

Chapter 5

Further topics of discussion at the gatekeeper roundtable

5.1 This chapter presents a range of other topics that were considered during the roundtable, including:

- regulation of the self-managed superannuation fund (SMSF) sector;
- integrated reporting;
- the granting of an Australian Financial Services Licence (AFSL);
- detecting fraud;
- the challenges and opportunities of new communications technology;
- the merits and disadvantages of passive index funds versus active asset management; and
- the balance between market efficiency and investor protection in the financial services system.

Self-managed super funds

Regulatory frameworks for self-managed superannuation

5.2 There are crucial differences in the levels of responsibility and risk between the registrable superannuation entities (RSEs) regulated by the Australian Prudential Regulation Authority (APRA) and SMSFs that are regulated by the Australian Taxation Office (ATO). An APRA-regulated superannuation fund has a board of trustees and the members are eligible for compensation in the event of fraud or theft. This is not the case for an SMSF where the members are the trustees and must take personal responsibility for the management and protection of their assets.

5.3 van Eyk argued there was a discrepancy between the regulation in the financial planning sector which operates under model portfolios, platforms overseen by responsible entities (REs), and boards of directors in the case of the regulated superannuation sector, and the minimal regulation of advice provided to SMSFs:

if you compare the regulation required around providing advice in the self-managed space, it is far less than it is for the financial planning industry, which operates under this model portfolio approved investment list, which is typically off platforms that have responsible entities and which have higher levels of governance, if it is superannuation. There are independent boards that sit for products to come on and off. There are limitations around single-purpose hedge funds. There are limitations around leverage et cetera.

If you are looking for gaps in the system, I would say that the largest gap that you have at the moment would be around the regulation of self-managed super funds.¹

5.4 The Financial Services Council (FSC) gave a comprehensive update on the state of regulation in the SMSF sector, including recent changes pertaining to recognised accountants. It stressed that the essential differences in levels of responsibility, risk and protection between APRA-regulated and self-managed superannuation funds need to be communicated clearly in order to avoid an expectation gap regarding the level of oversight in the SMSF sector:

The SMSF regulatory regime, primarily overseen by the ATO, is largely distinct from the regime that applies to APRA regulated funds. This reflects the nature of the two types of funds – one where a third-party trustee is responsible for members' monies and the other where the member takes personal responsibility for the management of their own money.

As a result, the respective regulatory frameworks are also very different – as are the dynamics of each sector, most obviously in terms of the number of each type of fund. There are only a few hundred funds overseen by APRA versus over 470,000 SMSFs overseen primarily by the ATO.

It is not possible for there to be the same level of oversight of over 470,000 funds as there is over only a few hundred. It is arguably also not appropriate for there to be the same level of oversight given the key distinction between these funds – self managed versus third-party managed. Nevertheless, this may in itself give rise to an expectations gap if there is an assumption that the same level of oversight exists.

The FSC believes that this is the central distinction that should be conveyed to individuals who seek to establish or are advised to establish a SMSF. The key differences in levels of responsibility, risk and protection between self-managing your superannuation via an SMSF or relying on a third-party APRA regulated trustee to oversee your superannuation.

Beyond this, the most commonly cited regulatory gap in relation to SMSFs has traditionally been the carve-out for accountants under the Corporations Act which allowed them to provide SMSF establishment advice without being subject to the relevant protections under Chapter 7 of that Act.

However, as part of the Future of Financial Advice (FoFA) reforms, the *Corporations Amendment Regulation 2013 (No. 3) Select Legislative Instrument No. 101, 2013* requires recognised accountants to be Licensed to provide financial services such as advice on financial products. The regulation now brings recognised accountants within the Corporations Act (and FoFA), closing the regulatory gap and improving the quality of advice that SMSF trustees will receive in the future.

1 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 19.

