Submission by Platinum Investment Management Limited in response to the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

26 October 2018

INTRODUCTION

Platinum Investment Management Limited (AFSL 221935, "**Platinum**") is a Sydney-based investment management firm specialising in international equities. Established in 1994, Platinum today manages around $26 billion and has a large retail investor base throughout Australia.

We welcome the opportunity to respond to the Commission's Interim Report dated 28 September 2018 and submit the following comments and proposals in addition to our initial submission to the Commission on 16 April 2018, and a subsequent submission on 21 September 2018 in response to the Commission's round 5 hearings on superannuation.

Our submission relates primarily to Chapter 3 of the Interim Report – Financial Advice, and will also touch on some of the questions raised in Chapter 9 Entities: Causes of Misconduct, in particular, Section 7.5 Business Structures. Our views are expressed from the perspective of an independent asset management business that manufacturers and distributes financial products.

SUMMARY

The Commissioner identified three themes from the various issues that emerged in connection with financial advice: 1) culture and incentives; 2) conflicts of interest and duty, and confusion of roles; and 3) regulator effectiveness.[1] Our submission will focus on the second of these themes as we believe that the key to reforming the financial advice industry lies in improving independence and transparency across the related financial services providers and their practices.

Legislative and/or regulatory intervention to minimise the presence of conflicts of interest in the context of financial advice and product manufacturing will, in our view, have a direct and positive impact on consumer outcomes and the competitive landscape of the financial services industry more generally. The elimination or reduction of these conflicts is also likely to lead to an improvement in the overall culture, governance and remuneration structures, within financial services firms that currently adopt vertically integrated financial advice business models. This should ultimately result in better alignment between the interests of financial advisers and their clients.

Our first proposal, on which several of our other submissions are premised, is to revise and simplify the definition of financial product advice by removing the bifurcation between "personal advice" and "general advice". The legal distinction is rarely appreciated by retail investors and the terminology can compound consumer confusion about the nature of the advice they are receiving. We submit that the concept of financial product advice should be limited only to "personal advice" as currently defined

[1] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p155.

Level 8, 7 Macquarie Place, Sydney NSW 2000, Australia | GPO Box 2724, Sydney NSW 2001
Telephone 61 2 9255 7500 | Investor Services 1300 726 700 | Facsimile 61 2 9254 5590 | Email invest@pla inum.com.au | Website www.platinum.com.au
Platinum Investment Management Limited ABN 25 063 565 006 AFSL 221935 trading as Platinum Asset Management

under the legislation.[2] Information about financial products that does not take into consideration a client's personal objectives, financial situation and needs should simply not be considered to be "advice".

Our other submissions and recommendations can be summarised as follows in the form of brief answers to select questions raised by the Commission in its Interim Report:

- ***Can conflicts of interest and duty be managed?***

  Whilst it may be theoretically possible for some conflicts of interest to be managed appropriately, the Commission's inquiries (and ASIC's Report[3] on this topic) have clearly shown that in the context of vertically integrated financial advice business models, such conflicts of interest are frequently mismanaged and have in fact often resulted in poor client outcomes. As this has been clearly demonstrated, greater focus should therefore be placed on the *avoidance* of such conflicts of interest by directing relevant industry participants towards independent business structures that are by their nature conducive to achieving a greater alignment between the interests of financial advisers and those of their clients'.

- ***How far can, and how far should, there be separation between providing financial advice and manufacture or sales of financial products?***

  Separation between financial product advice and the manufacture/sales of financial products can and should be enforced. Whilst, this may not, on its own, be sufficient to eliminate inappropriate advice, it is arguably a necessary step to removing the inherent conflicts of interests that have been the root cause of past misconduct, poor culture and misaligned incentives within vertically integrated financial advice business models.

  The industry may require a period of transition to adjust to the structural separation and deal with its implications. However, evidently, independent business models are viable, with many independent financial advisers already running successful advisory practices. Legal and accounting professional services firms are also good examples of this. Furthermore, there are also a number of established product manufacturing firms that do not have advisory arms nor are they otherwise affiliated with financial advisers, Platinum being one such firm. In addition to the obvious benefits that independent financial advice will deliver to consumers, structural separation should also serve to level the playing field between independent and non-independent financial advisers and asset managers, improving competition.

  Advice affordability and efficiencies of scale have often been cited as reasons to support vertical integration. However, there is little evidence that subsidisation of the cost of advice by product issuers leads to net savings for clients. In fact, conflicted financial advice has been shown to lead to poor investment outcomes and can be costly. Furthermore, when part of the cost of financial advice is built into the cost of the product, the cost of advice is not lowered, it is simply hidden. That said, to improve the affordability of financial advice, the government should consider making the cost of

---

[2] Section 766B(3) of the *Corporations Act 2001* (Cth).

