

Fees versus Commission

A personal standpoint - by David Gunnensen BSc (Hons), MSc, AFPC, APFS, CFP

There is a common perception that financial advice is free.

Think again.

It may well be “common”,

And it may well be “free”.

Janis Joplin once sang: “Freedom’s just another word for “nothing left to lose””!

Hopefully, my advice will leave you with rather more than “nothing left to lose”.

If something is given away willy-nilly, free of charge or commitment, how valuable is it?

As with many things in life, you get what you pay for. “Free” advice may well be just that – but also worthless. It may be ill-informed, or biased by a hidden agenda such as sales commission or market-share and ownership considerations, all of which might render the advice a lot more expensive in the long term than meets the eye.

The vast majority of “Independent Financial Advisers” (“IFA’s”) have tended to work, and continue to work for the time being, on what has become known as “the commission basis”, rather than for professional fees.

I prefer to deliver advice on a purely professional basis, and here’s why . . .

The Commission Basis:

The “commission basis” means that the IFA:

- 1). Will offer an ostensibly “free” initial consultation, without charge or commitment, at which he will attempt to identify your financial needs and desires, and start the “fact-finding” process
- 2) May have other “free” meetings to complete the fact-finding process (which can/should be thorough, sometimes lengthy and complex), though as the IFA is “working for nothing” at this stage, the process might be rushed, in order to limit un-profitable time expenditure and comply with the minimum regulatory requirement of having given the

appearance of a proper “fact-find”.

3). Will give ostensibly “free” advice and recommendations, by identifying needs/desires and recommending specific solutions and recommendations, drawn from the whole available “market” for such “products”, and will declare in precise monetary amounts (because the Law now requires it), the commission he would receive if you were to proceed through his agency; and provide detailed product particulars/illustrations etc. setting out the impact of charges

4). Will, with your agreement, gladly implement said “product” recommendations

5) Will, upon completion of the above, receive a commission paid to him by the “provider” of the “product” (ie an insurance company or fund manager), the costs of which are provided for within the standard management charges taken from your money, built into the contract he has recommended.

6) Will usually receive a notional “renewal commission” for years to come (in the case of investments, usually of the order of ½% per annum of fund values), ostensibly to provide ongoing service, but with no checks and balances to ensure that he actually does provide this service. Most don’t, or if they do, it is limited to an annual telephone call to ask if further advice is needed.

The Law requires that an IFA must, *inter alia*,:

- Know his client (ie situation, resources, objectives/needs, timescale, risk attitude etc)
- Continually research and know the whole available “market” for products/strategies on which he advises
- Give “best advice” drawn from the whole market for products, or non-product-driven strategies, regardless of any commission considerations relating to his own remuneration.
- Effect any transactions recommended on a basis most beneficial to his client, without personal considerations influencing this basis (so-called “best-execution”)

These requirements have been effective in Law since July 1988.

IFA’s are, of course, commercial businesses and have to generate income and profits to survive. A “commission-basis” IFA derives all, or nearly all of his income for commission as described above. That is all there is. He may be a self-employed proprietor, or an employee acting in an IFA capacity within a large national/international IFA firm, in which latter case he would be considered an individual profit-centre in the organisation, and his costs and income carefully monitored against commission-production targets.

I have acted in both capacities in my past career -both as a sole trader, and as one of

several hundred “senior sales consultant/IFA’s” in three separate major international IFA firms, over my 24 year career to date. However, *non sum qualis eram*.

In either capacity, the commercial imperative is the same – income must be generated to survive, as with any business. Employment contracts typically emphasise that the role is to further and protect the employer’s interests. And remain completely silent about the clients’ interests!

In one large international IFA firm for which I worked in the past, it was a “serious disciplinary offence” [sic], punishable by summary dismissal (and therefore long term unemployment), on a par with gross dishonesty, violence etc. to fall short of one’s “sales production target”, which itself was imposed upon the consultant/advisors by management without their agreement. This was a major national firm, with, at the time, one in three of the Times Top 1000 companies as corporate clients. How would you feel if your “independent” adviser were under such pressure to sell you products?

