Submission to the Inquiry into Financial Products and Services by the Joint Parliamentary Committee on Corporations and Financial Services.

August 2009

Industry SuperFunds

Industry Super Network

About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN coordinates collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members.

Introduction

Industry Super Network (ISN) welcomes the opportunity to make a submission to the Inquiry into Financial Products and Services by the Joint Parliamentary Committee on Corporations and Financial Services.

The Committee has specifically decided to focus its inquiry into non-superannuation products and services. Notwithstanding the exclusion of superannuation products, given that the regulatory framework for the provision of financial advice is uniform across all product types, ISN would like to make submissions in relation to several of the Terms of Reference of this Inquiry.

In summary, ISN submits that there is an urgent need for reform of the regulatory framework for financial advice services in Australia. Industry Super Network advocates the introduction of a legal obligation on financial advisers to act in the best interests of their clients. Central to this obligation is the banning of conflicted remuneration practices (including commissions) which have embedded serious material conflicts of interest in the mainstream financial advice industry. The combination of these reform measures would not only reduce the likelihood and severity of the type of collapses which are the subject of this inquiry, but would also significantly improve the general quality of financial advice in Australia and transform the advice industry into a genuine profession, an ambition held by many planners.

ISN submits that the collapses being investigated by this inquiry should not just be considered as isolated and exceptional examples of the result of conflicts of interests in the financial planning industry. There is also a 'slow-burn' effect of sales commissions and conflicts of interest on the account balances of millions of Australians which while less scandalous than the collapses before this inquiry, in individual and aggregate terms compromises the advice and financial outcomes for most consumers receiving financial advice in Australia.

This submission will address the terms of reference relevant to our policy interest in improving the professionalism of financial advisers in Australia.

Executive summary

The Australian wealth management industry has an almost permissive approach to conflicts of interest. Conflicts of interest are regarded as inevitable; and acceptable so long as they are disclosed to consumers. This is patently not good enough. Sales and advice must be disaggregated.

The scandals being examined by the review are often presented by many in the financial planning industry as isolated incidents. Those involved are presented as 'bad eggs'. However, the financial planning practices involved in Storm and other large scale collapses were often substantial dealer groups and Principal Members of the Financial Planning Association (FPA). Further, the effect of commissions and conflicted remuneration structures are not isolated to these scandals. The erosive effect of these practices on superannuation savings is a 'slow burn' – often un-noticed by individual workers until they retire (if at all), but effecting millions of Australians and costing billions of dollars per annum.

ISN note that the Australian Securities and Investments Commission (ASIC) also proposes a ban on commissions and a requirement that financial planners act in the best interests of their clients. This conclusion reflects the views of both the Obama Administration and the UK's Financial Services Authority (FSA). It is also supported by the Australian community. According to a May 2009 Newspoll (commissioned by ISN), eight in ten Australians support the introduction of such a legal obligation on financial planners.

ISN rejects greater or improved disclosure and/or voluntary industry codes as sufficient measures to address the conflicts of interested embedded in the financial planning industry.

Recommendations

- ISN proposes that the Corporations Law be amended to provide that all financial advisers be subject to a requirement to act in their client's best interests.

- ISN proposes a ban on commissions and other forms of conflicted remuneration including shelf fees, volume rebates and asset based fees.

The role of financial advisers

Due to the concentration of ownership of financial advisory businesses by banks and other large financial conglomerate institutions, ISN submits that the role played by financial advisers in Australia is compromised and falls short of providing professional, impartial advice in which only the client's interests are being served.

The financial planning industry has emerged over the past couple of decades and has steadily grown so that there are now over 18,000 individual financial planners operating in Australia.[1] The financial planning industry has evolved from its beginnings as the sales force for life insurance and other financial products. ISN contends that while the financial planning industry aspires to become a fully fledged profession, it is still in the process of transition.

The financial planning industry in Australia is dominated by large vertically integrated financial institutions. These large conglomerate institutions typically own all aspects of the financial services value chain from banking, wholesale funds management, product manufacture, administration and retail distribution including financial planning. The bulk of the financial planning industry is concentrated in the hands of relatively few institutions. Rainmaker Information reports that 73% of adviser groups are institutionally owned, if taken by adviser numbers, or 78% if taken from funds under advice. Many financial institutions operate a number of different sub-brands within their groups, as set out in the Table 1.

