



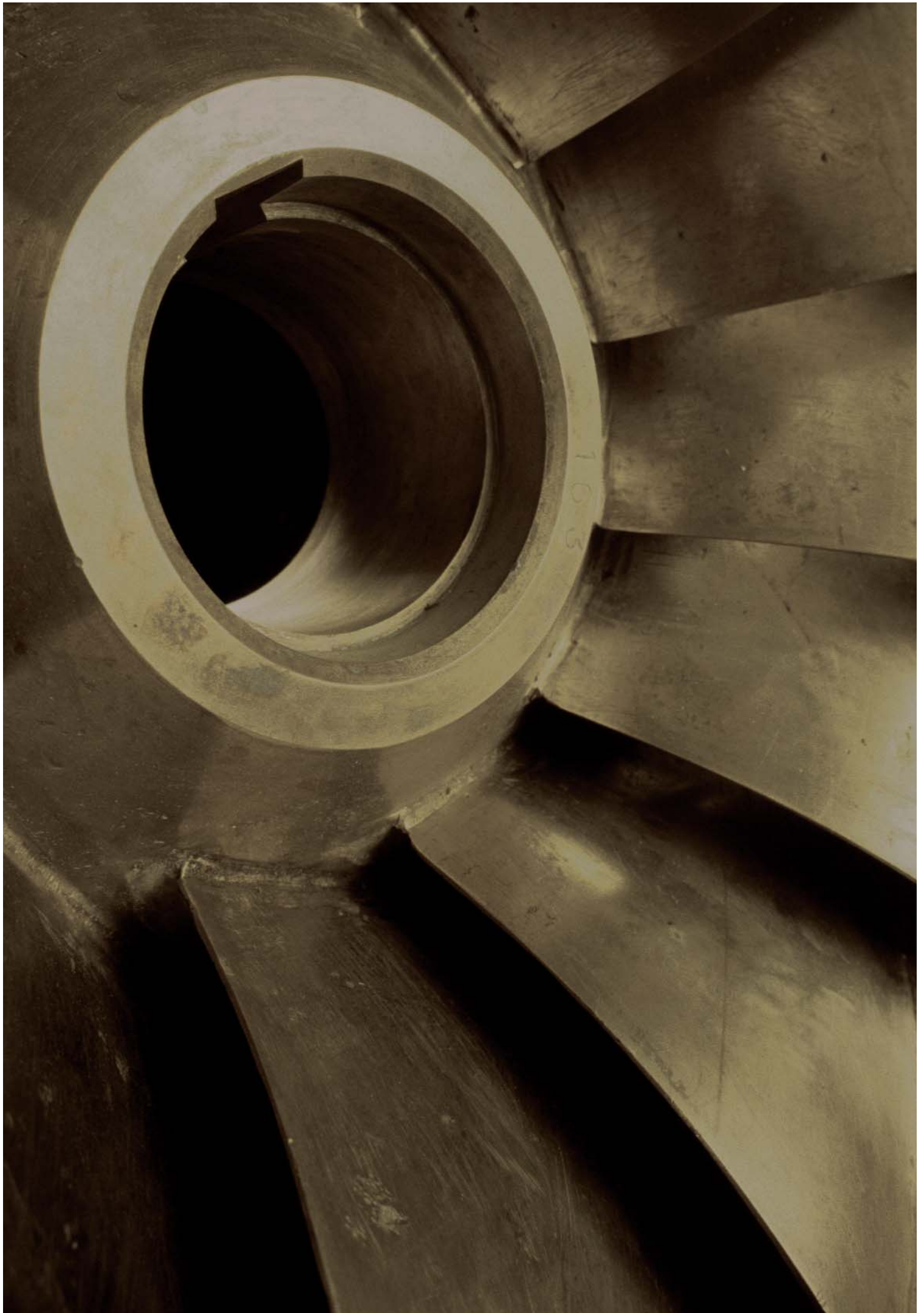
Investment and Financial Services Association Limited

An insight into the structure and operation of Financial Advisory Networks

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strength through advocacy



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# Financial Advisory Networks

## Introduction

Australia's top 100 Financial Advisory Networks (FANs) provide support and services to more than 15,000 Authorised Representatives, yet many remain unaware of the value added by this important sector of the industry.