The antediluvian basis of assessing an IFA’s job performance according to how much commission he has produced recently is surely a grotesque prostitution of the advisory profession. I have advocated the prohibition of “sales commission” for IFAs, as did the Government-commissioned Sandler Report into Financial Services, but the FSA, which is financed *inter alia* by compulsory monetary levies on the commission-driven IFA firms which it regulates, has not implemented this.

Tied Agents:

The other current class of financial advisers is “tied agents”, who can only recommend the products of one provider, but have a duty to give “best advice” from within that product range, and have similar commercial imperatives; but don’t have to research or be aware of the rest of the market, and are rarely seen as a source of expert impartial advice by discerning investors. However, they don’t pretend to be anything other than one-provider product salesmen, if asked. They can be very knowledgeable about their products and good at their job of selling them to you.

The Drawbacks of the Commission Basis:

Sadly, this system is very far from perfect, as the Government-appointed regulatory authorities have now realised, over 15 years after it became effective.

The main drawbacks are:

- 1). The commission-driven IFA is essentially a product salesman. If he doesn’t recommend and successfully implement a commission-paying product, he earns nothing for his advice. *In extremis*, this can and does mean that the best and most honest, expert IFA’s go out of business by being commercially punished for their integrity. If they are bankrupted as result of this, they can probably never work again in the profession.

2). Some courses of action (or indeed courses of inaction) may be in the best interests of the client, but may not earn the IFA/salesman any commission, so won't be recommended, or may be glossed over. This is often the case in estate planning/inheritance tax mitigation exercises, where significant IHT savings can be achieved without recourse to any insurance based/commission-yielding solutions.

3) The commission-driven IFA is likely to truncate or ignore those areas of the factfinding and needs-identification process of the "know your client" requirement which he can see from outset are unlikely to present a legitimate opportunity to present a solution involving the recommendation and sale of a commission-generating product.

4). Even if a commission-generating product does legitimately present itself as a suitable recommendation, the fact is that different "providers" of such products may pay different rates of commission to the IFA for the same or very similar products. Contrary to popular belief, the commission earned by IFAs is not their profit, but their gross income. They have very significant overheads, especially in terms of compliance and Professional Indemnity Insurance costs, so that most IFAs probably operate of a profit margin of under 10% of turnover, if indeed they make any profit at all. Many don't.

So differences in commission rates between different providers of the similar products, which can be very large, make a big difference to profit margins and are an irresistible temptation to the IFA to colour his "provider-recommendation" in light of "commercial considerations", despite Criminal Law prohibiting this.

(There used to be a "maximum commissions agreement" to put a ceiling on commission rates for the same products between different providers, to prevent this distortion, but the Government decided that this was an anti-competitive measure, and abolished it).

I know from wide experience that major national/international IFA firms restrict the recommendations that their "IFA Consultant-employees" may recommend to clients, to those companies on a pre-approved "best advice panel". This panel is constructed by an internal management committee, and I have heard the panel-constructors openly admit, internally to the sales-consultancy-force in conference, that "commercial considerations" play a major part in the panel constituent selection process.

(ie: Client considerations are not the sole selection basis, but commission amounts and payment terms are indeed an influence to the construction of these "best advice panels".)

There can be little doubt that the need for commission-driven IFAs to sell a commission-earning product causes their advice to be skewed, in terms of the strategy recommended, the product and provider selection, and also sometimes in terms of the specific features of contracts established (eg a regular investment plan with contractual automatic escalation of the investment amount each year pays the adviser a lot more commission than one with level contributions, yet might appear to "cost" the same initially, to the client).

5). The compulsory disclosure of the commission (as pounds and pence) in the

illustration provided by the IFA for the product he recommends, together with the statement of charges from which the commission is payable is virtually useless in helping the client to reach an informed judgment about the merits of the IFA's recommendation relative to potential competitor products. This is because there is no known correlation between charges and investment performance, and of course the commission is taken from the charges. The commission amounts give no indication of the contact's features nor its suitability for the client's circumstances, nor whether alternative non-commission-generating courses of action might be better.

6). A drawback from the IFA's perspective is that the prospective client may "steal" his advice. The IFA has done the research and made the recommendation in writing, in the hope that the client will deal through him on full commission. But there is no requirement or guarantee that he will. The client could effect the recommendations elsewhere, for example through a discount broker, who gives no advice but processes the paperwork for a small fee and foregoes the commission – thereby enhancing investment allocations/reducing the premium for the client. Or the client can achieve a similar result by dealing through the internet.