Table 1: Ten largest institutionally owned Adviser Groups and their sub-brands

		Group totals		Component totals	
Group	Sub-brand	Advisers	FUA $B	Advisers	FUA $B
ING/ANZ	ANZ Financial Planning	1,706	35	410	12
	Financial Lifestyle Solutions Pty Limited			181	1
	Financial Services Partners Pty Limited			185	3
	ING Financial Planning Pty Ltd			20	0
	Millennium 3 Financial Services Pty Ltd			601	6
	Oasis Wealth Pty Ltd				
	RetireInvest Pty Limited			214	10
	Sentry Financial Services Pty Ltd			95	
	Tandem Financial Advice Limited			0	3
AMP group	AMP Financial Planning Pty Limited	1,620	50	1,314	40
	Hillross Financial Services Limited			306	11
PIS/Aviva group	Financial Technology Securities Pty Ltd	1,574	19	20	
	IFMA Investment Services Pty Ltd			35	
	Professional Investment Services Pty Limited			1,511	18
	PSI Investments Pty Ltd			3	0
	Security National Financial Services Pty Ltd			5	0

[1] Financial Planning Report, Rainmaker Information, Vol2: No 1, January 2009, p1

AXA Australia	AXA Financial Planning Limited	1,315	21	356	
	Charter Financial Planning Limited			462	3
	Genesys Wealth Advisers Limited			374	12
	IMB Financial Planning Limited			5	0
	ipac Securities Limited			53	3
	MMW Financial				
	Monitor Money Corporation Pty Ltd			21	1
	Portfolio Planning Solutions			5	
	Tynan Mackenzie Pty Ltd			39	3
NAB	AdvantEdge Financial Management	1,281	32		
	Apogee Financial Planning			166	3
	Garvan Financial Planning			361	6
	Godfrey Pembroke Financial Consultants			177	5
	MLC Financial Planning			102	3
	National Australia Financial Planning			475	14
Commonwealth Bank	Commonwealth Financial Planning	1,174	34	730	24
	Enterprise121				
	Financial Wisdom Limited			444	10
Westpac Bank	Magnitude Financial Planning	571	24	39	2
	Westpac Financial Planning			532	22
St George/Securitor	SECURITOR Financial Group	552	16	438	12
	St George Bank Limited			114	3
Suncorp group	Guardian Financial Planning	336	16	136	1
	Suncorp Financial Planning Pty Ltd			200	15
Zurich group	Lonsdale Financial Group Limited	256	9	256	9

Source: Financial Planning Report, Vol 2: No 1, Rainmaker Information, Jan 2009, Table 6

In a study on the effects of conflicts of interest in the financial planning industry on superannuation fund flows undertaken by the Workplace Research Centre at the University of Sydney (commissioned by ISN), the concentration of ownership of financial planning was summarised as follows:

> *… in financial advice and sales, the big four banks (after the merger of St George/Westpac) will have around a third of financial advisers and 30% of funds under advice. A further 40 percent of the financial planning industry is owned by insurance/ fund conglomerates.*[2]

The institutional ownership of the bulk of financial planning dealerships is significant because it reinforces the concern that financial advisers are compromised by the commercial imperative of selling and distributing the products manufactured by their parent or related party organisations.

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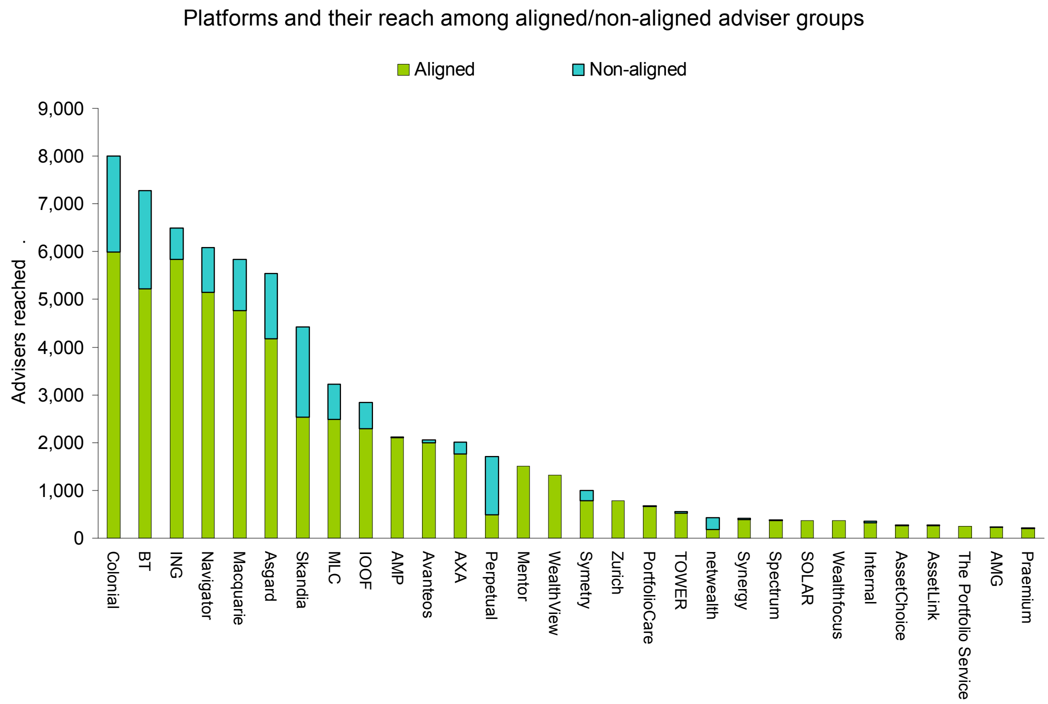
[2] Bryan, D., Ham, R. & Rafferty, M- *Does Good Money Go After Bad in the Australian Superannuation Industry? Performance, Fund Flows and Financial Planning*, Workplace Research Centre, University of Sydney, June 2009, p34 (unpublished)

The primary vehicle through which wholesale fund managers and product providers issue their products through financial planning networks is through investment platforms. Platforms are the primary tool through which financial planners administer, manage and report on investments for their clients. Most of the largest investment platforms are part of financial institutions which own or are related to the major financial planning dealerships. The following graph represents the reach of major platforms amongst aligned and non-aligned adviser groups.



