

## Chapter 2

### The gatekeeper framework in Australia

#### Background

2.1 The roundtable with financial system gatekeepers was convened to examine expectation gaps in Australia's financial services system and to discuss the steps that are being taken to deal with those gaps.

2.2 Gatekeepers play a crucial role in the functioning of the financial services system. While the Australian Securities and Investments Commission (ASIC) sets the regulatory standards for the gatekeepers and expectations of their performance, the system is 'self-executing'. As ASIC Chairman, Mr Greg Medcraft, told the committee in September last year:

ASIC is not a prudential regulator, not a conduct and surveillance regulator. The system we have is based on gatekeepers doing the right thing and it is self-executing. It is quite important in understanding what we are currently resourced to do. We are not resourced to be looking at everybody, and that is a very important message.<sup>1</sup>

2.3 Gatekeepers such as the research house, Lonsec Research Property Ltd, acknowledged that the financial services system has historically been lightly regulated. Lonsec observed that the regulator has outsourced significant elements of the gatekeeper function to the private sector, and that ASIC's role is to hold the gatekeepers to account.<sup>2</sup>

2.4 The problem of 'expectation gaps' was raised by ASIC at the inquiry held by the Parliamentary Joint Committee on Corporations and Financial Services (the committee) into the collapse of Trio Capital Limited (Trio). ASIC's submission to the inquiry pointed to potential expectation gaps between the role of gatekeepers in Australia's financial services system and investors' expectations of that role.<sup>3</sup>

2.5 Chapter 7 of the committee's report into Trio canvassed a series of expectations gaps between what investors and the public expected the gatekeepers to

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1 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 12 September 2012, p. 15.

2 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

3 Australian Securities and Investments Commission, *Submission 51*, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012, [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_ctte/completed\\_inquiries/2010-13/trio/submissions.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2010-13/trio/submissions.htm) (accessed 2 July 2013).

achieve, what gatekeepers were legally required to do, and what their roles involved in practice:

- first, and most significantly, most Trio investors in self-managed superannuation funds (SMSFs) seemed not to be aware that their investment was not protected to the same extent as investments made in Australian Prudential Regulation Authority (APRA) regulated superannuation funds. This has been a clear and recurring theme during this inquiry and is of particular concern to the committee;
- second and related, there is an expectation among investors that financial advisers will check the investments that they recommend to their clients, to ensure not only that there are prospects for good returns but that they are run legitimately;
- third, there is a lack of understanding as to how Australian Financial Services Licences (AFSLs) are issued. The AFSL attaches to the company, not the directors;
- fourth, both the regulators and investors have expressed frustration at the role of Trio Capital's financial statement and compliance plan auditors, particularly their inability to verify information. The auditors cite the limitations on their role and that the primary responsibility for detecting fraud rests with the responsible entity (RE). They note that auditors can only obtain reasonable assurance that a financial report is free from material misstatement, whether caused by fraud or error;
- fifth, there is an expectation in the public mind that custodians will act to protect and secure the underlying investment. By contrast, Trio's custodian, the National Australia Trustee Limited, has noted that the custodian does not have the expertise to question underlying values of either domestic or offshore funds;
- sixth, there is a lack of understanding as to the claims made in the reports issued by research houses and in particular, whether the data provided by the RE upon which these reports are based has been verified. There is also some confusion as to whether the ratings are intended as an indicator of future performance, or simply an assessment of past performance; and
- finally, ASIC has noted that, compared to the United States and Europe, the level of underlying portfolio disclosure of managed investment schemes in Australia is very limited. Both ASIC and Morningstar have suggested there should be disclosure at asset level for registered managed investment schemes to help investors assess both the type of financial products they are exposed to, and the extent of that exposure.<sup>4</sup>

2.6 In March 2013, at its Annual Forum, ASIC convened a session titled 'Bridging the gap'. The session examined expectation gaps and how gatekeepers try to deal with them.<sup>5</sup>

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4 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, pp 123–124, [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_ctte/completed\\_inquiries/2010-13/trio/report/index.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2010-13/trio/report/index.htm) (accessed 12 June 2013).

5 Australian Securities and Investments Commission, 'Bridging the gap', *Annual Forum 2013—The New Normal*, 25–26 March 2013, Hilton, Sydney NSW, <http://www.asic.gov.au/annual-forum> (accessed 3 June 2013).

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2.7 The committee wanted to examine these issues in more detail by taking a holistic or system-wide view. At the roundtable, the interest was not only in how the gatekeepers saw their own roles and responsibilities, but in how they perceived each other's roles. In other words, in addition to examining gaps that might exist between investor expectations and gatekeeper roles, the committee wanted to see whether there were gaps in the system, with confusion or misunderstanding by one group of gatekeepers about the role of another group.

2.8 Following the roundtable, the committee placed a series of written questions on notice to ASIC based on the discussion with the gatekeepers. These responses are presented in Appendix 2.

### **The gatekeepers**

2.9 The key gatekeepers in the financial services system—financial planners and financial advisers, custodians, research houses, auditors, trustees, and REs—are regulated by ASIC. In the wake of the Trio fraud and other corporate collapses, ASIC has focused on the roles and standards of these groups. The roundtable also gave the committee an opportunity to engage with the gatekeepers and ASIC on the consultations and regulatory changes since Trio.

2.10 Some gatekeepers are dual-regulated entities. For example, of the 500-plus REs operating in Australia in 2012, 33 held both an AFSL from ASIC to operate as an RE, and a registrable superannuation entity (RSE) licence from the Australian Prudential Regulation Authority (APRA) to operate as an RSE.<sup>6</sup>

2.11 Trio was a dual-regulated entity. It provided RSE trustee services for a series of APRA-regulated superannuation schemes and RE services for more than 20 managed investment schemes (MISs).

2.12 Directors also function as vital gatekeepers in the Australian financial services system. Although the committee did not specifically invite directors as a distinct group, the panel did include gatekeeper representatives that acted as managing directors, as director and chief executive officer, and as executive directors in their respective businesses.

2.13 The following sections provide background information on the different gatekeepers, noting what they do and their different structures and business models.

2.14 The gatekeepers are discussed in the following order:

- research houses and research report providers;
- financial planners and financial advisers;

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6 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 11.

- custodians;
- REs and fund managers;
- trustees; and
- auditors.

### ***Research houses and research report providers***

2.15 Research report providers include research houses. The terms research house and research report provider have both been used by government agencies when referring to the research report industry. In November 2008, Treasury and ASIC released a joint report on credit rating agencies and research houses,<sup>7</sup> while ASIC's most recent regulatory guidance is targeted at research report providers.<sup>8</sup> For ease of use, and given that the committee invited two research houses to participate in the roundtable, this report refers to the providers of investment research as research houses. However, this designation comes with an important proviso, and that is that some research is also produced internally by other entities within the financial services sector such as advisory groups and fund managers.

2.16 Research houses produce investment research on financial products such as managed funds, structured products, superannuation funds and insurance products.<sup>9</sup> A research report typically provides an express or implicit opinion and a rating (except a credit rating) about an investment product, and a recommendation to buy, sell or hold the product.<sup>10</sup>

2.17 Wholesale users such as financial planners and financial advisers are the main users of research reports. In other words, the main target group for research houses are the financial intermediaries in the system. Financial advice businesses construct an approved product list based on research reports for use by their authorised

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7 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008. [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep143.pdf/\\$file/rep143.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep143.pdf/$file/rep143.pdf) (accessed 12 June 2013).

8 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg79-published-10-December-2012.pdf/\\$file/rg79-published-10-December-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg79-published-10-December-2012.pdf/$file/rg79-published-10-December-2012.pdf) (accessed 12 June 2013).

9 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008, p. 23.

10 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 9.

representatives. However, some research houses also offer subscriptions to their reports on superannuation products to retail clients.<sup>11</sup>

2.18 Given that research reports are used by both financial planners and financial advisers (and some retail clients), the quality of investment research has a direct bearing on the quality of advice that retail investors receive. ASIC has underscored the importance of improving the quality of research reports by noting that positive research reports have been given to products just prior to their failure:

In a number of recent corporate collapses in Australia, the investment products that failed were either highly rated or the subject of very recent positive recommendations by research report providers just before the product failure.<sup>12</sup>

2.19 In addition to poor quality investment research, ASIC also noted other issues of concern including a lack of due diligence and an over-reliance on research reports by financial intermediaries, and a lack of awareness about the potential compromises involved in the reports themselves:

Risks for the investment community are amplified where there is undue reliance on research reports and a lack of awareness of real and potential conflicts of interest which may adversely impact on the independence and therefore the reliability of those reports.<sup>13</sup>

2.20 The various conflicts of interest associated with the business models adopted by Australian research houses are explained in the next section.

#### *Australian research houses: business models and conflicts of interest*

2.21 There are five major research houses currently operating in Australia: Lonsec, Mercer, Morningstar, van Eyk and Zenith. Mercer and Morningstar are the only two global businesses in the Australian research market.

