Parliamentary Joint Committee on Corporations and Financial Services

Questions on Notice – 21 June 2013
Sydney

Statutory Oversight of the Australian Securities and Investments Commission: the role of gatekeepers in Australia's financial services system

Number	Witness
1	Australian Custodial Services Association
2	Australian Institute of Superannuation Trustees
3	Australian Securities and Investments Commission
4	BT Financial Group
5	CPA Australia
6	Dixon Advisory
7	Ernst & Young
8	Financial Services Council
9	Lonsec Research
10	Macquarie Group

Australian Custodial Services Association: answers to questions taken on notice, 12 June 2013.

There is no consistent single practice across ACSA members for the location of staff who perform net asset valuation calculations. That said, a common practice, especially with the global banks, is to have some of the pre-work and first order calculations performed in offshore locations. This can include trade and corporate action processing, sourcing of asset prices and initial validation checks. Where any use of offshore locations is conducted, the following principles are adhered to :

1) The staff performing the work are employed by the relevant organization. That is the work is not "outsourced" to a third party. They are staff of that organization and held to the same code of conduct and other expectations as if they were local staff.
2) Similar operational controls are performed as would be performed if the work was conducted locally.
3) The client location (in this case Australia) retains full accountability for the end product and often (but depending on each ACSA member's operational layout, possibly not in every situation) staff in Australia perform the final validation of the net asset valuation and release to the clients. This also means that the Australian staff would be responsible to explain any questions arising from the net asset valuation for the Australian clients.
4) The offshore locations are subject to Australian audit controls and oversight.
5) Onshore clients are able to visit and conduct due diligence of operations run outside of Australia.

It is worth noting that, where it is available, the use of offshore locations achieves a global best practice so that Australian investors get the benefit of scale, knowledge, operating controls and systems development that is representative of the same core business approach as for the largest global funds.

Australian Institute of Superannuation Trustees

18 July 2013

Dr Patrick Hodder
A/g Senior Research Officer
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House Canberra ACT 2600

Via email:

Dear Dr Hodder,

Gatekeeper roundtable - Questions on notice to AIST

AIST is pleased to provide its responses to the Parliamentary Joint Committee's questions on notice arising from the Gatekeeper roundtable.

Question 1 – What measures do trustees undertake to assess the source and adequacy of valuation data, particularly if parts of its unit pricing process are conducted off-shore?

In assessing the source and adequacy of valuation data, trustees may typically examine groupings of assets:

i. Listed assets in discrete portfolios

Listed assets within discrete portfolios happen where the fund appoints an investment manager and the custodian holds the account. In these cases, the trustee uses industry accepted standards of valuing these assets.

ii. Unlisted assets such as direct property and infrastructure

There is a formal process for the appointment and review of valuers by Investment Committees and Boards. As noted at the Sydney roundtable on 21 June, the custodian is not involved in this valuation process and therefore does not have information regarding these valuations. In addition to the formal processes of appointing valuers, a fund may also appoint a suitably qualified expert to undertake a due diligence process in terms of valuation practices. Directly held assets are valued by qualified experts.

Question 2 – 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 concerns reporting obligations when a managed investment scheme (MIS) invests 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.

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

Australian super funds use a "best endeavours" basis of gaining the underlying exposures, given that Australian law does not cover these jurisdictions.

Question 3 – Mr Thomas of van Eyk told the committee that 'the largest [expectation] gap that you have at the moment would be around the regulation of self-managed super funds and how people are being licensed to establish those in the first place' (Proof Hansard, p.19).

b. **Can you comment on this claim that the largest expectation gap is around the licensing and establishing of SMSFs? Do you see this as an area in need of reform and if so do you have any suggestions as to how the licensing system could be improved?**

Superannuation savings are critical to Australia's prosperity. Safety of superannuation moneys is needed so that fewer fall back on the Age Pension. It is therefore imperative that all superannuation moneys are required to be governed in a rigorous way. 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. To this end, AIST recommends the following changes:

Stage 1 – Decision making phase of establishing an SMSF

i. 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.

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

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

Stage 2 – SMSF up and running

i. 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.

ii. SMSF trustees must be required to continue accredited training each year while managing an SMSF.

AIST thanks the Parliamentary Joint Committee for both being invited to the roundtable and with the opportunity to respond to these questions on notice. If you have any further questions, please contact Karen Volpato, Senior Policy Adviser, on either or

Yours sincerely

Tom Garcia
Chief Executive Officer

Australian Securities and Investments Commission: answers to questions taken on notice on 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 PPPST?

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 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 AASB 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'.

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

(g) 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 s601HG(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.

(b) 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.

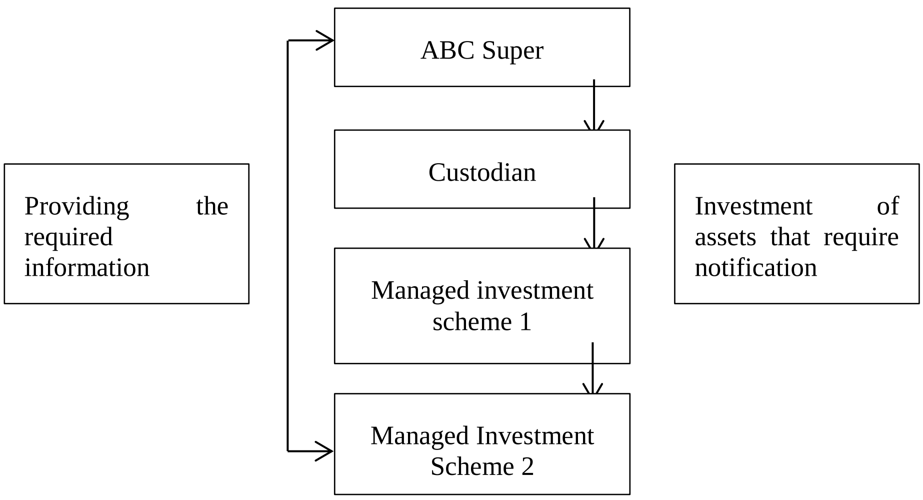
In this example, ABC Super must notify the custodian the assets are those of ABC Super.

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?

<u>Answer</u>

See below.

<u>Question 12</u>

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.

Question 13

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?

Answer (a)

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

No answer 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.

12 July 2013

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Email:

Dear Secretary,

Re: BT Financial Group – Response to Questions on Notice

BT Financial Group appreciates the opportunity to provide a response to the Committee's Questions on Notice arising from our involvement in the Gatekeeper Roundtable on 21 June 2013.

Question 1. 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:

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.

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?

We do not employ advisers to sell products. We employ advisers to provide financial advice and to help meet the financial needs of our customers.

We believe in the value of financial advice and we provide quality advice to customers in a strong and sustainable model.

We do not impose product sales targets on any of our financial advisers.

In the adviser channels we own (i.e. Securitor and BT Select) we work with financial adviser practices by helping them to attract and service customers but we do not specify sales or revenue targets for these practices or their financial advisers.

The salaried adviser channels (e.g. Westpac Financial Planning and St.George Financial Planning) have revenue targets, and planners participate in a bonus scheme. All revenue (initial and ongoing), and all asset categories or products (ie. managed funds, direct equities, etc), are treated equally under this scheme. Salaried advisers are only eligible to participate in the bonus scheme if they have met certain requirements within a particular period (including feedback from customers and meeting compliance requirements). There are no sales targets relating to particular products, Westpac Group products or asset classes.

We take our responsibilities seriously in supporting quality advice to customers. We require planners and management to comply with the law as well as applicable regulations and company policies. In particular, we require our planners to comply with best interest obligations and consequences of failing to comply are serious and can include withholding or cancelling a planner's bonus, performance management and, potentially, termination. We carry out regular auditing of planners. We also assess and review our obligations, key controls, including our monitoring system, at least annually.

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?

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.

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?

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 *3 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?

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

1. *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.

2. *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?

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?

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?

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 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.

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[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.

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.

For any further information, please feel free to contact Royce Brennan, General Manager Risk, BT Financial Group, or myself directly.

Yours sincerely

Ryan Bloxsom
Head of Government & Industry Affairs
BT Financial Group
Telephone:

Parliamentary Joint Committee on Corporations and Financial Services: Statutory Oversight of the Australian Securities and Investments Commission

Roundtable: Gatekeepers and 'expectation gaps' in Australia's Financial System

CPA Australia Responses to Questions on Notice

12 July 2013

1. CPA Australia has noted both at the roundtable and at previous hearings the global developments occurring with 'integrated reporting'. Would you be able to explain this concept to the committee and the advantages that you believe it offers to both professional and non-professional investors?

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?
  - 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>

CPA Australia Chief Executive Officer Alex Malley FCPA is a member of the International Integrated Reporting Council. For further information in regard to <IR>, we recommend the publication *<IR> Business leaders: what you need to know*.

2. CPA Australia has stated that an audit report is 'intended to increase the degree of confidence users have in information in financial statements — not about the state of the company itself or whether it is a safe investment.' In its report on Trio Capital, the committee expressed concern that the approval of financial statements by an auditor 'does not necessarily mean that the actual assets underlying the financial statements exist'. The ASIC audit report (p. 12) criticises auditors for not obtaining independent evidence to confirm the existence of underlying assets held overseas, yet ASIC does note that it is not a mandatory requirement. This appears to be another gap between what is expected of auditors by both ASIC and investors, and what they are actually responsible for doing.

a) Who is currently responsible for verifying the existence of underlying assets?

Section 5C of the *Corporations Act 2001* sets out the duties of responsible entities with regard to scheme property, including assets, which effectively mean they are primarily responsible for the way in which scheme property is dealt with, valuation of scheme property and hence verifying the existence of underlying assets on an ongoing basis.

Auditors have the responsibility to obtain reasonable assurance as to the existence of assets recognised in the financial statements as part of an annual audit process. Australian Auditing Standard *ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* states (para 5):

> As the basis for the auditor's opinion, Australian Auditing Standards require the auditor to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial report is materially misstated) to an acceptably low level. However, reasonable assurance is not

an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

b) To what extent does an audit verify the existence and value of underlying assets, including those held overseas, and what would be involved in securing this verification through the audit process?

In an audit conducted under Australian Auditing Standards, the nature, timing and extent of audit procedures intended to verify the existence and value of assets recognised in the financial statements depends on the auditors' assessed risk of misstatement at the assertion level[1].

Australian Auditing Standard *ASA 330 The Auditor's Responses to Assessed Risks* states (para 6-7):

> 6. The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.
>
> 7. In designing the further audit procedures to be performed, the auditor shall:
>
> (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
>   a. The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and
>   b. Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
>
> (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Audit procedures conducted to obtain reasonable assurance as to the existence and valuation of assets recognised in financial statements vary widely depending on the circumstances. Assets being held overseas may or may not lead to increased risk of misstatement and practical challenges in carrying out audit procedures and obtaining evidence. Neither of these factors relieve the auditor of their responsibility to obtain reasonable assurance as to the existence and valuation of assets recognised in financial statements, and an increased assessment of the risk of misstatement would require the auditor to obtain more persuasive evidence.

[1] *Assertions* mean representations by management and those charged with governance, explicit or otherwise, that are embodied in the financial report, as used by the auditor to consider the different types of potential misstatements that may occur (ASA 315). For example, *existence* and *valuation* are two key assertions relevant to assets recognized in financial statements.

