Chapter 3

Interaction between research houses, fund managers, financial planners and financial advisers

Introduction

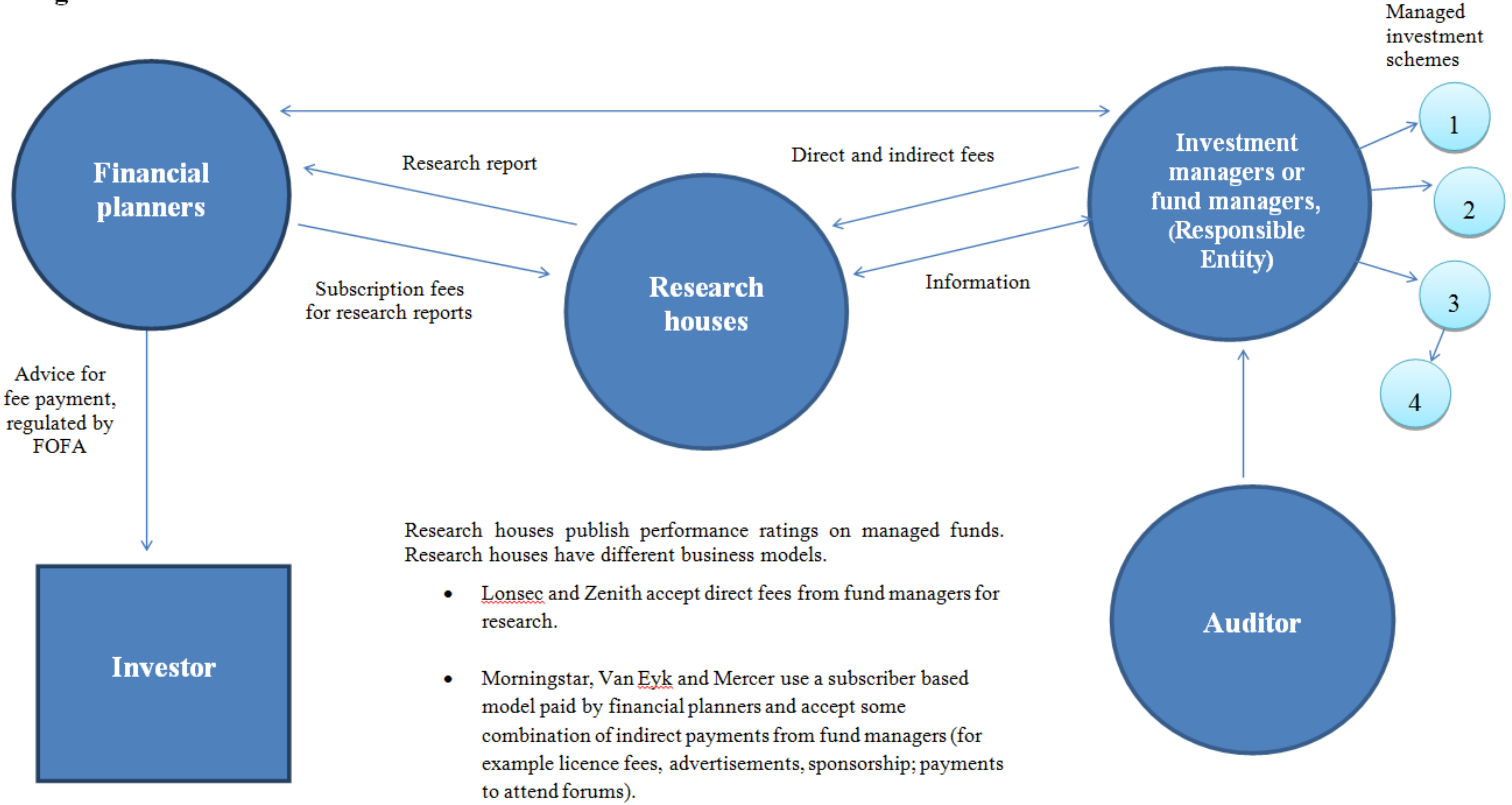
3.1 The next three chapters present the evidence from the gatekeepers' roundtable. It is important in considering this evidence to bear in mind the different business models within gatekeeper groups, and the potential impact that those differences can have on the interactions between gatekeeper groups. As discussed in the previous chapter, these differences include:

- the subscription model and the pay-for-research/ratings models, and the differences between direct and indirect payments in the research house sector;
- the operation of internal research functions by some advisory groups; and
- the vertical integration in large parts of the financial services system where banks and/or fund managers are either affiliated with, or own, financial planning and financial advisory dealerships.

3.2 With these differences in mind, the committee devised diagrams 3.1 and 4.1, representing how the gatekeepers may interact. Gatekeepers' functions are not necessarily performed by companies operating solely in one part of the financial services sector. In some instances, all the gatekeeper functions—except auditing—are performed by different entities within the same corporation. For example, entities within Macquarie Group offer fund management, RE services, custody services, trustee services, financial advice and private banking. Likewise, entities within BT Financial Group offer fund management, RE services, trustee services, financial planning and private banking. Both Macquarie Group and BT Financial Group also have an internal research function. Several of the other gatekeepers also offer multiple services. The auditors are the exception in this regard, operating independently of the functions of the other gatekeepers in the system.

3.3 This chapter deals with the interactions shown in diagram 3.1 between research houses, financial planners and financial advisers, and fund managers. A key focus in this diagram is the business model of the research house.

Diagram 3.1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Research houses publish performance ratings on managed funds. Research houses have different business models.
• Lonsec and Zenith accept direct fees from fund managers for research.
• Morningstar, Van Eyk and Mercer use a subscriber based model paid by financial planners and accept some combination of indirect payments from fund managers (for example licence fees, advertisements, sponsorship; payments to attend forums).

3.4 The first area of committee interest was the relationship between research houses and financial planners and financial advisers, and between research houses and fund managers. Several factors led to a focus on the nature of these interactions.

3.5 Firstly, in its report into Trio, the committee had found an expectation gap around the perceived role of research houses and research reports including the claims made in a research report and the basis for their formation:

> 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 responsible entity 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.[1]

3.6 Secondly, as noted in chapter 2, the different research houses operate different business models, with fees and payments to research houses flowing from the financial planning and advisory sector, and also in some cases, from the fund managers whose funds are being rated. Given concerns about the potential impact of conflicts of interest on research quality, the committee wanted to understand how the different business models worked and how the conflicts of interest that emerge under those models are either managed or avoided.

3.7 Thirdly, in November 2011, the Australian Securities and Investments Commission (ASIC) consulted with the research houses, and in December 2012 it released a regulatory guide for research houses. The roundtable gave the committee the opportunity to gain the insight of the research house sector into the operation of the new guidelines.

3.8 Fourthly, following an observation in the 'Bridging the Gap' session at the ASIC Annual Forum in March 2013 about the influence that research houses exercise in the system, the committee wanted some perspectives on the impact that a rating has on the flow of new capital into a recommended fund.