2.22 The research houses use different business models to fund their research and rely on various combinations of the following:

- subscription fees from end-users such as financial planners and advisers ('downstream' payments);

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11 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008, p. 24; Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 4.

12 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 4, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg79-published-10-December-2012.pdf/\\$file/rg79-published-10-December-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg79-published-10-December-2012.pdf/$file/rg79-published-10-December-2012.pdf) (accessed 12 June 2013).

13 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 5.

- direct payments from fund managers who offer and may have designed the financial product ('upstream' payments); and
- indirect payments from fund managers ('upstream payments').

2.23 Direct payments from fund managers have raised concerns because of the inherent conflicts of interest that arise when a research house assesses a fund manager's product and accepts a fee from the fund manager for that assessment.

2.24 'Downstream' payments from independent financial planners and advisers have not raised the same concerns because they avoid these conflicts. However, less obvious conflicts may still arise when a research house based on a 'downstream' subscription model does accept indirect payments from fund managers.

2.25 In 2012, Fairfax journalist Ruth Williams listed some examples of indirect payments to research houses:

- the licence fees charged by Morningstar when fund managers use the Morningstar logo and ratings on promotional materials;
- payments from fund managers to advertise in van Eyk's twice-yearly magazine;
- payments from fund managers to advertise in Morningstar's *Investor Daily* online newsletter;
- sponsorship from fund managers for Morningstar's Investment Conference;
- payments from fund managers to attend Mercer forums;
- payments by funds to be listed in Morningstar's industry database; and
- van Eyk's partnership with Advisor Edge, which does accept fees from product issuers.<sup>14</sup>

2.26 Lonsec and Zenith accept payments from fund managers to conduct research into products. Mercer, Morningstar and van Eyk do not accept these payments and instead use a subscriber-based business model where financial planning and advisory firms purchase the research. However, Mercer, Morningstar and van Eyk do accept some forms of indirect payments from fund managers.

2.27 There has been debate in the industry about the number of research houses in the Australian market. These views have been canvassed in the publication *Money Management*, although some contributors preferred to remain anonymous. Even with the departure of Standard and Poor's in 2012, it has been said that there are still too many research houses in the Australian market. Some such as Mr Tim Murphy, co-Head of Fund Research at Morningstar, and Mr Mark Thomas, Chief Executive

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14 Ruth Williams, 'Research houses facing the heat', *Sydney Morning Herald*, 1 May 2012, <http://www.smh.com.au/business/research-houses-facing-the-heat-20120430-1xuy6.html> (accessed 12 June 2013).

Officer at van Eyk Research, have argued that the only reason that so much research exists in Australia is that Australia still permits a pay-for-ratings model (direct 'upstream' payments) that underwrites to some extent the business models of certain research houses.<sup>15</sup>

2.28 A corollary of the pay-for-ratings model is that it may have a negative impact on the perceived value for money of the investment research provided by those research houses that do not accept fees for rating fund managers and that rely to a greater extent on charging financial planners for the research.<sup>16</sup>

2.29 By contrast, others such as Mr Giles Gunesequera, Head of Third Party Sales at Principal Global Investors have argued that the diversity of research houses in the Australian market adds depth and rigour, and that there is no evidence that conflicts of interest in the pay-for-ratings model have any discernible impact on the outcomes of investment research.<sup>17</sup> These arguments are also put forward by Lonsec in chapter 3.

#### *Recent regulatory developments*

2.30 The global financial crisis gave rise to concerns about the impact of conflicts of interest within the credit ratings and research report sectors and the adequacy of existing regulations.<sup>18</sup> On 22 May 2008, the former Minister for Superannuation and Corporate Law, Senator the Hon. Nick Sherry MP, announced a review into the regulation of credit rating agencies and research houses. Following a joint report in

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- 15 See the arguments cited in Benjamin Levy, 'Lonsec named Research House of the Year for 2012', *Money Management*, 27 August 2012, <http://www.moneymanagement.com.au/analysis/rate-the-raters/lonsec-named-research-house-of-the-year-for-2012> (accessed 11 July 2013); see also Bela Moore and Milana Pokrajac, 'Rate the raters 2012', *Money Management*, 29 June 2012, <http://www.moneymanagement.com.au/analysis/rate-the-raters/rate-the-raters-2012> (accessed 11 July 2013); Jason Spits, 'Fund managers and research houses – a cold war thaw?', *Money Management*, 5 July 2013, <http://www.moneymanagement.com.au/analysis/rate-the-raters/fund-managers-and-research-houses-a-cold-war-thaw> (accessed 11 July 2013); Jason Spits, 'Are there too many ratings houses in Australia?', *Money Management*, 5 July 2013, <http://www.moneymanagement.com.au/analysis/rate-the-raters/are-there-too-many-ratings-houses-in-australia> (accessed 11 July 2013).
- 16 See the arguments cited in Jason Spits, 'Fund managers and research houses – a cold war thaw?', *Money Management*, 5 July 2013.
- 17 See the arguments cited in Jason Spits, 'Fund managers and research houses – a cold war thaw?', *Money Management*, 5 July 2013.
- 18 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 5.

October 2008 by the Treasury and ASIC,<sup>19</sup> the government instituted reforms to the regulation of credit rating agencies in Australia.<sup>20</sup>

2.31 In November 2011, ASIC released a consultation paper on research houses,<sup>21</sup> followed in December 2012 by its regulatory guide on research report providers.<sup>22</sup>

*Avoiding, controlling and disclosing conflicts of interest*

2.32 In its regulatory guide on research report providers, RG 79, ASIC notes that 'indirect conflicts can be as corrosive as direct conflicts to the integrity of the research'. ASIC provides examples of direct and indirect conflicts:

- direct conflicts include circumstances where another part of the business (e.g. investment bank) has provided underwriting or consulting services to an entity that is the subject of the research;
- direct conflicts include issuer commissioned research ('upstream' payment). The research report provider's dependence on the income stream generated by the client relationship has the potential to adversely influence the independence of the research, ratings process and outcome; and
- indirect conflicts include circumstances where the client relationships and revenue streams generated by ancillary business units such as consulting or funds management services may indirectly conflict with the integrity of the research service. Such conflicts may not directly relate to or affect a specific piece of research on a specific product or issuer. Nevertheless, these indirect conflicts share the potential to negatively affect the independence and integrity of the overall research process. Unlike direct conflicts, this impact may not be as readily apparent to a user of the research.<sup>23</sup>

2.33 Section 912A(1)(aa) of the *Corporations Act 2001* requires licensees to 'have in place adequate arrangements for the management of conflicts of interest'.<sup>24</sup>

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19 The Treasury and the Australian Securities and Investments Commission, *Review of credit rating agencies and research houses*, Joint Report, No. 143, October 2008.

20 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 5.

21 Australian Securities and Investments Commission, *Strengthening the regulation of research report providers (including research houses)*, Consultation Paper, No. 171, November 2011, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp171-published-16-November-2011.pdf/\\$file/cp171-published-16-November-2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp171-published-16-November-2011.pdf/$file/cp171-published-16-November-2011.pdf) (accessed 12 June 2013).

22 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide No. 79, December 2012.

23 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 32.

24 *Corporations Act 2001*, ss. 912A(1)(aa).

2.34 Given that research houses face conflicts of interest in relation to the funds and products that they assess, RG 79 identified the management, and where necessary, the avoidance of conflicts of interest, as a core element in improving the 'credibility and integrity' of research. RG 79 does not prohibit research houses from accepting payments from product issuers to research an issuer's products. Rather, ASIC requires the conflict of interest to be 'effectively and robustly managed'.<sup>25</sup>

2.35 The committee notes that RG79 will come into effect on 1 September 2013. ASIC will conduct surveillance to monitor the effective management of conflicts of interest, and it has given notice that it reserves the right to revisit conflict avoidance if research standards do not improve.<sup>26</sup>

#### *Quality and transparency of the research report*

2.36 RG 79 sets out the criteria for quality and transparency in research methodology and the processes used to compile a research report. ASIC expects a research report to:

- have clear, unambiguous and transparent reasons for recommendations and opinions;
- be based on 'reasonable grounds': objective, verifiable facts and analysis;
- have 'proper purpose': offers or threats of favourable or unfavourable research must not be used to solicit benefits or other business, and research must not be used to unfairly or artificially increase trading volumes or to otherwise generate revenue for the provider's ancillary businesses;
- provide a past performance warning where research ratings are based on past performance;
- have a clear and prominent disclosure statement about who commissioned and paid for the report;
- publish all research (including adverse research) to reduce the perception that conflicts of interest may interfere with the research process and outcome;
- date all research and give users the information to assess whether the research is current; and
- provide both positive and negative research ratings, with access to historical research to counter any perception that conflicts of interest may influence the ratings process.<sup>27</sup>

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25 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 7.

26 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 7.

27 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, pp 23–28.