In addition, the FoFA reforms impose a number of higher conduct requirements on all Australian Financial Services License holders who provide financial services including the provision of financial advice. The reforms include a statutory best interest duty and a ban on conflicted remuneration along with various new disclosure requirements.

Finally, a further strengthening of the regulatory framework in relation to SMSFs was the recent introduction of a requirement for SMSF auditors to register with ASIC. To be successfully registered, auditors are required to pass a competency exam, have certain educational qualifications and supervised experience.

Notwithstanding the perceptions and/or expectations gaps, the FSC is of the view that it is important to analyse the impact all of these reforms will have on the uptake of SMSFs, and the types of individuals who decide to establish SMSFs, before determining that further regulatory change is required.²

5.5 Ms Volpato from the Australian Institute of Superannuation Trustees (AIST) said that the most effective way to communicate with investors about the risks involved with SMSFs would be for financial planners and financial advisers to have an official leaflet to hand to investors clearly stating that people setting up an SMSF do so at their own risk. She argued that placing the same information on the ATO website would not be as useful because there is no guarantee that investors would receive the information.³

5.6 The committee believes that both options are important. It recommended in its report into the collapse of Trio Capital that the ATO include a warning on its website that SMSFs are not covered in the event of theft. The committee notes that the ATO has posted information on its website explaining that 'SMSF trustees have fewer avenues of recourse against fraud and theft compared with trustees of APRA-regulated super funds'.⁴ However, the warning is not prominently placed on the website.

5.7 Ms Nerida Cole, Managing Director of Financial Advisory at Dixon Advisory pointed out that SMSF trustees must sign an ATO declaration acknowledging the SMSF sector has limited access to compensation arrangements:

...my understanding is that it is a requirement of the ATO for trustees to sign a declaration upon commencing a self-managed super fund, which lists

2 Financial Services Council, answer to question on notice, 28 June 2013 (received 17 July 2013).

3 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 4.

4 Australian Taxation Office, 'Legal Protection for SMSFs', <http://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/News/General-information/Legal-protection-for-SMSFs/> (accessed 19 July 2013).

a number of specific risks including the limitations for the compensation scheme arrangements that they have access to and that must be signed before they can commence a self-managed super fund. That is certainly a process amongst other disclosure and education requirements that we try to go through with our trustees before they commence the self-managed super fund.⁵

5.8 One Investment Group thought that public expectations around SMSFs may be unrealistic. Mr Epstein questioned the ability of the average Australian to run an SMSF, emphasised the need for portfolio diversity, and suggested the requirements to establish an SMSF should be set higher:

We have to question whether the hurdles for an individual to run a SMSF are high enough. I do not think that an investor can invest in any product without reading anything and assume that the product is going to be a good product. I do not think it is reasonable to expect that an average Australian can actually run an SMSF. If we relate it back to the property comment and expect that they are going to only invest in property, I do not think that that is a diversified portfolio that warrants the investor investing on that basis.⁶

5.9 Ms Cole said that as a financial planner, she would be very concerned that any SMSF would place all their funds into one asset:

any SMSF that would have 100 per cent of their funds in one single asset is taking on an extreme amount of risk and would not be something that a prudent investor or adviser would be normally recommending.⁷

5.10 CPA Australia agreed that the best interest duty required a financial planner or adviser to recommend a structure that is appropriate for the client and their desires. Mr Amir Ghandar, Policy Adviser at CPA, noted that SMSFs will likely be a key vehicle for many investors, but also noted that APRA-regulated funds are now offering greater flexibility for people to choose their investment portfolios:

So, if the client is interested in property—and as we know, that is a large part of Australian culture—and wants to invest in direct property, then SMSF is probably the only vehicle that provides them with that capability.

