Submission
to
Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into Financial Products and Services in Australia
as a supplementary submission 4
22 June 2009

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Reducing costs of advice and funds management for consumers.

In 1/6/09 Asset Magazine, Leng Yeow reports

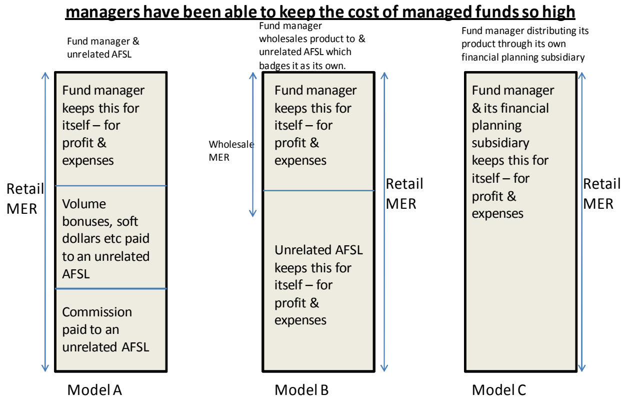
> *"There is no sign fees are falling, despite Superannuation Minister Nick Sherry's efforts. Sherry is pushing for total fees on super guarantee contributions to fall to less than 1 per cent of funds under management. He can't understand, given the huge growth of super funds and the scale benefits that growth affords, why fees are so high.*
> ***'[Super] assets under management have gone from about $50-$60 billion 20 years ago to over a trillion dollars today**, and fees as a proportion have been running at about 1.25 per cent,' Sherry said in April, when he released his Communiqué of Principles on the superannuation system. **'They haven't come down, so as the industry's grown, the fees have remained static.' "***

Given these facts, it should not be surprising that any government would be becoming frustrated and be looking for solutions to this problem. This is the problem that this supplementary submission seeks to provide solutions for.

- Breaking down the existing distribution channels for unlisted managed funds AND
- ensuring that financial planning AFSLs get paid the same regardless of whether they recommend an unlisted managed fund or a listed security (eg shares, LICs and Exchange Traded Funds),
- would force much greater price competition between inexpensive listed securities and expensive unlisted investments.
- This would result in a much better deal for consumers.

- We also need a system for consumers to transact unlisted managed funds and superannuation with the same simplicity and same low cost as buying a share through E-trade or CommSec.
- The conflicts of interest of the financial planning AFSL are far more powerful source of tainted advice, than the conflicts of interests of individual financial planners.

Non-price competition by controlling distribution channels is how fund managers have been able to keep the cost of managed funds so high



These are just different packaging of the same product distribution business model.
To be consistent, if Model A is banned by banning commissions, then you must ban Model B & Model C.
Model A, Model B and Model C each have the same conflicts of interest that can taint advice and keep costs high.

Table of Contents:

Executive Summary:

Costs to consumers can be reduced in a range of different ways, specifically:-

- **Reducing the cost of funds management. Why have economies of scale not delivered lower costs to consumers?** Simple - **because there is very little price competition.** Therefore, to reduce costs for consumers, measures need to be taken to force price competition.
    - Break down the industry structure, which is focused on competing on distribution channels rather than price. This would mean for example, that fund managers could not own advisers through whom they can distribute product without competing on price. A fee-based adviser who is not owned by a fund manager is much more likely to recommend a low cost investment product (eg index fund, ETF or listed security) than a high-cost managed fund.
    - Force industry consolidation of managed funds industry. Measures like the breaking down existing distribution channels, forcing competition on price should be used to help drive the main-stream, high-volume non-differentiated index-hugging investment products to consolidate into a small number of low-cost passive index funds.
    - Provide simpler access to inexpensive US listed securities and mutual funds. Competition.
    - Force price competition between platforms by:-
        - forcing this product category to compete as a separate discrete product set funded solely from fees paid by consumers, with these product providers not being allowed to charge managed funds shelf-space fees or any other types of fees and not being to provide commissions, volume over-rides or any other financial incentives.
        - Fund managers would be forced to divest themselves of current platforms, so that these platforms become owned by discrete, separately regulated companies – similar to the way the ASX is a separate regulated entity for listed securities. A strong parallel.
        - Remove the barriers that make it difficult for consumers to roll funds from one platform to another. Greater competition will exist if there is less lock-in by making it easier for consumers to switch between one platform and another – or off the platform altogether.
    - Industry efficiency. Create of an unlisted transaction system similar to CHESS & Integrated Trading System (ITS) for listed securities.
- **Reducing the cost of the advice itself**
    - Empower consumers
        - legislate that any trail brokerage can be rebated to client at discretion of client
    - Reducing the cost of providing Intra-Product Advice – as outlined in AFR article 3/6/09 "Funds may soon be advising members".
    - Design other lower-cost superannuation service delivery channels to compete with current service providers. Eg
        - For simple superannuation situations, facilitate the creation of low-cost H&R Block-style simple super services.
        - ATO to become a Superannuation Clearing House. ATO to develop an **e-tax**-system-like Internet application to provide simple super services.
    - Shorter SoAs – 3-page SoAs – to pass the Nick Sherry's Bernie Pub test. See Puzzle Financial Advice second supplementary submission for great discussion of this point.
        - removing documentation of basis of advice in SoA – advice to be defensible.
    - By refocusing regulatory protection of consumer away from FORM and onto the key principles in law (see main body of this paper), a lot of the costs of providing advice will be reduced.
    - A key layer of cost can readily be cut from advice-costs, at no loss of consumer protection, by implementation the law in a way to get rid of the advice compliance industry – particularly for small independent AFSLs which are potentially one of the lowest cost avenues for tailored advice – because often these businesses have no fancy or expensive overheads.
    - Greater competition for advice – make it easier for experienced financial planners to get an AFS licence. Alternately, licence individual advisors rather than current structure.