3.9 And fifthly, following criticism of research houses during this session, the committee was keen to question research houses about their accountability within the financial services system.

What does a rating mean?

3.10 The committee report into Trio identified confusion around what a rating actually means. The committee asked Lonsec Research Pty Ltd (Lonsec) to clarify the meaning of a rating, the basis for its formation, whether it is an indicator of future performance, and the nature of quantitative and qualitative investment research.

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 123.

3.11 Lonsec told the committee that financial product ratings and research opinions constitute general advice that is supplied to advice-giving intermediaries, such as financial planners and financial planners. It noted that ratings should not be the sole basis of financial advice:

> Each of the five research houses in Australia ascribe ratings to unlisted financial products. The universe of available financial product is large (approximately 4000 managed funds at the 'headline' or 'parent' level, and approximately 12,000 funds once tax structures and platforms variants are accounted for). Each research house identifies a significantly smaller subset of this universe to submit to their proprietary research processes and the result is typically a research report (or reports) containing factual information, opinion, and an overall investment rating.
>
> Each research house has a different basis for, and therefore definition of, its ratings. This is one of the key points ASIC identified in RG79 – that users of research needed to be aware of, and understand, the varying meanings attached to ratings across the research house industry. Generally speaking though the following statements can be made:
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> Financial product ratings and accompanying research opinions are primarily supplied to financial advisers, as opposed to end investors. They therefore only constitute general advice.
>
> A key part of research house ratings processes is the categorisation of financial products in order to form peer groups.
>
> Research house ratings are descriptors or labels which reflect the relative merits of financial products, as determined by each research house's disclosed ratings process, and consistent with the stated ratings definitions. Ratings are typically scale based and therefore relative to other ratings of like financial products (ie x stars out of 5, A-B-C-D, Highly Recommended, Recommended, Investment Grade etc). Ratings definitions are typically displayed within the research report itself, whereas detailed explanations of research processes are typically made available to users of research via research house subscriber websites.
>
> Research houses do not typically publish their ratings without accompanying research. Lonsec believes (and we believe that all research houses are of the same view) that financial product ratings require context and guidance (within the bounds of general advice) in order to be used appropriately. A positive financial product rating can be broadly interpreted as a professional opinion that a financial product provider has the requisite investment people and investment processes in place to achieve their stated product objectives in the future over an appropriate investment time horizon (naturally, the rating is not a guarantee). A rating (in isolation from its supporting research) does not tell an investor who the financial product is or isn't suitable for, how to use the financial product, how the financial product should 'behave' in certain market environments, or what key risks should be considered prior to investing into the financial product. Within the bounds of general advice, a good research report will provide general guidance and general opinion to assist financial advisers in forming their

> professional views on these aspects. In summary, Lonsec contends that financial product ratings should form one part of an adviser's overall due diligence process and should not be used as the sole basis for recommending a financial product.
>
> In Australia, financial product ratings take into account varying degrees of historical quantitative information (return, risk etc) but are primarily determined (in a peer reviewed, systematic fashion) by professional qualitative judgement (subjective opinion). Lonsec understands that an exception to this general statement is the Morningstar 'Star' rating system, which we believe to be completely quantitative.[2]

3.12 While ratings and research were not intended 'to be a predictor of future market performance', Lonsec noted that qualitatively determined financial product ratings were 'intended to be forward-looking':

> Research houses will generally have a well defined research process that outlines the key criteria for determining a financial product rating. Typically, these processes will have elements of qualitative and quantitative based analysis. In Lonsec's case the research process is skewed to qualitative research as Lonsec believes that qualitative based research is a better indicator of whether a financial product provider has the requisite people and processes in place to meet their stated product objectives in the future. Lonsec believes that while quantitative analysis is useful in assessing a financial product provider's historical performance and risk attributes, it is a poor indicator of a financial product provider's ability to meet their objectives in the future.[3]

3.13 Lonsec stated that qualitative assessments of investment people and investment processes accounted for approximately 80 per cent of the rating that it would give to mainstream asset classes, while quantitative factors such as emphasis on the returns, risk and consistency of the financial product would account for 20 per cent of the rating.

Quality and type of investment research in Australia

3.14 The type of qualitative investment research that features strongly in Australia is more expensive to produce than quantitative research. Lonsec pointed out that compared to the United States (US), the Australian market is highly geared towards qualitative research:

> the Australian research house sector conducts its managed funds research in a predominantly qualitative manner. Certain other markets in the world, most notably the US, are dominated by research houses that operate primarily quantitative research and ratings processes. Quantitative processes are mechanised, driven primarily by technology and are scalable.

2 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

3 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

> In contrast, qualitative processes rely far more heavily on people, are therefore more expensive to operate and are far less scalable unless revenue is directly linked to research volume.[4]

3.15 According to interviews conducted by Mr Jason Spits, a freelance journalist who contributes to the publication *Money Management*, overseas-based fund managers offering investment products into the Australian market are:

> often surprised by the depth and rigour local research houses bring to their work in assessing funds, as well as the necessity of having products rated before releasing them to the financial planners.[5]

3.16 Mr Giles Gunesekara, Head of Third Party Sales at Principal Global Investors, observes that the quality of research in Australia is higher than elsewhere:

> having a tight ratings market has been a contributor to the level of sophistication of the Australian market, with managers from the UK and US commenting to us that the research process here is at a higher level than any other country.[6]

3.17 The argument has been made by Mr Tim Murphy, co-Head of Fund Research at Morningstar that the rigour and independence of the investment research produced by the research sector in Australia has industry-wide benefits because:

> there were less product blow-ups here than in the US and Europe during and since the global financial crisis. On that score product providers, regulators, planners and consumers have been well served by a robust research house market.[7]

Research houses as gatekeepers

3.18 Lonsec explained that elements of the gatekeeper function in the financial services system have been outsourced to the private sector by the regulator. Research houses therefore perform a gatekeeper role that includes assessing products for risks and fitness for purpose:

> In contrast to a number of other industries governed by consumer protection legislation, the wealth management industry in Australia has historically

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4 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

5 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 15 July 2013).

6 Giles Gunesekara, Head, Third Party Sales, Principal Global Investors, cited in Jason Spits, 'Fund managers and research houses—a cold war thaw?', *Money Management*¸ 5 July 2013.

7 Tim Murphy, co-head of fund research, Morningstar, cited in Jason Spits, 'Research houses stand their ground', *Money Management*¸ 5 July 2013, http://www.moneymanagement.com.au/analysis/rate-the-raters/research-houses-stand-their-ground (accessed 15 July 2013).