This paper outlines the basic structure and role of FANs in promoting savings, supporting good compliance practices and raising standards of professionalism, which is critical to securing the financial well-being of all Australians.

IFSA has developed this paper in order to assist and inform government, the media and, most importantly, the customers IFSA members' serve.

## Background

The development of FANs has come as a result of both the increased regulatory complexity imposed upon the financial services industry and the explosion in the number of products available to retail investors.

Initially, investment products (particularly unit trusts, cash management trusts) were sold directly by the product manufacturer, through their sales network if they were a large institution, or through a number of stock brokers who were expanding into financial planning. By the early 1980's, financial planners were required to be licensed by the state Corporate Affairs Commissions although there were still only several hundred licensed financial planners then operating. The introduction of the Managed Investments Act 1998 and then the various CLERP reforms culminating in the introduction of the Financial Services Reforms (FSR) in 2002 has resulted in a tightly regulated industry which has imposed detailed and ongoing compliance obligations on industry participants, including financial advisers, such as the requirement to be licensed<sup>1</sup>. The total number of Authorised Representatives operating under the auspices of the 'Top 100 Dealer Groups' grew to 15,252 in the 2006-07 year, whilst the Financial Planning Association of Australia (FPA) notes on its website that approximately 12,000 financial planners are FPA members<sup>2</sup>.

Given the cost and complexity of the regulatory burden, including licence costs and compliance processes, together with the business necessity to maintain efficient client management systems and asset management platforms the need for an entity that was able to provide these services, and support the financial planner, became absolutely necessary. The whole concept of advice had also broadened to encompass not only financial product advice, but also strategies for retirement planning, superannuation, taxation, life and risk insurance, estate planning, debt advice and wealth creation which required a much greater depth of support and training within the financial planning practice.

It was against this background that we have witnessed the development and expansion of FANs in order to cater for both the substantial expansion of the industry fuelled to a large extent by the growth of superannuation and product diversification and to enable advisers to meet the burden of their compliance and regulatory obligations.

Some of the confusion in relation to FANs may have started with the naming of these structures. Generally they have been known in the industry as Dealer Groups or Financial Planning Groups, although more recently the concept of FAN is becoming more widespread.

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<sup>1</sup> Sect 911A Corporations Act 2001

<sup>2</sup> Money Management Blue Book 2006

# Financial Advisory Networks

## The different Financial Advisory Network structures

Whilst a considerable number of financial planners have formed themselves into financial planning practices, they have generally found it to be uneconomical and practically impossible to operate as stand alone businesses, which have to provide their own IT systems, client management platforms, compliance processes and product research. Outsourcing these processes, particularly IT and platform systems is also generally uneconomic for smaller businesses, given their limited bargaining power. The development and growth of FANs has essentially occurred in order to meet the needs of planners and their clients. In broad terms it could be suggested that FANs are similar in structure to any grouping of professionals. A law or accounting firm provides back office, IT systems, and technical research to enable the professionals working within the firm to deliver their services to the consumer. A large law firm or accountancy practice will have the economies of scale to provide these services to its professionals in a cost effective manner.

It is estimated that there are some 158 FANs operating, of which the top 100 had 15,252 Authorised Representatives. Of these the largest FANs had 1,444 authorised representatives whilst the second and third largest had 1,222 and 885 authorised representatives respectively<sup>3</sup>.

Whilst the basic structure of FANs are similar (see diagram page 11) there are

many variations of the basic model. A FAN will be the holder of an Australian Financial Services Licence (AFSL) which will enable it and its authorised representatives to provide financial advice to the public. There are three main variations to the basic FAN: (a) the one which is part of a larger institutional group and whose authorised representatives may be salaried or commission based; (b) the franchise structure with authorised representatives (financial planners) all operating under the FAN's brand although essentially operating their own businesses subject any restrictions imposed by the FAN; and (c) the independent model where the FAN provides support for independent financial planning practices which operate under their own brand.

