Fiduciarys Friend Pty Ltd
PO Box 965
Edgecliff NSW 2027

Mr John Lonsdale
Head of Secretariat
The Financial System Inquiry
The Treasury
GPO Box 89
Sydney NSW 2001

fsi@fsi.gov.au

Dear Mr Lonsdale

Re: Efficient Allocation of Capital, Innovation and Patent Law

Fiduciarys Friend is making a submission to the Financial System Inquiry as a start-up "dynamic financial service provider" operating in the Australian Financial Services sector, as outlined in point 4.4 of the Terms of Reference. Our specialists have extensive experience within the Australian finance industry - including in superannuation: administration, investment, regulation and as trustees. We hope that by sharing our experiences gained over the past four years we will add value to the deliberations of the inquiry in a way that submissions from larger more established players may not.

Background

Fiduciarys Friend is a company dedicated to the introduction of a new product called Trustee Tailored Super (TTS) which is designed for a superannuation funds default option. The publicly released details of TTS can be found at www.trusteetailored.com. In summary this Australian patented product relies on using factors beyond just a member's age, such as projected retirement balance, to divide default members into different Hurdle Levels (cohorts). Each Hurdle Level is assigned a more appropriate glide path (risk return profile) than the current simplistic one size fits all default approach and members' investment balances are then automatically moved into their Hurdle Level and onto their glide path. This type of product, confirmed as permissible within the MySuper framework, provides for more efficient use of a member's investment horizon compared to current practices.

We assert that the efficiency gains achieved by the introduction of this product into the Australian market can be up to 1% p.a. across the whole pool of members in the default option (from 4.5% real to 5.5% real) – while decreasing the potential for loss as retirement approaches (for those over 55 years from 1 in 5 years to 1 in 6.5 years). This 1% p.a. increase correlates to a 35-40% increase in retirement balances across these default investors – in the same manner as referred to in a familiar television advertisement. These assertions use standard industry earning rates and loss ratios as published on fund websites. The results achievable depend upon the criteria set by trustees, which in turn will be influenced by the specific demographics, wages and hence expected retirement balances of their default members. These impacts are significant for individual retirees and for future Federal Budgets.

It is also strongly inferred that trustees using TTS would select glide paths that contain, on average, a higher proportion of longer dated investments (including infrastructure and agricultural land) than is currently the case. This is because of longer member investment time horizons (up to retirement) recognised by this next generation lifecycle approach compared to the current 'one size fits all default' or the life stage options based only on a members' age.

Terms of Reference

1. Developments since the 1997 inquiry

A major change in the Australian financial system since the Wallis Inquiry has been in relation to superannuation assets which have grown to more than $1.6 trillion and are greater than Australia's GDP. This is now a major factor in how Australia funds its growth.

One result of this growth has been a huge shift in deposits from banks to superannuation funds - including to default investment options (approximately $500 billion).

There are significant implications for growth and 'capital for end users' that flow from this impact. One of these implications is that Australia must increasingly look to its superannuation trustees to provide an efficient mechanism for financial intermediation, in particular matching investors (members) available risk tolerances and investment time horizons with underlying investments. The current one size fits all default option is simplistic, dated and is no longer best fit for this purpose. It is inefficient and concentrated on the short term rather than longer term growth orientated outcomes.

This short term focus is a function of the adoption by trustees of fund manager styled benchmarking and remuneration practices. This KPI/performance measurement approach may have been appropriate in the past, but now that superannuation has matured, it is not. A more sophisticated mechanism based on retirement benefits, the purpose of the superannuation system, needs to evolve.

2. Philosophy, principles and objectives of a well-functioning system

In looking increasingly to superannuation trustees, rather than banks, for financial intermediation there are a number of obvious philosophical differences. These include the *trust and fiduciary* nature of superannuation trustees' obligations to members, versus to the *corporation and contractual* 'banking' relationship between depositors and borrowers.

These differences impact on the usual market based drivers and signals for change, in particular the pace of efficiency gains and the uptake of innovation due to competitive forces. It is hard to ascertain what market force will drive superannuation trustees to adopt innovation involving their default membership base, so that they more efficiently match members' long term retirement prospects with current investments. The 'signal for change' that is being sent is very weak.

Trustees considering acting in this area face considerable headwinds including that the quantum of assets in the default is always large, the changes involved relate to apathetic disengaged members (partly driven by the compulsory nature of superannuation) and there is very limited personal/reputational upside for individual director trustees. This is despite much academic research and industry commentary exposing the issues and inefficiencies with the current default options.

There is a leadership role for government because of the missing market drivers.