Question 2 mentions an instance where the Australian Securities and Investments Commission (ASIC) notes in its Report 317 *Audit inspection program report for 2011–12* that “there is no mandatory requirement to obtain external confirmations[2]”. Note that while external confirmations are a specific type of procedure, this does not mean that the requirement to obtain sufficient appropriate audit evidence as to the existence and valuation of assets recognised in financial statements (see question 2 (a) above) is not mandatory. The same standards of obtaining reasonable assurance apply to all assets on the financial statements, regardless of whether those assets are held in Australia or overseas.

3. 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.

a) What is your understanding as to why these functions are kept separate?

We understand that the separation of these two functions is designed to promote independence between the compliance plan auditor and financial statement auditor. We note that these requirements which existed previously in the *Managed Investments Act 1998* predate the current independence requirements of auditors which have been extensively enhanced through CLERP 9 reforms in 2004, and the adoption of the international *Code of Ethics for Professional Accountants (APES 110)*.

b) Does this separation make the task of conducting the audits more difficult, and if so, what steps do auditors take to overcome this?

We are not aware that this separation makes the task of conducting the audits more difficult.

4. A financial statement audit requires that an auditor obtain reasonable assurance that assets exist and that there are not misstatements in the financial statements as a result of error or fraud.

a) Are there instances where it might be expected that a compliance plan audit would detect other types of fraud that do not show up as a material misstatement of the financial statements?

Yes, there may be instances where it might be expected that a compliance plan audit would detect other types of fraud that do not show up as a material misstatement of the financial statements.

The objective of a compliance plan audit is for the auditor to express an opinion on:

- compliance by the responsible entity with the scheme’s compliance plan during the financial year
- whether the compliance plan of the scheme continues to meet the requirements of Part 5C.4 of the *Corporations Act 2001*

[2] *External confirmations* are a specific type of audit procedure, defined in Australian Auditing Standards as “audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.”

In applying the requirements of Australian Standards on Assurance Engagements, compliance plan auditors (*ASAE 3100 Compliance Engagements*, para 28):

> Obtain an understanding of the entity, the requirements, suitable criteria and other compliance engagement circumstances, sufficient to identify and assess the risks of the entity's non compliance with the requirements as measured by the suitable criteria, and sufficient to design and perform further evidence-gathering procedures.

This includes (para 29):

> Identifying where special consideration may be necessary, for example factors indicative of fraud.

b) Related to the previous question, which gatekeeper has responsibility for detecting fraud where it is not apparent as a material misstatement of the financial statements?

In regard to a registered managed investment scheme, it is the responsibility of the directors of the responsible entity to have in place risk management systems to evaluate and manage risks, which depending on the circumstances would to varying degrees include the risk of fraud.

Compliance plan and financial statement auditors' responsibilities in respect to fraud are outlined in the response to question 3(a) above.

It is important to distinguish these responsibilities from specifically setting out to investigate or *detect* fraud. As a relatively rare, and by definition deliberately concealed occurrence, we recognise the challenges involved in preventing or detecting fraud for all those involved in the system. As John Price, then Senior Executive Leader at ASIC advised the Committee "if someone is minded to commit a fraud, whatever regulatory system you have in place may find it difficult if that person is determined and wilful to commit that fraud."

The role of the ASIC is crucial in detecting and addressing fraud and includes enforcing the *Corporations Act 2001*, with powers to:

- investigate suspected breaches of the law
- issue infringement notices in relation to alleged breaches of some laws
- ban people from engaging in credit activities or providing financial services
- seek civil penalties from the courts
- commence prosecutions

c) If an auditor uncovered an instance of suspected fraud that did not result in material misstatement, would the auditor approach management, or the directors, or notify ASIC?

Both financial statement and compliance plan auditors have responsibilities to notify ASIC where they have reasonable grounds to suspect significant suspected contraventions of the law under section 311 and 601HG of the *Corporations Act 2001*. This includes where a person attempts to "unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit", or "otherwise interfere with the proper conduct of the audit".

Australian Auditing Standards also establish responsibilities for auditors that have identified a fraud or obtained information that indicates that a fraud may exist to notify those charged with governance (normally the directors of a company or responsible entity), management and others as appropriately, as follows (*ASA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report)*:

> 40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.
>
> 41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:
>
> (a) Management;
>
> (b) Employees who have significant roles in internal control; or
>
> (c) Others where the fraud results in a material misstatement in the financial report,
>
> the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.
>
> 42. The auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgement, relevant to their responsibilities.

5. In its submission to the Trio inquiry, ASIC suggested that the government might consider civil liability provision for compliance plan audits.

a) What is the perspective of the CPA Australia regarding these suggestions?

While the ASIC submission of September 2011 outlines a list of "key issues" alongside the suggestion of a civil liability provision (Table 5, page 46), it is not clear how the suggestion of a civil liability provision relates to the issues raised. The issues raised in the ASIC submission relate to the nature of compliance plan requirements, the approval process and the standards applicable for compliance plan audits (see also question 7(a) in regard to the standards applicable for compliance plan audits), which are distinct from the liability of compliance plan auditors.

CPA Australia believes that consideration of civil liability provisions should be based on analysis and evidence as to whether there is a need for recalibration of the accountabilities of those who would be subject to such provisions, together with relevant implications.

b) Has ASIC engaged in any consultation with the audit profession regarding either of these suggestions?

We are not aware of consultation by ASIC with the profession on the suggestion of a civil liability provision for compliance plan auditors.

6. CPA Australia, amongst others, has expressed concern about the potential for regulation to cause a 'compliance-driven, box-ticking' approach that is ineffective in dealing with the issues confronting capital markets and the financial services industry.
a) Firstly, could you clarify whether this is predominantly an issue with the auditing of financial statements, or whether it applies to compliance auditing as well?

This statement is relevant in regard to regulation throughout the financial system and capital markets. A key challenge in setting regulation and standards, including those applicable to both financial statement and compliance plan auditing, is to strike an appropriate balance in addressing specific issues and the learnings of past cases, while avoiding excessive complexity and enabling a system that can work effectively as a whole to anticipate future problems and highly challenging issues such as fraud that may not have been previously identified.

At the Committee's roundtable on 21 June 2013, in previous hearings and in the Committee's *Report on Trio Capital*, there is a recognition that fraud is very hard to identify and that the risk of a well planned and deliberately concealed fraud may not be possible to avert whatever the regulatory setting.

If the balance described above is not given appropriate recognition in setting regulation and standards, there is a risk that the resulting complexity could mean well intentioned participants in the financial system and capital markets would find it more difficult to anticipate and identify where illegal conduct is occurring.

b) Secondly, could you explain your preferred approach to improving the effectiveness of compliance plan auditing and outline any discussions that you have had, firstly with other bodies including directors, management and compliance committees, and secondly with ASIC, on this topic?

CPA Australia believes the comprehensive and internationally equivalent standards issued by the Australian Auditing and Assurance Standards Board (AUASB) for compliance plan audits (see also question 7(a)) and the applicable provisions of the *Corporations Act 2001*, set an appropriate framework for high quality compliance plan audits. CPA Australia recognises that continuously improving the effectiveness of compliance plan auditing is essential and has implemented a range of programs geared toward continuous improvement of audit quality, including compliance plan audit quality (See also CPA

Australia's submission to the Committee dated 20 March 2013, for further detail regarding these programs).

CPA Australia has been involved with and provided input to the AUASB and International Auditing and Assurance Standards Board (IAASB) in the development of the standards applicable to compliance plan auditing, and also in the AUASB project to develop specific guidance in Australia for the audit of compliance plans of managed investment schemes (see also question 7(a) for information about the standards applicable to compliance plan audits).

7. With regard to compliance plan audits:

a) Are there any qualitative standards by which a compliance plan auditor must conduct their audit and do those standards have the force of law?

The following standards issued by the AUASB are applicable to compliance plan audits:

- *ASAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information*
- *ASAE 3100 Compliance Engagements*

These standards are mandatory for members of CPA Australia and other major professional accounting bodies in Australia. The standards are issued by the AUASB which is an Australian Government statutory body established under section 227A of the *Securities and Investments Commission Act 2001*.

The applicable standards set out comprehensive detailed requirements for compliance plan audits including in regard to:

- The objective of a Compliance Engagement
- Relevant definitions
- General Principles of a Compliance Engagement
- Ethical Requirements
- Quality Control
- Compliance Engagement Acceptance and Continuance
- Agreeing on the Terms of the Compliance Engagement
- Planning and Performing the Compliance Engagement
- Understanding the Entity
- Elements of a Compliance Framework
- Assessing the Appropriateness of the Subject Matter
- Assessing the Suitability of the Criteria
- Materiality and Compliance Engagement Risk
- Obtaining Evidence
- Representations by the Responsible Party (responsible entity)
- Using the Work of an Expert
- Evaluation and Communication of Deficiencies and Breaches

- Considering Subsequent Events
- Documentation
- Preparing the Compliance Report
- Reporting Additional Information - Findings and Recommendations
- Modifications to the Compliance Report
- Other Reporting Responsibilities

The AUASB has also issued the following relevant guidance statement for compliance plan auditors:

- *GS 013 Special Considerations in the Audit of Compliance Plans of Managed Investment Scheme*

b) If not, what recourse do persons have if they have suffered material loss as a result of making decisions based on the outcomes of a poor quality compliance plan audit?

As detailed in the answer to question 7(a) comprehensive, internationally equivalent standards for compliance plan audits do exist. A range of legislated, common law and other professional accountabilities to which compliance plan auditors are subject, including the *Corporations Act 2001* and the professional standards required to be adhered to by a member of CPA Australia or other major Australian professional accounting bodies.

The requirements for a compliance plan audit are enforceable by ASIC in its role of enforcing the *Corporations Act 2001*. The situation described in this question would involve a range of relevant factors that would impact on the recourse available and in such a scenario it is unlikely that the compliance plan audit would be the only factor involved.

c) Is there a risk that this lack of qualitative standards might result in a gap between what might be expected from a compliance plan audit and what a compliance plan audit is actually required to deliver?

Comprehensive, internationally equivalent standards for compliance plan audits do exist (see response to question 7(a) and (b)).

We concur with KPMG's comments as quoted by the Committee in its *Report on Trio Capital* (Chapter 7) in regard to the key expectations gaps perceptible in respect to compliance plan auditors:

> stakeholders often have erroneous expectations that: auditors are primarily responsible for the preparation and presentation of financial statements; that 'clean' audit opinion provides absolute assurance over the accuracy of the financial statements and guarantees the entity's future solvency; that auditors perform a 100 per cent check over all items recorded in the accounts; that auditors are to provide early warning regarding the possibility of a corporate collapse; and that an auditor's role includes detecting all fraud.

The applicable standards for compliance plan audits are internationally equivalent and robust (see also question 7(a)). Importantly, these standards recognise the limits of what a compliance plan audit can achieve and seek to clarify this in the compliance plan auditor's reporting. A compliance plan auditor's report issued in accordance with the applicable standards and guidance outlined under question 7(a) would include the following statement:

> *Inherent Limitations*
>
> Because of the inherent limitations of any compliance measures, as documented in the compliance plan, it is possible that fraud, error, or non-compliance with laws and regulations may occur and not be detected. An audit is not designed to detect all weaknesses in a compliance plan and the measures in the plan, as an audit is not performed continuously throughout the financial year and the audit procedures performed on the compliance plan and measures are undertaken on a test basis.
>
> Any projection of the evaluation of the compliance plan to future periods is subject to the risk that the compliance measures in the plan may become inadequate because of changes in conditions or circumstances, or that the degree of compliance with them may deteriorate.
>
> The audit opinion expressed in this report has been formed on the above basis.

