

The Great Fee Debate

And why I learned to love the letter of engagement

I recently sent out an email broadcast requesting commission-based financial planner/advisors to respond to a very short survey¹. I was trying to devise a fair revenue comparison model to further my research into the transition from a commission-based practice to a fee-based one. Since I haven't been commission-based in 10 years, I needed a little re-education to understand the current financial implications of a transition to fees.

Well two things happened that really surprised me. The first was that about a third of the responses were from fee advisors, front-end 0% advisors, or those in the process of transitioning to fees who implied that commissions are bad. The second was the number of advisors who asked: "What exactly is a fee?"

What is a Fee?

Jack Gallagher, CFP, R.F.P., a commission-only financial planner with Investors Group asked, "Can you clarify for me the exact definition of a fee-only planner. Is it someone who gets all their remuneration from the client by billing such as a CA or lawyer or is most of their revenue from asset-based fees?"

Timothy Ming, P.Eng., MBA, CFP with Ming & Associates/FundEX Investments Inc. says this whole fee-based thing is confusing at best and possibly misleading. Everyone has a definition of fee-based and the CFP Association Conference in San Diego was quite clear recently about not using the term fee-based unless all of your revenue comes directly from billing clients and not through third parties.

Whenever these issues come up, and believe me they come up quite often, I commonly refer to the debate as the *fee fairy tale*. There is no standard definition of what a *fee* is in Canada and there is no body that regulates the term. There is some regulation surrounding the use of the term in the U.S., as Ming pointed out, but with two important differences.

The first is that it is structurally easier in the U.S. for an advisor to switch to fees from a licensing and platform point of view. The second is that the term and method of charging fees are clearly defined to the point that even commission advisors can still offer (and advertise) a fee service as long as there is no bait and switch.

I think we need a little more latitude here in Canada (I frequently get emails and phone calls from advisors whose dealers won't even allow them to charge a fee). So my interpretation would be that a fee is any form of income that encourages a relationship and is tied directly to the engagement, while a commission encourages a transaction. Also, a fee format has a bias toward retention while the

¹ You can see the results at www.tofeeornottofee.com/resources.html

commission model has a bias in favor of acquiring new clients. That means anything that is a front-end or DSC commission would not qualify as fee-based, but charges to the client either directly or deducted from the assets (which includes trailer fees) would qualify.

Trailers would not fit the U.S. definition of fees, but why not here? My current research indicates that the front-end 0% load model may be the most prevalent fee (like) model used by non-commission Canadian advisors because they don't have easy access to any other fee model. Look at it this way, no one ever argued that a mutual fund management fee was a commission. It is seen as a fee for ongoing management of the mutual fund portfolio. So why is the portion of that fee paid to the advisor suddenly considered a trailing commission?

Warren J. Baldwin, CFP, R.F.P., CIM, Regional Vice-President with T.E. FINANCIAL CONSULTANTS LTD. disagrees. "Nope! These are trailing COMMISSIONS, pure and simple. How and why do they get paid to an advisor? Simple, as a result of transactions. Where is the requirement for analysis, where is the statement of service, where is the commitment to what statements or reviews are deliverable in exchange for the cost to the client, and where is the DISCLOSURE? Also, correct me if I'm wrong, but I have yet to see a mutual fund, any fund, state to the unitholder how much the advisor is paid as a trailer or what is the quarterly or annual dollar cost of the MER (or any other form of advisor remuneration for that matter). Heck, the advisor could DIE and the trailer would continue to be paid to their estate (now that's a tough service structure to fulfill)!!"

Baldwin has a stricter definition of fees. "A Fee-Only planner is one who, in all circumstances, is compensated solely by fees charged to or for the client, with neither the advisor nor any related party receiving compensation that is contingent on the purchase or sale of a financial product. A fee-only planner should not receive commissions, rebates, awards, finder's fees, bonuses, or any form of compensation from others as a result of a client's implementation of his or her recommendations."

What Is Fee-Only?

As succinct as the above definition is, believe it or not there is also some debate within the fee advisor community as to which method of fees is more pure. Sandra Foster, CFP, R.F.P, CIM, TEP, CHRP, FCSI, President of Headspring Consulting Inc. suggests two different ways to look at fee-only, "The first where the fees paid by the client are based on time and level of expertise required. The second where fees (particularly in the investment counselling type of account) are based on the size of the client's account (with a potentially ever-increasing annual fee assuming the size of the account increases annually".

