BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

COMMISSION AUTHORIZED

May 19, 1989

Senator Jim Hill
Oregon Senate
Chair, Committee on Business,
Housing and Finance
453-D State Capitol
Salem, Oregon 97310

Dear Sen. Hill:

We are pleased to respond to your request for our views on Oregon House Bill No. 2785, presently before the Oregon Senate, which proposes certain restrictions on competition among accountants.[1] This bill would prohibit accountants' use of referral fees and commissions. We believe that H.B. No. 2785 would reduce competition among accountants and restrict the dissemination to consumers of information about accounting services, thereby adversely affecting consumers' ability to obtain accounting services on terms they want.

Interest and Experience of
the Federal Trade Commission

The Commission has recently considered the validity under the federal antitrust laws of restrictions, similar to those proposed in H.B. No. 2785, that had been imposed by a private group of accountants on its members. On March 28, 1989, the Commission announced that it had accepted for public comment, Commissioner Azcuenaga dissenting, a consent agreement in which the American Institute of Certified Public Accountants agreed not to impose similar restrictions on its members.

Since the early 1970's, the Federal Trade Commission staff has been studying the effects of restrictions on the business practices of licensed professionals, including accountants, lawyers, physicians and others. Our goal has been to identify restrictions that harm consumers by reducing competition without producing any countervailing benefits, such as higher quality services or enhanced consumer choice among service options. In general, we have concluded that certain kinds of restrictions on

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1 These comments represent the views of the staff of the Federal Trade Commission's Bureau of Competition, and not necessarily those of the Commission itself or any individual Commissioner.

the ways in which professionals can market their services and set their prices are likely to lead to higher prices without offering any offsetting benefits to consumers.[2] We believe this is true of accountants, also.

The Proposed Legislation

H.B. No. 2785 appears intended to eliminate any potential for conflicts of interest arising from accountants' financial arrangements with third parties that may affect their clients, or with their clients that may affect third parties. The avoidance of conflicts of interest is particularly important in the accounting profession because of the role accountants play in promoting the reliability of financial reporting. But restricting the dissemination of information about accounting services, and denying consumers pricing terms and service options that they want, may limit consumer choice more severely than is reasonably necessary to address potential conflicts of interest. There are less restrictive means of assuring the independence of auditors and the availability of objective financial advisors.

Several state boards of accountancy and the American Institute of Certified Public Accountants have abandoned their prohibitions of referral fees and commissions.[3] Some have replaced them with the less restrictive alternatives of (1) requiring that referral fees and commissions be disclosed, and (2) limiting accountants' use of commissions to services for

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2 Numerous reports and articles have addressed the effects that various restrictions on professionals have on market performance. *See, e.g.*, Calvani, Langenfeld, and Shuford, *Attorney Advertising and Competition at the Bar*, 41 Vand. L. Rev. 761 (1988); Jacobs *et al.*, *Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising*, Cleveland Regional Office and Bureau of Economics, Federal Trade Commission (1984); Bond, Kwoka, Phelon, and Whitten, *Effects of Restrictions on Advertising and Commercial Practice on the Professional: The Case of Optometry*, Bureau of Economics, Federal Trade Commission (1980); Muris & McChesney, *Advertising and the Price and Quality of Legal Services: The Case for Legal Clinics*, 1979 Am. B. Found. Research J. 179 (1979); McChesney & Muris, *The Effects of Advertising on the Quality of Legal Services*, 65 A.B.A. J. 1503 (1979); Cady, *Restricted Advertising and Competition: The Case of Retail Drugs* (1976); Benham and Benham, *Regulation Through the Professions: A Perspective on Information Control*, 18 J.L. & Econ. 421 (1975).

3 Indeed, only two states, California and Iowa, have statutory prohibitions on referral fees and commissions.

clients for whom they do not provide attest services.[4] The National Association of State Boards of Accountancy has approved a Model Code for adoption by its member state boards of accountancy that takes the same approach.[5]

We believe that prohibiting the use of referral fees and commissions by accountants would not be in the public interest. These prohibitions would be more restrictive of competition than is reasonably necessary to protect consumers against conflicts of interest. We believe that the less restrictive alternative of requiring that referral fees and commissions be disclosed is a preferable means of ensuring that consumers have sufficient information to protect themselves against conflicts of interest. Also, limiting the use of commissions to nonattest clients is a less restrictive, and therefore preferable, means of ensuring that accountants remain independent when they provide attest services.

Referral Fees

H.B. No. 2785 would prohibit accountants from paying "a commission to obtain a client." This provision would prevent accountants from using a potentially effective means of making consumers aware of their services. Some accountants, for example, would like to pay referral fees to marketing firms to disseminate information about their services. Other accountants would like to pay referral fees in the form of discounts to clients for referring new clients.