CPA Australia recognises that in any effort to address expectation gaps, it is critical to consider both sides of the gap: stakeholder awareness and education on how roles within the financial system stand currently; and how those roles may be enhanced toward meeting the needs of stakeholders and evolve along with the business environment and wider economy into the future. See also question 9 in regard to initiatives CPA Australia is involved in toward addressing both of these aspects.

8. 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 would be 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?

CPA Australia concurs with the merit of consideration as to how governance arrangements for managed investment schemes could be strengthened through option one. However, we note some practical aspects that would need to be worked through, and which may point toward option two as a more practical option. First, "mandating" infers a black letter law solution, whereas practice in director independence stems largely from non-statutory corporate governance frameworks which are adopted and applied on a 'comply or explain' basis. A second observation is that the compliance committee requirements (Pt 5C.5 of the *Corporations Act 2001*) are placed within a comprehensive statutory scheme (Chapter 5C), relevant to particular and specific types of investment vehicles which involve relationships that may only be loosely analogous to that between a shareholder and a company underlying listed public company contexts. Thirdly, it would be important to clearly demonstrate that section 601JB of the *Corporations Act 2001* (Membership of compliance committee) is insufficient prior to overlaying this with a broader notion of independence. We would recommend that any reform in this direction needs to be cognisant of specific fiduciary rules that pertain to a managed investment scheme. Finally, it would be important for there to be some allowance for statutory ‘connections’ that have been established for good reason – for example between the compliance committee provisions and compliance plan requirements (Part 5C.4 *Corporations Act 2001*).

b) Could you comment on the perspectives that independent directors bring to a board?

Independent directors bring a range of characteristics to boards which have been increasingly recognised as crucial aspects of good governance globally. Independence from the company and its management is essential as a capacity to guide policy, give stewardship and safeguard the interests of the company and is an essential component in the conduct of board committees. Formal independence is different from, but related and a contributing factor to the capacity to exercise an independent mind. It is important to note that in addition to individual attributes, board processes are also crucial in achieving director independence.

9. 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 says that in order to 'maintain its relevance, the audit profession needs to acknowledge this expectation gap and looks for ways to formally adapt the scope of what we do'.

a) Do you agree with Mr Sayers that an expectation gap exists?

CPA Australia recognises that expectation gaps are a challenging characteristic of financial systems globally. Substantial ongoing effort is required for enduring progress toward resolving such gaps. As mentioned in 7 (c), any effort to address expectation gaps, should consider both sides of the gap: stakeholder awareness and education on how roles within the financial system stand currently; and how those roles may be enhanced toward meeting the needs of stakeholders and evolve along with the business environment and wider economy into the future.

b) Do you agree with Mr Sayers on the need for formal change? If yes, could you explain to the committee whether CPA Australia has given consideration as to what formally adapting the scope of an audit may involve in practice?

CPA Australia has publicly advocated the need for auditing and assurance to evolve with changes in capital markets, the business environment and stakeholder needs, and has been actively involved in initiatives toward achieving this.

CPA Australia recognises that certain stakeholders have increasingly demanded comprehensive information and questioned the role of auditing and assurance around business models and risk – particularly risks associated with business continuity. While we recognise that the role of reporting, auditing and assurance cannot fully mitigate such risks which are an inherent part of the financial system and capital markets, we propose that two significant developments are needed to respond to the needs of stakeholders:

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

CPA Australia has been extensively involved in the development of <IR> which is a substantial global initiative toward addressing the first point above (see also question 1).

In an audit or assurance engagement, the appropriateness of the subject matter and suitability of the criteria on which the engagement is conducted and conclusions are drawn is critical. With sufficient development, <IR> could provide appropriate subject matter and criteria for the auditing role to evolve and address many of the expectations of stakeholders that have featured prominently in discussion and research on audit expectation gaps. 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 also recognised that to underpin the enhancement of the audit role, there is a need for capability and knowledge within the profession to also be enhanced and cover an increasingly broad range of subject matter. 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. We have also established the Foundation Level in the CPA Program which provides a pathway into the profession for graduates of a wide range of other disciplines.

A further need recognised by the profession is for auditors to provide stakeholders with more extensive information through their reporting. CPA Australia has promoted and provided input in an international project focusing on significantly enhancing the communication of auditors with stakeholders through audit reporting. The IAASB has developed an enhanced model for auditor reporting where the auditor would provide insights into key matters of audit significance, and further clarity on key areas of stakeholder interest such as going concern. This model is expected to be encapsulated in a draft standard to be exposed in July 2013.

CPA Australia recognises the need for analysis and empirical insights to genuinely enhance the role of auditing and assurance, and promote the continued effectiveness of auditing and assurance. Along with the specific initiatives mentioned above, CPA Australia is actively involved in promoting, funding and otherwise supporting a wide range of research into these matters. CPA Australia was the primary sponsor of the International Symposium on Audit Research 2013 held in Sydney – a premier conference drawing researchers globally. The CPA Australia Global Research Perspectives Program has funded a number of relevant projects. CPA Australia has also supported research projects through a range of mechanisms including providing access to participants, technical expertise and channels of communication with the profession.

10. In the UK, the Competition Commission recently issued a provisional finding that shareholders play very little role in appointing auditors compared to executive management, and that where the demands of executive management and shareholders differ, auditors compete to satisfy management rather than shareholder demand.

a) Do you believe that this finding is applicable to Australia? If not, why not?

In Australia, under the *Corporations Act 2001*, auditors are appointed by shareholders based largely on the recommendation of company directors who are their elected governance representatives. An effective relationship between auditors and executive management of audited entities is critical to the effectiveness of the audit and financial reporting process and in achieving relevant and reliable financial reporting. CPA Australia believes that the professional standards and legal framework applicable to auditors in Australia are appropriate and sufficient to address situations where the demands of executive management and shareholders may differ. The oversight role of audit committees and directors, as representatives of shareholders, plays a critical part in addressing this risk. CPA Australia has publicly supported the UK Competition Commission's proposals to strengthen the role of audit committees and enhance shareholder engagement in auditor appointments.

The IAASB, has in conjunction with the profession internationally, developed an enhanced model for auditor communication with shareholders and other stakeholders through audit reporting. This model represents a substantial shift and facilitates increased engagement of shareholders in understanding the work and role of auditors in financial reporting and deciding on their appointment (see also question 9(b)).

CPA Australia has also recognised the need for an examination of competition and structure in the audit market, and has undertaken an extensive project geared toward providing key facts on the Australian context over the past year (See also CPA Australia's submission to the Committee dated 20 March 2013 which included a report on the preliminary findings of this study).

b) If the finding is applicable, what steps is the auditing industry taking to address such misaligned incentives?

Refer to question 10(b) regarding ongoing initiatives aimed at addressing associated risks.

11. Regarding the relationship between auditors and an audit committee with respect to the auditing of financial statements:

a) Could you explain the interaction between the audit committee of a responsible entity and the auditor?

Directors of responsible entities are responsible for appointing auditors to managed investment schemes and may receive recommendations from an audit committee to guide this decision. There are a number of obligations for interaction between the directors of a responsible entity and its auditors including particularly the auditor's communication in accordance with *ASA 260 Communication with Those Charged with Governance*[3]. *ASA 260* outlines a framework including specific interactions required, such as the matters that the auditor must communicate to Those Charged with Governance (TCWG).

ASA 260 recognises the importance of two-way communication between the auditor and TCWG, stating in its mandatory requirements that effective two-way communication is important in assisting:

> (a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;
>
> (b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
>
> c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial report.

[3] "Those Charged with Governance" means "person(s) or organisation(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity". In the case of a responsible entity this would normally be the directors of the responsible entity.

Under *ASA 260*, the objectives of the auditor include:

> (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial report audit, and an overview of the planned scope and timing of the audit;
>
> (b) To obtain from those charged with governance information relevant to the audit;
>
> (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
>
> (d) To promote effective two-way communication between the auditor and those charged with governance.

The specific nature of these interactions would vary widely depending on the context but in general would be geared toward a two-way exchange of information to enhance the achievement of objectives of auditors and TCWG in audit and financial reporting.

b) How effective do you believe audit committees to be in assessing the level of professional scepticism employed by auditors?

Audit committees play a crucial role in their interactions with auditors related to key matters of financial reporting, compliance and audit significance, and the level of professional scepticism employed in regard to these matters. As a sub-committee of the board of directors, audit committees play a role in overseeing how matters have been dealt with by auditors from the board's perspective, and in auditor appointment and retention. Professional scepticism is nonetheless required of auditors under the auditing standards independent of any relevant input from the audit committee.

Having the appropriate proximity to and knowledge of the subject matter (i.e. a managed investment scheme or a company's business), expertise and position in representing the interests of investors or shareholders, audit committees and directors are the best equipped group to perform this oversight role effectively.

c) Are you aware of instances where an audit committee has challenged the findings of an auditor as insufficiently sceptical of the approach proposed by management?

The deliberations of audit committees in this respect are confidential and hence it is not possible to comment on specific instances. However, we note that in general, the interactions between TCWG and auditors as described under question 11(a) above are generally robust and that the points of view of auditors and management would be put under considerable scrutiny by effective audit committees on a frequent and ongoing basis.

d) Conversely, if an audit committee agrees with the Chief Financial Officer and challenges an auditor's accounting treatment, and if the client company approached the auditing company about the matter, how would you expect the auditing firm to proceed in relation to the auditor?

While there are a range of factors that may impact on this hypothetical scenario, we would expect that in accordance with applicable professional standards, including *APES 110 Code of Ethics for Professional Accountants,* the auditing company or firm would address any threats to independence that arise through these circumstances and would review and support the auditor and their judgement on the accounting treatment. If the client would not agree to a material proposed audit adjustment in regard to the accounting treatment, we would expect that the auditor would issue a qualified or adverse audit opinion under *ASA 705 Modifications to the Opinion in the Independent Auditor's Report*.

dixonadvisory

12 July 2013

Deborah O'Neill MP

Parliamentary Joint Committee on Corporations & Financial Services

By Email: Corporations.Joint@aph.gov.au

Dear Ms O'Neill,

Thank you for providing Dixon Advisory with the opportunity to participate in the recent roundtable. Enclosed are our responses to the questions on notice from the committee.

Yours Sincerely,

Nerida Cole

Managing Director – Financial Advisory

CANBERRA
Level 1, 73 Northbourne Avenue
CANBERRA ACT 2601
GPO Box 1481 CANBERRA ACT 2601

NORTH SYDNEY
Level 15, 100 Pacific Highway
NORTH SYDNEY NSW 2060
PO Box 29 CROWS NEST NSW 1585

MELBOURNE
Level 2, 250 Victoria Parade
EAST MELBOURNE VIC 3002
PO Box 140 FITZROY BC VIC 3065

NEW YORK
1000 Plaza Two, Floor 10
Harborside Financial Center
JERSEY CITY NJ 07311

CONTACT DETAILS
T 1300 883 158 | F 1300 883 159 | E info@dixon.com.au
dixon.com.au | **AFSL** 231143 | **ABN** 54103071665

PJC Roundtable – Questions on notice

1. *In your statement to the Parliamentary Joint Committee, you note that there can be concerns about conflicts of interest as some research houses may receive income from fund managers that they are providing ratings for.*

    a) *When Dixon Advisory sources external research, do you have a preference for investment research from a research house that is generated under a particular business model, or is it enough for Dixon Advisory's advisers to satisfy themselves that any conflicts of interest in the research house business model have not only been declared, but also adequately managed?*

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

2. *In their statement to the Parliamentary Joint Committee, Lonsec argued that 'the entire research house sector provides a materially discounted service to the financial planning industry, due to the inability and/or unwillingness of its participants to accept the full cost of production'.*

    a) *Would you be able to comment on this proposition from your perspective as both a purchaser of external research and as an advisory business that also produces some in-house investment research?*

If there was high quality independent research available in Australia that not only satisfied compliance requirements but also provided unique investment thesis, we would be willing to pay an appropriate price for this research. We have shown this by subscribing to international research on macro economic views from companies that have a pure independent business model.

b) Do you believe that ultimately the end-user, namely the investor, is, at least in some cases, unable or unwilling to pay for the cost of high quality qualitative investment research?

