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

Round 5: Superannuation

Submissions by Platinum Investment Management Limited – 21 September 2018

OVERVIEW

Platinum Investment Management Limited (AFSL 221935, "**Platinum**") is a Sydney-based investment management firm specialising in international equities. Platinum was established in 1994 and has $26 billion in funds under management (as at 31 August 2018). Since its establishment, Platinum has remained an independent fund manager, unaffiliated with any other financial product manufacturer, financial adviser, dealer group or platform provider other than through arm's length commercial agreements.

We refer to our initial submission to the Commission and welcome the opportunity to respond to some of the policy issues subsequently raised by the Commission during the round 5 hearings on superannuation. Whilst, during this round of hearings, the Commission focussed on conflicts of interest arising within the superannuation fund sector, we note the prevalence of conflicts of interest throughout the wealth management industry in general, of which superannuation forms a large part. Financial services providers prioritising their own interests over those of their clients is, in our view, at the root of much of the misconduct and many inappropriate practices uncovered by the Commission.

ASIC's Report 562 *Financial advice: Vertically integrated institutions and conflicts of interest* very clearly demonstrates that conflicts of interest are inherent in vertically integrated groups that provide personal advice and product manufacturing solutions. This has been borne out by the Commission which has also highlighted the conflicts of interest that exist for dual-regulated entities ("**DREs**") i.e. single entities serving in the dual capacities of trustee of a superannuation fund and an operator/responsible entity of an IDPS/IDPS-like scheme, respectively, or a responsible entity of another type of managed investment scheme. Trustees of APRA regulated superannuation funds, operators of IDPS schemes and responsible entities of IDPS-like schemes are hereinafter collectively referred to as "**Platform Operators**". All of these groups face competing obligations and interests either in their dealings with their related parties or because they are wearing more than one hat when attempting to discharge their fiduciary responsibilities.

However, conflicts of interest can and do arise when Platform Operators deal with unrelated parties. For example, undisclosed fee sharing arrangements entered into between Platform Operators (or their related parties) with third party fund managers ("**Third Party Fund Managers**"). These arrangements leave investors vulnerable to excessive fees, reduced access to quality managers, and ultimately poor investment outcomes. Accordingly, we have specifically focussed on this issue in our submission.

More generally, it is our belief that independence and transparency are the core principles that should guide any legislative change for Platform Operators and their related parties. We are also of the view that where it has been clearly demonstrated that a specific conflict of interest cannot be managed appropriately, it simply should not be permitted to exist.

We believe that by requiring Platform Operators and their related parties to comply with the proposals set forth below, this should significantly enhance their ability to comply with their existing fiduciary obligations, leading to stronger consumer protection and improved investor outcomes:

- **Shelf space fees** paid to Platform Operators by Third Party Fund Managers should reflect the value of the services provided by the Platform Operator to the Third Party Fund Manager (if any) and Platform Operators should be obligated to explicitly, consistently and transparently disclose to their investors the amounts of those fees and the services to which they relate.
- **Cost savings from investment management fee rebates/wholesale rates** negotiated by Platform Operators (or their related parties, often under a white labelling arrangement) with Third Party Fund Managers should be required to be wholly passed onto investors.
- **Mark-ups by Platform Operators on Third Party Fund Managers' managed fund standard investment management fees** should be required to be explicitly, consistently and transparently disclosed by Platform Operators to their investors so that investors are able to clearly understand the cost of accessing a Third Party Fund Manager's managed fund products directly as opposed to indirectly via the Platform Operator.
- **Product manufacturing and financial product advice should be carried out by unrelated entities** – this is necessary to ensure that the inherent conflicts of interest associated with these organisational structures are removed. We intend to make a separate submission on this specific issue in response to the Commission's interim report.
- **Platforms Operators' dealings with their related parties for non-investment management services and products** i.e. banking, insurance, securities dealing etc. must be conducted on an arm's length basis in order to ensure that they are able to properly discharge their fiduciary duties. Platform Operators should be obligated to explicitly, consistently and transparently disclose such dealings and the associated costs to their investors and such dealings must be demonstrably in the best interests of investors. Cost must be a factor in this assessment. Adherence to these requirements should be subject to external scrutiny by independent auditors, as is the case for listed companies.

These policy measures will, in our view, steer Platform Operators to adopt business models that will align their own interests with those of their clients, and to implement governance frameworks that will ensure that any conflicts of interest are either avoided or otherwise appropriately managed. In turn, this should help to build a foundation of consumer trust, resulting in more reliable, efficient and competitively-priced financial services for all Australians.

DETAILED SUBMISSIONS

Platinum wishes to respond specifically to the following policy issues raised by Counsel Assisting in the closing submissions to the Commission's round 5 hearings on superannuation:

Payments from external responsible entities of managed investment schemes

825.6 Is it appropriate for the trustee of a superannuation funds [sic] to retain payments from the responsible entity of a managed investment scheme where that payment is derived from the investment of members' money?

