Senate Select Committee on Superannuation and Financial Services

Main Inquiry
Reference (a)

Submission No. 74

Submittor: First Samuel Limited
Level 6, 470 Collins Street
MELBOURNE VIC 3000
Mr Anthony Starkins
Managing Director
☎ - (03) 9620 0833
- (03) 9620 0899

Senate Select Committee on Superannuation and Financial Services

Submission

Main Inquiry Reference (a)

Anthony Starkins
Managing Director
First Samuel Limited
Level 6
470 Collins Street
Melbourne
Victoria

03 9620 0833

EXECUTIVE SUMMARY

Proposition

The existing legislative and self-regulatory regime for retail financial (especially superannuation) services has failed the consumer by overlooking the "fiduciary" relationship between financial advisers[1] and their clients.

A fiduciary relationship creates a fiduciary duty, the principal element of which is:

> "The duty to act for the sole benefit of the client."

When an adviser receives commissions or other benefits from third parties, he/she is not acting for the sole benefit of the client.

Disclosing that such commissions or other benefits are received does not eliminate the fiduciary duty, as it does not represent informed consent.

Outworking

Members of the public are investing (sometimes their life savings) not on the basis of recommendations that are made in their best interests, but on the basis of recommendations that are influenced by the size and value of the commissions and other benefits their advisers receive.

This is a clear breach of what the legislative and self-regulatory regime intended, and creates situations in which an investor's life investment plan might be inappropriate and lead to inappropriate and possibly ruinous investment.

Recommendation

> **That the law should clearly recognise the fiduciary nature of the relationship between the financial adviser and the client; and make illegal the payment and receipt of commissions or other benefits – whether disclosed or not.**
>
> **Commissions include upfront, hard dollar, soft dollar, and trailing commissions. Other benefits include bonuses or other benefits paid by employers to employees as "rewards" for recommending clients invest in in-house products.**

[1] Throughout this document the reference to financial adviser is not to a stockbroker adviser, but to a financial planning adviser.

SUBMISSION CREDENTIALS

First Samuel Limited is a private client portfolio management company, providing an integrated wealth planning and portfolio management service to high worth clients.

It does not service the broader retail market and therefore does not stand to gain financially if any of the recommendations contained in this submission are adopted. First Samuel's concern is in helping to create a market in which the interests of the investing public are foremost.

Anthony Starkins, the Managing Director and Chief Executive Officer of First Samuel Limited, has had 22 years' experience in the investment and finance industry. He worked with J.P. Morgan Investment for nine years, most recently as Head of Marketing Asia Pacific based in Singapore and spent 10 years with Schroders PLC in a variety of capital markets and treasury related capacities in Melbourne, Sydney, Tokyo and London. Immediately prior to the establishment of First Samuel, Anthony was the Managing Director of Norwich Investment Management.

Anthony is a Chartered Financial Analyst, holds Bachelors' degrees in both Laws and Economics from Monash University, has completed the University of Oxford Advanced Management Program, and is a member of the Australian Institute of Company Directors, the Association for Investment Management and Research, and the Financial Planning Association.

He has a strong interest in ethics, especially in the financial services industry and recently presented a paper "Ethics and Trust in the Private Banking Industry" to the Private Banking Conference.

1. WHAT IS THE NATURE OF THE CLIENT/ADVISER RELATIONSHIP?

1.1 The relationship between a financial adviser and the client is a fiduciary one. Whilst the nature and extent of what constitutes a fiduciary relationship is subject to discussion, especially in relation to the role of company directors, there is little doubt as to its application in the case of client/financial adviser.

1.2 Without going through an exhaustive list of commentaries and legal cases, the definition of fiduciary is broadly accepted as follows:

> "A person will be a fiduciary in his relationship with another when and in so far as that other is entitled to expect that he will act in that other's interests...to the exclusion of his own several interests...That expectation will be found... where the function the adviser represents himself as performing...is that of counseling an advised party as to how his interests will or might be best served in a matter which our society considers to be of importance to the advised's personal or financial well-being."[2]

1.3 This is precisely the situation with a client/financial adviser relationship. The elements of this relationship are:

1.3.1 The test is subjective, that is, it is viewed from the eyes of the client. It is how the client views the relationship, not how the adviser views the relationship.

1.3.2 The client is entitled to expect that the adviser will act in his, the client's, interests, to the exclusion of the adviser's interests. In seeking and paying for financial advice, the client will expect that his interests are being served and that the adviser will not allow that advice to be compromised by personal gain by the adviser.

