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APESB

Accounting Professional & Ethical Standards Board

Explanatory Memorandum: Exposure Draft 03/12 APES 230 Financial Planning Services

Contents

Note: Definitions from the Exposure Draft 03/12 APES 230 Financial Planning Services are capitalised in the Explanatory Memorandum.

1. Background to the development of ED 03/12: APES 230 *Financial Planning Services*

1.1 Introduction

This Explanatory Memorandum provides the background, development process and rationale for Accounting Professional & Ethical Standards Board Limited's (APESB) key decisions in respect of Exposure Draft 03/12 APES 230 *Financial Planning Services* (the Exposure Draft). It has been prepared by Technical Staff of APESB and approved by the Board of Directors of APESB.

The Explanatory Memorandum **does not** form part of the Exposure Draft and is not a substitute for reading it.

1.2 The Exposure Draft

APESB issues the Exposure Draft for public comment. It has been prepared following consideration of matters raised by respondents and other key stakeholders to ED 02/10 Proposed Standard APES 230 *Financial Advisory Services (now renamed Financial Planning Services)* issued by APESB in June 2010 (the Initial Exposure Draft).

APESB received 67 submissions from Members, the three major Australian professional accounting bodies, other professional bodies, Firms, financial institutions, consumer groups and the Australian Securities & Investments Commission (ASIC). Thereafter APESB consulted with key stakeholders to understand their differing points of view on the Initial Exposure Draft and the Board of APESB has considered all of the matters. This Explanatory Memorandum will assist stakeholders understand the rationale for significant changes made to the Initial Exposure Draft and the basis for this Exposure Draft.

1.3 Existing Standard APS 12 *Statement of Financial Advisory Services*

The Exposure Draft has its origins in APS 12 *Statement of Financial Advisory Service Standards* (APS 12)[1] issued jointly by the National Councils of CPA Australia and the Institute of Chartered Accountants of Australia in October 2005. APS 12 has requirements and guidance for Members of the accounting profession who provide Financial Advice (as defined in APS 12) on how to identify and safeguard against threats to the fundamental principles of the Joint Code of Conduct, the predecessor to APES 110 *Code of Ethics for Professional Accountants* (the Code).

[1] Refer to APS 12 *Statement of Financial Advisory Service Standards*.

1.4 Recent developments in the Financial Services Industry

Since APS 12 was issued in 2005, the financial services industry in Australia and globally has experienced a number of negative events, which have resulted in significant investment losses and thus adversely affected public opinion of the industry and increased regulatory interest in the industry's affairs. Some recent high profile cases where the investing public was perceptibly harmed include Storm Financial, Opes Prime and Westpoint. As a direct result of the fallout from these and other events in the financial services industry, the Australian government in February 2009 initiated the Parliamentary Joint Committee (PJC) on Corporations and Financial Services inquiry into financial products and services in Australia. The PJC inquiry issued its report in November 2009.

On 26 April 2010 the Federal Government released for comment *The Future of Financial Advice (FoFA)* in response to the findings of the PJC inquiry. *FoFA* proposed three key areas for reform:

- A prospective ban on conflicted remuneration structures including commissions and any form of volume based payment and a ban on percentage-based fees on geared products or investment amounts.
- Introduction of a statutory duty for financial advisers to act in the best interests of their clients; and
- Introduction of an adviser charging regime which retains a range of flexible options for consumers and includes a requirement for retail clients to "opt in" to receive continued advice from their financial adviser.

On 25 June 2012 the *FoFA* legislation was passed by the Australian parliament and will apply to financial advisers from 1 July 2013.

1.5 APESB's development process and stakeholder consultations in respect of the Exposure Draft

The APESB project to replace APS 12 commenced in August 2007 and has undergone three key consultation processes:

(i). Issue of Consultation Paper on *Review of APS 12 Statement of Financial Advisory Service Standards* in October 2008;

(ii). Issue of the Initial Exposure Draft in June 2010; and

(iii). Public Consultation with key stakeholders at the May 2011 (Melbourne) and August 2011 (Sydney) Board Meetings.

(i) Consultation Paper – Review of APS 12 – October 2008

APESB's first consultation process took place in October 2008 with the release of its Consultation Paper *Review of Miscellaneous Professional Statement APS 12: Statement of Financial Advisory Service Standards* for public comment. The Consultation Paper sought stakeholder views on the scope of any replacement pronouncement, the application of the fundamental ethical principles of the Code, and the appropriateness of remuneration methods taking into consideration those principles. Stakeholders were encouraged to identify potential threats to compliance with the Code when providing financial advisory services to Clients and to recommend appropriate safeguards that Firms and Members could apply to reduce those threats to an Acceptable Level.

In developing the Initial Exposure Draft APESB considered the submissions received from Professional Bodies, Firms and Members in response to the Consultation Paper.

