



# IS THE ONLY WAY UP?

CBA's financial planning arm has laid bare some of the problems that a vertically integrated business model can face. Is this business model appropriate in a post-FoFA, professional environment? Simon Hoyle reports.

As the full extent of the issues plaguing the financial planning arm of Commonwealth Bank of Australia were laid bare during June, one key aspect of how the bank was set up, structured and managed attracted particular attention.

So-called "vertical integration" (VI) – whereby multiple businesses at different points in a manufacturing or production process are housed under one roof – was being blamed for not only encouraging but failing adequately to rein-in a culture where sales volumes were king, and where clients' interests apparently took a back seat to the interests of the bank, its in-house products and the authorised representatives of Commonwealth Financial Planning Ltd (CFPL). Commonwealth Bank declined to be interviewed for this article.

Don Trapnell, a director of independent

licensee Synchron, says vertical integration is the greatest threat there is to financial planners discharging their best interests obligation, both in accordance with the *Future of Financial Advice* (FoFA) reforms, and professionally.

He says the conflicts inherent in vertically integrated businesses drive all sorts of behaviour that is contrary to clients' interests. Whether the drivers are explicit or implicit is really a moot point; Trapnell says the result is the same.

However, vertical integration is neither illegal nor necessarily even undesirable. In some quarters (principally among institutions) it is viewed as a natural and inevitable consequence of regulatory reforms that have been under development for at least the past four years. In other quarters it is viewed as a necessary response to pressures created by the global financial crisis (GFC). Implemented well,

it can generate significant efficiencies, leading to lower costs and better products and services for consumers.

But in other areas, VI is seen as one of the most insidious and malign influences on the financial services landscape; one which drives institutionalised behaviour that is often contrary to the clients' best interests – and which was in large part actually responsible for, rather than being a result of, the GFC.

In a landmark report published in 2010, Dr June Smith, who conducted her PhD research through Victoria University, found that the "contextual" factors – those influences determined by the employer and inculcated in the workplace – have a greater bearing than "individual" ethics on whether an individual is prepared to put his or her interests ahead of the client's. (See box on page 14.)

Mark Spiers, general manager of advice



## “WHAT YOU NEED IS THE MORAL AND ETHICAL FABRIC THAT CONNECTS ALL THAT UP

Whatever the arguments for or against, vertically integrated institutions already dominate the Australian financial services landscape. In the current economic and regulatory environment, the structure throws up some big management challenges. The interests of shareholders, clients and financial planners (who may have individual professional obligations) must be balanced against each other; and the business has to conform with new financial planning regulations, embodied in the FoFA reforms.

Some claim that these interests simply cannot equitably be reconciled in a vertically integrated structure, because such a structure will naturally tend to favour the institution's interests over its consumers'. Others argue that the full obligations of complying with FoFA can only be satisfied in such a structure, where the cost of operating an advice business can be subsidised from elsewhere – for example, client funds placed into in-house investment products generate profits for the institution that subsidise losses made from running a sub-economic advice business.

Spiers says it is “absolutely possible” for each separate entity in a vertically integrated business to be profitable in its own right.

“The whole thing about vertical integration is that it's about accounting treatment within a business and an enterprise,” he says.

“If you look at why it's possible, it's because there are boutiques and large stand-alone fund managers; there's boutiques and medium/large financial planning businesses; there are boutiques,

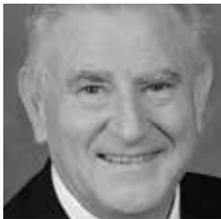
for BT Financial Group, says vertical integration gets a bad name when things go wrong, but more often than not it isn't the business model at fault but the culture of the organisation.

“Let's assume we've got all the best systems and all the best policies in the world, what you need is the moral and ethical fabric that connects all that up,” Spiers says.

“That is called culture, and it's called leadership and it's called management. That is the sine qua non – that which you cannot do without – over and above everything else, because policy, process and procedure is open to control breakdown.