[3] ASIC Report 562 Financial advice: Vertically integrated institutions and conflicts of interest

financial advice tax deductible. Access to quality financial advice should arguably reduce the financial burden on the government in the long run.

- ***Should financial product manufacturers be permitted to provide financial advice?***
  - ***At all?***
  - ***To retail clients?***

On the basis of our earlier submission that the definition of "financial product advice" should be simplified to include only "personal financial advice", we are of the view that product manufacturers, including their affiliated entities, should not be permitted to provide financial product advice to any client, regardless of the client's level of sophistication. All financial services licensees are required to manage their conflicts of interest appropriately[4], regardless of whether their clients are retail and/or wholesale. Impartiality is key to the ability to be able to provide quality advice. Accordingly, whilst wholesale clients may arguably be more financially astute and able to distil and appreciate the conflicts of interest that may arise when financial product manufacturers or their affiliated entities provide financial product advice, the high-level principle remains the same. That said, the problem is clearly exacerbated when retail clients are involved as financial advisers are additionally bound by statutory duties to act in those clients' best interests and to prioritise those clients' interests over their own. In this situation the conflict of interest that arises is intrinsically irreconcilable with these statutory duties.

We further acknowledge that the existing legislative framework governing financial product advice and financial product disclosure distinguishes between retail and wholesale clients, in terms of the levels of protection that they are afforded. However, we would note that "sophisticated investors"[5], broadly defined as any investor with of a gross annual income of $250,000, net assets of $2.5 million or an investment amount of $500,000 in the relevant financial product, are currently caught under the wholesale client definition for these purposes and therefore do not benefit from the additional protections. These "sophisticated investor" thresholds were set a number of years ago, and as a result, many investors who arguably today should be regarded as "retail clients" are falling under the wholesale client definition. Accordingly, should the Commissioner seek to impose the restriction only in respect of retail clients, we submit that the definition of "sophisticated investor" should be revisited, failing which any restriction should apply to both retail clients and sophisticated investors alike.

- ***Should financial product sellers be permitted to provide financial advice?***
  - ***At all?***
  - ***To retail clients?***

We are of the view that financial product sellers should not be permitted to provide financial product advice - at all. Their earnings are derived from sales, often directly, which arguably makes them very likely to be partial and motivated by sales. In cases where the financial product seller is affiliated with the financial product manufacturer, the seller, like the manufacturer, is inherently unlikely to be able to provide advice which is free from bias. Even if a seller is not incentivised to

[4] s912A(1(aa) of the *Corporations Act 2001* (Cth)
[5] As defined in s708(8) of the *Corporations Act 2001* (Cth) and regs 6D.2.03 and 7.1.28 of the Corporations Regulations 2001 (Cth).

promote any particular product, it is nevertheless incentivised to sell products (affiliated or not), and the purchase of a financial product may in itself be contrary to their client's interest (for example, when it is in the client's interest to not invest in any financial product at all and to simply keep its savings in a cash account or to use its savings to pay down debt).

In short, only independent and impartial entities should be permitted to provide financial product advice.

- ***Should an authorised representative be permitted to recommend a financial product manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated?***
  - ***At all?***
  - ***Only on written demonstration that the product is better for the client than comparable third party products.***

We are of the view that authorised representatives of advice licensees that also manufacture financial products (or whose related entities manufacture financial products) should not be permitted to provide financial product advice at all.

The results of the Commission's and ASIC's inquiries show that financial advisers (whether employed by financial advice licensees or acting as their authorised representatives) within vertically integrated financial services groups are more likely to recommend in-house products, sometimes clearly to the detriment of their clients' interests, and that this is so even in the absence of commissions being paid by product manufacturers. These results demonstrate that bias in financial product recommendations can be caused by other factors including organisational affiliation, other deeply rooted organisational cultural factors and indirect incentives.

We believe that independence is fundamental to a financial adviser's ability to provide quality financial advice. In this respect, the conflicts that arise between a financial adviser's (or its advice licensee's/related entity of the advice licensee's) financial interests and the best interest duty owed by the financial adviser to the client, must be avoided. Instituting prescriptive measures, to demonstrate in writing that an in-house product is better for the client than comparable third party products, is likely to lead to more 'box-ticking' by financial advisers and licensees, than any substantive change in their behaviours. To ensure that financial advisers will truly think and act in the best interests of their clients, structural separation and independence between financial advice and financial product manufacturing is crucial.

Should the grandfathered exceptions to the conflicted remuneration provisions now be changed?