(ii) Initial Exposure Draft – June 2010

The Initial Exposure Draft expanded on the definition of fee for service included in APS 12. The definition of fee for service, consistent with APESB's submission to the PJC inquiry, excluded the use of Commissions, percentage based asset fees, production bonuses and other forms of remuneration that are calculated by reference to product sales or the accumulation of Funds Under Management (FUM), whether paid by the Client or a third party such as a product manufacturer.

In June 2010 APESB approved the issue of the Initial Exposure Draft for public comment. Key issues identified by respondents were:

- Application to Members in Business (refer chapter 3);
- Fiduciary duties (refer chapter 4);
- Definition of fee for service (refer chapter 5);
- Application to insurance and risk products (refer chapter 5);
- The retrospective effect of the proposed standard in respect of trailing Commissions (refer chapter 5); and
- Operative date and transitional provisions (refer chapter 7).

The Board considered the issues raised at the January and March 2011 Board meetings and decided at the March meeting to invite about 20 key stakeholders/ respondents to present their views at a later meeting of the Board. Presenters were selected based on organisation type and size, as well as the nature and analysis of the issues raised and the adequacy of coverage of the different issues identified.

(iii) Public Consultation with key stakeholders at the May and August 2011 Board Meetings

At the May and August 2011 meetings the Board held public consultations with the key stakeholders on the issues identified in the Initial Exposure Draft. Following these extensive consultations the Board made a number of amendments to the Initial Exposure Draft. The following chapters summarise the key matters considered and the amendments made by APESB when redrafting the Exposure Draft for public comment.

APESB has also been monitoring the *FoFA* reforms, in order to give them due consideration in the development of the Exposure Draft.

It is the Board's opinion that sufficient clarity now exists on the direction of *FoFA* for the Board to issue the Exposure Draft with a 45 day comment period.

2. The Accounting Profession and the Code of Ethics

2.1 APESB and Professionalism

APESB has existed in its present form as an independent standard setting body for the three major professional accounting bodies in Australia (CPA Australia, the Institute of Chartered Accountants in Australia, and the Institute of Public Accountants) for over six years.

The obligation to serve the public interest is what distinguishes professionals from other occupations. Due to this predominant self-imposed obligation to serve the public, professions (such as the medical, legal and accountancy professions) are accorded a high occupational status in society. Research has indicated that there are five distinct characteristics that set professions apart from other occupational groups:

- a systematic body of theory;
- professional authority;
- sanction of the community;
- a regulatory code of ethics; and
- a professional culture.

The common theme embedded in these characteristics is the profession's overriding obligation to place the public interest ahead of its own interests.

2.2 The Code of Ethics and Remuneration Methods in Financial Planning

For professional accountants in Australia the fundamental ethical principles that must be adhered to are enunciated in the Code. The Code requires Members to comply with the fundamental ethical principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour and to take reasonable steps to identify circumstances that could pose a threat to compliance with these principles. When actual or potential threats arise, a Member must apply appropriate safeguards to eliminate or reduce to an Acceptable Level any threats to the fundamental ethical principles. A self-interest threat to the fundamental ethical principles arises from conflicted remuneration such as Commissions, percentage based asset fees which are linked to FUM and other incentive based remuneration, which operate in a manner to influence a Member's behaviour that is contrary to the Client's best interests.

A common basis for remuneration in the financial planning industry is a percentage of FUM, which may motivate actions that are not aimed at creating wealth for the Client. This remuneration method may influence a financial planner to increase FUM, without due consideration of the Client's objectives, needs or risk appetite, resulting in a conflict of interest and threats to the fundamental ethical principles of objectivity, integrity and professional competence and due care. 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 the APESB 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.

Recent Australian examples of the adverse impact of conflicted remuneration include Storm Financial, which remunerated financial planners through a combination of percentage based asset fees linked to FUM and trailing Commissions, and Westpoint, which incentivised financial planners through upfront Commissions at relatively high rates. In some cases, financial planners advised Clients to borrow funds against their homes and invest in securities markets. This strategy assumed increasing market returns would cover the upfront Commissions and fees and that credit would continue to be easy to obtain. Both assumptions were proven wrong due to a downturn in the global economy and many investors were left with debt that they could not repay.

2.3 ASIC approved Codes

A significant element of the *FoFA* reforms is the "opt-in" provision whereby a retail client must receive a fee disclosure statement from the financial planner when initially engaged. Further, with one important exception, the retail client must opt in to renew the engagement every 2 years or the arrangement terminates within 30 days of the renewal period regardless of whether the retail client provides notice of termination. This provision of *FoFA* was designed as a safeguard to ensure that the retail client remains aware of all fees being charged and does not by default continue to pay for services that are not provided on an ongoing basis.

However, the *FoFA* legislation provides that financial planners will be exempt from the "opt in" requirements if ASIC approves the applicable code of ethics of the professional body of which the financial planner is an active member. The rationale for the exemption is that the applicable code of the professional body will have requirements that minimise conflicts of interests in relation to remuneration thus obviating the need for the "opt in" clause.