We believe that referral fees, like expenditures for advertising, are likely to increase competition among accountants by increasing the dissemination of information about accounting services to consumers. By making more information about accountants available to consumers, referral fees may reduce consumers' costs of searching for accountants whose services are

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4 By "attest services," we mean an accountant's report that states or implies some degree of assurance as to the reliability of any financial statement; such services include audits, reviews and some compilations. "Nonattest services" refers to all other services offered by accountants, including tax, management advisory, reimbursement, and financial planning services.

5 Although many state accountancy boards still restrict accountants' use of referral fees and commissions, these restrictions are subject to scrutiny under the antitrust laws unless the state legislature has clearly articulated and affirmatively expressed the intent to supplant competition of this nature.

appropriate to their particular needs. This in turn places competitive pressure on accountants to provide the services consumers want at prices they are willing to pay. Banning referral fees, therefore, may lead to increased prices and reduced quality of accounting services, with reduced satisfaction of consumer needs and preferences.

Proponents of a ban on referral fees argue that accountants who pay them will have to increase their fees in order to pass on the cost of referral fees. We do not believe this is a valid concern. First, referral fees, like any marketing expenditure, are intended to build a larger client base and thus to reduce the cost of serving each client. To the extent that the cost per client can be reduced, accounting fees are likely to decline rather than to increase. Second, prohibiting the payment of referral fees is likely to cause accountants to use other, less efficient means of promoting their practices. To the extent that this happens, the cost of serving each client will be higher than it would with more efficient marketing methods, and accountants will therefore be likely to charge higher fees. Finally, if accountants refer clients to other accountants with greater expertise in the services desired, the time necessary to provide such services may be reduced, and accordingly the total fees may be lower.

Supporters of a ban on referral fees also assert that such arrangements may deceive consumers. That is, the payment of a referral fee may provide the incentive for an inappropriate referral, not to the most appropriate accountant, but rather to the accountant who pays (or pays the highest) referral fees. The fact that a referral fee is paid may therefore be material to a consumer's assessment of the appropriateness of a referral, and withholding this material fact may amount to deception.

A ban on referral fees, however, is more restrictive of competition than is reasonably necessary to prevent any deception that might otherwise occur. The less restrictive alternative of requiring disclosure of referral fee arrangements to consumers would enable them to make informed choices. If for any reason a consumer preferred to deal with an accountant who does not pay referral fees, disclosure would preserve that option. Accounting regulators increasingly appear to favor this approach. State accountancy boards in Maryland, Oklahoma, Texas, and West Virginia, and the American Institute of Certified Public Accountants permit disclosed referral fees, and the National Association of State Boards of Accountancy has approved a Model Code permitting disclosed referral fees for adoption by its

member state boards of accountancy.[6] We therefore believe that a ban on referral fees, as proposed in H.B. No. 2785, would be likely to result in a smaller net benefit for consumers than would permitting accountants to use referral fees, subject to an appropriate disclosure requirement.

Commissions

H.B. No. 2785 would prohibit accountants from receiving "a commission for a referral to a client of products or services of others." This restriction would prevent an accountant and his client from agreeing that the accountant's only compensation for preparing a financial plan will be the commissions received if the client decides to purchase any recommended investments. It would also prevent an accountant and client from agreeing that the accountant's only compensation for recommending necessary computer equipment and software comprising a financial reporting system will be the commissions paid on the sale of the computer products.

A ban on commissions would inhibit competition among accountants. Since tax services constitute a substantial portion of the business of many accounting firms, activities aimed at securing tax business are an important means of competition among accountants. And because financial planning services may sometimes be supplied most efficiently if they are provided together with tax services, accountants can compete to obtain tax business by offering to provide financial planning services at little extra cost. However, under the bill's restriction on commissions, this might not be economically feasible.

We have learned in the course of our investigation leading to the AICPA consent order that some consumers want to be able to obtain commission-based financial planning services. In states where accountants are permitted to accept commissions, some accountants have attracted new tax clients from other accountants by offering commission-based financial planning, and they now provide all of their new clients' financial planning, tax, and other accounting services. Other accountants believe that if they did not provide commission-based financial planning services, many of their existing clients would take their tax and other business to another accountant who would do so. As the use of commission-based financial planning increases, accountants who provide financial planning services on a fee basis may be forced

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[6] National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 104 (April 1989). The state accountancy boards in Maryland and West Virginia do not have any restrictions on referral fees.

to reduce their fees in response to competition from accountants who provide commission-based financial planning.

Direct consumer benefits can result when accountants are allowed to receive commissions on, for example, the sale of financial products to clients. A consumer may desire an accountant's assistance in preparing a financial plan, but wish to pay for it only if he believes it will be useful. If the accountant is willing to undertake preparation of a plan in the expectation of being compensated only through commissions on the sale of investments, and the commission arrangement is disclosed to the client, the accountant communicates to the client his belief that the plan will be useful. Commissions also allow the accountant to shoulder the risk that the client may not be persuaded the plan is useful, since the accountant will not be compensated unless the client decides to implement the plan. Moreover, the better the financial plan (as measured by the client's decision to implement its recommendations), the more likely it is that the accountant will receive commissions. Thus, the commission arrangement provides an incentive for the accountant to provide higher quality services.

