

# Changes Underway for Financial Advisors

The Index Investor

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### Big Changes Underway for Financial Advisors

As readers of [The Index Investor](#) know, there are major changes underway in the financial advisory business in the U.K., Australia, India and the U.S., largely focused on tighter distinctions between the roles of product salesperson and a fiduciary providing advice, and the elimination of commission payments to the latter, with preference given to fee-based compensation. For example, consider the following excerpts from the recent submission of Quantum Financial Services to the Australian Parliamentary Inquiry into Financial Products and Services: “We note the current major issues facing the financial services industry, including low current consumer opinion towards financial planners / financial advisors; recurring examples of failures of financial institutions and rampant abuse of consumers; [and] lack of professionalism among many who hold themselves out as financial planners/financial advisors...”

“The relationship between product providers and advisers completely taints the professional financial planning advice process and decreases consumer confidence in the whole industry. From the clients’ perspective, typically they trust the advice of the financial planner that the product that they are recommending is the best one for them. They should be able to rely on that advice, free of conflicts of interest that the relationship between the advice and product creates. In our opinion, unfortunately this third relationship is too strong as product providers actively seek to influence financial planners to direct their clients into their products via the following strategies largely hidden to consumers:

- **Volume bonuses** – and other profit sharing arrangements such as platform rebates based on the volume of business a financial planner channels into a particular product provider. These are kickbacks paid to advisors and AFSLs in all but name, pure and simple. Obviously, the more

- business the financial planner channels into a product provider, the higher the volume bonus or platform rebates and shelf fees they receive.
- **Fee sharing arrangements** – These are a complex form of soft dollar influence not necessarily based on volume sales and therefore not banned under this code, but potentially worth millions of dollars.
  - **Provision of soft dollar benefits** – This may include provision of research, lavish lunches, cheap personal financial products (eg mortgage, financing, etc), travel expenses, profit sharing arrangements, payment of conference fees and airfares.
  - **Buyer of last resort** – An arrangement where a fund manager guarantees it will buy the financial planning practice when the planner decides to sell if there is no other buyer willing to pay the asking price. That price will multiply in line with business generated by the planner for that fund manager.
  - **Ownership of financial planning firms by product providers** – the vast majority of financial planners in Australia work for AFS Licensees owned in part or in whole by product providers. Buying a financial planning firm as a sales force enables product providers to channel clients into their products. This is the easiest way for product providers to influence control the supposedly independent advice process. This can be done easily though staff targeted volume bonuses, approved product lists that make the firms products easier to invest in, providing research on own products, etc. In one of the few public glimpses the public have been allowed to see regarding the large financial planning firms approach to channeling clients into their parent or associated company's products, ASIC reported the following: "*Between January 2005 and October 2005, ninety three (93) percent of all new investment or superannuation business resulting from the advice of AMPFP Planners was invested in AMP products. This is not atypical of dealers*" (*ASIC Enforceable Undertaking of AMP*). We ask you 'Would a reasonable person call this advice or sales?'"

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In the U.K., the Financial Services Authority has issued a new consultation paper on its Retail Distribution Review that provides detailed recommendations for the implementation of reforms that have already been proposed, including a ban on commission payments to advisers by the end of 2012. The FSA clearly states that one of its key goals is making sure that “recommendations made by advisers are not influenced by product providers.” In India, there are proposals to ban front end commissions, and to fully disclose trailing commissions. And in the U.S., the Obama Administration has proposed a rule change that would hold registered broker dealer representatives to the same fiduciary standard that now governs the behavior of Registered Investment Advisers, including much more extensive disclosure of compensation arrangements with product providers.

Other recent articles highlight why the changes that have been proposed across many countries are both long-overdue and critical. A recent article in Australia’s *Money Management* noted that “nearly half of all Australian high net worth clients lost confidence in their wealth management firms and financial advisers during the downturn, leading to 26 percent of all HNW clients withdrawing their assets or leaving the firm altogether in 2008.” Apparently, this trend was strongest among clients who are under 45 years old. In the U.K., *FT Adviser* reported the results of a survey that found “forty percent of private investors said they disagreed with the advice they were given by their advisers over the past 24 months, or felt their advisers were too slow to respond to the challenge of the financial crisis.” Finally, in the *Journal of Indexes*, Jack Bogle offered a new analysis that used funds flow data to compare the actual rates of return earned by investors in different ETFs and index mutual funds with the returns on the underlying indexes over the past five years. The clear conclusion was that over-trading (and the relative underperformance it causes) was much worse among ETF investors. As a result, their realized returns underperformed the indexes by much greater amounts than was the case for investors in index mutual funds, who traded much less. In sum, the financial advice industry seems to be at a turning point, not only in those countries where change is already underway, but also elsewhere, in places like the Eurozone and Canada, where

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the practices criticized in Australia, the U.K., India and the U.S. are also widespread. We cannot help but think that it will be increasingly difficult for the Eurozone and Canada to maintain their current systems after substantial changes have been made in these other countries.