2.37 ASIC proposes further measures in RG 79 that it considers to be best-practice for research houses. These measures include:

- back-testing 'the past performance of researched or rated products against relevant benchmarks',<sup>28</sup>
- mentoring, supervision, and ongoing training and development for research analysts as a response to continuing innovation in financial products;<sup>29</sup> and
- subjecting all research reports to evaluation such as peer review.<sup>30</sup>

### ***Financial planners and financial advisers***

#### *Background*

2.38 The financial planning and advice industry has been a key focus of this committee through the 2009 Inquiry into Financial Products and Services,<sup>31</sup> The Trio inquiry in 2012, various bill inquiries into the Future of Financial Advice (FOFA) legislation, and the proposed amendments to the *Corporations Act 2001* to restrict the use of the terms 'financial planner' and financial adviser'.<sup>32</sup>

2.39 The next section describes business models (such as vertical integration) in the financial planning and financial advisory sector. It also gives a brief outline of the conflicted remuneration models that existed in the financial planning and financial advisory industry prior to FOFA. This is followed by a summary of the FOFA reforms.

2.40 The committee notes, however, that despite the FOFA reforms, concerns have been expressed in the media that FOFA does not adequately address the conflicts of interest arising from vertical integration in the financial planning and financial advice

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28 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 20.

29 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 22.

30 Australian Securities and Investments Commission, *Research report providers: Improving the quality of investment research*, Regulatory Guide, No. 79, December 2012, p. 22.

31 Parliamentary Joint Committee on Corporation and Financial Services, *Inquiry into financial products and services in Australia*, November 2009.

32 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, February 2012; Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2013*, May 2013.

industry.<sup>33</sup> These concerns and the responses to them by roundtable participants are discussed in chapter 3 in the section on the quality of financial advice and the relationships that financial advisers have with research houses and fund managers.

### *Business models and remuneration*

2.41 A significant degree of vertical integration exists in the financial services sector whereby large banks and financial conglomerates own a fund management arm that creates financial products and also own large financial advisory dealer groups that may recommend these products.

2.42 In its submission to the committee's financial products and services inquiry in 2009, ASIC noted that there were '749 adviser groups operating over 8,000 practices and employing around 18,200 people'. However, large dealer groups and banks dominate with the top 20 dealer groups having approximately 50 per cent market share. In 2009, the top groups included Professional Investment Services, AMP Financial Planning, Count Wealth Accountants, Commonwealth Financial Planning, ING-ANZ, AMP Group, Aviva Group, AXA Australia, NAB and Commonwealth Bank.<sup>34</sup>

2.43 As a consequence of vertical integration, the committee's report noted:

Around 85 per cent of financial advisers are associated with a product manufacturer, either as financial advisers working within the group and using the dealer's support services or as directly employed authorised representatives under that corporate entity's AFSL.<sup>35</sup>

2.44 Furthermore, of the remaining financial advisers, many received commissions from product manufacturers. ASIC therefore concluded that in addition to providing advice, the vast majority of financial planners and financial advisers acted as a sales force for product manufacturers.<sup>36</sup>

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33 Leng Yeow, 'This advice will remain unchanged', *Australian Financial Review*, 29 June 2013, p. 17;

David Potts, 'A new year's fizzer', *The Age*, 26 June 2013,

<http://www.theage.com.au/money/planning/a-new-years-fizzer-20130625-2otfr.html> (accessed 26 June 2013);

*The Sydney Morning Herald*, Editorial, 'Legal reforms will not let ASIC off the hook', 22 June 2013, p.13.

34 Australian Securities and Investments Commission, *Submission 378*, pp 108–109, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

35 Parliamentary Joint Committee on Corporation and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, p. 16.

36 Australian Securities and Investments Commission, *Submission 378*, p. 110, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

2.45 The various business models in the financial advisory sector were explained by ASIC in their submission to the financial products and services inquiry:

- Medium to large sized 'dealer groups' that often operate like a franchise where the licensee offers back office support. The advisers operate as authorised representatives who retain a right to take clients with them if they move to another licensee. The licensee is paid a proportion of the remuneration made by the authorised representative. Example: AMP Financial Planning.
- Institutional-owned financial adviser firms with employed advisers. Advisers in bank owned financial adviser firms are generally employed by the bank. Advisers are paid a proportion of the commissions earned or salaries or a combination of both. Example: Westpac Financial Planning.
- Smaller firms that have their own licence and might outsource compliance functions to specialist dealer services providers such as Paragem Partners or to large dealer groups who provide dealer to dealer compliance services. Example: Securitor.<sup>37</sup>

2.46 Prior to FOFA, ASIC advised that in 2008, only 16 per cent of total advisor revenue came from fee-for-service. The proportion was higher among truly independent advisers. The vast majority of remuneration came from commissions paid by product manufacturers and volume-based bonuses:

Because an explicit fee for service would likely be perceived by retail investors as high in relation to the value of advisory services, most financial advisers tend to charge low or zero fees for service, in order to encourage business. They then get remuneration indirectly by receiving commissions from product manufacturers on the funds invested by retail investors. Product manufacturers recover the costs of commissions from the overall charges within the investment products.

Trailing commissions (usually 0.6% of account balances) are the main remuneration method for financial planners, with seven in ten planners citing them as a form of remuneration. Other forms of remuneration include initial commission on new investment/contribution (up to 4-5% of contributions), volume bonuses (i.e. additional commission of up to 0.25% of account balances), and fee for service charged to the client (up to 1% of account balance, or a flat fee, perhaps related to the hours involved). These amounts would not all be paid at the maximum level.

Trailing commissions are more common among aligned independent and aligned planners, while bank-based planners favour up-front commissions.<sup>38</sup>

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37 Australian Securities and Investments Commission, *Submission 378*, pp 109–110, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

38 Australian Securities and Investments Commission, *Submission 378*, pp 110–111, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

2.47 After considering the business models in the financial planning and advisory sector, the committee highlighted the sales-advice conflict: that is, the sales imperative within the business structure of the vast majority of the financial advisory sector may conflict with the financial advisers' duty to provide advice that best suits the needs of the client.

2.48 Accordingly, the committee's report on financial products and services recommended that the *Corporations Act 2001* be amended to explicitly include a fiduciary duty for financial advisers to place their clients' interests ahead of their own, and that payments from product manufacturers to financial advisers should be banned. The FOFA provisions arose out of these recommendations and are covered next.

#### *Future of Financial Advice (FOFA) reforms*

2.49 The FOFA provisions came into force from 1 July 2013. Between December 2012 and March 2013, ASIC issued five regulatory guides on FOFA. They are:

- RG 246 on the 'conflicted remuneration provisions' in Divisions 4 and 5 of Part 7.7A of the *Corporations Act 2001*,<sup>39</sup>
- RG 245 on the disclosure provisions in the FOFA reforms,<sup>40</sup>
- RG 183 that, among other matters, clarified exemptions from the 'opt-in' requirement,<sup>41</sup>
- RG 175 on the 'best interests' duty of financial product advisers;<sup>42</sup> and
- RG 244 on scaled advice.<sup>43</sup>

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39 Australian Securities and Investments Commission, *Conflicted remuneration*, Regulatory Guide, No. 246, March 2013, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg246-published-4-March-2013-B.pdf/\\$file/rg246-published-4-March-2013-B.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg246-published-4-March-2013-B.pdf/$file/rg246-published-4-March-2013-B.pdf) (accessed 22 July 2013).

40 Australian Securities and Investments Commission, *Fee disclosure statements*, Regulatory Guide, No. 245, January 2013, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg245-published-25-January-2013.pdf/\\$file/rg245-published-25-January-2013.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg245-published-25-January-2013.pdf/$file/rg245-published-25-January-2013.pdf) (accessed 22 July 2013).

41 Australian Securities and Investments Commission, *Approval of financial services sector codes of conduct*, Regulatory Guide, No. 183, March 2013, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg183-published-1-March-2013.pdf/\\$file/rg183-published-1-March-2013.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg183-published-1-March-2013.pdf/$file/rg183-published-1-March-2013.pdf) (accessed 22 July 2013).

42 Australian Securities and Investments Commission, *Licensing: Financial product advisers—Conduct and disclosure*, Regulatory Guide, No. 175, December 2012, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-175-published-13-December-2012.pdf/\\$file/rg-175-published-13-December-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-175-published-13-December-2012.pdf/$file/rg-175-published-13-December-2012.pdf) (accessed 22 July 2013).

43 Australian Securities and Investments Commission, *Giving information, general advice and scaled advice*, Regulatory Guide, No. 244, December 2012, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-244-published-13-December-2012.pdf/\\$file/rg-244-published-13-December-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-244-published-13-December-2012.pdf/$file/rg-244-published-13-December-2012.pdf) (accessed 22 July 2013).

2.50 Two of the key provisions in the FOFA legislation are the ban on commissions on superannuation and investment products, and the fiduciary duty for financial planners and financial advisers to act in the best interest of their clients.

