% fee on an investment return of 5% is 40% of the portfolio return, and this kind of fee analysis should be disclosed to the client.
- Alternative remuneration benefits, including soft dollar benefits received from third parties, place the interest of the financial adviser in significant conflict with those of the client. Analysis by *The Australian Financial Review* showed the 10 biggest retail investment firms made $5.5 million in soft-dollar payments in the 12 months to March 2007[12]. These benefits can undermine the independence and professionalism of the advice that the public is receiving from financial advisers.

Whilst it is the product manufacturers who set the remuneration terms for financial advisers by building commissions and trails into products, it is the financial advisers who are criticised for accepting them. Recently some product manufacturers have started introducing financial products that do not have an inbuilt commission.

Transparency of all transactions and in particular fees is fundamental to the clients' interests and the professionalism of advisers. Fees and expenses should be unbundled so that consumers can clearly evaluate the components and reasonableness of the fees paid. If product manufacturers are forced to separate product fees from advice fees then financial advisers and their clients will have greater control over amounts charged.

Existing APS 12 and consultation paper

APS 12 states that independence is aligned with how fee for a service is determined, not how the fees are received.

APS 12 which has been in existence since October 2005 states:

- **a clear preference for the fee for service approach as being more consistent with professional independence (Paragraph 17.2);**
- **When setting a fee for service a member needs to consider client requirements, statutory duties, levels of expertise and responsibility, degree of complexity, amount of time taken, and professional and financial risk associated with providing the advice (paragraph 18.5)**
- **a mere standardised percentage basis applied to all funds under management is not a fee for service (Paragraph 18.4).**

APS 12 also focuses on members recognising the potential threats created by personal and business relationships, the acceptance of commission or other benefits, and financial involvements which, by reason of their nature or degree, might threaten the member's objectivity. The standard imposes a positive obligation on the member not to be adversely influenced by third party remuneration in the provision of advice to a client.

APS 12 defines alternative remuneration benefits as all monetary and non monetary benefits, except direct client advice fees and monetary commissions that financial advisers and their licensees may receive for the recommendation of certain financial products. APS 12 bans the acceptance of alternative remuneration benefits including soft dollar benefits, particularly linked to product and volume sales that place the interest of the financial adviser in direct conflict with the interest of the clients. APS 12 stipulates that the receipt of other benefits to be registered for public disclosure in an Alternative Remuneration Schedule if they exceed $300 in any one year.

APS 12 require accountants in public practice undertaking financial advisory services to disclose the following information to their clients:

a. Conflicts of interest generated by any relationship with brokers or other entities, other client accounts, fee structures, or other matters.
b. Management fees and other investment costs charged to clients, including what costs are included in the fees and the methodologies for determining fees and costs.
c. The amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.

Recommendations

<u>Commissions</u>

We recommend the transition from a commission based remuneration model to a 'fee for service' model where the financial advisers and their clients have greater flexibility in the manner in which the fee is negotiated and managed. As previously noted in this paper and APESB's Consultation Paper issued in October 2008, all remuneration models are not equal.

The general public may wish to obtain financial advice on an 'independent' basis or have an expectation, when they engage an adviser that the advice is provided in an objective manner. To achieve 'independence' the financial adviser must ensure that the financial advice provided is not constrained in any way, including by any relationships, financial interests, agreements or associations that the financial adviser has with any third party or third parties, including product providers.

Financial advisers should be prohibited from accepting commissions, including asset-based percentage fees of FUM (in circumstances where it is the only or main basis of calculating the fee) and other payments such as volume bonuses, platform rebates, sales bonuses, fee sharing arrangements and soft dollar payments. Any remuneration received from third parties that are not avoidable must be:

(a) disclosed to the client in full; and
(b) rebated to clients in full when received.

The Financial Services Authority in the UK has also recently implemented the banning of commissions and we highlight the following FSA reform strategy:

"For independent advice to be perceived as truly independent, new requirements remove product provider influence over adviser remuneration and advisers are required to set their own charges for advice"[13]

In June 2009, the US Treasury Department published a paper *Financial Regulatory Reform: A New Foundation* where it proposes a higher fiduciary legal burden on financial advisers and the banning of payments such as commissions that are in the interest of the financial adviser and not the client. We highlight the following from the paper:

"The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but not in the investors best interest" [14]

An analyst report by Merrill Lynch Australia titled *Commission Crackdown Lacks Conviction* states that a fee-for-service payment option will not address the conflict of interest across the retail industry if businesses continue to allow asset-based fees. It recalls the time when MLC introduced a fee model in 2006 which was widely criticised by its competitors for masquerading commissions as fees because it still allowed asset-based percentage fees. The report also notes that '*while banning trails does reduce conflicts between retail products, retaining assets-linked fees does little to remove potential conflicts over recommending non-retail products*'[15].

To regain public trust the industry needs to remove the layers of conflict inherent in remuneration models that encourage the sale of products or the accumulation of FUM.