With regard to the question around the desire to invest in direct equities, that again, probably, has traditionally been the domain of the self-managed super fund, although it is interesting to see APRA-regulated funds now moving into that capability. To me it boils down to the point that, as long as the adviser is acting in the best interest of the client, the SMSF has a

5 Ms Nerida Cole, Managing Director, Financial Advisory, Dixon Advisory, *Proof Committee Hansard*, 21 June 2013, p. 9.

6 Mr Justin Epstein, Executive Director, One Investment Group, *Proof Committee Hansard*, 21 June 2013, p. 9.

7 Ms Nerida Cole, Managing Director, Financial Advisory, Dixon Advisory, *Proof Committee Hansard*, 21 June 2013, p. 19.

valuable part to play, if that is the desire of the client in terms of the way they want to invest.⁸

5.11 Ms Volpato agreed with the Future of Financial Advice (FOFA) process and the best interest duty as it relates to SMSFs, but argued that a key deficiency in the current process is the lack of understanding that a client has about what is actually recommended in the statement of advice. She proposed that advice should be formatted in a manner that people could easily understand, and that this approach should be tested on the end-users.⁹

5.12 Ernst & Young agreed 'that the overall framework associated with self-managed super is not as robust' as the APRA-regulated sector, but he noted (as mentioned earlier by the FSC) that ASIC has introduced a registration requirement for external auditors of SMSFs that operates from 1 July 2013. Mr McKenzie said that standards for SMSF auditors have risen, and that the registration requirement appears to have significantly reduced the number of auditors qualified to sign off on SMSFs.¹⁰

5.13 The AIST raised a series of concerns about the SMSF sector. It emphasised the importance of the safety of superannuation savings, noted that rigorous governance is required for all superannuation monies, and stated that:

Expectations of and behaviours within SMSFs should, so far as possible, be placed on a level playing field with the rigorously governed APRA regulated funds.¹¹

5.14 In support of this, the AIST made a series of recommendations for both the decision-making stage of establishing an SMSF, and for when an SMSF is operating:

Stage 1—Decision making phase of establishing an SMSF

- The current accountant's licensing exemption of 3 years to 1 July 2016 to provide advice regarding SMSFs should be removed, or at a minimum brought back to 6 months;
- AIST welcomes the Moneysmart Self Managed Super June 2013 fact sheet. AIST recommends investigating how to ensure that distribution of this fact sheet to a client is a requirement where an accountant or financial planner is recommending establishment of an SMSF. AIST notes that the current requirement that potential SMSF new trustees must sign a form saying they are

8 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, p. 21.

9 Ms Karen Volpato, Senior Policy Adviser, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 21 June 2013, p. 20.

10 Mr Graeme McKenzie, Partner and Global Head of Pensions, Ernst and Young, *Proof Committee Hansard*, 21 June 2013, p. 19.

11 Australian Institute of Superannuation Trustees, answer to question on notice, 28 June 2013 (received 18 July 2013), p [2].

aware of their responsibilities insufficiently highlights the lack of regulator coverage. A warning from the regulator would have more weight; and

- SMSF trustees must be required to have accredited training prior to establishing an SMSF.

Stage 2—SMSF up and running

- SMSFs will be a major recipient of the efficiency reforms which SuperStream will bring. While AIST believes that these efficiencies will be forthcoming, it is estimated that the cost of implementing these reforms is \$467 million. However, it is APRA regulated funds which will bear these costs. AIST recommends that SMSFs should also be required to bear some of these costs, since they participate in the system; and
- SMSF trustees must be required to continue accredited training each year while managing.¹²

Integrated reporting

5.15 The usefulness of audits and company reports has been a key challenge for investors in deciding on their investment strategies. The committee notes that on 20 February 2013 in the *Australian Financial Review*, Luke Sayers, Chief Executive Officer of PricewaterhouseCoopers Australia, said that as the complexity of issues facing business grows, an expectation gap has arisen between what auditors do and what market participants assume or expect from an audit. Mr Sayers said that in order to 'maintain its relevance, the audit profession needs to acknowledge this expectation gap and look for ways to formally adapt the scope of what we do'.¹³