Source: Financial Planning Report, Vol 2: No1, Rainmaker Information, Jan 2009, Figure 14

One further measure of the lack of independence in the financial planning industry is to look at the number of planners who operate on a purely fee for service basis, which is a remuneration model which excludes the potential for any conflict of interest. Only 4% of financial advisers operate on a purely fee based model, if taken by numbers of advisers.

ISN submits that the vertical integration of the financial services industry is highly problematic because of the material conflicts of interest it builds into financial advice. Later in our submission, we will demonstrate how these issues of vertical integration impacted upon the Storm case.

The general regulatory environment for these products and services

While the Committee will be familiar with the regulatory environment for financial advice, for the sake of completeness, ISN sets out a summary of the key professional obligations when providing personal advice.

The FSR reforms were introduced into the Corporations Act in 2004 and put in place the licensing regime and regulatory framework which currently governs the provision of financial advice. A major guiding principle of FSR was to create a single and uniform framework for financial services regulation, across all types of financial products and services. One of the primary objectives of FSR was to rectify the piecemeal and product-specific approach to the way financial services and products were sold to consumers and in so doing to improve the protection of consumers and efficiency of the market. The unified approach to financial services has been a highly successful aspect of the FSR reforms.

The FSR provisions of the Corporations Act provides for two categories of financial advice, personal and general advice. **Financial product advice** includes any recommendation or statement of opinion which is intended, or could reasonably be regarded as being intended, to influence a person in making a decision in relation to a particular financial product or class of products (s766B). **Personal financial advice** is advice which is given or directed to a person where the provider of the advice has considered one or more of the person's objectives, financial situation or needs (or where a reasonable person might expect the provider to have considered one or more of those matters) (s766B(3)). General advice is financial advice that is not personal advice (s766B(4)).

The primary obligation on an adviser when providing personal financial advice is to ensure that there is a reasonable basis for advice given. The Corporations Act sets out the requirements for ensuring that a reasonable basis for advice exists in s945A(1), as follows:

- The person providing the advice must determine the relevant personal circumstances of the client;
- The person providing the advice must make reasonable enquiries in relation to those personal circumstances;
- Having regard to the information obtained from the client in relation to those personal circumstances, the person providing the advice must give such consideration to, and conduct such investigation of, the subject matter of the advice as is reasonable in all the circumstances; and
- The advice must be appropriate to the client, having regard to that consideration and investigation.

A Statement of Advice is also required to be provided to the client which sets out various details including information about the advice provided, information about the basis on which the advice was given, remuneration or other interests or associations that might reasonably be expected to be or have been capable of influencing the advice (ss946A, 947B & 947C). Additional information must also be provided where the advice recommends the replacement of one product with another (known as "switching"), including charges a client may incur and any other significant consequences for the client taking the recommended action (s947D).

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

Conflicted remuneration structures affects most financial advice in Australia

The dominant remuneration structure in the financial advice industry remains based on a commission or asset based fee payment made by a product provider to the financial adviser.

While notionally a payment for advice, asset based fees are a de facto sales commission. Currently, the way that most financial advisers are remunerated means that their interests are more closely aligned with the sales and distribution function of large financial institutions than with their clients. Therefore, while most consumers would be likely to assume that they are obtaining the services of an impartial adviser, the dominant remuneration structures which are used in the financial planning industry means that most advice is tied to a sales or distribution function for large financial institutions.

Robert Brown, a financial planner and industry commentator, summarises the issue of conflict in the financial advice industry succinctly:

> Some supporters of commission-based arrangements take exception to the proposition that their advice could be biased, even though they must sell a product to make a living. It appears that they do not accept that receipt of commission puts a financial planner in an impossible position of conflict, or appearance of conflict.
>
> The conflict exists at several levels. The first level is that a third party is paying the remuneration, not the client. The nature of this relationship is best described by the old proverb that 'he who pays the piper calls the tune'. The second level is that a product must be sold to receive remuneration in the first instance. The third level of the conflict is that advisers may be tempted to recommend the product that pays the highest level of remuneration. As a result, commission must always be inconsistent with being a professional adviser.[3]

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[3] Brown, Robert M.C. "*Reinventing Financial Planning"*, Institute of Chartered Accountants in Australia, March 2007, p11

ISN submits that commission based fees are problematic because they:

- Cause a conflict of interest because the adviser is paid by the product provider not the client, and so will only be paid for recommending a certain product and receives payment only after a recommendation is implemented
- Are often combined with other conflicted remuneration structures such as shelf fees and volume rebates
- Are anti-competitive in the sense that products with higher commissions are favoured; good products which do not pay a commission will seldom be recommended even if they are superior.
- Are economically inefficient in the sense that they are not tied to the provision of a quantity of advice – commissions are paid irrespective of ongoing provision of advice services.
- In some cases commissions lead to bad advice because they encourage the planner to steer consumers into strategies which inflate their investments or exposure, to increase up front commissions (for example, the gearing strategies used in the Storm cases)
- Are difficult for consumers to understand; this reduces the capacity for consumers to compare prices or to digest the financial impact that commissions have on their investments
- Are more erosive on retirement savings and other investments than one off advice fees (the longer term the investment, the more erosive commissions are)
- Are designed to suit the business models of financial advisers, rather than serve the needs of the client.

Numerous scandals and pieces of research have now demonstrated the correlation between poor quality advice and conflicted remuneration practices including commissions.

Storm, Westpoint & Timbercorp

The following table summarises three of the recent, more extreme examples of the deleterious impact which commissions have on the quality of financial advice.

Product	Product Type	Distribution Method/s	Commissions Paid	Investors affected/ loss
Westpoint	Mezzanine Product investing in property backed debt securities managed by Westpoint Corporation. The product offered a return of 11% in November 2004, an extremely high return given the cash rate was 5.25%. Mortgage funds of this type typically return 1-2% above the cash rate.	Financial Planners ($200m of the $300m invested) Accountants Direct	Upfront commissions to 10%	4300 investors lost $300m
Storm Financial Group	Margin Lending into Managed Funds	Financial Planners working directly for Storm	Upfront commission of up to 7% plus an ongoing trail of up to	While the total client base was around 13,500

	Storm offered a rebranded Colonial run indexed fund with an MER of 1.14%, which included an embedded trail. For comparison, Vanguard's indexed equity fund has an MER of 0.35%.		0.385%.	clients, ASIC advised that as of 12/12/2008 there were 450 investors whose margin loan exceeded their investment.
Timber Corp/ Great Southern	Managed Investment Scheme	Financial Planners, including large dealerships such as Professional Investment Services & Accountants	There were three commission options for these products but all incorporating relatively high (up to 10%) up front commissions. Planners also received a trail of 0.5% if the unpaid balance of any loan taken through Timbercorp	Timbercorp 18,500 investors put $2b into 36 schemes Great Southern 43,000 investors, $1.8b

These high profile cases are the subject of numerous inquiries including this Parliamentary Inquiry and ongoing investigations by ASIC, and so obviously ISN will not comment on them in any detail. The numerous submissions made by victims to this inquiry show the tragic and devastating consequences which follow from bad financial advice.

However, ISN believes that there are some obvious conclusions to draw out of these examples.

Firstly, ISN submits that the conflicted remuneration arrangements are at the heart of these cases. These products offered very lucrative commissions when compared with other similar products, many loaded as up front payments. In some cases, advisers were further motivated to recommend aggressive gearing strategies in order to maximise the amount of funds under advice and therefore their own asset based remuneration.

Secondly, it is important for the Committee to note that the planning dealerships implicated in some of these cases were large, established practices, some of them principal members of the FPA. While Storm Financial's business was substantially located in Queensland, they reportedly had approximately 14,500 clients and $4.5B in assets under management. Professional Investment Services (PIS) was involved in distributing both Westpoint and Timbercorp/Great Southern product. PIS is the largest adviser group in Australia, by number of planners.[4]

Finally, in light of some of the strategies and events which have been reported, it is not unlikely that some of the parties involved will be found to have breached the requirements of the Corporations Act. However, because the existing regulatory framework permits these business models and the conflicted remuneration practices which motivate them, the current laws were not enough to prevent these widespread and significant collapses.

[4] Financial Planning Report, Vol 2: No 1. Rainmaker Information, January 2009, p.1 It is interesting to note that PIS was recently excluded from the sale of AVIVA to NAB.

The Systemic Effects of Commissions

The examples of Storm Financial and other collapses present the committee and the broader community with the most egregious examples of the effects of conflicted financial advice on the savings of Australians. However, ISN submits that the 'slow burn' effect of commissions and conflicted advice on the superannuation savings of millions of working Australians, demonstrates that these scandals are not isolated examples of poor practice but evidence of the "structural corruption" caused by conflicted remuneration practices. Further, these practices are embedded in the financial planning industry.

ISN has conducted many pieces of research, most of which examine the impact of commissions in the superannuation sector. Despite the fact that this Inquiry is focused on non-super products, we think that our research is nonetheless relevant to demonstrate that the effects of conflicted remuneration practices, including sales commissions, are not isolated to the scandals that are the subject of this review.

The Opportunity Cost of Conflicted Advice

The effects of this structural conflict is particularly evident in the superannuation sector due to the existence of stark differences in investment performance between the retail super fund sector and the industry super fund sector. Research undertaken by APRA and independent ratings and research houses have shown that industry super funds have demonstrated sustained investment out-performance when compared with retail super funds over 1, 3, 5 and 7 years.

Notwithstanding this sustained net investment outperformance, most financial planners, who act as distributors of retail superannuation products, do not recommend the better performing lower cost super funds (or sectors) because they do not pay commissions. ISN conducted internal modelling of the historic and projected opportunity cost of this structural bias towards retail super funds, noting that:

> *The cost to individual employees of being in poorer performing funds can be measured in terms of the reduction in super balances that individuals receive when they retire.*
>
> *The aggregate or systemic cost resulting from millions of individuals being in poorer performing funds, receiving lower returns than otherwise, year after year, is a massive reduction in assets across the superannuation system. Over time, this translates to a very significant reduction in national savings.*[5]

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[5] Australia's Lost Savings, Aggregate opportunity cost of investment in retail super funds, 1997 to 2020, December 2008 p5

ISN released the results of this modelling in a report entitled 'Australia's Lost Savings', and found as follows:

> *This report calculates the opportunity cost of redirecting savings invested in retail funds to be invested in industry super funds. The opportunity cost is the value of the best alternative foregone as the result of making an inferior decision. In an investment context the opportunity cost is the expected net return forgone by bypassing of other potential investment activities for a given level of savings.*
>
> *The report estimates that the historical opportunity cost of workers directed to underperforming retail funds, by financial advisers, away from better performing retail funds over the last 12 years from 1997 to 2008 inclusive is $50 billion ($49,559 million) in today's money. This is equivalent to more than 8% of Australia's net foreign debt liability of $600 billion net foreign debt liability (as at June 2008). In effect, 1 in 12 dollars of Australian net foreign debt liability is attributable to persistent poor performance by retail superannuation funds.*
>
> *The report then projects the estimated opportunity cost forward from, 1997 to 2020 (12 years back and 12 years forward). The opportunity cost to Australia's national savings in forgone higher investment returns and lower fees is around $250 billion ($253 billion) in today's money.*[6]

While this modelling is specific to the super sector, it is relevant to the terms of reference of this Inquiry because it demonstrates the economic cost of structural bias in the financial advice industry caused by conflicts of interest. Further it demonstrates the scale of the effect of conflicts of interests and reinforces that Storm et al can not be regarded in isolation.

Wherever a client is given advice, and that advice is skewed towards particular products due to related party interests or the availability of commission or other incentive based payments, their financial outcomes are very likely to be diminished. On an aggregate scale, the economic cost is substantial.

Improved disclosure is an insufficient solution

The existing regulatory framework with the FSR provisions of the Corporations Act relies heavily on the disclosure to overcome conflicts of interest. Certainly, the mainstream financial planning industry often point to existing disclosure requirements as an effective policy response to the issue of conflicts of interest. However, ISN remains deeply sceptical of the efficacy of disclosure given the lack of engagement, low levels of financial literacy of most Australian consumers and the knowledge asymmetry which would typically exist between a financial adviser and his or her client.

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[6] Australia's Lost Savings, Aggregate opportunity cost of investment in retail super funds, 1997 to 2020, December 2008 p2

The Storm case clearly demonstrates that many if not most consumers struggle to understand what is being disclosed and how this might impact on the advice given to them. Ironically, behavioural finance research demonstrates that rather than making consumers alert to the possibility of bias, disclosure has perversely led to increased levels in trust.[7] It should also be remembered that the relationship between financial adviser and client is a personal one built on trust and on the sharing of reasonably personal information not only about their financial situation but also their hopes and plans for the future.

ISN is generally supportive of reform measures which promote simpler and more concise disclosure. However, we do not believe that improved disclosure alone is an adequate policy response because it will only support better decision making by engaged and informed consumers – a small minority of the market.

Fee for Service Advice Cheaper for Consumers

Commissions are often justified as being a cost effective way for consumers to pay for advice, particularly for lower income consumers. ISN has long challenged this view due to the ongoing nature of commissions and the fact that commissions are paid irrespective of whether ongoing advice is provided. ISN commissioned research by Rice Warner Actuaries to look at the comparative cost of fee or commission based financial advice. Rice Warner modelled five different superannuation related financial advice scenarios, and found that in all cases, paying for advice on a fee for service basis was cheaper than paying by commission. The study concluded

> *Based on the average retail superannuation product costs and ongoing commission rates, the estimated cost of advice from a commission remunerated adviser was found to be 2.1 to 13.8 times the cost of similar advice provided by IFFP.[8] In other words the effect of an adviser receiving an average ongoing commission over a reasonable time horizon… can result in remuneration 2 to 13 times higher than the remuneration charged by IFFP over the same period.[9]*

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[7] Cain, D., Loewenstein, G. and Moore, D.- '*The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*' Journal of Legal Studies, Vol 34 (Jan 2005)

[8] IFFP is a fee for service financial planning practice used in the modelling by Rice Warner Actuaries.

