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13 December 2002

Ms Ruth Smith                      FAX: (02) 6263 2882  
Financial Systems Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

**Response to "Compensation for Loss in the Financial Service Services Sector – Issues and Options".**

Dear Ms Smith

This submission is on behalf of small dealers (small businesses who are dealers) around Australia. Many of these small dealers fear that the future definition of "Adequate Compensation Arrangements" has the potential to drive them out of business. In recent weeks many of our members have contacted me with their concerns and issues relating to this matter. We seek in this submission to air some of those concerns – and we would appreciate being able to contribute (and provide feedback) on Treasury's views on how this problem should be solved.

**In summary:**

We believe a sensible & practical solution to the "reasonable compensation arrangements" problem, can be found to keep the legislators happy, the regulators happy, small dealers happy and also protect the consumer.

"Reasonable Compensation Arrangements" is an issue where it would be very easy to create a quick and arbitrary "solution", but such "quick solutions" could be disastrous for small dealers. Since our previous discussions with ASIC and the Parliamentary Joint Committee has convinced us that both government and regulator are keen to ensure that a flourishing small dealer community exists (because it is very important for consumer choice), we are keen to participate in dialogue with Treasury about solutions that might be considered.

*We believe that the best solution to "Reasonable Compensation Arrangements" is based around professional indemnity insurance. However, at the moment we are experiencing a "failure of the market" in the insurance industry. A solution that we strongly recommend for consideration is that the government re-enter the business of being an insurer, to restore insurance-writing capacity thus reducing the damage being caused to the community through the existing lack of capacity.*

However, to the extent that professional indemnity insurance is not available because of "lack of capacity" in the insurance industry, any effected dealer should be allowed to come up with a creative alternative that does not impose unreasonable cost.

Extra protection might perhaps be achieved by having "compensation arrangements" documented on the Financial Services Guide (even though to some investors this might be an invitation to sue). We believe that compensation arrangements that have been in place pre-FSRA have been adequate, and at most these requirements need only minor fine-tuning. For example, it was generally believed that with adequate PI cover and the introduction of FSRA that the need for the old security deposit no longer existed.

"Adequate compensation arrangements" is a potentially life or death issue for small dealers and so we would appreciate dealing with this situation with sensitivity.

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**Who is the Boutique Financial Planning Principals Group Inc?** The Boutique Financial Planning Principals Group Inc (BFPPG) is an association of small dealer businesses which are each principal members of the FPA. We incorporated with 9 founding member businesses in April 2002 to help address the common problems of small dealers – and to fill the vacuum of lack of representation of the interests of small dealers. Most of our 25 member businesses have less than 5 advisors on staff – often just one or two advisors. Our membership is based around highly experienced advisors who believe that holding their own dealers (or AFS) license enables them to create the best possible environment in which they can most effectively service the real needs of their clients. Most of our members run advice-focused businesses. Many of our members run fee-based advice businesses. *In this regard, the BFPPG is probably the only group which represents the interests of financial planning businesses which are offering the style of advice that the Australian Consumer Association say that they want from financial planners.* (See Money Management 12/12/2002, "ACA slams industry as 'structurally corrupt.'" attached) In that regard, we believe small dealers are crucial to consumer choice in financial planning. The appendices argue the case about why small dealers are important for consumer choice.

Since incorporation, the primary issue that BFPPG has been focused on has been the Financial Services Reform Act and related policy statements. This has been because small dealers around Australia saw this change in regulatory environment as a huge potential threat to their businesses – because of the lack of certainty of what the new rules meant – and because the weight of compliance burden (and the perceived cost in transition in licenses) was so heavy in terms of time and money. We have had extensive consultations with ASIC in the development of ASIC's November 2002 "Small Business and your AFS license" document and we believe this document represents a very significant improvement for small dealers. We are also have appreciated the support of Parliamentary Joint Committee in this matter.

**Some concerns and fears of small dealers about some proposals we have seen.**

**Professional Indemnity Insurance.**

*There are many reports of "lack of capacity" in the insurance industry to carry the level of professional indemnity required by the community. This is a failure of the market. There is demand for a product/service but not enough providers to supply. This suggests a need for the government to consider re-entering the insurance industry – that it used to be active in when it owned GIO, SGIO etc. This would also help solve the problems of insurance for obstetricians and gynaecologists, life savers, country town shows, tourist businesses (offering services from horse-riding to bungy jumping -many being forced out of business through lack of insurance) etc etc which have been damaged by the current insurance industry crisis.*

*The government has a very important role to play where the market fails. We believe it is now one of those times. We believe that the government should resume being an industry operator in the insurance industry to restore capacity for the provisions of key areas of insurance where the community is suffering through lack of insurance-writing capacity.*

Failing the government stepping into this role, the industry participants must be allowed flexibility to organise themselves in a matter to solve the problem in alternate ways. A dealer who is unable to get insurance cover (because of lack of capacity – and noting that a recent IFA Magazine article suggested that this was mainly effecting more small independent dealers in the UK) should be able to put an alternative arrangement in place – and protect the public by ensuring that compensation arrangements are disclosed eg in their Financial Services Guide. An alternate arrangement with disclosure is better (for the public) than preventing independent, ethical, competent dealers from operating because preventing this dealer (and dealers like him/her) from practising ends up denying the consumer choice – and that choice will inevitably be the choice for small independent dealers.