The Exposure Draft is not intended to detract from any responsibilities which may be imposed by law or regulation, such as those pertaining to ongoing fee arrangements arising from the *FoFA* reforms. The Exposure Draft contains a requirement for Members to act in accordance with APES 305 *Terms of Engagement* and hence to document and communicate the Terms of Engagement with the Client. APES 305 recommends that a Member should include the basis for fees charged in the engagement document and provides guidance to Members for reissuing engagement documents for recurring engagements. A Member should reissue an engagement document for reasons such as a change in remuneration or the introduction of new legal requirements (i.e. *FoFA*'s requirements).

3. The scope of APES 230 *Financial Planning Services*

The proposed standard will apply to Members of the three major Australian accounting bodies providing personal Financial Planning Advice to Clients. This includes advice related to personal financial affairs in respect of insurance, risk products and mortgage broking.

It does not 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. It is also not intended to capture Taxation Services that are not otherwise connected with Financial Planning Advice, rather only the tax considerations that arise from the provision of Financial Planning Advice. Members should note that there are other APESB Standards that address these services. The Exposure Draft does extend to tax advice related to financial products or dealing in financial products, real estate and non-product advice which is related to financial strategies or structures.

Some of the more significant scoping issues considered by the APESB in the Exposure Draft are discussed below.

3.1 Change of title of the proposed standard

APESB amended the title of the proposed standard from "Financial Advisory Services" to "Financial Planning Services" to provide greater clarity over the scope of the proposed standard and the type of services the proposed standard seeks to address. It also reduces the potential to inadvertently capture other professional services provided by Firms that could reasonably be considered as "Financial Advisory Services" but are not related to Financial Planning Services.

3.2 Coverage of Insurance, Risk and Mortgage Products

A significant proportion of respondents to the Initial Exposure Draft were of the view that professional services provided by Members in respect of insurance and mortgage broking should be excluded from the scope of the Exposure Draft due to the fact that existing industry remuneration practices are based on Commissions paid by the product manufacturers or product providers.

The provision of Financial Planning Services is considered an integrated discipline comprising advice on all personal wealth management matters. The Exposure Draft addresses all Financial Planning Advice provided by a Member to Clients on wealth management, retirement and estate planning, as well as insurance, risk and mortgage broking services.

When determining the scope of the Exposure Draft, APESB's view was that all Financial Planning Services should be treated in the same way. They all must comply with the same fundamental ethical principles in the Code. Accordingly, APESB determined that insurance, risk and mortgage broking services provided by Members must remain within the scope of the Exposure Draft.

3.3 Reference to Members in Business

A number of respondents expressed concern over the application of the Initial Exposure Draft 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. To address this issue APESB has made amendments and introduced appropriate flexibility for Members in Business to apply the Exposure Draft.

4. Best Interests of the Client

4.1 Fiduciary responsibilities versus Best Interests of the Client

The Initial Exposure Draft referred to fiduciary responsibilities that the Member was required to comply with when providing Financial Planning Services. The Australian government's *FoFA* reform imposes an obligation to consider the Best Interests of the Client. Some respondents were concerned that there would be confusion between *FoFA's* statutory Best Interests of the Client and the professional obligations imposed by the fiduciary responsibilities in the Initial Exposure Draft.

The relationship between a Client and a Member providing Financial Planning Services begins with a significant knowledge gap between the Member and the Client in relation to the range of investment and financial planning options available to the Client. The Client places his or her trust in the integrity, objectivity, and professional competence of the Member and for this reason is in a vulnerable position concerning their wealth and financial security. This relationship of trust places obligations on the Member to assume a level of responsibility to act appropriately in the Client's best interest when providing Financial Planning Services. Both the Exposure Draft and the *FoFA* reforms require proactive action to ensure that the Member has adequate information to act in accordance with the Client's best interests.

APESB considered the issue raised by respondents and determined that Best Interests of the Client, which is aligned with the *FoFA* reforms, should replace the fiduciary responsibilities in the Exposure Draft. Accordingly the provisions dealing with fiduciary responsibilities are now removed and, consistent with the government's *Further FoFA Measures* Division 2 *Best interests obligation*[2,3] reference to Best Interests of the Client is now included in the Exposure Draft.

Best Interests obligations are guided by the principle that the objectives, relevant circumstances and needs of the Client are paramount when a Member provides Financial Planning Advice. In order to best achieve this outcome and improve the overall quality of Financial Planning Advice for Clients, all ethical and professional conflicts must be dealt with. Removing all sources of conflicted remuneration and any other incentives that give rise to an actual or perceived conflict of interest between the Member and the Client is a positive step towards developing a trusted adviser relationship.