1. Categories of cost reduction for consumers.

Costs to consumers can be reduced in a range of different ways, specifically:-

1.1 Reducing the cost of funds management.

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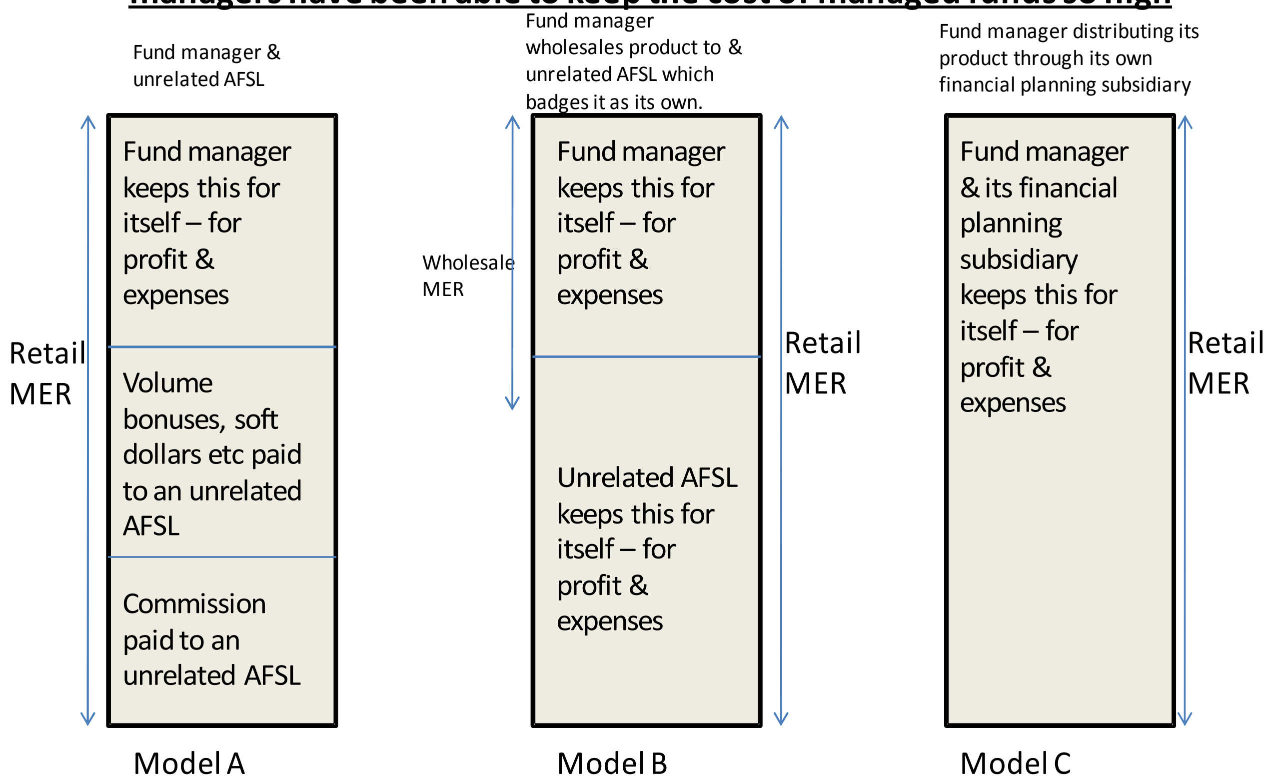
> *"There is no sign fees are falling, despite Superannuation Minister Nick Sherry's efforts. Sherry is pushing for total fees on super guarantee contributions to fall to less than 1 per cent of funds under management. He can't understand, given the huge growth of super funds and the scale benefits that growth affords, why fees are so high.*
> *'[Super] assets under management have gone from about $50-$60 billion 20 years ago to over a trillion dollars today, and fees as a proportion have been running at about 1.25 per cent,' Sherry said in April, when he released his Communiqué of Principles on the superannuation system. 'They haven't come down, so as the industry's grown, the fees have remained static.' "*

