Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

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Vertical integration in the Financial Services Industry

The Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry acknowledges the issues caused by vertical integration within the industry. For example it notes:

> *"The evidence about platform fees (and service provision) thus invited attention to some fundamental questions about aspects of the structure of the financial advice industry. In particular, ... how the vertical integration of the industry may harm clients by protecting platform entities associated with advice licensees from competitive pressures. Clients end up paying more for platform services than other providers would charge for the same service"*[1].

Further, the Interim Report of the Royal Commission referred to ASIC's January 2018 report *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest*. That report highlighted how often the conflicts of interest were 'managed' in a way that aligned with the adviser's interests. The ASIC report shows that advice that benefits the adviser 'commonly' does not advance the interests of the client and in a significant number of cases does actual harm to the client[2].

Vertical Integration and the role of Responsible Entity

One highly relevant aspect of vertical integration within the financial services industry not as yet directly highlighted by the Royal Commission is the role of investment scheme Responsible Entity.

As created by the Managed Investments Act (MIA) 1998 the role of the Responsible Entity was designed to replace the manager/trustee in managed investment schemes. According to the MIA a Responsible Entity has the dual role of trustee and manager of an investment scheme, and must be appointed if an investment scheme needs to be registered. Furthermore, the Responsible Entity must be an Australian public company, with certain levels of net tangible assets, depending on the value of the scheme's assets. In addition the Responsible Entity must hold an Australian Financial Services Licence. While all of these conditions seem reasonable there is a fundamental potential conflict which that MIA has created which may cause harm to consumers.

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1 Commonwealth of Australia, *Interim Report Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 2018, 137.

2 ASIC, *Report 562: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest*, 24 January 2018, 35.

The potential conflict stems from vertical integration and relates to the fact that under the MIA the Responsible Entity can be owned by the same group as the fund manager, i.e. an "internal" responsible entity. Thus there is potentially a lack of structural independence with both Responsible Entities and Superannuation Responsible Entities.

Concerns relating to the lack of an independent custodian has been highlighted for many years. As Moody and Ramsay noted in 2003:

> *"to permit self-custody and related-party custody introduces a higher risk of maladministration. This heightened compliance risk may not be sufficiently counterbalanced through the other protective and supervisory mechanisms that currently exist under the Corporations Act 2001 (Cth)"*[3] .

Moody and Ramsay (2003) also proposed that with the increasing concentration in the area of financial asset schemes due to mergers and acquisitions there could be greater self-custody and related-party custodial arrangements. This has indeed happened over time. In addition they note that public sector supervision is hampered by financial restraints and private sector supervision has been restricted by the legislation[4].

The MIA does provide for independent oversight through the compliance committee (or an equivalent independent board) and the compliance plan auditor. The fact that these provisions were considered necessary may be an admission that self-monitoring by the Responsible Entity may not of itself an effective governance policy[5]. However, while compliance committee members are under statutory duties to act honestly and with care and diligence, they are not under a duty to act in the best interests of investors and their allegiance is owed to the entity that they are expected to supervise. Further they meet at most quarterly i.e. post the resolution of an event and thus do not have the ability to actively overlook the resolution of an issue on a timely basis.

This lack of structural independence has been highlighted in the Royal Commission in the case of IOOF (not to mention similar issues regarding lack of structural independence with CBA, NAB and AMP). Even prior to the announcement of the Royal Commission of lack of structural independence and its resulting consequences was noted in the media. The case of Macquarie Investment Management Ltd (MIML) and the van Eyk Blueprint International Shares Fund (VBI Fund) is a case in point. MIML was Responsible Entity of the VBI Fund while concurrently having an arrangement to profit from the sale of van Eyk. The arrangement involved MIML having an option to take a 40 per cent share of any sale proceeds, if the funds under management were less than $2.5 billion or 35 per cent of the sale proceeds if the funds were greater than $2.5 billion. According to media reports details of the arrangement did not appear in any documents provided to unit holders statements[6,7].

The lack of structural independence may be addressed with appropriate legislative reform. A tangible solutions would be to legislate an independent Responsible Entity and / or Superannuation

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[3] Moodie, G. and Ramsay, I. *Managed Investment Schemes: An Industry Report*, The Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2003, 78.
[4] Ibid.
[5] Ibid, 79.
[6] https://www.smh.com.au/business/banking-and-finance/macquaries-secret-interest-in-van-eyk-funds-20140919-10j4cs.html
[7] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2016-releases/16-199mr-asic-commences-proceedings-against-macquarie-investment-management/

Responsible Entity with its own AFSL and material net tangible assets and public indemnity cover where the sponsor of the scheme or fund is either the investment manager and / or the administrator of the scheme and/or a superannuation promotor. Such a separation of duties may help ensure that the best interests of investors are protected.

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