We are aware of two types of industry practices involving payments to trustees of regulated superannuation funds and Platform Operators more generally (including their related parties) from responsible entities of managed fund products and other Third Party Fund Managers:

- Shelf-space fees: these are fees paid by Third Party Fund Managers to Platform Operators for Third Party Fund Managers' managed fund products to be "hosted" on the platform and included on the Platform Operators' investment menu; and

- Investment management fee rebates negotiated by Platform Operators (or their related parties, usually under a white labelling arrangement) with Third Party Fund Managers: this is where a Platform Operator (or its related party) repackages a Third Party Fund Manager's managed fund products and/or investment management capabilities for inclusion on the Platform Operator's investment menu, but charges investors fees which are in excess of the wholesale rate that has been negotiated by the Platform Operator with the Third Party Fund Manager i.e. the Third Party Fund Manager's standard investment management fee rate less the negotiated fee rebate.

Whilst the Commission touched on platform shelf-space fees in the IOOF case study during the Commission's round 5 hearings, this topic did not receive a thorough examination by the Commission. Accordingly, we wish to highlight this practice as well as the other problematic industry practice of where there is a lack of transparency in the fee rebate or discount arrangements agreed between Platform Operators and Third Party Fund Managers. All of these practices, we submit, have had adverse implications for consumers and deserve further consideration by the Commission when reporting on its findings and policy recommendations.

With respect to shelf-space fees, Platinum submits that the payment of such fees by a Third Party Fund Manager to a Platform Operator is not appropriate if the Third Party Fund Manager is not receiving a genuine service or the fee paid is not commensurate with the service being received, particularly if the amount of the fee and the related services are not explicitly, consistently and transparently disclosed by the Platform Operator to its investors.

Platform Operators are trustees who owe fiduciary duties to their beneficiaries. In our view, the aforementioned practices are tantamount to a breach of the trustee's common law duty not to profit from the trust and its statutory duty to act in the best interests of its beneficiaries. Accordingly, shelf-space fees are only appropriate if they reflect the value of the services provided *and* are explicitly, consistently and transparently disclosed by the Platform Operator to its investors. As such, fees that are not commensurate with services provided are not appropriate and should not be permitted. Additionally, where it is appropriate for a Platform Operator to charge a Third Party Fund Manager a shelf-space fee for genuine services, the Platform Operator should be under an obligation to explicitly, consistently and transparently disclose such fees and the services to its investors. Such disclosure should be made both in point-of-sale documents (such as product disclosure statements) as well as in periodic reports to clients (such as annual accounts and fee statements).

Interestingly, IOOF argued before the Commission that shelf-space fees are paid by Third Party Fund Managers in return for "*the administration of contributions and distributions and all of the operations that are required to - for money to flow through to [an external fund manager's] managed investment scheme*",[1] and "*the provision of access and the administration of that flow, and subsequent income distribution payments that come back from the fund manager and tax reporting and – and aggregation of tax and those activities*".[2]

We contend, however, that shelf-space fees, particularly volume-based fees, cannot be wholly justified on administrative grounds because Third Party Fund Managers are not the beneficiaries of these administration services from Platform Operators. The administration and reporting services referred to by IOOF, form a natural and necessary part of a Platform Operator's duties to its investors for which investors already pay the Platform Operator an administration fee, which is not insignificant[3]. As such, it is our view that volume-based shelf-space fees, top the extent that some have been grandfathered under FoFA, should be phased out as soon as practicable, and that "flat-rate" shelf-space fees should be subject to the requirements of being commensurate to the value of the services provided to Third Party Fund Managers, being charged at consistent rates across Third Party Fund Managers, and being explicitly, consistently and transparently disclosed to investors.

Before 1 July 2013 when compliance with the FoFA rules became mandatory, shelf-space fees were often volume-based i.e. they were charged as a percentage of the total value of funds invested in a product through the platform, as illustrated by IOOF's pre-1 July 2013 fund manager deeds.[4] Post FoFA, a common variant of volume-based shelf-space fees was the emergence of an investment management fee rebate arrangement whereby a Third Party Fund Manager agrees to rebate to a Platform Operator (or its related party) a portion of the investment management fees the Third Party Fund Manager earns from investors that have accessed its products through the platform. Such investment management fees themselves being based on a percentage of the funds under management. For example, an externally managed fund may be listed on a Platform Operator's investment menu with a management fee of 1.2% p.a. (the Third Party Manager's standard rate), which is what the investor will pay to the Platform Operator, but of that, say, 0.5% p.a. is then paid by the Third Party Fund Manager back to the Platform Operator under a fee rebate arrangement.

We submit that, as is the case with shelf-space fees, this practice is also tantamount to a breach of the trustee's common law duty not to profit from the trust and its statutory duty to act in the best interests of its beneficiaries, particularly as these practices are seldom disclosed to investors in any meaningful way. Accordingly, we submit that any savings derived from negotiated wholesale fee rates/rebates should be required to be passed onto the Platform Operator's investors.