There will always be investors who are either unwilling or don't have the capacity to pay for high quality research. However, we believe there are investors that would be willing to pay the additional cost for high quality independent research if it was from a research house that had a proven track record. As the Australian market already has a significant amount of available research (from investment banks, commercial banks, broking houses and research houses) an independent research house would first need to convince investors that their research is of a higher quality than what is already available before investors would be willing to pay for it.

c) Can you comment on the cost of high quality qualitative research from research houses relative to the cost of Dixon Advisory conducting the same quality of research in-house?

It is not cost effective for a firm of our size to hire a full time research team to conduct all of the research our advisors and clients require. As such external research is a piece of puzzle that our internal research team use to meet the advice needs of the business.

d) If the cost of high quality qualitative investment research does raise an issue for both the research house and financial advising sectors, how do you currently manage this?

When considering if we should use external research or bring the research function in house we consider what is available in the market and the particular asset class or product type in question. In practice this may mean that where we have a significant focus on an asset class or product type we will look to add capabilities to our firm so that we can conduct this research in house. For asset classes and product types that we only see as a small part of a diversified portfolio or that are extensively well covered by external research we will generally use external research.

e) Are there other suggestions that you would make to address this dilemma?

Ultimately it is up to research houses to prove to investors and the financial advising sector that the research that they sell will provide additional insights not available elsewhere. Until they can justify that the quality of their research is worth the cost they will not be able to charge the full cost of production.

We strongly believe that external research is only one of the information sources that advisors need to use when making a decision on an investment product. As such we would be concerned if the investment industry moved to a situation where a certain number of endorsements from research houses are required before a product can be recommended. This could further increase the expectation gap for retail investors by suggesting that a rating is a 'tick of approval'.

3. In its statement to the Parliamentary Joint Committee, Lonsec made several points about a subset of the financial planning industry, namely that 'research houses continue to encounter 'expectations overreach' from a subset of financial planners in the following areas':

- *What a rating is and is not and the degree to which it can be relied upon;*
- *An expectation that it is the role of investment research to accurately and consistently predict, thus avoid, financial product failure;*
- *An expectation that well rated financial products will consistently outperform their benchmarks over 'short term' periods;*
- *An expectation that well rated financial products will offer 'downside defensiveness' when markets fall;*
- *An expectation that all well rated financial products are suitable for all clients.*

a) From your perspective, do you think that 'expectation overreach' exists within a subsection of the financial planning industry?

In our business we believe a 'expectations overreach' does not exist due to the specialisation of our advisors. We have a team of advisors who solely provide investment advice and manage portfolios for our clients. They are not general financial planners. Our advisors have access to external research but it is only one of the many sources of information they use when formulating recommendations.

We cannot comment on how other businesses operate but it is conceivable that an 'expectation overreach' exists within a subsection of the financial planning industry. Increased education standards for financial planners may assist in addressing this.

b) *Do you think that it would be reasonable or unreasonable for financial planners and advisers to hold the expectations listed above?*

We believe that it would be unreasonable for financial planners and advisers to hold these expectations. Inherently investments are uncertain. The view of one research house is only one possible outcome for the investment. Research house views cannot be used in isolation when recommending an investment product for a client. A professional advisor needs to use their knowledge and skills to assess information from a variety of sources before they can make an informed recommendation for a client.

Building a better working world

Ernst & Young ABC Pty Limited
121 Marcus Clarke Street
Canberra ACT 2600 Australia
GPO Box 281 Canberra ACT 2601

Tel: +61 2 6267 3888
Fax: +61 2 6246 1500
ey.com/au

Dr Patrick Hodder
Senior Research Officer
Parliamentary Joint Committee on Corporations & Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra
ACT 2600

11 July 2013

PJC Questions on Notice

Dear Patrick

Attached please find EY's response to questions on notice arising from the meeting of the Parliamentary Joint Committee (PJC) on Corporations and Financial Services held on 21 June 2013.

Whilst we believe these responses will be consistent with the views of the other major firms (and indeed professional bodies), we confirm that the opinions expressed herein are those of EY alone.

Thank you for the opportunity to participate in the Parliamentary Joint Committee inquiries.

Please contact either myself or Graeme McKenzie if you have any queries of if we are to be of any further assistance.

Yours sincerely

Tony Smith
Partner
Asia Pacific Leader - Regulatory and Public Policy

Attachment EY Response
Copy to: Graeme McKenzie

PJC Inquiry, 21 June 2013 - Questions on Notice

1. 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.

a) What is your understanding as to why these functions are kept separate?

We understand that the segmentation between compliance plan auditor and the auditor of the Responsible Entity ("RE") (not the fund financials) is due to the philosophy that the compliance plan auditor should have the best interest of the investors in the fund front of mind, while the auditor of the RE should consider more the interests of the shareholders of that corporate entity. There appeared to be a belief that there may be a conflict of interest if auditing both the compliance plan and the RE. Note that there is no prohibition on the compliance plan auditor also performing the statutory audit of the fund's financial statements.

b) Does this separation make the task of conducting the audits more difficult and, if so, what steps do auditors take to overcome this?

The separation does not inhibit the performance of effective and robust compliance plan audits, but there is no doubt that having separate partners involved on what is effectively the one audit is less efficient.

There are three different models that the firms currently employ when completing the audit of the RE, the financials of the fund(s) and the compliance plan. The first, which is quite common, is to have the same audit partner of the compliance plan and the fund financial statements, and have a separate audit partner on the RE. The second, which is often utilised by EY as we have dedicated compliance partners, is to have one audit partner responsible for the financial audit of the RE and the fund financials, and to have a separate partner responsible for the compliance plan audit. The final, which is rarely used, is to have three different partners on the three engagements.

While the separation of the roles is not a major concern of EY, no doubt it is less efficient than having, where appropriate and if legislatively possible, the one audit partner responsible for the three engagements (compliance plan, fund financials and RE financials). The efficiency savings would arise due to the common processes/accounts that the fund financials and the RE financials have, such as RE and Investment management fees/income. Other efficiencies would arise when undertaking compliance reviews of the fund (for the compliance plan audit) and of the RE (for the Australian Financial Services Licence audit). An additional side benefit may be improved engagement with the board/compliance committee if there was a consistent audit partner rather than having interface with two partners/teams.

2. A financial statement audit requires that an auditor obtain reasonable assurance that assets exist and that there are not misstatements in the financial statements as a result of error or fraud.

a) Are there instances where it might be expected that a compliance plan audit would detect other types of fraud that do not show up as a material misstatement of the financial statements?

While the identification of fraud is a matter covered by specific auditing standards, which we will not repeat here, from a practical perspective it would be more the responsibility of the financial auditor (of the fund or the RE) to identify fraud. Per the model outlined above, being the separation of compliance plan auditor from the financial auditor, then it would be unlikely, but not inconceivable, for a compliance plan auditor to identify instances of fraud. We form that view based on the quite specific role that a compliance plan auditor executes, being the assessment of whether the Plan complies with the Law and the operation of that plan in practice, as opposed to the broader role of a financial auditor.

b) Related to the previous question, which gatekeeper has responsibility for detecting fraud where it is not apparent as a material misstatement of the financial statements?

Those charged with Governance and management have the primary responsibility to prevent and detect fraud and they have a responsibility to implement internal controls systems to reduce the risk of fraud and monitoring systems such as internal audit.
Neither the external auditor nor the compliance plan auditor has any responsibility to detect fraud which does not give rise to a material misstatement of the financial report. The external auditor's responsibility is to plan and perform financial audits to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatements whether caused by error or fraud. As compliance plan auditors our role is quite narrow, and as a result would not generally address matters such as undetected fraud.
As financial auditors, we approach each engagement with a questioning mind that accepts the possibility that a material misstatement due to fraud could occur, and design the appropriate procedures to consider such risk. Our financial audit focuses on:

- Identifying fraud risks during the planning stages
- Inquiry of management about risks of fraud and the controls put in place to address those risks
- Consideration of the effectiveness of management's controls designed to address the risk of fraud
- Determining an appropriate strategy to address those identified risks of fraud
- Performing mandatory procedures regardless of specifically identified fraud risks.

Therefore, of the two key audit roles of financial auditing and compliance auditing, generally we would see that the financial statement auditor is better placed to identify instances of fraud.

c) If an auditor uncovered an instance of suspected fraud that did not result in material misstatement, would the auditor approach management, or the directors, or notify ASIC?

From an external audit perspective if fraud is uncovered, unless totally insignificant, the matter would, as a matter of course, be reported to senior management and the directors (generally via the Audit Committee). We would engage ASIC in relation to fraud related matters, where Whistle-blower laws require such disclosure, or we believed there was a deliberate material deception by the company of its financial performance, or if in the course of our compliance plan audit or external audit we had:

- On reasonable grounds suspected that a contravention of the Act has occurred and the contravention is significant; or
- if the contravention is not significant, but the auditor believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or by bringing it to the attention to the directors; or
- the auditor is aware of circumstances that amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit; or
- the auditor is aware of circumstances that amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit.

3. In its submission to the Trio inquiry, ASIC suggested that the government might consider civil liability provision for compliance plan audits.

a) What is the perspective of Ernst and Young regarding these suggestions?

The compliance plan auditor's role/responsibility pursuant to section 601HG(3) of the Corporations Act (the Act) is limited to examination, auditing and reporting on the RE's compliance with the plan and further ensuring that the plan meets the requirements under the Act. On our review of the relevant commentary/submissions in regard to the Trio collapse, the primary criticisms from a compliance plan perspective appear directed towards a lack of sufficient detail and prescription within the Act itself. This lack of prescription then cascaded down into the individual compliance plan, raising concerns in relation to the ongoing effectiveness of compliance plans and the requirement of more detail to be provided. In the circumstances, given current requirements under the Act are set at a relatively high level, it cannot be suggested that the compliance plan auditor failed to fulfill its obligations under the existing legislative framework. Thus in the absence of direct evidence to the contrary, we are reluctant to support the imposition of civil liability provisions upon compliance plan auditors which, as ASIC correctly submits, will lead to an increase in compliance plan costs.

b) Has ASIC engaged in any consultation with the audit profession regarding either of these suggestions?

We are not aware of ASIC engaging in consultation, however that is not to say that it has not occurred.

4. With regard to compliance plan audits:

a) Are there any qualitative standards by which a compliance plan auditor must conduct their audit and do those standards have the force of law?

The audit of a compliance plan is required under Chapter 5C of the Act. The role of the compliance plan auditor under section 601HG(3) of the Act is to examine the scheme's compliance plan and carry out an audit of the RE's compliance with the plan within 3 months after the end of the financial year of the registered scheme. The compliance plan auditor must give to the scheme's current RE an audit report which states whether in the auditor's opinion, in all material respects:

- the RE, or each RE, has complied with the scheme's compliance plan for the financial year ended [balance date] ; and
- the compliance plan continues to meet the requirements of Part 5C.4 of the Act as at that date.

