Appendix 2

Answers to questions on notice

Australian Securities and Investments Commission: answers to questions taken on notice 21 June 2013, received 23 and 24 July 2013

Question 1

Would the committee be able to receive, either in public or in camera, a copy of the legal advice that ASIC has received which doubts the likelihood of a successful prosecution against Mr Maher (formerly Gresham)?

Answer

The legal advice that was referred to by ASIC during its hearing before the Committee was advice about whether ASIC was in a position to seek orders preventing Mr Maher from travelling. ASIC has advice from Senior Counsel that it does not have reasonable grounds for bringing such an application.

ASIC is not in a position to provide a copy of Senior Counsel's legal advice to the Committee as we are concerned that to do so would waive legal professional privilege. ASIC is very reluctant to waive privilege in circumstances where we have an ongoing investigation of Mr Maher.

Question 2

Does ASIC have a view as to whether Mr Maher has purchased assets with the $2 million dollars that he received in undisclosed commissions from recommending the ARP Growth Fund and PPST?

Answer

In responding to this question we are presuming that the Committee is referring to approximately $2 million dollars in undisclosed commissions that Mr Maher received for recommending certain investments for PPPST.

As indicated previously, ASIC has not identified Mr Maher as owning any assets of any substance that could be pursued to recover funds for investors. In addition, ASIC is not aware of the liquidators of Trio Capital Ltd (in liquidation) finding any such assets.

Question 3

In its submission to the Trio inquiry, ASIC noted that the assurance standards that are relevant to a compliance plan audit do not have the force of law. ASIC suggested possible reforms to improve the effectiveness of compliance plans, auditors and committees. This included introducing an approval process for compliance plan auditors and civil liability provision for compliance plan audits.

a) What progress has ASIC made in this area and what feedback have you had from stakeholders?

Answer

Introducing an approval process for compliance plan auditors and civil liability auditors is a policy matter for government.

We are consulting with the Auditing and Assurance Standards Board (AUASB) concerning a possible update of its guidance for compliance plan audits in GS 013 Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes (GS 013), which was issued in August 2009. We wrote to the AUASB in November 2012 with the following matters:

(a) Form of revised pronouncement:

We recognise that the Board has issued GS 013 as a guidance statement because it:

(i) is largely a restatement of the law and ASIC guidance; and

(ii) is underpinned by the auditing and assurance standards.

Should the revised pronouncement include any additional requirements specific to compliance plan audits, the Board may wish to consider issuing a standard. While a standard would not have the force of law, it would be mandatory for members of The Institute of Chartered Accountants in Australia, CPA Australia and the Institute of Public Accountants.

(b) Revised ASIC regulatory guide:

ASIC intends to issue a revised regulatory guide RG 132 Managed Investments: Compliance Plans (RG 132) to provide enhanced guidance as to our expectations for the content of compliance plans. The revised RG 132 may also incorporate the guidance current in regulatory guides RG 116 to 120. The Board should consider the revised RG 132 in developing its revised pronouncement.

(c) Materiality:

The existing guidance on applying materiality in reporting by the auditor of non-compliances with a compliance plan resides in an ASIC Information Sheet. Recognising that reporting immaterial matters could detract from the identification of material non-compliances, we intend to continue this guidance but may include it in a regulatory guide.

(d) Other ASIC regulatory guides:

Since GS 013 was issued, ASIC has issued a number of regulatory guides that are relevant to specific types of registered schemes. The AUASB should consider the extent to which the following regulatory guides impact on the role of the auditor and should be addressed in an updated pronouncement, an updated GS 014 Auditing Mortgage Schemes or a separate new pronouncement. These regulatory guides are:

(i) RG 46 unlisted property schemes—improving disclosure for retail investors;

(ii) RG 45 mortgage schemes—improving disclosure for retail investors;

(iii) RG 231 infrastructure entities—improving disclosure for retail investors;

(iv) RG 232 agribusiness managed investment schemes—improving disclosure for retail investors; and

(v) RG 240 hedge funds—improving disclosure.

(e) ASIC audit firm inspection programme findings:

The Board should consider the extent to which findings concerning compliance plan audits that have been identified in ASIC's inspection of audit firms indicate matters that could be addressed in a revised pronouncement. These are outlined in our last public audit inspection report (Report 317 Audit Inspection Program Report 2011–12). While the matters identified by ASIC concern compliance by auditors with their existing obligations, AUASB standards or guidance may assist auditors in better understanding their obligations and conducting quality audits.

Some specific findings from our audit firm inspections are:

(i) Performing compliance testing only for selected schemes managed by a single responsible entity without due regard to differences between schemes and the controls operating for each scheme;

(ii) Failure by auditors of registered schemes relying on the report of an auditor of a custodian to ensure that the report addresses relevant aspects of compliance with the compliance plans of those schemes; and

(iii) Audit evidence not being obtained or insufficient documentation of audit evidence obtained.

