Koda Capital Pty Ltd
kodacapital.com
+61 2 8651 3400

19 February 2020

The Australian Government Treasury

By email: stampingfeeteam@treasury.gov.au

Subject - Koda Capital Submission on Stamping Fees

Koda Capital welcomes the opportunity to consult with Treasury on the merits of the current stamping fee exemption in relation to listed investment entities.

Koda Capital is an independent wealth adviser to $8 billion of investment assets for high-net-worth individuals, families and charitable institutions. Koda Capital was founded by a group of experienced professionals who have previously worked in financial service firms spanning financial planning, stockbroking and insurance. We have deep experience in advising private clients in both listed and unlisted securities. Koda Capital is genuinely independent and we have no conflicts of interest in the advice that we provide our clients.

We believe we are well positioned to provide insight into the current stamping fee exemption in relation to listed investment entities.

Koda Capital supports the Government's effort to ensure that Australian's receive quality advice that is in their best interests. We believe for an adviser to give clients truly impartial advice they must be free of conflicts of interest. They cannot accept payments for the distribution of investment products. The law requires an adviser to exercise professional judgement and a conflict of interest will compromise that judgement. For this reason, all other forms of product directed payments that an adviser receives have been banned.

Our position is that the current exemption should be closed: The payment of a sales commission creates a conflict of interest and therefore undermines trust and confidence in Australia's advice system.

Our position is evidenced in 5 observations about selling commissions on listed investment entities:

1. Selling commissions are illegal in unlisted investment entities because of the risk of poor client outcomes. There are insufficient differences between a listed and unlisted environment to justify an exemption to this rule.
2. Selling commissions compromise the integrity of the best interests duty framework and act to undermine basic consumer protections the regulations are designed to deliver.
3. There is mounting evidence that investment products exempted from the ban on selling fees are delivering inferior outcomes to clients.
4. Selling commissions create conflicts of interest that are inconsistent with the intent of the regulatory framework for Australia's advice system.
5. An inconsistent regulatory framework that allows poor outcomes will undermine trust and confidence in Australia's advice system.

Koda Capital Pty Ltd
kodacapital.com
+61 2 8651 3400

We have set out the detail of our observations below. In addition, we have provided some observations on the arguments put forward in support of the exemption.

I would be very pleased to provide further detail on any aspect of our submission if required.

Yours sincerely,

Paul Heath
CEO, Koda Capital

Selling fees, the best interests duty and poor client outcomes.

The regulations banning selling commissions came about because "FOFA recognised that product commissions: ...may encourage advisers to sell products rather than give unbiased advice that is focused on serving the interests of the clients. Financial advisers have potentially competing objectives of maximising revenue from product sales and providing professional advice that serves the client's interests" (1)

Observation #1: Selling commissions are illegal in unlisted investment entities because of the risk of poor client outcomes. There are insufficient differences in a listed environment to justify an exemption to this rule.

For a fund manager to raise investment capital in an unlisted trust, they must do so entirely on the investment merits of the offer. We cannot identify any differences between an unlisted and listed context that warrant the need for a selling fee that reduces the sole dependence on the investment merits to determine the success of the fund raise.

In fact, we argue that there are negative structural features in the listed space that place an even greater dependence on the merits of the investment offer.

1. In a listed entity, the manager is raising permanent capital. The right to manage that capital and earn fees from doing so is not subject to delivering satisfactory performance in the same way it is for an unlisted fund manager. The efficient flow of capital away from poorly performing fund managers – a fundamental feature of an effective capital market - is compromised.
2. The means for an investor to enter and exit the listed investment is subject to the existence of buyers, sellers and prevailing market conditions. The provision of liquidity is not an obligation of the manager of the listed fund. This means liquidity can be highly variable. In many LICs trading today, daily liquidity is very small in the context of the total size of the issue. The listed credit fund KKC, has traded on average less than $1mln/day of value in the last month. This daily volume represents just 0.1% of the value of assets in the fund.
3. The share price of the listed entity can deviate away from the true value of the underlying investment (measured by Net Tangible Assets, or NTA) which may result in a worse outcome for the investor. Whilst a LIC/LIT may trade at a premium to NTA, the more common outcome is a discount to NTA. Again, using KKC as an example, the current share price (at time of writing) of $2.45 represents a 3.3% discount to the most recent NTA of $2.5336. This discount represents over half the targeted annual return of the fund.

Observation #2: Selling Commissions compromise the integrity of the Best Interests Duty framework and act to undermine basic consumer protections the regulations are designed to deliver.

The FOFA reforms began in the Joint Parliamentary Committee Inquiry led by Bernie Ripoll in 2009 following the collapse of Storm Financial and Opes Prime. Whilst there was consideration of imposing a fiduciary obligation on financial advisers, the inquiry (and legislation) stopped short of requiring an adviser to act as a fiduciary and instead set out a lesser standard – that of a duty of care. This resulting duty of care is what we now know of as the best interests duty.

