

# **Finance advisers mostly a sales force, report says**

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**“He who pays the piper calls the  
tune”**

**Briefing Note on Remuneration Structures  
Consistent with the Introduction of a Best  
Interests Obligation on Financial Planners**

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**Industry  
Super  
Network**

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## 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 maximizing the retirement savings of five million industry super members.

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# 1 Executive Summary

Industry Super Network and industry super funds have been advocating for two decades for the abolition of conflicted types of remuneration for financial advice in particular commissions and more recently, for the introduction of an obligation for financial advisers to act in their clients' best interests.

Our campaign has been motivated by the following objectives:

- to raise the minimum professional obligations for financial planners and in doing so improve the quality and impartiality of financial advice in Australia;
- improve the capacity for financial advisers to contribute to competition and efficiency in financial services and products by ensuring that their interests are aligned with their clients rather than with product issuers and fund managers; and
- to stop the erosion of superannuation savings by ongoing commissions and asset based fees.

In summary:

- The provision of financial advice and sales must be disaggregated.
- Financial planners must be subject to a fiduciary obligation requiring financial advice to be in the best interests of clients. Such an obligation is inconsistent with conflicted remuneration practices, including commissions, asset based fees, volume bonuses etc.
- This proposal is consistent with proposals by the Obama administration and the UK's Financial Services Authority, and the Australian regulator, ASIC.
- Payment for financial advice must be explicitly and transparently tied to the service received. Often this is not the case in financial planning. There are many people paying ongoing commissions and/or asset based fees and yet receiving no ongoing tangible service. These can be termed "inertia payments". Consumers continue to pay for a service they do not receive because of inertia.

## 2 The introduction of a meaningful fiduciary obligation

A legislated fiduciary obligation (or “best interests” test) placed upon financial planners logically requires the removal of material financial conflicts of interest facing financial planners. Conflicted remuneration practices such as commissions are entirely inconsistent with accepted definitions of a ‘fiduciary obligation’ where an adviser is expected to act in the best interests of their client, which means excluding their own interests from the relationship as far as is possible. The purpose of sales commissions (and other forms of conflicted remuneration for example asset based fees) is to incentivise a financial planner to sell a particular product.

ISN believes that the introduction of a fiduciary obligation/best interests test which does not explicitly and unambiguously deal with obvious material conflicts of interest created by these remuneration practices will fail to address the underlying causes of the Storm, Westpoint, Great Southern and TimberCorp scandals.

It has been erroneously suggested that under common law financial planners already currently have a fiduciary obligation to their clients. There is no evidence to this effect. If this were the case there is a very real risk that class actions will inevitably occur as investors seek to prove that product recommendations were made by financial planners because of incentives paid by product providers and not in their client’s best interests.

ISN is concerned that a recommendation by the committee that sought to introduce a fiduciary obligation whilst continuing to tolerate conflicted forms of remuneration would be counter to existing case law and both local and international interpretations of the role of a fiduciary. Such a recommendation would inevitably lead to uncertainty among the advice industry and consumers and greater risk of future class actions.

ISN believes any amendments to the Corporations Act to include a fiduciary obligation/best interests test would require an explicit explanation of the duties and obligations of a financial planner and potentially the methodology by how a financial planner could be paid.

The existing regulatory framework with the FSR provisions of the Corporations Act relies heavily on 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 typically exists between a financial adviser and his or her client.

### 3 ISN's Policy on a Best Interests Obligation for Financial Advisers

The following summarises ISN's policy proposals for reform of the regulatory setting of financial advice.

#### 3.1 Introduction of a Best Interests Obligation for all Personal Financial Advice

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 of this obligation will be:

- It will be owed by an individual planner to his or her client. Licensees will also continue to hold responsibility for advisers operating under their licence.
- The best interests obligation requires the planner to give clients their undivided loyalty, which means the financial planner must strive to avoid any actual or perceived conflict of interest. Advisers must act only in their clients interests in the advice and recommendations they provide.
- 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. A planner's expertise or the complexity of the advice provided can be reflected in the charging rate of the planner. Where the client and adviser agree on an asset based fee, this must be approved in writing by the client at least annually. 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.
- The standard against which this obligation is measured is that of reasonable skill, care and diligence to be expected of an ordinary prudent person acting in the capacity of a professional adviser. It does not of itself leave the planner liable if they fail to select the highest performing products of investments in any year.

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.

### 3.2 Ban on payment of commissions by product providers

ISN proposes a ban on all product providers, including superannuation trustees and their parent trustee companies, from offering commissions or other incentives to adviser groups to secure sales of their product. This ban includes all incentives, including soft dollar incentives, shelf fees buyer of last resort mechanisms and volume bonuses.

### 3.3 Requirement for clients to regularly opt-in to financial advice and stop “Inertia payments”

It is critical in a functioning market that the amount paid for a service is clearly and transparently tied to the service received. Often this is not the case in financial planning. There are many people paying ongoing commissions and/or asset based fees and yet receiving no ongoing tangible service. These can be termed “inertia payments”. Consumers continue to pay for a service they do not receive because of inertia.

ISN proposes that clients should opt-in, on a regular basis (say annually or biennially) 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. This requirement that consumers explicitly agree to pay for and receive financial advice on a regular basis (eg annually) would facilitate a system where ongoing advice could be provided to investors seeking this service while ensuring those consumers seeking one-off advice pay for this advice only once. This proposal matches supply with demand.

The alternative (that clients elect to opt-out of receiving and paying for financial advice as proposed by the financial planning industry) is insufficient and designed to take advantage of consumer inertia.

The “opt out” method proposed by the financial planning industry places the onus on the consumer to understand what they are paying for and ignores consumer inertia, information asymmetry and low financial literacy. While disclosure of fees (in dollar terms) can go some way to mitigating the risk of consumer paying for a service they do not receive, requiring a client to actively agree to receiving ongoing advice places the control with the consumer, not the financial planner.

Research conducted in 2009 by Rice Warner (commissioned by Industry Super Network) has found that where consumer pay for financial advice on a fee for service basis rather than through ongoing percentage fees and commissioned the cost of the advice can be up to thirteen times less. The report concludes: “The higher the ongoing product fees the lower the resultant value delivered through the advice.”

## 4 Asset based Fees

Ongoing asset based fees are a commission by another name and remain problematic for the following reasons:

- Asset based fees do not necessarily eliminate conflicts of interest, nor are they designed to do so.
- Such fees are dependent upon the preparedness of a product issuer to permit such fees (and their quantum) to be deducted from a member's account and therefore paying for advice in this way is contingent on the sale of a particular product. This means the structural bias towards retail products (which will be prepared to facilitate payment of asset based fees) will be left in place.
- Such fees are ongoing in nature and therefore not necessarily reflective of the advice received. As with commissions there is not necessarily a relationship between the cost of providing the advice and the amount paid by the consumer, which will often mean that over time, consumers pay for a lot more advice than they receive.
- Asset based fees can in some cases cause serious conflicts where advisers are motivated to increase funds under management or gearing to increase their own remuneration (Storm being an extreme example).
- Asset based fees are by nature percentage based and so are more difficult for consumers to understand and negotiate.
- Asset based fees are also particularly problematic in long term investments such as superannuation because they compound and are significantly more erosive of consumers' savings than one off fees.

Ongoing asset based fees are therefore inconsistent with a financial planner being required to act in their client's best interests.

## 5 ASIC Proposals regarding a Fiduciary Style “Best Interests” Obligation

In its submission to the Parliamentary Joint Committee Inquiry into Financial Products and Services in Australia (the Storm Inquiry), the Australian Securities and Investments Commission (ASIC) signalled a significant policy shift and is now supporting regulatory change to introduce a fiduciary style of obligation for financial advisers to act in the best interests of their clients. In addition, ASIC has signalled that the Government should also ban all conflicted remuneration types to ensure that advice is not distorted by the way it is paid for.

ASIC’s shift is part of a trend towards rethinking the regulation of financial services which is occurring in most key western economies post the GFC.

ASIC’s submission proposes that in addition to the reasonable basis test, the Corporations Act could be amended to clarify that financial advisers must act in good faith in the best interests of their clients, and where there is a conflict between their clients’ interests and their own, to give priority to their clients’ interests. Any contract which attempts to exclude this duty would be void.

The submission provides a concrete example of the way this duty would operate. It states:

*For example, under the current test, an adviser may have a reasonable basis to recommend a client invest in any three different products. Of the three products, the adviser could recommend the product that delivers the adviser the greatest fee revenue, provided the conflict of interest is clearly disclosed to the client. However, under the higher standard proposed above, they would be required to recommend the lower fee product because the adviser is required to prioritise the interests of their client (i.e. by paying the lowest fees possible) before their own interest in receiving higher remuneration.*

ASIC also proposes that Government should assess changes to the regulatory regime that would require advisers to more prominently disclose the restrictions on the advice given to consumers (i.e. limited to certain products only). In particular, ASIC has raised concerns about the fact that there is no legislative requirement for an adviser’s marketing material to disclose a link or association with a product issuer. ASIC proposes a requirement for any association to be prominently disclosed and for advertising and marketing material to state that an adviser can advise only on a limited range of products. ISN strongly supports this proposed requirement.

## 6 ASIC's Proposals regarding the Abolition of Conflicted Remuneration for Financial Advice

ASIC notes in its submission that various industry bodies are undertaking work to address conflicts of interest (referring to the recent papers of the FPA and IFSA). However, ASIC notes that such measures may be insufficient to address potential conflicts of interest. ASIC then proposes that Government should consider the abolition of conflicted forms of remuneration for financial advice.

ASIC's submission itemises the various distortions which conflicted remuneration have the potential to cause, including:

- causing an adviser to sell product rather than give strategic advice (ie pay off your mortgage);
- cause an adviser to recommend an inappropriate product linked to higher commissions (noting this had led to higher risk products such as Westpoint to be inappropriately recommended);
- failure to recommend products which are in the interests of the client but do not pay a commission (such as industry super funds); and
- recommending a client invest more or borrow to invest more, because of asset based fees.

The ASIC submission notes that disclosure can be an inadequate regulatory tool to manage conflicts of interest due to the strength of the conflict and consumers' difficulty in understanding their impact.

ASIC notes that the introduction of a best interests obligation will impact on the ability of financial advisers to accept commission remuneration. Nonetheless, ASIC has also signalled that the Government should also ban all conflicted remuneration types to ensure that advice is not distorted by the way it is paid for, including up front commissions, trail commissions, soft dollar incentives, volume bonuses, rewards for reaching sales targets and fees based on a percentage of funds under advice.

ASIC notes that the impact of their proposals are hard to predict without further regulatory impact analysis. While ASIC expects that their proposals would cause some consolidation in the industry, it would be unlikely to increase the actual cost of advice.

ASIC also raises the prospect of banning the receipt by financial advisers of any form of remuneration by product manufacturers, and the payment of other fees such as shelf fees or payments to research houses.

The proposals put forward by ASIC are far reaching, comprehensive and are consistent with the policy position developed by ISN over the past couple of years.

## 7 Conclusion

The UK's Financial Services Authority (FSA) has proposed that all financial planners – both tied to product providers and independent – be subject to a fiduciary duty in their dealings with their clients. This has inevitably led to proposals that all conflicted forms of remuneration be banned. ISN believes this approach is worthy of close consideration by Australian regulators and policy makers.

Consumers need financial advice that is impartial and in their best interests. The manner in which a financial planner is remunerated is central to their capacity to fulfil their obligation to act in their client's best interests. The introduction of a best interests obligation on financial planners will be ineffective in addressing structural conflicts of interest unless the reforms also regulate appropriate remuneration structures for financial planners.

To ensure that a financial planner is giving impartial advice in their client's interests and not being influenced by product issuers or fund managers, it is essential to prohibit the receipt of commissions, rebates, shelf fees and any other payments or soft dollar benefits by financial advisers or dealerships.

The financial planning industry continues to downplay the importance of their remuneration in the debate about quality and value of advice. This is obviously self-interested. The reality is that "he who pays the piper calls the tune".