> been lightly regulated. Political acceptance of popular economic theory currently dictates low intervention in financial markets in the name of market efficiency; this is not a peculiarly Australian phenomenon. Consequently, the powers of regulatory authorities (such as ASIC) to act as broad ranging 'gatekeepers' are relatively limited. Parts of the gatekeeper function are, by necessity, 'outsourced' from regulators to free market participants and the regulator's role becomes one of 'holding gatekeepers to account' for those functions. In more heavily legislated industries, regulators may undertake a wider range of gatekeeping activities including the assessment of product 'safety' (risks) and 'efficacy' (fitness for purpose). In the wealth management industry, this role is performed by research houses.[8]

The role of research houses and investment research and expectation gaps

3.19 Mr Richard Everingham, General Manager of Strategy and Development at Lonsec, stated that the role of a research house is 'to provide independent opinion on the quality of investment products in the marketplace'.[9] He noted that Lonsec achieved this by:

> issuing investment product ratings with supporting investment product research. Lonsec's ratings are determined on the basis of our level of conviction that the investment products can achieve their objectives and on our opinion of the relative attractiveness of the products versus their peers.[10]

3.20 Mr Everingham differentiated the role of the research house from that of a financial planner by drawing attention to the general nature of advice provided by research houses, and contrasting this with the client-specific advice produced by financial planners and advisers:

> Research houses also produce opinion on the nature of investment products, guidance on how to use them and what features and attributes they may have which may assist in determining investor suitability. However, this advice and opinion must by law be general in nature. We do not know the end investor and, as such, we cannot provide personal advice. This is the role of a financial adviser.[11]

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

9 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

10 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

11 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 6.

3.21 Lonsec claimed that some financial planners have misplaced expectations about the nature and use of investment research, and the responsibilities of the various players in the financial advice chain. In arguing the need for greater professionalism in some parts of the financial planning and financial advice sector, Lonsec drew an analogy between the role and responsibility of a medical practitioner in the health system and the role and responsibility of a financial planner or financial adviser in the financial services system:

> To illustrate this point, Lonsec draws a parallel between the medical 'advice chain' looking after an individual's 'physical health' and the financial 'advice chain', looking after an individual's 'financial health' (the latter expressed in brackets below).
>
> Few would argue that a doctor (advice giving intermediary) who prescribes an approved (rated) drug (product) to a patient (client) without first assessing whether a) it is the right drug for the right patient and the patient’s current circumstances (client suitability and client best interests), b) understanding what dosage is appropriate and when to take the drug (how to use the product, including portfolio weighting) and what interactions the drug may have with others already being taken (overall portfolio impact and correlations) has failed to discharge their duty of care (common law fiduciary duty, statutory 'best interests' duty) to their patient. The regulator (ASIC), the pharmaceutical company (financial product issuer) and independent advice giving bodies such as the National Prescribing Service - NPS (research houses) may provide information, education, and guidance which speak to these aspects, but ultimately the doctor must take this generalised guidance (general advice) and apply their education, training and experience to each patient's specific circumstance to make a holistically tailored recommendation (translate the general advice to 'personal advice').
>
> Despite this clarity in the medical advice chain, a significant number of participants in the financial advice chain, including financial planning industry associations, still argue and debate the respective roles of ASIC, research houses and financial planners. Research houses encounter misunderstanding, misconception and, in some cases, clear abrogation of responsibility from a subset of financial planners with respect to what constitutes investment research, how it should be used, its limitations and the respective responsibilities of all parties in the advice process.
>
> Specifically, research houses continue to encounter 'expectations overreach' from a subset of financial planners in the following areas:
>
> - What a rating is and is not and the degree to which it can be relied upon;
> - An expectation that it is the role of investment research to accurately and consistently predict, thus avoid, financial product failure;
> - An expectation that well rated financial products will consistently outperform their benchmarks over 'short term' periods;
> - An expectation that well rated financial products will offer 'downside defensiveness' when markets fall; and

- An expectation that all well rated financial products are suitable for all clients.[12]

Research house business models and conflicts of interest

3.22 Chapter 2 described the various research house revenue models including subscription fees paid by financial planners and financial advisers ('downstream' payments) and direct and indirect payments from fund managers ('upstream' payments).

3.23 A conflict of interest arises in the research function when a fund manager pays a research house (direct 'upstream' payment) to conduct research and produce a rating on one of their funds. However, depending on the business model, there is a range of indirect as well as direct payments that flow between fund managers and research houses.

3.24 In its submission to the Trio inquiry in September 2011, ASIC suggested that the government might consider banning payments made by fund managers and product issuers to research houses.[13] Yet there is no mention of this suggestion in the Regulatory Guide issued by ASIC in December 2012.[14] The committee was therefore concerned to understand the suitability and sustainability of the various business models used by the research houses, and the adequacy of the arrangements for managing conflicts of interest.

3.25 Lonsec argued that the business models operated by the research houses are a result of the financial planning industry being unable or unwilling to pay the research house sector for the full cost of producing investment research. Because of the cost sensitivity of the end-user, Lonsec claimed that 'the entire research house sector provides a materially discounted service to the financial planning industry'.[15]

3.26 As a consequence, Lonsec stated that 'a stand-alone, user pays research subscription business model is currently economically unviable',[16] and therefore some combination of payments from the issuers of financial products or cross-subsidization from other parts of the business is unavoidable:

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12 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, pp [5–6].

13 Australian Securities and Investments Commission, *Submission 51*, pp 83–84, Inquiry into the collapse of Trio Capital Limited, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

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

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

16 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [5].

> To ensure a sustainable business model, **all** research houses cross subsidise the cost of investment research production through accepting some combination of payments from financial product issuers, be they direct or indirect, and/or the operation of one or multiple ancillary business units (emphasis original).[17]

3.27 Lonsec pointed out that most users of investment research require 'high quality, timely research with sufficient breadth to provide an appropriate range of financial products for Approved Product Lists'. According to Lonsec, however, 'these three needs (*quality, volume, timeliness*) *are operationally conflicting and cannot all be individually optimised*' (emphasis original).[18] Given the operational constraints in the research market at present, Lonsec argued that the costs involved in producing enough high quality research are best met by direct payments from product issuers:

> Conducting sufficient volume of high quality *qualitative* research in a timely manner is very resource intensive and therefore very costly, and inherently difficult to scale up unless revenue is directly linked to research volume (as it is under a 'pay for research' business model) (emphasis original).[19]

3.28 Mr Everingham outlined the conflicts of interest that arise from the choices facing research houses:

> Research houses have a choice. They can adopt a model which is funded, in part at least, by the product issuer. Alternatively, they can cross-subsidise their research activities from other business units. These indirect conflicts generally arise through the activities of the other ancillary business units—not always, but generally. We believe—and we submitted this to ASIC in the RG79 process—that these types of indirect conflicts are potentially more problematic, because they are generally not disclosed. They are generally more multidimensional and they are generally not alerted to the end investor. The direct conflict in the pay-for-research model, on the other hand, is apparent and is disclosed. For example, the first line of our disclosure in our research report mentions that we are paid for the research process by the product issuer.[20]

3.29 Lonsec concluded that:

> the interests of all stakeholders - users of investment research (financial planners), consumers, research houses, Government and ASIC - are aligned

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

18 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [4].