In addition to the Law, the Auditing and Assurance Standards Board has issued Guidance Statement 013 Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes to aid the audit profession. This Guidance Statement provides guidance to assist the auditor to fulfil the objectives of the audit or assurance engagement. It includes explanatory material on specific matters for the purposes of understanding and complying with AUASB Standards (which do have the force of Law). The Guidance Statement does not prescribe or create new mandatory Requirements.

b) If not, what recourse do persons have if they have suffered material loss as a result of making decisions based on the outcomes of a poor quality compliance plan audit?

We believe it would be quite unusual for an investor to pursue an external auditor in relation to their compliance plan audit, due to the limited nature of such an audit. More likely would be the pursuit of the financial statement auditor of the fund as cases generally involve the misplacement of investments which is more directly related to the financial audit. We do recognise that a component of a compliance plan would be the support for Scheme property, but typically such assurance will be provided to the Compliance plan auditor from the financial auditor.

5. 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 would be 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?

As you would be aware, an RE can either have a majority of independents on its board or, where there is not a majority of independents on the RE Board, have an independent Compliance Committee. We have seen both models in operation and it is difficult to comment if one is better/stronger than the other. What we would say however is that at times we have seen Compliance Committees operate quite separately from the business. While this is a positive from an independence of thinking perspective, it is also possible that there could be items that “fall between the cracks” without having a full business perspective.

The model adopted by businesses will depend on how they operate their RE. If the RE board is very active in the management of the business it may not be appropriate/desirable to have independents dealing in such detail (and incurring additional cost for the RE and ultimately the investors in the fund).

In relation to management not acting on the recommendations/demands of the Compliance Committee, we do not see widespread abuse by management in not responding to the requests of the Compliance Committee.

b) Could you comment on the perspectives that independent directors bring to a board?

There is general acceptance that independent directors can bring a wealth of experience, insight and challenge to a business, so overall we are supportive of independent directors. Of course, the strength of such a model is dependent on the skills of the Directors.

6. In the UK, the Competition Commission recently issued a provisional finding that shareholders play a very little role in appointing auditors compared to executive management, and that where the demands of executive management and shareholders differ, auditors compete to satisfy management rather than shareholder demand.

a) Do you believe that this finding is applicable to Australia? If not, why not?

While globally and potentially locally the perception may be that external auditors “compete to satisfy management” the reality is quite different. Certainly to ensure an efficient and effective audit it is appropriate to have good, professional, working relationships with management, however we clearly see that our ultimate stakeholder to be the shareholder. From a practical perspective, that relationship is managed by Board Audit Committees.

It should also be noted that shareholders, via the directors, do appoint external auditors, not management.

b) If the finding is applicable, what steps is the auditing industry taking to address such misaligned incentives?

As outlined in my evidence to the PJC, there is no doubt that there are challenges in relation to expectation gaps as to the role of the external auditor. We recognise that the auditor makes a significant contribution to a company producing financial statements that accurately reflect reality and that comply with the law, and helps ensure that the market is provided with correct financial information. Much of the auditors' best work is done behind the scenes, in discussions with client management about accounting requirements and key judgments and assumptions, to help produce information that provides a true and fair view and complies with accounting standards.

However, there are public views that suggest auditors' role is to detect fraud and to provide absolute assurance that the financial statements are free from errors and fraud. Also there is often a belief that it is the auditor's role to stop all business failures, however in the majority of cases a business fails due to its business model and the environment in which it operates, as opposed to the quality of the external audit. Such variances in views will require better education of investors as well as considering what improvements can be made in auditor reporting to bridge this expectation gap.

The International Auditing and Assurance Standards Board (IAASB) in its recent Invitation to Comment: Improving the Auditor's Report (ITC), proposed a number of suggested potential improvements to enhance the relevance of the auditor's report in the public interest. Issued in June 2012, the ITC is the IAASB's second consultation in its auditor reporting project. The ITC seeks to address the question of what auditors can do through the auditor's report to help address the requests by investors and other stakeholders for more relevant and decision-useful information about the audited entity, its financial statements and the audit process itself.

We strongly support meaningful change to increase the usefulness and informational value of the auditor's report. Equally we fully endorse enhancements by management to ensure that meaningful, timely, information is provided to stakeholders.

7. Regarding the relationship between auditors and an audit committee with respect to the auditing of financial statements:

a) Could you explain the interaction between the audit committee of a responsible entity and the auditor?

If an RE has an Audit Committee (and not all do) then we would have a range of interactions with them. At a minimum we would:

- provide a summary of our audit plan/approach, provide engagement letters, inclusive of fees for approval
- provide status updates and then report back on the findings of the audit both in the context of the areas of focus outlined in our audit plan and any new issues
- cover a range of matters that we need to address to those charged with Governance, including independence, fraud, etc.

Where an RE does not have an Audit Committee, then the interaction will vary depending on the overall corporate structure in which the RE operates in, whether there is a majority of independents (and therefore no need for a Compliance Committee), and the general preference/desires of the Board. At a minimum we would provide a copy of our engagement letter and then a letter to those charged with governance at the completion of the audit.

b) How effective do you believe audit committees to be in assessing the level of professional scepticism employed by auditors?

It is difficult to make blanket conclusions to this question, as the make-up of the members of the Audit Committee will generally dictate how robust they are in their assessment of an external auditor's professional skepticism and work overall. Having said that, it is our observation that post the Centro failing Audit Committee's have become significantly more interested in the findings of the external auditor and engage/challenge with more vigour than historically.

c) Are you aware of instances where an audit committee has challenged the findings of an auditor as insufficiently sceptical of the approach proposed by management?

Yes, while not a frequent occurrence, such challenge/discussion does happen. Obviously such challenge will be dependent on a range of factors, including: financial position of the business; dominance of the executives; "robustness" of the external auditor; and the depth/strength of supporting management and audit papers.

d) Conversely, if an audit committee agrees with the Chief Financial Officer and challenges an auditor's accounting treatment, and if the client company approached the auditing company about the matter, how would you expect the auditing firm to proceed in relation to the auditor?

While challenge can come from the Audit Committee and, at times, they will "side" with management, the course of action outlined in your question of going to the audit firm is not a frequent occurrence. For listed clients and audits where it is determined there is wide public interest, we will always have an independent review partner to challenge and assist the engagement partner on technical matters. In addition, we have a senior partner as our Professional Practice Director, and they will become directly engaged in circumstances where there are material differing opinions with clients. Therefore, the instances where there are widely differing technical interpretations are not common.

Where we have seen instances of clients approaching our senior management is more generally in relation to a service issue, as opposed to a technical interpretation. Where such matters are raised, our senior management will assess all factors to determine the appropriate course moving forward.

Ernst & Young
11 July 2013

Building a better
working world

Ernst & Young
121 Marcus Clarke Street
Canberra ACT 2600 Australia
GPO Box 281 Canberra ACT 2601

Tel: +61 2 6267 3888
Fax: +61 2 6246 1500
ey.com/au

Dr Patrick Hodder
Senior Research Officer
Parliamentary Joint Committee on Corporations & Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra
ACT 2600

16 July 2013

PJC Follow Up Questions Issued to EY/External Auditors

Dear Patrick

Attached please find EY's response to follow up questions as requested via email on 10 July 2013.

The responses and opinions contained herein are those of EY alone.

Please contact either myself or Graeme McKenzie if you have any queries of if we are to be of any further assistance.

Yours sincerely

Tony Smith
Partner
Asia Pacific Leader - Regulatory and Public Policy

Attachment EY Response
Copy to: Graeme McKenzie

Role of the auditor and the interaction between auditors and research houses.

Increasing the threshold of reasonable assurance is unlikely to pass a cost benefit analysis. Instead the quality of audits within the existing regulatory framework should be improved. This could be achieved by:

I. Requiring that the audit of managed investment schemes is more robust as investors and the public confidence in the financial system rely on the audits being performed to a high standard. The cost of this will ultimately be borne by the investor but the audit opinion will be more meaningful.
II. Putting more focus on using emphasis of matter paragraphs and highlighting these to the investor if there is uncertainty in the financial statements. This is particularly relevant if there has been uncertainty when testing the existence and/or valuation of assets.
III. Increasing the standard of the half yearly audit review for managed investment schemes so that the chance of fraud being uncovered on a timely basis is increased. A full audit every six months would be more costly but the outcome of an audit is more useful to an investor than that of a review.

Before we specifically address the questions/statements raised by Dixon Advisory, let us just restate as per our written submission to the PJC the assessment of the level of engagement/interaction between auditors and research houses. "While we see that Research houses play an important role in financial markets, the level of interaction that auditors have with them is typically not significant. Generally the rating of a security that is owned by a financial institution will be important in deriving the "yield curve" on which an investment is priced (eg investment grade, non-investment grade) but other than that component to the pricing of a fixed interest security there would, in our view be little or no reliance on the output of a ratings house by an external auditor. "

Notwithstanding the above, the points raised by Dixon Advisory are important issues in the broader context of the quality of external audit and the usefulness and reliance of external audit reports by stakeholders. Let us address each of the suggestions by Dixon.

I. Robustness of external audits

While we do believe our external audits are robust, we recognise that firstly we must continue to enhance our quality, and secondly the "expectation gap" in relation to the role of external audit needs to be narrowed. The area of quality of audits has been getting a lot of focus both locally and internationally. As a firm we are investing heavily in technology and training to ensure, to the highest degree possible, that the audits that we execute are completed to the best quality.

Given the complexity of financial institutions with large volumes of data, highly sophisticated IT systems and evolving products, it is not commercially possible to provide absolute assurance from an external audit. In addition, it is extremely difficult for auditors to detect well concealed fraud. If such absolute assurance was to be provided, as Dixon Advisory has indicated, the cost associated with audit would be unacceptable from a customer perspective. We therefore, per the auditing standards, utilise sampling and modify our testing based on assessments of the inherent risk of an account balance and the associated internal controls that interplay with such accounts.

In relation to "expectation gap", being the difference in views as to the role of external audit from a customer/investors perspective relative to the legislated role outlined in the Corporations Act and Auditing Standards, there is no doubt that more work is needed. For the reasons outlined above, no audit will provide absolute assurance over financial balances, and an audit is not a guarantee that the business model in operation by a fund/corporate is fool-proof. We do note that the International Auditing and Assurance Standards Board (IAASB) in its recent Invitation to Comment: Improving the Auditor's Report (ITC), proposed a number of suggested potential improvements to enhance the relevance of the auditor's report in the public interest. Issued in June 2012, the ITC is the IAASB's second consultation in its auditor reporting project. The ITC seeks to address the question of what auditors can do through the auditor's report to help address the requests by investors and other stakeholders for more relevant and decision-useful information about the audited entity, its financial statements and the audit process itself.

We strongly support meaningful change to increase the usefulness and informational value of the auditor's report. Our views on potential changes to auditor reporting are guided by certain overarching considerations that seek to keep investors' interests and audit quality at the forefront.

II. Emphasis of matter statements

We see that external audit has a very important role in relation to providing confidence to stakeholders on financial statements. In relation to a fund financial audit, there is no doubt that a key component is gathering evidence to support the valuation and existence of investment assets. If in completing our procedures we had concern over either the existence or valuation of a material assets or class of assets, then it would be appropriate for us to consider having an emphasis of matter section in our audit report.

