Submission
to
Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into Financial Products and Services in Australia
as a supplementary submission 6
17 July 2009

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Corporations Law creates big incentives for planners to build distribution businesses.

Count Financial – a case study of a financial planning business.

For the PJC Inquiry to make its determinations, it first needs to understand how the payment systems works in financial planning.

Problem: The structure of Corporations Law pushes financial planning businesses down the path of building product distribution businesses – as explained in this submission. Only small financial businesses who are totally committed to being advice businesses resist these forces. Is this good for consumers who are seeking high quality good financial planning advice? I believe the simple answer is NO – because it inevitably leads to very large conflicts of interest that taints advice. These forces that push financial planning businesses to become product distribution businesses create a situation where there are comparatively few pure-advice businesses – and this makes it very difficult for consumers to find truly independent advice. If the government is seeking to make quality unconflicted advice readily available to consumers, then the disincentive of being in the advice business needs to be removed.

The solution: 1) License individual advisors rather than businesses. 2) Ban all factors which can bias financial planners to recommend expensive investments over inexpensive investments. 3) Adopt the UK FSA's proposal from the June 2009 consultation paper section 4.15 that "where firms access lower prices they will have to pass these on completely to their consumers, without retaining a margin." This would ensure more complete and clearer disclosure of fees.

"Wrap fees are disclosed in so many different documents it would take a forensic accountant to work out who gets what." Pru Moodie in "Fingers in the Pie" CPA web site. What chance does an investor have of getting clear, concise and effective disclosure of fees?

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Attachments:

- Count Financial FY08 Annual Report
- A Count Financial Financial Services Guide + other Count documents
- Asset magazine article "Waging the war of independence" July edition. In this article the journalist exposes how a range of different planning practices maximise their profits by "**transfer of margins from fund managers to distribution**".

"I don't think I could get up here and explain super fees to you; let alone a lay audience. Where would I start? How could I explain the web of charges and commissions, splits between players, volume and other sorts of rebates, shelf fees, contribution fees, exit fees, asset level versus account level, buy/sell spreads and maybe even arrangements I don't yet know about? Surely, nobody could follow it without studying a diagram, unless, of course, they have been living with it for years."

Jeremy Cooper 18/6/09 presentation to ASFA.

1. Making sense of the payment systems and business models in financial planning industry

To make its determinations, the Parliamentary Joint Committee on Corporations and Financial Services needs to understand in detail how the financial planning industry works, what motivates the players, what creates the conflicts and how the money flows.

To assist the PJC Inquiry therefore, I have attempted to dis-assemble how a financial planning business works. Since Count Financial is listed on the stock exchange, we can get a fair bit of public data about their financials. So with a little industry knowledge we can have a reasonable approximation as to how the business works.

> **Caveat:** This is not to pick on Count Financial – but as a listed company their data is readily at hand. I am not aware of anything they are doing wrong under the current regulatory environment. I suspect Count Financial are doing no different from many other financial planning AFSLs. My point is simply that I think that under our current regulatory system, there are a number of widespread accepted practices that ought to be banned – because these practices have a negative impact on consumers.

An analysis of Count's financials.

For FY08, "Asset-based income" were $31.57million. Total profit was $33.42million.

What is asset-based income?

The FY08 annual report (page 7) provides the following explanation:-

> "2. Asset-based income (Line item 2)
> This is the fastest growing income stream, up 23% compared to a reduction in preferred platforms FUA (down by 6.61%) for the year. The divergence is largely due to timing issues and a very strong opening FUA, up 36% on prior year and a very weak FUA year-end due to market conditions, down 6.6%. Income is primarily driven from Funds Under Administration (FUA) of $6.92 billion ($7.41 billion 30 June 2006) in the six recommended platforms from four providers – BT/Westpac $4.60 billion; Skandia One $1.41 billion; Colonial/CBA $0.55 billion and Perpetual $0.36 billion. FUA is expected to continue to grow and provide Count with slightly increased margins overall compared to Retail investments from line 1. Increased margins are a result of the efficiency of platforms and **the transfer of margins from fund managers to "distribution".** Whilst Count sees itself as supporting its network of advisers and not "distribution", the reality is that by using buying power to improve financial arrangements from platforms and fund managers, Count can charge franchisees less. In return, franchisees can be more financially secure and/or pass on better terms to their clients."