19 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [5].

20 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, pp 10–11.

> and best served through the existence of a diverse, competitive and commercially sustainable research house segment.[21]

3.30 The implication of this argument is that if ASIC moved to ban the pay-for-ratings model, the sustainability of a substantial part of the research sector would be at risk and competition in the research house sector could be diminished.

3.31 Mr Mark Thomas, Director and Chief Executive Officer of van Eyk Research Pty Ltd, pointed out that the van Eyk subscriber-based business model represented the investor and that van Eyk research can only be accessed by those subscribers that pay for it ('downstream' subscription payments from financial planners and financial advisers).[22]

3.32 Mr Thomas distinguished between indirect payments related to use of the ratings material and the acceptance of payments to advertise in a research house magazine or attend a research house conference. He also noted that van Eyk discloses any indirect payments that it receives:

> I do believe that there is indirect and indirect. You need to look at indirect payments which relate to the process of using the ratings material. Some houses use a royalty system where they are paid by the issuer for the use of the rating. We operate a model which does not employ those sorts of indirect payments. We do have a magazine which has advertising in it. We do have, in that magazine, advertisements from fund managers who we have rated well—but who have also been rated well by our competitors. They put those badges of honour on their advertisements as well. But that is a commercial decision after the event—after the ratings process.
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> […]
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> The indirect side of it—yes, it is disclosed. We run a magazine. We have a conference. People pay to attend. They may also invite people to come along as their guest. But that is, again, an arm's-length piece.

3.33 Furthermore, Mr Thomas observed that in his consultation with ASIC, the key criteria that concerned ASIC was not necessarily the research house business model, but rather the research outcome, and in particular that the research results were free from bias. Mr Thomas pointed out that the research results produced by van Eyk illustrated his point:

> As it turns out, we recommend less than half of the investments we review and in our view that is an unbiased outcome.[23]

21 Lonsec Research Pty Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [1].

22 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 7.

23 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 7.

3.34 The contrast between the results generated under the van Eyk model and those generated under the pay-for-ratings model (that is, paid for by the fund manager or product issuer) were discussed. Mr Thomas argued that the higher level of recommendations given under the pay-for-ratings model indicated that the gatekeeper role of the research houses that used the pay-for-ratings model was being compromised:

> The point I would bring this back to is that it is really about results and independence around those results. When you look at a universe of investments, you need to make sure that you are assessing it on merit. In some cases you will recommend more on merit and in some cases you will recommend less on merit. But ultimately you need to make a decision and you need to provide that advice independently to your users. If you are providing advice and granting a positive recommendation to too many things, clearly you are not being a gatekeeper—at least not in my mind. We drew attention in our submissions to ASIC to the unbiased component. As part of that, we felt that there was clearly a need for higher levels of regulation in the payment-for-ratings process—because, on the analysis we had seen, there was a greater level of recommendation occurring there than on the other side, which is a purely subscription based mechanism where we are just providing advice to the investor and charging them for that.
>
> We recommended a couple of options there, which ASIC chose not to take notice of. One was a quota system of higher regulation if that situation were to occur.[24]

3.35 This perspective was disputed by Mr Everingham who argued that because Lonsec rated less than 20 per cent of the total number of funds in the market (in other words, it screened out most of the funds), the results would necessarily include a higher proportion of positive ratings:

> I think to complete that information we would like to say that the spread of ratings under a pay-for-research model is necessarily skewed to the right of the curve, if you like, because of the number of products that have been screened out or not rated. For example, Lonsec, which do operate under this research model, currently rate around 720 headline funds. These permeate through different tax structures and platforms and so forth, but it is essentially 720 funds. There are about 4,000 in the universe of the equivalent total headline funds. So you can see from that that we do not rate the vast a majority of funds. We have significant screening, significant filtering, and we would actually contend that the proposition that pay-for-research leads to a skewing of the ratings that are a positive is actually incorrect.[25]

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24 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 11.

25 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 11.

Perspectives on conducting internal research versus purchasing external research

3.36 There is a trend towards internal or in-house investment research being conducted by financial advisory businesses. Internal research is typically used to complement the external research that financial advisory businesses source from research houses.

3.37 Mr Tony Graham, Executive Director and Head of Macquarie Adviser Services at Macquarie Group, noted that Macquarie Group operated an in-house research function in partnership with external research houses.[26] Macquarie Group emphasised that it always sought independent external research on any managed fund:

> In Macquarie's financial advising business, a managed fund will only be considered for the investment menu if supported by at least one independent research report e.g. Mercer, Morningstar, van Eyk, Zenith, and Lonsec. If one doesn't exist and we feel there is a compelling reason to consider a fund, then we undertake our own in-house research. We may incorporate a form of research from the manager itself, but not solely rely on it.[27]

3.38 Mr Graham said that Macquarie Group was mindful of the business model used by the research houses, but that the more important criteria for Macquarie Group in choosing a research house for a particular piece of work was 'the expertise of the research manager. We are looking at the next layer down—their track record and depth of expertise in a particular area to help inform us even more'.[28]

3.39 Macquarie Group outlined the criteria that it uses to critically evaluate a research house report:

> Macquarie firstly considers the research house that is providing the report, e.g.:
>
> - its reputation;
> - whether the research report is paid for by fund manager or subscribers;
> - the expertise of the research house in the specific area.
>
> Macquarie’s advisers next consider the report itself and the level of detail provided on matters such as:
>
> - fund personnel;
> - history of the fund;
> - performance of the fund under different market conditions;

26 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, p. 8.

27 Macquarie Group Ltd, correspondence to the committee, 19 July 2013.

28 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, pp 8–9.

- investment process;
- decision making capability;
- experience of staff;
- funds under management (FUM);
- ownership structure;
- fees; and
- risks.

> Macquarie also considers the resources available to the research house, both personnel and analytical tools.
>
> We acknowledge that many financial advisers may only use one research house for a view on funds, given the high cost of having multiple providers.[29]

3.40 Macquarie Group also outlined the way in which a fund or product was added to the approved product list:

> Macquarie Advisers do not determine the funds or products which are available on our Investment and Product Menu, they are assessed by our Unlisted Investment Committee. In order for a fund or product to be proposed for consideration for inclusion to the menu (in the majority of cases), an investment grade rating by an external research house is required, as are other operational criteria. Failing that, or in the event of any change in rating or other criteria, supplementary research is undertaken by the MPW Research team and submitted to the Committee.[30]

3.41 Mr Royce Brennan, General Manager of Risk at BT Financial Group, said that from a trustee's perspective, research houses had expertise in different areas and that an important determinant in selecting a research house was the degree of expertise that the research house had in the relevant area. He noted that BT Financial Group had their own research internal research capability which they used to complement the work of the external research houses.[31]

3.42 BT Financial Group explained how their in-house research teams function:

> BT Financial Group is supported by two key in-house research teams, focusing on Advice and Fund Manager Governance.