So here we have an industry that has flourished because of the generosity of government-provided tax-breaks for superannuation. Yet this industry is hoarding the financial benefits that come from economies of scale. The consumers/tax-payers are missing out. It is understandable that any government would become frustrated with this outcome. So how do we fix this problem?

Why have economies of scale not delivered lower costs to consumers? Very simple. Costs to consumers have not come down **because there is very little price competition.**

Non-price competition by controlling distribution channels is how fund managers have been able to keep the cost of managed funds so high



These are just different packaging of the same product distribution business model.

To be consistent, if Model A is banned by banning commissions, then you must ban Model B & Model C.

Model A, Model B and Model C each have the same conflicts of interest that can taint advice and keep costs high.

So how do we get costs down? Breaking down non-price competition is the key to lower consumer costs. To get lower prices for consumers, you need to break down non-price competition, forcing greater competition on price. This can be down by:-

- breaking down the industry structure, which is focused on competing on distribution channels rather than price.
- Industry consolidation. Measures like the breaking down existing distribution channels, forcing competition on price should be used to drive the main-stream, high-volume non-differentiated index-hugging investment products to consolidate into a small number of low-cost passive index funds. This still allows space for innovative non-index funds.

○ **Industry consolidation and economies of scale.** In Financial Standard 25/5/09 article "Less choice, more returns", former head of strategy at GMO Jack Gray argues that net returns to superannuation investors can be significantly increased through consolidation of more than 500 hundred existing funds to six (each with an average Funds Under Management of $110billion). Jack argues that "choice of fund" costs an estimated 1 percent per annum. This article is attached.

○ **Forcing greater competition on price – by breaking down non-price competition.** Currently, there is very little competition on price between unlisted managed funds. This is because all **the big fund managers have very similar undifferentiated products (index huggers) and they compete in distribution but not on price.** These big fund managers dominate distribution channels through having very large sales-forces of their own (80% of financial planners are owned by fund managers) and large financial incentives exist to influence the remaining 20% of financial planners. This industry structure ensures fat margins for all big fund managers. If the big fund managers could no longer compete through their control of distribution channels, they would be forced to compete on price. This would would result in industry casualties (survival of the fittest) and Management Expense Ratios (MERs) would fall. Yes, a range of boutique fund managers provide very valuable highly differentiated products, but largely Australia would be better served (through lower costs) by replacing a lot of the big mainstream funds with low-cost high volume index funds (unlisted funds like the Vanguard Australian Share Index Fund http://www.vanguard.com.au/personal_investors/investment/managed-funds-over-$500000/australian-shares/en/australian-shares.cfm , Vanguard Personal Plan Balanced http://www.vanguard.com.au/personal_investors/superannuation/personal-superannuation-plan/diversified/balanced.cfm or Exchange Traded Funds [ETF] like State Street's SPDR S&P/ASX200 http://www.spdrs.com.au/etf/fund/fund_detail_STW.html). These downward pressures on price (MERs) would be assisted if Australian consumer's had more ready access to US-listed ETFs, where a much wider choice of low cost ETFs are available

- **Background:**
  - Let me use **Australian share funds** as an example. The big mainstream funds have tight tracking errors in the design of their funds. They do this to manage their business risk. This is widely known and understood. Tight tracking errors mean that each year, the fund manager's target is (before fees) to achieve the returns of the ASX300 plus or minus (say) 2%. One year one fund is just ahead of the index. The next year this fund is just behind the index. Over the medium-term on average all these big funds approximately achieve index performance before fees – and then they deduct their higher active management fees from the returns. **Wouldn't Australia be far better off if these big funds were replaced by a few passively managed index funds which also achieved ASX300 performance before fees – but where the fees charged to Australian investors was the much lower index fees?**

- I would mount the same argument for diversified funds such as **balanced funds.**

Note:

- Breaking down the existing distribution channels for unlisted managed funds AND
- ensuring that financial planning AFSLs get paid the same regardless of whether they recommend an unlisted managed fund or a listed security (eg shares, listed investment companies and Exchange Traded Funds),
- would force much greater price competition between inexpensive listed securities and expensive unlisted investments.
- This would result in a much better deal for consumers.