Question 4

Under section 601HG(2) of the Corporations Act, the auditor of an entity's compliance plan cannot be the auditor of that entity's financial statements, although the auditors may work for the same audit firm. In its submission to the Trio inquiry, KPMG stated that the requirement for different persons to carry out the compliance audit and the audit of the financial statements 'increases disaggregation in the oversight of the MIS'.

(a) What is ASIC's perspective on this?

(b) What does ASIC see as the risks that might arise if the same person were permitted to carry out both types of audit?

Answer

The independence and objectivity of the auditor is an important contributor to audit quality and market confidence in the independence assurance provided by the auditor. Having a separate person within a firm audit the compliance plan to the auditor of the financial report of the responsible entity can only enhance the independence and objectivity of the auditors. The risk and perception that the auditor may be less willing to raise and report concerns in the compliance plan audit to avoid any impact on the relationship with the responsible entity and fees from that entity is reduced.

Question 5

At the time of the Trio inquiry, ASIC observed that Part 5C.4 of the Corporations Act:

- did not impose any qualitative standards by which a compliance plan auditor must conduct their audit;
- did not make it an offence to conduct a poor-quality compliance plan audit;
- only required the auditor to check compliance with the compliance plan, not the compliance of the RE with the constitution of the MIS; and
- unlike the assurance standards for an audit of financial statements, the assurance standards for a compliance plan audit did not have the force of law.

In your submission, ASIC provided a forward work plan which identified regulatory options for improving the quality of compliance plan audits.

(a) Can you outline your progress in each of the above areas since Trio?

(b) Since Trio, has there been a successful action against a compliance plan auditor?

Answer

We continue to review audits of compliance plans as a part of our inspections of audit firms. There have been no successful actions against a compliance plan auditor.

Question 6

As a result of the compliance plan audit inspections undertaken over the last year, has ASIC identified any further areas of systemic concern across the industry?

Answer

In addition to the matters mentioned in response to question 3, our November 2012 letter stated that our public report on audit firm inspections in the 18 months to 30 June 2012 identified the following concerns with compliance plan audits for managed investment schemes conducted under s.601HG(1) of the Corporations Act:

(a) Where functions such as custodial or investment administration or back-office accounting are outsourced, auditors often choose to rely on a report prepared by the auditor of the service organisation reporting on the design, implementation and/or effectiveness of operating controls, or in relation to specific assertions such as valuation and existence of investments.

(b) We found that auditors of compliance plans did not always obtain sufficient and appropriate audit evidence on which to base their conclusions in areas such as:

  (i) whether the compliance plan continued to meet the requirements of Pt 5C.4 of the Corporations Act;

  (ii) the adequacy of procedures for reporting and assessing breaches of the compliance plan;

  (iii) the assessment of whether the service organisation auditor's report could be relied on in relation to outsourced functions, risk assessments performed by the auditors, and the relationship to work performed on areas of the compliance plan audit; and

  (iv) the testing of specific areas, such as subsequent events up to the date of issuing the compliance plan audit report, net tangible asset calculations (for the responsible entity), and cash flow projections.

Question 7

Many frauds are undiscovered for some time and may only come to light because of a whistle-blower within the organisation. Directors are often seen as the principal gatekeeper with responsibility for detecting fraud. If the directors are in on the fraud, to what extent would ASIC expect a compliance plan audit to detect fraud?

Answer

A compliance plan audit is not designed to identify fraud. It might identify failure to apply controls which would have helped reduce the risk that the fraud occurred and in this way attract attention to a fraud. If incidentally to a compliance plan audit, the auditor has reason to suspect a fraud that would constitute a contravention of the *Corporations Act 2001*, the auditor may have an obligation to report the matter to ASIC under s.601HG of that Act.

Question 8

Given that a compliance plan auditor is only required to ascertain the compliance of an RE with its compliance plan, could you clarify for the committee who is actually responsible for ensuring that an RE adheres to the constitution of the RE's MIS?

Answer

A compliance plan audit also covers whether the compliance plan itself complies with the Act.

The responsibility for ensuring that a responsible entity adheres to the constitution is with the directors of the responsible entity.

Question 9

During the Trio inquiry, KPMG suggested a need for greater oversight of managed investment schemes. KPMG argued that one option would be to mandate a majority of truly independent directors of the responsible entity which would remove the need for a compliance committee. The second option is to strengthen the role of the compliance committees and hold management accountable for acting on the recommendations of the compliance committee.

(a) Could you comment on these two options?

Answer

The role of the compliance committee concerns the compliance plan and compliance with that plan. The directors have a broader responsibility in relation to the conduct of the overall scheme.

If there is a compliance committee with a majority of independent members with appropriate capacity, powers and duties, it is unclear on what basis there is a need for a majority of independent directors if the objective of the arrangements is to promote compliance.

It would not be appropriate to require officers of the responsible entity to be subject to direction by the compliance committee. Indeed that would undermine the compliance committee's capacity to provide independent oversight. If management is unable to address concerns arising from monitoring by the compliance committee, the compliance committee's function is to report the matter to ASIC.