Under the Auditing Standards, we utilise emphasis of matter paragraphs in our reports where, in the auditor's judgement, a matter is of such importance that it is fundamental to the users' understanding of the financial report. Importantly, such matters are only reported when the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial report. That is, we cannot use emphasis of matters for account balances where we are not satisfied that, based on the accounting policies and disclosures in the financials that the balance is materially correct (ie the assets exist and are valued materially correctly). In practice, emphasis of matters statements are generally used to highlight uncertainty - about the future financial performance, or the outcome of a legal case, for example.

III. Review V's Audit of half year financials

There is no doubt that the rigor associated with an "audit" is significantly higher than a "review" which is typically what is performed for half year financial statements. Indeed, our review opinion states that "a review of a half-year financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion."

While the directors of a Responsible Entity/Corporate can request a full audit at a half year, such requests are very uncommon, so we would generally execute a review, not an audit, of half year financial statements.

While it is difficult to be precise regarding cost/fee differential between an audit and a review, a reasonable estimate is that a review costs (the client, therefore ultimately the investors) around one third the amount of an audit. While such a differential may not be significant in the context of a scheme's funds under management, typically Responsible Entity boards are very cost conscious.

Is there a threshold between treating something as an 'emphasis of matter' and treating it as something that requires a modified opinion in the audit? What is the threshold and how is it determined? Are there general rules that an auditor can apply? On the other hand, if it is more the case that each instance must be judged on its merits, how would an auditor make this decision? Does it primarily come down to experience and professional judgement?

Yes, there is a threshold question in determining if an audit opinion is "modified" (ie qualified) or an emphasis of matter is appropriate. In particular:

- ASA 705 - Modifications to the Opinion in the Independent Auditor's Report defines the need to modify (qualify) an opinion when:
  - The auditor concludes that, based on the audit evidence obtained, the financial report as a whole is not free from material misstatement; or
  - The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial report as a whole is free from material misstatement.
- ASA 706 - Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report requires an emphasis of matter paragraph when:
  - The auditor considers it necessary to draw the users' attention to a matter presented or disclosed in the financial report that, in the auditor's judgement, is of such importance that it is fundamental to the users' understanding of the financial report, provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial report. Such a paragraph shall refer only to information presented or disclosed in the financial report.

These two standards therefore provide the threshold between when a modified opinion is required and when an emphasis of matter is needed. A modification is applied when the financial statements are deemed materially incorrect, or the auditor is unable to obtain adequate evidence to form a positive view on the financial position of the entity. A modification is therefore pervasive, but an emphasis of matter is drawing to the reader's attention a matter that they should contemplate when considering the financial statements.

While on first read of the above it may be concluded that arguably there should be more emphasis of matters in audit reports, ASA 706 does state that a proliferation of emphasis of matter paragraphs is not desirable as it diminishes the effectiveness of an auditor's communication with stakeholders. From an audit profession perspective we believe that it is more desirable that companies/funds provide adequate disclosure in the financial statements so that the need for emphasis of matters is diminished. Indeed, the financial accounting standards are, we believe, comprehensive and do require adequate disclosure in financial statements over:

- Key financial risks within the business
- Sensitivities of certain financial assets
- The sources and nature of valuation techniques of investments, which is particularly relevant for managed investment schemes
- Details in relation to movements of provisions
- Contingent liability information

Every audit has professional knowledge and judgement applied, particularly in relation to the determination of the audit strategy and risk assessments. Such judgement is also required in relation to forming a final view of the financial statements and the nature of the opinion to be provided. Where it appears that there may be a need for some form of qualification, within our firm the engagement partner is required to consult with, at least, another experienced audit partner and/or our Professional Practice Director. Typical scenarios that will be considered and the resulting forms of opinions are:

- Management cannot adequately demonstrate existence of a material asset or group of assets – modification (ie qualification)
- Management cannot adequately support assumptions used in the valuation of a material asset or group of assets – modification
- Management has not adequately disclosed risks and sensitivities in accordance with accounting standards (such as AASB 7) – modification
- Management has used assumptions in their valuation of assets that are appropriate but subject to considerable uncertainty (and are appropriately disclosed) – emphasis of matter
- Management has used assumptions that are appropriate(but are, nevertheless, assumptions and therefore subject to some uncertainty) – standard, unqualified opinion

Ernst & Young

16 July 2013

Mr Thomas of van Eyk told the committee that 'the largest [expectation] gap that you have at the moment would be around the regulation of self-managed super funds and how people are being licensed to establish those in the first place' (Proof Hansard, p. 19).

Can you comment on this claim that the largest expectation gap is around the licensing and establishing of SMSFs? Do you see this as an area in need of reform and if so, do you have any suggestions as to how the licencing system could be improved?

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.

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.

12 July 2013

Ms Deborah O'Niell MP
Chair
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra
ACT 2600

Dear Ms O'Neill,

Re: questions on notice to Lonsec Research arising from ASIC oversight hearing on Friday 21 June 2013

We refer to the email from Patrick Hodder on your behalf dated Friday 28th June 2013, for which we thank you.

Lonsec welcomes the opportunity to answer the questions on notice. Please note, in some sections we felt it appropriate to address multiple questions within the one answer and we have indicated this accordingly below. We hope this proves appropriate for the needs of the committee.

Thank you again for the opportunity to attend the recent hearing. Lonsec welcomes any discussions the Committee or ASIC may wish to initiate regarding future legislation or regulation of the investment research industry which involve matters of consumer protection.

Sincerely

Amanda Gillespie
CEO
Lonsec Research

Richard Everingham
GM – Strategy & Development
Lonsec Research

LONSEC RESEARCH PTY LTD

ABN 11 151 658 561, AFSL no: 421445
Level 22, 500 Collins Street Melbourne VIC 3000 **PO Box 46, Collins Street West Vic 8007** Phone: (03) 9623-6300 • Fax (03) 9623 6990
Level 14, 2 Bulletin Place, Sydney, NSW, 2000 **PO Box R1174, Royal Exchange, NSW, 1225** Phone: (02) 8651 6777 Fax: (02) 8651 6790

ANSWERS TO QUESTIONS ON NOTICE ARISING FROM PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES HEARING ON 21 JUNE 2013

Gatekeeper roundtable—Questions on notice for Lonsec

Would you be able to clarify for the committee some of the issues that were raised in your statement and at the roundtable:

a) What does a rating mean and on what basis is it formed?

Each of the five research houses in Australia ascribe ratings to unlisted financial products. The universe of available financial product is large (approximately 4000 managed funds at the 'headline' or 'parent' level, and approximately 12,000 funds once tax structures and platforms variants are accounted for). Each research house identifies a significantly smaller subset of this universe to submit to their proprietary research processes and the result is typically a research report (or reports) containing factual information, opinion, and an overall investment rating.

Each research house has a different basis for, and therefore definition of, its ratings. This is one of the key points ASIC identified in RG79 – that users of research needed to be aware of, and understand, the varying meanings attached to ratings across the research house industry. Generally speaking though the following statements can be made:

- Financial product ratings and accompanying research opinions are primarily supplied to financial advisers, as opposed to end investors. They therefore only constitute general advice.

- A key part of research house ratings processes is the categorisation of financial products in order to form peer groups

- Research house ratings are descriptors or labels which reflect the relative merits of financial products, as determined by each research house's disclosed ratings process, and consistent with the stated ratings definitions. Ratings are typically scale based and therefore relative to other ratings of like financial products (ie x stars out of 5, A-B-C-D, Highly Recommended, Recommended, Investment Grade etc). Ratings definitions are typically displayed within the research report itself, whereas detailed explanations of research processes are typically made available to users of research via research house subscriber websites.

- Research houses do not typically publish their ratings without accompanying research. Lonsec believes (and we believe that all research houses are of the same view) that financial product ratings require context and guidance (within the bounds of general advice) in order to be used appropriately. A positive financial product rating can be broadly interpreted as a professional opinion that a financial product provider has the requisite investment people and investment processes in place to achieve their stated product objectives in the future over an appropriate investment time horizon (naturally, the rating is not a guarantee). A rating (in isolation from its supporting research) does not tell an investor who the financial product is or isn't suitable for, how to use the financial product, how the financial product should 'behave' in certain market environments, or what key risks should be considered prior to investing into the financial product. Within the bounds of general advice, a good research report will provide general guidance and general opinion to assist financial advisers in forming their professional views on these aspects. In summary, Lonsec contends that financial product ratings should form one part of an adviser's overall due diligence process and should not be used as the sole basis for recommending a financial product.

- In Australia, financial product ratings take into account varying degrees of historical quantitative information (return, risk etc) but are primarily determined (in a peer reviewed, systematic fashion) by professional qualitative judgement (subjective opinion). Lonsec understands that an exception to this general statement is the Morningstar 'Star' rating system, which we believe to be completely quantitative.

b) To what extent is a rating a guide to future performance?

Financial product ratings aim to provide a point in time view on whether a financial product provider has the requisite skill, people and processes to achieve their stated investment objectives over the relevant investment time horizon. Ratings are not intended to be a predictor of future market performance, nor are they intended to guide financial advisers in making short term tactical market calls.

d) Do research houses publish qualitative research that is forward-looking, and if so, on what basis is it formed?

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

e) Are recommendations to buy, sell or hold based solely on the qualitative forward-looking research?

As mentioned, in Australia, financial product ratings issued by research houses are primarily qualitatively determined and are intended to be forward looking. That said, poor long term quantitative results can be symptomatic of qualitative issues such as team instability, inadequate risk controls etc. Lonsec understands that an exception to this general statement is the Morningstar 'Star' rating system.

It is important to understand that research house ratings are not advice to buy/sell or hold a financial product, rather they are a view on the relative strengths of a manager / financial product within their respective financial product peer group and their ability to meet their objectives. Ratings do not take into account individual client circumstances and tolerance to risk. However, within accompanying research reports research houses will often refer to how financial products may behave in different market environments and what the key risks to consider are. This doesn't drive a rating but it forms part of the research report.

Lonsec cannot comment as to the efficacy of the ratings of our industry peers. Lonsec can however state that our aggregated ratings in traditional asset classes exhibit efficacy. There are a number of ways to define and measure efficacy, however efficacy is most typically determined by comparing the returns of positively rated financial products to 'peer average' returns or the returns of the most commonly adopted benchmark for that sector or sub sector.

Financial product ratings and accompanying research opinions are primarily based on 'front of house' investment capabilities, as opposed to 'corporate' or 'operational' aspects or current or forecast market conditions. As stated in Lonsec's opening statement to the committee on 21st June 2013, we do not believe that research houses have either the knowledge or the expertise or the resources to accurately and consistently identify fraudulent conduct that may lead to financial product failure. Nor can research houses accurately and consistently predict extraordinary market events that may cause market failure.

In Lonsec's case, we believe that investment research should be forward-looking and qualitatively skewed. Accordingly qualitative factors generally account for 80% of our rating for most mainstream asset classes, while quantitative factors account for 20%. Within the qualitative component, Lonsec's assessment of investment people and investment processes has the greatest impact on the rating. Within the quantitative component there is an emphasis on the returns, risk, and consistency of the financial product in question over three years and beyond (however, this is not essential for new investment teams if the core of the team has a proven track record of managing money in a similar manner at another organisation). In some specialist sectors, such as Alternative Income, and where relevant quantitative data is unavailable, the research process can be 100% qualitative. As per ASICs guidance in RG79 ratings are subject to peer review involving senior members of the Lonsec research team.