- Greater price competition by providing simpler access to inexpensive US listed securities and mutual funds. Make it easier for Australian investors to access listed US securities. Among other things, there are huge numbers of Exchange Traded Funds (ETFs) listed on US stock exchanges. ETFs are often a good substitute for an unlisted managed funds – and ETFs tend to have very low MERs.

- **Reducing the costs of platforms – i.e Wraps and Master Trusts.** Over recent years, financial planners have increasingly used platforms for a range of different reasons. However, platforms in Australia are still significantly more expensive than they could be. A range of measures can be used to drive down the costs of platforms such as Wraps and Master-trusts. Measure taken should include:-
  - forcing this product category to compete as a separate discrete product set funded solely from fees paid by consumers, with these product providers not being allowed to charge managed funds shelf-space fees or any other types of fees and not being to provide commissions, volume over-rides or any other financial incentives. These measures would help remove non-price competition.
  - Fund managers would be forced to divest themselves of current platforms, so that these platforms become owned by discrete, separately regulated companies government by new specific regulations. There is a very strong parallel between the way the Australian Stock Exchange (ASX) is a separate regulated entity for listed securities. This would force openness and transparency of the cost-structures of these entities – and could be used to regulate against consumer gouging.
  - Remove the barriers that make it difficult for consumers to roll funds from one platform to another. Greater competition will exist if there is less lock-in by making it easier for consumers to switch between one platform and another – or off the platform altogether. What is needed to make this possible?
    - Creating of an unlisted transaction system similar to CHESS & Integrated Trading System (ITS) for listed securities.
    - Obliging platforms to transfer (on receipt of request) an investors funds from one platform to another within a limited time – as is the case for superannuation rollover requests.
    - Capital gains tax relief for rolling over from one superannuation Wrap to another eg to rollover from BTSuperWrap to Macquarie SuperWrap.
  - **Outlawing provision of financial benefits by fund managers to financial planning AFSLs such as volume over-rides.** This would considerably reduce the costs of providing platform services, and if we forced more price competition, this would result in lower MERs. All financial benefits from platforms to financial planning AFSLs should have to be banned, except where specifically approved by the consumer.
  - **Outlawing platforms from charging fund managers on those platforms for shelf-space fees and any other fees.**

    - **Consumer to control payments directly.** These last two point are really part of a bigger agenda whereby:-
        - The advisor is paid solely by the consumer – payment from consumer to advisor.
        - The platform is paid solely by the consumer – payment from consumer to platform.
        - The fund manager is paid solely by the consumer – payment from consumer to fund manager.
        - In summary, no cross-subsidisation, no non-price competition, no third line forcing.

- **Creation of an unlisted fund transaction system similar to CHESS & Integrated Trading System (ITS) for listed securities.**
    - This sort of unlisted transaction system would be to the unlisted managed funds industry, equivalent to Telstra's long-line backbone network for Telephone Companies (Telcos) in Australia.
    - At the moment, a small number of platforms (Wraps and Mastertrusts) are developing oligopoly pricing power – and consumers are largely locked in, as are advisers. Therefore, there is no strong competition on price.
    - If Australia had a transaction system for unlisted managed funds (and super funds) similar to CHESS and ITS, this would be a critical step towards lower consumer costs and greater price competition.
    - Part of the implementation of this concept, might include regulatory intervention to cause a separation of platforms (Wraps and mastertrusts) such that the transaction system was separated from other components of the service. All of the platform providers would be required to use the new unlisted fund transaction system.
        - This would help ensure greater mobility (easier switching) from one platform to another. For listed securities, if I want to move from one broker to another, I just move my HIN (Holder Identification Number) from one stock broker to another. Why shouldn't moving from one platform to another for managed funds be this easy?
            - Note: Please observe how much lower transaction costs are for listed securities through Internet brokers such as E-trade and Commsec. Our objective should be to have transaction costs for unlisted managed funds to be as low as transaction cost of a listed security through E-trade or Commsec.
        - Much of the logic in this is very similar to the government's logic in forcing **Telstra** to *split it's retail from its wholesale operations.*

<u>1.2 The role of financial planners (and their AFSLs) in keeping costs high.</u>

As a large part of the financial planning industry now works, financial planners have a big incentive to recommend expensive products that have fat profit margins from which the financial planner can get a fat kick-back. For financial planners who are owned by product manufacturers, there is a very big incentive to recommend expensive products from their employer, because otherwise they do not get to keep their job.

