Level 10, 9 Castlereagh St Sydney NSW 2000
P (02) 9225 6000 F (02) 9225 6029
www.vaneyk.com.au

23 September 2011

The General Manager
Retail Investor Division
The Treasury
Langton Crescent
PARKES, ACT 2600

By email: futureofadvice@treasury.gov.au

Attention: Mr Richard Sandlant

Dear Sir,

van Eyk Submission – Future of Financial Advice Legislative Reforms

van Eyk greatly appreciates the opportunity to provide a submission into the recent Future of Financial Advice legislative reforms.

By way of background, van Eyk is a research house that provides ratings of investment fund managers and supplies investment research, investment management and asset consulting services to financial advisers and other subscribers. van Eyk operates using a subscription service, based on a "no pay for ratings" model, where the fees that financial advisers/subscribers pay for our service are used to pay for the costs of producing the research.

In relation to the first tranche of draft FoFA legislation, we have been particularly interested to see how the Best Interests obligations will potentially impact on the financial advice industry in Australia, and on the research houses that operate in it.

van Eyk strongly agrees with the Federal Government's measures to ensure financial advisers act in the best interests of their clients. Conflicts of interest in the financial advice industry, real and perceived, have contributed to negative attitudes towards financial planners and have tended to discourage the public from seeking advice. These conflicts have also encouraged some advisers to recommend financial products which were not necessarily in their clients' best interests because the sale of that product came with a financial reward for the adviser through a commission or other payment.

Focusing on just the financial advisers, however, ignores other conflicts of interest built into the investment recommendation process. Even an independent, thoroughly professional financial adviser relies on advice from others in order to choose the best investments for their client. In today's increasingly complex investment market, it is not possible for an adviser to personally investigate the worth of all of products available to them. They rely greatly on the professionalism and knowledge of others to provide a skilled and appropriate assessment of financial products in the marketplace.

Level 10, 9 Castlereagh St Sydney NSW 2000
P (02) 9225 6000 F (02) 9225 6029
www.vaneyk.com.au

Of vital importance in the financial advice process is the role of research houses. These firms, of which there are only a few in Australia, provide research reports and product ratings on investments and fund managers which are used by advisers to assess the best places to put their clients' money. Ratings also reduce costs and complexity in the financial system by acting as a "signal" that those recommending a product have done their due diligence.

Most research firms rely on a business model known as "issuer pays" or "pay for ratings". This means that the investment company whose financial product is being rated pays the research house for the product to be rated. Fund managers will typically pay $15,000 to $25,000 per fund to be rated, depending upon the asset class and the number of funds to be rated by a single manager. We firmly believe that this model introduces an inherent conflict between the best interest of the research firm providing the rating and the best interests of the adviser and the investor. It can lead to the situation where the research firm may feel obliged to issue a favourable rating for a product which may be of low standard because it is being paid a substantial fee for issuing a rating and a poor rating may discourage future business. This is obviously against the interests of the adviser and investor who should be solely interested in a product being rated on its investment merit.

This fact was recognised by the Australian Securities and Investments Commission (ASIC) in a recent 2008 report (REP 143) on the sector: "As most research houses are dependent on issuers for research income, this creates a disincentive for them to provide negative ratings or research reports."

Furthermore, with a number of research houses to choose from, issuers of financial products can "shop around" until they receive the highest rating and then publish only the favourable one.

ASIC also acknowledged the damage cause by flawed product ratings, noting they were an important factor in the collapse of property finance companies such as Westpoint and Fincorp. Certain Westpoint products had been given investment-grade ratings before they collapsed.

It has also been broadly accepted that flawed product ratings and the "pay for ratings" business model used by credit ratings agencies (similar to research firms but focused on providing ratings on the creditworthiness of debt issuers) were significant contributors to the global financial crisis of 2008. Flawed assessments of structured financial products such as collateralised debt obligations (CDOs) encouraged investors to buy these products even though many of the assets packaged within them, particularly US residential mortgages, proved to be worthless.

The revenue generated from the payment for ratings by the investment banks which created these structured products became increasingly important to credit ratings agencies (CRAs). This fact arguably helped spur the growth in issuance of these types of assets. By 2007, rating of structured products accounted for 40 to 50 per cent of global CRA revenue.

Perhaps the issue is best summed up in a quote from a report by the US Securities and Exchange Commission (dated July 2008, titled Summary Report of Issues- Examination of Select Credit Rating Agencies) which stated: "The conflict of interest inherent in this model is that rating agencies have an interest in generating business from the firms that seek the rating, which could conflict with providing ratings of integrity."

Level 10, 9 Castlereagh St Sydney NSW 2000
P (02) 9225 6000 F (02) 9225 6029
www.vaneyk.com.au

Of the five main research houses operating in Australia, van Eyk is the only one which accepts no payment for rating a financial product. One other firm, Morningstar, does not charge for ratings but does charge an annual royalty fee for the rated company to use its rating in advertising and other promotions. van Eyk receives revenue from subscribers to its research and recommendations, mainly financial advisers. We believe that this model, which has been in operation for over 20 years, is the best way to ensure integrity and independence in the ratings process.

van Eyk believes the subscriber-pays model leads to higher quality, more discriminating research outcomes. There is clear evidence of this from the distribution of ratings across the research houses. Research we recently conducted (and which was published in the Australian Financial Review) identified that fund managers who pay to have their products rated by research houses were twice as likely to be awarded a “recommended” or “highly recommended” rating, in comparison to fund managers who did not pay. Summary details of these findings are contained in **Appendix 1** to this submission.