[2] Refer to proposed subsection 961 of the proposed *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2012* on page 6

[3] Refer to Chapter 1 of the *Replacement Explanatory Memorandum – Further FoFA Bill 2012* on page 5

5. Remuneration Methods

5.1 Financial Planning Advice

The common forms of remuneration methods used by financial planning practices in respect of Financial Planning Advice are:

(a) Commissions which are paid by product manufacturers;

(b) Percentage based asset fees which are linked to FUM;

(c) Fee for service (flat or fixed fees based on professional services provided to Clients which are unrelated to sale of products or FUM); and

(d) Hybrid fee for service (combination of flat/fixed fee up-front for the financial plan and an ongoing percentage based fee on the portfolio managed. In some cases the initial fee may be rebated if the prospect proceeds and an on-going percentage based fee is charged).

As discussed throughout this document, the fundamental ethical principles of the Code that are threatened by remuneration derived from Commissions and percentage based asset fees are:

- Integrity;
- Objectivity; and
- Professional competence and due care.

Threats to the fundamental ethical principles of integrity, objectivity, and professional competence and due care arise from receipt of conflicted remuneration. The self-interest threats created by percentage based assets fees which are linked to FUM and Third Party Payments influence the Member's professional judgment and may result in advice given by the Member which is not in the Best Interests of the Client.

APESB has concluded that Commissions and percentage based asset fees which are linked to FUM create threats of self-interest to the fundamental ethical principles of the Code for which no safeguards exist that can reduce the threats to an Acceptable Level.

The Initial Exposure Draft went a step further than the guidance in APS 12 and in Section 9 *Fee for Service* 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. In addition Section 10 *Soft Dollar Benefits* of the Initial Exposure Draft proposed restrictions on a Member from accepting other forms of conflicted remuneration, unless they are trivial or insignificant.

After considering respondents' comments and feedback from the stakeholder consultations, the Board has redrafted the Exposure Draft so that Section 8 *Professional Fees* now specifies the requirements for Members charging professional fees for Financial Planning Services. The revised wording in paragraph 8.3 states that a Member shall not charge a professional fee for service that is expressed or collected as a percentage of the value of a Client's assets or FUM (or any component of, or changes in such values). The Exposure Draft does not prohibit taking into account the value of the Client's assets as one of the factors for determining the fee. However, it cannot be the only or dominant determinant.

Refer below to a discussion of the common remuneration methods used by Members who provide Financial Planning Advice and how the fundamental ethical principles in the Code affect them.

(a) Commissions

There are a number of reasons why Commissions create threats to the fundamental ethical principles of the Code. Commissions are not transparent payments and not paid by the Client. The Member's decision making is impacted by another party external to the Client-adviser relationship. The receipt of Commissions paid by a financial services company 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 received by the Member.

Most Commissions will be prohibited under *Further FoFA Measures* Division 4 *Conflicted Remuneration* and Division 5 *Other Banned Remuneration*. However the government's reforms will be implemented on a prospective basis which means that existing Commissions-based arrangements will be allowed to continue in perpetuity, even where it is possible to arrange for the Commissions to be provided as a rebate to the Client.

Ongoing Commission trails arising from previous advice will give rise to conflicted remuneration for existing Clients where those Clients seek advice in the future about whether to continue to hold those products. The Member's advice about whether to quit the original investment may be influenced by the loss of the Commission trail.

(b) Percentage based asset fees which are linked to FUM

The *Corporations Amendment (Further Future of Financial Advice Measures) Draft Bill 2012 – Regulation Impact Statement* (paragraphs 3.40 through 3.45) discusses how Storm Financial's use of asset based fees (as well as Commissions) in charging fees to Clients led to an inevitable conflict of interest between the financial planner/AFSL licensee's interests in increasing revenue and the interests of the Client in receiving appropriate advice.

With asset based fees, remuneration is based on quantity of product sold or FUM. This results in an actual or perceived conflict since it is in the Member's best financial interest to sell more product to the Client or to increase FUM, when the best option for the Client may be an alternative, such as to use surplus funds to repay existing debt. These volume or quantity based sales incentives may not take into account the Client's financial objectives or risk appetite when purchasing financial products. The Member may be influenced instead to put the Client on a sales or product platform so that FUM is increased which in turn will provide the maximum remuneration to the Member.

Respondents to the Initial Exposure Draft who are supportive of percentage based asset fees which are linked to FUM are of the view that:

- A percentage of FUM is easily understood by the Client;
- It allows Clients to access Financial Planning Advice;
- It is widely used and consumers are familiar with it;
- As platform fees are asset based, efficiency and consistency will be achieved if the financial adviser also gets remunerated on an asset based structure; and
- A percentage of FUM provides an incentive for a Member to grow returns for the Client.

Respondents to the Initial Exposure Draft who do not favour percentage based asset fees which are linked to FUM believe that:

- This remuneration method influences the behaviour of a Member to recommend investment strategies that accumulate FUM as opposed to other financial strategies on which a percentage cannot be earned (eg. Investment properties, lowering debt, salary sacrificing into a company/industry superannuation fund, investments in cash in falling markets);
- There is a lack of objectivity and the existence of a self-interest threat for a Member to make recommendations to invest in FUM (as remuneration is linked to a percentage of FUM);
- Whilst there is an upside opportunity there is also a downside risk in having a Member's remuneration linked to the performance of the market; and
- A percentage of FUM may be transparent in a conceptual sense, but it may not be clear in an absolute dollar sense.