29 Macquarie Group Ltd, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. 2.

30 Macquarie Group Ltd, answer to question on notice, 28 June 2013 (received 19 July 2013), p. [2].

31 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 9.

> *Advice*
>
> The Advice in-house research team is responsible for the review of investments to formulate an Approved Products List which provides guidance to financial planners when providing advice to customers.
>
> The team undertakes a formal research process to identify best of breed investment opportunities across all asset classes and product types. Investments are reviewed and monitored on a regular basis. We note that the in-house research team is required to assess internally and externally sourced products in the same way in its research assessment.
>
> The Advice in-house research teams have access to external research resources including Zenith Investment Partners, Chant West, JP Morgan, Bloomberg and Morningstar as inputs into the research process.
>
> For the Advice business, external research is also used to supplement broader investment choice for our external adviser networks.
>
> 1. *Fund Manager Governance*
>
> The Fund Manager Governance in-house research team is responsible for monitoring and oversight of all investments across our platform, superannuation and investment businesses.
>
> The team provides analysis and recommendations in relation to selecting investment options and appointing fund managers, as well as oversight and monitoring of investment options, for the platforms, superannuation and investment businesses.
>
> As well as undertaking its own due diligence on investment managers, the team has access to external research resources including Lonsec, Zenith Investment Partners, Chant West, van Eyk and Morningstar as inputs into the research process.
>
> One of the key functions of both in-house research teams is to support the delivery of quality outcomes to clients. We believe an in-house research function allows greater support that is tailored to the needs of our financial planning network and allows better oversight of the quality of the research conducted.[32]

3.43 Importantly, BT Financial Group pointed out that they do not offer incentives to their internal research teams to recommend that any particular product or asset class be placed on an approved product list.[33]

3.44 In explaining its approach to conflicts of interest in the research sector, Dixon Advisory made the point that external research is just one of many inputs into its investment advice:

32 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 4.

33 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 3.

> Dixon Advisory understands that most major research houses receive direct and/or indirect income that creates a perceived or actual conflict of interest. We prefer to source research from a provider that has either a clearly articulated business model or adequate disclosures of the conflicts so that we can assess the severity of the conflict and evaluate the research with this in mind. More importantly, we try to mitigate the impact conflicts of interest may have by only using external research as one of the many sources of information we use when considering an investment. We don't believe it is appropriate to use external research as the sole decision making criteria when recommending investments. [34]

3.45 Dixon Advisory performs some investment research in-house and noted that this is a trend within the advisory sector. It cited better focus and 'transparency over the quality' as an advantage,[35] but noted that in-house research can increase business costs and that 'it is not cost effective for a firm of our size to hire a full time research team to conduct all of the research our advisors and clients require'.[36]

3.46 Other factors that Dixon Advisory consider in making a decision about whether to purchase external research are the asset class or product type in question and the availability of external research:

> In practice this may mean that where we have a significant focus on an asset class or product type we will look to add capabilities to our firm so that we can conduct this research in house. For asset classes and product types that we only see as a small part of a diversified portfolio or that are extensively well covered by external research we will generally use external research.[37]

3.47 However, Dixon Advisory also recognise a dilemma in that the growing trend to in-house research could damage the business models of the research houses, which would have negative consequences for the advisory sector:

> the research houses need to remain profitable and limiting their revenue streams could lead to a scarcity of high quality affordable research – especially on smaller funds. This would be a counterproductive outcome.[38]

3.48 Dixon Advisory also commented on the claims made by Lonsec that the research houses provided a 'materially discounted service to the financial planning industry', noting that:

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34 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

35 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

36 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

37 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

38 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [3].

> If there was high quality independent research available in Australia that not only satisfied compliance requirements but also provided unique investment thesis, we would be willing to pay an appropriate price for this research. We have shown this by subscribing to international research on macro economic views from companies that have a pure independent business model.
>
> […]
>
> Ultimately it is up to research houses to prove to investors and the financial advising sector that the research that they sell will provide additional insights not available elsewhere. Until they can justify that the quality of their research is worth the cost they will not be able to charge the full cost of production.[39]

3.49 Lonsec said that the size of the financial advice licensee typically influences how they use internal and external research:

> Research from research houses is used by financial advisers in many ways, ranging from being 'hard coded' into the licensee's compliance framework to being just one input amongst a number in an overall internal licensee research effort. An example of the first approach, which Lonsec typically observes in smaller financial advisory practices, is where a licensee decrees that the Approved Product List (APL) comprises only Lonsec financial products rated Recommended or Highly Recommended (Lonsec's two highest ratings). Such licensees may also decree that the Lonsec's core 'model portfolios' are adopted as the licensee's 'model portfolios'.
>
> An example at the other end of the spectrum, which Lonsec typically sees adopted within the largest institutional advice businesses, is where research house research and ratings are used as a starting point and a back up to the internal research effort. These licensees typically subscribe to research from multiple external research houses. The in-house research team then does 'overlay' and 'gap' research, typically in areas of heightened end investor demand, heightened risk, heightened financial product complexity, or areas of perceived weakness in the external provider's capabilities. The in-house team prescribe their own ratings, select their own APL, and create their own model portfolios (often in conjunction with consulting input from a research house). The external research house research and ratings are not 'hard coded' into the licensee's compliance framework.

3.50 The advantages and disadvantages of the two approaches to using external research were outlined by Lonsec:

> The primary advantages of the former approach are cost savings and advice efficiency – essentially the licensee has outsourced the bulk of the financial product research process to a third party. A second advantage is that the size of the APL tends to be relatively large based on this type of blunt construction criteria and therefore there are fewer transition issues to

39 Dixon Advisory, *answer to question on notice*, 28 June 2013 (received 12 July 2013).

> consider when new financial advisers join the group (new financial advisers often bring with them clients who are invested into financial products that are not on the APL of the new licensee). A third advantage is APLs will be manufacturer agnostic and independent.
>
> The primary disadvantages of this approach are that the licensee has not refined the APL or model portfolios to suit their specific client base and the relatively large APL creates a relatively large compliance burden (and risk). A secondary disadvantage lies in the aforementioned over-reliance on ratings relative to other features and benefits of potential value to clients which may exist in lesser rated financial products. For example there may be 'Investment Grade' (this is the Lonsec rating below 'Recommended') financial products excluded from the APL which have better tax efficiency at certain marginal tax rates or better insurance features (for superannuation financial products) than the higher rated financial products included on the APL. Underlying clients of the financial advisers within this licensee will not have access to these financial products.
>
> The chief advantage of the second approach is greater overall due diligence and governance, and a more focused APL to meet the needs of the main end client types or end client scenarios which prevail in that group. A key disadvantage of this approach is cost – typically only the institutional licensees and the larger mid tier licensees operate in-house research teams in excess of 1 person, therefore the capacity to undertake meaningful 'overlay' or 'gap' research is limited. A secondary potential disadvantage is the possibility of restricted access of non-aligned financial product to the marketplace. Institutional advisory practices are vertically integrated and, subject to appropriate internal governance, 'group' or 'aligned' financial product may in some instances dominate certain sectors within the APL. Given APLs are often 'capped' in total size (to reduce compliance burden and maximise oversight and control) this can have the effect of blocking out 'non aligned' financial product from these APLs within certain sectors.