Transparency of fees and expenses

Clients are entitled to full and fair disclosure of costs associated with the financial advisory services provided. These disclosures should include information relating to all fees paid to the financial adviser. At a minimum, financial advisers should provide clients with gross- and net-

of-fees returns and disclose all expenses. Fees and expenses must also be unbundled so that consumers can clearly evaluate the reasonableness of the different components of fees paid to money managers, brokers, consultants and custodians.

A financial adviser must use plain language in presenting fees and expenses to clients. They must clearly explain the methods for determining all fixed fees, commissions and other expenses that will be borne by clients and explain the transactions that will trigger the imposition of these expenses[16].

Other remuneration

Receipt of 'other benefits' or 'soft-dollar benefits' from third parties that are linked to the provision of advice to clients create a significant conflict of interest which could, in some circumstances, impair the quality of the advice provided to clients (either in fact or appearance). Receipt of such benefits could have the effect that the financial adviser fails to meet their fiduciary duties owed to the client, or create a perception of that effect[17]. We recommend that financial advisers avoid such situations, and where they do receive such benefits, to ensure they fully and properly disclose them to the client and that they obtain the client's informed consent.

2. THE APPROPRIATENESS OF INFORMATION AND ADVICE PROVIDED TO CONSUMERS CONSIDERING INVESTING IN THOSE PRODUCTS AND SERVICES, AND HOW THE INTERESTS OF CONSUMERS CAN BEST BE SERVED

The appropriateness of information and advice provided to clients and how the interests of the clients can be best served needs to be considered when implementing a prudent investment process. We offer the following as our current thinking on these processes and we are considering their inclusion in the revised version of APS 12.

Investment products and techniques are rarely designed with the intent to be inherently imprudent. The investment decision making process and the circumstances in which particular products are used will determine whether the prudence standard has been met. If proper procedural prudence is adopted, even the most aggressive and sophisticated investment strategies are capable of achieving the relevant investment objectives. Whilst the lack of procedural prudence could lead to the most conservative and traditional investment strategies not meeting its investment objectives.

Recommendations

We recommend that the following procedures be adopted as appropriate:

- Prior to taking any investment actions for clients, financial advisers must take the necessary steps to understand and evaluate the clients' financial situation, investment objectives, tolerance for risk, return objectives, liquidity needs, any other unique circumstances (including tax considerations, legal or regulatory constraints etc) and any other relevant information that would affect investment policy. This information should be disclosed in an Investment Policy Statement (IPS) for each client. The purpose of the IPS is to provide financial advisers with a written strategic plan for each client. The financial adviser should discuss with the client the various techniques and strategies to be employed in meeting the clients investment goals[16].

- Financial advisers must act with prudence and make sure their decisions have a reasonable and adequate basis. Prior to taking action on behalf of their clients, financial advisers must analyse the investment opportunities in question and should act only after undertaking **due diligence** to ensure there is sufficient knowledge about specific investments or strategies. Financial advisers need to exercise diligence, independence and thoroughness when making investment recommendations[16].

- There should be a reasonable and adequate basis supported by appropriate research and investigation for any recommendation. The financial adviser's duty is satisfied with respect to a particular investment if they have thoroughly considered the investment's place in the overall portfolio, the risk of loss and opportunity for gains, tax implications, diversification, liquidity, cash flow, and overall return requirements of the assets or the portion of the assets for which the financial adviser is responsible[16].

- Financial advisers must retain records that substantiate the scope of their research and reasons for their actions or conclusions[16].

- The client's objectives and constraints should be maintained and monitored periodically to reflect any changes in the client's circumstances. The financial adviser should review each client's IPS with the client at least annually and whenever circumstances suggest that the existing strategy needs to be modified[16].

- If the financial adviser requires particular competencies, skills, expertise and related resources to perform a particular part or aspect of a financial advisory engagement, which is not available through the financial adviser's firm itself, the financial adviser must obtain the services of a suitably qualified expert[18].

- Developing and maintaining clear and regular communication practices with clients is critical to providing high-quality financial advice. Understanding the information communicated to them allows clients to know how financial advisers are acting on their behalf and gives clients the opportunity to make well-informed decisions regarding their investments. Financial advisers must determine how best to establish lines of communication that fit their circumstances and that enable clients to evaluate their financial status[16].

3. THE GENERAL REGULATORY ENVIRONMENT FOR THESE PRODUCTS AND SERVICES

The vast majority of financial advisers work for Australian Financial Services (AFS) Licensees providing financial advice on financial products (as defined by section 766C of the Corporations Act) such as shares, managed funds, master funds, wrap accounts and insurance. There is also the provision of financial advice which is not subject to AFS licensing such as non product related advice on financial strategies or structures.

We consider that there needs to be greater differentiation of the various parties who provide what might generally be termed 'financial advice'. These may cover[19]:

- Broker/Agent: The financial adviser is authorised to act on another party's behalf. The financial adviser's conflict of interest should be fully disclosed.

