Submission to ASIC re RG179 Consultation Paper
by Bruce Baker BSc MBA DFP, Puzzle Financial Advice Pty Ltd
3/5/13

Introduction.
Many smaller AFSLs have turned to the use of Limited Managed Discretion Accounts, to efficiently solve a problem that ASIC has refused to grapple with – that modern portfolio theory is broken and that timing does matter. Rather than fix the problem, ASIC (in its RG179 consultation paper) seems to be seeking to shut-down the most viable solution – and this cannot be good for Australian investors.

One of ASIC's biggest failings, is that after acknowledging that it is administering Corporations Law based on flawed theory (http://puzzlefinancialadvice.com.au/090808%20AFR%20ASIC%20Dalosio%20on%20efficientmarkets.pdf AFR 8/8/2009 "Striking the right balance between regulation and efficiency."), it has not taken the step finding a replacement framework through which to judge the advice provided by financial planners. This is a serious short coming in this important area.

Here is a little of the relevant history:-

- "Altering the mandate for regulation should be a decision of the government, not the regulator. Until that happens, ASIC will continue to work with current policy settings". Said Chairman of ASIC in the above 8/8/2009 AFR article. This is sadly ASIC just burying its head in the sand over this very important problem.
- Treasury also acknowledges the weaknesses in efficient market theory. http://puzzlefinancialadvice.com.au/090813%20treaury%20is%20moving%20away%20from%20efficient%20market%20theory.pdf
- Bruce Baker's submission to the Ripoll Inquiry on some of the failures in modern portfolio theory. http://puzzlefinancialadvice.com.au/Puzzle%20Financial%20Advice%20supplementary%20submission%207%2020090730%2023.pdf

The implications resulting from recognising that modern portfolio theory is a flawed theory include:-

- That the basis for long-term buy-and-hold portfolios is flawed. Ask American financial advisors (who have been giving advice over the last 13 years) whether timing matters, the overwhelming majority would now agree … and yet, before 2000, the vast bulk of American advisors advocated relatively static asset allocations in long-term buy-and-hold portfolios. Does Australia need to experience a period of terrible markets (as it has been for US investors over the last 13 years) before the regulator is motivated to grapple with this problem?
- That the long-term buy & hold strategies recommended (and sold) by most of the product distribution arms of the large Australian fund managers are flawed.
- That the MySuper concept that came out of the Cooper Inquiry (which by the way was relatively similar to that advocated in my submission http://puzzlefinancialadvice.com.au/Puzzle%20Financial%20Advice%20supplementary%20submission%204%2020090622%2016.pdf See section 1.1) is likely to fail Australian superannuants badly when Australia next experiences markets like the US has experienced over the last 13 years. I am now of the view that a better solution would probably be that the vast bulk of mum & dad superannuants have their super managed by the Future Fund. I think the Future Fund seems to be demonstrating the sort of skills that are required – and should be able to achieve this task very cost-effectively.

Response to some points raised in RG179 discussion paper.

Selected sections of RG179 consultation paper – *plus commentary in orange italics as feedback.*

A Background to the proposals

This consultation paper sets out our proposed amendments to Regulatory Guide 179 Managed discretionary account services (RG 179) and the accompanying class order relief in Class Order [CO 04/194] Managed discretionary accounts

.

Overview of our proposals

20 This consultation paper focuses primarily on the provision of MDAs to retail clients, in reliance on [CO 04/194], except where we have expressly indicated otherwise.

22 We propose to retain most elements of our current guidance and relief for the provision of MDAs to retail clients, including our definition of an MDA, as well as our AFS licensing requirements, conduct requirements for MDA operators, MDA contract and investment program conditions, client reporting requirements and the MDA annual review condition.

24 In particular, we propose to:
(a) revoke the two outstanding no-action letters, incorporate a modified version of the relief offered under those letters into [CO04/194] , and provide guidance on our modified relief in RG 179;
(b) require MDA operators to meet enhanced financial requirements, similar to those that have applied to responsible entities since 1 November 2012;
© require MDA operators that provide custodial and depository services and external MDA custodians to meet enhanced financial requirements, equivalent to those proposed in Consultation Paper 194 Financial requirements for custodial or depository service providers (CP 194);
NO ISSUE
(d) prohibit MDA operators from investing any of the retail client's portfolio assets in products or arrangements where recourse is not limited (e.g. contracts for difference);
SOUNDS REASONABLE
(e) require specific upfront disclosure about how the client may terminate their MDA contract;
NO ISSUE
(f) require specific upfront disclosure about the operation of outsourcing arrangements, where the MDA operator outsources significant functions of the MDA; and
NO ISSUE
(g) update our guidance to reflect the changes in the law that have been implemented as part of the FOFA reforms.
UNCLEAR WHAT THIS MEANS

B Resolving the two outstanding no-action positions

Key points

We propose to revoke the regulated platform no-action letter and instead require AFS licensees who currently rely on this no-action position to comply with our licensing requirements for MDA operators and the conditions of [CO 04/194], with some modifications, as outlined in this section. We propose to provide a two-year transition period to give licensees time to apply for the necessary AFS licence authorisations or to wind up their MDA activities.