Therefore, if these incentives were taken away, this would help reduce the overall costs to consumers.

<u>Note:</u> Independent advisors (because they are not product distribution channels) tend to recommend a higher proportion of direct listed securities (as compared with unlisted managed funds) because of the lower costs. The more direct and unconstrained competition that the managed funds industry gets from inexpensive alternatives like direct listed securities, the more down-ward pressure there will be on MERs (Management Expense Ratios) of managed funds including superannuation. Again, this comes back to removing sources of non-price competition.

1.3 Reducing the cost of the advice itself

- Empower consumers
  - legislate that any trail brokerage can be rebated to client at discretion of client – and that all products be required to be able to rebate all commissions. At any time, a consumer must be able to direct any fund manager that all trailing brokerage is to be rebated to the consumer. Eg if service is poor or non-existent.

- Reducing the cost of providing Intra-Product Advice – as outlined in AFR article 3/6/09 "Funds may soon be advising members". These proposed changes clearly should give access to at least some limited advice to a large proportion of Australians who currently have access to no affordable cost-effective advice. While some financial planners are fearful that this proposed change will cause an "uneven playing field" for providers of advice, I feel that good financial planners should have little to fear from this change, particularly if further refinement of FSR is undertaken to reduce/remove compliance burden that is FORM and not SUBSTANCE. See Puzzle Financial Advice second supplementary submission for greater discussion of this point. As this supplementary submission points out there is a lot of room for improvement without removing strong consumer protection.

- **Design other lower-cost superannuation service delivery channels to compete with current service providers.**
  - **Option 1 – very basic level superannuation services** through very low-cost channels. (eg H&R Block for Superannuation)
    - There are a number of very low-cost narrowly-focused channels providing tax return preparation services for PAYG taxpayers. A similar or the same concept could be applied to simple narrowly focused superannuation services. Some examples of the low-cost tax-return service providers are H&R Block and Income Tax Professionals (ITP) eg I saw one operating at the shopping centre on Saturday offering $95 tax returns –the service was limited to mum & dad simple PAYG taxpayers. There may be some regulatory issues to be worked through with this concept.
  - **Option 2 – expanding the proposed Superannuation Clearing House role of the ATO.**
    - The ATO have been introducing its excellent Internet-based e-tax system over the last few years, to make it much easier for tax payers to prepare their tax returns. For many taxpayers, e-tax enables many tax payers to prepare their tax returns without a tax agent.
    - Maybe a new facility like e-tax could be developed for super. In the same way that the ATO's e-tax software hand-holds a taxpayer in preparing their personal tax returns, a similar system could be developed to help mainstream Australia manage their superannuation. The concept might go like this:
      - The ATO provides the standardised interface service for the e-Super services. This interface would handle activities such as switching between super fund providers, investment selection, death benefit nominations, contributions & withdrawals, super fund pension elections, consolidation of lost super.
      - And that all Super Fund providers (excluding SMSFs and SAFs) be required to develop an interface between their superannuation administration systems and the ATO.
      - The ATO would become the central clearing house for these simple super services.
      - Consumer's access all these superannuation services via a new ATO Internet application – lets call it e-super.

- Greater competition for advice – make it easier for experienced financial planners to get an

AFS licence. Alternately, licence individual advisors rather than current structure.

- Shorter SoAs – 3-page SoAs – to pass the Nick Sherry's Bernie Pub test. See Puzzle Financial Advice second supplementary submission for great discussion of this point.
  - removing documentation of basis of advice in SoA – advice to be defensible.

- Refocus regulatory protection of consumer away from FORM and onto the following key principles in law, a lot of the costs of providing advice will be reduced. Those key principles are:-
  - The well established common law obligations in terms of negligence, duty of care, fiduciary duty etc.
  - The Corporations Act 2001 requirement that:
    - there was a **reasonable basis** for the advice and the advice was reasonable in the circumstances. Section 945A
    - a licensee must "do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly" s912A(1)(a)
  - The ASIC Act 2001 provision for protection in respect of:
    - Misleading or deceptive conduct. Section 12DA.
    - False or misleading representations. Section 12DB.
    - Requirements to apply "due care and skill", and that advice is "fit for the purpose". Section 12ED