---

[1] Transcript, Mark Oliver, 10 August 2018, 4573 and 4573.
[2] Transcript, Mark Oliver, 10 August 2018, 4573 and 4575.
[3] Administration fees charged by platforms and master trusts are typically higher than the administration fees charged by industry super funds and MySuper products, reflecting the benefits of the greater range of investment options and flexibility offered by platforms/master trusts.
[4] Module 5: Superannuation, Closing Submissions, 28 August 2018, 192; Transcript, Mark Oliver, 10 August 2018, 4573.

Platform Operators have essentially evolved to become a gateway for Third Party Fund Managers to access retail investors. While the selection of external investment products for inclusion on investment menu(s) is largely driven by adviser demand, Platform Operators' selection decisions may, to some extent, be influenced by their commercial relationships with Third Party Fund Managers, rather than being solely based on the calibre of a Third Party Fund Manager and its track record. It is also common for Third Party Fund Managers who are unwilling to accept the Platform Operator's fees to be restricted in their access to investor information and communication channels, all of which are controlled by the Platform Operator. Thus, in exchange for access to fund flows and investors, Third Party Fund Managers are unfortunately encouraged to participate in these rent-seeking behaviours.

The Commission has already demonstrated that the existing regulatory framework has failed to compel Platform Operators to appropriately manage their conflicts of interest in this area. As such, Platinum submits that legislative change is required to ensure that Platform Operators are no longer commercially incentivised, when selecting Third Party Fund Managers, to act in a manner which is contrary to the best interests of their investors.

We are also aware of other practices which give rise to conflicts of interest between the pecuniary interests of the Platform Operator and the interests of it investors. These practices involve Platform Operators adding their own margin to the standard fee rates charged by Third Party Fund Managers to access their managed fund products. Whilst such practices do not constitute payments by Third Party Fund Managers to Platform Operators, they do give rise to conflicts of interest if they are not adequately disclosed to investors, since investors are not able to fully understand and appreciate the additional costs that they are incurring by accessing such managed fund products through a platform, as opposed to directly via the Third Party Fund Manager. Our review of a number of product disclosure statements issued by various Platforms Operators indicates that where these practices are being adopted, Platform Operators are seeking to rely on ad-hoc, generic and inadequate disclosure of these arrangements as a means of managing their conflicts of interest. Accordingly, we submit that Platform Operators that engage in these practices should be under a specific obligation to explicitly, consistently and transparently disclose to their investors (in their product disclosure statements) the difference between the standard fee rate charged by a Third Party Fund Manager to access its managed products directly, versus the costs charged by the Platform Operator to access the same product via the platform.

Managing conflicts

825.17 Are there structures that raise inherent problems for a superannuation trustee being able to comply with its fiduciary duties. For example, where a trustee is a dual-regulated entity, that would seem to raise an inherent conflict of interest, or the potential of a conflict of interest. Are there other structures such as investment of funds in insurance policies issued by related party insurers or the integration of a superannuation trustee into an advice business that also raise inherent problems? Is it possible to say that these conflicts are ever manageable?

825.18 If certain structures do raise inherent problems, is structural change of entities, mandated by legislation or otherwise, something that is desirable?

DREs and entities operating within vertically integrated corporate groups frequently face inherent conflicts of interest. In our view, many of these are not being adequately managed under their existing governance frameworks and therefore legislative intervention is required to address these structures.

ASIC's recent report[5] into conflicts of interest within vertically integrated advice models clearly demonstrated that Platform Operators, dealer groups and financial advisers within the same corporate group are either being required or incentivised to include or recommend in-house financial products on and from their restricted investment menu(s) in priority to third party products that may be more appropriate for their clients, leading to poor client outcomes in some cases, and denying financial product choice. Furthermore, as revealed in the Commission's round 2 hearings, conflicted and biased advice, such as advice that favoured in-house or affiliated products over external managers' offerings, or those retaining clients on legacy products with grandfathered commissions, appears to be widespread.[6] We believe that history has demonstrated very clearly that these conflicts of interest by their very nature are simply not capable of being managed and thus legislative change is required to ensure that these structures are prohibited. We intend to make separate submissions on these specific issues in response to the Commission's interim report.

Platform Operators within vertically integrated business models also tend to appoint related party entities to provide non-investment management services and products such as banking, dealing and insurance. In doing so, they are able to maximise revenue for their broader financial services group. However, these related party fees and charges, which are borne by investors, are either hidden or poorly disclosed, and therefore not well understood. Accordingly, legislative change is necessary to require that Platform Operators' explicitly, consistently and transparently disclose their dealings with their related parties. Such disclosure should be made both in point-of-sale documents (such as product disclosure statements) as well as periodic reports to clients (such as annual accounts and fee statements). Furthermore, any appointment of a related party by a Platform Operator for such services must be demonstrably in the best interests of investors. Cost must be a factor in this consideration. Adherence to these requirements should be subject to external scrutiny by independent auditors, as is the case for a listed entity.

[5] ASIC Report 562 (January 2018) (Financial advice: Vertically integrated institutions and conflicts of interest)
[6] ASIC Report 582: Financial Advice: Vertically Integrated Institutions and Conflicts of Interest, January 2018.