Regulated platforms

36 On 5 November 2004, we issued a no-action letter to IFSA (the 'regulated platforms no-action letter'), addressing the situation of MDA operators who hold a limited power of attorney that is valid only within a regulated platform, and is limited to authorising the MDA operator to transfer funds between investments offered through the regulated platform, but not to contribute or withdraw funds.

Switches on regulated platforms to be regulated as MDAs

Proposal

B4 We propose to revoke the regulated platforms no-action letter and modify our guidance to specify that:
(a) where AFS licensees or their representatives give instructions at their discretion to regulated platform providers, including instructions to switch between investment options, these arrangements will be regulated as MDAs; and
(b) AFS icensees that wish to undertake this activity will need to obtain the relevant AFS licence authorisations.

This would mean that many small AFSLs would need to get an MDA licence. And yet, ASIC has shown great reluctance to allow AFSLs to upgrade their licence to including MDAs. So unless ASIC's reluctance changes, ASIC is not offering ANY solution here. So ASIC needs to be tabling real solutions which in practice will be available.

Your feedback

B4Q1

Do you agree with our proposal to require AFS licensees offering MDAs through a regulated platform to obtain the relevant AFS licence authorisations? If not, please explain why you think this licensing relief should continue, given the similarity between MDAs operated through regulated platforms and other MDAs.

What is the problem that ASIC seeks to solve? Unless we understand that, we cannot see the logic in what positive things ASIC can achieve with the proposed changes.

B4Q2

Will this proposal impose costs on your business? If so, please identify the type of costs, their value and whether they would be one-off costs or ongoing.

With the level of detail available, it is hard for us to determine the extra costs we would experience but superficially, the costs would include:-

- *Cost of getting MDA licence (though I have heard it is very difficult to achieve)*
- *ANY additional costs re ongoing compliance*
- *Any additional costs relating to any additional financial requirements.*
- *AND IF I cannot get an MDA licence for whatever reason, it may well put me out of business.*

In this sort of very difficult environment (post-GFC + aftermath), managing client's portfolios on a discretionary basis seems like the only way I can see to provide the service that they need efficiently, cost-effectively (including for the client) and in a timely manner – and within reasonable risk to me.

Rationale

47 In our discussions with MDA operators, as part of our regulatory review, several operators raised concerns that the regulated platforms no-action letter created an alternative, less onerous regulatory regime for some MDA operators in comparison to others. Although the existing no-action approach does not permit the discretionary withdrawal of funds from the platform, we do not think there is a strong argument for maintaining the current regulatory distinction between different types of MDAs, depending on whether or not they are offered through a regulated platform.

Since the proposed changes will have most impact on small AFSLs, these proposals seems to be driven by lobbying from the big end of town, seeking to reduce competition from small AFSLs. While small independent AFSLs are a comparatively small part of the financial planning "industry", they tend to attract sophisticated investors with large portfolios, because they seek a long-term relationship with personal service from a knowledgeable advisor – and they don't want to simply be sold a product. This sort of service seems hard to get from the big end of town .... and I regularly hear (when a client comes to us from the big end of town) that they hate being regularly passed on from one advisor to another.

49 While some MDA operators use the no-action letter in a limited way to undertake portfolio rebalancing between managed investments, we understand that other operators have interpreted the boundaries of the no-action position quite expansively, and consider that trading in equities or other assets and setting up and operating 'model portfolios' for clients can be done within the bounds of the relief. We think that these latter activities are very similar to those undertaken by MDA operators that do not use the no-action letter and must comply with our general guidance on MDAs. We therefore think that it is appropriate and simpler to apply similar regulatory requirements.

Superficially at least this argument sounds reasonable – but custody at least, seems be a huge differentiator. Also, when a regulated platform is used, investments are always in the client's name rather than in the name of (say) a broker's trust account. These are huge differentiators eg from a risk perspective of the client. Also with a regulated platform, the client can always login directly to the regulated platform to see what is happening in their account – so they can monitor the activities that are occurring under the LMDA service – again, this transparency reduces the risk of the MDA operator "going rogue" and for example, generating a huge bunch of trades on the client's account just to generate brokerage fees for their employer or themselves.

In our case, we also offer clients the additional transparency of clients being able to log into our Xplan records, to view their portfolio whenever they wish.