FoFA legislation bans charging percentage based asset fees linked to FUM for geared products. However, the concerns about conflicted remuneration are present regardless of whether or not the FUM are linked to a geared product. The same concerns exist for a Client without any borrowings obtained to invest in a financial product (eg a share portfolio), since the better option may be to pay down the Client's home loan first and thereafter increase the amount invested in the share portfolio.

With the use of percentage based asset fees, in essence, the amount of the financial planner's fee for the Financial Planning Advice is linked to the relevant products or FUM. A similar example in the accounting profession is if auditors charged fees based on a percentage of the value of a Client's assets. Then it would be in the auditor's interest to allow the Client to overstate its assets as the audit fee would be higher. However, APES 110 prohibits the use of contingent fees or similar fee arrangements in respect of assurance engagements. APESB has also prohibited the use of contingent fees in respect of professional services that are delivered on an independent basis in five other APESB standards[4].

In March 2012 ASIC published a report on the results of its *Shadow shopping study of retirement advice*[5] research which demonstrated that the quality of financial advice sampled in the study was rated as "adequate" to "poor". The research also found that *"where fees were contingent on a product recommendation, there were numerous examples where the advice appeared to be structured towards recommending or selling financial products. In some cases, this was at the expense of optimal strategic advice…"*

A study performed on the market for financial advice in the USA in late 2008[6] revealed similar tendencies for financial advisers in the US market, including the propensity for financial advisers to act in ways that further their own self-interests, e.g. maximize fees. Some financial advisers were found to have no problem discouraging their Clients from following their current investment strategy and entering into new arrangements that were more in the interest of the financial adviser.

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[4] APESB has prohibited the use of Contingent Fees in certain circumstances. These circumstances are described in the following APESB Standards:

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

[5] *Report 279: Shadow shopping study of retirement advice, March 2012, Australian Securities & Investments Commission, retrieved 29th March 2012*

[6] *Mullainathan, S.; Noeth, M.; and Schoar, A. 2012, The Market for Financial Advice: An Audit Study, National Bureau of Economic Research, retrieved 2nd April 2012*

Prohibiting Members from entering into conflicted remuneration arrangements will over time lead to public confidence that Members of the accounting profession are seeking to improve the quality of Financial Planning Advice delivered and to develop a trusted adviser relationship with their Clients.

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

The Initial Exposure Draft proposed that a Member providing a Financial Advisory Service (now Financial Planning Service) must only charge on a fee for service basis.

Respondents to the Initial Exposure Draft who are in favour of this remuneration method note that:

- When a fee for service remuneration method is used the Member's commercial interest is not linked with the sale of products or accumulation of FUM;
- It complies with the fundamental ethical principles of the Code and minimises conflicts of interest (which are present with Commissions and percentage based asset fees);
- It allows the Member to provide objective unbiased and strategic Financial Planning Advice which is in the best interests of the Client without the imperative to sell products or accumulate FUM;
- It creates a relationship of trust between Members and Clients;
- It can be applied to Clients of all sizes, large and small, thus widening the availability of Financial Planning Services; and
- It is transparent and provides Clients with an actual dollar amount upon which they can evaluate whether the benefits of the intended purchase outweighs the cost.

Respondents to the Initial Exposure Draft who are not supportive of fee for service are of the view that:

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

APESB concluded that the consultation phase identified no significant barriers to implementing a fee for service approach.

(d) Hybrid fee for service structure

Some respondents advocated the use of a hybrid fee for service whereby a fee for service as defined in the Initial Exposure Draft is charged on the initial strategy advice and thereafter an asset based fee/Commissions is charged on the portfolio that will be managed by the Member on an ongoing basis. Some of the Members who adopt this approach also use a sliding scale whereby as the amount of FUM increases the percentage of fees charged decreases.

The concerns with this approach are in substance the same as those with percentage based asset fees which are linked to FUM.

5.2 Insurance and risk products

The most common remuneration method in respect of insurance and risk products is Commissions. These are generally paid by the insurance company to the Member selling the insurance product and are most often calculated as a percentage of the cost of the insurance policy premiums. It is noted that Members who use a fee for service approach are rebating the Commissions they receive from the insurance companies to the Client.

Respondents who want to maintain the existing Commissions based remuneration structure for insurance and risk products state that:

- The insurance company sets the Commissions based remuneration structure and therefore Members have no say in the remuneration method;
- A similar set of Commission rates are applied to all financial planners;
- Charging Clients an upfront fee for service will only exacerbate the existing underinsurance problem in Australia as Clients will not pay a fee for initial advice, implementation and annual review of their insurance needs;
- Insurance is a product that needs to be sold and to do so requires the product manufacturer to pay Commissions to the adviser who sells the product;
- Clients should be offered a choice to pay a fee for service or allow the financial planner to receive a Commission; and
- Clients undergo a traumatic and stressful time when claiming life insurance. A fee for service remuneration structure will require a payment from the Client to the financial planner to prepare the insurance claim. On the other hand where Commissions are charged throughout the life of the policy, no additional amounts are payable to make the insurance claim.

Stakeholders who do not favour Commissions for insurance and risk products have presented the following views:

- The current embedded Commissions based remuneration actually contributes to the ongoing problem of underinsurance in Australia by adding to the cost of insurance and removing trust in advice offered (by embedding conflicts of interest);
- Commissions on these products are very similar to percentage based asset fees/trailing Commissions in investments with ongoing trails received over the years the policy is held irrespective of whether an ongoing service is provided;
- One of the major factors in determining how insurance premiums are priced is the embedded, up-front financial adviser Commissions factored into the premium charged to consumers. A survey of initial Commissions reveals that they can be in the range of 100-130% of the premium for the first year and around 11% on an ongoing basis. This means that the Client will have to stay with the insurance company for at least five years to make it sustainable for the insurance company. However, if there is a high churn rate, this will lead to insurance companies pushing the cost of premiums higher, which potentially contributes to the under insurance problem in Australia;
- There are four different types of Commissions. The most problematic are upfront Commissions (noted above) and stepped Commissions as both result in high upfront Commissions and low ongoing Commissions. These two methods of Commissions have the potential to encourage churning to enable financial advisors to obtain the high initial Commission. Compared to these methods, the hybrid and level Commissions methods have stable Commissions throughout the life of the policy and the churning rate is significantly lower than the upfront and stepped Commissions;

- As price is a key factor for consumers when choosing an insurance policy, if premiums were lower, then this may lead to more consumers being attracted to insurance. Fee for service financial planners state that they can save Clients up to 30% of annual insurance premiums;
- Every person will have a different insurance need. For instance, as an individual moves through life and their debts are repaid their financial planner should consider reducing their insurance cover, but often this creates a self-interest threat for the advisor as it reduces the Commissions on the insured amount or the adviser will lose the trailing Commission on the initial product sold; and
- The underinsurance problem in Australia has existed for several decades and the present Commissions-based remuneration practices have not solved it.

5.3 Mortgage products

Some respondents to the Initial Exposure Draft are of the view that mortgage broking should be excluded from the scope of the proposed standard because the government's new credit regime will provide protection for consumers. Respondents argue that all brokers receive the same rate of Commission from the banks and brokers therefore are not incentivised to put Clients in to more risky products due to Commission differences. Furthermore, these respondents are of the view that the Commission percentage relating to a mortgage is very minor at only 0.24-0.4% per annum.

APESB Technical Staff has performed a calculation on an average loan of $500,000 at 6.8% standard variable interest rate over 30 years with a Commissions rate of 0.34% p.a. The result is that a financial planner will receive over $25,000 in trailing Commissions over the life of the loan. With the same loan terms over a period of 7 years, the total trailing Commissions is estimated at over $4,000.

Examples provided to the APESB suggest that a financial planner using fee for service will charge between $1,500 to $2,000 for the initial loan evaluation and will rebate the full upfront Commissions of a similar amount to the Client. Thus at the start of the loan the cost to the Client is similar for the two remuneration methods, however over the life of the loan a financial planner using fee for service will rebate to the Client the Commissions received, which based on the examples given, are estimated at between $4,000 and $25,000 depending on the term of the loan. Should the Client require further advice during the life of the loan then a fee for service would be applicable at that time.

There is a lack of transparency in only disclosing the small percentage which is applied to the outstanding loan balance and it is difficult for a consumer to estimate the monetary value of the trailing Commissions without doing a detailed calculation.

5.4 Client's Choice

A number of respondents are of the view that Members should not be restricted by the remuneration method and that they should allow Clients to choose how they want to remunerate their advisor. These respondents further state that conflicts do not exist if a Client has made a decision based on full disclosure of information and provided their consent to use either a percentage based asset fee, Commissions or fee for service to remunerate a Member.

Some respondents state that they have Clients who prefer to tie the fees charged by the financial planner to the market rather than pay a flat/fixed/hourly rate as this will enable Members to make better decisions when evaluating financial strategies and financial products.

Furthermore, some respondents argue that many Clients in need of Financial Planning Advice may not be able to afford the upfront payment to the Member and therefore Commissions should be allowed in respect of insurance and mortgage broking, and that the proposals in the Initial Exposure Draft are likely to make Financial Planning Services unaffordable to Australians who need it most.

Respondents who support fee for service maintain that remuneration models fundamentally influence the behaviour of Members, and that allowing percentage of assets based fees which are linked to FUM and Commissions in any area of financial planning practice lead to conflicted advice, a lack of trust and poor advice which is not in the Clients' interests. Where a Client is made fully aware of the true cost of the advice and services they are paying for they are in a better position to make an informed decision. Removing conflicted remuneration as a fee option provides the Client with increased transparency in fee determination and should facilitate a choice that is in the Client's best interests.