The FY08 annual report (page 12) says:-

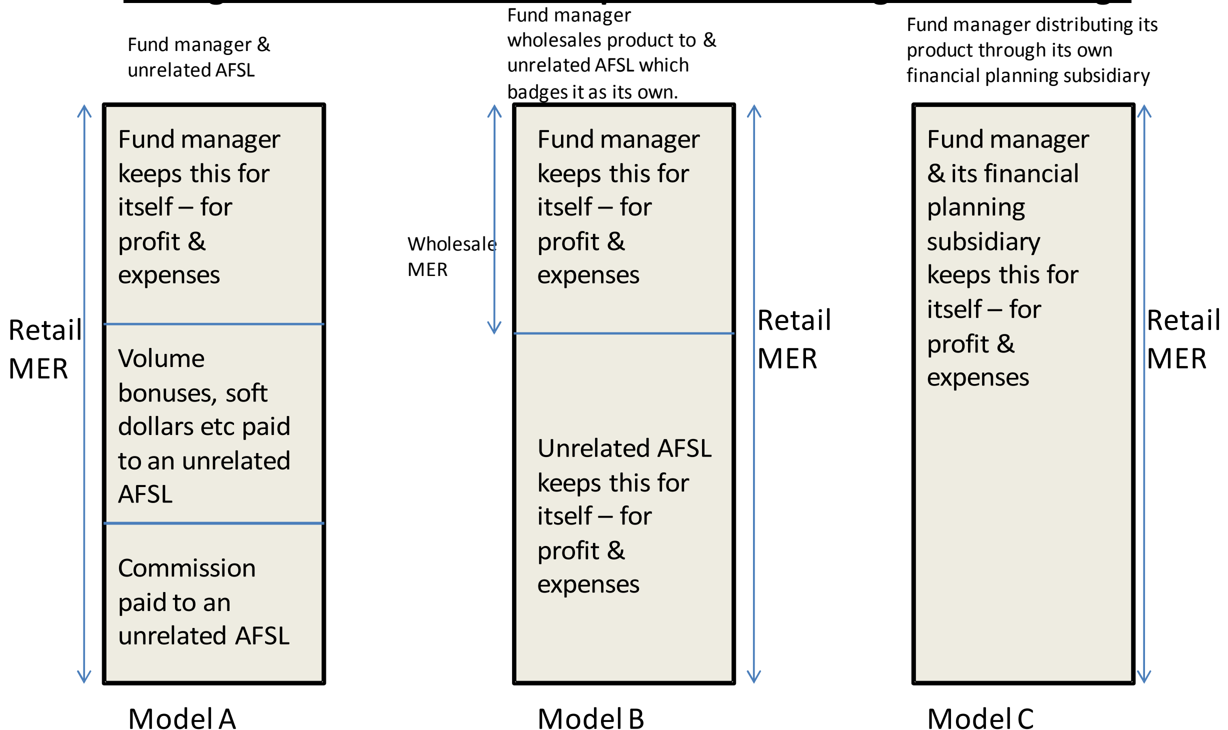
> "**Preferred Platform Update**
> The core of our business is the preferred platforms we use to facilitate the advice process. The revenue generated through these platforms is reported as **asset based income**. Over the 12 months Funds Under Advice (FUA) has been impacted by market conditions but was down by less than 7%, compared to the industry FUA which was down 12% and the All Ordinaries Index decline of 16% for the same period. Despite this decrease, asset-based income grew by 23% due to the timing of the payments and

starting from a larger base in July 07 due to the super opportunities that ended June 2006."

Since the income statement shows, "Fees and commissions" as a separate line item, this leads me to conclude that "asset-based income" must be a combination of:-

- volume over-rides from Skandia, Colonial/CBA, and Perpetual. I am not aware of these 3 platforms allowing white-labelling, and therefore the primary way to "**transfer of margins from fund managers to distribution"** is to extract a volume over-ride from the platform provider.
- White-labelling the BTWrap platform. As explained in supplementary submission 4, white labelling a platform transforms the BTWrap platform into Count Financial's own badged platform. Typically the way this works, is that BTWrap provides it's platform to an AFSL like Count at a wholesale price and Count takes a share of the MER of the platform. And so as explained in my supplementary submission 4, white-labelling (badging) achieves the same "**transfer of margins from fund managers to distribution"** as volume over-rides do. The diagram below is from supplementary submission 4.
    - Note: **White-labelling a platform, transforms the financial planning business into the role of product manufacturer.** So it would appear that Count Financial is both a **product manufacturer and a distributor of its own product.** There are a range of examples in the financial planning industry, where a large financial planning business has used this combination of strategies to maximise profit. In attached Asset magazine article "Waging the war of independence", the journalist explains how other financial planning businesses use similar strategies.