“What sits above and through it is the cultural fabric based on the values and the ethics of the organisation. At a group like ours, we have deep-rooted right through the organisation – not just through BT or the wealth business but right through Westpac – all about the customer first, the customer at the centre.

“We only use 'customer' because it is the vernacular of the bank; it's interchangeable with 'client'. But that pervasiveness about everything we do, everything we stand for, is all about putting the client first; and if you have a culture around that, inappropriate practices and potential conflict get flushed out, identified and dealt with through putting in place the appropriate controls to manage those conflicts.”



“ THEY FELT IT WAS INAPPROPRIATE AND WRONG THAT THEY SHOULD BE FORCED TO DO THAT

DON TRAPNELL

large and stand-alone insurance operations. So if you say we have [all] this in one enterprise because we get synergy benefits across costs, we get synergy benefits about meeting all of our customers' needs, and we have control of cost, quality service and delivery, that's a different model from someone who says I want to operate singly, but the fact that there are many stand-alone participants says they can be stand-alone in the wrapper of an enterprise. And quite frankly, given the benefits of scale, given the synergy benefits...arguably they could be more [profitable]."

Spiers says vertical integration isn't limited to institutions – it's a structure for providing holistic advisory services that applies to organisations of all sizes.

"It's about where a business participates across all areas of the value chain," he says.

"For us, and for many others in the industry, it's around asset management, administration, insurance, superannuation and advice. And vertical integration is often referred to and commented on [but] I do not think it's actually vertical integration per se that people are questioning or is implicit in their conversations; it's about the fact that large wealth management providers are vertically integrated.

"Large institutions...participate across key areas of the value chain and it's the size and scale of the operations, market share and balance sheet strength that we have, and then the potential conflicts that go with that, that people question.

"And when people talk about vertical integration they naturally drift to the large institutions, but there are plenty of examples of large, medium and small businesses in wealth management, including institutions, that can be considered vertically integrated.

"Many participants have activities across the value chain, from developing, designing and deploying their own proprietary software; running their own self-managed accounts, IMAs [individually managed accounts], their own models; from providing advice; badging and joint-venturing with asset managers; their own asset management. Which is fine – but by definition, they're vertically integrated.

"The truth is, it's not limited to a size; it's limited to how you want to compete in the marketplace. It's a slant that I think never comes up."

Matt Lawler, chief executive officer of Yellow Brick Road, says "vertically integrated businesses are not evil, as long as they are managed properly".

"What you've got to do is make sure the system works from the client backwards, and that you protect the sanctity of the adviser-client relationship," he says.

"But that does not preclude you from having different parts of the



## WHO SETS THE STANDARD?

Ethical standards are largely set by the organisations that individual financial planners work for, according to a landmark report published in 2010.

*Ethics and Financial Advice: The Final Frontier*, by Dr June Smith through Victoria University, examined a range of examples of unethical behaviour by financial planners and found that it is often superficial to conclude simply that a planner in question is a crook.

The report found that there are both individual and "contextual" issues when planners make decisions that are detrimental to their clients. It found that contextual factors – the environment in which a planner works – have the greater influence. If a financial services organisation does not effectively instil a culture of thinking and behaving ethically, or if it institutes practices designed to serve its own interests better than those of its customers or clients, an individual financial planner is more likely to behave unethically.

Some of the "individual" factors that influence ethical behaviour include "the ethical reasoning ability of the individual decision-maker, which in turn is influenced by the decision-maker's age, experience and whether they hold a professional designation".

However, "the contextual factors are numerous and seem to have more influence on ethical conduct outcomes than individual factors", the report said.

"These contextual factors include remuneration structures, the role played by the individual decision-maker, the ethical climate and culture of the organisation and the presence of ethical leadership."

A clear outcome of this finding is that "improvement in individual conduct and competency standards, whilst necessary, may not achieve [the] objectives" of ensuring that high-quality financial advice becomes the norm, and financial planning achieves recognition as a true profession.