Question 10

In ASIC's submission to the Trio inquiry, you noted that a MIS can be a complex product and yet there was no specific statutory requirement for the RE of a MIS to disclose its scheme assets at the asset level. This committee also recommended in its Trio report that the government release a consultation paper on this issue, a recommendation that the government has accepted.

(a) Could ASIC update the committee on progress in this area, including whether a consultation paper has been released?

Answer

See below.

Question 11

On 1 July 2013 under the Further MySuper bill, new arrangements come into force. The EM (pp. 39–40) provides the following example:

An RSE licensee (ABC Super) invests assets of their fund through a custodian. The custodian must invest as directed by ABC Super. The custodian, at the direction of ABC Super, invests assets in a financial product provided by Managed Investment scheme 1.

Managed Investment Scheme 1 makes investments into other managed investment schemes. It is a fund of funds.

Managed Investment Scheme 1 invests in a financial product offered by Managed Investment Scheme 2 by purchasing units in that scheme.

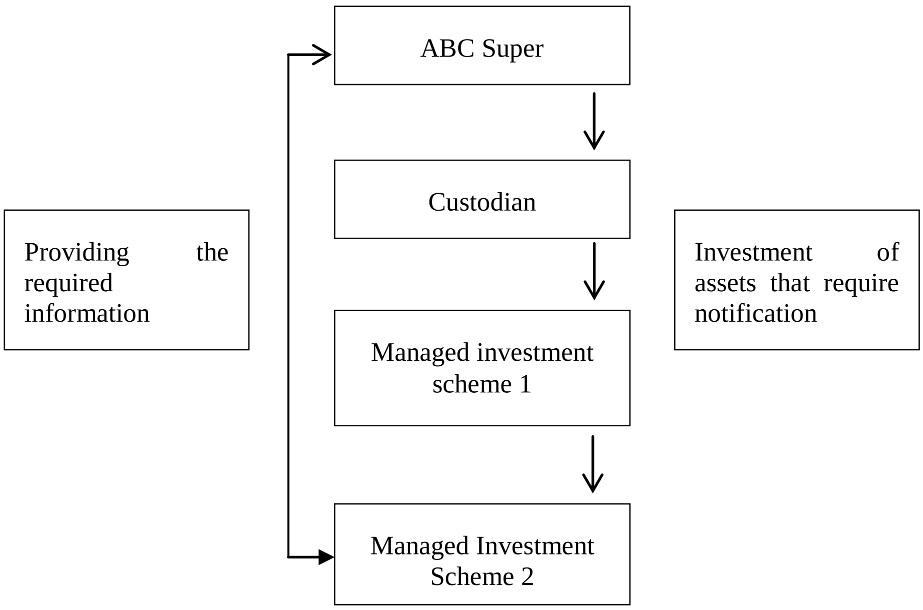
In this example, ABC Super must notify the custodian the assets are those of ABC Super.

The custodian must then notify Managed Investment Scheme 1 that the assets invested are those of ABC Super as it is an investment in a financial product.

Managed Investment Scheme 1 must subsequently notify Managed Investment Scheme 2 that it is investing assets derived from the assets of ABC Super as it is investing in another financial product.

Managed Investment Scheme 2 will have an obligation to provide information directly to ABC Super that is sufficient to identify its financial product and the value of ABC Super's investment.

The steps involved are set out in the Diagram.



(a) How will these arrangements improve the reporting of underlying asset values?

(b) What will these arrangements improve the reporting of underlying asset values?

Answer

See below.

Question 12

The committee understands that reforms proposed in the Further MySuper bill last year will be introduced via regulation and not through the enactment of the bill.

Treasury has begun to consult on the draft regulations. One of the proposed changes revolved around the obligations that were incurred when an MIS invested funds from a superannuation fund into a second MIS. The committee understands that the second MIS would be required to report back to the RSE trustee on its portfolio holdings.

Could you tell the committee whether that obligation would apply if the second MIS was an unregistered overseas fund?

Answers to questions 10, 11 and 12

ASIC has not produced a consultation paper at this stage, in relation to either managed investment scheme or superannuation funds portfolio holdings disclosure. At present, we are waiting for settled legislation, particularly with regards to portfolio holdings disclosure as part of the Stronger Super reforms. We are currently providing feedback and assistance to Treasury on the drafting of regulations in relation to portfolio holdings disclosure. These regulations will give greater detail to the requirements in section 1017BB of the Corporations Act 2001, as inserted by the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012 (Tranche 3). The Explanatory Memorandum for Tranche 3 is quoted in the question above. The timeframe for this aspect of the Stronger Super reforms has been changed in the Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act (Tranche 4) so that the first reporting date for portfolio holdings disclosure is 90 days after 30 June 2014, as opposed to its original timeframe of 90 days after 31 December 2013.

We may issue further consultation papers or regulatory guidance after these regulations are settled. We anticipate that there may be changes to these proposed regulations from original drafts that were circulated publicly in May 2013, following industry feedback.