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.

I cannot see another interpretation of this data that is possible.

Let us examine the numbers just a little closer. If we look at the statement that Asset-based income *"is primarily driven from Funds Under Administration (FUA) of $6.92 billion ($7.41 billion 30 June 2006) in the six recommended platforms from four providers – BT/Westpac $4.60 billion; Skandia One $1.41 billion; Colonial/CBA $0.55 billion and Perpetual $0.36 billion",* we can calculate how much they earn for each dollar that they have under management. The calculation are are follows:-

- Count had $6.92billion funds under administration (FUA)
- Revenue Count earned from this FUA was $31.57million
- Therefore Count earns 0.45%pa of all FUA – this is an impressive share of the total Management Expense Ratio of the funds that Count has under administration.
  - Appendix B provides an analysis on how Count achieves this 0.45%pa from FUA, by analysing how this is achieved on the BTWrap product. In summary, that since Count's wealth-e-account (a badged BTWrap product) charges approximately 0.3%pa more than DKN's Assetlink (another badged BTWrap product), then its is clear that on Count's main platform, they achieve this (approximately) 0.45%pa of profit by adding this margin on to the wholesale price that BTWrap charges Count.
  - Note:
    - In the UK Financial Services Authority's June 2009 Retail Distribution Review consultation paper (http://www.fsa.gov.uk/pubs/cp/cp09_18.pdf), the UK FSA makes the following proposal.
      - "**Adviser Charging: what it means for product providers**

        4.14 To end the system of product providers offering amounts of commission to adviser firms, we are proposing new responsibilities on product providers, as well as on adviser firms. Just as the rules we are consulting on would prevent adviser firms from receiving commissions set by product providers, we are also consulting on a ban on product providers offering commissions (or other payments or benefits) in relation to advice on investments given to retail clients.

        4.15 This requirement is not designed to prevent product providers from offering different product prices through different distribution channels (for example, a large IFA network might be able to secure a product with a lower product charge than a sole trader). In order for the market to operate competitively, we are content that different product prices will continue to be available through different channels, but where firms access lower prices they will have to pass these on completely to their consumers, without retaining a margin."
      - If the proposal in Section 4.15 was applied to Australia, then if Count Financial wanted to charge its clients this specific 0.45% fee indicated above, then Count Financial would have to charge this fee explicitly to the client rather then burying this fee within the MER of the Count's wealth-e-account. **This would ensure more complete and clearer disclosure of fees.**

The implications of Count's financial statement therefore is that it is in the business to generate profit from the distribution of managed funds and platforms. This is clear, because this accounts for nearly 100% of Count's profit. Therefore in my view, Count is primarily a product manufacturer and product distributor. This is its business model.

Since businesses exist to make profit for the shareholders, it is only natural that the financial

planning AFSL creates incentives for it's representatives to behave in a manner which maximises profit. Therefore, it should not be a surprise that Count incentivises it's representatives to maximise profit. If we go to Count's Financial Services Guide we see some evidence of a Count incentive scheme to shape representative behaviour towards maximising asset-based fees (the source of Count's profit).

> ***"Fund manager payments*** Count may receive payments from financial institutions, based on the average balance of all funds placed by Count advisers in each relevant institution's investment option(s). These payments are not shared with your adviser, however they may receive indirect benefits as described in '*Incentives'* below.
>
> ***Incentives*** Franchisees may be rewarded with Count share options (see below) and other benefits based on their contribution to Count's profit each financial year. Each Count service offered by your adviser has a different Contribution to Count (CTC) value based on the service's profitability. By reaching specified CTC thresholds, franchisees may become eligible for fee waivers, cash rebates and a higher commission split paid by Count on some products.
>
> ***Option incentives*** Franchisees who increase their CTC level by 12.5% each year may be allocated discretionary Count Financial Limited (COU) options. COU options may be converted to shares at a prescribed point in the future, upon payment of an agreed price."