2.51 Prior to FOFA, a financial planner or financial adviser could charge a client on-going fees regardless of the level of service provided. Under FOFA, however, 'opt-in' and fee disclosure requirements have been introduced that mean advisers must gain client consent for on-going fees:

Advisers will be required to request their retail clients opt-in, or renew, their advice agreements every two years if clients are paying ongoing fees. In addition, an annual statement outlining the fees charged and services provided in the previous 12 months must be provided to clients paying ongoing fees. This means advisers will be in regular contact with their clients and will need to demonstrate the value of the services they are providing their clients.<sup>44</sup>

2.52 However, there is a provision for exemption from the 'opt in' requirements if a financial planner or financial adviser can show ASIC that they are bound by a code of conduct that achieves a similar outcome to 'opt-in'.

2.53 The Financial Planning Association (FPA) has submitted its code to ASIC. Should ASIC find the code acceptable, approximately 8500 FPA practitioners would be exempt from the 'opt-in' requirements. The Association of Financial Advisers is also drafting its own code of conduct, which if accepted, would exempt another 2000 practitioners from 'opt-in'.<sup>45</sup>

## ***Custodians***

### ***Background***

2.54 Chapter 7 of the *Corporations Act 2001* states that under an arrangement between a provider and a client, the custodian holds a financial product, or a beneficial interest in a financial product, in trust for, or on behalf of, the client or another person nominated by the client.<sup>46</sup> In other words, a custodian holds the assets of another party for safekeeping. The Australian Custodial Services Association (ACSA) defines custody as the:

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44 The Treasury, Future of Financial Advice, Frequently asked questions, What are the key elements of the reforms, <http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq.htm> (accessed 22 July 2013).

45 Leng Yeow, 'This advice will remain unchanged', *Australian Financial Review*, 29 June 2013, p. 17.

46 *Corporations Act 2001*, ss766E(1).

safekeeping of assets (such as shares, bonds and other investments). The safekeeping function reduces risk for clients (asset owners), and provides the definitive book of record for institutional holdings and transactions.<sup>47</sup>

2.55 The use of a custodian means that the assets are separated from the investment manager, and it is argued, the assets are therefore better protected in the case of the insolvency of a RE or trustee.<sup>48</sup>

2.56 Although the principal role of a custodian is the safekeeping of assets and the settlement of securities transactions, additional custodian services may involve administration of the fund or scheme including unit pricing, tax and statutory reporting, portfolio/fund valuation, and unit registry services.<sup>49</sup>

2.57 Furthermore, where trustees do not satisfy the capital requirements of either APRA for superannuation trustees or ASIC for registered MISs, a custodian is appointed as a condition of a licence being granted to the trustee.<sup>50</sup>

2.58 Custodians fall under the remit of ASIC, but the operations of custodians are also of interest to APRA because custodians provide services to RSEs that are regulated by APRA.<sup>51</sup> Furthermore, where a custodian is an authorised deposit-taking institution, it falls under APRA's supervision.

#### *Size and structure of the industry*

2.59 As at 31 December 2011, assets of Australian investors worth approximately \$1.82 trillion were held in custody. ASIC expects this figure to increase to \$6.4 trillion by 2026.<sup>52</sup>

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47 Australian Custodial Services Association, *The role of the custodian*, p. 7, [http://www.custodial.org.au/uploaded\\_files/news\\_files\\_uploads/1335847172\\_109.pdf](http://www.custodial.org.au/uploaded_files/news_files_uploads/1335847172_109.pdf) (accessed 18 June 2013).

48 One Investment Group, Custody services, <http://oneinvestment.com.au/services/custody-services/> (accessed 2 July 2013).

49 Australian Custodial Services Association, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013.

50 Australian Custodial Services Association, *Submission 43*, p. 2, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

51 Australian Prudential Regulation Authority, 'Custodian operations in the superannuation industry', *Insight*, No. 1, 2011, p. 12.

52 Australian Securities and Investments Commission, *Custodial and depository services in Australia*, Report, No. 291, July 2012, p. 4, [http://www.asic.gov.au/asic/pdfflib.nsf/LookupByFileName/rep291-published-5-July-2012.pdf/\\$file/rep291-published-5-July-2012.pdf](http://www.asic.gov.au/asic/pdfflib.nsf/LookupByFileName/rep291-published-5-July-2012.pdf/$file/rep291-published-5-July-2012.pdf) (accessed 22 July 2013).

2.60 The custodial industry in Australia is highly concentrated among a few firms, with the six largest custodians having 84 per cent of the market:

<b>Major custodians</b> <sup>53</sup>	<b>Assets in custody</b>	<b>Market share (%)</b>
National Australia Bank Asset Servicing	\$539.8 billion	30
JP Morgan Treasury and Securities Services	\$366.5 billion	20
BNP Paribas Securities Services	\$269.1 billion	15
State Street Global Services	\$133.3 billion	7
Citi Global Transaction Services	\$119.2 billion	7
HSBC Securities Services	\$103.3 billion	5

### *Expectation gap around the role of the custodian*

2.61 The Trio inquiry exposed an expectation gap between what retail investors understood as the role of a custodian and what custodians are legally required to do. There was an expectation that a custodian would act to protect and secure underlying assets. However, in its submission to the Trio inquiry, ANZ laid out the functions of a custodian. Significantly, it noted that custodians are not required to confirm the existence of underlying assets:

It has been suggested in submissions made to the Committee that a custodian is required to confirm the existence of a fund's underlying assets. This is incorrect. The custodian's role and function, as bare trustee, is to hold assets on behalf and upon instruction of the RE. Its duty, which is owed exclusively to the RE, is to act on proper instructions from the RE in relation to those assets. The role of the RE is to manage the assets of the scheme, including activities such as investment strategies and valuations. A custodian does not have discretion to choose whether or not to act on a proper instruction which is lawfully given by the RE. The custodian has no discretion regarding the investment or management of the custodial assets.<sup>54</sup>

2.62 Given the misunderstanding of the role of the custodian, in its report on Trio, the committee recommended that ASIC should consider changing the name 'custodian'

53 Australian Securities and Investments Commission, *Custodial and depository services in Australia*, Report, No. 291, July 2012, p. 14.

54 ANZ, *Submission 70*, p. 3, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012; see also Australian Custodial Services Association, *Submission 43*, p. 2, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

to a term such as 'Manager's Payment Agent' that better reflected the limited role of the custodian.<sup>55</sup>

### *Recent developments*

2.63 Between 2009 and 2011, ASIC reviewed the Australian custodial industry, including industry liaison and surveillance. In July 2012, ASIC released Report 291, 'Custodial and depository services in Australia'.<sup>56</sup> The proposed name change was one element of discussion.

2.64 In its submission to Report 291, ACSA argued that changing the name 'custodian' to a term such as depository would do little to close any expectation gap around the role of a custodian. In particular, ACSA noted that custodian businesses operate globally and that under proposed European Union directives, the terms custodian and depository will have different meanings and different responsibilities. ACSA expressed concern about the confusion that could arise if Australia diverged 'from globally accepted practice'.<sup>57</sup>

2.65 This perspective was reiterated at the hearing by Mr Paul Khoury, Deputy Chairman of ACSA:

We are strongly of the view that the title 'custodian' is firmly appropriate, for a number of reasons. Most importantly, we operate in a global environment and, from a consistency perspective that is a broadly well-accepted term that we operate in. But ultimately what we are trying to do is avoid confusion.<sup>58</sup>

2.66 Instead of a name-change, Mr Khoury observed that a better approach would be to educate Australian consumers on the functions and responsibilities of a custodian. He also suggested that specific information about the role of a custodian could be included in prospectuses and product disclosure statements.<sup>59</sup>

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55 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 133, Recommendation 8.

56 Australian Securities and Investments Commission, *Custodial and depository services in Australia*, Report, No. 291.

57 Australian Custodial Services Association, *Submission to ASIC Report 291—Custodial and depository services in Australia: name of custodian*, 6 September 2012, p. 2, [http://www.custodial.org.au/uploaded\\_files/news\\_files\\_uploads/1354148479\\_124.pdf](http://www.custodial.org.au/uploaded_files/news_files_uploads/1354148479_124.pdf) (accessed 19 June 2013).

58 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 14.

59 Mr Paul Khoury, Deputy Chairman, Australian Custodial Services Association, *Proof Committee Hansard*, 21 June 2013, p. 14.

2.67 As part of its education campaign, ACSA released a document in 2012, 'The role of a custodian'. The document clearly set out the functions, roles, and responsibilities of a custodian. In it, ACSA cautions that:

It is important not to *over* or *under* interpret the benefits provided by the custodian:

- The custody function protects the fund's assets firstly by providing clear separation from each investment manager, and also by ensuring that payments of money and delivery of securities only take place as the result of a proper instruction (and in accordance with the rules and conventions of the relevant market's clearing and settlement functions).