5.16 One initiative intended to address the challenge of meaningful information is integrated reporting (IR). IR is a new corporate reporting model being developed at a global level by businesses and investors. CPA Australia has indicated that the instigation of integrated reporting on a global scale offers the prospect of presenting relevant information including 'increasingly complex business models and systems' to the investor in an easily digestible format.¹⁴

5.17 IR is designed to support 'better decision-making by providers of financial capital'.¹⁵ According to Mr Paul Druckman, Chief Executive Officer of the International Integrated Reporting Council (IIRC):

12 Australian Institute of Superannuation Trustees, answer to question on notice, 28 June 2013 (received 18 July 2013), pp [2–3].

13 Mr Luke Sayers, Chief Executive Officer, PricewaterhouseCoopers Australia, 'Auditor's role needs to evolve', *Australian Financial Review*, 20 February 2013.

14 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, pp 21–22.

15 International Integrated Reporting Council, *Integrated Reporting—Business leaders: what you need to know*, p. [2], <http://www.theiirc.org/wp-content/uploads/2013/04/Business-Leaders-What-you-need-to-know-English.pdf> (accessed 16 July 2013).

IR is the essential next step in the corporate reporting journey. It anchors the reporting process in a more meaningful expression of how value is created which is helpful in attracting investment. It also focuses businesses and investors on the short, medium and long term factors that are vital to achieving the macro aims of financial stability and sustainability.¹⁶

5.18 IR and the benefits that it offers to investors were explained by CPA Australia as follows:

Integrated reporting or IR is a comprehensive framework to concisely communicate varied and often complex aspects of organisations, normally contained within multiple reports and other sources, in a unified and holistic way that investors can understand, and that is practically useful in informing their decision making. Importantly, IR responds to the growing need for insight into business models, risks and future prospects which have been highlighted in discussions of expectation gaps of the Committee and more broadly.

An integrated report is defined in the Consultation Draft of the International IR Framework as a concise communication about how an organisation's strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term.

The advantages of IR for both professional and non-professional investors include:

- a deeper and wider understanding of organisational practices, performance and prospects and improved long-term allocation of capital in potential or existing investments;
- more concise and accessible insights into material factors that create value over the short, medium and long term - of particular value to non-professional investors;
- concise and accessible answers to important questions including:
 - What does the organisation do and what are the circumstances under which it operates?
 - How does the organisation's governance structure support its ability to create value in the short, medium and long term?
 - What are the specific opportunities and risks that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
 - Where does the organisation want to go and how does it intend to get there?
 - What is the organisation's business model and to what extent is it resilient?

16 Mr Paul Druckman, Chief Executive Officer, International Integrated Reporting Council, *Integrated Reporting—Business leaders: what you need to know*, p. [4].

- To what extent has the organisation achieved its strategic objectives and what are its outcomes?
- What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
- enhanced performance through the promotion of 'integrated thinking' across organisations implementing IR.¹⁷

5.19 Mr Alex Malley, Chief Executive Officer of CPA Australia, is a member of the IIRC and his organisation has been extensively involved in the development of IR. In terms of the suggestion by Mr Sayers about adapting the scope of an audit, CPA Australia proposed two developments that would respond to changes in capital markets, the business environment and stakeholder needs:

1. reporting needs to evolve in order to give a holistic picture of business impact across the full range of dimensions, including financial, non-financial, governance, management discussion and analysis to provide for a deeper understanding of company practices, performance and prospects and improved long-term allocation of capital;
2. auditing will be critical in the reliability and hence usefulness of enhanced reporting. In turn, an established framework for reporting on business models and risks would provide a valid grounding for auditors to fulfil an enhanced role in respect to assurance around these aspects that are central to expectation gaps in regard to the work of auditors.¹⁸

5.20 CPA Australia notes that the first recommendation above would be substantially addressed by IR and that this could address many of the expectation gaps around the role of auditing. To this end, CPA Australia is pursuing several initiatives including the following:

CPA Australia has initiated an Australian Research Council linkage project working together with the University of New South Wales and the Institute of Chartered Accountants in Australia which is intended to make a substantial contribution toward the development of assurance in respect to (IR), and hence enable progress regarding this enhanced role.