In terms of ratings definitions (as opposed to the factors which influence ratings outcomes) Lonsec's ratings are an expression of a) Lonsec's level of conviction that an financial product can achieve risk adjusted returns in-line with relevant objectives, and b) Lonsec's view of the relative attractiveness of the financial product vs its peers (peers being similar financial products grouped together into a 'sector' or 'sub-sector'). As mentioned, each research house has a different definition for its ratings and we cannot comment upon alternative definitions.

LONSEC RESEARCH PTY LTD

ABN 11 151 658 561, AFSL no: 421445
Level 22, 500 Collins Street Melbourne VIC 3000 **PO Box 46, Collins Street West Vic 8007** Phone: (03) 9623-6300 • Fax (03) 9623 6990
Level 14, 2 Bulletin Place, Sydney, NSW, 2000 **PO Box R1174, Royal Exchange, NSW, 1225** Phone: (02) 8651 6777 Fax: (02) 8651 6790

c) Are these ratings made publicly available, or are they fee-for-service?

It is Lonsec's understanding that all research houses in Australia sell their research and ratings to subscribers (ie fee for service). These subscribers are typically advice giving intermediaries such as financial advisers. Lonsec understands that an exception to this general statement is Morningstar who we understand allow their 'Star' ratings to be made publicly available.

f) Are the concerns that Lonsec has expressed about the cost of high quality research and the limits on the ability of the financial planning and financial advice sector to pay for that research related primarily to qualitative research?

Yes. As mentioned above, the Australian research house sector conducts its managed funds research in a predominantly qualitative manner. Certain other markets in the world, most notably the US, are dominated by research houses that operate primarily quantitative research and ratings processes. Quantitative processes are mechanised, driven primarily by technology and are scalable. In contrast, qualitative processes rely far more heavily on people, are therefore more expensive to operate and are far less scalable unless revenue is directly linked to research volume.

2. In your statement to the Parliamentary Joint Committee (PJC), you stated that 'financial planning dealer group licensees (on behalf of their financial planners) are, in turn, only willing to value investment research at around one tenth of the cost of its production'. You note that this is based on Lonsec estimates.

a) Are you able to provide the committee with the evidence that substantiates this claim?

Unfortunately Lonsec is unable to supply the committee with the evidence to substantiate this claim as the information is commercial-in-confidence.

3. In your statement to the PJC, you make some recommendations for closing the 'expectations gap' between research houses and financial planners, including that ASIC could provide further clarity on 'the role and responsibilities of research houses and users of investment research (in this instance, financial planners)'. a) Would you be able to specify what it is that you would like further clarity on that is not covered in, for example, Regulatory Guide 79?

Lonsec believes that at the heart of the 'expectations gap' is an over-emphasis and over-reliance on the use of ratings in isolation from supporting research, and in isolation from fully formed views (at the financial adviser level) about how a given financial product should be used and who it is and isn't appropriate for. This can lead to a 'one rating fits all' mentality. It is akin to a doctor (GP) prescribing an 'approved' drug without knowing what type of people and conditions it is designed for, what type of people and conditions it isn't suitable for, what its dosage should be, what its side effects are, and how the drug may react with other drugs already being taken.

Lonsec believes that the Future of Financial Advice (FoFA) reforms, specifically those relating to 'best interests' and ASIC's associated guidance contained within RG175 should go a considerable way to improving this situation. In particular we believe ASIC's guidance that financial product based advice must leave clients in an 'improved position' (RG 175.165 (v), RG 175.218 (d), RG 175.228 – RG 175.235) and that 'one size fits all' solutions must be avoided (RG175.239) will lead to better investment advice and behavioural changes from financial advisers around the use and reliance on ratings in isolation from supporting research. We believe the reforms will lead to financial advisers concentrating much more closely on 'client suitability' aspects of financial products such as product complexity, tax efficiency, income levels, environmental, social & governance (ESG) factors and minimum investment time horizons. We believe financial advisers will further up-skill on investment knowledge and that the financial product recommendation process will become more interactive with the client in order to flesh out 'valued features and benefits'. Lonsec foresees the financial product advice process expanding from the current '2D' approach, where financial product 'quality' (proxied by ratings) and price (fees) are the predominant drivers, to a more '3D' approach where financial product quality, price and suitability (or 'fit') are considered more holistically and proportionally.

Lonsec believes that the above improvements from RG175 and the enhanced disclosure requirements flowing from RG79 will shrink the 'expectations gap' materially, however we also believe ASIC could further facilitate the process in the following areas:

ASIC could provide the marketplace with a statement as to what financial product ratings are (and aren't) and what they can (and can't) be relied upon for (by users of research). In particular, Lonsec believes an expectations gap will remain as long ASIC remains silent on the expectations from some users of research : that a) it is the role of research to accurately and consistently identify fraudulent conduct which may lead to financial product failure, and b) that research houses should be able to accurately and consistently predict extraordinary market events which may cause market and in turn financial product failure

ASIC could provide specific and granular guidance that before recommending a financial product it is the ultimate responsibility of the financial adviser, not the research house, to understand the following :

<u>The nature of the financial product</u>

How complex is the financial product? What assets or other investments does the manager of the financial product invest into? What drives the performance of those investments? What are the key risks of the financial product which pertain to the probability of: a) loss of capital, b) loss of income, and c) loss of access to the investment (liquidity)? What are the objectives of the financial product? What is the likely performance of the financial product under common market scenarios? How tax efficient is the financial product at various marginal tax rates? Where the financial product's objective is stated as a targeted return, what is the likely split of return between capital growth and income? How, at all, does the financial product take into account environmental, social, or governance factors? What other features and benefits accompany the investment (eg insurance within a superannuation fund, platform implementation, administration and reporting features and benefits where the fund is accessed via a platform). What are the costs of investing into the financial product and accessing any additional features and benefits?

<u>The investor types or investor scenarios best suited to the financial product</u>

Based on the nature of the financial product and the financial adviser's knowledge of individual client needs, goals, objectives, tolerances, preferences and financial literacy, which clients are suitable for the financial product?

<u>The appropriate use of the financial product</u>

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

In Lonsec's view, research houses have a major role to play in helping financial advisers to reach an understanding of the nature of financial products, a moderate role with respect to understanding the appropriate use of financial products and a minor role with respect to identifying investor types and investor scenarios best suited to financial products.

4. At the ASIC Annual Forum in March this year, it was claimed that the ratings and recommendations produced by research houses influence the flow of revenue from both wholesale and retail investors into particular funds. It was also suggested that research houses should have more 'skin in the game'.

a) To what extent do you think you think the claim about the flow of funds is a valid and reasonable assessment?

There is no doubt research house ratings have influence on fund flows but this, in Lonsec's opinion, is primarily a function of the over reliance on ratings in isolation from the supporting research. Licensees ultimately control their APLs and have the responsibility and the authority to make the final call on what financial products are made available to their financial advisers to recommend to their clients. Research houses do indeed perform a filtering, sorting and relative assessment function, as ultimately expressed through ratings, but the licensee is ultimately the true gatekeeper. To the degree that licensees choose to determine their APLs through selecting only the highest rated financial products from a research house, the influence of research houses is obviously significant. Lonsec would contend however that this approach has disadvantages and is likely to become less prevalent with FoFA reforms now enacted. For further context please refer to our answer to questions 5 a) and b). Further, with respect to FoFA reforms, Lonsec is optimistic that ASIC's guidance within RG175 will in fact lead to lower reliance by financial advisers on a small number of highly rated financial products or on 'one size fits all' advice solutions. In particular we draw the committee's attention to RG175.239 and RG175.355.

b) What 'skin' do research houses have in the game?

c) Is there a direct link between the quality of a research report, that is the accuracy of its ratings and recommendations, and the rewards that a research house receives or the losses that it suffers; in other words, how accountable are research houses to the end-users of their products if their research is poor?

The following answer relates to both 4 b) and 4 c). Research houses have strong commercial incentives to produce high quality research and ascribe efficacious financial product ratings. Firstly, as Australian Financial Services Licence (AFSL) holders, research houses are regulated by ASIC and are subject to meeting the relevant standards and requirements of the Corporations Act. If a research house fails to meet any of the required standards or requirements significant reputational damage would result. Secondly, research houses operate within a very competitive commercial environment. The marketplace for research is therefore self regulating. Research houses are typically engaged on short term contracts and purchasers of research can and do quickly strip market share from participants that are perceived to be managing their conflicts poorly or producing compromised or poor quality research.

On a fund by fund basis, to Lonsec's knowledge, there are no linkages between the accuracy of ratings and recommendations and research house compensation. On an aggregated basis there is however a link. It is a common practice for research houses to be asked by their clients (or prospective clients during tenders) for aggregated attribution analysis of the performance of their ratings and model portfolios. During tenders, research houses are also asked what their research and ratings history has been with various failed financial products. The practice is well established and in Lonsec's experience the track record of the research house in these aspects typically forms a material component of the overall decision to retain or hire.

d) To your knowledge, has a research house ever been the subject of a compensation claim following the failure of a product that had been either rated highly or recommended?

With respect to the Australian research house sector, to our knowledge no. In the adjacent credit ratings agency sector we understand Standard & Poors has been subject to a compensation claim. Please refer to: http://www.clmr.unsw.edu.au/article/compliance/federal-court-awards-damages-decision-against-credit-rating-agency

5. The committee understands that some firms such as Macquarie Group and Dixon Advisory have internal research functions.

a) Can you comment on the advantages of using a stand-alone research house for ratings and analytical research as distinct from advisory firms conducting their own analysis?

b) Can you comment on the claim by Dixon Advisory in their statement to the committee that in-house research 'can be better focussed and that the organisation has more transparency over the quality'?

The following answer relates to both 5 a) and 5 b). Research from research houses is used by financial advisers in many ways, ranging from being 'hard coded' into the licensee's compliance framework to being just one input amongst a number in an overall internal licensee research effort. An example of the first approach, which Lonsec typically observes in smaller financial advisory practices, is where a licensee decrees that the Approved Product List (APL) comprises only Lonsec financial products rated Recommended or Highly Recommended (Lonsec's two highest ratings). Such licensees may also decree that the Lonsec's core 'model portfolios' are adopted as the licensee's 'model portfolios'.

An example at the other end of the spectrum, which Lonsec typically sees adopted within the largest institutional advice businesses, is where research house research and ratings are used as a starting point and a back up to the internal research effort. These licensees typically subscribe to research from multiple external research houses. The in-house research team then does 'overlay' and 'gap' research, typically in areas of heightened end investor demand, heightened risk, heightened financial product complexity, or areas of perceived weakness in the external provider's capabilities. The in-house team prescribe their own ratings, select their own APL, and create their own model portfolios (often in conjunction with consulting input from a research house). The external research house research and ratings are not 'hard coded' into the licensee's compliance framework.

The primary advantages of the former approach are cost savings and advice efficiency – essentially the licensee has outsourced the bulk of the financial product research process to a third party. A second advantage is that the size of the APL tends to be relatively large based on this type of blunt construction criteria and therefore there are fewer transition issues to consider when new financial advisers join the group (new financial advisers often bring with them clients who are invested into financial products that are not on the APL of the new licensee). A third advantage is APLs will be manufacturer agnostic and independent.

The primary disadvantages of this approach are that the licensee has not refined the APL or model portfolios to suit their specific client base and the relatively large APL creates a relatively large compliance burden (and risk). A secondary disadvantage lies in the aforementioned over-reliance on ratings relative to other features and benefits of potential value to clients which may exist in lesser rated financial products. For example there may be 'Investment Grade' (this is the Lonsec rating below 'Recommended') financial products excluded from the APL which have better tax efficiency at certain marginal tax rates or better insurance features (for superannuation financial products) than the higher rated financial products included on the APL. Underlying clients of the financial advisers within this licensee will not have access to these financial products.

The chief advantage of the second approach is greater overall due diligence and governance, and a more focused APL to meet the needs of the main end client types or end client scenarios which prevail in that group. A key disadvantage of this approach is cost – typically only the institutional licensees and the larger mid tier licensees operate in-house research teams in excess of 1 person, therefore the capacity to undertake meaningful 'overlay' or 'gap' research is limited. A secondary potential disadvantage is the possibility of restricted access of non-aligned financial product to the marketplace. Institutional advisory practices are vertically integrated and, subject to appropriate internal governance, 'group' or 'aligned' financial product may in some instances dominate certain sectors within the APL. Given APLs are often 'capped' in total size (to reduce compliance burden and maximise oversight and control) this can have the effect of blocking out 'non aligned' financial product from these APLs within certain sectors.

A final scenario involves licensees who only conduct internal research (they do not use any external research). Lonsec agrees with Dixon Advisory that an advantage of this approach is that the research effort can be tailored to proprietary requirements and therefore there is strong focus and relevance to the research effort. We do however question whether the quality, and the breadth, of internally produced research can consistently meet that produced by external research houses. External research houses are afforded a level of consistent access to portfolio managers and other key investment professionals within funds management organisations, which is unlikely to be granted to individual advisory firms. Further, by way of scale of operations, research houses can hire multiple specialist researchers, and have systems and processes in place that allow for strong governance, deep consistent high quality research, and relatively wide research coverage across the marketplace (compared to an individual firm). We therefore believe there are significant disadvantages to the internal research only model, chiefly that there are unlikely to be enough resources to achieve an adequate coverage of investment options to meet a range of client needs, and that the relatively limited number of specialist investment researchers available for hire within the marketplace means accessing the required analytical talent in a cost effective manner may be problematic.

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

6. In a media release (11–255) coinciding with the release of Consultation Paper 171 on 16 November 2011, ASIC identified an apparent 'expectations gap' between financial advisory firms and research houses about the nature and role of research. Advisers expressed a view that research houses should cover less products and undertake more in-depth research. By contrast, some research houses saw their role as providing product coverage for a range of products in each market segment and identifying the 'best of breed' products. a) Could you comment on this finding by ASIC?

As free market enterprises, research houses respond to the needs and demands of their clients (financial advisers) in order to be commercially successful. To infer there is a disconnect between what financial advisers have wanted and what they have received assumes this free market mechanism is distorted or hampered in some way. A more likely explanation is that financial adviser preferences around financial product research have changed and Lonsec believe it is pertinent to ask why this may be the case.

In the decade leading up to the Global Financial Crisis (GFC) Lonsec experienced considerable growth in subscribing financial advisers through materially broadening our coverage of financial products (without compromising quality or depth). Wide financial product coverage from research houses was preferred as wide APLs were preferred by licensees, primarily to allow maximum choice and flexibility to existing and incoming financial advisers to the dealer groups. Notwithstanding this widening coverage, the main criticism Lonsec received from our clients was that we did not research new financial products quickly enough and that the range of financial products we researched was still not wide enough.

As the GFC unfolded and a number of financial products experienced large drawdowns, liquidity freezes and failures, a desire on the part of licensees to reign in and 'clean up' APLs became evident. Avoidance of 'toxic' financial products became paramount. The desire for unconstrained choice was replaced by the desire to avoid problematic investments. APLs in general contracted.

Against this backdrop ASIC consulted a sample of financial advisers in late 2011 and these financial advisers expressed the view that research houses should be doing more in-depth research. Lonsec believes that this desire was actually mis-stated and that the primary (but unstated) desire was for financial product research to be able to be relied upon as a failsafe insurance policy against exposure to any and all 'failed' financial products. Or stated in alternate terms, we believe the desire for more in depth research actually reflected an unrealistic desire that financial product research produced by research houses should be flawless and that every instance of financial product failure, however caused, should be detected before the fact and screened out.

If financial advisers were genuinely interested in more in depth research for the purposes of greater financial product understanding, self education and better investment advice for their clients, this would become evident in the way Lonsec's research was used. To this point, Lonsec tracks (by way of hit counts on our subscriber website) which research reports are opened (and presumably read) by our subscribing financial advisers. For a given financial product Lonsec produces an in-depth (6-10 page) product review, an abbreviated (2 page) product summary report and a 'fees and features' only fund profile (1 page). We also produce in-depth 'sector review' summaries. By far the most downloaded piece of Lonsec research continues to be our 'fees and features' only fund profile. By comparison our comprehensive sector reviews and in-depth financial product reviews continue to be infrequently accessed. In short, in Lonsec's experience, financial advisers have not been seeking greater depth of information, guidance or opinion on financial products. We believe the stated desire for greater depth of research actually reflects an unrealistic expectation that all financial product failures, however caused, can and should be identified before the fact and avoided.

In a recent paper in the Journal of Economic Perspectives, veteran American economist, Burton G. Malkiel, critiques advertisements that suggest individuals would be better off switching into actively managed funds with four or five star ratings rather than simply holding a broad-based index fund (http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.27.2.97). Malkiel states on page 108 that one of the premier research houses acknowledged that 'simply ranking funds by expense ratio provides a better predictor of future returns'.

Could you explain the expense ratio to the committee, and why (or why not) ranking funds by their expense ratio would be a better predictor of future returns than a rating system?

An expense ratio is a measure (usually expressed as a percentage of the amount invested) of the costs associated with an actively managed fund. The ratio primarily reflects the costs of the active management provided by investment staff but may also include marketing, legal and third party costs associated with distribution of the fund to investors.

In the paper the author questions the value of the fees associated with active management of investment portfolios. The merits of active management have been debated for many decades and Lonsec believes the debate will continue for many more. A key tenet of Lonsec's research philosophy is that active management is worthwhile, however obviously not all managers will outperform their chosen benchmarks over all time periods. Furthermore, it is difficult to rely on historical returns as an indicator of future performance; hence as previously stated, Lonsec's research process has a qualitative and forward-looking skew.

Lonsec would question whether simply ranking funds by expense ratio would provide a better predictor of returns, particularly in markets which are less than perfectly efficient or during periods where there are major dislocations such as those experienced during the GFC. In Lonsec's opinion the statement is most relevant in markets where the prices of securities accurately reflect all available information in a timely manner. Lonsec believes that with the possible exception of large cap Australian equities, most asset classes in Australia do not exhibit this characteristic.

LONSEC RESEARCH PTY LTD

ABN 11 151 658 561, AFSL no: 421445
Level 22, 500 Collins Street Melbourne VIC 3000 **PO Box 46, Collins Street West Vic 8007** Phone: (03) 9623-6300 • Fax (03) 9623 6990
Level 14, 2 Bulletin Place, Sydney, NSW, 2000 **PO Box R1174, Royal Exchange, NSW, 1225** Phone: (02) 8651 6777 Fax: (02) 8651 6790

Gatekeeper roundtable—Questions on notice for Macquarie Group

Macquarie Responses in BLUE

1. 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.

    a) The committee understands that Macquarie Group makes financial products and also employs advisers to sell those products. Can you comment on whether Macquarie Group's financial advisers are subject to sales targets, and if so, could this create tension for your advisers in meeting the best interests of their clients?
    b) Does Macquarie 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?
    c) If Macquarie Group does not rely solely on the financial adviser complying with the new FOFA reforms, what protocols does Macquarie Group have in place to avoid or manage this conflict should it arise?

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

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

    With regard to conflicts of interest, even prior to the FOFA reforms, the Corporations Act required AFS Licensees, such as Macquarie, to have in place arrangements for the management of conflicts of interest. This legislative obligation is supplemented by extensive ASIC guidance and the new section 961J of the Corporations Act requires advice providers to give priority to their clients’ interests where a conflict exists.

    In addition, the new section 961L requires AFS Licensees, such as Macquarie, to take reasonable steps to ensure that representatives of the Licensee (e.g. advisers) comply with the best interest duty and client priority rule. We believe these obligations are adequate to ensure that AFS Licensees appropriately manage any conflicts of interest which may impact on representatives/advisers providing advice to their clients.

2. In your statement to the Parliamentary Joint Committee, you note that one of the criteria that Macquarie's advisers would use to critically evaluate a research report is whether the research report is paid for by a fund manager or by subscribers.

    a) When Macquarie Group sources external research, do you have a preference for research from a research house that is generated under a particular business model, or is it enough for Macquarie's advisers to satisfy themselves that any conflicts of interest in the research house business model have not only been declared, but also adequately managed?

    Macquarie does not have a preference for a particular research house business model. We leave it to the research houses to determine their approach in providing services to the market. We choose our research suppliers on the basis of transparency, the quality of their processes and reputation. The reports are one of a number of inputs into our decision-making as to whether to include a fund on our Investment and Product Menu.

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

3. In their statement to the Parliamentary Joint Committee, Lonsec argued that 'the entire research house sector provides a materially discounted service to the financial planning industry, due to the inability and/or unwillingness of its participants to accept the full cost of production'.

    a) Would you be able to comment on this proposition from your perspective as both a purchaser of external research and as a business that also produces in-house investment research?
    b) Do you believe that ultimately the end-user, namely the investor, is, at least in some cases, unable or unwilling to pay for the cost of high quality *qualitative* investment research?
    c) Can you comment on the cost of high quality qualitative research from research houses relative to the cost of Macquarie Group conducting the same quality of research in-house?
    d) If the cost of high quality *qualitative* investment research does raise an issue for both the research house and financial advising sectors, how do you currently manage this?
    e) Are there other suggestions that you would make to address this dilemma?

    We are not in a position to comment on the different business models of research houses. It is a competitive marketplace and we leave it to suppliers to determine their fee structure.

    In the main, Macquarie utilises the services of those research houses which have a subscription model, however, our selection is based on the considerations outlined above. We use external suppliers in order to benefit from the economies of scale such research houses afford, with the belief this ultimately benefits the end-user. This external research is the starting point; Macquarie undertakes its own research on a supplementary basis to validate the information and data sourced from external research houses. This in-house research has a greater emphasis on the potential applicability and risks of using that product and as such is not directly comparable to that carried out by an external research house.

4. In its statement to the Parliamentary Joint Committee, Lonsec made several points about a subset of the financial planning industry, namely that 'research houses continue to encounter ‘expectations overreach’ from a subset of financial planners in the following areas':

    - What a rating is and is not and the degree to which it can be relied upon;
    - An expectation that it is the role of investment research to accurately and consistently predict, thus avoid, financial product failure;
    - An expectation that well rated financial products will consistently outperform their benchmarks over ‘short term’ periods;
    - An expectation that all well rated financial products are suitable for all clients.

From your perspective, do you think that 'expectation overreach' exists within a subsection of the financial planning industry?

a) Do you think that it would be reasonable or unreasonable for financial planners and advisers to hold the expectations listed above?

Due to our approach to research, as outlined above, we do not believe ‘expectations overreach’ exists within Macquarie. A subsection of the financial planning profession may have very high expectations of the capability of research houses, however, we do not survey participants and are therefore unable to comment.

5. A paper just published in the *Journal of Economic Perspectives* by veteran American economist, Burton G. Malkiel,http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.27.2.97)[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?

We have referred this question to our representative body, The Financial Services Council. The FSC were at the round table and we believe they will be in a better position to provide information on this research to the Committee. We understand the FSC will respond directly to the Committee.

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.