The legislation sets out the process an adviser must follow (the safe harbour steps) to demonstrate they have met this duty. The fifth step of the best interests duty process clearly states that an adviser must "conduct a reasonable investigation into the financial products that might achieve the objectives and meet the needs of the client that would reasonably be considered relevant to advice on that subject matter".
This obligation has its challenges. In an almost limitless set of financial products available it is not feasible for an adviser to assess all of them. However, the law requires the adviser to exercise some level of professional judgement on conducting a reasonable investigation.

Here is the precise point at which a selling fee, which creates a conflict of interest, has the potential to cause the best interests duty framework to break down. Because when an adviser is required to exercise professional judgement, a conflict of interest will, inevitably, compromise that judgement. To argue otherwise is to ignore the very nature of financial incentives and human behaviour.

An adviser does have a duty to act in the best interests of their client. But where a conflict of interest exists, a client cannot be certain the best interests duty is affording them the protection the regulatory framework is designed to deliver. The professional rigour of "a reasonable investigation" is utterly compromised.
As The Hon Kenneth Hayne noted in his final report of the Royal Commission, "Experience shows that conflicts between duty and interest can seldom be managed; self-interest will almost always trump duty".

Observation #3: There is a growing body of evidence that investment products exempted from the ban on selling fees are delivering inferior outcomes to clients.

Any static, point in time analysis of investment returns has its limitations – both the timing of the observation and the selection of an appropriate benchmark are highly subjective and influential on the outcome of the analysis.

With that said, there is growing evidence that the LIC and LIT investment funds raised since 2014 are delivering inferior investment outcomes to clients.

There is a growing body of credible industry participants who have called out concerns that listed investment entities may be delivering poor outcomes to investors:

> **ASIC**, https://www.afr.com/companies/financial-services/asic-warns-treasurer-on-risky-funds-20191217-p53ksp
> **Stockspot**, https://www.afr.com/markets/equity-markets/broker-loophole-cost-shareholders-1-6b-20200210-p53zgi
> **ETF Watch**, https://www.etfwatch.com.au/2019-financial-year-etf-lic-performance-report/
> **Value Investing For a Living**, https://valueinvestingforaliving.com/2019/07/05/asx-lic-performance-comparison-not-such-a-happy-financial-year/

Whilst we have not done our own analysis of relative performance, our value to the consultation process would be the observation that for every LIC/LIT IPO investment opportunity that we have analysed since Koda commenced in 2015, our own reasonable investigation has been able to identify an unlisted investment solution that – in our view – would provide our clients a more efficient and effective exposure to the same investment thematic.

Conflicts of interest undermine trust and confidence in Australia's advice system.

Observation #4: Conflicts of interest are inconsistent with the intent of the regulatory framework for Australia's advice system.

Three major regulatory artefacts for the advice industry – FOFA and the best interests duty, The Findings of the Royal Commission and the FASEA Code of Ethics - all point out the problematic nature of conflicts and all signal an intent to remove conflicts of interest from our advice system.

1. FOFA and the best interests duty:

The best interests duty is not a fiduciary duty. A fiduciary duty exists where a person or company, acting for another, is required to put the interests of the other party ahead of their own. In a legal sense, a fiduciary obligation is of the highest standard and there are very strict legal obligations imposed on a fiduciary. A fiduciary cannot act with a conflict of interest.

Whilst the architects of the FOFA reforms gave consideration to imposing a fiduciary obligation on financial advisers, the inquiry (and legislation) stopped short of requiring an adviser to act as a fiduciary and instead set out a lesser standard – that of a duty of care.

The lesser standard of care was a pragmatic legislative response to massive industry resistance to the notion that an adviser couldn't act if they had a conflict of interest.

2. The findings of the Royal Commission:

The final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry laid out the role of conflicts of interest in industry misconduct.

> Third, consumers often dealt with a financial services entity through an intermediary. The client might assume that the person standing between the client and the entity that would provide a financial service or product acted for the client and in the client's interests. But, in many cases, the intermediary is paid by, and may act in the interests of, the provider of the service or product. Or, if the intermediary does not act for the provider, the intermediary may act only in the interests of the intermediary. The interests of client, intermediary and provider of a product or service are not only different, they are opposed. An intermediary who seeks to 'stand in more than one canoe' cannot. Duty (to client) and (self) interest pull in opposite directions.
>
> Chapter 7 of the Corporations Act 2001 (Cth) (the Corporations Act), and the National Consumer Credit Protection Act 2009 (Cth) (the NCCP Act) (but not the Superannuation Industry (Supervision) Act 1993 (Cth) – the SIS Act), speak of 'managing' conflicts of interest. **But experience shows that conflicts between duty and interest can seldom be managed; self-interest will almost always trump duty.** The evidence given to the Commission showed how those who were acting for a client too often resolved conflicts between duty to the client, and the interests of the entity, adviser or intermediary, in favour of the interests of the entity, adviser or intermediary and against the interests of the client. Those persons and entities obliged to pursue the best interests of clients or members too often sought to strike some compromise between the interests of clients or members and their own interests or the interests of a related third party (such as the person's employer, or the entity's owner). A 'good enough' outcome was pursued instead of the best interests of the relevant clients or members". (2)

3. FASEA and the Code of Conduct

The Corporations Amendment (Professional Standards of Financial Advisers) Act 2017 established the Financial Adviser Standards and Ethics Authority (FASEA) in April 2017, to set the education, training and ethical standards of licensed financial advisers in Australia. FASEA have issued a Code of Ethics which sets out a set of principles and core values for financial advisers.

