

Obtaining an Australian financial services licence

INTRODUCTION

Those who have read the papers on Financial Sector Reform published in the November 2001 and August 2002 editions of *Taxation in Australia* will be aware that the *Financial Services Reform Act* ("FSRA") will impact on the way all tax professionals conduct the practices¹. At present the accounting and legal professional bodies are working with ASIC, Treasury and government in a late attempt to win further concessions that might spare some of us from the harsher compliance problems created by the new licensing regime. This means it is still too early to decide exactly what type of licence will be required by lawyers, accountants and tax agents.

However, most of the prerequisites for obtaining an Australian Financial Services licence ("AFS licence") are the same, no matter what type of financial services a professional provides. This paper will briefly summarise what will be required of a tax professional who engages in regulated activities after the end of the FSR transition period².

If your practice provides financial services you will eventually need to decide between three business models: cease providing services that are regulated by the "FSRA", become an Authorised Representative of a licensee, or obtain your own AFS licence. Each option comes with its own advantages and disadvantages and some practices may choose a combination of these business models so as to manage different parts of the practice in different ways.

CEASE PROVIDING FINANCIAL SERVICES

This business model might be attractive to smaller practices that are able to specialise in services that are not regulated by the FSRA or who can limit their activities to products and services³ that the professional bodies are able to carve out of the FSR regime.

For example, a firm that earns most of its revenue from tax compliance work could enter into a strategic alliance with other firms that specialise in providing regulated services such as financial planning, establishing business structures or advising on, and

dealing in, risk management products such as insurance policies, commodity hedging contracts and forward purchase agreements. Under this strategic alliance each specialist firm could agree to refer work outside their specialisation to other firms within the alliance. Another firm might limit its financial product advice to products such as excluded securities, debt facilities that have been exempted from the regime by regulation or deposit products issued by state banks⁴.

By shifting responsibility for regulated activities to an appropriately licensed associate the tax compliance firm would not require an AFS licence and the other firms could avoid the compliance work that goes with being a registered tax agent. However, firms that adopt this model will still need to make some changes to their business practices.

The first issue to address will be the need to change the way individual practitioners respond to clients who seek financial product advice. Most clients will have trouble understanding that a trusted taxation adviser will no longer be able to give advice in areas traditionally within the tax adviser's areas of practice (eg: establishing a self managed superannuation fund). And, many tax advisers will find it difficult to admit to clients that they are no longer qualified to respond to the client's questions.

This situation is by no means new to the financial services industry. I am sure that senior practitioners are always very careful to counsel junior staff not to 'bluff their way through' when a client asks a question that the staff member cannot competently answer. However, being able to respond to a client's question in a positive and constructive manner, without stepping over the new boundary into providing financial product advice, will take some time to practise. Individual practitioner will also require training to assist them identify where that boundary lies.

Many financial planning groups and larger financial service providers have been providing formal 'no advice' training to their staff for years. This training assists staff identify what areas they are not allowed to traverse and respond positively to questions that a staff

member is not allowed to answer. Most legal, accounting and tax practitioners will need to provide similar staff training. Even those practices that do migrate into the new regime.

Practitioners who decide not to opt into the new regime will also need to change their operating procedures to ensure that referrals to licensees conform with the regulations made under the FSRA. At this stage, the main issues are to ensure that operating procedures minimise the risk of overstepping the rules in regard to the amount of preliminary advice that can be given (very little) and ensuring full disclosure in regard to referral fees and commissions (including non-monetary rewards).

Staff will also require appropriate business tools to assist make the referral safely and retain the client's goodwill. When a referral is made staff will often be encouraged by clients to give some general guidance on what options are available. In order to minimise the risk of staff extending their answer beyond what is legally allowed I recommend that unlicensed tax practices develop handouts that answer these basic questions. These handouts can also provide written advice on any referrals fees and commission that will be paid to the tax practitioner by the licensee.

BECOME AN AUTHORISED REPRESENTATIVE

This second business model will require most tax professionals to undertake further training to satisfy the knowledge and skill requirements found in Policy Statement 146 (more on this below).

This business model will probably be the one most commonly used by lawyers and accountants. I say this because most tax practitioners will need to be able to advise clients who seek advice on the best business structure for their new enterprise. For example, if you answer this question by recommending that the client operate the business through a family trust with a corporate trustee you will be providing financial product advice. If you then go on and arrange for the company and trust to be established you will be dealing in financial products. Both these activities require an AFS licence unless the practitioner is a lawyer. Lawyers are allowed

to give the advice mentioned, but will require an AFS licence before they arrange for the two entities to be created⁵.

An alternative to obtaining an AFS licence would be for the practitioner to become an Authorised Representative of a business that specialises in creating shelf companies and trusts. The shelf company incorporator requires an AFS licence before it can provide these entities to the public and I would expect that they will be very keen to defray some of the expense associated with obtaining an AFS licence by establishing a tied network of accounting and law firms through which to sell (and maintain) these financial products.

The main advantage of this business model is that the licensee will assume most of the FSRA regulatory burden and be responsible for complying with the FSRA capital adequacy and liquidity standards. However, your activities as a representative will be subject to fairly close control by your licensee.

Policy Statement 146

While compliance with Policy Statement 146 (PS 146) is not a statutory obligation ASIC have said that they will include as a condition of every AFS licence that licensees may only allow people who comply with the PS 146 guidelines to become Authorised Representatives. PS 146 sets out the generic and specialist knowledge, skill and experience levels that a person must achieve prior to being made an Authorised Representative.

Authorised Representatives must have a basic general understanding of the financial services they provide, and specialist knowledge about the specific products and markets in which they operate. ASIC's knowledge and skill requirements apply to a range of financial services regulated by ASIC however this policy statement has yet to address many of the financial services that are covered by the incidental advice exemption that lawyers and accountants have under the old law.

In addition to theoretical knowledge, representatives will need to develop certain practical skill levels in regard to products and markets in which they operate. These skill levels vary according to complexity of the products and markets and their clients' likely needs. The skill requirements are also

set out in Policy Statement 146, as are certain ethical standards and guidelines.

OBTAIN AN AFS LICENCE

Obtaining your own AFS licence will ensure that you retain control of your business, provide your practice with the most flexibility and allow you to shop around for the best price on financial services provided by other licensees.

However, obtaining your own AFS licence will be expensive and time consuming. I say this because the FSRA places the following obligations on licensees⁶. You must:

- (a) do all things necessary to ensure that services are provided efficiently, honestly and fairly;
- (b) comply with the conditions on the licence and financial services laws;
- (c) take reasonable steps to ensure that its representatives comply with the financial services laws;
- (d) have available adequate resources (financial, technological and human resources) to provide the financial services covered by the licence;
- (e) maintain own competence and ensure that representatives are adequately trained and competent;
- (f) where services are provided to retail clients – have internal and external dispute resolution systems in place;
- (g) have adequate risk management systems in place; and
- (e) have satisfactory compensation arrangements in place for retail clients.

I will now briefly expand on some of these obligations.

Professional competencies

I have already touched on ASIC's requirements in regard to the competency standards for Authorised Representatives. As would be expected, the standards required by the responsible officers nominated on the AFS licence are higher than the standards required of a representative.

The responsible officer competency standards are set out in Policy Statement 164. Many people who are qualified to be a responsible officer will also need to undertake PS 146 compliance training

before they will be qualified to provide some of the financial services covered by their own AFS licence.

Adequate financial resources

ASIC has provided the following guidance as to what 'adequate financial resources' means⁷. These standards focus on the strength of a licensee's balance sheet and cash flow.

Balance sheet strength

- Net tangible assets must be equivalent to at least 0.5 per cent of total assets (\$50,000 minimum)
- Any licensee who holds client money or property must have surplus liquid funds of at least \$50,000
- Any licensee who transacts with clients as a principal (example being the promoter of a managed investment scheme) must have surplus liquid funds of at least \$50,000 + 5 per cent of the licensee's 'adjusted' liabilities.

Cash flow

- Most licensees will need to hold 20 per cent of their next 3 month's budgeted outflow in cash⁸; however,
- If cash flow projections satisfactorily take into account adverse commercial contingencies the licensee only needs to be able to demonstrate that it has sufficient cash flow to meet all expenditure over three months⁹.

These balance sheet and cash flow tests have to be independently confirmed by annual audit assurance¹⁰.

Compliance arrangements

Every licensee must establish and maintain compliance measures that ensure that the licensee complies with its legal obligations¹¹. ASIC's expectations in regard to compliance systems are summarised in Policy Statements 164.13 and 164.43 and include an obligation:

- to document the processes;
- review the processes if circumstances change;
- subject the processes to external review, where appropriate;

- establish a compliance function that is independent of line management and is properly resourced function

While not an absolute pre-requisite ASIC have suggested that Australian Standard AS 3806-1998 provides a useful benchmark as to what is required¹².

Dispute resolution processes

Section 912A(2) of the FSRA sets out the minimum standard required of licensees. ASIC have expanded on this in Policy Statement 165. Every licensee is required to:

- Join an External Dispute Resolution (EDR) scheme approved by ASIC. There are currently four approved EDRs, however the only one of relevance to tax professionals is the Financial Industry Complaints Service Limited¹³.
- Have an internal dispute resolution (IDR) plan which satisfies the *Essential Elements of Effective Complaints Handling* in Australian Standard AS 4269-1995.
- The IDR process must be documented and address issues such as: how complaints are received and dealt with, remedies the licensee offers and how complaints are referred to the relevant EDR scheme¹⁴.
- Have a system for informing complainants about availability and accessibility to the licensee's EDR scheme.

Risk management

ASIC's expectations can be summarised as:

- Establishing documented systems for monitoring & reporting;
- Putting in place a structured & systematic process;
- Paying particular attention to risks of non-compliance with the *Corporations Act*;
- Demonstrating that the risk management system can adapt to and manage change¹⁵.

ASIC expect that the risk management system will comply with Australian Standard AS 4360-1999.

CONCLUSION

The hurdles summarised above should leave readers in no doubt that no matter which business model you adopt the FSR regime will increase the compliance costs of conducting a traditional legal, accounting or tax practice. ASIC, Treasury and government do not apologise for this fact. The overriding objective of the FSR regime is to lift consumer protection standards and improve the quality of service provided by financial services businesses.

In my opinion, even if the professional bodies win 100 per cent of the carve-outs and concessions that they are currently seeking the wide scope of the new regime



will still require most tax practitioners to make some changes to the way they conduct their practice.

I started this article by saying that it is still too early to decide exactly what lawyers, accountants and tax agents need to do about FSR compliance. However, given the time that will be required to complete the formal training to become PS 146 and PS 164 compliant this is an area that practitioners might want to investigate sooner, rather than later.

The FSR transition period gives accountants and lawyers until 11 March 2004 to adapt to the new regime. However, if you decide to obtain your own AFS licence you will need to start working on the issues identified above as soon as you return to your office after the Christmas/New Year break. This is because it will take most of us at least six months to complete the licence process and ASIC have said that licence applications received after November 2003 are unlikely to be processed

by the end of the transition period. ASIC point out that it has not been their practice in the past to grant extensions or concessions to people who run out of time in similar situations and they do not intend to extend the transition period, or drop their standards, when the inevitable last minute rush of AFS licence applications are received. ♦

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Reference Notes

- 1 See article *The Price of Advice Taxation in Australia* vol 37 no. 2 p88 for a discussion of the scope of the FSR regime and the practical implications for tax professionals.
- 2 This being the earlier of 11 March 2004 or the date on which a practitioner obtains an AFL licence.
- 3 See article *The Right Advice Taxation in Australia* vol 36 no. 5 p253 for a discussion of what activities are regulated by the FSRA
- 4 These facilities are specifically defined not to be financial products by s 765A of the FSRA. Further carve outs are found in the regulations and ASIC has authority to issue determinations that certain products are also exempt
- 5 See article *The Price of Advice Taxation in Australia* vol 37 no. 2 p 88
- 6 Refer ss 912A and 912B of the FSRA
- 7 Refer: Policy Statement 166 and conditions 11 – 17 in *Pro Forma 209*
- 8 See PS 166.26
- 9 See PS 166.31
- 10 See PS 166.35
- 11 See *Pro Forma 209* condition 4
- 12 PS 164.54
- 13 For information on this service refer www.fics.asn.au
- 14 See Reference B6 in the *AFS Licensing Kit* issued on 1 February 2002
- 15 See Reference B7 in the *AFS Licensing Kit* issued on 1 February 2002