In terms of the reporting of asset values, there is a proposed regulation that will enable ASIC to determine how assets should be valued and described: see proposed regulation 7.9.07W. These arrangements may help improve the reporting of underlying asset values as ASIC may be able to impose a consistent methodology for asset valuation.

However, we see the primary function of portfolio holdings disclosure to be increasing consumer awareness of the nature and types of investments being made by trustees with their superannuation monies. This enables people to better understand the risks associated with their investment and to monitor how the fund complies with its stated investment strategy. Greater transparency will also assist consumers to make more informed decisions about their superannuation fund and whether an investment option is suitable.

In the current drafting of the portfolio holdings provisions in Tranche 3, there are look-through arrangements that require managed investment schemes that are invested in by trustees to report back to the trustee as to where the money has ultimately been placed. There are jurisdictional limitations where the fund invested in is offshore. ASIC cannot insist on the offshore fund reporting to the trustee as to where the money has been placed. However, it is expected that the trustee would report the initial offshore investment to the extent that it is known to the trustee.

In the further regulations on portfolio holdings disclosure, there may be changes to the look-through provisions that are detailed in the question above.

We understand that the Government may be interested in extending similar portfolio holdings requirements to managed investment schemes following Trio. ASIC has consistently expressed its full support for this position. We consider that the primary function of portfolio holdings disclosure by superannuation funds, stated above, to apply equally to managed investment schemes.

Further, we remain fully supportive of industry initiatives with regards to improvements in portfolio holdings disclosure.

<u>Question 13</u>

In your submission to the Trio inquiry, ASIC stated that the government might consider banning payments by issuers to research houses for research.

(a) What has caused ASIC to change its position in the recent regulatory guide on research report providers?

(b) Does ASIC have greater concerns about particular types of business model employed by research houses?

<u>Answer (a)</u>

In our consultation paper, CP 171 Strengthening the regulation of research report providers (including research houses) released in November 2012, we consulted on whether conflicts of interest associated with product issuers paying for research: (a) can be effectively and robustly managed; or (b) should be avoided entirely.

We received 27 submissions in response to our CP. In response to our questions on the conflicts associated with issuer pays research, most respondents considered that this conflict could be managed with robust processes and appropriate controls. Many also noted that that there was a range of other business model conflicts that can have similarly adverse impacts on the quality, integrity and reliability of the research. Some respondents also noted that requiring avoidance of this conflict may have an adverse impact on the availability of research in the current market.

On consideration of the issues and submissions, our updated guidance requires providers who operate issuer pays business models to maintain robust controls to ensure fee and contractual arrangements, relationship management and /or ancillary business units are kept separate from the ratings process and outcome. We also expect clear disclosures for users of research that the research was commissioned and paid for by the issuer.

Our expectations of conflicts management for both direct and indirect business model conflicts is set out in Table 5 of Regulatory Guide 79 Research report providers: Improving the quality of investment research (RG 79). On releasing our updated guidance, we also committed to conducting targeted surveillance of research report providers to assess compliance with our updated guidance, measuring both broad compliance as well as discrete issues such as conflicts management. We have given a clear signal to industry that if standards do not improve, we will revisit the regulation of research report providers to consider whether specific law reform is needed. Further, we have also said to industry that if as an outcome of our surveillance activity, conflicts of interest for example, are not being managed appropriately; we will take regulatory action and if necessary, revisit the need to suggest law reform in relation to this sector.

Answer (b)

Different conflicts of interest are present or can arise across the spectrum of business models adopted by research providers. We recognise that the structure of a business can increase or reduce the incidence of conflicts of interest and expect research providers to consider the impact of conflicts in choosing their business model. We expect each provider to consider real and perceived conflicts of interest and where appropriate to manage the conflict with robust controls. Where conflicts of interest cannot be managed, we expect providers to avoid the conflict entirely. The effectiveness of these arrangements will be the subject of ASIC's surveillance activity.

Question 14

Does ASIC view research houses as providers of financial advice or as providers of information?

Answer

RG79.25 sets out what we consider to be a research report. We consider that a research report:

- is general advice that is in writing;
- includes an express or implicit opinion or recommendation about a named or readily identifiable investment product; and

- is intended to be, or could reasonably be regarded as being intended to be, broadly distributed (whether directly or indirectly) to clients (whether wholesale or retail) in Australia.

Question 15

Some participants at the ASIC Annual Forum expressed a desire to see research houses have more 'skin in the game' and face greater accountability for the quality of their research.

(a) Does ASIC believe that research houses have enough 'skin in the game'

(b) Is ASIC comfortable with the level of accountability to which research houses are currently subjected?

Answer (a)

Research is prepared and distributed to retail and wholesale clients and is an important input into the quality of financial advice retail investors receive. It is a commercial imperative for research providers to deliver research services that their clients can have confidence in. The changes we have made to our policy to improve the quality of investment research in RG 79, which comes into effect on 1 September 2013, are designed to assist wholesale clients, such as advisory businesses, to do their own due diligence on potential third party service providers such as research providers. Where the service offering is not of good quality or where conflicts of interest are not effectively managed, we expect purchasers of research services to 'vote with their feet' and choose alternative providers who can deliver quality, reliable services.