[9] Rice Warner Actuaries, '*Value of IFFP Advice*', February 2009, p16

The claim that commissions are a cost effective option for consumers has proved to be puzzlingly tenacious, which was noted by Ric Battellino, the Deputy Governor of the Reserve bank of Australia:

> *There appears to be a general reluctance on the part of retail investors to pay for financial advice on a fee-for-service basis. Instead, there has been a preference for commission-based advice, despite the conflicts of interest that can arise in this situation. This reluctance to pay for advice upfront appears to be a form of money illusion, whereby investors may feel that they are somehow paying less for financial advice if the cost is buried in reduced earnings in the future.*[10]

The need for any legislative or regulatory reform

ISN's Proposed Policy Solution – the Introduction of an Obligation for Financial Advisers to act in their Client's Best Interests

ISN proposes that the Corporations Law be amended to provide that all financial advisers be subject to a requirement to act in their client's best interests.

The best interests obligation will replace the requirement for advice to have a reasonable basis (s945A).

The key elements which this obligation will be:

- It will be owed by an individual planner to his or her client. Licensees would also continue to hold responsibility for advisers operating under their licence.
- The best interests obligation would require the planner to give clients their undivided loyalty, which means the financial planner must strive to avoid any actual or perceived conflict of interest.
- The method of payment for financial advice must reflect the planner's undivided loyalty to their client. An individual adviser or a licensee cannot receive any payments from product providers or fund managers. Payment for advice must be made by the client and would ideally be based on the amount of time or advice provided. Up front commissions or fees would not be permitted.

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[10] Battellino, Ric, 'Opening Remarks to the 20th Australasian Finance and Banking Conference' Sydney 12 December 2007, www.rba.gov.au

It is also proposed that the obligations set out in the existing s945A(1)(a) & (b) (determining and making reasonable inquiries about the client's personal circumstances and investigating the subject matter of the advice) would be retained.

The best interests obligation would also impact the construction of approved product lists, which would need to include a variety of product types to meet all client needs.

Remuneration arrangements of internal or related party planners providing financial advice must eliminate all sales or volume based incentives or payments. Trustees and product providers would still be required to manage any other conflicts of interest which might arise under the existing requirements of the Corporations Act.

ISN proposes that as part of the structural adjustment of the industry, advice fees paid directly by the client should be tax deductible.

ISN also proposes that as part of this process of reform, ASIC be additionally resourced and motivated to supervise the transition of the industry to this higher professional standard, and where necessary, to undertake enforcement activities.

ISN would also like to stress that the regulatory framework would continue to ensure that the definition of financial product advice is broadly defined so that all product recommendations are governed by the Corporations Act, as is currently the case. There should be no weakening of this aspect of the regulatory framework, as it is a critical feature of the consumer protection framework.

Does a best interests obligation give rise to an unrealistic professional expectation of financial advisers?

A number of commentators have argued that a best interests obligation is incompatible with the role of financial advisers as it carries an unrealistic expectation of professional performance. However, this view misrepresents traditional understandings of the fiduciary concept of 'best interests'. The traditional understanding of a fiduciary is that in order to look after their client's best interests, they have to put their own interests aside as far as possible. A fiduciary must obtain "informed consent" for any conflicts of interest which can't be avoided. The concept of informed consent goes beyond the type of disclosure typically provided in financial services.

Central to the concept of acting in a client's best interest is scrupulously avoiding any actual or perceived self-interest on the part of the adviser. Avoidance of self-interest is the hallmark of the professional and is a standard is adhered to by other professionals including lawyers and doctors.

In order to satisfy the 'best interests' obligation, an adviser's work would be measured against a standard of reasonable skill, care and diligence to be expected of an ordinary prudent person acting in the capacity of a qualified adviser. However, the obligation to act in the client's best interests would not require financial advisers to predict the best or highest performing products. Superannuation trustees are subject to a 'best interests' obligation which does not expose them to liability for failing to pick the best performing investment managers for their fund in any year. The best interests obligation is not retrospectively evaluated based solely upon the performance results of the superannuation fund, but rather by examining whether the trustees exercised a reasonable standard of skill, care and diligence in selecting and monitoring investment managers.

Other professions are from time to time criticised for self-interested behaviour, for instance, the receipt by doctors of benefits from pharmaceutical manufacturers. However, these tend to be cases on the margin and are strongly criticised by the remainder of the profession. These cases contrast with the situation in the financial advice industry, where the mainstream professional associations representing planners strongly defend their conflicted position.

Notwithstanding the Financial Planning Association's (FPA) belated efforts to promote a voluntary code to remove commissions there has been a lack of any serious effort by the financial planning industry to admit let alone address the corrupting influence of dominant remuneration practices.

Indeed, the inadequacy of such codes is perhaps best captured by the FPA's Chief Executive Jo-Anne Bloch in her email to members just four days after the launch of the draft code:

> *"We are not recommending banning commissions at all. We are recommending transitioning away from commission based advice from, say, 2012, and with regard to legacy products which will be grandfathered; life insurance products which will need further discussion with product providers and planners; and with sensitivity and attention to longstanding commission based businesses that cannot change their remuneration models at this stage. We are trying to be as flexible and as accommodating as possible while also moving forward with changes that will position financial planning advice more appropriately and according to expectations."*[11]

How will a best interests obligation differ from the reasonable basis test?