3.51 Lonsec concluded that investors benefit most when there is synergy between internal and external research teams:

> In Lonsec's experience the most effective outcomes for end investors occur when external and internal research teams work in tandem and the internal teams leverage the full range of external research services, such as investment consulting (for APL and model portfolio construction, and investment committee representation) and the option of direct access to Lonsec's analysts (to discuss financial products).[40]

Quality of financial advice and relationships that financial advisers have with research houses and fund managers

3.52 In its 2012 shadow shopping report on the quality of personal retirement advice provided by financial advisers, ASIC found that:

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40 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

- 39 per cent of the advice examples were poor;
- 58 per cent of the advice examples were adequate; and
- 3 per cent of the advice examples were good quality.[41]

3.53 Lonsec was also critical of the professional standards within segments of the financial planning industry, arguing that the industry in general made poor use of investment research, including failing to adequately match products with client needs:

> The first thing I will say is that by necessity that is a generalised statement. Of course there are many good financial planners. The issue that the industry has is that there are not enough of them. If you look at the ASIC shadow-shopping survey, from the last results five per cent or so were deemed good or better in terms of plans audited. In what we see, the use of research by the typical or average planner can perhaps be best described as a compliance tick or something akin to an insurance policy. It is purchased on price upfront and when something goes wrong the features of what you have purchased are closely scrutinised.
>
> In terms of the rating, we do our best in our reports to give guidance on how products should be used. We clearly make it known that a highly rated product is not suitable for everybody and we see it as the role of the financial planner to marry the product to the right client—to determine product suitability. We are making a statement about the outright quality of the product. The planner must sit in the middle between the product and the investor and determine whether or not it is the right fit. We take calls and get feedback. When you have a market downturn as severe as during the GFC you cop a lot of flack. These are points we make in our paper. They are a summary of the flack we have copped post GFC.[42]

3.54 Mr Graham said it would be 'very risky' for a financial adviser not to get independent research on a fund and that the common industry practice was to have independent research to support the advice that would be given to a client regarding a particular fund.[43] He noted that the current industry standard is for a financial planner or financial adviser to work from an approved product list. The approved product list is constructed based on independent research, which may be internal research and/or external research from a research house. Typically, an adviser may prefer to recommend managed funds, or direct equities, or there may be model portfolio

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41 Australian Securities and Investments Commission, *Shadow shopping study of retirement advice*, Report No. 279, March 2012, p. 8, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep279-published-27-March-2012.pdf/$file/rep279-published-27-March-2012.pdf (accessed 2 July 2013).

42 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 16.

43 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, p. 15.

structures from which an adviser may choose.[44] The model portfolios form the basis of the statement of advice.

3.55 However, Mr Everingham was critical of the minimal extent to which the research produced by research houses ends up in the statement of advice produced by a financial planner:

> The degree to which a research house's research makes it to the end consumer is dependent upon what the financial adviser decides to pass through. Our experience from our organisation, given the sorts of hit counts and so forth we can generate from our website, is that only the most rudimentary short-form pieces of research are making it into statement of advice plans that the financial planners approve.[45]

3.56 A key determinant of the quality of financial advice is the extent to which a financial planner or financial adviser understands the needs of their clients and carefully explain their recommendations. Dixon Advisory emphasised that:

> It is the role of advisers to understand what factors are important to their clients when making recommendations. Advisers in general can assist to clearly explain their role and their process for selecting investments to investors so that the opportunity for expectation gaps to arise is minimised.[46]

3.57 Part of the advice relationship with investors involves identifying the probability of various risks occurring:

> All investors (from institutional through to retail) are exposed to virtually limitless risk. This means that an important consideration is the probability of the risk eventuating. While investors need to be aware of the risks they are facing it is not helpful to highlight all risks equally as this detracts from the fact that the probability of each risk occurring is different.[47]

3.58 Ultimately, however, Dixon Advisory said that investors must take responsibility for the risks they are taking on by 'informing themselves using the information provided to them by advisers and other gatekeepers'.[48]

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44 Mr Tony Graham, Executive Director, Macquarie Group Ltd, *Proof Committee Hansard*, 21 June 2013, p. 18.

45 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 16; see also Lonsec Research Pty Ltd, answer to question on notice No. 6, 28 June 2013 (received 12 July 2013).

46 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [2].

47 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [2].

48 Dixon Advisory, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 17 June 2013, p. [2].

3.59 The Future of Financial Advice (FOFA) reforms place a statutory onus on financial planners and advisers to put the best interests of their clients first and to avoid conflicted remuneration. However, in the wake of the scandal involving the Commonwealth Bank and Commonwealth Financial Planning,[49] concerns have been aired in the media that when a financial institution creates financial products and also controls a financial advice network, a situation could still arise where the commercial interests of the licensee conflicts with the financial adviser's best interest obligation to their client.[50]

3.60 The committee put these concerns to both BT Financial Group and Macquarie Group. BT Financial Group replied that:

> As part of the recent Future of Financial Advice (FOFA) reforms, which we support, we have implemented new 'best interests' requirements to further support planners in demonstrating they have met their best interests obligations to customers.
>
> We have strong and well-established risk management and governance frameworks. These establish clear protocols for how we operate as a business, including the products we offer to our customers whether through our Approved Product Lists or otherwise. We accept that conflicts of interest may arise from time to time in the normal course of business. However, we are confident that we have appropriate processes and protocols in place for managing any such conflicts.
>
> In addition:
>
> - Our advisers are not restricted to recommending our products, and they can and do advise on and recommend other products to our customers.
> - We are continually improving our products to ensure they meet the needs of our customers.
> - We have strong controls in place to ensure that our advisers only recommend products when it is in the best interests of our customers. Our advisers are required to place customer interests above their own

49 Adele Ferguson and Chris Vedelago, 'Profit above all else: how CBA lost savings and hid its tracks', Weekend Business, *Sydney Morning Herald*, 1 June 2013, pp 8–10;
Adele Ferguson and Chris Vedelago, 'The boiler room—How the Commonwealth Bank's financial planners partied while their clients went bust', Business News, *Sydney Morning Herald*, 22 June 2013, pp 1 and 6–7.

50 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.