- A key layer of cost can readily be cut from advice-costs, at no loss of consumer protection, by implementation the law in a way to get rid of the advice compliance industry – particularly for small independent AFSLs which are potentially one of the lowest cost avenues for tailored advice. FSR has spawned a large compliance industry that has added a significant extra layer of cost on AFSLs. This compliance industry causes added consumer cost at no consumer benefit because:-
  - It is focused on check-list tick-the-box FORM of advice and advice-process rather than good quality advice with substance. It operates under the mistaken belief that good process equals good advice. Yes, it is true that a strong process can help create a consistency of service on a production line – and this form of quality control may be appropriate for large distribution channels. However for a small financial planning AFSL, informal systems together with good culture and sound ethics is the most appropriate form of quality control – for the businesses which provide highly-tailored advice – rather than production line cookie-cutter advice.
  - Most of these compliance people understand too little about investment markets to recognise poor or dangerous investment advice, but if the advice passes the checklist test of being good (as Storm Financial advice would have), then these compliance people regard the advice as being good – even when it is bad for consumers. This is a terrible situation which, if not fixed, will result in many more disasters like Storm Financial.
  - FSR has spawned an education compliance industry which creates education that produce accredited CPD (Continuing Professional Development) points where much of the education material has little educational value for experienced financial advisors. However, it "ticks the box". However, this compliance industry has perfected the art of handing at accredited Continuing Education Points, even where the "education" has little value.
  - Unfortunately, consumers can be damaged because they have been led to believe that this highly compliant FORM of advice, is quality advice. Again Storm Financial comes to mind.
  - Nothing beats experienced ethical professionals providing advice with integrity.

Appendix A. Sources of conflict in the different styles of distribution channel.

> **Note:** All these different styles of distribution channel tend to have a strong bias against recommending less expensive investments like listed securities. This is because listed securities (such as ETFs and Index Funds such as those from Vanguard) do not pay trailing commissions, volume over-rides or any other financial incentive to the financial planning AFSL.

I make the following observations, recognising that:-

- to most financial planners, the statements below are just stating the obvious,
- but also recognising that many financial planning AFSLs carry on a charade, to at least in public pretend that these conflicts of interests do not exist, or pretend that these conflicts are manageable and are well-managed,
- and also recognising a large proportion of consumers are not aware of these distribution channel structures (conflicts of interest) let alone how distribution channel structures both taint advice and cause the cost of advice to be higher than it otherwise might be.

To properly understand these conflicts of interest, we must recognise that under Corporations Law, a fund manager is not allowed to pay a commission directly to a financial planner. Yes, fund managers do seek to influence advice by providing benefits known as "soft dollars" directly to financial planners. And yes, recent press would have you believe that commissions are paid to financial planners. And it is also true that it helps the cause of the big fund managers to perpetuate the myth that fund managers pay commissions to planners because this takes the spot-light off the practices of the financial planning subsidiaries of these fund managers.

The facts are:-

- Corporations Law requires commissions to be paid by fund managers to financial planning AFSLs.
- Volume over-rides are paid by fund managers to financial planning AFSLs.
- Marketing support is paid by fund managers to financial planning AFSLs.
- Shelf-space fees are paid by fund managers to financial planning AFSLs.
- Some financial planning AFSLs create their own products to sell to generate more profit. This practice is very wide-spread, particularly by the large financial planning firms that are not owned by a fund manager. Examples of this are:-
  - Storm Financial which created Storm-badged products.
  - Professional Investment Services has created some investment products of its own to sell.
  - Many of the larger financial planning firms (no owned by an institution) white-label BT's Wrap platform. White-labelling is where a financial planning firm badges the BTWrap product as their own and sells it to their clients. A primary objective of badging a product as your own, is to capture a greater share of the management fees of the product for the financial planning AFSL. Count Financial is one of many who white-labels the BTWrap product.
  - From recollection, AMP badge the Asgard Master trust.

So the first thing that consumers need to know is that commissions, volume over-rides and a complex web of other payments and financial benefits are paid to financial planning AFSLs. These payments are not paid to financial planners.

The financial planning AFSL then has discretion on how it wishes to incentivise it's financial planners. These arrangements can include the following options:-

- some financial planners are paid salaries – typically with large bonuses depending on performance (eg performance in many financial planning firms equates to how much product was sold). Obviously financial planners who are employees of financial planning AFSLs get to keep their job is they achieve the outcome their employer is seeking – and this can be a powerful incentive for a financial planner who desperately needs his job.