The IFA remains legally liable for the recommendation, however, regardless of whether it was actioned through him. You may think that he is likely to go out of business as a result. Many would prefer that their advisers are not bankrupts, but stay in business.

Other Professions – An Analogy:

To illustrate the shortcomings of the commission basis for IFAs, imagine the following scenario:

The Doctors:

You find yourself ill. You don't know what is wrong with you, so you realise you need a doctor. Implicitly, you are admitting that you recognise that the doctor knows more about his subject than you do, which is why you are seeking his expert advice, and why you recognise that you are not in a position to make judgments about whether his advice is correct. You are placing your trust in his hands on the understanding that he is properly qualified and acting in your best interests.

There is a choice of two doctors available:

1). Doctor Quack is very clever, spent many years studying, qualifying and is widely experienced. He doesn't charge you a fee, and there is no NHS to pay his salary from your taxes regardless of his performance. (For the purposes of this discussion, I am assuming a resumption to economic and commercial reality, after the NHS has finally disappeared, as it surely will, being a socialist construct).

His only source of income is commission paid to him by pharmaceutical companies for drugs he sells to you. You have to pay for the drugs he recommends.

But:

- a). The drugs are very expensive
- b). Identical drugs, made by different companies, cost different amounts and pay the doctor different commission rates.
- c) Different drugs, made by the same company, cost different amounts and pay different rates of commission to the doctor
- d) The more of one particular manufacturer's drug he sells, the greater the commission rate he receives on each sale; and the manufacturers agree targets for him to sell pre-agreed quotas of their drugs behind closed doors (this is called a "volume-overrider")
- e) There may be several alternative drugs suitable for your condition – it is at the doctor's discretion to decide which he recommends, and you don't know which is best.
- f) The best remedy for your illness might involve no drugs at all, in which case the doctor would earn nothing
- g) Some of the drugs are addictive, and would mean the doctor would continue to supply more of them to you in future and secure his commission-earnings-stream
Stopping the course of drugs early costs you even more
- i) You know that he has a mortgage and family to support, and needs income fairly desperately, and is being pressured by his management and the drug manufacturers to meet his drug-sales target

2). Doctor Feelgood is also very clever and spent years studying and qualifying, and has lots of experience. But he charges you a professional fee to reflect this, and the time spent on your consultation, and promises to give you the best advice. He refuses to accept any commission from pharmaceutical companies, which he considers tantamount to bribery, and so can sell their drugs to you more cheaply, but only if he ("she" of course included without prejudice), in his professional judgment, feels that they would be in your best interest.

You balk a bit at having to write out a cheque for his fees, which are significant, but you feel good, because you are well, and rest assured that he has acted in your best interests, because he has no other "axe to grind". Indeed he is likely to receive introductions from you to other prospective new patients if and when you and your relatives are satisfied that he has done a good job for you. So it is in his commercial interests to act in your best interests within the remit of his profession.

You know that you are not in a position to judge the relative technical competence of the two experts, otherwise you wouldn't have been seeking their expert advice in the first

place, and are therefore not in a position to complain from an informed standpoint.

Which one would you consult over a serious condition, Doctor Quack or Doctor Feelgood?

Would you entrust your health and maybe your life to a corrupt commission-driven drug-pusher; or to a professional gentleman/lady?

If you feel this analogy is over-dramatic, consider that certain aspects of personal financial planning advice can and are indeed almost a matter of life and death – healthcare costs being an obvious example of immediacy – but long term financial provision for one’s retirement, and one’s children’s/grandchildren’s education are another.

There is an alternative:

The Fee Basis:

I personally firmly believe that Dr Feelgood is better. This is the basis upon which I prefer to operate.

Doctor Quack is surely analogous to the commission-driven sales sector of the IFA business.

Although I am willing to offer an initial consultation free of charge or commitment, this is primarily to establish whether there is sufficient need and scope for me to deliver expert and impartial advice. Although I am classed as an “Independent Financial Adviser” (which is the legal definition) I prefer the term “Impartial Financial Advisers”.