5.5 Summary

Having considered all views presented, a self-interest threat, which contravenes the Code, was clearly identified in using percentage based fees linked to FUM, and Commissions based remuneration for mortgage broking, insurance and risk products. The Board believes that no adequate safeguard exists to reduce this threat to compliance with the Code to an Acceptable Level.

In the Exposure Draft Members are prohibited from charging a professional fee for a Financial Planning Service that is expressed or collected as a percentage of the value of the Client's assets or FUM. Certain transitional provisions discussed later in this Explanatory Memorandum will apply.

6. Legacy Products

6.1 Types of Legacy Products

Generally with legacy products there are those where the Commissions can be rebated (refunded) by the product provider to the Client within the product and those where either the Commissions can be paid by the product provider to the Member or the product provider retains the Commissions. To ‘switch off’ the Commissions the Member would need to remove themselves as the servicing financial planner and normally the Client would not receive the rebated Commissions. This is not ideal for any party except the product provider.

In certain instances Members will provide advice to Clients on administrative platforms, wrap accounts, ‘white label’ products, master funds and similar products for which the Member receives volume based rebates where the calculation of Commissions per Client is complex due to tiering of Commissions rates. In this case the Member can request the product provider to rebate the Client directly the amount of Commissions related to that Client. If the provider is unwilling or unable to rebate the Commissions directly to the Client but is able to provide the rate of Commissions per Client, the Member can still apportion and rebate the Commissions to each Client. In the case where the provider does not provide Client specific Commissions rates, the Member can rebate the Commissions to Clients on a reasonable pro rata basis.

6.2 Detrimental impact on the Client

An issue identified by some respondents in respect of legacy products is that in certain circumstances the Commissions payments cannot be turned off and renegotiation of the contract may have a detrimental impact on the Client. For example, a change may trigger capital gains tax, transaction costs or redemption penalties or, in the case of insurance policies, leave the Client without adequate insurance coverage. Further the new product may not be the most suitable to meet the Client’s financial objectives. In these circumstances it is not necessary to rescind the existing contract. The Member can make arrangements to rebate the Commission payments to the Client and charge a professional fee for the services provided by the Member.

6.3 Summary

Section 9 *Third party payments and Soft Dollar Benefits* of the Exposure Draft requires a Member in Public Practice who receives Commissions, production bonuses or other payments from third parties such as product providers, for which there is no reasonable way of having such payments made directly to the Client by the third party, to fully rebate any such payments to the Client as soon as practicable. Where a payment by the third party is not related specifically to an individual Client, the Member is required to apportion the amount amongst all relevant Clients in a fair and reasonable manner. The Standard does not apply retrospectively to Financial Planning Services provided in the past, however it does apply to new instances where Clients require advice on existing products. In circumstances where the Member is unable to provide new and conflict free advice, the Member may be required to state that, due to conflict, advice should be sought from another advisor.

7. Transition to an APES 230 compliant Professional Fee basis

7.1 Transitional provisions and operative date

The Initial Exposure Draft proposed an operative date of 1 July 2011 and did not include transitional provisions. The Board acknowledges that the introduction of the proposals in this Exposure Draft may impact some businesses significantly in terms of systems and current business models. However, it should be noted that the government's *FoFA* reforms have a mandatory commencement date of 1 July 2013.

The Board considered this issue and determined to align the commencement date of the Exposure Draft with the *FoFA* reforms. Accordingly, for all Financial Planning Services that commence on or after 1 July 2013 the proposed requirements in the Exposure Draft will be applicable.

The proposed transitional provisions take into account the time required to implement these changes in respect of existing Financial Planning Services. Accordingly, for Financial Planning Services which commence before 1 July 2013 the requirements of paragraphs 8 and 9 in respect of professional fees, Third Party Payments and Soft Dollar Benefits are effective from 1 July 2015.

APPENDIX A - *Frequently asked Questions and Answers*

This Appendix contains a series of frequently asked questions and answers to assist Members with understanding the application of the proposals in the Exposure Draft. Members are cautioned that each circumstance should be judged based on the particular facts that apply in that instance. The examples contained in this Appendix are provided for illustrative purposes only and are not intended to be, and cannot be, all inclusive. The examples are not a substitute for reading the Exposure Draft. In all of the examples presented below it is assumed that there are no unmentioned facts which would be relevant to the consideration of the application of the proposals in the Exposure Draft.

(i) Members in Business

Question: How does a Member in Business employed as a Finance Manager with a Firm that derives revenues from Commissions or Third Party Payments from Financial Planning Services ensure compliance with the Exposure Draft?

Facts: The Member in Business is not involved in the provision of Financial Planning Services. The Member is paid an annual salary and may receive an incentive payment based on a combination of the Firm's and the Member's personal performance.

Answer: As the Member is not providing Financial Planning Services as a condition of employment nor is the Member being directly remunerated from those services, the requirements of the Exposure Draft do not apply to the Member.