- Some financial planners are paid a share of fees and commissions that the the financial planner generates.
- As an extra incentive, some financial planners are also offered shares in the financial planning AFSL or in a related party.
- In summary, there is a very wide range of subtle and not-so-subtle incentives that financial planning AFSLs utilise to focus the financial planners on achieving the outcomes desired by the AFSL. These "incentives" have a very large potential to over-ride the ethical of professional values of the financial planner. Indeed, over the years I have talked with many financial planners who have felt torn between the employers requirements and the planners own ethics and professional values.

At the risk of again stating the obvious – since Corporations Law licenses AFSLs rather than individual financial planners, we must consider what motivates the financial planning AFSL. **Most AFSLs are corporations – and most corporations are driven to maximise profit** – particularly where the financial planning AFSL is a publicly listed company or a related party of a publicly listed company. If the CEO of a publicly-listed company delivers a poor profit, the CEO may be sacked and board members voted out by shareholders.

The key point is that **it is the objective to maximise profit which is a very central to the conflicts of interest that taint financial planning advice.** Understanding this, is central to understanding some of the conflicts in each of the distribution channels below.

What are some of the conflicts of interest that are created in the 3 different product distribution models identified below:

- In **Model A**, “obviously” maximising commissions and volume bonuses has the potential to maximise profit in a product sales business that is independently-owned. These incentives create the potential for the financial planning AFSL to put its own needs ahead of the consumer's needs. The financial planning AFSL clearly has an incentive to incentivise its financial planners to maximise commissions and volume bonuses.
- **Model B-1 White labelling.** In **Model B-1**, “obviously” maximising the sale of the badged product has the potential to maximise profit. This incentive create the potential for the financial planning AFSL to put its own needs ahead of the consumer's needs. The financial planning AFSL clearly has an incentive to incentivise its financial planners to maximise sales of the badged product.
- **Model B-2 where a financial planning firm creates a whole new product – typically a fund of funds or a composite product build of other industry products.** There is a second variation of Model B. The same conflicts exist as in Model B-1. Example of this style include **Storm Financial** badged products from what I understand. Professional Investment Services also has built some investment products this way. There are others who have built products like this, that I could name. It is quite common for a large financial planning AFSL to create their own product. It might be argued that the MER's for some of these products which have a “captive” client-base, are unreasonably high – achievable only because of non-price competition and effective product salesmanship.
- In **Model C**, “obviously” maximising the sale of the fund managers products has the potential to maximise the profits of the fund manager. This incentive create the potential for the financial planning AFSL to put the fund manager's own needs ahead of the consumer's needs. The financial planning AFSL clearly has an incentive to incentivise its

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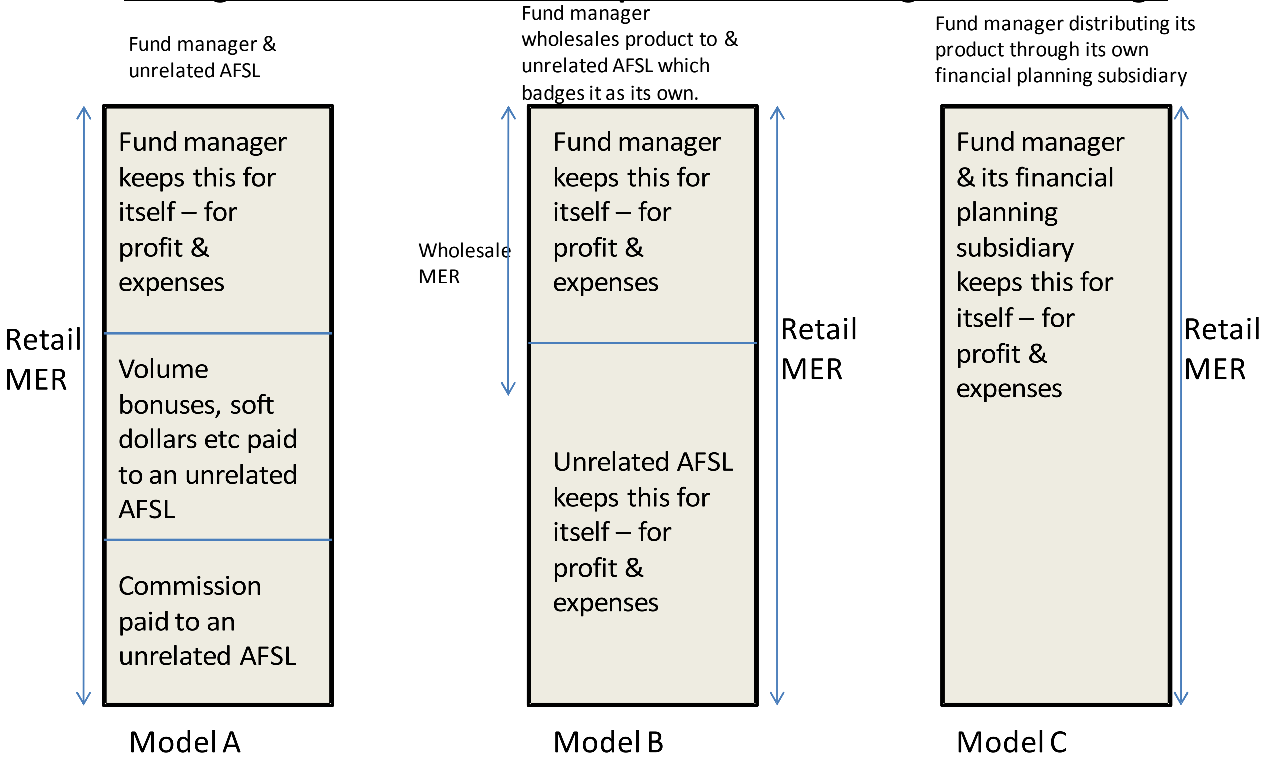