> and above those of the BT Financial Group and the Westpac Group, and there are consequences for our advisers if they do not do this.[51]

3.61 The committee also questioned BT Financial Group about whether its financial advisers were subject to sales targets, and any tensions that may exist for its financial advisers in meeting the best interests of their clients. BT Financial Group stated that:

> We do not employ advisers to sell products. We employ advisers to provide financial advice and to help meet the financial needs of our customers.
>
> We believe in the value of financial advice and we provide quality advice to customers in a strong and sustainable model.
>
> We do not impose product sales targets on any of our financial advisers.
>
> In the adviser channels we own (i.e. Securitor and BT Select) we work with financial adviser practices by helping them to attract and service customers but we do not specify sales or revenue targets for these practices or their financial advisers.
>
> The salaried adviser channels (e.g. Westpac Financial Planning and St.George Financial Planning) have revenue targets, and planners participate in a bonus scheme. All revenue (initial and ongoing), and all asset categories or products (ie. managed funds, direct equities, etc), are treated equally under this scheme. Salaried advisers are only eligible to participate in the bonus scheme if they have met certain requirements within a particular period (including feedback from customers and meeting compliance requirements). There are no sales targets relating to particular products, Westpac Group products or asset classes.
>
> We take our responsibilities seriously in supporting quality advice to customers. We require planners and management to comply with the law as well as applicable regulations and company policies. In particular, we require our planners to comply with best interest obligations and consequences of failing to comply are serious and can include withholding or cancelling a planner's bonus, performance management and, potentially, termination. We carry out regular auditing of planners. We also assess and review our obligations, key controls, including our monitoring system, at least annually.[52]

3.62 Macquarie Group explained its use of financial advisers as follows:

> Macquarie employs Financial Advisers primarily to provide financial advice and other related services to clients. It is not for the purpose of selling financial products, whether they are created internally or externally.

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51 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), pp 1–2.

52 BT Financial Group, answer to question on notice, 28 June 2013 (received 12 July 2013), p. 2.

> Macquarie Advisers do not have sales targets. There are performance related remuneration criteria in place, however, these apply equally to Macquarie issued and externally issued products (i.e they do not incentivise Advisers to recommend Macquarie products, rather than external products).[53]

3.63 Macquarie Group noted that the FOFA legislation may encourage greater collaboration between financial advisers and product issuers as financial advisers will now be required to have a better understanding of the financial products that they recommend to their clients:

> FOFA may create an incentive for financial planners and financial advisers to work more closely with fund managers and product providers, as they would be keen to ensure that products are developed to meet the needs of their clients, in terms of features, benefits, services, etc, to ensure that they satisfy the best interest duty obligations.[54]

3.64 Mr Martin Codina, Director of Policy at the Financial Services Council, noted that in relation to approved product lists and statements of advice, FOFA will not only impact on financial advisers, but will also oblige licensees to help their authorised representatives to give advice in the best interest of the client, and that taken together, this would provide 'quite a robust framework'.[55]

3.65 The committee also asked ASIC to comment on a situation in which the financial product manufacturer and issuer also owns a financial advisory network, leading to a potential conflict between the commercial interest of the product manufacturer and the financial adviser's best interest obligation to its clients. ASIC responded:

> Section 961J [of the Corporations Act] requires that if a provider knows, or reasonably ought to know, that there is a conflict between the interests of the client and the interests of the provider or an associate or representative, the provider must give priority to the client's interests when giving advice. This obligation applies to advisers working for an advice network that is controlled by a financial institution.[56]

Relationships between research houses and fund managers

3.66 As noted earlier, fund managers in Australia regard it as necessary to have their products rated before releasing them to market. Mr Spits found that a diversity of

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53 Macquarie Group, answer to question on notice, 28 June 2013 (received 19 July 2013), p. [1].

54 Macquarie Group, Statement to the Parliamentary Joint Committee on Corporations and Financial Services, 21 June 2013, p. 3.

55 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, pp 18–19.

56 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 6.

views on the relationship between research houses and fund managers exists, with some fund managers expressing the view that they are beholden to research houses that act solely in a gatekeeper role, whereas other fund managers see research houses in a much more collaborative way and view the financial planner as the ultimate gatekeeper. Fund managers that espouse a collaborative relationship note that feedback from research houses helps to increase the quality and sophistication of the financial product. Just as fund managers have different views on their relationships with research houses, there is a divergence of views among the research houses on their relationship with fund managers.[57]

3.67 van Eyk told the committee that it was not only financial advisors that practiced ratings-shopping, but there were also fund managers that would refuse a review because they feared a negative outcome. Mr Thomas said that research houses should disclose to ASIC those fund managers that refused to participate in a review:

> There are always going to be people who will shop something because they are looking for a different outcome. I would argue that it is not only the advisers who shop the ratings. The fund managers will also shop the ratings. We have had a number of fund managers refuse reviews from us because they knew they were not going to get a positive outcome. So they chose not to participate. That is something which RG 79 covers: we should disclose to ASIC which fund managers have refused to participate and for what sorts of reasons.[58]

Proposals for an industry body for the research house sector

3.68 Lonsec argued that an essential part of addressing the expectation gap between research houses and financial planners would be for the research house sector to form an industry body.[59]

3.69 In the wake of the Trio inquiry, Mr Everingham noted that the Financial Planning Association (FPA) had expressed a hostile stance towards research houses. He argued that one advantage of a research house industry body would be the ability to engage constructively with the FPA over points of difference 'and to try and come to some sort of consensus on the way forward'.[60]

3.70 Mr Thomas noted that the research houses do have 'informal gatherings where we have roundtables and discuss things' and that van Eyk 'would be favourable to

57 Jason Spits, 'Fund managers and research houses—a cold war thaw?', *Money Management*¸ 5 July 2013.

58 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 17.

59 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 16.

60 Mr Richard Everingham, General Manager, Strategy and Development, Lonsec Research, *Proof Committee Hansard*, 21 June 2013, p. 17.

regular communication'. However, he questioned whether an industry body was necessary.[61]

3.71 The different perspectives expressed by Lonsec and van Eyk on the need for an industry body probably speak to the intense competition in the sector and the division within the industry over the pay-for-ratings business model that was identified in chapter 2.

Responses to criticism of research house accountability

3.72 In the 'Bridging the Gap' session at the ASIC Annual Forum in March 2013, there were pointed comments about the influence that research houses exercised in the system, and in particular the impact that a rating has on the flow of new capital into a recommended fund.

3.73 While acknowledging that ratings do influence the flow of funds, Lonsec stated that this was primarily a function of the 'one size fits all' approach adopted by many financial planning licensees:

> There is no doubt research house ratings have influence on fund flows but this, in Lonsec's opinion, is primarily a function of the over reliance on ratings in isolation from the supporting research. Licensees ultimately control their APLs and have the responsibility and the authority to make the final call on what financial products are made available to their financial advisers to recommend to their clients. Research houses do indeed perform a filtering, sorting and relative assessment function, as ultimately expressed through ratings, but the licensee is ultimately the true gatekeeper. To the degree that licensees choose to determine their APLs through selecting only the highest rated financial products from a research house, the influence of research houses is obviously significant. Lonsec would contend however that this approach has disadvantages and is likely to become less prevalent with FoFA reforms now enacted.[62]

3.74 Another criticism broached during the 'Bridging the Gap' session centred on an apparent lack of accountability to which research houses were subjected: that is, there was a feeling that research houses did not have enough 'skin in the game' because they were not sufficiently accountable to the end-users of their products when their research was poor.