Answer (b)

We have said to industry that if, as an outcome of our surveillance activity, conflicts of interest, for example, are not being managed appropriately, we will take regulatory action and if necessary, revisit the need to suggest law reform in relation to this sector.

Research providers must hold an AFSL and comply with the general licensing obligations including those relating to the management of conflicts of interest and other obligations relating to the provision of general advice, and a range of prohibitions, including those against misleading and deceptive conduct, dishonest conduct and insider trading, for example.

Our policy settings in RG 79 update the regulatory framework and are designed to improve the production of research and to increase the sophistication of retail and wholesale clients in their level of reliance on research reports. In releasing our updated guidance for research providers, we clearly communicated our expectation that research providers needed to 'lift their game'.

Question 16

Financial planners pay research houses for the time and expertise that is involved in producing a research report into a fund or product.

(a) To what extent does ASIC then expect a financial planner to undertake their own critical evaluation of a research report and what does ASIC think this should involve?

Answer

Regulatory Guide 175 Licensing: Financial product advisers—Conduct and disclosure RG 175.314 - 317 sets out our guidance for advice providers using research reports. We expect advice providers to make inquiries and research the products they give advice on. Where they use research, we expect them to conduct due diligence on research report providers that they intend to use and our updated guidance in RG 79 will help them to do this. We consider the due diligence will need to consider the business model, conflicts of interest associated with that service provider, how it selects products for rating, the methodology it employs and its spread of ratings. This will help the advice provider to form a view about the service provider and the extent to which the adviser can rely on the research. Regardless of their use of third party service providers such as research providers, the advice provider remains responsible to the client for the advice they give.

Question 17

In its submission to the Trio inquiry, the Financial Planning Association (FPA) noted a conflict between the commercial interest of some licensees and the best interests of a financial planner's clients. The FPA recommended a statutory best interest duty 'for the consumer as a whole' to apply to all licensees and not just those dealing directly with retail clients.

(a) Could ASIC comment on this proposal?

(b) Does ASIC have any concerns that even after the FOFA reforms concerning 'client best interest' and 'conflicted remuneration' are in place, that when a financial institution creates financial products and also controls a financial advice network, the situation could still arise where the sales target of the financial institution conflicts with the financial adviser's best interest obligation to their client?

Answer (a)

Under the Corporations Act, licensees must do all things necessary to ensure that the financial services covered by their license are provided efficiently, honestly and fairly. Licensees are also subject to obligations under the ASIC Act including: implied warranties as to due care and skill and fitness for purpose. The desirability of law reform to impose further or more explicit obligations on product manufacturers to take account of the needs of consumers as a whole is a matter for Government.

Answer (b)

Section 961J 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. Regulatory Guide 175 states that in order to comply with this obligation, an advice provider must not over service clients to generate more remuneration for themselves or related parties where the level of service is not commensurate with the client's needs.

Question 18

In its submission to the Trio inquiry, the Financial Planning Association (FPA) welcomed the 'best interest duty' and the banning of commissions under the FOFA reforms. However, the FPA noted that product reform is not being addressed, including in the area of potentially misleading claims being made about products.

(a) Is ASIC considering ways to enhance the responsibility of product providers and fund managers in developing products for retail investors?; and if so,

(b) What consultation has ASIC undertaken in this area, what has been the industry response, and is ASIC considering anything more than appealing to the best interests of product providers and fund managers?

Answer

Answer not yet supplied.

Question 19

Does ASIC have an expectation that a custodian would communicate with an auditor when preparing net asset value calculations for an RE?

Answer

See below.

Question 20

Given that the requirements faced by a custodian appear to be primarily around the holding of sufficient assets, to what extent does ASIC view custodians as critical gatekeepers in the system as compared to the role played by auditors, research houses and trustees?

Answers to question 19 and 20

A custodian may or may not be engaged to prepare net asset value calculation for an RE. If a custodian does undertake an engagement to prepare net asset valuations, the custodian would not routinely consult with an auditor, whether the auditor of the RE, of the managed investment scheme or of the compliance plan for the managed investment scheme, in performing such calculations. On the other hand in performing an audit, an auditor may seek information from the custodian concerning the assets held, and the systems that the custodian uses to hold assets and in performing any calculation functions where it is relevant to the subject matter of the relevant audit.

In ASIC Report 291 ASIC stated that 'We consider custodians to be gatekeepers within the financial services industry, with responsibility in the product chain for the safe keeping of client assets'. It is not possible to assess whether a custodian is more or less 'critical' compared with auditors, research houses and even trustees or responsible entities - they all have a significant but distinct role to play. Custodians play an important operational role in the day-to-day activities of the finance industry and in keeping assets in custody. They are generally only engaged to act on authorised instructions of the RE. The role of a custodian does not include any investment management or other discretionary decision making powers in relation to those assets.