- ***How far should they be changed?***
- ***If they should be changed, when should the change or changes take effect?***

Grandfathered exceptions to the conflicted remuneration provisions of FoFA should be subject to a definitive sunset date. Even though the grandfathering provisions were intended to help the industry transition to the new regime, the Commission has shown that certain licensees and advisers have sought to exploit these transitional rules by prolonging the receipt of grandfathered

commissions. In doing so, they have allowed the continued conflict between financial interest and duty to compromise the quality of their advice, sometimes to the demonstrable detriment of their clients. The industry has already had several years to adjust to the ban on conflicted remuneration and the grandfathered exceptions have served their purpose. They should now be discontinued within a reasonable period.

Platinum would also support other policies that encourage and facilitate this transition, such as capital gains tax exemptions for investors moving from legacy products to comparable products that do not involve conflicted remuneration.

- ***Should any part of the remuneration of financial advisers be dependent on value or volume of sales?***

  The design and regulation of adviser remuneration should be guided by the central objective of achieving alignment with clients' interests. Financial advisers should charge their clients on a fee-for-service basis. Variable components of advisers' remuneration should be designed to incentivise advisers to deliver the best outcomes for their clients. Remuneration that is based on the volume of transactions may incentivise an adviser to recommend the churning of financial products, and should not be permitted.

- ***Are current product and interests disclosure requirements sufficient to allow customers to make fully informed choices?***

  Currently the disclosure of conflicts of interest by financial services providers is governed by various sections under the *Corporations Act 2001* (Cth) and other regulatory guidance issued by ASIC[6]. We believe that whilst the current requirements are comprehensive, all too often than not financial services providers tend to make generic statements about the existence of conflicts, often buried in various obscure parts of disclosure documents, without clearly and meaningfully disclosing the details of any specific conflicts of interest and how such may impact on the ability of the financial services provider to provide the financial service. Whilst our starting point, in the context of vertically integrated financial advice business models, is that conflicts of interest should simply be avoided, failing this, we believe that consumers would benefit from more prescriptive and standardised disclosure requirements, to enable them to fully understand and appreciate the extent of the conflicts of interest which may exist and to be able to quantify how this may impact them.

  With respect to fees and costs disclosure, this has already been an area of extensive regulatory focus which has resulted in prescriptive legislative and regulatory requirements. However, despite this, it would appear that, in some cases, customers are still unable to make fully informed choices. The problem is particularly acute with respect to fees and costs disclosure by platform operators (and some of the financial advisers recommending the use of platforms), who often fail to make adequate disclosure about the cost difference between investing through the platform and investing in the same underlying products directly, in spite of the regulatory guidance on the need

---

[6] For example, sections 942B and 942C of the *Corporations Act 2001* (Cth), ASIC Regulatory Guide 181 Licensing: Managing conflicts of interest, Section C, ASIC Regulatory Guide 148 Platforms that are managed investment schemes and nominee and custody services, RG 148.42-148.44, RG 148.162-148.163 and RG 148.188-148.193, and ASIC Regulatory Guide 175 Licensing: Financial product advisers – conduct and disclosure.

to do so.[7] We refer to our round 5 submission to the Royal Commission dated 21 September 2018 in which we expounded, in more detail, the need for greater transparency around the operation of platforms, including a need for a platform operator to explicitly, consistently and transparently disclose any shelf-space fees it charges third party fund managers, any mark-ups it adds to third party managers' standards fees, any dealings it has with related parties, and other conflicts of interest that may impact on its product offerings.

In addition, in the recent Review of ASIC Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements*, Mr Darren McShane highlighted the specific concerns and challenges around platform fee disclosure "because of the multiple layers of products".[8] He noted that while "fee comparison between accessible investments within a given Platform works adequately", "provider level comparison between Platforms and non-Platforms or between investment selections within a Platform and the same or a similar investment option outside that Platform is rather more complex."[9] In this regard, it may be that further regulatory guidance, in addition to improved enforcement of existing rules and guidance (such as ASIC RG 148), is needed.

- ***Should platform operators be permitted to deduct fees on behalf of licensees without the express authority of the client of the platform operator?***

  Platform operators should not be permitted to deduct fees on behalf of advisers or licensees without the express authority of the client. Platform operators may not be in a position to verify or adjudicate the legitimacy of advisers' fee entitlements. In some cases, taking funds from a client's account without express authorisation may amount to a breach of the platform operator's fiduciary duties to its client.

  Adviser/licensee fees should be invoiced to clients on a periodic basis via itemised statements to provide clients with clarity and transparency in respect of the services provided and the corresponding fees charged. Platform operators should only be permitted to deduct adviser/licensee fees from a client's platform account with the client's express authorisation on a statement-by-statement basis (as opposed to via standing instructions).

- ***Do the events that have happened suggest that manufacturers of financial products should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?***

  Yes. As stated above, we are of the view that the events that have happened point to a need for structural separation between financial product advice and financial product manufacturing and sales.

---

[7] ASIC Regulatory Guide 148 Platforms that are managed investment schemes and nominee and custody services, RG 148.14(a)(ii), RG 148.17, RG 148.151 and RG 148.188-189.

[8] ASIC Report 581, Review of ASIC Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements,* Darren McShane, July 2018, p11.

[9] ASIC Report 581, Review of ASIC Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements,* Darren McShane, July 2018, p113.

- ***More particularly, do they provoke examination of how and to what extent conflicts of interest and duty arising from the structure of the business can be managed?***

  Yes. In our view, the events that have happened have provided ample evidence, often at tremendous cost to the individuals affected, that vertically integrated financial advice business models, are simply incapable of appropriately managing the conflicts of interest that are inherent within those models. To allow these conflicts of interest to continue, would, in our view, be an irresponsible approach to regulation. Greed is part of human nature and the pursuit of profit (on its own) is a legitimate objective of for-profit enterprises. The structural separation between financial product advice and product manufacturing within vertically integrated financial advice business models is required to remove these conflicts of interest, more closely align the interests of financial advisers with the interests of their clients, and to ensure compliance with the law.

In addition, the Commissioner also indirectly raised the question whether platform operators should be required to permit in specie transfers requested by clients wanting to change platforms.[10] The answer, in our view, is unequivocally yes. Furthermore, platform operators should not be permitted to impose fees or charges on in specie transfers that are significantly in excess of their actual cost of service.

We further submit that the government and the industry as a whole should do more to improve the portability of investment products, providing consumers with greater flexibility and promoting greater competition within the industry. This should include mandating the centralised and automated processing and settlement of transactions in unlisted managed funds, which would, in our view, improve portability of financial products and increase efficiencies, leading to reduced costs for investors. In the US, this role is played by the Fund/SERV, which is part of Depository Trust & Clearing Corporation (DTCC). In Europe, Euroclear's FundsPlace and Clearstream's Vestima both provide competitive services to perform this function.

The mFund Settlement Service, launched by ASX Ltd in 2014, currently provides a centralised settlement service for unlisted managed funds and enables full portability of assets, since it is not a custody service. However, despite these obvious consumer benefits, participation by broker firms and product manufacturers has to date been low.

[10] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p138.

DETAILED SUBMISSIONS

1. The need for structural separation between financial advice and product manufacture

Conflicted advice leads to poor investment outcomes for clients, and the inherent misalignment of incentives within firms that integrate product manufacturing and personal financial advice create systemic conflicts that have been shown to be extremely challenging, if not impossible, to be adequately managed by the entities involved.

As the Commission noted in its Interim Report, both the findings in ASIC Report 562: *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest*, January 2018 ("**ASIC Report 562**"), and the cases examined in the Commission's hearings, show "how often the conflict… is 'managed' in a way that aligns with the adviser's interests", in some cases while doing "actual harm to the client", and that "the choice between interest and duty is resolved, more often than not, in favour of self-interest".[11] Indeed, these cases "on their face, deny a fundamental premise for the legislative scheme of the FoFA reforms: that conflicts of interest can be 'managed' by saying to advisers, 'prefer the client's interest to your own'".[12]

We agree with the Commissioner's observations, and believe that allowing advisers to operate in an environment faced with frequent and serious conflicts of interest and duty, while expecting them to consistently put clients' interests before their own, is a fundamentally flawed approach to regulating financial advice. The ban on conflicted remuneration introduced under the FoFA reforms is a significant step towards reducing conflicts between interest and duty for advisers. Conflicts, however, have persisted post-FoFA, which to a significant extent can be attributed to vertical integration (apart from the obvious legacy issues of grandfathered commissions and other exemptions from the ban on conflicted remuneration). This is supported by the findings in ASIC Report 562, which revealed a manifest bias towards in-house products by aligned advisers even in situations where commissions were not a consideration. With respect to new customers who could not be subject to grandfathered commissions, between 60% and 74% of their invested funds were directed to in-house products by eight of the ten licensees reviewed, and as high as 90% by another licensee.[13]

Even in the absence of direct incentives such as commissions and volume-based bonuses, the mere fact that an adviser is ultimately employed within a group that is engaged in both the provision of advice and the manufacture of financial products, and that his or her personal interest (whether it is compensation, holistic performance appraisal or career progression within the organisation more generally) is ultimately tied to the group's overall success, can influence the adviser's product recommendations to clients, through conscious or unconscious bias. Both the Commission and ASIC have received clear evidence that conflict management policies, procedures and training programs employed by these organisations can often be inadequate and ineffective at managing conflicts

---

[11] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, pp90-91.
[12] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p91.
[13] ASIC Report 582: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest, January 2018, paras 125-126.

inherent in a vertically integrated business model.[14] As such, the logical path to reform is to mandate the *avoidance* of conflicts which requires structural, organisational and financial independence.

We note the Productivity Commission's statement in its recent report on Competition in the Australian Financial System that it "has not found any competition issues in [...] wealth management markets that are clearly associated with integration".[15] However, consumer outcomes are impacted by more factors than competition alone and, in so far as consumer protection is concerned, the findings in the Commission's Interim Report and ASIC Report 562 point unequivocally to the conclusion that the current regulatory framework has failed. Even the Productivity Commission conceded that "poor consumer outcomes [...] may be compounded at times by integration".[16] The solution, we propose, needs to begin with the separation of advice from product manufacture and a requirement for all providers of financial advice[17] to be independent from the issuers of financial products.

2. All advice must be personal; all advisers must be independent

We contend that the licensing regime for the provision financial product advice needs reform. Firstly, the legal distinction between "personal advice" and "general advice" is rarely understood and appreciated by retail investors, and the terminology can compound consumer confusion over the nature of the information they receive, when a piece of information is advice and when it is sales, when a recommendation is independent and when it is (or has the potential to be) biased.

As such, we propose that the definition of "financial product advice" should be simplified to remove the bifurcation between "personal advice" and "general advice". There should only be one type of financial product advice, consisting of what constitutes "personal advice" under the current legislative definition.[18] Information that does not take into consideration the client's objectives, financial situation and needs should not be referred to as "advice". This is consistent with recommendation 10.2 by the Productivity Commission in its final report on Competition in the Australian Financial System, in which it concluded that:[19]

> *General advice, as defined in the* Corporations Act 2001 *(Cth), is a misleading term and should be renamed. Any replacement must ensure that the term 'advice' can only be used in association with 'personal advice' – that is, advice that takes into consideration personal circumstances.*

Secondly, we propose that the licence to provide financial product advice should be mutually exclusive with the licence to operate a registered scheme. It should be a licensing condition for licensees seeking to provide financial product advice that the licensee as well as its authorised representatives must not be affiliated with any issuer of financial products, whether through equity ownership, joint ventures,

---

[14] In its Report 474: Culture, Conduct and Conflicts of Interest in Vertically Integrated Businesses in the Funds Management Industry, March 2016, ASIC stated that it "found that on matters of outsourcing, product selection, remuneration and board membership, there may be areas where financial services organisations could better demonstrate a commitment to managing and, where appropriate avoiding conflicts of interest", that "in some instances, conflicts of interest may not have been adequately managed" (para 5).
[15] Productivity Commission, Competition in the Australian Financial System, Inquiry Report, No. 89, 29 June 2018, p267.
[16] Productivity Commission, Competition in the Australian Financial System, Inquiry Report, No. 89, 29 June 2018, p267.
[17] For convenience, we will refer to financial services licensees licensed to provide financial product advice, their officers and employees who act as their representatives in providing advice, as well as their authorised representatives (who are not employees) collectively as "advice providers".
[18] Under s766B(3) of the *Corporations Act 2001* (Cth).
[19] Productivity Commission, Competition in the Australian Financial System, Inquiry Report, No. 89, 29 June 2018, p295.

distribution agreements, or other arrangements that could reasonably be expected to influence the financial product advice or recommendation given by the licensee or representative.

Conversely, product issuers/manufacturers (i.e. entities licensed to operate a registered scheme), as well as their affiliated entities, should not be permitted to provide financial product advice, including by their authorised representatives. Advice, by nature, should be impartial and is for the benefit of the recipient, rather than that of the giver of the advice. Entities with a direct or indirect interest in the sale and distribution of a particular product have an inherent incentive to promote that product. The conflict of interest places them in a position that is intrinsically unfit for giving advice or making product recommendations, a task that fundamentally requires impartiality. To the extent that a product issuer publishes any information or promotional material in relation to its products or engages personnel (employees, authorised representatives, third party distributors or other agents) to market or distribute its products, the promotional nature of the materials or the activities must be made clear to the recipient or the audience. The functions of sales and advice are fundamentally different and should be explicitly separated.

The Commissioner pointed out that the "conduct identified and criticised in [the Interim Report] was driven by the pursuit of profit".[20] The pursuit of revenue and profit, by for-profit businesses, is not itself wrong or inappropriate. The solution to inappropriate advice and many other types of misconduct by financial services providers, therefore, is not to impose a blanket ban on remuneration structures that are centred on incentivising better financial performance. What is required and will be more effective to improve consumer outcomes, we believe, are new independent business structures that inherently minimise conflicts and more closely align the interests of the financial adviser with the interests of their clients. Customers' best interests must always come first.

The industry needs to continue its fundamental shift from the historical model where advisers performed a key distribution function for – and were remunerated by – product manufacturers, to new business models where financial advisory businesses must stand on their own as providers of independent professional services, in the same way that tax advisers and lawyers are, and are compensated by the clients for such services. Many advisers have already made this transition in full, but the industry at large is at various stages. Structural separation may not be a panacea and will not solve the entire problem on its own, but it is a crucial step towards removing the significant conflicts of interest that were left unaddressed under FoFA and which have been the root cause of much of the misconduct under scrutiny today. It will induce financial advisers and product manufacturers to respectively focus on client outcomes without the distraction and misaligned incentives to cross-sell products and services.

Without affiliation with product manufacturers, advisers will have greater neutrality, objectivity and autonomy when recommending products to clients. If advisers' revenue generation is more aligned with the ultimate investment outcomes of their clients, and is not in any way directly or indirectly impacted by the revenues generated in respect of the products they recommend, it would be fair to assume that advisers will be more likely to focus on achieving better results for their clients. Remuneration structures

[20] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p302.

will also likely evolve to reflect the closer alignment with clients' interests, and the culture of licensees and advisory firms will likely improve as a result.

3. Advisers and platforms

Platforms (IDPSs and IDPS-like schemes) have evolved to play a unique role in asset management over the last two decades. Generally, platforms are regulated as financial products (managed investment schemes) and platform operators are regulated as financial product issuers. However, functionally, platforms are in fact a tool for administration, a means of product distribution and, importantly, they play a role as aggregators of both in-house and third party investment products.

Where the platform operator, the issuer of some of the underlying investment products offered through the platform, and the adviser are affiliated entities within a vertically integrated group, the multiple layers of conflicts, compounded with the large information asymmetry, render clients particularly vulnerable to biased advice and recommendations of unsuitable products. As the Commission has heard, AMP advice licensees knowingly kept numerous clients in in-house platforms with uncompetitive fees.[21] Such evidence indeed "invited attention to how the vertical integration of the industry may harm clients by protecting platform entities associated with advice licensees from competitive pressures."[22]

ASIC's investigations found that the bias towards in-house products is the most extreme with respect to the choice of platforms. For the ten licensees it reviewed, 91% of the total funds invested in platforms by all customers were in in-house platforms, versus 9% in external platforms,[23] and the proportion of in-house platforms increases to 96% for new customers.[24] Compare 96% with 48% for in-house superannuation and pension products, 31% for in-house insurance products and 58% for in-house investment products,[25] the data suggests that while advisers would exercise a degree of judgment and weigh up external products against in-house counterparts when recommending products such as managed funds and insurance policies, the use of an in-house offering is almost a given when it comes to selecting a platform.

There could be a variety of possible reasons for the extreme bias in relation to in-house platforms, such as better compatibility, integration and support for IT systems, given the affiliation between the advice licensee and the platform operator. However, such advantages, while benefiting the adviser, do not necessarily translate into benefits for the client or justify the use of the in-house platform.

Investing through a platform involves more complex fee structures and other added issues (such as legal and beneficial ownership, voting rights), compared to investing in the underlying products directly. But paradoxically it invites less scrutiny from clients as platforms are, in practice, often perceived more as an administrative tool than an investment product. Recommending an in-house platform may not give the same appearance of bias as does recommending an in-house managed fund. This means that there is a heightened need for clear and detailed disclosure to clients about the potential benefits and disadvantages of using a particular platform. Disappointingly, despite ASIC's detailed guidance

---

[21] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p137.
[22] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p138.
[23] ASIC Report 582: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest, January 2018, para 120.
[24] ASIC Report 582: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest, January 2018, para 127.
[25] ASIC Report 582: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest, January 2018, para 127.

specifically on the obligations of advisers providing financial product advice on platforms,[26] including on how to manage conflicts and comply with the best interest duty, the Commission's case studies and the findings in ASIC Report 582 suggest that non-compliance is a serious issue.

All too often the use of a platform, in-house or otherwise, is itself unsuitable to the client's needs and circumstances. The multitude of fees charged by platform operators (such as cash administration fees, mark-ups on external fund managers' investment management fees, and higher transaction costs), and the lack of flexibility to leave a platform, can often be detrimental to the clients' interest and outweigh the benefits provided by the platform, such as ease of portfolio monitoring and consolidated reporting. For advisers, however, platforms provide a convenient tool to aid their job of monitoring clients' portfolios, executing trades on clients' behalf, and delivering performance and tax reporting to clients. Furthermore, platforms assist advisers with fee collection by automatically deducting adviser fees from clients' accounts and remitting them to advisers. Some platforms even charge clients a fee solely for not having an adviser while offering a more limited range of services, thus incentivising (or coercing) clients to retain the services of an adviser.

Such benefits to advisers create conflicts between clients' interests and advisers' own interests which need to be minimised, first, by ensuring that advisers are not affiliated with platform operators and, secondly, by ensuring that advisers, when recommending the use of any platform, comply strictly with the requirements stipulated in Section E of ASIC Regulatory Guide 148. They must discharge their best interest duty by properly assessing and disclosing the costs and benefits of using the platform, including by explicitly comparing its costs with the alternative of investing in the same or similar underlying products directly.

In addition, platform operators should not be permitted to deduct fees on behalf of advisers or licensees without the express authority of the client as they are not in a position to verify or adjudicate advisers' fee entitlements. Adviser/licensee fees should be invoiced to clients on a periodic basis via itemised statements to provide clients with clarity and transparency on the services provided and the corresponding fees charged. Platform operators should deduct adviser/licensee fees from a client's platform account only with the client's express authorisation on a statement-by-statement basis (as opposed to via standing instructions).

4. Advice affordability

Advice affordability and efficiencies of scale have often been cited as reasons to support vertical integration. However, as the Commissioner noted in the Interim Report, "the internal efficiency of the 'one stop shop' does not necessarily produce efficiency in outcomes for customers",[27] and the proponents of vertical integration have not shown that they have passed on the cost savings derived from their economies of scale to end customers. There is little evidence that subsidisation of the cost of advice by product issuers leads to net savings for clients. In fact, empirical evidence points to the contrary – conflicted financial advice leads to poor investment outcomes and can be costly. A survey of evidence by the Council of Economic Advisers in the United States found that conflicted advice reduces

[26] ASIC Regulatory Guide 148 Platforms that are managed investment schemes and nominee and custody services, Section E, in particular, RG 148.178 – 148.192.
[27] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p79.

investment returns by roughly 1% for savers receiving that advice, in aggregate costing them US$17 billion a year.[28]

When part of the cost of financial advice is built into the cost of the product, the cost of advice is not lowered, it is simply hidden. It may be the case that the services of independent advisers, free from grandfathered commissions and subsidies (financial or otherwise) from affiliated entities, may be perceived as being more expensive, but the adjustment has already begun with FoFA and, over time, more and more consumers will appreciate the benefit of unbiased financial advice. To improve the affordability of financial advice, the government should consider making the cost of financial advice tax deductible, similar to the cost of managing one's tax affairs.

5. The need for greater transparency and better disclosure

Currently the disclosure of conflicts of interest by financial services providers is governed by various sections under the *Corporations Act 2001* (Cth) and other regulatory guidance issued by ASIC[29]. We believe that whilst the current requirements are comprehensive, all too often than not financial services providers tend to make generic statements about the existence of conflicts, often buried in various obscure parts of disclosure documents, without clearly and meaningfully disclosing the details of any specific conflicts of interest and how such may impact on the ability of the financial services provider to provide the financial service. Whilst our starting point, in the context of vertically integrated financial advice business models, is that conflicts of interest should simply be avoided, failing this, we believe that consumers would benefit from more prescriptive and standardised disclosure requirements, to enable them to fully understand and appreciate the extent of the conflicts of interest which may exist and to be able to quantify how this may impact them.

With respect to fees and costs disclosure, this has already been an area of extensive regulatory focus which has resulted in prescriptive legislative and regulatory requirements. However, despite this, it would appear that, in some cases, customers are still unable to make fully informed choices. The problem is particularly acute with respect to fees and costs disclosure by platform operators (and some of the financial advisers recommending the use of platforms), who often fail to make adequate disclosure about the cost difference between investing through the platform and investing in the same underlying products directly, in spite of the regulatory guidance on the need to do so.[30]

We refer to our round 5 submission to the Royal Commission dated 21 September 2018 in which we expounded, in more detail, the need for greater transparency around the operation of platforms, including a need for a platform operator to explicitly, consistently and transparently disclose any shelf-space fees it charges third party fund managers, any mark-ups it adds to third party managers' standards fees, any dealings it has with related parties, and other conflicts of interest that may impact

[28] "The Effects of Conflicted Investment Advice on Retirement Savings" Executive Office of the President of the United States, February 2015. See also Burke J, Hung A. A., Clift J. W., Garber S., and Yoong J. K., RAND Labor & Population, "Impacts of Conflicts of Interest in the Financial Services Industry", Working Paper, August 2014.

[29] For example, sections 942B and 942C of the *Corporations Act 2001* (Cth), ASIC Regulatory Guide 181 Licensing: Managing conflicts of interest, Section C, ASIC Regulatory Guide 148 Platforms that are managed investment schemes and nominee and custody services, RG 148.42-148.44, RG 148.162-148.163 and RG 148.188-148.193, and ASIC Regulatory Guide 175 Licensing: Financial product advisers – conduct and disclosure.

[30] ASIC Regulatory Guide 148 Platforms that are managed investment schemes and nominee and custody services, RG 148.14(a)(ii), RG 148.17, RG 148.151 and RG 148.188-189.

on its product offerings. We would like to reiterate the need for platform operators to improve their fee disclosures to improve comparability between accessing products directly and investing through the platform, and to allow both investors and their advisers to make informed choices. We note that the same issue is also highlighted in the recent Review of ASIC Regulatory Guide 97: *Disclosing fees and costs in PDSs and periodic statements*. In this regard, it may be that further regulatory guidance, in addition to improved enforcement of existing rules and guidance (such as ASIC RG 148), is needed.

6. A competitive alternative to platforms

The Commissioner indirectly raised the question whether platform operators should be required to permit in specie transfers requested by clients wanting to change platforms.[31] The answer, in our view, is unequivocally yes, and, moreover, platforms should not be permitted to impose fees or charges on in specie transfers that are significantly in excess of their actual costs for facilitating the transactions. In fact, we submit that the government and the asset management industry as a whole should do more to improve the portability of investment products, providing consumers with greater flexibility and promoting competition within the industry. The same thinking around account portability is already occurring within the banking sector.

One of the key attractions of platforms is the ease of managing a portfolio of investments across multiple asset classes and in products managed by different investment managers. Transacting in managed funds has traditionally been a particularly cumbersome process, given their unlisted nature and the lack of system standardisation across managers. Compared to accessing each product directly through the underlying fund manager, using a platform tends to save the investor a significant amount of transaction paperwork and provide consolidated reporting.

However, paying for an expensive platform account should not be the only option for streamlining the administrative processes of investing in managed funds. The government, we believe, should mandate centralised and automated, processing and settlement of transactions in unlisted managed funds. A centralised and automated order processing and settlement service would provide significant efficiency improvements leading to reduced administration costs for investors.

In the US, this role is played by the Fund/SERV, which is part of Depository Trust & Clearing Corporation (DTCC). In Europe, Euroclear's FundsPlace and Clearstream's Vestima both provide competitive services to perform the function. The important point is that such services require industry-wide participation in order to offer investors a wide range of investment choice and achieve the economies of scale that will enable the provision of a cost-effective alternative to existing platform operators. For reference, Fund/SERV, the division for processing and settlement of transactions in mutual funds at the Depository Trust & Clearing Corporation (DTCC), the leading post-trade financial service company in the US, handled 900 million trades daily at a per-trade cost of US$0.06 (as of 2016). By contrast, the mFund Settlement Service offered by ASX Ltd charges A$5.00 per trade, a clear indicator that the cost of service can be significantly lowered through increased economies of scale.

The mFund Settlement Service, launched by ASX Ltd in 2014, is a facility that provides the type of centralised settlement service for managed funds as envisaged above, but participation is currently

---

[31] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Vol 1, p138.

voluntary. It is an automated electronic processing system for the settlement of transactions in unlisted managed funds. mFund uses the same settlement system (CHESS) that is used for settling transactions in shares listed and quoted on the Australian Securities Exchange. mFund is not a nominee or custody service and investments are held in the investor's own name. This enables full portability of assets without the potential tax implications that may come with a change of legal ownership when moving away from a platform.

However, despite the numerous benefits mFund offers to consumers, participation by broker firms and product manufacturers has been underwhelming, with a meagre 17 broker firms currently offering the service to clients. Notably, there has been resistance by some of the major broker firms. It is conceivable that such non-participation has in part been motivated by considerations of mFund competing with the platform services operated by these firms or their related parties. As of the end of the 2016-17 financial year, mFund had more than $370 million in funds under management,[32] compared to $765 billion in funds under administration via platforms.[33]

There are also a relatively small number of funds available on mFund (currently fewer than 200, compared to a typical choice of 350 or more on major platforms), partly because, until very recently, only "simplified managed investment schemes"[34] were eligible to participate,[35] partly because some fund managers have chosen not to participate, but also because of the lack of adoption by many of the leading broker firms.

ASIC has now amended Class Order 13/1621[36] to allow funds with long-form prospectus to be settled through mFund, though product issuers and ASX are still working on implementation. This is an encouraging step towards providing easier access to a greater range of products to retail investors. But more is needed, particularly in the form of a coordinated effort by regulators and industry players, to promote a standardised, automated transaction infrastructure for unlisted managed funds in Australia, thereby improving industry competition and providing cost efficient services to benefit consumers at large.

[32] ASX Ltd 2017 Annual Report p3.
[33] Goldman Sachs Group Inc., Global Investment Research, "The Rise of the Emerging Platforms; Buy NWL (on CL), HUB", 31 January 2018.
[34] As defined in reg 1.0.02 of the Corporations Regulations 2001.
[35] ASX Operating Rules Schedule 10A Rule 10A.3.3(h)(i).
[36] ASIC Corporations (Amendment) Instrument 2016/1212.