Standard 3 states "you must not advise, refer or act in any other manner where you have a conflict of interest or duty". The Code of Ethics standards came into force on 1 January 2020.

Clarity and consistency are core to the effective operation of any regulatory framework. For some time now the regulatory framework has been clearly working towards an advice system that is free of conflicts of interest. The exemption to the ban on selling fees for unlisted investment entities is clearly inconsistent with both the substance and intent of the regulatory framework for the Australian advice system.

Observation #5: An inconsistent regulatory framework that allows poor outcomes undermines trust and confidence in Australia's advice system.

The government has an obligation to set a regulatory framework that builds trust and confidence in the advice system in Australia.

The clear intent of the existing regulatory framework is for conflicts of interest to be avoided, rather than managed or disclosed. The current stamping fee exemption in relation to listed investment entities is inconsistent with that intent.

Furthermore, there is growing evidence that the combination of the structural features of LICs and LITs combined with the role of selling fees in compromising the best interests duty are delivering poor outcomes for investors. In our view, these poor outcomes will inevitably undermine consumer trust in the advice system.

Our rebuttal of arguments supporting the exemption.

1. Advisers should be paid for the work they do.

As an advice firm, Koda wholeheartedly supports the view that advisers should be paid for their work. However, to avoid a conflict of interest, an adviser can only be paid for their work by the client. Regardless of whether the fee is a fixed fee, asset-based fee or transaction fee, this principle must be applied to all reward mechanisms.

If there is to be a fee paid by the product issuer for the work in assessing the merits of a fund, it should be paid to the licensee (where the work is invariably done) as a research fee and not the individual adviser.

At Koda, we estimate that sensible due diligence on an investment strategy takes between 15-20 hours of work to meet the manager, understand the strategy and add the product to an approved product list (APL). We would estimate the value of this work to be $1,000/hr. This suggests a research fee of $15k-$20k and this is the level where a cap on payments from product issuers should be set.

Individual advisers who then choose to promote the strategy to the client should be paid, by the client, for the work of building that investment into the individual portfolio of the client - in exactly the same way that an individual client would pay the adviser (via brokerage or fee) for the work of adding any secondary listed security (single stock, hybrid, ETF or otherwise) into their portfolio.

If the argument that there needs to be a payment for the work is accepted, then the fund manager should pay the "research fee" irrespective of whether the licensee chooses to make the investment or not because the work will have been done.

2. Without a selling fee, clients would not get access to good strategies.

For the most part, we have no argument with the quality of the fund managers who are raising capital via listed entities. And we fully support the notion that a well-diversified portfolio across all of the asset classes is in the best interests of private investors.

However, we do not believe that a commission paying LIC or LIT is the only way to achieve this result.

Our own experience is that there are a range of ways to create diversification in client portfolios. As detailed above, for every LIC/LIT that we have analysed, we have concluded that there were more efficient and effective solutions already available in the marketplace to deliver that exposure to a client portfolio. In many cases, the same manager will have a similar unlisted product. Other managers with better track records are available, or existing LIC/LIT structures trading at a discount will deliver a comparable outcome.

In our view, a selling fee creates the incentive for advisers to overlook alternative strategies and settle on a "good enough" outcome.

3. There is strong consumer demand and there is no evidence that selling fees are impacting the quality of advice.

We do accept that there is demand for alternative ways to get exposure to investment markets. And we do accept that choice for consumers is a good thing. If, however, there is demand, why does a high quality manager, with a good investment solution to meet this demand need to provide incentives for advisers to provide access to the solution for their client?

4. The "broking" model of advice is different and requires different fee arrangements.

Our view is that the obligation to provide advice that is unbiased and truly in the best interests of clients is a universal obligation on all advisers – financial planners or stockbrokers. Different legacy fee and remuneration methodologies are no basis for undermining the integrity of the regulatory framework that governs those advisers.

Concluding remarks

Koda Capital supports the Government's effort to ensure that Australians receive quality advice that is in their best interests. We believe for an adviser to give clients truly impartial advice they must be free of conflicts of interest. They cannot accept payments for the distribution of investment products. The law requires an adviser to exercise professional judgement and a conflict of interest will compromise that judgement. For this reason, all other forms of product directed payments that an adviser receives have been banned and we see no justification for listed investment entities to be exempt from this requirement.

Allowing exemptions to continue will undermine consumer trust and confidence in the advice system of Australia.

Footnotes:

(1) https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/FOFA/Report/c06
(2) https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf