

Submission
to
Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into Financial Products and Services in Australia

as a supplementary submission 1

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Continuing the discussion of separation of financial product sales from advice.

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A good advisor working in the interests of clients does not need their business to be subsidised by a share of product MER, because the consumer will find the advice to be of value.

However, a good salesman does not necessarily need to provide a high quality of advice to stay in business because the business is typically subsidised by the product provider.

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On professionalism among financial planners.

- There are many highly professional advice-focused financial planners out there – and there have been for many years.
- Unfortunately, a majority of people who call themselves financial planners are really product sales people. The biggest single thing therefore that is holding back the financial planning profession as a whole in Australia, is that we have all these sales people who are allowed to also call themselves financial planners – that there is not a division between sales people from advisors either under the law, or in the professional associations.

Introduction:

This supplementary submission needs to be read as an addendum to the initial submission dated 6th April/2009.

In this supplementary submissions, we first illustrate how poor the standards of behaviour are in financial planning by comparing them with the reasonable standards that the community expects of people who deal in real estate. This does not reflect well on the financial planning “industry”.

A set of tests are provided below to draw the dividing line between real advisors and financial product salespeople. Further work will be required to extend and flesh out this list. One the great values in drawing the dividing line between sales people and advisors is that it highlights a very key feature of the financial planning industry, specifically:-

- **At one extreme there are Australian Financial Service Licensees (AFSLs) which are very clearly in the product sales business.** By definition, the representatives of these AFSLs are sales people because **under Corporations Law, a representative is simply the delivery vehicle and the advice is the responsibility of the AFSL.** The AFSL is responsible for the advice and the behaviour of the representatives. **Therefore in this submission, we will focus on classifying the AFSL as being either sales or advice.**
- **At the other extreme, there are AFSL which are very clearly in the advice business.**
- However, **the clear majority of the financial planning industry are in the grey zone between** – exhibiting some of the characteristics of an advice provider and some of the characteristics of a financial product sales business. **It is time that financial planners and the AFSLs were forced to choose which side of the fence that they live on – ADVICE or SALES** – and that each group be clearly labelled as such (for consumers to see) and that relevant different standards of behaviour be applied to each group.

The FPA moves to ban commissions (by 2012) is a step in the right direction – but it misses the most important issue, from a consumer perspective.

Even after commissions are gone (and that needs to include volume over-rides), we will be in precisely the same position as we are today: i.e. we will have some AFSL reps who are SALESpeople and some who are real ADVISORS. And consumers will still need to be able to distinguish one from the other.

Consumers cannot wait until 2012 only to discover that banning commission does not solve the main problem – which is that there are sales people out there masquerading as advisors – and many consumers cannot recognise which the sales people are. *(Sir Anthony Mason “criticises Australian laws for allowing a financial product seller to describe themselves as a financial adviser”. Presentation to SPAA Annual conference 2009)*

There is better consumer disclosure when you buy real estate.

Consider this situation.

- You engage a real estate buyer's agent (<http://www.rebaa.com.au/>) for a fee of \$10,000 to help you buy a house.
- Based on the findings and recommendation of the buyers agent, you purchase a house.
- Later you find that the buyer's agent has a standing (financial) relationship with a property developer or real estate agent to help sell their properties.
- How do you feel?
 - I am sure **you would feel as if you had not got the service you felt you had paid for.** And you feel that you may not have got value for money.
 - If you believed you were dealing with a buyers agent, **you are expecting the agent to be using their best endeavours to get the best outcome they can for you.** But with the facts now on the table, it is clear that the agent might have seeking to sell a property for the vendor or property developer.
 - Is it just possible you got sold a lemon, and that the conflict of interest of the buyer's agent has caused the buyers agent to act against your best interests.
 - In this illustration, the buyer's agent has broken the Code of Ethics of the Real Estate Buyers Agents Association – and this association's code of ethics is as you would have expected for a Buyers Agents Association.

- However:-
 - If, in the above illustration, we substituted the words “real estate” with “financial product” and the words “real estate buyer's agent” with “financial planner”, we find that the financial planner has not broken any laws – and almost certainly no-one will take action against the financial planner for unethical behaviour as this form of behaviour is widespread.
 - This is bad for consumers.
 - In our 6/4/09 submission, we advocated protecting Australian consumers from this by separating financial product SALES from ADVICE. Below, you will find our proposed tests for whether the AFSL rep is a salesperson or an advisor.

What are reasonable community expectations of ADVISORS vs SALES people?

- The real estate illustration above reflects the different nature of service expectations there are for advisors and salespersons.
 - **Advisors:**
 - Consumers should be able to expect that the advisor be diligent using their best endeavours to get the best outcome they can for you.
 - Consumers should also expect a higher level of competency of advisors. For example, advisors should have a degree to illustrate a level of discipline in thinking processes.
 - Higher ethical standards need to apply – as with the Real Estate Buyers Agents Association.
 - **Financial Product Salespersons:**
 - A lower level of service expectation is to be expected, because the consumer acknowledges and accepts (assuming adequate disclosure) that the salesperson is acting for the vendor.
 - Therefore, the Corporations Law test “that the advice is reasonable in the circumstances” is a low hurdle but adequate.
 - Consumer would reasonably expect protection from these sales businesses by requiring a very high standard of disclosure of factors which might taint advice – plus consumer education about these conflicts of interest – plus consumer education about how these conflicts might taint advice.
 - I have heard many stories over the years about how a consumer, on first dealing with a financial planner, did not question the size of the commissions because they assumed these were normal AND they were oblivious of many of the financial arrangements between product manufacturers and advisors (and the advisors AFSL). This lack of knowledge of consumers makes them very vulnerable to unethical practices and gouging.
 - ASIC can assist in this education process and by enforcing disclosure requirements more effectively.
 - Largely the current rules on disclosure of factors which might taint advice are fairly comprehensive. However, in my view, **ASIC does not seem particularly diligent in enforcing the law as it relates to disclosure – and does not seem motivated to systematically investigate failures in this space – and many small AFSLs that I have talked to have given up reporting Corporations Law breaches by other AFSLs because of the view that ASIC simply does not act on these reports. If ASIC is serious about “getting rid of the bad apples” it needs to use industry intelligence far more diligently and far more systematically.**

Draft TESTS of whether you are a SALES REP or an ADVISOR.

There are a range of indicators that can help us determine whether an AFSL representative is a Sales Rep or an Advisor. These indicators can be broken into two categories:

- Indicators that DEFINITELY indicate a sales rep.
- Indicators that together with the other facts of the situation indicate PROBABILITY of being a sales rep.

You are DEFINITELY a salesperson IF:

- The advisor's AFS licensee is in the **products sales (distribution) business.**
- The advisor has been **employed to sell product**

- The advisor will be fired if he/she does not **sell a quota of product**.
- If an advisor ever feels **pressured (by management) or directed to recommend a particular product**.
- If the advisor feels that he **needs to sell a product to be paid for the advice**.
 - The primary principle here is that the financial benefit for the AFSL (and any other related party) and the advisor needs to be independent (neutral) of the advice – to remove a source of potential taint. This relates to **compensation structure** of the AFSL/advisor.

From a compliance point of view, there may be challenges in gathering the proof that, for example, the AFSL is in the product sales business. However, if these tests are advertised widely, the reps who work for these AFSLs will know that they are representing a sales business – and the facts will come to the surface in due course. For example **the reps will know they are conducting misleading and deceptive conduct if they are holding themselves out as ADVISORS whereas in fact they are in the product sales**. So the penalties can be applied when the facts come to surface. As well, in the BFPPG, we have seen people come to us and talk about getting their own AFSL because of the ethical conflict they feel when the advisor is seeking to provide good advice, and this desire is in conflict with the AFSL's direction to sell product. So the facts do not remain hidden forever, for those who are prepared to listen.

Where the full facts are available about an AFSL, we can use a range of tests to help form a view of whether it is a sales business. **If the AFSL fails one of these tests, then the AFSL is PROBABLY in the business of product sales**. If the AFSL is classified as being in the product sales business, all their reps should be classified as sales reps.

- **What does the AFSL recommend?**
 - If the **approved product list** is dominated by a related parties products, then this is a sales business. (i.e. AFSL and product provider are related parties). **FORM**.
 - If more than 50% of financial products recommended are from related parties, then this is a sales business. (i.e. AFSL and product provider are related parties). **SUBSTANCE**.
- If you have any **ownership links** with a product provider.
 - A consumer at a Ford dealership expects to be buy a Ford. Likewise, a consumer dealing with a rep from AMP Financial Planning, is not surprised to have AMP products recommended.
 - **Truth in labelling** is required, so that when a consumer is dealing with a financial product manufacturer's dealership, the consumer is aware of this before a relationship commences – so that the consumer does not feel they are committed before they become aware. However, Roy Morgan's research clearly shows that many consumers are dealing with financial product manufacturer's dealerships without being aware of that fact. A stronger label like “sales representative” might help deal with this very real and existing problem.
- **Volume over-rides – similar issues to ownership links**. If the AFSL that the advisor represents gets a volume over-ride (which is usually a commission based on volume of business, and which is not normally disclosed as a commission in a PDS, and where it seems that it is quiet common that the advisor does not disclose this as a commission received by the AFSL), the AFSL is a product provider because the AFSL is receiving part of the ongoing MER of the product sold. Therefore / product salesman because you are receiving part of the MER of the product.
- **Once-off investment product related advice is more likely to be a sale than advice**. A financial planning business that focuses primarily on once-off advice is more likely a financial product sales business.
- Are there reports that the reps of this AFSL is pressuring the reps to sell a product that the reps do not feel is in the best interests of the consumer.

If (under the tests above) the AFSL is classified as PROBABLY in the SALES business then the onus of proof needs to be reversed. The AFSL then needs to provide a high standard of proof that the AFSL is not in the sales business.

Related Observations on Volume Over-rides

Largely these volume over-rides are not disclosed by financial planners from what I gather even though it is very clearly “commission” which must be disclosed under the wording of Corporations Law section 947B(2)(9) which says an SoA must contain “information about any remuneration (including commission) or other benefits that any of the following is to receive that might reasonably be expected to be or have been capable of influencing the providing entity in providing the advice”

- Many advisors (representatives) are not even aware what volume over-rides their dealer (AFSL) gets, so how can it be disclosed as Corporations Law requires? Recently, I talked with a rep of a large AFSL. One of the reasons why this adviser was getting their own AFSL was that he knew that Corporations Law required him to disclose all commissions (and financial benefits that the AFSL received – including volume over-rides) and certainly the AFSL was receiving volume over-rides – and yet the advisor could not disclose what volume over-rides the AFSL was getting because the AFSL had not disclosed these amounts to the advisor. **ASIC does not seem interested in investigating failure of disclosure of volume over-rides. Why?** Clearly failure to disclose volume over-rides is a breach of Corporations Law.
- **Related issue:** The Boutique Financial Planning Principals Group Inc (BFPPG), as association of 75 independently-owned financial planning AFSLs, is a particularly useful source of intelligence of what is happening in the financial planning industry because financial planners regularly leave the large financial planning AFSLs to get their own AFSL. These new AFSLs know the businesses practices of the large financial planning AFSLs that they have left. Therefore **ASIC should be taking a much greater interest in sources of industry intelligence such as this, if it is to cost-effectively and systematically deal with consumer-damaging systematic breaches that are occurring in financial planning.** Likewise, members of our group hear about small AFSLs that are behaving in unethical ways. ASIC needs to be using this industry-intelligence more effectively.

This is how ASIC ought to investigate disclosure of volume over-rides:

- ASIC should go to each of the major product providers but at least the major platform providers and require disclosure of all the AFSLs that volume over-rides are paid to.
- Then, ASIC should sample SoA disclosure of volume over-rides from each of these listed AFSLs to see if the volume over-rides are being disclosed as required under Corporations Law.
- This is a simple and effective way of investigating this issue, and I am sure that it would rapidly lead to a much higher compliance with the law on this important issue.

There is an important place for financial product sales businesses.

First, let me observe, that there is a place for financial product sales businesses. For example:-

- That for **simple and inexpensive advice**, a sales business can provide a useful part of consumer choice because:
 - the sales reps do not need expensive initial and ongoing training – and this can reduce the cost of providing advice can potentially be passed on to consumers – particularly if there is strong competition and well-informed consumers.
 - The sales reps are not given much latitude in what they can recommend, and this can help the AFSL provide a consistent quality of “advice” to help reduce the risk of the advice being dangerous or damaging to the consumer.
- That for **simple relatively inexpensive products like car insurance**, a product sales business may be the only practical way to cost-effectively provide this service to consumers.
- Consumer's who are seeking to buy a FORD car, are happy to deal with a FORD dealership because it may give them some comfort that if they have a problem with the FORD car down the track, they have some leverage with FORD to get the problem fixed.
 - Some consumers likewise might get some comfort in dealing with a big known brand (eg AMP) because they might feel that if something goes wrong with the advice they receive, they have some leverage on AMP which might seek to rectify the problem so that their image is not damaged.
- Also – when a consumer is first seeking some financial advice, if they have not had a personal recommendation to a trusted advisor, then a known brand may provide some comfort to help them take their first step in seeking financial planning advice.

But these styles of practices do not suit all styles of consumers for all styles of advice.

From my observations, many astute investors migrate towards conflict-free advisors as they gradually get to understand how the financial planning industry works.

Weaknesses in product sales businesses.