(a) The institutional group FAN initially existing as a distribution arm for the products of the institution although recent regulatory reforms have cast obligations on advisers to ensure that clients have access to broad product options which will meet their individual needs. This has resulted in the expansion of the product lists of these organisations to include products other than those of the institution. The institutional FAN is able to call upon the resources of the institution to provide the necessary platforms and software in order to manage their clients' investments and trades on the brand of the institution.

(b) The franchise structure may be a significantly capitalised entity listed on the stock exchange or a smaller privately owned business which will either own or have access to operating platforms (IDPS's or WRAPs) through a licence agreement or a referral arrangement. It will have a product list that it will have established to meet its own particular philosophy or charter and which will be managed and monitored by its internal research resources. This structure may employ a number of planners operating out of its own branch network as well as franchise its brand to other financial planning practices who will operate under its AFS licence and use its client management and back office systems.

(c) The independent model similar to (b) may be a stock exchange listed entity or a smaller privately owned entity. It will provide services and licensing requirements to independent financial planning practices that will operate under their own brand whilst utilising the FAN's back office systems, platforms, research and compliance resources. Only where it is legally required will the name of the FAN appear on material issued by the planning practice. This model tends to be favoured by accounting practices wishing to provide financial planning services to their clients whilst continuing to use their own name. Finally, a FAN may have any combination of the above.

The structure of FANs would appear to be sufficiently flexible to accommodate a variety of regulatory regimes which make it at least technically possible for local FANs to expand their operations outside the current jurisdiction of Australia to places such as Singapore and Hong Kong.

<sup>3</sup> Money Management 2006 survey

# Financial Advisory Networks

## Legal framework

Before he or she can begin providing advice to clients, a financial planner must either hold an AFS licence or be an authorised representative of an AFS licence holder. Whilst there is no restriction on a natural person applying for an AFS licence the application requirements and the ongoing licence conditions imposed by the Australian Securities and Investments Commission (ASIC) mean that, for all practical purposes, the applicant will almost always be a body corporate.

It is generally accepted that an adviser or a group of advisers need to have at least \$60-80 million<sup>4</sup> under advice to justify the cost of holding a separate AFS licence.

The AFS licence holder will be responsible for the actions of their proper authority holders. It is a requirement as part of its licence conditions, to have appropriate processes in place to monitor and support their proper authority holders.

There is no specific mandate or legal requirement calling for the establishment of a FAN, but given the responsibilities imposed on both AFS licencees and their proper authority holders, it makes good sense for planners to be attached to a FAN. Indeed, it could be argued that without FANs to support financial planners it would not be possible under the existing regulatory structure for independent planners to operate other than within large institutions.

Nonetheless, the ownership of FANs vary and they may be part of a larger institutional group, an ASX listed entity or a privately owned business. In a number of cases FANs are owned or partially owned by the financial planners who operate under them.

FANs are of fundamental importance to the growth of a diversified planning industry containing smaller independent planning practices, many of which operate in and service regional areas. Without these smaller regional practices financial planning advice would only be available in the major cities and regional centres.

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<sup>4</sup> The costs of running a license include personal indemnity insurance, compliance, software, research, legal and accounting costs. In addition to these, there are the costs of developing the business, including practice development, staff training and recruitment.

# Financial Advisory Networks

## Aspects of Financial Advisory Networks: the benefits of scale

The main aspects or functions of FANs are the provision of services to advisers operating under the FANs AFS licence or advisers operating under their own licence, but who do not have the resources or infrastructure to maintain these services. These services can be varied but generally consist of compliance services in the form of compliance monitoring software, internal audit and compliance resources, client asset management platforms such as WRAPS, front end software systems and technical support and product lists and investment research.