"It is suggested that regulatory responses may not always resolve these issues and that a more comprehensive solution may be required," the report said.

It recommended that ethical guidelines be incorporated into organisational structures in the same way as corporate governance, risk management and compliance "as an alternative or complementary mechanism to the reliance on constant regulatory reform going forward".

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chain, from an ownership basis and from a value-creation basis.

“Whenever you intervene in the client-adviser relationship, on the basis that you are influencing a vertically integrated benefit, you’ve actually stepped over the line.”

Lawler says stepping over the line can include setting up dealership splits that favour in-house product over external product; and buyer-of-last-resort (BOLR) formulas that ascribe a greater value to a business based on funds aggregated within in-house products versus third-party products.

“But if you leave the client and adviser to agree on what the fee is, and then the adviser’s remuneration is calculated on the aggregate amount of fees they’ve collected from the clients, then if you make money out of the platform and make money out of being a fund manager, that’s fine,” Lawler says.

“It’s as simple as that – as long as you do not step in. And the ways you step in are, one, by biasing your licensee split; a second [way] is your buyer-of-last-resort or equity scheme biases the value that’s created; and a third is that you give away products and services on the basis that [advisers] will support the product. Because again, you’re stepping into the breach [between] the adviser and the client.”

Synchron’s Trapnell says the potential problems of vertically integrated businesses were graphically illustrated when two new advisers recently joined his dealer group.

“I had two reps join us from a licensee – and it’s probably not



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right that I say which licensee, but a licensee that had a vertically integrated model – and they joined us because they were having pressure put on them to support the product of the parent,” he says.

“It was financial pressure. In other words, if you sell the parent’s product, you will make more money – over and above what everyone else makes. And substantially more.

“These two reps had a very strong moralistic view on that and they felt it was inappropriate and wrong that they should be forced to do that.

“Whilst the licensee was institutionally owned, they always in the past had felt that it was run independently, as an independent model. Once this happened, straight away they felt prostituted.”

Trapnell says once the individuals had ascertained that Synchron does not offer favourable terms for selling any particular product over any other, the decision to jump ship was a no-brainer.

“[They asked,] do you put any pressure on [us] to support one company over another? I said no, we do not direct the traffic,” Trapnell says.

“They said, do you have a ‘preferred’ list; I said no, we do not have a ‘preferred’ list.

“It was the fact that we do not direct the traffic that was the big plus for joining Synchron. And I thought, if the feeling is that strong out there that someone is prepared to leave their licensee – and it’s a big decision to leave a licensee; you do not make these decisions lightly – if someone thinks that strongly about this issue...there must be a lot of feeling about that.

“So I decided to investigate further and find out how big a problem it was. It did not take me long to find five licensees, owned by institutions, that were directing traffic. When I say ‘directing traffic’, it’s not an overt ‘you must write with this company’ – it’s a financial incentive to write business for one particular company or another.”

Trapnell says that what he found was chilling.

“In one particular case, where 90 per cent of an adviser’s new

business was placed with the parent company, the licensee fee was almost waived. That’s a pretty big incentive,” he says.

“Others have, for example, what we call ‘favoured terms’ for preferred partners, and that will always include the owner of the licensee. So Life Insurance Company A owns Licensee B, which then enters into agreements with four other life companies to say these four will be our ‘favoured’ life companies. If the adviser favours those four life companies, they receive a higher brokerage rate than if they use other life offices that are available out in the marketplace.”

In case it’s unclear why one institution would encourage a licensee that it owns to sell the products of other institutions, Trapnell says the answer is simple.

“Shelf-space fees, to be blunt,” he says.

“We have been asked on a number of occasions to have a preferred list by life companies. A number of times life companies have come to us and said, why don’t you do a preferred list; it therefore reduces the amount of life companies out there that you are spreading your business amongst; that therefore increases the concentration of new business; and therefore we can pass the savings on back to Synchron in the form of a cheque. These cheques can be quite substantial.