The current legal requirements imposed on financial advisers when providing personal advice are too permissive of conflicts of interest and in particular, conflicted remuneration structures.

[11] FPA CEO e-news May 5, 2009

There is no significant case law in which the interpretation of the 'reasonable basis for advice' provisions has been judicially considered.

However, in the 2007 Report by the Parliamentary Joint Committee on Corporations and Financial Services on the Structure and Operation of the Superannuation industry, it was noted in relation to existing obligations that "…*as long as disclosure requirements are met, it is legally permissible for an adviser to recommend a product privately knowing it is not the best option for the client.*" [12] ISN submits that this is unacceptable.

A best interests obligation differs substantially from the current minimum standard for providing personal advice, because it requires the adviser to *avoid* conflicts of interest (particularly those associated with remuneration) which can and too often do lead to bias in advice.

To give a concrete example of the flaws in the reasonable basis test, a financial planning dealership might only have their own managed investment product on their approved product list. However, this product might be more expensive or offer a higher commission than most other managed investment products on the market. It would be possible in most cases for a planner to recommend their own product and demonstrate that it is appropriate for the client who needs a managed investment product, although the planner is aware that there are many other similar products which would be cheaper for the client or have less beneficial remuneration for themselves.

The FPA's Professional Principle of "Client's First"

The FPA introduced a principle of "Client's First" into their Code of Ethics in November 2007. The Code of Ethics is one aspect of the work undertaken by the FPA in recent years to transition their membership into a profession and address criticisms regarding conflicts of interest in financial planning.

ISN is strongly of the view that voluntary codes are not an adequate solution to this problem.

More importantly, however, we think that the FPA principle falls short of the fiduciary standard which must be required of financial planners. **In summary, the difference between "clients' first" and "clients' best interests" is that with best interests, the financial adviser should strive to make a recommendation based *only* on the client's interests. With "clients first", each adviser must be trusted to appropriately prioritise between their clients and**

[12] *The Structure and Operation of the Superannuation Industry* (2007) – Parliamentary Joint Committee on Corporations and Financial Services, paragraph 7.3.

their own interests. Given that a perception of a conflict of interest can often be as damaging to the professional perception of financial planners as an actual conflict, the legal framework must go further in encouraging the financial planning industry to reduce its dependence on conflicted forms of remuneration.

Structuring Remuneration to Ensure Advice is in the Client's Best Interests

The only remuneration model which is consistent with financial advice given in a client's best interests is for a fee to be paid by the client to the adviser.

In the last few months both the Investment and Financial Services Association (IFSA) and the FPA have put forward proposals to phase out the payment of commission payments to financial advisers. However, both IFSA and the FPA have put forward an asset based 'fee for service' model for charging clients as an alternative, which in our view replaces one conflicted type of remuneration with another.

On asset based fees, ISN notes the following:

- Asset based fees do not necessarily eliminate conflicts of interest, nor are they designed to do so;
- Such fees are typically still dependent upon the sale of a particular product (and the preparedness of that product to permit such fees to be deducted);
- Such fees are ongoing in nature and therefore not necessarily reflective of the advice received.

Importantly, such structures are not consistent with acting in the client's best interests.

The method of payment for financial advice must reflect the planner's undivided loyalty to their client. An individual adviser or a licensee cannot receive any payments from product providers or fund managers. Payment for advice must be made by the client and would ideally be based on the amount of time or advice provided.

Where the client and adviser agree on an asset based fee, this must be agreed and approved by the client at least annually. ISN proposes that clients should opt-in, on an annual basis and in writing, to receive and pay for financial advice. This is typical in client-professional adviser relationships and ensures that consumers are only paying for advice that they desire and receive.

Therefore, while a product provider can facilitate payment of the advice fee directly from the client's account, this must be based on a written authority from the client, with an annual renewal.

Consumer support for Best Interests Proposal

ISN has conducted research through Newspoll over the past few years to explore consumer attitudes to the introduction of a best interests obligation on financial planners. This study was last conducted in April 2009 and found overwhelming support for ISN's proposed reform.

In particular the Newspoll research revealed that:

- 82.8% agree that a law should be put in place requiring financial planners/advisers to provide advice or make investments only in the best interests of their clients
- 78.5% of respondents agree that the payment of commissions to advisors in exchange for recommending particular products compromises the advice provided

International developments in line with ISN's policy proposals

In the wake of the GFC, there is a global push for reform of much of the financial services industries and in particular the role of intermediaries. In considering the regulation of financial advice and the tolerance towards conflicted remuneration structures, it is striking that the policy solutions proposed by regulators in the UK and USA are consistent with those advocated by ISN:

- The Obama administration is seeking to introduce a requirement that all types of financial advisers have a fiduciary obligation to their clients, and ban conflicted forms of remuneration.
- The UK's Financial Services Authority (FSA) is preparing to ban sales commissions on investment products.