1.3.3 The advice relates to the client's personal or financial well-being. The seeking of personal financial advice clearly falls within this definition, and is similar to the relationship between a client and his/her lawyer or accountant. The oft-cited simile of a travel agency commission system is therefore a nonsense.

1.4 The High Court has held that the relationship between a stockbroker and the client is a fiduciary relationship[3].

1.5 The most significant outworking of the fiduciary obligation is that:

"A fiduciary ...

(b) cannot, in any matter falling within the scope of his service, have a personal interest or an inconsistent engagement with a third party – unless

---

[2] "Fiduciary Law and the Commercial World" Paul Finn, p 9-10; in "Commercial Aspects of Trusts and Fiduciary Obligations" ed. E McKendrick. Finn is a leading authority on fiduciary issues, and his views accurately reflect the state of the law.

[3] Daly v. Sydney Stock Exchange Limited (1986) 4 ASLC 283.

this is freely and informedly consented to by the beneficiary or is authorized by law."[4]

1.5 The effect in the client/adviser relationship is that, at common law, **the adviser cannot receive a commission or benefit from a fund manager or broker, unless the client has given free and informed consent.**

1.6 This means that, if there has been a breach of fiduciary duty, and the adviser has caused loss to the client, then the client has an equitable remedy.

1.7 However, the issues to be resolved are:

1.7.1 Does the receipt of commissions or other benefits from a third party constitute having a personal interest with a third party?

1.7.2 Is the disclosure of commissions and other benefits received "free and informed consent?"

2. ARE COMMISSIONS OR BENEFITS RECEIVED "PERSONAL INTERESTS" WITH A THIRD PARTY?

2.1 There is little doubt that commissions and benefits received constitute personal interests with a third party. There is value in defining different types of benefits that can be received. Many people are familiar with only one or at best two variations of benefit. There are at least five, the basic types of which are:

2.1.1 Front-end commissions.

These are hard dollar (i.e. paid in cash, compared to in kind) payments. The practice involves a fund manager or product manager paying a fee to an individual or organization for introducing business. Typically, the fee is between 1% and 5% of the value of the investment and is deducted from the capital value of the investment and paid directly to the adviser. For example, a 4% commission on a $100 investment would result in $96 being invested in the product and $4 being paid to the adviser.

There is an increasing trend for large investment amounts for some or all of such commissions to be "rebated" or paid back to the client.

2.1.2 Trailing commissions

These are hard dollar payments. The practice involves a fund manager or product manager paying a so-called trailing fee each year to the organization or person who introduced the client. The payments are in arrears and tend to be annual. Typically they are between 0.40% and 0.80% p.a. of the value of the investment. Trail commissions are in effect loyalty fees – they are paid only as long as the client continues investing in the product. The attraction of these commissions is their annuity nature; an adviser with just $10m "under advisement" can

[4] Finn, p. 10. There is considerable case law to this effect.

expect some $50,000 p.a. in annuity income by ensuring that his clients remain invested in the trail-paying product.

2.1.3 Brokerage Rebate

These are hard dollar payments. The practice involves a stockbroker paying a fee to an adviser for brokerage that adviser introduces. The fee (usually termed a "brokerage rebate") is typically 0.50% of the value of the trade. For example, an adviser places an order for a client where the brokerage is 1.50%. The broker will pay back to the adviser 0.50%.

2.1.4 Soft dollar commissions

Soft dollar commissions are payments in kind. Hence they are indirect. They tend to be rewards paid by product managers for high volume business introductions. The link to the client is indirect, with the benefit coming from the pooling of clients' investments into a product provider. An example is the so-called trip to Europe for an "educational conference" as a reward for high volume recommendations.

Stockbrokers also pay soft dollar commissions to advisers in the form of payments to third parties for, for example, the provision of electronic information, e.g. Reuters or Bloomberg terminals. This practice, however, is more prevalent in the wholesale market.

2.1.5 Salary bonuses & differential commissions for in-house recommendations

This practice is little known, but widespread and probably the most unethical of all commission-type practices.

These are individual hard dollar payments. They are paid to advisers who are employees of product providers, typically banks. The payments, usually in the form of a bonus, are a reward for introducing clients to "in-house" products.

For example, an adviser employed by ABC Bank, considers that the client should invest in a "Master Fund" (an administration systems that facilitates the investment in a range of managed products). ABC Bank offers a master fund and will pay a bonus to the employee/adviser if he recommends that his client invest in ABC Bank's master fund.

Another example is where the level of bonus is paid on the revenue the in-house product will provide to ABC Bank. Equity products are more profitable than, say, fixed income products, and hence a higher bonus will be paid to the employee for recommending an equity in-house product, even though these higher fee products may be inappropriate for the client.