**Minor quirk in current requirements for professional indemnity cover.**

Currently Life Brokers licensed under the Insurance (agents & brokers) Act 1984, are required to have professional indemnity insurance cover. A life broker with one representative is required to have 2 reinstatements in the professional indemnity insurance policy. A life broker with one hundred

representatives is required to have 2 re-instatements in the professional indemnity insurance policy. Clearly this requirement means that small brokers are by comparison, required to have a higher degree of cover (i.e. The number of reinstatements per advisor is much higher for small dealers.) This is a simple example of where current rules are imposing a comparatively higher cost on small businesses. Many small dealers also hold a life-broking license.

#### **Industry Self-regulatory Body.**

- ① Ideas of an *industry self-regulatory body* (as part of the solution) need to be discouraged because of the structure of the financial planning industry. The fear of small dealers is that the highly-resourced, powerful large dealers (banks and subsidiaries of large fund managers) could take the self-regulatory body hostage, to the disadvantage of small dealers.

#### **Professional Standards Model.**

- ① We have concerns about the proposed "*professional standards model*" because of its focus on "process" rather on quality of the output of the advice process. Small dealers are very different from big dealers in very many ways, and there is no consumer benefit in trying to force small dealers to behave like big dealers. All that will be achieved by such proposals will be the reduction of consumer choice (with the demise of many small dealers) and this would be a great disadvantage to the consumer. The professional standard model which focuses on the advice process rather than the quality of the output of advice, is:-
  - ① fatally flawed, because it is focused on something other than what the consumer needs. The consumer is looking for quality advice. It will always be easy to have a squeaky clean, "compliant process" but be delivering poor, negligent or unethical advice.
  - ① In addition, there is the simple fact: There is no evidence of any relationship between advice process and quality of advice.
  - ① However, a professional standards model may help drive down the cost of professional indemnity insurance because it may make it more difficult (through business risk management strategies) to sue an adviser who has provided poor, negligent or unethical advice. However, this is probably not consistent with the sort of consumer protection that the government is seeking when defining "reasonable compensation arrangements."

#### **An Indemnity/Fidelity Fund.**

An industry-wide indemnity fund is problematic in that it will result the good guys being punished for the behaviour of the bad guys.

However, there is potential merit in specific groups (eg groups of dealers) setting up their own indemnity fund, where there can be much greater control of who is and who is not in the fund – and where specific rules might exist in each grouping which could help protect the ethical players. However, an indemnity fund should not be a mandated requirement – just an approach that some groups might choose to adopt for various reasons.

#### **In summary.**

We would be pleased to work with the Treasury, Parliamentary Joint Committee and ASIC to help ensure a good outcome to this issue.

Yours Sincerely



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Certified Financial Planner

President, Boutique Financial Planning Principals Group Inc (the association of small dealers)

## Appendix A. Why do small dealers come into existence?

A key reason why many small dealerships come into existence is because very capable, experienced advisors get disillusioned with the constraints that large dealers impose on their representatives. By taking out their own license (free of product sales targets or constraints on which product they can offer), these experienced advisors feel they can create an environment in which they can better service their clients needs.

## Appendix B. The evolving structure of the financial planning industry.

The regulatory environment is based on the premise that all financial planning businesses are based on a product sales business model. You will find many in our industry have this view – and in discussions with senior ASIC staff, they have also had acknowledgement of this problem.

It is a problem in that it results in a regulatory environment that is shaped to only suit part of the industry, and it disadvantages the style of financial planning business which we believe the Australian Consumer Association would prefer – and the style of financial planning business which we believe many politicians would prefer. In summary, it is a problem because advice-focused business are disadvantaged by the regulatory environment – and because the growing compliance burden is making it more and more difficult for advice-focused businesses to prosper – and we believe this industry advice-focused segment is crucially important for consumer choice.

Over the last 5 years there has been a very distinct polarisation in the financial planning industry in a number of ways including:-

- 1) Only big and boutique dealers - very few in the middle tier left. IFA Magazine 2/12/02 notes that 5 years ago, 50% of FPA principal members were small dealers. Now 87% of principal members are small dealers.
- 2) There has also been polarisation between product sales businesses and advice-focused businesses, with *the advice-focused businesses being almost exclusively found among the small dealers.*
- 3) Needless to say there has been a 3rd polarisation. Large dealers are almost entirely owned by large banks or large fund managers. Most small dealers are independently owned ... but (under FSRA) not allowed to use the word "independent" even though they clearly have removed one of the main sources of "conflict of interest" by not being owned by a product provider.