Question: How does a Member in Business in a senior role with an organisation deriving revenues from Commissions or Third Party Payments from Financial Planning Services who has the ability to determine policies and procedures of the organisation ensure compliance with the Exposure Draft?

Facts: The Member in Business is in a senior role and can determine the organisation's policies and procedures in respect of Financial Planning Services.

Answer: As the Member in Business is in a position to change the policies and procedures of the organisation in respect of Financial Planning Services, the Member should use the Member's best endeavours to change the relevant policies and procedures to enable Members within the organisation to comply with the Exposure Draft. Irrespective of the outcome the Member in Business must still comply with the requirements in the Exposure Draft that are applicable to all Members, whether in Public Practice or in Business, and follow the guidance to the extent practicable.

Question: How does a Member in Business employed in an organisation deriving revenues from Commissions or Third Party Payments from Financial Planning Services who does not have the ability to determine policies and procedures of the organisation ensure compliance with the Exposure Draft?

Facts: The Member in Business is an employee and cannot determine the organisation's policies and procedures in respect of Financial Planning Services.

Answer: As the Member in Business cannot determine the policies and procedures of the organisation in respect of Financial Planning Services, the Member is unlikely to be in a position to influence changes in them. However, the Member in Business must still comply with the requirements in the Exposure Draft that are applicable to all Members, whether in Public Practice or in Business, and follow the guidance to the extent practicable.

(ii) Insurance and risk products

Question: How does a Member in Public Practice who receives Commissions from insurance companies for selling life insurance contracts prior to the commencement date of the Exposure Draft subsequently ensure compliance with the Exposure Draft?

Facts: This is an existing policy and the insurance provider is unable or unwilling to rebate the Commissions to the Client through a reduced premium. Further the Best Interests of the Client may not be served by changing to an alternative insurance product, as in the case where a medical condition would preclude the Client from entering into a new policy.

Answer: Since cancellation of the insurance policy is not in the Client's best interests and the Member is unable to avoid receiving conflicted remuneration, the Member should request that the insurance provider rebate the Commissions to the Client directly. If this is not possible the Member must rebate the Commissions received from the insurance provider to the Client. At this point the Member should take the opportunity to negotiate a professional fee for the professional services provided.

Question: How does a Member in Public Practice who receives Commissions from insurance companies for selling life insurance products with lengthy contractual terms and cancellation penalties prior to the commencement date of the Exposure Draft subsequently ensure compliance with the Exposure Draft?

Facts: For whole of life or endowment policies with cash surrender values (often referred to as legacy products) the Client may suffer negative financial consequences for cancellation.

Answer: If the Member in Public Practice will receive Commissions after the commencement date of the Exposure Draft as a result of having sold this product, this is not a reason for the Member to advise the Client to consider changing the insurance policy. Instead, the Member should first request the insurer to rebate the Commissions to the Client's linked investment account. If this is not possible the Member must rebate the Commissions received to the Client. At this point the Member should take the opportunity to negotiate a professional fee for the professional services provided.

(iii) Mortgage broking

Question: How does a Member in Public Practice who receives Commissions from mortgage broking ensure compliance with the Exposure Draft?

Facts: The Member in Public Practice is unable to offer a Client a mortgage product that is not linked to a Commissions payment or the Client has an existing mortgage that pays the Member trailing Commissions. In most cases there are fees involved in renegotiating mortgage contracts or changing lenders.

Answer: The Member in Public Practice should first request the lender to rebate the Commissions to the Client. If this is not possible the Member must rebate the Commissions received to the Client. At this point the Member should take the opportunity to negotiate a professional fee for the professional services provided.

(iv) Legacy products

Question: How does a Member in Public Practice receiving Commissions on legacy products with a term past the commencement date of the Exposure Draft ensure compliance with the Exposure Draft?

Facts: The Client will suffer negative financial consequences for cancellation of some legacy products including capital gains taxes and/or cancellation penalties.

Answer: If the Member in Public Practice is receiving Commissions as a result of having sold this product to the Client, and the term of the product extends beyond the commencement date of the Exposure Draft, the Member should first request the insurer to rebate the Commissions to the Client's account. If this is not possible the Member must rebate the Commissions received to the Client. At this point the Member should take the opportunity to negotiate a professional fee for the professional services provided.

(v) Third Party Payments

Question: How does a Member in Public Practice receiving Third Party Payments in the form of volume rebates for achieving sales targets on a provider platform ensure compliance with the Exposure Draft?

Facts: The product provider is unwilling or unable to either rebate these payments directly to the Client or provide the Member in Public Practice with a per Client rate so that the Member can rebate them to the Client.

Answer: The Member in Public Practice must establish the total volume rebates received from the product provider, perform a calculation to estimate on a pro rata basis what portion of the rebates relate to each Client, and then rebate them to each of the Clients. At this point the Member should take the opportunity to negotiate a professional fee for the professional services provided.