2. Why is Count Financial's business model a natural outcome of Corporations Law?

Count's business model is a logical outcome of the structure of Corporations Law. Corporations Law does not licence financial planners individually. Instead, Corporations Law licences businesses and financial planners must work as a representative of an Australian Financial Service Licensed (AFSL) business.

Businesses exist to make profit. The larger the business, the stronger the drive is to make profit. In the financial planning industry, the simplest and easiest way to make profit is to sell and distribute products because:

- a salesman needs less education and training than a good advisor
- sales people are easier to replace than good advisors.
- Perhaps even more important, **if you sell product, you can get paid from a share of the fees that the product manufacturer charges the consumer** – and the quality of any advice provided does not have to stand on its own feet. i.e. **You can get paid far more than value that the consumer places on your service.**

So how does a financial planning AFSL maximise it's share of the fees that a product manufacturer charges to the consumer? By accumulating more financial planners as representatives, a financial planning AFSL has more leverage when negotiating with product manufacturers, specifically:-

- **Volume over-rides.** By the time you get about $30million Funds Under Management (FUM), you are able to start demanding volume over-rides from some product manufacturers. As my supplementary submission 3V2 explains, volume over-rides are simply extra commission over and above the normal level of trailing commission that is identified in the Product Disclosure Statement.
- **White-labelling (product badging) is the next step to maximising profit** – requiring the planning business to have achieved significantly greater scale eg maybe somewhere between $250million and $1billion FUM might be sufficient to warrant white-labelling a product like BTWrap. From a profit perspective, the value in white-labelling is two-fold:-
  - First, the financial planning AFSL can set the management fees of the product as high as it wishes – so the white-labelled product may potentially have a higher MER than the original BTWrap branded product.
  - Second, to enable the financial planning AFSL to take a greater share of the overall MER than otherwise it could achieve.
- **Creating your own product is the third step in maximising profit.** The simplest way of doing this, is to have your own product invest in one or more wholesale managed funds. By creating your own product, you can again increase profit by charging a higher MER.
- **Listing on the Australian Stock Exchange is the last step to maximise profit**. Firstly, as Count Financial shows, listing your business increases the capital value (sale value) of the business from about 3-5 times earnings to about 20 times earnings. Then you can buy all or parts of other small financial planning businesses for maybe 3-5 times sustainable earnings, and the market immediately re-rates these new earnings at 20 times earnings, thus driving the share price up.
  - Count Financial was an early financial planning business to list and play this game.
  - Professional Investment Services was seeking to go down this path.
  - **Storm Financial** was seeking to go down this path.

3. Conclusion and Recommendations.

The structure of Corporations Law creates very powerful incentives for financial planning businesses to build product distribution businesses that create easy profit by travelling the paths for profit indicated above. Only small financial businesses who are totally committed to being advice businesses resist these forces. Is this good for consumers who are seeking high quality good financial planning advice? I believe the simple answer is NO – because it inevitably leads to very large conflicts of interest that taints advice. These forces that push financial planning businesses to become product distribution businesses create a situation where there are comparatively few pure-advice businesses – and this makes it very difficult for consumers to find truly independent advice.

If the government is seeking to make quality unconflicted advice readily available to consumers, then the disincentive of being in the advice business needs to be removed.

Recommendations:

1. License advisors rather than businesses. In short, if your want a much higher prevalence of "real financial advisors" rather than product sales people, Corporations Law needs to be changed so that advisors are licensed rather than businesses.
2. **Ban all factors which can bias financial planners to recommend expensive investments over inexpensive investments.** These factors include (and are not limited to):
    1. all payments and incentives provided by product manufacturers to financial planning businesses like volume over-rides, marketing support, shelf-space fees, and commissions and
    2. ownership links between planners and product manufacturers.
3. **Adopt the UK FSA's proposal from the June 2009 consultation paper discussed above section 4.15 that "where firms access lower prices they will have to pass these on completely to their consumers, without retaining a margin."**
    1. In Count's case, this would prevent Count from marking up the wholesale price of the BTWrap platform by approximately 0.45%pa when they resold this product under the Count wealth-e-account product and it would require Count to explicitly charge this fee to the client (if it required this margin). **This would ensure more complete and clearer disclosure of fees.**