### How does the regulatory environment disadvantage advice-focused financial planning businesses?

This is a big topic and further information can be provided if necessary (eg if it is not obvious), but it starts off with basic little items like the definition of Statement of Advice, Section 947A of the legislation.

## Appendix C. Consumer choice and small dealers.

**Small dealers are an important alternative for consumers seeking financial planning advice - an important part of consumer choice.**

Indeed, small dealers were a major driving force towards professionalism in financial planning. Over the last 15 years, many small dealers have contributed a lot of their time (particularly through the Financial Planning Association), to furthering the cause of professionalism. *Many of the most experienced financial planners often work in small dealerships.* And other than the historical reasons, many of these experienced small dealers choose to work in small dealerships because *they believe this provides an environment where they can best serve their clients.* [Eg In a small business, financial planners are less likely to find themselves under an obligation to "sell a quota of product". Rather, the financial planner can focus on doing the best for their client.]

**Clearly small dealerships have an important place in the future of financial planning. Clearly small dealers are also an important part of consumer choice.**

**Note:** Small independently-owned firms do not face the same conflict of interest as:-

- The large Wall Street brokerage houses who for example were recommending stocks in companies on one hand while they were receiving big investment banking fees from the same companies (eg relating to floats, or mergers and acquisitions). We have all seen the scandal that has erupted over this since the bursting of the tech bubble. In case you are not aware of the press discussion of these issues, an example of the stories relating to is (AFR 23/5/2002 Page 13.) For an Australian angle on this story, you might reference Australian Financial Review 25/5/02 Page 20.
- There are also conflicts of interest where a large fund managers has a securities dealers licensee (or AFS Licensee) as a subsidiary or related party. Again, the issues are widely known and understood. Perhaps recommendations of a related parties product need to be explicitly identified as such, to ensure the consuming public is adequately informed.

With these points, we are not claiming small dealers (AFS Licensees) are "holier than thou". Unethical small financial planning businesses exist as do unethical large financial planning businesses. This is why compliance does have an important place. With these points about conflicts of interests, **we are identifying that many small dealers do not have the above specific conflicts of interest - and as such, this is another reason why small financial planning businesses do have a very important place in consumer choice - and in providing competition in this sector.**

Of course, the other place where discussions take place regarding conflict of interest - is the fees vs commission debate. For those who believe that fees independent of advice, reduces this conflict of interest - please observe that a greater predominance of fee-based advice occurs in small to medium-sized financial planning businesses. Again, **this is further reason why the government and regulators should be encouraging and supporting the development of small financial planning businesses. Clearly the consumers lose, if these small financial planning businesses are regulated out of existence.**

### Background - Un-acknowledged public safeguards offered by small business licensees.

The rules may seem appropriate for large organisations - not suited, tailored or designed for small businesses. For example:-

- **Larger financial planning businesses tend to have multiple locations - often widely spread geographically.** It is widely recognised that supervision of compliance requirements (even as they have stood pre-FSRA) was far more problematic in these scenarios. We agree that clearly in such cases, tighter compliance procedures are required. However, our membership mainly operate from one location where it is much easier to supervise compliance.
- **Management in larger financial planning businesses are employees.** If they behave inappropriately, they may lose their job. By contrast, **management in smaller practices are owners.** If they behave inappropriately, they may lose their job and their house - and other assets.

Under such circumstances, you would expect the management of smaller practice to be more diligent in ensuring they comply. This extra public safety factor does not seem to be acknowledged.

- **Many of the most experienced financial planners often work in small dealerships** - see comments above. We believe this experience results in a better, more appropriate service - something which has not adequately been recognised in PS146.
- **Small financial planning practices are generally more advice-focused** - see comments above. In small practices, financial planners are less likely to find themselves under an obligation to "sell a quota of product". This can result in smaller financial planning practices being "safer" places to be serviced.
- **In small practices, the business owner generally has a personal relationship with his clients.** We believe this reduces the chance of unethical behaviour. In a large dealer, the business owner generally has no personal relationships with the clients of the business.

Generally, in smaller practices there are less clients per advisor. This relates to the fact the businesses tend to be more advice-focused, rather than product sales focused. Again this leads to multiple benefits from a public protection angle because:-

the advisor tends to get to "know their clients" (as required) much better, increasing the chance of well-tailored, appropriate advice.

the advisor has a much better chance to educate his/her client (eg more fully be able to discharge obligation to ensure clients understand the relevant investment risks of the investment strategy.)

Again, the closer bond between client and advisor, the less likely the trust will be abused. The clients are more than simply a name on a register.

**Bottom line: We believe that rather than disadvantaging small business financial licensees under the FSRA (including requirements for reasonable compensation arrangements), related regulations and Policy Statements, the government would serve the public interest by creating positive incentives for experienced financial planners to take up their own Australian Financial Service Licence - and by ensuring that any requirements for reasonable compensation arrangements was supportive of the development of a flourishing "independent" small dealer segment to help maximise consumer choice.**

We would be pleased to work with the Treasury, Parliamentary Joint Committee and ASIC to help ensure a good outcome along these lines.

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# ACA slams industry as 'structurally corrupt'

By Ben Athoff

THE Australian Consumers Association (ACA) has hit out at the funds management and financial planning industry in Australia, stating it is "characterised by structural corruption".

The comments were made last week at an industry conference by ACA chief executive Louise Sylvan, who was referring to incentives such as commissions and soft-dollar bonuses received by financial planners.

She says these incentives compromise the independence of financial planners and drive the cost of products up for consumers.

In the context of superannuation choice in Australia, Sylvan says there is a possibility that advisers will "churn" clients to obtain commissions, making the UK pension mis-selling problem "look like a picnic compared to the Australian situation".

The comments by Sylvan come on the back of a spate of recent attacks by other industry bodies on

the lack of adviser independence.

The Australian Prudential Regulation Authority's Charles Litzrell was recently quoted as saying the retail investment industry is "based on bribery" when referring to commission-based investment advisers, while CPA Australia recently claimed independent financial advice is diminishing due to increasing ownership of large dealer groups by institutions.

The Financial Planning Association (FPA) responded by argu-

ing financial planners were able to adopt a professional mindset, despite commissions to provide honest, competent advice.

Sylvan disagrees, saying the ACA is considering if it will take the position that it is impossible to be both an adviser and a product seller.

She says the ACA is moving toward a possible new model of financial planning in the Australian marketplace that would see a structural separation of advice and product sales.

She also argued that the increas-

ing dealer group reliance on fund manager infrastructure was an unsatisfying outcome for the industry.

Sylvan says that the fee-for-service model is not being taken up widely in the industry, and that while commissions exist, it will be hard for consumers to see the value in an up-front fee.

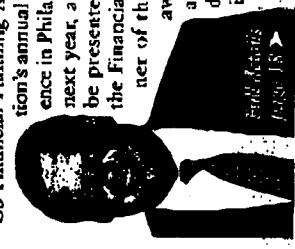
She says the problem is that advisers are seen by consumers as being independent and impartial, although in reality they are striving to act more like tied agents.

## Kiddell: planner of the year

VICTORIAN financial planner Robert Kiddell has won the *Money Management* Financial Planner of the Year award for 2002, after being a field of well-known financial planners.

Kiddell led the pack ahead of Peter Leggett, John Hewison and Peter Richards, who have all been given Highly Commended awards for their contributions to financial planning, the financial services industry and the community.

Kiddell will receive a trip to the US Financial Planning Association's annual conference in Philadelphia next year, and will be presented with the Financial Planner of the Year award at a Gala dinner in May.



Financial Planner of the Year 2002

# MLC/Garvan revolt over dealer fee

By George Lionfis

THE National Australia Group owned Garvan Financial Planning and MLC Financial Planning dealer groups are facing a groundswell of dissatisfaction from their 600 advisers over a decision to charge a "minimum contribution fee" and push ahead with proposals to take a cut of advisers' trail commissions.

Advisers attached to the dealer groups who contacted *Money Management* have labelled the moves "greedy" and said they would encourage planners to "just product flag".

The new minimum contribution charge, announced to planners in March but due to be paid for the first time this month, requires all planners to generate at least \$20,000 in income for their dealer from new business sales alone each year.

If they do not, they will be required to pay any shortfall back to the dealer.

The proposal to take a cut of advisers' trail commissions is still the subject of intense negotiations between the two dealerships and the National Planners Association, an alliance of advisers working for the two groups.

The president of the association, Mark Lewis, has confirmed the changes are causing



Chips are down: MLC/Garvan makes grab for adviser income.

widespread consternation amongst advisers across the two groups, although he says this is unlikely to force a backdown by the dealers.

"The minimum contribution payment is already in and that is a fact of life. The second phase of the changes is for them to get a slice of the trail. They are going to implement that, it is just a question of the rate," he says.

A spokesperson for the two dealers says the new costs are standard industry practice

and reflect a range of new support services the dealerships are offering.

However, Lewis says it has been explicitly stated during negotiations that the new measures are also being introduced to make up for declining revenues across the two dealer groups.

"All dealer groups are struggling at the moment and they have to look at ways of

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