Purely commission-driven “IFAs” are not “independent” – they are *dependent* upon selling commission-producing products, and upon seeking and finding client situations where this can be achieved.

Because I operate on a professional fee basis, my advice is fully professional, at arms length, and in your best interests. I will present a tailor-made fee agreement to you after the initial consultation outlining the scope of the work which we propose to do for you and specifying the fee charging basis.

In return for this, I can instruct any “providers” of financial “products” that I may in my impartial capacity feel are indeed appropriate, not to pay us commission upon completion, but to enhance your investment allocation or reduce premium costs accordingly. This affirms and reinforces the impartiality of my advice in the eyes of some, though can be less tax-efficient than the following alternative:

Alternatively, I can agree a fee-basis with you whereby if you proceed with investments

etc. I can and do receive commission, and this amount of commission is deducted from the fee invoiced to you. If it exceeds the fee, then you pay no fee. Commission is not subject to VAT whereas pure professional fees can be.

Alternatively, others prefer to engage me solely on a time-spent fee basis, with or without commission offset; and others prefer a single pre-agreed flat monetary amount for a discreet piece of work.

Predicting in advance which alternative is likely to be better is impossible – it depends on the complexity and size of the work.

So I offer my clients the choice as to how they structure their fee agreement before it is signed.

My fees are set at a reasonable level to reflect our qualifications, experience and expertise, and in some cases are related to the quantifiable results that I achieve for you.

Although I have a London presence, my hourly rate is set at a competitive level similar to that charged by partners of provincial professional firms of solicitors, accountants etc., rather than the exceptionally high professional fees that one might pay to leading London firms (which can be several hundred pounds per hour). It is often the case, however, that work done “on the cheap” can indeed be “cheap and nasty” – and turn out to be much more expensive in the long term, so it is worth paying a fair fee for good work.

Without wishing to appear immodest, you may be reassured to know that my qualifications and experience are at a level to justify the fee charging levels (see enclosed career summary – “About David Gunnensen”).

There may be client circumstances in which I feel that the level of expertise required and complexity of client circumstances is not sufficient to justify my fees. Nevertheless, all IFA firms have a heavy minimum burden of compliance and record-keeping work to perform for every client, so I set a minimum fee payment to cover these fixed costs. If the circumstances presented to me do not warrant this level of fee, I may feel that the client may be better served by seeking advice elsewhere, in which case I would respectfully decline to accept an instruction.

My services are primarily, though not exclusively, aimed at high-net-worth individuals with significant investment sums and earnings available, and with personal and taxation circumstances requiring bespoke expertise.

Typically, this would involve investment portfolios upwards of £100,000 and in the case of inheritance tax and estate planning, I normally advise upon estates of value upwards of £3/4million.

A merchant of “bog-standard off-the-shelf” product-solutions to the hoi polloi I am not, and if one accepts that the overall “purpose” of promoting quality independent financial

advice is to further the cause of personal self-determination, self-fulfillment, and self-reliance, away from Welfare State dependency, which some would say is a quasi-political agenda, then it is unlikely that the lumpenproletariat would be interested in my services.

Many of our clients are themselves self-employed professionals, for whom an additional benefit of the fee basis is that our fees can be paid from practice accounts and offset against tax as a business expense.

Various recent government-commissioned “independent” enquiries into the financial services industry have tended to agree that in order for advice to be impartial and independent, it should be provided primarily on a professional fee-charging basis, rather than for sales-commission. At least one such report has also recommended that for advisers to be permitted to style themselves as “IFAs” in future, the higher level Advanced Financial Planning Certificates should be held by each advisor in each area in which he advises. I do not disagree with this, though it has not yet happened.

I already hold seven of the certificates.

For those advisers who will be unable to achieve this grade, there may be a new category of “multi-tied” adviser status – essentially a commission-driven product salesman/organisation with agencies with more than one provider company – but with no legal duty to give best advice drawn from the whole of the market. A number of large, well-known nation IFA firms may well pursue this business model in future, especially those owned by insurance or investment product-providers, whose parent companies may have paid handsomely to buy extra “retail-outlets” for their “products”.

Many members of the public may still deal with them in the belief that they are receiving independent advice, but I believe that certain clients are more discerning and will want and deserve truly impartial, qualified expert advice in their best interests. Uncommonly good advice in fact.