I know in my practice, over the years I have had many clients who when they came to me expressed that:-

- they had tried the big end of town with a few different advisors and they had been dis-illusioned by the experience,
- From their experience, they now knew what they did not want in an advisor,
- And they now wanted to deal with an advisor who had no ownership links with any product providers. A common complaint was that other advisors they dealt with simply wanted to sell them a product – rather than provide good advice. Another common complaint was that other advisors have insufficient understanding about investment markets – which I think reflects on 2 things:-
 - First, it reflects on the fact that product sales businesses employ people whose primary skill is selling, and this is not the primary skill you need if you are in the advice business. These sales people often have a comparatively shallow understanding of investment markets and of investment history.
 - **Second, this reflects on the education system (including compliance obligations) for advisors:-**
 - **RG146 is necessarily a very basic starting point for a financial planner** – and only the flimsiest understanding of investment markets.
 - Yes, there are many courses which go a lot further than RG146, but all long-established professions understand that **formal education can only ever be the beginning**, the foot in the door, the starting place. Most long-established professions also have a professional year, or intern year or something similar where the new graduate starts gaining a much more practical understanding of their new profession by working under the wing of a highly experienced professional. To a fairly large degree, financial planning lacks this dimension at this point in time with the EXCEPTION of at least one style of situation I am familiar with – which is where in smaller independently-owned AFSLs, many principals expect to “grow” their own advisors in the practice because only by doing so is the principal confident that the new advisor in the practice has the knowledge and the cultural values that the principle needs in someone who is representing the practice.
 - As far as the accredited ongoing education is concerned, **the accredited ongoing education requirements have a feel of excessive dominance of product manufacturers who need their products sold – rather than accrediting relevant ongoing education that supports advice-focused advisors to provide the very best advice** in these very challenging investment markets.
- Also, I have received complaints from some, that when they were dealing with one of the large institutionally-owned financial planning businesses, they regularly got passed from advisor to advisor, with no consistency of advice. At least in a small AFSL where the advisor owns the financial planning business, the principal is not going anywhere – and the consumer has the opportunity for a long-term relationship with the advisor – and this is very important in a financial planning ADVICE relationship.

What are some of the consumer risks in dealing with a products sales business?

In many situations, financial products sales businesses may be providing advice which is “appropriate in the circumstances.”

However, please consider these scenarios.

- In some circumstances, the needs of the product sales business may be placed above the need of the consumer.
 - We are running short of revenue this month, what strategies or products can we sell this month to raise some extra revenue. The imperative to sell has over-ridden the needs of the consumer.
- Consider the situation where the AFSL does not have on its approved list, the most appropriate products or investments that might best suit the consumer. In these circumstances, there is a potential for the consumer to be recommended a poor alternative instead. This may not serve the client well. However, it is still possible that the advice did not fail Corporation Law eg not

negligent, and arguably it still might be reasonable in the circumstances – but the advice may be a long way from being good or best in the circumstances.

- Consider the situation where an institutionally-owned advisor has recommended a hybrid property fund (managed by the institution) to his client. (A hybrid property fund contains illiquid real property plus some listed property – and typically offered a 30-days redemption period.) Now just say this advisor can foresee a crash in the property market which might cause this property fund to become illiquid (i.e. Frozen) as many of them have over the last 12 months. The employer might feel that advisor was acting against the employers interests, if the advisor was to recommend (to all the advisor's clients) redeeming this investment – and this advisor might therefore feel reluctant to make the recommendation which was in the best interests of the consumer. By contrast, it seems that the defence that “no-one else saw that event coming” seems to be universally accepted as an acceptable defence.

Because of these sorts of issues, it is critical that consumers are made aware:

- that these are financial product sales businesses and
- that the conflicts which may taint the advice, are properly disclosed in a manner in which consumer will read and understand – and that this disclosure is effectively enforced by ASIC.

Unbundling of platforms should occur as well as unbundling of advice from product.

A key argument in unbundling advice from product, is that the product must stand on its own merits and the advice must stand on its own merit. This gives consumers:

- more choice,
- it should create more competition
- it should empower the consumer by giving the consumer more control over what the AFSL is paid for any advice,
- and it is a step down the path to helping to reducing conflicts of interest that can taint advice.

A very similar line of argument can be mounted for using this timing to **regulate platforms (Wraps and MasterTrusts) more tightly**, denying them the right to impose fees on the products that might sit on the platform, and denying them the right to pay volume over-rides (undisclosed commissions) to AFSLs that recommend that platform. This is important right now, because if advisor fees are going to be unbundled from product for all advisors and all products, the new regulations will probably be delivering greater control to the platforms (Wraps and Mastertrusts) and therefore the platforms really should be regulated more tightly to ensure:

- greater consumers choice of product on the platforms – because platforms will not be able to extort gate-keeping fees from fund managers (shelf-space fees etc)
- hopefully this should help drive down costs of platforms over time – and this is important to help reduce the cost of superannuation in Australia.