A third example is where the adviser retains, say, 80% of the commission received by ABC Bank for recommending an in-house investment, but only 40% for an external investment.

3. NON-DISCLOSURES AND THE FIDUCIARY RELATIONSHIP

3.1 To repeat the clear conclusion from 1.4 above:

- **Non-disclosure of any type of benefit/commission received from a third party by a fiduciary in fulfilling his service is clearly a breach of duty and is actionable at common law.**

3.2 Hence, if a financial adviser does not disclose to his client all of the types of benefit he receives then an action may arise at common law.

However, the reality is that few aggrieved clients will take common law action.

Moreover, if the recommendations of this paper are followed, then the issue does not arise.

4. Where there is disclosure as practiced in by the financial services industry is this "informed consent"?

4.1 As a matter of public policy and reality, disclosure of a commission or other benefit received by an adviser cannot mean "informed consent".

The concept of "informed consent" contemplates a relationship between equals. In the world of financial advice for retail clients, it is rare that this exists. This situation is explicitly recognized with the concept of the "sophisticated investor", which excludes certain applications from the need for a prospectus.

4.2 The common law explicitly expresses this by suggesting that there is no fiduciary relationship where "the adviser is reasonably entitled to expect that...the other party, because of his position, knowledge, etc. will make his own evaluation of the matter including the information or advice given and will in consequence exercise an independent judgment in his own interests in the subject of the decision."[5] Hence the dismissing of the fiduciary concept arising from information exchanges between businesspersons in a business dealing.

4.3 It is submitted that, at worst, there can be no informed consent with an unsophisticated client. The reality is that the client has little real knowledge of investments/ investing. The client will not be aware of the effect of any benefits that the adviser receives, either in terms of:

a) the effect on long term investment performance; and

b) any bias in recommendations or structures.

Moreover, the client's real need may not be an investment need, for example, the need might be a simple restructuring or broad financial advice. But the temptation is for the commission-remunerated adviser to impose a solution that will yield commissions, i.e. an investment solution.

---

[5] Finn p 11, noting James v ANZ Banking Group. (1986) 64 A.L.R. 347 at 366-8.

4.4 The effect on long-term performance of commission payments made at the client's direct expense can be calculated and presented to the client. However, the greater issue is that of subjectivity in product recommendations: appropriate alternatives to the adviser's commissioned products will not be considered.

5. CASE STUDY

A case study from our records displays all three issues.

5.1 A recently retired couple, with very little investment experience, had a self managed superannuation fund (SMF), with investments in shares and cash from an undeducted contribution of the proceeds of the recent sale of their small business. They sought financial advice from their bank. The bank's financial planner, an employee, recommended a) terminating the SMF, b) selling all the shares, and c) using the proceeds and the cash to purchase an allocated pension product offered by the bank. The allocated pension was d) administered by a master fund offered by the bank with e) over 60% of the investments invested in bank managed funds.

5.2 The adviser was a salaried employee. He disclosed that he would receive some $12,000 in bonuses/commissions for his recommendations, that bank would receive a certain amount of up front commissions from the 40% non bank managed fund providers, and his department a trailing commission from the bank master fund.

5.3 Question 1. Was the relationship between the client and the adviser a fiduciary relationship?

Answer. Yes. There was an expectation that the adviser would act in the client's interests and to the exclusion of his own. The relationship would affect the client's financial well-being.

5.4 Question 2. Was the disclosure "informed consent?"

Answer. No. Informed consent contemplates a relationship between equals. This is clearly not the case. The adviser is an experienced financial professional. The client had little or no investment experience.

5.5 To the objective observer, a simple question should be: has the adviser given biased advice? If the financial plan showed that the adviser had researched non-bank alternatives and had objectively come to his conclusion, then arguably there would not be any bias. But if there was objective advice and no bias, what is the role of the payment of the $12,000 by the employer? Presumably its role was to overcome the objectivity of the adviser.

5.6 Two conclusions arise, either:

5.6.1 The adviser breached his duty to his client by making biased recommendations; or

5.6.2 ABC Bank acted corruptly by making the $12,000 payment to influence the adviser's decision.

5.7 As it turned out, the financial plan revealed no evidence of any research undertaken into either alternative non-ABC Bank master fund or wrap account structures or non-ABC Bank product alternatives.

5.8 Moreover, the financial plan revealed no research into retaining the client's existing structure (i.e. of an SMF) and using it as the vehicle for the paying the allocated pension.

5.9 The couple were saddled with costly closure of the SMF, a poor and expensive investment structure, and, as it turned out, poor investment advice.