As an AFSL holder, a FAN is responsible for the actions of its authorised representatives in meeting their obligations under the FAN's licence. FANs are therefore required to have compliance systems in place to ensure that these obligations are met. As most FANs and/or their proper authority holders are members of a professional industry body such as the Financial Planning Association (FPA), any compliance systems will generally need to be sufficiently detailed to enable monitoring of Professional Standards and Codes of Ethics imposed by that professional industry body, the FPA in addition to the general legal responsibilities imposed under the Corporations Act.

Access to both asset management systems and front end client management systems are an integral part of a financial planners practice, however such systems can be prohibitively expensive.

It has been suggested that one of the bank owned financial services groups recently spent in excess of \$200 million replacing its front and back office systems whilst a larger independent FAN spent \$10 million building a front end client management system.

One of the more critical services provided by FANs is therefore the ability to provide access to client management systems and asset management platforms.

In order to provide clients with up to date advice on investment products and broad economic trends, planners need to be able to access independent reviews and comment on the products offered by the FAN and performance trends of both products and asset classes. A major function of FANs is therefore their product and investment research which may be provided by in house resources or provided externally from specialist organisations.

FANs, particularly the larger ones are able to negotiate Professional Indemnity insurance cover for themselves and their planners over and above that which an individual or small independent planning practice could ever obtain. The result of this is that consumers have the benefit of greater and broader cover which is obtained at a cost which is affordable for the planner.

# Financial Advisory Networks

## Role in the development of product lists

The development of product lists is an important function of any FAN, as the product list will reflect the particular philosophy of the FAN and any degree of specialisation which it may use to distinguish itself from other groups.

The development of product lists also acts as a means of monitoring and controlling the advice provided by a FAN's proper authority holders and avoiding clients being placed in products which may not be suitable or are outside of the accepted risk parameters.

The past decade has seen an increase in the number and variety of investment products available within the Australian market which now number conservatively several thousand.

It is beyond the capacity of the individual planner or small planning practices to effectively research and select a preferred product list from such a broad selection and yet it is incumbent upon the planner to recommend "the most suitable and most appropriate" products for the client.

A FAN may select a range of products to reflect its own views through the use of external asset specialists, research houses, or through its own internal research resources.

A number of FANs utilise a manager of manager process whereby specialist funds are structured using a combination of underlying externally managed funds.

According to the 2006 Money Management survey, the top three research houses are van Eyk, Lonsec and Mercer who collectively provide product and asset research services to over 90% of the 'Top 100 Dealer Groups'.

Research provided includes managed funds, property and direct equities with different research processes such as qualitative or quantitative used to review products and provide a rating which the FAN can then use as a guide when compiling or reviewing their product lists.

These product lists generally comprise a minimum of 50 different products, although the product lists of the larger organisation run into hundreds.

An individual planner or small planning practice is not in a position to maintain such a range of investment products without the resources of a FAN.

# Financial Advisory Networks

## Raising Standards

### Role in professional development

Financial Services regulation imposes an obligation on licensees to ensure that their representatives are adequately trained, are competent to provide financial services and that they maintain that competence<sup>5</sup>.

In support of these regulations ASIC has issued Regulatory Guide 146 which sets out its requirements as regards to licensees' training obligations and ensures that the licensee implements policies and procedures to ensure that their representatives undertake continuing training to maintain and update the knowledge and skills that are appropriate for their advice activities.

Whilst the level and detail of training is not prescribed, the licensee must be able to demonstrate that it is appropriate for the type of advice and products which the representative is providing.

In addition, most financial planners as members of the Financial Planning Association (FPA) are required to undertake a minimum amount of professional development each year in order to retain membership. The FPA does provide some adviser education and professional development programs but, it is generally left to the FAN to operate professional development programs which will

enable their Authorised Representatives to meet their obligations under the AFS licence.

The generally accepted minimum amount of Continuous Professional Development (CPD) training is around 30-40 hours per annum and this may be accumulated by attendance at relevant conferences, external training courses and internal professional development programs. A number of institutional FANs and larger independent FANs provide structured training programs utilising on-line training which incorporate inbuilt monitoring to ensure that representatives undertake the minimum amount of training prescribed by the organisation.