3.75 When this criticism was put to Lonsec, it observed that the research sector was commercially competitive, and that aggregated ratings performance was a determining factor in whether a research house would obtain or retain a contact:

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61 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 17.

62 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

> Research houses have strong commercial incentives to produce high quality research and ascribe efficacious financial product ratings. Firstly, as Australian Financial Services Licence holders, research houses are regulated by ASIC and are subject to meeting the relevant standards and requirements of the Corporations Act. If a research house fails to meet any of the required standards or requirements significant reputational damage would result. Secondly, research houses operate within a very competitive commercial environment. The marketplace for research is therefore self regulating. Research houses are typically engaged on short term contracts and purchasers of research can and do quickly strip market share from participants that are perceived to be managing their conflicts poorly or producing compromised or poor quality research.
>
> On a fund by fund basis, to Lonsec's knowledge, there are no linkages between the accuracy of ratings and recommendations and research house compensation. On an aggregated basis there is however a link. It is a common practice for research houses to be asked by their clients (or prospective clients during tenders) for aggregated attribution analysis of the performance of their ratings and model portfolios. During tenders, research houses are also asked what their research and ratings history has been with various failed financial products. The practice is well established and in Lonsec's experience the track record of the research house in these aspects typically forms a material component of the overall decision to retain or hire.[63]

A proposed role for ASIC in closing the expectations gap between research houses and financial planners

3.76 Lonsec made suggestions that ASIC could undertake to help close the expectation gap between research houses and financial planners. However, they prefaced this by reiterating their view that the inappropriate use of ratings by financial planners was the root cause of the problem:

> at the heart of the 'expectations gap' is an over-emphasis and over-reliance on the use of ratings in isolation from supporting research, and in isolation from fully formed views (at the financial adviser level) about how a given financial product should be used and who it is and isn't appropriate for. This can lead to a 'one rating fits all' mentality.[64]

3.77 Lonsec also laid out how it saw the role of the research house in relation to the financial planner:

> In Lonsec's view, research houses have a major role to play in helping financial advisers to reach an understanding of the nature of financial products, a moderate role with respect to understanding the appropriate use

63 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

64 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

of financial products and a minor role with respect to identifying investor types and investor scenarios best suited to financial products.[65]

3.78 While acknowledging that the FOFA reforms and the guidance in RG 175 would improve the quality of financial advice and help close the expectations gap significantly, Lonsec outlined proposals for ASIC intervention:

> ASIC could provide the marketplace with a statement as to what financial product ratings are (and aren't) and what they can (and can't) be relied upon for (by users of research). In particular, Lonsec believes an expectations gap will remain as long ASIC remains silent on the expectations from some users of research: that
>
> a) it is the role of research to accurately and consistently identify fraudulent conduct which may lead to financial product failure, and
>
> b) that research houses should be able to accurately and consistently predict extraordinary market events which may cause market and in turn financial product failure.
>
> ASIC could provide specific and granular guidance that before recommending a financial product it is the ultimate responsibility of the financial adviser, not the research house, to understand the following:
>
> <u>The nature of the financial product</u>
>
> How complex is the financial product? What assets or other investments does the manager of the financial product invest into? What drives the performance of those investments? What are the key risks of the financial product which pertain to the probability of: a) loss of capital, b) loss of income, and c) loss of access to the investment (liquidity)? What are the objectives of the financial product? What is the likely performance of the financial product under common market scenarios? How tax efficient is the financial product at various marginal tax rates? Where the financial product's objective is stated as a targeted return, what is the likely split of return between capital growth and income? How, at all, does the financial product take into account environmental, social, or governance factors? What other features and benefits accompany the investment (eg insurance within a superannuation fund, platform implementation, administration and reporting features and benefits where the fund is accessed via a platform). What are the costs of investing into the financial product and accessing any additional features and benefits?
>
> <u>The investor types or investor scenarios best suited to the financial product</u>
>
> Based on the nature of the financial product and the financial adviser's knowledge of individual client needs, goals, objectives, tolerances, preferences and financial literacy, which clients are suitable for the financial product?

65 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

> The appropriate use of the financial product
>
> For those clients deemed suitable, how does the financial product fit within an overall portfolio? What should be the maximum portfolio exposure limits (%) to the financial product? How is the financial product likely to interact with other investments within the portfolio (correlations)? What is the minimum time frame for investing into the financial product? What is the appropriate time frame to review the performance and efficacy of the financial product?[66]

3.79 Lonsec's criticisms do not apply to all financial advisory firms. As noted earlier, Dixon Advisory told the committee that a professional advisor must analyse a range of information from a variety of sources and that external research was only one input into informed investment advice.[67]

Committee view

3.80 This chapter has focussed on the role of research houses in the Australian financial system and in particular, their links to the upstream market (fund managers and product designers) and the downstream market (financial advisers and planners). It has noted that while ASIC has identified some measures to improve the quality of investment research in Regulatory Guide 79, there remain some fundamental systemic questions about the role of research houses, the utility of their products and the way they are remunerated.

3.81 The committee received some evidence that financial planners and financial advisers have not used research house reports to the extent that research houses would want. This may partly reflect the fact that financial planning firms have increasingly conducted their own in-house research; but it may also suggest that the type of general product research that research houses provide is simply not valued by financial advisers.

3.82 The committee believes that research houses' 'downstream' interactions with financial planners are particularly important. This is the 'user pays' business model. The utility of research houses, the quality of their research and the extent to which they should be held accountable for their output must all be linked to the end-users of their products—the clients of financial advisers and financial planners.

3.83 ASIC has told the committee that in using research house services, the financial adviser or planner will need to consider the business model of the research house, potential conflicts of interest because of the associations of the research house, how the research house selects products for rating, the methodology the research house employs and its spread of ratings. Even with this due diligence, it will be interesting to see whether the FOFA changes—with the best interest duty enshrined—

66 Lonsec Research Pty Ltd, answer to question on notice, 28 June 2013 (received 12 July 2013).

67 Dixon Advisory, answer to question on notice, 28 June 2013 (received 12 July 2013).

will change financial advisers' and planners' uptake of research house products. It may be that financial planners need to do more of their own research.

3.84 In this context, the upstream linkages between research houses and fund managers are of concern. This is the 'issuer pays' business model. The committee believes that research houses should carefully manage their pecuniary arrangements with fund managers, whether direct or indirect. To the extent that these arrangements exist, they should be disclosed to ASIC and to financial advisers that use the research. The committee also supports ASIC's position that robust controls should be in place to ensure fee and contractual arrangements, relationship management and/or ancillary business units are kept separate from the ratings process and outcome.[68]

68 Australian Securities and Investments Commission, answer to question on notice, 27 June 2013 (received 23 July 2013), p. 4.