Additionally, the custodian provides a consolidated view of holdings and transactions. This role, as a trusted record-keeper (across all of the client's assets and portfolios), provides the cornerstone for efficient and consistent reporting and monitoring.

The custodian does not (and cannot) second guess investment decisions or over-ride proper instructions.

- The role of the custodian is analogous in many respects to that of a bank or credit union processing payments for its customers. Banks or credit unions do not stop payments of customers because they think that spending money on a particular transaction is 'wrong' or 'unwise'. In fact, confidence in the banking system relies on this lack of discretion and client confidentiality.<sup>60</sup>

## ***Trustees***

### *Background*

2.68 A trustee is a person or company that holds or administers property or assets on behalf of a beneficiary. A trustee must act in the best interests of the beneficiary and is generally not allowed to benefit or profit from its position unless specified in the trust document. Trustees perform a range of functions involving estate planning and management such as the preparation of wills, Enduring Powers of Attorney, investment and executor and financial administration services.

2.69 In the corporate trustee sector, the three main licensed trustee company roles are as debenture issuers, RE and custodian. However, the Financial Services Council noted that the 'scope of the duties and functions of each role is different ... and is determined by the structure of the scheme and the documents that govern the scheme.' For example, the role of an RE is similar to a trustee, but the RE has additional

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60 Australian Custodial Services Association, *The role of the custodian*, p. 9, [http://www.custodial.org.au/uploaded\\_files/news\\_files/uploads/1335847172\\_109.pdf](http://www.custodial.org.au/uploaded_files/news_files/uploads/1335847172_109.pdf) (accessed 18 June 2013).

statutory obligations, while a custodian acts as a 'bare trustee', meaning the scope of its obligations to an RE is very narrow.<sup>61</sup>

2.70 Trustee companies often operate as a group of companies with subsidiary companies that hold an RE licence or a custodian licence.<sup>62</sup> For example, One Investment Group holds several AFSLs and is licenced to act as a custodian, as a trustee for unregistered schemes, and as RE for registered schemes.<sup>63</sup>

2.71 The roundtable focussed on the role of company trustees as custodian and as RE.<sup>64</sup> The RE role is covered in the next section.

2.72 The committee was also interested in the role of trustee as it related to superannuation funds. At \$1.3 trillion, Australia has the fourth largest funds management market in the world, with approximately 45 per cent of that due to the size of Australia's superannuation savings that now exceed \$530 billion.<sup>65</sup> Given that the Trio fraud involved superannuation funds being invested in a fraudulent MIS, the committee wanted to scrutinise the role that superannuation trustees play within the APRA-regulated part of the system as trustees for registrable superannuation entities.

### *Recent developments*

2.73 On 26 March 2008, the Council of Australian Governments agreed that the Australian Government would assume responsibility for regulating traditional services provided by trustee companies. On 6 November 2009, the Corporations Act was amended to include the regulation of traditional services provided by trustee companies under chapters 5D and 7 of the Corporations Act.<sup>66</sup> Traditional services provided by a trustee are now specified as a financial service under section 766A(1A) of the Corporations Act.

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61 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

62 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [2].

63 One Investment Group, Trust services, <https://oneinvestment.com.au/trust-services/> (accessed 2 July 2013); One Investment Group, Company overview, <https://oneinvestment.com.au/about/> (accessed 2 July 2013).

64 Although debenture trustees were not a focus area at the roundtable, the committee has monitored recent developments in the debenture sector including the recent ASIC consultation paper on strengthening regulation of the sector. See Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, No. 2, May 2013, pp 55–58.

65 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 146.

66 The *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009*.

2.74 On 15 March 2010, ASIC issued a consultation paper on the new obligations facing trustee companies, including the requirement to hold an AFSL.<sup>67</sup> Prior to these changes, some trustees already held an AFSL that authorised them to provide custodial and depository services. Companies wishing to provide traditional trustee services along with custodial and depository services now need to modify their licence to include trustee services.

2.75 Some trustee companies (RSEs) are regulated by APRA. For those traditional trustees not regulated by APRA, the new regulations introduced by ASIC required the trustee to:

- have risk management systems in place to deal with the risk that its financial resources may be inadequate to enable it to continue its business;
- meet specified base level financial requirements; and
- hold at least \$5 million in net tangible assets.<sup>68</sup>

#### *Trustee interactions with custodians*

2.76 In a recent article, APRA has drawn attention to an expectation gap between what custodians provide to the trustees of an RSE and what trustees assumed they were receiving, particularly in the area of asset valuation:

Custodians can play key roles in providing investment accounting and unit pricing services to superannuation trustees, and may also provide trustees with investment performance reporting or services such as foreign exchange or currency overlay.

APRA observed that, in a number of cases, trustees rely on custodian information and practices around valuation sources, tax calculation approach and unit pricing methodology without sufficient enquiry or assertion of the trustee's expectations in this area. This is a consistent theme identified by APRA in respect of asset valuations.

Based on APRA's experience, trustees often place reliance on the fact that valuations for unlisted assets are 'sourced' from the custodian and thus assume the valuations to be both robust and independent. However, APRA found that custodians operate predominantly on client trustee instructions and the extent of custodian input in the area of valuation was less than that expected by trustees.<sup>69</sup>

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67 Australian Securities and Investments Commission, *Trustee companies: financial requirements and conduct obligations*, Consultation Paper, No. 132, March 2010, p. 6, [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/cp132.pdf/\\$file/cp132.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/cp132.pdf/$file/cp132.pdf) (accessed 22 June 2013).

68 Australian Securities and Investments Commission, *Trustee companies: financial requirements and conduct obligations*, Consultation Paper, No. 132, March 2010, p. 10.

69 Australian Prudential Regulation Authority, 'Custodian operations in the superannuation industry', *Insight*, No. 1, 2011, p. 13.

2.77 In 2011, APRA indicated that it would discuss with trustees the extent to which trustees monitored and assessed the accuracy of the information that trustees received from custodians:

As part of its supervisory practices going forward, APRA will discuss with trustees the extent to which they obtain assurance that unlisted asset valuations used in NAV (net asset valuation) calculations are adequately robust. It is not sufficient to simply state that the NAV is obtained from the custodian and hence it is 'independent'. Trustees also need to assess the source and adequacy of valuation data used by the custodian. In all cases, trustees should remember that the valuation process affects member interests and is a trustee responsibility. Similarly, trustees should have an understanding of the controls in place at the custodian to check the reasonableness of the pricing (valuation) data received. APRA expects trustees to know the extent to which stale price valuations are being monitored and to ensure they are receiving adequate and timely reporting from the custodians on such prices.<sup>70</sup>

2.78 Given the importance of this interaction, the committee was keen to build on APRA's initial work and examine the wider relationship between RSE trustees, custodians and REs, and also between the auditors of those of entities.

### *Fund managers and Responsible Entities*

2.79 In Australia, the term 'managed funds' covers 'two broad types of institutions':

The first are managed funds institutions (such as life insurance companies, superannuation funds and unit trusts), which buy assets on their own account. The second are investment or fund managers, which act as investment agents for the managed funds institutions, as well as others with substantial funds to invest.<sup>71</sup>

2.80 The inquiry was concerned with the investment fund managers that manage a portfolio of assets and act as the RE for a range of MISs.

### *Size of the Australian managed funds sector*

2.81 The Australian managed funds sector is one of the largest in the world. REs manage a significant amount of non-superannuation assets:

As at February 2013, over 500 responsible entities operated about 4,000 registered managed investment schemes (schemes). The largest ten investment management groups collectively managed \$531 billion for

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70 Australian Prudential Regulation Authority, 'Custodian operations in the superannuation industry', *Insight*, No. 1, 2011, p. 13.

71 Australian Bureau of Statistics, Managed Funds, 1301.0–Year Book Australia, 24 May 2012, <http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/by%20Subject/1301.0~2012~Main%20Featu res~Managed%20funds~268> (accessed 31 May 2013).

numerous schemes in the September 2012 quarter, amounting to roughly one quarter of the funds under management in Australia. In contrast, smaller investment managers in the sector may only operate one scheme with a relatively small asset value.<sup>72</sup>

2.82 Some of the larger Australian retail fund managers include Australian Ethical, Australian Unity Investments, BlackRock Investments, BT Financial Group, Challenger, Colonial First State, Hunter Hall, Lifeplan Funds Management, Macquarie Group, Man Investments, MLC, OnePath, Perpetual and Zurich.