### Role in compliance

FANs play an important role in assisting financial planners to meet their regulatory and professional obligations. In addition to their obligations under their AFS licences and general corporate obligations under the Corporations Act 2001, Trade Practices Act etc, most FANs are Principal members of the Financial Planning Association which as a condition of membership imposes professional standards and a code of ethics on its members. All FANs will operate compliance programs that are generally IT rather than paper based systems which allow easier oversight and control by the FAN as AFS licence holder.

Programs will cover such matters as:

- Overseeing planner adherence to licensee standards and legislation;
- Managing complaints and disputes;
- Coordinating all reporting; and
- Manage and control planner risk

Often, the internal audits provided by the FAN will include a total review of the financial planners business as well as an educational process to ensure that the planners understand their responsibilities and obligations. Many FANs have in place a system of reviewing all financial plans prepared by their authorised representatives prior to them being issued to the client to ensure that they meet with the standards imposed by both regulation and the FANs internal standards.

In addition, FANs may arrange planner training via professional development days, generally in conjunction with the services of professional training organisations such as Integratec or Kaplan. FANs may also arrange for planners to attend technical days put on by fund managers and research houses.

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<sup>5</sup> Sect 912A(1) Corporations Act 2001

# Financial Advisory Networks

## Dispute resolution

All AFS licence holders are required to be members of an ASIC approved External Disputes Resolution scheme (EDR) as well as maintain internal complaints resolution processes<sup>6</sup>. FANs as AFS licence holders are responsible for the actions of their authorised representatives and it is in their interests to ensure that where complaints or disputes arise between planners and clients they are dealt with in a fair and expeditious manner, and where possible do not escalate to the External Dispute Resolution scheme or become the subject of a legal claim. A FAN's success is very much tied to its reputation and it is therefore in their best business interests to avoid the bad publicity that can accompany complaints. A successful business can be destroyed very quickly by consumer complaints.

Despite the large growth in planner numbers and the amount of advice being provided in recent years there has been no perceptible increase in the number of complaints proceeding to external EDRs such as the Financial Industry Complaints Service<sup>7</sup>. This could well be because of the better controls being implemented and the increased support provided to planners through the FAN networks which ensure that any client dispute is dealt with in a fair and transparent manner and can be resolved without reference to any external process.

## Economic basis

Contrary to popular belief, a FAN does not charge a client additional fees but rather shares fees or commissions with the client's adviser. This fee sharing is in effect compensation to the FAN for providing the services it does to the planner. By law a product manufacturer must pay any commissions due on a product to the AFS licence holder, i.e. the FAN who will then share that commission with the financial planner in accordance with their business arrangements. In many cases because of the volume of business, the FAN is able to waive or rebate a portion of their commission which results in a direct saving to the consumer. Depending upon the structure of the FAN, it may charge the financial planner directly for services such as research or platform access or where those services are provided, through a third party, simply pass the share of the licence fee through to the planner.

In some instances, clients may be charged a fee by the FAN for WRAP or platform services particularly where those services are sourced externally.

## Australia compared with other jurisdictions

Whilst legislation overseas varies, it is generally not as detailed and prescriptive as Australia and consequently the establishment of FANs overseas has tended to be driven by economic rationalism and the attractions of increased buying power. The Registered Investment Adviser (RIA) market in the United States has recently been undergoing some consolidation through acquisitions and mergers in order to meet growing competition from the broker/dealer channels, allowing the larger merged entities to invest more heavily in more advanced software technology. These entities whilst resembling FANs as we know them are generally more broadly based businesses covering mortgage, finance, tax and broking.