As she sees it, a fee-based model, even when paid by the client, has its own potential problem when it is based on the size of the account. Says Foster, "There

usually is no cap on the annual fee, nor a discussion as to how much is enough.”

Douglas V. Nelson, CFP, CLU of Nelson Financial Consultants also found that we are potentially over-paid for those larger clients in a fee-based or commission model. He solved this issue by offering his clients both a tiered flat-fee (a flat-fee that increases with every AUM threshold) and a clearly defined tiered service (the client receives more frequent and additional services as the fee increases). The client pays more, gets more.

My fundamental belief is that fees are more appropriate for our industry, though that doesn't necessarily imply that commissions are bad. In certain cases, such as the sale of insurance, there is no such thing as a no-load option.

Conflicts of Interest and Disclosure

I think potential conflicts of interest and full disclosure are more important.

There is a conflict of interest in any compensation model. Commissions encourage a transaction over the advice; hourly fees have a bias to stretch out the engagement; you want to do the work as quickly as possible in a flat-fee engagement; and the advice is skewed towards the assets under a management in a fee-based relationship. I think what differentiates us as professionals is how we manage those conflicts.

One way for fee advisors to deal with any potential conflict of interest built into a model is to charge the appropriate fee for the particular service. John Page, CFP, R.F.P. and President of Page and Associates, offers two types of fees: fees for planning and fees for managing assets. The former is based on time and the complexity of the situation, and the latter is based on the client's assets under management. In fact, a U.S. study found that only 22% of fee advisors bundled the planning and asset management fee together. Most charge them separately².

I believe that we should be focusing on the issue of full disclosure. Do your clients understand the costs, what services they are getting from you, and how you are ultimately compensated?

In the UK, if you are an "independent" financial planner/advisor, you are obliged to offer your prospects a fee option. You are also required by the Financial Services Authority³ to provide your prospects with a Keyfacts document about the cost of your services. This document fully details compensation options, fee schedules, and commission examples leaving the prospect fully informed about their costs and your compensation. Interestingly enough, even under this

² Troucing Adversity, by Raymond Fazzi, *Financial Advisor Magazine*, November 2002

³ http://www.fsa.gov.uk/consumer/o2_HOW/Advice/keyfacts_costs.html

regulatory system, the fee and commission model makes up the largest share of compensation methods used by CFPs⁴.

Foster, who was also the Chair of the advisor transition group as part of the Fair Dealing Model (FDM), is fully in favour of disclosure. The whole discussion of compensation still boils down to a reluctance by advisors to disclose costs and value and the belief that some compensation methods are above repute.”

“Having clients clearly appreciate their costs would be helpful, as would an understanding by clients/advisors of the value received/provided in return (sometimes this value proposition is too thin).” Foster discussed this in her book "Who's Minding Your Money" published by John Wiley in 2000. She recently stated “Not much has changed since my first advisor survey in early 2001. Disclosure should also encourage the discussion of value, and that's what some advisors fear. However, the bottom line is ethics. Either you are an ethical advisor or you are not.”

Under these circumstances even Baldwin relented a bit. Could a trailer BE a FEE? "Yes," he says, "But the pain and screaming from the investment industry over up-front disclosure and proper ongoing disclosure communications to clients will NEVER let this happen! I was on a sub-committee of the OSC's FDM (that stressed disclosure and well-defined advisor/client relationship service sets) and, while fundcos can easily report to advisors on a MONTHLY basis how DSC commissions and trailers are being paid and how much, it is strange how virtually impossible it would appear to be to provide this kind of information to clients who, after all, pay the bill in the end."

So under a fee-for-service model (charging the appropriate fee for a given service) who cares how you are paid as long as the client understands what they are buying and how you are ultimately compensated for providing this service? And have your clients acknowledge this by signing the letter of engagement.

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⁴ UK Institute of Financial Planning 2005, CFP compensation methods (estimates): Commission only (15%), Salary & Other (10%), Fee only (20%), Fee & Commission (55%).