Consumers enjoy an additional benefit where accountants can use commissions: the option of one-stop shopping for financial planning services. Some consumers prefer to have their accountant both prepare a financial plan and implement it by recommending and arranging the purchase of investments. The ban on accountants' receipt of commissions proposed in H.B. No. 2785, however, would prevent accountants who have prepared financial plans from implementing them. Preparation of financial plans, which generally provide an outline of the steps necessary to achieve the client's goals, requires considerable research and analysis. If accountants are prohibited from accepting commissions, the only way they can be adequately compensated for preparing financial plans is by charging a substantial fee. Consumers would either have to forego using an accountant's financial planning services or both bear the cost of financial planning services and pay commissions to broker-dealers on purchases of investments. In addition, consumers would lose the convenience of dealing with only one professional, which saves the time and effort that are necessary to establish knowledgeable, trusting relationships with multiple advisors.

The bill's restriction on commissions is thus likely to reduce competition among accountants; increase consumer costs, because consumers would receive less information about accounting services and assume greater risks; and eliminate an incentive for accountants to provide higher quality services. The result is likely to be an increase in the price and a reduction in the quality of accounting services, with a reduction in the satisfaction of consumer needs and preferences.

Proponents of a ban on commissions argue that prohibition is necessary to preserve accountants' independence. Our view is that independence concerns are met by permitting accountants to receive commissions only for services provided to nonattest clients. The state boards of accountancy in Oklahoma and Texas, the Model Code approved by the National Association of State Boards of Accountancy,[7] and the American Institute of Certified Public Accountants permit accountants to receive commissions in connection with services provided to a client for whom the accountant performs only nonattest services.[8]

It has also been argued that prohibiting the receipt of commissions for recommending products or services to nonattest clients is justified because commissions can create a conflict of interest and loss of objectivity. The concern is that accountants might recommend services or products that clients do not need or that are less valuable to consumers than other services or products that would produce lower commissions.

We believe that commissions need not be banned in order to prevent such abuse. During the course of our investigation that led to the AICPA consent order, we learned that accountants who wish to respond to consumer demand for commission-based financial planning services are likely to promote their services by informing consumers that they receive commissions. We also learned that accountants who provide financial planning services on a fee basis are likely to inform consumers through their advertising that fee-based financial planning is an alternative to commission-based financial planning. Consumers are therefore likely to become aware of their options and to question their accountant about his method of compensation. Businesses that purchase products recommended by accountants are likely to be aware of their options. Thus, consumers who prefer to deal with an accountant who does not accept commissions will have the opportunity to do so.

The state boards of accountancy in Oklahoma and Texas require accountants to disclose, when they recommend products or services, that they accept commissions from third parties. The

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7 National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 101(b)(3) (April 1989).

8 The Texas Board of Public Accountancy permits accountants to receive commissions in connection with nonattest services provided to an attest client, if the amount of the commissions is not material with respect to the total fees from the client. The state accountancy board in Maryland does not have any restriction on commissions, and the state accountancy board in South Dakota permits accountants to receive commissions in some circumstances.

National Association of State Boards of Accountancy's Model Code takes this approach as well.[9] This approach also affords consumers the opportunity to make an informed choice between fee-based and commission-based financial planning services.

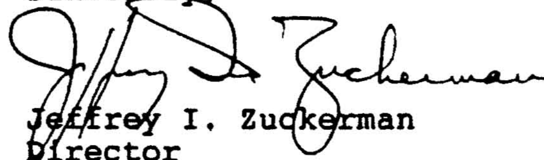
Accordingly, we believe that consumers would be better served if accountants are permitted to use commissions in connection with services provided to nonattest clients. If the Committee believes mandatory disclosure is needed, it may want to consider amending H.B. No. 2785 by adding an appropriate disclosure requirement.

Conclusion

In summary, we believe that H.B. No. 2785 in its present form would impose restrictions on competition among accountants and on the dissemination to consumers of information about accounting services that are likely to reduce consumers' ability to obtain accounting services on terms they want, without providing any countervailing benefits. The Committee may therefore want to consider amending the bill so as to permit accountants to pay referral fees, with appropriate disclosure, and allow consumers to enjoy the benefits of using appropriately disclosed commissions as methods of payment for accounting services.

We hope that our comments will be helpful to you and other Committee members. We appreciate the opportunity to present our views and would be happy to provide any further assistance you might request.

Sincerely,



Jeffrey I. Zuckerman
Director

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[9] National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 103 (April 1989). Competition also provides a significant disincentive for exploitive behavior by accountants. Since accountants depend heavily on client referrals as a method of obtaining new business and on repeat business from existing clients, there are strong incentives for them to make appropriate recommendations to their clients. State licensing board discipline and potential law suits by injured clients provide further incentives to make appropriate recommendations.