The evidence is that financial advisers also recognise that investment recommendations are compromised under a pay-for-ratings research model. A survey of financial planners commissioned by van Eyk and conducted by market researcher Inqbase found 77% of respondents indicated that quality would be compromised by such a model, with more than 50% then indicating that it would be considered very or highly compromised.

To ensure that financial advisers are able to act in the best interests of their clients under the new legislation, it would be preferable if they did not rely on potentially flawed, conflicted product recommendations. However, acknowledging the changes which would be required to the business models to move to a subscription model, we submit that if the “pay for ratings” model is to continue in the marketplace, then at the very least that inherent conflict must be appropriately and clearly disclosed to financial advisers and their clients in order to enable them to make fully informed decisions.

While financial planners include a brief profile of the funds in which they have invested their client’s money in a Statement of Advice, there is currently no requirement to disclose how the underlying research/product rating is paid for or any conflicts of interest. Where a dealer group or independent financial adviser is relying on a research house that utilises the “pay for ratings” business model, we strongly submit that it is in the client’s best interests that they be required by law to clearly and explicitly disclose that fact in plain English in the Statement of Advice given to a client, so that the client has more complete and accurate information upon which to base their investment decision.

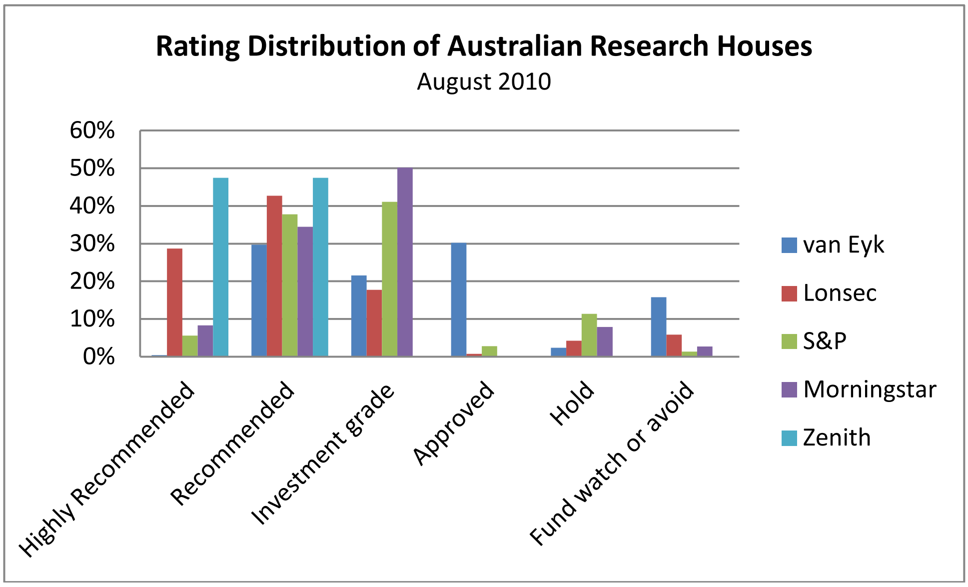
Thank you for considering this submission and I would be more than happy to provide further information on any of the aspects raised above.

Kind regards,

Mark Thomas
Chief Executive Officer

Level 10, 9 Castlereagh St Sydney NSW 2000
P (02) 9225 6000 F (02) 9225 6029
www.vaneyk.com.au

APPENDIX 1



	van Eyk	Morningstar	Lonsec	S&P	Zenith
Remuneration Type	**Subscriber**	**Subscriber**	**Fund manager / subscriber**	**Fund manager / subscriber**	**Fund manager / subscriber**
Highly Recommended	**0.4%**	**8.3%**	**20.0%**	**8.5%**	**95% ***
Recommended	**29.7%**	**34.5%**	**52.0%**	**43.5%**	
Investment Grade^	**21.6%**	**50.2%**	**17.0%**	**35.4%**	**n/a**
Approved^^	**30.2%**	**n/a**	**n/a**	**2.25**	**n/a**
Hold	**2.4%**	**7.9%**	**4.0%**	**9.0%**	**n/a**
Fund Watch or Avoid	**3.9%**	**2.7%**	**6.0%**	**1.4%**	**n/a**
Total Strategies Rated	**451 (used by 2688 funds)**	**303 (used by 4111 funds)**	**514 (used by 3376 funds)**	**554 (used by 1775 funds)**	**559**

*** Zenith's highly recommended and recommend not differentiated, therefore has been split 50:50 between the two rating categories for illustrative purposes**
^ Note the AFR has treated van Eyk BB rated managers as Investment Grade. van Eyk does not classify all BB ratings as Investment Grade.
^^ van Eyk defines AFR's "Approved" as being non-Investment Grade, and therefore not Approved
Source: Australian Financial Review