The global move towards better regulation of financial advisers reflects the need to improve consumer protection and increase confidence in the system.

US regulatory change proposals

The need for more robust regulation of the financial services sector in the US arose in particular following the sub-prime crisis. However, the US Treasury argues that better regulation of the finance sector as a whole is also required.

The Obama administration is proposing the creation of a single regulatory agency, a Consumer Financial Protection Agency (CFPA). Its purpose is to reduce gaps in federal enforcement, improve coordination with states (there can be different regulatory standards by state), set higher standards for financial intermediaries and promote consistent regulation of similar products.

The US Treasury argue that consumer protection is a critical foundation for the financial services industry. Treasury also note that for consumers to have sustainable confidence in the system, it is the responsibility of government to promote a culture of consumer protection in the industry and within the regulator.

Reforms to consumer protection include:

- Better disclosure, including simpler and more concise disclosure, and consistent with the approach taken by Australian regulators.

- Imposing appropriately tailored duty of care on financial intermediaries, including the requirement that all financial advisers have a fiduciary duty to their clients.

The Obama administration is also concerned about the capacity of consumers to understand complex financial products and the conflicts of interest held by intermediaries.

The US Treasury paper states:[13]

"Impartial advice represents one of the most important financial services consumers can receive…When [these] intermediaries accept side payments from product providers, they can compromise their ability to be impartial. Consumers, however, may retain faith that the intermediary is working for them and placing their interests above his or her own, even if the conflict of interest is disclosed."

The solution they propose is to require all investment advisers to have a fiduciary duty to their clients (currently there are two classes of adviser: "broker-dealers" and "investment advisers").[14]

The harmonisation of regulation between these two classes reflects the need for all financial advice to be in the best interest of the client.

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[13] Financial Regulatory Reform, A new foundation: rebuilding financial supervision and regulation, Dept of Treasury, June 2009 (p68)

[14] Ibid, p71. The paper notes that broker-dealers and investment advisers operate under different regulatory frameworks and yet provide services that are virtually identical from a retail investors perspective.

The Securities Exchange Commission (SEC) is to 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."*

This proposal has been welcomed by the Financial Planning Coalition in the US,[15] who comment: *"The proposal's recognition that providers of financial advice must be held to a fiduciary standard is an important development that will have lasting benefits for American consumers. Given the increased responsibilities individuals hold for establishing their financial security, all Americans who seek professional financial advice deserve to receive services provided in their best interests."*

UK regulatory change proposals

The UK proposals are part of a three year process to review how investment products are distributed. The intention of the review was to consider how to increase the quality of financial advice, improve consumer outcomes and therefore confidence and trust in the system that will result in its long term viability.

Expected benefits include increased quality of advice, increased persistence and greater use of advisers as a result of increased confidence in the advice process.

The UK's Financial Services Authority consultation paper[16] proposes the abolition of commissions and the banning of financial advisers from recommending products that automatically pay commission. Their consultation paper states:

"The proposals bring to an end the current, commission-based system of adviser remuneration: we propose to ban product providers from offering amounts of commission to secure sales from adviser firms and, in turn, to ban adviser firms from recommending products that automatically pay commission. Consumers will still be able to have their adviser charges deducted from their investments if they wish, but these charges will no longer be determined by the product providers they are recommended."[17]

The UK has two streams of advisers – independent and tied. Tied advisers are to disclose that the advice they provide is "restricted" to certain products.

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[15] www.cfp.net

[16] Distribution of retail investments, delivering the RDR, Financial Services Authority, June 2009

[17] Ibid, p4

Payment for financial advice (whether up front or deducted from a consumer's account) must reflect the advice services being provided, and should not be a payment for the product being recommended.

The FSA also proposes that all financial advice must be in the best interests of the consumer.

Adviser firms are expected to decide their own charging structures, as opposed to them being determined by product providers. FSA comment that differences in compensation between products (eg where one commission is higher than another) creates a potential conflict of interest that is damaging to the consumer and undermines confidence in the system.

Product providers will also be banned from offering commissions.

Soft commissions (soft dollar payments) and other such inducements will also be banned.

Advisers employed or tied to vertically integrated firms (eg banks and insurers) will be required to separate product and advice fees.

Conclusion

Financial planning will become increasingly important service relied upon by Australian consumers over the coming decades. The lessons to be taken from the unfortunate events surrounding the cases being examined by this Inquiry provide a clear case for reform of the regulatory framework for financial advice.

Australian consumers should be able to look to financial planners for high quality advice which is not clouded or compromised by the commercial motivations of product issuers or the financial planners own remuneration arrangements. The legislative obligations on financial advisers should ensure that this expectation is met.

Industry Super Network advocates reform of the Corporations Act to require all financial advice to be given in the client's best interests and to ban the payment of commissions and other conflicted remuneration payments for financial advice. Such reform is now supported by key industry stakeholders including ASIC and is in step with international developments in the wake of the GFC. Not only would these reforms reduce the incidence and severity of collapses such as Storm, they would also significantly improve the general quality of financial advice in Australia and enable the industry to transition into a true profession.