“We have at all times rejected those offers because we believe as a licensee we have a primary duty of care to both the adviser and the client to make sure all products are presented equally.”

Lawler says regardless of whether a planner works for a truly independent licensee, works for a bank and is paid by salary, or is self-employed and the authorised representative of an institutionally owned licensee, the guiding principles must be the same.

“As long as your relationship with the client is not impeded in any way by how you get remunerated – people can influence you; people can say, ‘I reckon the BT Wrap is better’ – and as long as you make that decision not on the basis of whether you’re getting paid



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more but because it's better for the client because of functionality or price, then that's actually 'best interests,'" he says. "You're making the decision because your relationship with the client is a good one, is a protected one."

Lawler says it is not imperative that the provision of advice be profitable in its own right. Vertically integrated business models routinely subsidise the cost of advice from other areas – potentially most troubling, from investment products – and in that case the entity responsible for overseeing and ultimately providing advice could find itself relying on an inherent conflict for its very survival. If that's not strongly

"That's a good starting point, because... it influences the rest of the industry if they say, I'm not going to be influenced by you, because you cannot pay me, so what I'm demanding is great service, great product that's affordable and if I see something else out there that's better for my client I'm going to put pressure on you to become competitive, or you're going to lose my business."

Lawler says that some form of vertical integration of businesses in financial services is almost inevitable.

"I'm not saying that only because we can't run a business without it; I'm saying it because it's common for all business

that creates a better industry – because then, competition is about improving [and] being cheaper...not about what formula or what sneaky way can you come up with to feather your nest."

But the message to planners is often clear: sure, support whatever products you think are appropriate, but if the licensee is not profitable, it could be your job on the line.

"I don't think you can say that; you cannot threaten people on that basis," Lawler says. "And the other thing is, those guys should be free to go."

Lawler says the economics of the licensee should be such that regardless

## “THE QUESTION FOR ME COMES DOWN TO, STILL, IS THAT **IMPEDING THE RELATIONSHIP BETWEEN THE ADVISER AND THE CLIENT?**”

managed, it can go haywire.

"Absolutely. And it has. It has gone haywire," Lawler says.

"My last couple of years at MLC, Steve [Tucker] and I could see that these sorts of issues were going to come. I'm not saying we were incredible philosophers or futurists or anything like that; but you could just tell where it was going to go, and that trust was the main thing we had to sell. All this other stuff that was happening was eroding trust.

"The industry has to decide that there is a sanctity between the adviser and the client that needs to be protected. At the end of the day it's the same as accountants. Accountants are not licensed through the firm that they work for, they're licensed as an individual. They have individual responsibility to maintain that licence.

models that exist today," he says.

"Even industry funds. AustralianSuper, which now has its own internal investment team, that's vertical integration.

"The question for me comes down to, still, is that impeding the relationship between the adviser and the client? As long as you don't, then that's OK.

"The only form of remuneration that an adviser should see – like an accountant, like a lawyer – should be the fees that they charge the clients. As long as that's the case, then competition will be [about] how do we make products and platforms cheaper, easier to deliver and better performing for both the adviser and the client. If you're making the decision on which product you will use based on performance rather than the indirect remuneration you're going to receive,

of the service or the product an individual adviser uses, the potential benefit to the licensee is the same.

"The aggregate of all the revenues that group can get is going to make it a viable thing. I'll give you an example. We charge a 25 per cent split on revenue. The financial planning market just laughs at a 25 per cent split, because they're saying these guys [other licensees] are going to give it [licensee support] to me for free.

"I'm saying, we can't give it to you for free. You either go to those guys, and they won't actually give it to you for 'free', there will be something that you have to do in order to get something.

We say we'll charge 25 per cent, we will look to get fair compensation for the services that we provide, but you are free to write any product that you want." ■