- Steward: The financial adviser has agreed to act on another party's behalf – there is a basis of trust and confidence. The interests of the financial adviser should be aligned with those of the other party.

- Fiduciary: The financial adviser has accepted legal responsibility to act on another's behalf. The financial adviser can have no conflicts of interest.

There may well be varying degrees of obligations placed on each of these parties, and clarification here may assist consumers better understand the nature and therefore appropriate expectations they can have of their advisers. This would also give rise to consideration of the existence of a fiduciary relationship arising within some or all of these categories. It would be most useful in our view, to have a discussion about the question of the fiduciary role of financial advisers, and some clarity about when financial advisers may be acting in a fiduciary capacity.

Recommendations

Broader definition

The term financial adviser is constructed narrowly in the existing legislation in that the term focuses primarily on the delivery of investment product advice rather than the holistic approach required for true wealth creation and maintenance. By that we mean understanding the purpose of the wealth for the client, their succession & estate plans, risk profile and asset allocation, the structuring of their investments to maximise the after tax return, appropriate due diligence on investments and managers, risk management and monitoring of the outcomes against the IPS. Therefore we recommend that consideration be given to the revision of the definition of financial adviser in the *Corporations Act* to a more holistic role of wealth creation and preservation of wealth.

Principles based

The Australian Financial Services Legislation should be reviewed and if possible should be written in a manner that the overarching principles are in legislation and the rules relating to particular matters are in regulations.

Further regulation

In the UK, the Financial Services Authority (FSA) has recently introduced a compulsory Professional Standards Board and a code for the financial planning industry. In the USA, the Financial Planning Association has advocated that financial planning needs to be recognised as a distinct profession under the oversight of a national professional board.

Worldwide, the reaction by the general public, regulators, professional bodies and other interested stakeholders have put pressure on governments to implement regulatory measures in this industry.

However, properly defining the role of the financial adviser within legislation, removal of conflicts of interest with regard to remuneration models and proper procedural prudence may mean that further regulation is not required.

Bibliography

1. Accounting Professional & Ethical Standards Board Limited, October 2008, *Invitation to comment: Review of Miscellaneous Professional Statement APS 12: Statement of Financial Advisory Services (Consultation Paper.,*
2. Rice Warner Actuaries, February 2009, *Value of IFPP Advice.*
3. Edwards, J. November 14 2006, "Prepared remarks for Workshop 1.2.4: Corporate Governance and Financial Markets," *a paper given at the World Congress of Accountants in Istanbul, Turkey*, pp.1–9.
4. Financial Planning Association of Australia Ltd. 5 May 2006, "FPA reaffirms support for advice-based fee model", *Media Release*, downloaded from http://www.fpa.asn.au/FPA_LatestNews.aspx, on 10 September 2006.
5. Financial Planning Association of Australia Limited, 8 August 2007, "Committee recommendations show support for value of advice," *Media Release.*
6. Financial Planning Association of Australia Limited, 5 May 2008, "FPA calls for end to SMSF exemptions for accountants," *Media Release.*
7. Financial Planning Association of Australia Limited, 12 March 2008, "FPA welcomes government review and consultation of SMSF's", *Media Release.*
8. Financial Planning Association of Australia Limited, 18 March 2008, "Quarterly Meeting with ASIC," *FPA CEO E-News*, , downloaded on 7 May 2008 at www.fpa.asn.au/Members/FPA_latestnews.aspx?eventgroup=1&EventItem=57.
9. Financial Planning Association of Australia Limited, March 2008, *Practice Standards Consultation: Member Consultation Paper, Financial Planning Association of Australia Limited, Sydney.*
10. Financial Planning Association of Australia Limited, 23 June 2006, *Guidance to FPA Members on Principles to Manage Conflicts of Interest, Financial Planning Association of Australia Limited, Sydney.*
11. The Australian Financial Review, Wednesday 9 July 2008, *Sherry's shake-up targets fees, charges*, page 14.
12. The Australian Financial Review, 9 July 2008, *Taint of bias brings change.*
13. Financial Services Authority (UK), November 2008, *Retail Distribution Review.*
14. US Treasury Department, 17 June 2009, *Financial Regulatory Reform: A new Foundation.*
15. Klijn, W, IFA Issue, A matter of trust: is moving to fee-only remuneration enough?.
16. CFA Institute, 2008, *Ethical and Professional Standards.*
17. New Zealand Institute of Chartered Accountants, November 2008, *Invitation to Comment ED/Engagements to Provide Financial Advice and Related Services, Professional Standards Board of the New Zealand Institute of Chartered Accountants, Auckland, New Zealand.*
18. New Zealand Institute of Chartered Accountants, November 2008, *Exposure Draft: Engagements to Provide Financial Advice and Related Services, Professional Standards Board of the New Zealand Institute of Chartered Accountants, Auckland, New Zealand.*
19. Trone, D 2008, *Investment Ethos*, Fiduciary Ethos, Mystic Connecticut, USA.