CPA Australia has incorporated (IR) and a broad range of relevant topics including sustainability and governance into the CPA Program (CPA Australia's core professional qualification) and continued professional development courses for members. CPA Australia is also working with several Australian universities to incorporate such content into undergraduate programs.¹⁹

17 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

18 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

19 CPA Australia, answer to question on notice, 28 June 2013 (received 12 July 2013).

Granting of an AFSL

5.21 In its report into the collapse of Trio Capital, the committee noted that ASIC stated that its ability to restrict the entry of a participant into the financial services industry is limited. ASIC drew attention to the low threshold for obtaining an AFSL and the high threshold for it to cancel an AFSL.²⁰

5.22 One Investment Group disagreed with this view. It noted that sections 913B, 913B(3), and 914A(1) of the Corporations Act appear to grant ASIC sufficient powers to restrict and revoke the granting of an AFSL. One Investment Group therefore argued that investors rightly have an expectation that ASIC will act to keep out or remove undesirable participants from the financial services system in Australia:

Accordingly, the expectation of investors in relation to the issuance of an AFSL is justified. That is, the expectation that undesirable individuals or entities are restricted by ASIC from being involved in the financial services sector is a reasonable and appropriate one. In this regard, it would appear that ASIC's interpretation of the Act and specifically the exercise of its powers for issuing and restricting licences falls short of investors' expectations and arguably the intention of the financial services laws.²¹

Fraud

5.23 Many of the participants at the roundtable made several points in relation to fraud:

- it is very rare and is the exception to the rule;²²
- it is very difficult to detect;²³
- different gatekeepers perform checks at various points in the system;²⁴
- it affects only a tiny fraction of the total funds under management;²⁵

20 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 128.

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

22 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 14; Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15; Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

23 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 14; Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15.

24 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 14.

- it does not necessarily constitute a gap in the system, but rather a case of illegality which needs to be dealt with through the legal system;²⁶
- most people that have lost everything were in undiversified self managed superannuation funds;²⁷ and
- the RE has the capacity to scrutinise the investment managers and custodians, and select appropriate auditors.²⁸

5.24 The FSC noted that Australia has a \$2 trillion funds management industry and that the level of regulation and oversight by gatekeepers was an important factor in the low incidence of fraud.

5.25 Lonsec observed out that research houses do not have the capacity to consistently detect fraud or predict market failure:

Lonsec does not believe that research houses have either the knowledge or the expertise or the resources to accurately and consistently identify fraudulent conduct which may lead to financial product failure. Nor can research houses accurately and consistently predict extraordinary market events which may cause market failure.²⁹

5.26 BT Financial Group provided some statistics on the extent of identified fraud within its business and emphasised the gatekeeper responsibilities exercised by the RE:

In the last four years we have checked this, we have \$80 billion of Australian assets looked after under our responsible entity, as well as 1,100 investment funds and 170 investment managers. We have self-identified within all our scrutiny only one evidence of fraud which we were then able to bring to the regulator's attention. It does give it a sense of scale, but I do think it is very important that the responsibility entity has the capacity to scrutinise its service providers to a high degree—and those are the custodians—but they are also responsible for selecting an auditor with

25 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15; Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

26 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15.

27 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 15.

28 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

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

sufficient capacity and expertise to understand the nature of the investments that are being audited and so on.³⁰

5.27 Fraud involves deliberately deceptive conduct that is by its very nature difficult to detect. This raises several important points. Firstly, auditors and REs play a crucial role in detecting fraud. However, in a situation such as Trio where the directors of the RE are complicit in fraud, the gatekeeper role of the RE can be rendered impotent. This makes it even harder for an external auditor to uncover a well-concealed fraud. This scenario implies that whistleblowers play a very important role in the system by exposing fraud (and other forms of misconduct or illegal activity). Consequently, there needs to be an effective response by regulators to evidence provided by whistleblowers. Furthermore, despite regulations, it is not necessarily possible to prevent illegal activity. Therefore, deterrence is crucial. This means having effective legal and policing mechanisms in place to apprehend, convict, and punish offenders.

Challenges and opportunities of new communication technology

5.28 The committee was keen to see if developments in communication technology were seen as a tool for overcoming literacy issues and possibly for presenting information in multiple languages.³¹

5.29 Ms Cole replied that new technology presented both opportunities and challenges. She drew particular attention to the difficulty that some people may have in distinguishing between information and advice, and that fact that gatekeepers and regulators are looking at this as an issue of concern:

With regard to accessing advice in different ways, at the moment that is an exciting but also challenging space for advisers. I think FSC has been working, perhaps with ASIC, on some additional guidance around this. The amount of information and the format of what is available on the internet, via YouTube and different web seminars and webinars, for everyday investors to access is incredible. Some of that information goes quite a way along the process to what may be perceived by many investors as giving them advice. That differentiation between what is information and what is advice can be quite hard for them to gather. That will be a very interesting space to watch as well.³²

30 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 15.

31 Ms Deborah O'Neill MP, Chair, Corporations and Financial Services Committee, *Proof Committee Hansard*, 21 June 2013, p. 21.

32 Ms Nerida Cole, Managing Director, Financial Advisory, Dixon Advisory, *Proof Committee Hansard*, 21 June 2013, p. 21.

5.30 Ms Deborah O'Neill MP, Chair of the Corporations and Financial Services Committee, emphasised the importance of quality advice by pointing out that an investor may not always understand what is being advised at the time it is given:

As a former teacher, I know that there can be a very big gap between the delivery of information and the receipt of the same. Often we do not pay attention until we have to, and sometimes that can be long after the money is invested, hence the importance of the quality of the advice.³³

Index funds versus active management

5.31 As noted in chapter 2, the committee questioned the fund managers at the hearing about an American economist's claim that over the last 30 years, passively-held index funds had substantially out-performed the average active fund manager. BT Financial Group gave a comprehensive response, which is provided in Appendix 2. It noted that unlike a passive approach, an active approach can enhance risk adjusted returns, exploit pricing anomalies, pursue value investing strategies, engage in downside risk management, pursue different strategies at different periods in the market cycle, and consider the specific outcomes required by the investor. An active managed, it argued, 'needs to be good at picking stocks and also ensure the portfolio is appropriately diversified'.³⁴ BT noted that its active investment strategy has out-performed a passive benchmark over the last ten years.

The balance between market efficiency and investor protection

5.32 Australia's financial services regulatory system aims for efficiency, flexibility, competition, innovation and a low cost of capital. Retail investors have access to a wide range of products, including high-risk products. The system aims to prevent regulatory failure, rather than the failure of financial products. Indeed, as ASIC observed, the failure of a high-risk business strategy and consequent investor loss is an essential part of an efficient market.³⁵

5.33 Since the Trio inquiry, ASIC has suggested moving the balance between market efficiency and investor protection more in favour of retail investors. The committee sought the views of business and industry representatives on whether they considered that the balance in Australia between market efficiency and adequate protection for retail investors is right.

5.34 van Eyk observed that excessive regulation and an over-aversion to risk could undermine the end objective which was to ensure that compounded annual returns

33 Ms Deborah O'Neill MP, Chair, Corporations and Financial Services Committee, *Proof Committee Hansard*, 21 June 2013, p. 21.

34 BT Financial Group, *answer to question on notice*, 28 June 2013 (received 12 July 2013).

35 Australian Securities and Investments Commission, *Submission 51*, p. 14, paragraph 24(c), Inquiry into the collapse of Trio Capital, Parliamentary Joint Committee on Corporations and Financial Services, May 2012.

beat inflation, thereby ensuring that people's superannuation was sufficient to fund their retirement:

In respect of the comments I made previously around how the retail part of the industry gave advice—and that was a model-driven approach—typically in that there are balanced asset allocations varying in terms of exposure to shares and other risky assets and exposures to bonds, which are supposedly defensive assets and have performed very well in the last five years. There is an issue, though, that presents itself at the moment, and this touches on risk. I was interested in the comments made around trustees having to put their risk profiles in. The superannuation system is essentially unfunded for a lot of Australians. If you step back and you look at what is the issue here that we are trying to drive, it is about a lifestyle in retirement. There are some rogue investments, if I could categorise them in that space, and some of them have actually been in the conservative space. Look at some of those hedge fund strategies: they had very low volatility, which is one measure of risk. The question I would put is that we do not want to let the risk management cruel the end objective and make us take too little risk to meet our compounded annual return in excess of inflation. If we were to look at the current investments, a lot of the exposure is in bond markets, which are yielding one or two per cent, which is very unlikely to beat inflation, which is the real enemy in this whole process. So I would think that the major issue is: what are we doing around the defensive assets? A lot of these hedge fund strategies, which are difficult to look at, do operate in that low-risk space. Are we actually over-regulating in some spaces and not letting the natural course of the markets take its effect?³⁶

5.35 CPA Australia said that regardless of how the market is regulated, the key factor is the risk reward balance and supporting investors with the right information that is communicated in an easily understood format:

However you calibrate the market, investing is still going to be a matter of balancing up risks and rewards. We start with a belief that Australian investors, whether they are retail investors or professional investors, are focused on weighing up those risks and rewards in whatever way. What we can do to support them, what is really critical to do, is provide them with information that they can understand and use in order to make those kinds of decisions. We got onto the topic of too much information versus not enough information. What we need to be focused on, and what I think this forum is really fantastic in highlighting, is the right type of information and the right way of communicating with those stakeholders in a way that actually recognises their needs broadly and also in a way that they can calibrate individually.³⁷

36 Mr Mark Thomas, Director and Chief Executive Officer, van Eyk Research Pty Ltd, *Proof Committee Hansard*, 21 June 2013, p. 27.

37 Mr Amir Ghandar, Policy Adviser, Audit and Assurance, CPA Australia, *Proof Committee Hansard*, 21 June 2013, p. 27.

5.36 The FSC argued that in fact the pendulum has already swung towards greater investor protection with the raft of legislation and reforms that have been enacted in recent years.³⁸

5.37 BT Financial Group argued that the fundamental factor was risk appetite and getting the correct balance between risk and reward appropriate to the various stages of life. While asset allocation can be done at the individual or household level, Mr Brennan pointed out that BT Financial Group builds cohorts within their superannuation portfolios designed to match various age profiles of client groups. BT Financial Group trustees review the asset allocations within the portfolios on a regular basis, thereby relieving the individual of the need to check their asset allocation. Like Mr Thomas, however, he expressed concern that removing higher risk products may be counter-productive:

I do believe that the risk appetite is almost pertinent to the individual and the household. It really depends on whether you are at the beginning of life and just starting to build the pot to buy a house before you have got married, before you have got children, or you are at the end and the children have all left and you are about to start drawing down your pension. I think the fundamental to hitting that balance is actually the mix of assets that you hold, which is high-risk assets and low-risk assets. My fear, in the event of trying to go to a higher degree of investor protection, is you remove higher risk assets, which are actually an important part of a youngster's portfolio, perhaps. Then that turns you around to: how does one hit that balance? Unless you are highly versed in the financial markets, it is actually difficult.

One of the ways we do it in our superannuation product, our Super for Life, is we build cohorts within the portfolio so that if you are born in the 2000s, and therefore relatively young, the asset allocation is struck accordingly. Then as you get older the asset allocation is adjusted until you are approaching retirement and has much more lower risk assets. The trustees overview that asset allocation every six months to every year to ensure that it is operating as designed. By that method we try to glide people through to retirement in the best possible way. It also means that they can pretty much switch off that responsibility for how their assets are mixed. But for us to do that we actually need high-risk assets in the system. Does that make sense? There are two ways you can do it. You can do it as a household, or you can do it as a trustee on behalf of people who have gone into default—they have actually checked out of the decision.³⁹

38 Mr Martin Codina, Director, Policy, Financial Services Council, *Proof Committee Hansard*, 21 June 2013, p. 27.

39 Mr Royce Brennan, General Manager—Risk, BT Financial Group, *Proof Committee Hansard*, 21 June 2013, p. 28.

Committee view

5.38 This report has presented evidence on a range of issues relating to the role of the 'gatekeepers' in Australia's financial system—financial planners, research houses, RSE trustees, custodians, auditors and REs. The gatekeepers play a crucial role within this system to meet the overarching objective of protecting consumers, investors and creditors. ASIC enforces the Corporations Act and provides regulatory guidance to market participants. It is also responsible for maintaining gatekeepers' standards. In recent times, it has told research houses, auditors and some financial advisory firms that they need to improve their standards.

5.39 The gatekeepers are expected to self-regulate; to perform their respective functions according to the statutory requirements and in so doing provide investors and creditors with confidence that their interests are protected. It was of concern, therefore, that a consistent theme of the committee's inquiry into the collapse of Trio Capital was the gap in expectation between what was legally required of the gatekeepers and what investors and creditors thought was the gatekeepers' role.

5.40 The purpose of the committee's roundtable in June 2013 was to examine what each of the six gatekeepers viewed as their role, how they perceive the role and responsibilities of other gatekeepers, and how they interact. Chapters 3 and 4 of this report provided two angles to examine these complex interactions. Chapter 3 focused on the business model of research houses, and their interactions with financial planners / financial advisers and fund managers. Chapter 4 looked at how assets are valued and verified and the portfolio disclosure of managed investment schemes. Here, the focus was on the interactions between custodians, REs, trustees, and the auditors of RSEs and REs.

5.41 There is considerable evidence in both chapters 3 and 4 that the committee found very useful. It identifies the different business models used within gatekeeper groups (such as research houses) and areas of potential tension and misunderstanding between gatekeepers. Above all, the committee hopes that the roundtable and the information it has provided on the public record has generated interest—and areas for further discussion—among the various gatekeepers, their professional bodies and the wider investment community. It is important that there are future deliberative opportunities for the gatekeepers to engage with ASIC and the parliamentary process.

5.42 Over the term of this parliament, the committee has increased its ASIC oversight hearings from two to four per year. It has also used the oversight process to take evidence from a range of other stakeholders including the AUASB, the Financial Reporting Council and the Australian Stock Exchange, as well as the gatekeepers at the June 2013 roundtable. The greater focus on the committee's oversight process has been very useful: it has raised the committee's profile; allowed it to monitor ASIC's progress during a period of significant reform in the financial advice sector; focussed attention on gaps between what is expected of gatekeepers and ASIC and what they are actually required to do; and developed the committee's understanding of emerging

regulatory issues such as high-frequency trading and dark pools, and events such as the collapses of Banksia and Wickham Securities.

Recommendation 5.1

5.43 The committee recommends that the Parliamentary Joint Committee on Corporations and Financial Services in the next parliament continues to use the ASIC oversight process to monitor ASIC's activities regularly and closely, and raise the public's awareness of the roles and performance of the gatekeepers and statutory bodies in Australia's financial system. The committee believes that this forum is ideal for ASIC itself to clarify publicly what it does and does not do, and explain areas of emerging and ongoing regulatory concern.

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Chair