2.83 The managed funds sector invests in a range of assets including Australian and international shares, infrastructure, fixed income securities, mortgages, property, cash, unlisted private companies, and specialist sectors.<sup>73</sup>

### *Platforms*

2.84 Platforms have become a significant part of the retail investment market with most new investment occurring in this fashion. ASIC describes them as follows:

A platform is an administration facility that simplifies acquisition and management of a portfolio of investments. Platforms allow retail investors to purchase a range of investments through the one facility. In one sense platforms are like a department store where you can choose from different brand names and products in the one place, rather than having to visit a number of specialty stores.<sup>74</sup>

2.85 Financial planners generally place their clients into platforms because it consolidates the investment reporting process. Retail investors can gain advantage from being placed in a platform because retail funds can be pooled, thereby allowing access to products that are normally reserved for wholesale clients by virtue of the minimum investment requirements (typically \$500 000).<sup>75</sup>

2.86 The two most common types of platforms are:

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72 Australian Securities and Investments Commission, *Risk management systems of responsible entities*, Consultation Paper, No. 204, March 2013, p. 5, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp204-published-21-March-2013.pdf/\\$file/cp204-published-21-March-2013.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp204-published-21-March-2013.pdf/$file/cp204-published-21-March-2013.pdf) (accessed 30 May 2013).

73 Australian Securities and Investments Commission, *Risk management systems of responsible entities*, Consultation Paper, No. 204, March 2013, p. 5; Australian Securities Exchange, About managed funds, <http://www.asx.com.au/products/about-managed-funds.htm> (accessed 31 May 2013).

74 Australian Securities and Investments Commission, *Submission 378*, p. 112, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

75 Australian Securities and Investments Commission, *Submission 378*, p. 112, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

- master trusts – a master trust operates as a managed investment scheme. In a master trust the platform operator (or trustee) owns all the assets and the investors hold units in the managed investment scheme; and
- wrap accounts – a wrap account allows the investor to set up a portfolio of investments where the investment is made in the name of the wrap account operator (or custodian) but the investor has a specific beneficial interest in the assets reflected in the records of the wrap account operator (or custodian). This structure is increasing in popularity. The service 'wraps' or combines investments into a single account to facilitate the management of an investment portfolio.<sup>76</sup>

2.87 Platform providers charge service fees, and fees are also payable on specific platform investments.<sup>77</sup>

### *Index funds*

2.88 In contrast to a professionally/actively managed fund, index funds are passive mutual funds with a portfolio constructed to match or track the components of a market index, such as the Standard & Poor's 500 Index (S&P 500). An index fund typically provides broad market exposure, low operating expenses and low portfolio turnover. The Vanguard 500 Index Fund, launched in the United States in 1976 by Mr Jack Bogle, was the first industry fund for individual investors.<sup>78</sup>

2.89 Research by the American economist, Dr Burton G. Malkiel, indicates that over the last 30 years, passively-held index funds have substantially outperformed the average active fund manager. He also observes that the amount of under-performance is well approximated by the difference in the fees charged by the two types of funds. Dr Malkiel acknowledges that some active management is required for market efficiency because it ensures that information is properly reflected in securities prices. However, he found that 'the number of active managers and the costs they impose far

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76 Australian Securities and Investments Commission, *Submission 378*, pp 112–113, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

77 Australian Securities and Investments Commission, *Submission 378*, p. 112, Inquiry into financial products and services in Australia, Parliamentary Joint Committee on Corporations and Financial Services, November 2009.

78 Vanguard 500 Index Fund, Funds, stocks and ETF's, <https://personal.vanguard.com/us/FundsSnapshot?FundId=0040&FundIntExt=INT> (accessed 31 May 2013); see also Justin Fox, Just how useless is the asset-management industry?, *Harvard Business Review blog*, 16 May 2013, <http://blogs.hbr.org/fox/2013/05/just-how-useless-is-the-asset-.html> (accessed 31 May 2013).

exceed what is required to make our stock markets reasonably efficient' (see chapter 5).<sup>79</sup>

2.90 Although index funds were not the subject of the roundtable discussion, the committee did question the Australian fund managers about the issues raised by Malkiel. The responses by the fund managers are summarised in chapter 5, and the full responses are available in Appendix 2.

### *Responsible Entities and managed investment schemes*

2.91 Section 601ED of the Corporations Act states that an MIS must be registered if it has 20 or more members, or if the scheme is promoted by a person who is in the business of promoting MISs.<sup>80</sup>

2.92 An MIS is typically a collective investment such as a property trust, cash management trust, equity trust, agricultural scheme, timeshare scheme, mortgage scheme or actively managed strata title scheme.<sup>81</sup>

2.93 A registered MIS must appoint an RE,<sup>82</sup> and the RE must be an Australian registered public company that holds an AFSL permitting it to operate the scheme.<sup>83</sup> The scheme must lodge a constitution and compliance plan with ASIC.<sup>84</sup>

2.94 In effect, an RE is a single, clearly identifiable entity that is responsible to investors for the operation of a registered MIS in accordance with the scheme's constitution and compliance plan.<sup>85</sup>

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79 Burton G. Malkiel, 'Asset management fees and the growth of finance', *Journal of Economic Perspectives*, Vol. 72, No. 2, Spring 2013, pp 97–108; see also Justin Fox, 'Just how useless is the asset-management industry?', *Harvard Business Review blog*, 16 May 2013, <http://blogs.hbr.org/fox/2013/05/just-how-useless-is-the-asset.html> (accessed 31 May 2013); Michael West, 'Fundsters get the nod and the cash to go with it', *Weekend Business*, *Sydney Morning Herald*, 25 May, p. 2, <http://www.smh.com.au/business/fundsters-get-the-nod-and-the-cash-prize-to-go-with-it-20130524-2k6p6.html> (accessed 31 May 2013); Alexander Green, 'Why Burton G. Malkiel is more right than wrong', *Investment U*, Iss. 1299, 12 July 2010, <http://www.investmentu.com/2010/July/why-burton-g-malkiel-is-more-right-than-wrong.html> (accessed 31 May 2013).

80 *Corporations Act 2001*, s. 601ED.

81 One Investment Group, Responsible entities and managed investment schemes, <http://oneinvestment.com.au/responsible-entities-and-managed-investment-schemes/> (accessed 22 July 2013).

82 *Corporations Act 2001*, s. 601EA.

83 *Corporations Act 2001*, s. 601FA.

84 *Corporations Act 2001*, s. 601EA.

2.95 The RE has a trusteeship or fiduciary duty to the investors in the scheme.<sup>86</sup> The extent of an RE's accountability is laid out by Mr Justin Epstein, Executive Director of One Investment Group when he explains that:

The role of a Responsible Entity today, distinct from other gatekeepers, such as Custodians and Auditors, is to bear the ultimate accountability to investors for a registered scheme. That is, whilst the Responsible Entity is not prohibited from appointing an agent, the legislation states that the Responsible Entity is taken to have done (or failed to do) anything that the appointed agent has done (or failed to do), even where the agent acted fraudulently or outside the scope of their authority or engagement. In this regard, we consider the Responsible Entity to be the critical gatekeeper for registered schemes.<sup>87</sup>

2.96 The Corporations Act requires that all property in a MIS 'is clearly identifiable as scheme property and held separately from the property' of the RE and any other MIS, and that scheme property is valued regularly.<sup>88</sup>

2.97 Since 28 June 2007, however, neither ASIC guidelines nor the Corporations Act have placed restrictions upon the investment strategy of a registered MIS. This has allowed a registered MIS to diversify into, for example, foreign investments.<sup>89</sup>

#### *Responsible Entity business models*

2.98 There are two forms of RE: internal, where the manager of the scheme and the RE are related body corporates, and external where the RE is independent of the manager of the scheme and does not own or control the MIS.<sup>90</sup> One Investment Group operates as an external RE for registered schemes, as well as a trustee and custodian. BT Financial Group is a large financial services conglomerate that operates an internal RE function, as well as being a fund manager.

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85 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1]; Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

86 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

87 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

88 Australian Securities and Investments Commission, *Submission 51*, p. 36, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

89 Australian Securities and Investments Commission, *Submission 51*, pp 86–87, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

90 One Investment Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

2.99 The majority of REs are multi-function REs that operate more than one scheme. The Corporations and Markets Advisory Committee noted in a report published last year that:

- 39 per cent of REs operate one scheme;
- 32 per cent of REs operate more than one, but less than 5, schemes;
- 26 per cent of REs operate 5 or more, but fewer than 50, schemes (e.g. Trio); and
- 3 per cent of REs operate 50 or more schemes.<sup>91</sup>

2.100 Of the 500 plus REs operating in Australia, there are 33 dual-regulated entities that hold both an AFSL from ASIC to operate as a RE, and a RSE licence from APRA to operate as an RSE.<sup>92</sup> Trio Capital was a dual-regulated entity.

### *Compliance plans*

2.101 Section 601HA of the Corporations Act requires each registered MIS to have a compliance plan that sets out adequate measures for the RE to undertake to ensure that the MIS complies with its legal obligations under its constitution and the Corporations Act.<sup>93</sup>

2.102 However, ASIC warns of a 'fundamental risk' that the RE of an MIS may not follow 'the rules set out in the managed investment scheme's constitution or the laws governing registered managed investment schemes'.<sup>94</sup>

2.103 Chapter 5C of the Corporations Act aims to address the risk that an RE may not comply with its duties by setting out requirements for compliance plans, compliance audits and compliance committees.