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<sup>6</sup> s912A(2) Corporations Act 2001

<sup>7</sup> FICS website - complaints statistics

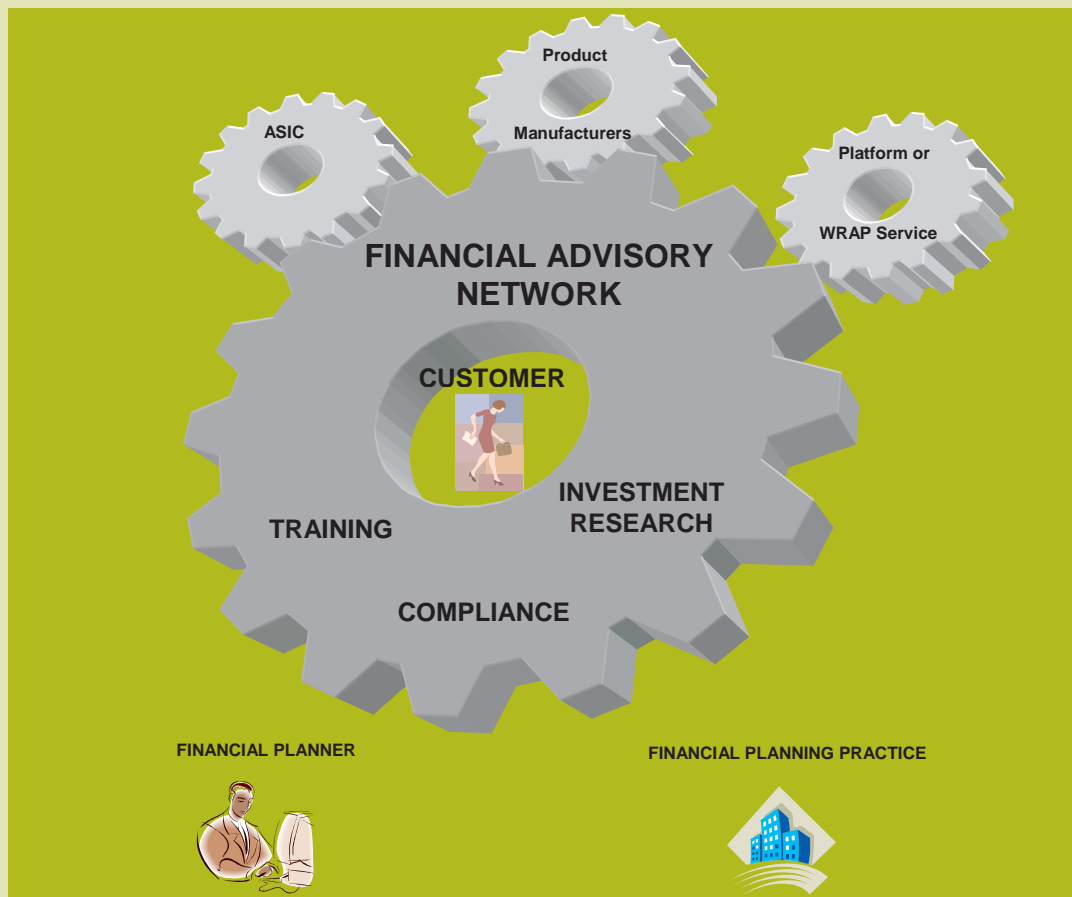
## Financial Advisory Networks

The recent establishment of the Financial Industry Regulatory Authority (FINRA) on 30 July 2007 to become the largest non-governmental regulator for the financial services industry in the U.S. may provide greater impetus for FAN development, particularly in the event of more regulatory oversight being imposed.

The Canadian model, like its U.S. counterpart appears to have less regulatory imposition driving the structure of financial planning networks than Australia, although that does not seem to have impeded the evolution of FANs. Like the U.S. the growth of FANs would seem to have been driven by economics although in neither jurisdiction would they appear to be the holistic organisations that exist in Australia providing support to advisers across the spectrum of advice, product compliance and systems.

The UK financial services industry continues to experience changes in regulatory structures with the advice industry now separated into Financial Advisers and Independent Financial Advisers. The Independent Financial Adviser (IFA) has approximately 9,000 members<sup>8</sup>, the majority of whom appear to operate in small financial advisory practices. Again, apart from the larger institutional groups, the UK equivalent of the FAN would not appear to provide the broad support services as the Australian model.

**Diagram:**  
Structure  
of a FAN



<sup>8</sup> [www.unbiased.co.uk](http://www.unbiased.co.uk)



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