Question 21

What checks would ASIC expect a trustee to undertake to ensure that the data being incorporated into the net asset valuation calculations by a custodian are robust and correct and how would this work in practice?

Answer

In the context of portfolio holdings disclosure, it is the trustee that needs to be confident that the information they are disclosing on their website is accurate and does not contain misleading statements. The trustee needs to undertake whatever checks it considers appropriate to be satisfied that the information it obtains from its custodian is accurate.

In a superannuation context, APRA has some oversight of trustees and their relationship with material outsourced service providers, which may include custodians. For example, APRA may scrutinise the level of review that the trustee engages in with its service providers.

We note that as a result of Stronger Super reforms and changes to reserve requirements, an increasing number of trustees may opt not to have a custodian at all.

Question 22

Could you explain what you aim to achieve with consultation paper No. 204 into the risk management systems of responsible entities?

Answer

Currently, under the Australian financial services licence regime, licensees including responsible entities (REs) are required to comply with a general requirement to 'maintain adequate risk management systems unless the licensee is regulated by APRA' (s912A(1)(h) of the Corporations Act (the Act)).

Consultation paper 204 Risk management systems of responsible entities (CP 204) outlines our proposals to strengthen risk management systems in a way that fleshes out what is adequate and what is good practice in a more applied context and aims to help REs to better identify and manage the risks they face in the operation of schemes including strategic, governance, operational, investment and liquidity risks.

We propose these changes in CP 204 on the basis of the findings from ASIC's 2011–12 review of the risk management systems of a selected group of REs. The review found that the risk management systems vary significantly in sophistication with REs. For example, we have concerns that the non-APRA-regulated REs tended to have less comprehensive and sophisticated risk management systems.

CP 204 proposed to enhance the general risk management obligation in s912A(1)(h) by way of a class order to subject REs to targeted requirements in relation to their risk management systems, supported by industry specific guidance for the managed funds sector to supplement our existing guidance in Regulatory Guide 104 Licensing: Meeting the general obligations. The consultation ended in May 2013. Responses received were generally supportive of the proposals in CP 204. ASIC is in the process of finalising the proposed class order and regulatory guidance.

BT Financial Group: answers to questions taken on notice 21 June 2013, received 12 July 2013

<u>Question 1</u>

The 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, there is a concern 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.

<u>Answer</u>

BT Financial Group is the wealth management arm of the Westpac Group and in addition to other bodies is regulated by the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investment Commission (ASIC).

BT Financial Group takes its responsibilities as a gatekeeper and a financial services provider seriously.

We place customers at the centre of everything we do, which includes acting in their best interests when providing financial advice.

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 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.

Question 1(a)

The committee understands that BT Financial Group makes financial products and also employs advisers to sell those products. Can you comment on whether BT Financial Group's financial planners and financial advisers are subject to sales targets, and if so, could this create tension for your financial advisers in meeting the best interests of their clients?

Answer

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 (i.e. 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.

Question 1(b)

Does BT Financial Group take any responsibility for managing the conflict of interest that may exist for its financial advisers between the 'best interest' duty to their clients and a perceived or real need for the financial advisers to promote the financial products of the Group within which they work?

Answer

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.

Specifically, we take our responsibility for both the construction of the Approved Product List (APL) and providing an appropriate framework for meeting best interests requirements extremely seriously.

Our Advice business’ internal research team follows robust processes and established protocols to create APLs to ensure customers gain access to quality products. These protocols include an ongoing benchmarking process to compare products against peers in the market to determine their suitability for inclusion on the list. Members of the research team are not incentivised to recommend that any particular product or asset class be placed on an APL. These research criteria, including the benchmarking process, is applied consistently to all products whether internally or externally sourced. All decisions on APLs are made independent of product issuers, and the decision-making process has appropriate controls and oversight.

Planners are ultimately responsible for determining what products are appropriate for their customers’ circumstances. We support our planners in order to meet this obligation, and have trained the planners to understand our process to establish the APL and their responsibilities to ensure they have separately considered any product they are considering recommending in light of the customers’ needs and objectives.

Through our internal research team, clear guidance is provided to support our planners on what products may or may not be appropriate for particular needs and circumstances. We do not impose product sales targets on any of our financial advisers.

Planners are required to place customers interests first and in priority to their own or those of the organisation. We will continue to embed the FOFA driven changes through continued training, support, monitoring and testing.

Any failure to demonstrate compliance with the best interests obligations will result in significant consequences under our policies, which can include withholding or cancelling a planner's bonus, performance management and, potentially termination. In addition, planners may be subject to additional controls including increased monitoring and supervision, mandated para-planning and vetting.

Question 1(c)

If BT Financial Group does not rely solely on the financial adviser complying with the new FOFA reforms, what protocols does BT Financial Group have in place to avoid or manage this conflict should it arise?

Answer

We provide support in order to assist the planner in meeting these obligations, including through robust processes in order to set the APLs and other policies, training and monitoring activities. The planner is ultimately responsible for complying with the new best interests FOFA reforms as discussed above.