### *Compliance committees*

2.104 Each registered MIS must have a compliance plan committee 'made up of independent and other auditors who are charged with the role of monitoring the RE's adherence with the plan and other scheme governing documents'.<sup>95</sup>

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91 Australian Government Corporations and Markets Advisory Committee, *Managed Investment Schemes*, Report, July 2012, p. 60.

92 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 11.

93 *Corporations Act 2001*, s. 601HA.

94 Australian Securities and Investments Commission, *Submission 51*, p. 35, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

95 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

2.105 Section 601JA of the Corporations Act requires each registered MIS to establish a compliance committee if less than half the directors of the RE are external directors.<sup>96</sup> The compliance plan committee is 'made up of independent and other auditors who are charged with the role of monitoring the RE's adherence with the plan and other scheme governing documents'.<sup>97</sup>

2.106 However, at the time of the Trio inquiry, ASIC noted that there were no 'legislative requirements as to experience, competence or qualifications for compliance committee members' and that there was no requirement for prospective compliance committee members to undergo training.<sup>98</sup>

### *Recent developments*

2.107 In March 2013, ASIC released a consultation paper that proposed changes to the risk management systems of those REs that are not regulated by APRA. The proposed regulations would also apply to dual-regulated entities (entities that are regulated by both ASIC and APRA). The changes include a focus on fundamental risk management practices, fostering a risk management culture, and reviewing the effectiveness of risk management systems.<sup>99</sup>

## ***Auditors***

### *Background*

2.108 Auditors undertake a crucial role in the financial services system, scrutinising both the financial statements and the compliance plans of entities.

2.109 Auditing standards in Australia are governed by the Corporations Act. The Auditing and Assurance Standards Board is established by section 227 of the ASIC Act.<sup>100</sup> It is responsible for developing auditing standards in Australia.<sup>101</sup> The

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96 *Corporations Act 2001*, s. 601JA.

97 Financial Services Council, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. [1].

98 Australian Securities and Investments Commission, *Submission 51*, p. 43, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

99 Australian Securities and Investments Commission, *Risk management systems of responsible entities*, Consultation Paper, No. 204, March 2013, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp204-published-21-March-2013.pdf/\\$file/cp204-published-21-March-2013.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp204-published-21-March-2013.pdf/$file/cp204-published-21-March-2013.pdf) (accessed 24 June 2013).

100 *ASIC Act 2001*, ss. 227AA(1).

101 *Corporations Act 2001*, s. 307A, ss. 336(1).

Australian Auditing Standards are based on the International Auditing and Assurance Standards Board International Standards on Auditing.<sup>102</sup>

2.110 Audits must be conducted in accordance with legally enforceable auditing standards that were introduced for financial reporting periods from 1 July 2006, following the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*.

2.111 Australia's financial reporting system is established by Part 12 of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). One of the main objects of section 224 of the ASIC Act is to develop auditing and assurance standards that:

- provide Australian auditors with relevant and comprehensive guidance in forming an opinion about, and reporting on, whether financial reports comply with the requirements of the Corporations Act; and
- require the preparation of auditors' reports that are reliable and readily understandable by the users of the financial reports to which they relate.<sup>103</sup>

#### *Key auditor attributes*

2.112 Auditor independence is a fundamental principle of the external auditing system.<sup>104</sup> By virtue of this independence from the other gatekeepers, auditors occupy a critical role in the financial services system given that the other gatekeeper roles including research, custody, trustee, RE, fund manager, financial planner and financial adviser can all function together as part of one large financial services corporation.

2.113 The Auditing and Assurance Standards Board (AUASB) has developed a set of requirements to which independent auditors are required to adhere. These include independence, and the application of professional scepticism and professional judgement. In addition, in order to obtain reasonable assurance, an auditor is expected to obtain:

sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.<sup>105</sup>

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102 Strategic Direction issued by the Financial Reporting Council (FRC) to the Auditing and Assurance Standards Board (AUASB) on 6 April 2005, published in Auditing and Assurance Standards Board, *AUASB Functions and Processes*, November 2012, p. 5.

103 *ASIC Act 2001*, ss. 224(aa).

104 *Corporations Act 2001*, s. 307C.

105 Auditing and Assurance Standards Board (AUASB), *Auditing Standard ASA 200—Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the Australian Auditing Standards*, October 2009, paragraphs 14–17.

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*Treasury consultation paper*

2.114 In March 2010, a Treasury consultation paper found that Australia's 'audit regulation framework is robust and stable' and 'in line with international best practice'.<sup>106</sup>

2.115 In particular, Treasury emphasised two crucial and unique attributes applicable to Australia. Firstly, that as a statutory body under federal legislation, ASIC regularly reviews the audit process with its audit inspection program. And, secondly, that accounting and auditing standards and auditor independence are all legally enforceable under the Corporations Act.<sup>107</sup> These two factors contributed significantly to the robustness of the audit regulation framework.

*ASIC's audit inspection program and the response from the audit profession*

2.116 Following the release of its audit inspection program report for 2011–12, ASIC has placed the audit industry on notice regarding the quality of financial statement audits.<sup>108</sup> In its recent ASIC Oversight reports, the committee questioned both ASIC and the audit profession at length about the steps that are being taken to raise the level of audit quality in Australia.<sup>109</sup>

2.117 The committee notes that on 13 June 2013, ASIC welcomed the development by each of the six largest audit firms in Australia of 'a genuine and comprehensive action plan to improve audit quality', noting that each firm had 'taken full ownership for the timely implementation of the plan and monitoring its effectiveness'.<sup>110</sup>

2.118 ASIC asked the six firms 'to focus on improving the consistency of the execution of audits' and to address the three broad areas requiring improvement that were identified in ASIC's audit inspection report:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and

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106 The Treasury, *Audit Quality in Australia: A Strategic Review*, March 2010, p. 7.

107 The Treasury, *Audit Quality in Australia: A Strategic Review*, March 2010, p. 3.

108 Australian securities and Investments Commission, *Audit inspection program report for 2011–12*, Report No. 317, December 2012.

109 Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, No. 2, May 2013, pp 5–23.

110 Australian Securities and Investments Commission, 'ASIC welcomes audit firm plans to improve quality', Media release, No. 13–138, 13 June 2013, <http://www.asic.gov.au/asic/asic.nsf/byheadline/13-138MR+ASIC+welcomes+audit+firm+plans+to+improve+quality?openDocument> (accessed 14 June 2013).

- the extent of reliance that can be placed on the work of other auditors and experts.<sup>111</sup>

2.119 In working with the firms, ASIC notes that the action plans will focus on:

- the culture of the firm, including messages from firm leadership focusing on audit quality and consultation on complex audit issues;
- the experience and expertise of partners and staff, including increased and better use of experts;
- supervision and review, including greater partner involvement in working with audit teams in the planning and execution of audits, and new or increased real time quality reviews of engagements; and
- accountability, including impacts on remuneration of engagement partners and review partners for poor audit quality, often extending the impacts to firm leadership.<sup>112</sup>

*CPA Australia guide to auditing and assurance*

2.120 In February 2013, CPA Australia released 'A guide to understanding auditing and assurance'. Mr Alex Malley, Chief Executive Officer of CPA Australia notes that the guide:

explains the value and purpose of auditing and assurance in plain language. This should assist shareholders who are not experts in auditing and assurance to better understand the messages from their company's auditor, and make use of this information in their decision making.<sup>113</sup>

2.121 The guide addresses some of the expectation gaps that have been highlighted in the wake of recent corporate collapses. In particular, it addresses the meaning and extent of the 'reasonable assurance' that is obtained in an audit of financial statements:

While the reasonable assurance obtained in an audit is a high level of assurance, it is not absolute assurance (a certification that the financial statements are completely correct). Obtaining absolute assurance is not possible in financial statement audits for a number of reasons, including:

- it would be impractical for the auditor to test and audit every transaction; and
- financial statements involve judgements and estimates which often cannot be determined exactly, and may be contingent on future events.<sup>114</sup>

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111 Australian Securities and Investments Commission, 'ASIC welcomes audit firm plans to improve quality', Media release, No. 13-138, 13 June 2013.

112 Australian Securities and Investments Commission, 'ASIC welcomes audit firm plans to improve quality', Media release, No. 13-138, 13 June 2013.

113 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 5, <http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/guide-understanding-audit-assurance.pdf> (accessed 21 March 2013).

114 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 7.

2.122 By contrast, the half-yearly review of financial statements by an auditor only provides limited assurance.<sup>115</sup>

2.123 The guide also deals with unmodified and modified opinions and explains that an emphasis of matter paragraph is not a qualification, limitation, or adverse conclusion:

An unmodified auditor's report effectively states the auditor believes the financial statements present a true and fair view, and are in accordance with accounting standards and relevant legislation. This is sometimes also called an 'unqualified' or a 'clean' audit opinion.

[...]

An unmodified review report effectively states the reviewer did not become aware of anything that suggested the financial statements do not present a true and fair view in accordance with accounting standards.

In some circumstances, the auditor will include additional wording in the auditor's report directing users to information that in their view is fundamental to understanding the financial statements. This may be information included in the financial statements, such as a note (called an 'emphasis of matter' paragraph), or information that is included elsewhere (called an 'other matter paragraph'). It is important to note that an emphasis of matter or other matter paragraph is not a qualification, limitation or adverse conclusion.

[...]

Modified auditor's reports are issued when the auditor believes the financial statements contain a material misstatement, or when the auditor is unable to obtain enough evidence to form an opinion.<sup>116</sup>

2.124 In response to a request from the committee, CPA Australia clarified the distinction between an emphasis of matter and a modified audit opinion:

There is a clear distinction between an emphasis of matter and modified audit opinion:

- a modified audit opinion is required where the financial statements are *materially misstated* or the auditor is unable to form a conclusion due to a *limitation of scope*; and
- emphasis of matter paragraphs highlight matters that are *not materially misstated* in the financial statements but which in the auditors' judgement are of such importance so as to be fundamental to users' understanding of the financial statements.

The use of an emphasis of matter paragraph does not ever replace the need for a modified audit opinion where the financial statements are materially

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115 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 7.

116 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, pp 8–9.

misstated - hence rather than representing a threshold, modified audit opinions and emphasis of matter paragraphs are two different things or heterogeneous.

Professional judgement is relevant to both of these aspects as it would be involved in forming a conclusion in regard to a material misstatement of the financial statements, and also in determining whether a matter is of such importance that it is fundamental to users' understanding of the financial statements. Australian auditing standards contain comprehensive requirements including general principles and specific rules where appropriate, together with a range of guidance statements that have been issued by the AUASB. However, the availability of this material does not replace the need for experience and professional judgement in performing an audit.<sup>117</sup>

2.125 Fraudulent activity can result in the material misstatement of financial statements. CPA Australia observes that even though an audit is not designed to uncover all instances of fraud, 'it is reasonable to expect that an audit would detect instances of fraud that result in material misstatement'.<sup>118</sup>

2.126 An auditor also makes a judgement about the ability of a company to continue as a going concern for the 12 months subsequent to the audit. This assumption may be inherently difficult to determine. Furthermore, investors need to be clear about the nature of an emphasis of matter paragraph if the company has already disclosed uncertainty about its ability to continue as a going concern:

The going concern assumption involves judgements about events taking place in the future, which are inherently uncertain. Where there is significant uncertainty in the company's ability to continue as a going concern and this has been disclosed by management in the financial statements, the auditor includes wording in the auditor's report to direct users to the applicable note in the financial statements. This is called an emphasis of matter paragraph. If the auditor ultimately does not agree with management's assumptions in regard to going concern, the result would be a modified opinion.<sup>119</sup>

2.127 Finally, and very importantly, an unmodified auditor's report is an opinion about the state of the company's financial statements that provides investors 'with a higher degree of confidence that the information is materially correct and unbiased. The audit does not, however, express an opinion 'about the state of the company itself or whether it is a safe investment'. In a similar way, the audit assesses 'the going concern assumptions used by management in preparing the financial statements'.

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117 CPA Australia, correspondence to the committee, 12 July 2013 (emphasis original); see also Ernst & Young, answer to question on notice, 10 July 2013 (received 16 July 2013).

118 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 12.

119 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 12.

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However, the audit opinion 'cannot be taken as a conclusion on the solvency or financial health of the company'.<sup>120</sup>

*Structure of the audit industry and conflicts of interest*

2.128 The audit industry in Australia and globally is dominated by four large audit firms: PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG. This has raised concerns both internationally and within Australia about the extent of competition within the audit market and its potential impacts on audit quality.

2.129 In February 2013, the United Kingdom (UK) Competition Commission issued the provisional findings of its market investigation into the supply of statutory audit services to large companies in the UK. It concluded that competition in the audit market 'is restricted by factors which inhibit companies from switching auditors and by the tendency for auditors to focus on satisfying management rather than shareholder needs'.<sup>121</sup>

2.130 Ms Laura Carstensen, Chair of the UK Audit Investigation Group, found that existing safeguards, such as audit committees, appeared insufficient to prevent misaligned auditor incentives or to facilitate a dynamic and independent auditing market:

Shareholders play very little role in appointing auditors compared to executive management-and despite the presence of audit committees and other safeguards-audit firms naturally focus more on meeting management interests. The result is a rather static market in which too often audits don't fulfil their intended purpose and thus fail to meet the needs of shareholders.

It is clear that there is significant dissatisfaction amongst some institutional investors with the relevance and extent of reporting in audited financial reports. This needs to change so that external audit becomes a more genuinely independent and challenging exercise where auditors are less like corporate advisors and more like examining inspectors.<sup>122</sup>

2.131 In its previous ASIC oversight report, the committee expressed concern about the potential conflict of interest that arises when an audit firm has to balance

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120 CPA Australia, *A guide to understanding auditing and assurance*, February 2013, p. 13.

121 Competition Commission (UK), 'Audit market not serving shareholders', Media release, 22 February 2013, [www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders](http://www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders) (accessed 27 March 2013).

122 Ms Laura Carstensen, Chair, UK Audit Investigation Group, cited in Competition Commission (UK), 'Audit market not serving shareholders', Media release, 22 February 2013, [www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders](http://www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders) (accessed 27 March 2013).

commercial pressures (retaining client contracts) with adherence to audit quality (highlighting matters of concern in financial statements and/or compliance plans).<sup>123</sup>

### *Compliance plan audits*

2.132 Section 601HG of the Corporations Act requires the compliance plan of the RE to be audited annually. Under section 601HG(2) of the Corporations Act, the auditor of an entity's compliance plan cannot be the auditor of that entity's financial statements, although the auditors may work for the same audit firm.

2.133 The compliance plan auditor is required to state in its report whether the RE complied with the MIS's compliance plan during the financial year and whether the plan continues to meet the requirements of Part 5C.4 of the Corporations Act.

2.134 According to ASIC however, Part 5C.4 of the Corporations Act 'does not impose any qualitative standards by which a compliance plan auditor must conduct their audit' and 'does not make it an offence to conduct a poor quality compliance plan audit'. Furthermore, the auditor is only required to check compliance with the compliance plan, not the compliance of the RE with the Corporations Act or the constitution of the MIS.<sup>124</sup>

2.135 Finally, the assurance standards for a compliance plan audit do not have the force of law, unlike the assurance standards for an audit of financial statements. At the time of the Trio inquiry, ASIC observed that there is no precedent for a successful action against a compliance plan auditor.<sup>125</sup>

### *Audits of self-managed superannuation funds*

2.136 From 1 July 2013, the *Superannuation Laws Amendment (Capital Gains Tax Relief and Other Efficiency Measures) Act 2012* introduced a requirement for auditors of self-managed superannuation funds (SMSF) to register with ASIC to conduct

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123 See the interchange between Mr Paul Fletcher MP and Ms Liz Stamford, Head of Audit Policy, Institute of Chartered Accountants Australia, *Committee Hansard*, 15 March 2012, pp 9–10; Parliamentary Joint Committee on Corporations and Financial Services, *Statutory Oversight of the Australian Securities and Investments Commission*, No. 2, May 2013, Committee views—2.63–2.65, pp 22–23.

124 Australian Securities and Investments Commission, *Submission 51*, pp 44–45, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

125 Australian Securities and Investments Commission, *Submission 51*, p. 45, Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

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SMSF audits.<sup>126</sup> The registration system administers a competency exam designed to test critical judgement in relation to superannuation requirements and tax compliance.<sup>127</sup>

*Key issues involving auditors*

2.137 In its report into the collapse of Trio, the committee drew attention to the role of auditors and expressed concern that:

- an auditor's approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist;
- an auditor's assessment of a compliance plan and the work of the compliance committee as 'effective' essentially only means that they exist; and
- in the case of Trio, the requirement for the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.<sup>128</sup>

2.138 At the roundtable, the committee was interested in several aspects of compliance plans including the adequacy of compliance plans, the capabilities of compliance committees, the degree of independence that compliance committees have from the management of the RE, the auditing of compliance plans, the relationships that the audit profession had with the compliance committees of REs and RSEs, and the degree of cross-referencing between financial statement and compliance plan audits.

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126 *Superannuation Laws Amendment (Capital Gains Tax Relief and Other Efficiency Measures) Act 2012*. Registration eligibility requirements include a competency examination, educational qualifications and supervised practical experience. See ASIC, 'SMSF auditor registration', [www.asic.gov.au/asic/ASIC.NSF/byHeadline/SMSF%20auditor%20registration](http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/SMSF%20auditor%20registration) (accessed 26 March 2013).

127 Mr Greg Tanzer, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 15 March 2013, pp 27–28.

128 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2013, pp xxii–xxiii.