3. Emerging opportunities and challenges that drive change

Where similar innovative solutions have been implemented within the wider sector, it has been usually via an international consulting firm introducing an overseas (often US) solution into Australia – adjusted for our often significantly different regulatory framework. While this reduces implementation, business and personal reputational risk because the product has been 'road tested' elsewhere, it also means that first mover advantages, intellectual property returns and having the best solution for the Australian market are rarely achieved.

Indeed there are numerous examples of Australian inventions, including in the finance sector, being implemented first overseas (typically in the US) and then 'boomeranged' back into Australia.

The Global Innovation Index, which is co-published by French business school INSEAD (2012), shows *Australia is brilliant at coming up with inventions – but comparatively poor at implementing them*. It is important to note here that it is always individuals rather than entities that have the physical mind to invent - corporations do not have a mind of their own. However it is corporations in the Australian regulated financial system that do the implementation.

Our experience with Trustee Tailored Super, a patented Australian product in the financial sector, highlights the reason why so many Australians choose to introduce their products overseas thereby diluting collective benefits to Australia. The legal, strategy and patent related advice received on TTS, from various well respected practitioners in these fields was firstly "*why aren't you launching TTS in the US first*". Our response: *Australia is logical - it's where we are based, we understand this market and we have used the PCT process to also lodge in numerous other countries including the US*.

While accepting these well considered reasons, it was only the additional reason that TTS particularly suits the Australian Superannuation System (in part due to the 'preservation rules') that they found convincing. These well respected practitioners, each in their own way explained the processes and challenges with the Australian patent system and why the US was usually the better option.

The processes do include the 'quid pro quo' of publishing the patent specifications including outlining the best method of implementation – so all in the industry can consider the product and understand its implications – in exchange for the 20 year exclusivity period.

The challenges can be summarised as follows *"Broadly speaking in Australia, for well established companies wanting to implement a published patent specification, often the best strategy is to re-engineer, then simply introduce it (rather than firstly purchasing or licensing it) and if a challenge for infringement occurs use the court system as the negotiating forum".*

For larger companies adopting this approach for Australian inventions the downside probability is currently low and the impact limited. From a negotiation perspective they can use their size to inflict disproportionate cost impacts on the start-up company. Furthermore, the regular acceptance of appeals to higher courts assists in dragging out the timeframe and the threat thereof additionally tips the negotiation scales. You would have thought that such flagrant action might cause the courts to apply additional damages pursuant to s122 (1A) of the Patents Act 1990 (Cth). However it is a well-trodden course to claim invalidity and non infringement and avoid such an outcome.

The availability of litigation funding is assisting in rebalancing the scales, however this is often a post fact consideration and it is not generally sufficient reason alone for inventors/start up's to choose Australia over the US.

It is critical that the culture and investment environment for implementing Australian inventions here be enhanced. In the financial sector this must focus on '*computer implemented business methods'*.

1. Firstly, there should be (more) clearly defined, government supported opportunities to promote financial sector businesses implementing inventions in Australia. In tandem, there needs to be strong negative signals, including negative reputational outcomes, for large financial businesses that harm this culture by backdoor re-engineering of business methods or who use the courts as a negotiating forum.

2. Secondly, the current Australian patent legal environment places unnecessary negative risk on investors looking to invest in Australian startups. It involves avoidable uncertainty that should be removed, particularly when compared to making similar investments in or via the US.

4. Recommended policy options

Recommendation 1

Superannuation trustees should be increasingly providing an efficient mechanism for financial intermediation, focused on improved retirement outcomes for members, as distinct from concentrating on one, three and five year return benchmarks.

Recommendation 2

The government should play a role where superannuation trustees usual market based drivers, in particular concerning the pace of efficiency gains and the uptake of innovation, are missing.

Recommendation 3

Given the quantum of funds that has now been built up in current simplistic one size fits all superannuation default options, a specific government funded 'task force' should be introduced to consider default option alternatives. It would produce publicly available research on the impacts on individual's retirement lifestyles (retirement balances and volatility as retirement approaches) and the long run impact on future Federal Budgets. It should be based on actual superannuation fund membership data from a range of funds in different sectors (industry, public and retail) and use published (website) expected return and volatility data.

Recommendation 4

The Patents Act 1990 (Cth) should be changed to:

- Provide patentability certainty for Australian patents in the financial sector
- Require large entities, who are alleged infringers of standard patents that have been issued and sealed by the Australian Patent Office and held by small entities, to pay court costs of both parties for any counterclaim of non validity (as distinct from non infringement).
- Ensure damages pursuant to s122(1A) are applied aggressively and publicly

On behalf of Fiduciarys Friend, I would be delighted to offer further information on this submission or present to the inquiry.

Yours sincerely

Douglas Bucknell
Managing Director
Fiduciarys Friend Pty Ltd
director@trusteetailored.com
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