We have a number of protocols in place. These include:

- conduct and behavioural standards incorporated into employment contracts, and performance and reward schemes;
- strong and well-established risk and governance framework;
- well-developed, robust and regular assessment of licensee and general obligations and the control effectiveness in ensuring compliance;
- a strong risk culture predicated on the three lines of defence strategy independently assessed as effective with a high degree of management alignment;
- embedded compliance objectives in management Job Descriptions and 'Scorecards' with defined measures;
- a range of practical controls to ensure the right planners are recruited, planners are adequately trained and accredited (beyond current industry requirements), supervised and monitored. This is further supported by a range of policies and consequences framework where standards are not adhered to; and
- a range of tools, systems and reports that support planners, and management in managing against new, and existing obligations in the provision of advice.

Question 2

Does BT Financial Group have an internal research house function? If so, can you comment on the cost of high quality qualitative research from research houses relative to the cost of BT Financial Group conducting the same quality of research in-house?

Answer

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

(a) 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.

(b) 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.

Question 3

Is BT Financial Group a dual regulated entity offering both Responsible Entity and Registrable Superannuation Entity services? Are there advantages in being licensed to act as a Responsible Entity and as a Registered Superannuation Trustee, and if so, what are they?

Answer

BT Financial Group is a holding company and is not a regulated entity. However, there are some entities within its group that are dual regulated entities operating as a Responsible Entity (RE) of a number of managed investment schemes and as a Registrable Superannuation Entity (RSE) licensee, as trustee of a number of public offer superannuation funds.

An RE and RSE licensee are both trustees with statutory and fiduciary duties to hold and invest assets for the benefit of beneficiaries. While there are some differences between the duties of an RE and RSE, they are not as significant as their similarities. The Stronger Super reforms that have amended the duties of RSE licensees and their directors are very closely modelled on those that apply to REs.

By combining the roles of RE and RSE licensee in a single company and Board, the beneficiaries of the company's managed investment schemes and superannuation funds benefit from:

- the specialist expertise of trustee directors appointed for their relevant knowledge and skills;
- risk management and conflicts management systems directed to the roles and duties of trustees; and
- specialist advisers including in-house counsel, who specialise in advising trustees.

Question 4

Given that a compliance plan auditor is only required to ascertain the compliance of a Responsible Entity with its compliance plan, could you clarify for the committee who is actually responsible for ensuring that a Responsible Entity adheres to the constitution of the Responsible Entity's managed investment scheme?

Answer

The compliance plan of a registered scheme must set out adequate measures that the responsible entity is to apply in operating the scheme to ensure compliance with the Corporations Act and the scheme's constitution.

The Board of a Responsible Entity is responsible for ensuring that the scheme's constitution is complied with. BT Financial Group's compliance and governance framework is designed to assist the Boards of each company that acts as an RE to oversee the company's compliance with all of its legal obligations, including complying with the terms of a scheme's constitution.

Question 5

A paper just published in the Journal of Economic Perspectives by veteran American economist, Burton G. Malkiel,[1] indicates that over the last 30 years, passively-held index funds have substantially out-performed the average active fund manager. He also observes that the amount of under-performance is well approximated by the difference in the fees charged by the two types of funds. Mr Malkiel acknowledges that some active management is required for market efficiency because it ensures that information is properly reflected in securities prices. However, he found that 'the number of active managers and the costs they impose far exceed what is required to make our stock markets reasonably efficient.

(a) Can you comment on the rationale for the higher fees for asset management charged by fund managers when the evidence gathered by Malkiel for the last three decades indicates that a passive investment would have brought greater returns for the investor?

Answer

What is 'active management'?

Active portfolio management is the process of applying research and skill in order to deliver superior results over an index based passive exposure. Investment managers that apply an active strategy will tend to charge a higher fee than passively managed strategies but the true measure of success is the return generated for clients after taking into account the fees charged.

Active management can be considered at the asset allocation level as well as at the sector level. Setting strategic asset allocations for an extended period and having

1 Burton G. Malkiel, Asset management fees and the growth of finance, Journal of Economic Perspectives, Vol. 27, No. 2, Spring 2013, pp 97–108.

strategies passively rebalance does not take into account the ever changing nature of markets and investor behaviour. Active management at this level is synonymous to risk management and is imperative to maximising the probability of meeting return objectives for investors over the medium and longer term.

At a sector level, in many markets, the degree of overall alpha (excess return above a benchmark) available to all managers and investors will tend toward zero over time. But there will always be winners and losers and the success of a variety of strategies will vary greatly according to the market environment, risk appetite and return drivers over the period being measured. In Australian equities over the last 10 years, 1st quartile managers have delivered more than 1.2% above the index after taking fees into account (Mercers data to end May 2013).

Active management can increase returns

It is our view that an active approach can enhance risk adjusted returns. Alpha opportunities exist as markets are not always efficient, and this provides the potential for pricing anomalies which can be exploited. Skilful managers can extract alpha even after their costs are deducted. Some managers have unique insight and can exploit opportunities in different market conditions. Our approach identifies these managers and invests with them, employing a disciplined and repeatable process through qualitative manager research. We also change managers to suit the forecast market conditions.

An active approach can support a higher return objective for long term investors than a passive approach would allow. Their investments can be evaluated against an absolute return target, expressed as a return of a certain level over inflation (or 'CPI+'). Over time, a passive strategy will require a higher degree of market risk for longer in order to achieve the same result as a well-managed active strategy.

Economies go through cycles that favour different investment approaches at different times. Active management allows the risks associated with these cycles to be mitigated while the opportunities presented by these cycles can be exploited. Different investing styles (such as 'value' or 'growth' investing within equities) add value at different times and an active strategy can tilt a portfolio in favour of an outperforming style. A passive approach does not allow for this.

Active management can mitigate risks

In a GFC-like event, a passive approach will not engage in downside risk management which can lead to a higher degree of capital erosion. In fact, passive strategies that follow an index will tend to invest in the companies that go bankrupt and in the bonds that will default.

Past performance over the last 10 or 30 years is not necessarily indicative of future trends and outcomes. There is no guarantee that the investing environment is the same, and indeed there are indications that we may currently be going into a different environment. Passive investing cannot provide the downside risk management that is only possible with active management.

Investments need to be managed through the cycle and this can be achieved using active asset allocation. This involves tilting a portfolio by holding more in asset classes likely to outperform and holding less in asset classes likely to underperform. Our process reflects our long-term views on asset classes in our Strategic Asset Allocation (SAA). Risks to this view from volatility and turbulence are then mitigated through our medium-term Dynamic Asset Allocation (DAA) and our short-term Tactical Asset Allocation (TAA).

Passive management has its own issues

There are problems with passive management and viewing this approach as a 'base case' or starting position for investment is flawed. Most benchmarks that are tracked in a passive strategy are weighted by market capitalisation. This means that more of the portfolio is held in securities that are worth more, while less of the portfolio is held in securities that are worth less. This is somewhat arbitrary and is not necessarily an appropriate basis for structuring a portfolio.

The main issue with using market capitalisation as the only source of information is that as a price of a security relative to others increases, the passive approach will invest more in that stock. This effectively embeds a momentum process into the stock selection, emphasising past winners in the portfolio and ignoring value opportunities. It equates to buying stocks after they have become more expensive and selling them after they have become cheaper.

Modern portfolio theory suggests that once targeted returns are reached, gains should be crystallised through the sale of outperforming assets. This is not possible with a passive approach, where in fact the opposite occurs. When tracking a market capitalisation-weighted index, investors are forced to hold more of stocks that have increased in value and less of stocks that have decreased in value.

It is also our view that market capitalisation is not the only relevant measure of the future return generating capacity of a stock. A passive process assumes stock prices are always a reflection of true value. It ignores diversification across sectors and size and can lead to undiversified portfolios of assets. Additionally, the composition of indices changes over time. This introduces risks to the portfolio that could otherwise be addressed through active management.

Finally, a passive approach cannot consider the outcomes required by the investor. For example, in the S&P/ASX 200, there is presently a large overweight tilt to bank stocks. A passive investor will therefore have a corresponding large overweight allocation to this sector. This is a risk that passive investing cannot address.

Case study – Standish Mellon International Fixed Interest

We have invested in Standish Mellon's International Fixed Interest strategy since October 2005, providing almost 10 years of data and offering an observable outcome of active management over a passive benchmark. Since inception to May 2013, the Standish mandate has returned 10.24% net (after fees) annualised while the Barclays Global Aggregate (Hedged to AUD) has returned 7.69%. The active approach has outperformed by 2.55% annualised over this period. This outperformance is significant and justifies taking an active approach.

During this time, the bond market has gone through significant shifts, and by employing an active approach Standish has been able to accommodate these shifts, mitigate the risks and add alpha to the fund. A passive approach through this environment has not been able to deliver the same outcomes.

Investment theory and technical considerations

A passive investment strategy seeks only to earn the benchmark or market return, known as beta. An active investment strategy receives the same beta, plus the excess return of the manager, known as alpha. By definition, alpha is uncorrelated to beta. This means that the outperformance or underperformance of a manager does not depend on whether the overall market is going up or down. This makes alpha a valuable and efficient source of return.

By examining risk-adjusted returns using an Information Ratio, it can be demonstrated that an active approach can deliver higher returns per unit of risk than a passive approach. Looking at a Sortino ratio can show similar information and additionally identify the downside protection offered by a strategy.

'The Fundamental Law of Active Management', developed by Grinold and Kahn, states that a manager's information ratio is a function of the information coefficient and the breadth of investments. This means that the risk-adjusted returns that a manager delivers above a benchmark can be explained by the manager's level of skill and the number of investment decisions it makes. In other words, to achieve a good result, an active manager needs to be good at picking stocks and also ensure the portfolio is appropriately diversified.