It is not difficult to imagine how the outcome would have different had the advice been provided on a fee-for-service basis only.

6 Examples of How Commissions Adversely Affect Clients

6.1 Front end Commissions

The clear issue with front-end commissions is: does the commission structure produce the best investment recommendation for the client? In high quality advisory businesses, all or most of the front-end fee is rebated to the client. The larger matter lies with more marginal advisers who recommend products that have modest or little investment merit but pay advisers large front-end commissions. Commissions of 5% and 6% are common in some property and agricultural products.

The compelling question is whether the attraction of the front-end commission overrides the investment merit of the product.

From a cost point of view: using the example in 2.1.1. the consequence is that to achieve a portfolio value of $110 after one year (i.e. a 10% return on $100), the $96 has to return 14.58% in the first year to catch up.

6.2 Trailing Commissions

Do trailing commissions produce the best investment recommendation? Or do they promote investment in high-trail products? The annuity nature of trailing commissions is a major issue. The common justification that trailing commissions pay for annual advice and ongoing review is a nonsense. If an adviser knows that the revenue is locked in, is there an incentive to give the quality review?

The cost to the client of trail commissions is the annual trail payment, that is between 0.40% and 0.80%.

6.3 Brokerage Rebate

The clear effect is to produce "churning" (high turnover), with commensurate high costs. Whilst is easy to focus on the additional brokerage costs, the additional cost of high turnover is the realization of capital gains. Hence the payment of capital gains tax is often overlooked.

Equally, the temptation of the brokerage rebate might encourage investment into new issues that might not be suitable investments for the client.

6.4 Soft Dollar Commissions

The effect of intangible benefits is difficult to assess. The greatest difficulty is where, say, a fund manager offers a European trip to advisers and their partners as a reward for the adviser booking $1m of business in the year. The adviser has written $800,000 of business by May and the fund manager suffers an exodus of senior staff. Will the adviser place the last $200,000 of business with that fund manager? Probably. But should the adviser have been in that position in the first place?

6.5 Salary Bonuses/Differential Commissions for In-house Recommendations

The effect is clear. There will be bias toward in-house structures (such as master funds) and products. Disclosure is sometimes unclear, and the option of alternatives outside the in-house product is rarely examined. Some banks reportedly prohibit the recommendation of products of direct competitors.

6.6 In each of these examples there is a very real possibility that the client is not receiving objective advice, that is the adviser is not acting for the sole benefit of the client. Disclosure does not change the lack of objectivity.

7. Additional Consumer Costs

7.1 The ancillary effect of the commission/benefit regime is that of increased costs. The managed fund industry incorporates into its fee structure the costs of administering and paying these commissions and benefits.

7.2 There is little doubt that if the regime of commissions/other benefits were to be made illegal that a more widespread fee-for-service regime would take its place. This is particularly so in the case of front-end commissions. The clear benefit is objective advice.

7.3 It is unlikely that trail commissions would be entirely replaced with a review fee, as not all advisers actually undertake formal reviews.

7.4 A "management" fee, perhaps an asset-based fee, might replace brokerage rebates. The clear advantage of this is there is no incentive to "churn" the portfolio with commensurate higher costs and realization of capital gains.

7.5 It is unlikely that soft dollar commissions would be replaced at all. Industry participants would just have to go without the European trip. But probably no net saving to the consumer. However, there would be the removal of the incentive to place funds with the provider of the best rewards.

7.6 The elimination of bonuses/differential commissions for in-house recommendations might be replaced by a fee-for-service. But again, the benefit is objective advice.

8. Responsibility for Action

8.1 It is clear that self-regulation of the industry has failed to the extent described in this paper. The industry bodies have a vested interest in maintaining the status quo. The Financial Planning Association is made up of members that broadly gain significant amounts of revenue from commission payments. The managed funds are comfortable with maintaining the commission regime because the commission structure assists poorly performing funds to continue to get inflows despite their performance. The first to break the mould and not offer commission payments would suffer reduced fund inflow. That shows how they perceive that it is not investment performance or service that determine fund inflow, but rather commission payments.

8.2 Hence, in this instance, self-regulation does not solve the problem.

9. Summary

9.1 The retail investor should be able to have independent and disinterested advice. However, the presence of commissions and other benefits as part of the decision regime considerably qualifies that advice, as shown.

9.2 The only way to resolve the issue is to recognize in legislation that the relationship between the adviser and the client is a fiduciary one. As a consequence of that relationship, the receipt of commissions or other benefits by advisers is a breach of their fiduciary duty.