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Why does all this concern me?

FINANCIAL TIMES 06/03/04

The Financial Services Authority is convinced that arming consumers with more information will make them "better equipped to shop around, compare costs across the market and get better deals".

But my adviser already tells me how much commission he will make when he recommends a product. What is changing?

Knowing how much he earns on a specific product does not tell you much. It does not tell you whether he earned more from this product than from another that would do the same job but cost you less. It does not tell you whether he is charging more or less than other advisers.

Under the system the FSA is proposing, your adviser will have to give you a document detailing the maximum commission he will earn on all the regulated products he might recommend compared with a market average.

If he is independent rather than working for a bank or life company, he will also have to offer you the option of paying a fee instead of commission. But there will be no market average comparison for fees. Advisers who already charge solely on a fee basis will not have to offer a commission alternative.

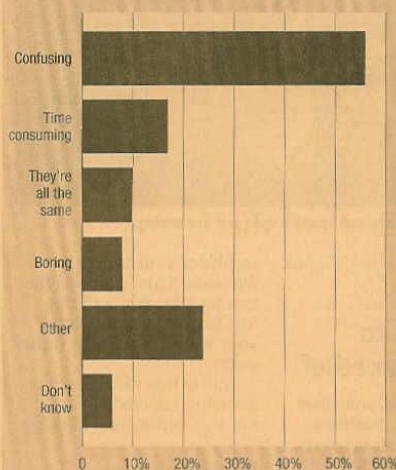
So will I be able to tell easily if it is cheaper to pay a fee or commission?

Not really. Fees might be stated on an hourly basis, or a percentage of portfolio value, or some other approach. You would have to ask your adviser for an estimate of how much you might pay for advice on a particular issue and compare that with the commission he would earn from selling you a product.

The menu will show the percentage commission, plus an example of the cost in pounds.

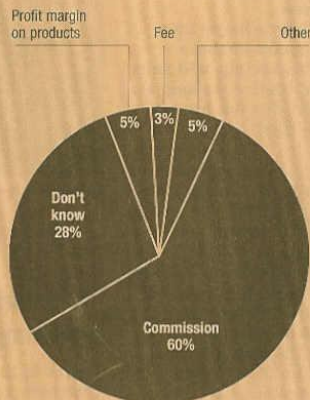
What do you think about advisers and financial companies?

Why is it difficult to compare them?



Source: FSA

How do you think they are usually rewarded for selling products/ services?



have to pay it whether or not I buy a product?

You are ostensibly paying for the advice you get in both cases. But the advice has to be product-related where an adviser is paid by commission, otherwise he will not get paid. If you pay a fee, the advice may involve buying a product that does not pay commission, or perhaps not buying a product at all. That is the independence you gain by paying a fee.

But won't advisers be able to make fees look more expensive if they want to persuade people to choose commission?

The FSA has tried to prevent that by including a rule that says fees may not be excessive. It says it believes it has a system that is proof against gamesmanship.

Does the FSA say it is better to pay a fee?

It does not take a view, although it did originally suggest that advisers who

advice from the cost of a product.

It abandoned both ideas in the face of strong opposition from the IFA sector to the first, and an inability to work out how to unbundle costs in a way that would make sense to consumers.

It now says commission may be more economic for some customers than paying a fee, so it is making both options available.

Commission is included in the total cost of a product, right? So what happens to it if I pay a fee?

It should be offset against fees, rebated to you or added to your investment.

Why do only independent advisers have to offer a fee option? Shouldn't anyone giving advice have to do the same?

If they were actually in the business of giving advice, they would. Advisers working for banks or life companies are employed to sell products. Any advice

be confined to selling just their own products. But they will not be offering the sort of advice that justifies charging a fee.

Most people don't want to pay fees anyway, do they?

So the research suggests. But that may be because they do not appreciate how much they are paying in commission.

There is a strong consumer education angle in the FSA's menu approach, which if successful, may lead to fees becoming more acceptable to consumers and hasten the slow move towards more advisers becoming fee-based.

When will I get this menu from my adviser?

The FSA's consultation on the new rules ends on June 1 and it expects to publish final rules in the autumn. Firms will have six months from then to comply, although they can start operating under the new rules whenever they are ready before that date. So by