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financial planners to maximise sales of the fund manager's own product. The widespread view is that fund managers only own financial planners, so as to distribute their own product.

- **Related point:** A fair few industry press article have suggested that quite a few financial planning AFSLs make very little profit. Just say AMP Financial Planning did not make a lot of profit. Why should AMP be unhappy with this if AMP Financial Planning distributed a lot of product for AMP?

We can see from the above, that in each of these product distribution business models, there are powerful profit-driven incentives that have great potential to taint advice, because there is strong motivation for the financial planning AFSL to provide powerful incentives to their financial planners to help maximise the profit of the financial planning AFSL. In our capitalist system, you should not expect otherwise.

The conflicts of interest of the financial planning AFSL are far more powerful source of tainted advice, than the conflicts of interests of individual financial planners.

The financial planning industry is very highly conflicted. The industry is riddled with conflicts of interest, many of which consumers are not aware of and do not understand. If the government wishes to fix the problem of conflicts of interest in financial planning, these incentives need to be taken away. The biggest single step that the government can take in reducing consumer costs and reducing conflicts of interest would be to ban product distribution businesses. Consumers would have much better access to un-conflicted advice if this were done.

<u>**Note:**</u>

- I am sure that many of these product distribution businesses have wonderful-looking FORM (processes and business models) demonstrating how they tightly manage the conflict of interest that comes with being in the product distribution business. However, in my view, the conflicts that come from being a product distribution business cannot be adequately managed. Many subtle ways (unidentifiable by normal audit) can be used to influence the financial planners in these businesses to sell the product that helps maximise profit. These are product sales businesses.
- I know that many of these product distribution businesses will proclaim vigorously that they are not in the product distribution (sales) business – but are in fact, in the advice businesses. You will know the old saying - *"If it looks like a duck, walks like a duck and quacks like a duck, it is a duck"*. These businesses must be labelled for what they are. i.e. Product sales businesses.

What will FPA's position be?

In light of these conflicts of interest it would seem that the overwhelming majority of distribution businesses would fail the FPA's new Code of Ethics (effective July 1, 2009) which includes the following principles:

- **"Principle 1: Client First** - Place the client's interests first - Placing the client's interests first is a hallmark of professionalism, requiring the financial planner to act honestly and not place personal and/or employer gain or advantage before the client's interests."
- **"Principle 3: Objectivity** - Provide professional services objectively - Objectivity requires intellectual honesty and impartiality. Regardless of the services delivered or the capacity in which a financial planner functions, objectivity requires financial planners to ensure the integrity of their work, manage conflicts and exercise sound

professional judgment."

However, based on past actions, FPA is most unlikely to take action against these breaches of its Code of Ethics because that would mean taking action against some of the FPA's largest principal members of the FPA. FPA cannot afford to bite the hand that feeds it. So again we see why the industry cannot heal itself. Regulation is required. In 22/6/09 AFR article "Banning commissions alone is not enough", Jeremy Cooper is on the right track.

Small financial planning AFSLs are the only place where ethics & ideal can win over profit.

Small financial planning AFSLs are one style of financial planning business, where the above problem is solved. **In a small financial planning AFSL, with only a few advisors, the ethics and professional ideals of the principal of the business can be a much more powerful force than the incentive of short-term profit.** I know many such small highly-idealistic, highly-ethical highly-professional financial planning AFSLs. This is what leads me to believe that **consumers would be far better off if financial planners were individually licensed – rather than licensing AFSLs.**