50 We think that our proposals facilitate the concurrent provision of MDAs and regulated platforms. Our proposals balance ASIC's aim to avoid imposing duplicate requirements on MDA operators with the need to ensure that investors who invest in an MDA operated on a regulated platform are afforded adequate protections, given the significant level of control that the client gives to the MDA operator.

Surely, the needs of consumers should be the primary focus, rather than simplifying regulations for the sake of it.

I think it is obvious that there is consumer demand for the services that ASIC seems set on eradicating – namely small dealers offering personalised MDA services.

C Updating financial requirements for MDA operators

Key points

We propose to increase the financial requirements for MDA operators to ensure that these correspond with the requirements that have applied to responsible entities of managed investment schemes since 1 November 2012 and with our proposed financial requirements for platform operators. We also propose to apply to MDA operators the same financial requirements as proposed to apply to responsible entities having regard to scheme property holding arrangements.

This seems like massive overkill surely. Difficult to believe that this is justifiable, unless ASIC simply has an unwritten objective of putting small AFSLs in this space out of business!!!!

It is important that MDA operators maintain adequate financial resources to operate their MDAs effectively and compliantly. We think that increased financial requirements will assist in achieving this objective,and will also ensure that our regulatory requirements for MDA operators are similar to the requirements for comparable investment arrangements, including registered schemes (including IDPS-like schemes) and IDPSs

Glibly, I can see this seems reasonable, but when you look a little closely this seems blatantly unreasonable. There seems very little comparison (or similarity) between a small dealer doing MDA on a regulated platform vs registered schemes and IDPS.

See the table below (also attached for your convenience).

This spreadsheet is to help respond to section C of RG179 (MDAs) - showing different level of client risk for different combinations.					
	Financial planner (AFSL) operating without MDA.	using MDA via an IDPS (eg Wrap) - Custodian is independent 3rd party.	MDA not via an IDPS (eg Wrap) - Custodian is independent 3rd party.	Financial planner (AFSL) using MDA not via an IDPS (eg Wrap) - Custodian is related party.	offering a product (managed investment scheme) where funds managed.
General comment	Very common	Quite common	Don't know if combination	Exists eg stock brokers	Exists
manages client money	YES	YES (not much different to financial planner who does not use MDA.)	YES	YES	YES
TRANSPARENCY & ACCOUNTABILITY.					
Transparency 1 - directly-held managed funds	Assets in client's name. Client can monitor assets directly with fund manager. Very transparent.	Assets in client's name. Client can monitor assets directly with IDPS. Very transparent. Similar to financial planner without MDA. If planner goes rogue, client can quickly withdraw	Client might only be updated quarterly, 6monthly or yearly. Not transparent. If operator goes rogue, it might be a long time before client become aware of this.	Client might only be updated quarterly, 6monthly or yearly. Not transparent. If operator goes rogue, it might be a long time before client become aware of this.	Client might only be updated quarterly, 6monthly or yearly. Not transparent. If operator goes rogue, it might be a long time before client become aware of this.
Transparency 2 - directly-held listed securities	Assets in client's name. Client can monitor assets directly with registry. Contract notes go to client. Very transparent.	Assets in client's name. Client can monitor assets directly with IDPS. Very transparent. Similar to financial planner without MDA. If planner goes rogue, client can quickly withdraw	Client might only be updated quarterly, 6monthly or yearly. Not transparent. If operator goes rogue, it might be a long time before client become aware of this.	Client might only be updated quarterly, 6monthly or yearly. Not transparent. If operator goes rogue, it might be a long time before client become aware of this.	Client might only be updated quarterly, 6monthly or yearly. Not transparent. If operator goes rogue, it might be a long time before client become aware of this.
Transparency 3 - assets held through IDPS (eg a Wrap)	Client can monitor assets directly with IDPS. Very transparent. Similar to financial planner without MDA. If planner goes rogue, client can quickly withdraw financial planner's authority.	Assets in client's name. Client can monitor assets directly with IDPS. Very transparent. Similar to financial planner without MDA. If planner goes rogue, client can quickly withdraw financial planner's authority.	N/A	N/A	N/A
Is financial planner Custodian?	NO	NO	NO	YES	YES
If AFSL is bankrupted, how are clients affected?	Inconvenient, but client simply finds another AFSL-financial planner.	Inconvenient, but client simply finds another AFSL-financial planner.	Arrangement needs to be unwound so client can get funds - make take time & money to achieve.	Arrangement needs to be unwound so client can get funds - make take time & money to achieve.	Arrangement needs to be unwound so client can get funds - make take time & money to achieve.
Should AFSL have higher financial requirements to cover costs of unwinding situation - and giving back	NO	NO	YES	YES	YES

As you can see, there are major differences (in terms of consumer risk) between a situations where a small AFSL uses a regulated platform to run MDAs and registered schemes or where a MDA is offered by a broker who is also custodian of the MDA assets. Where the small AFSL runs an MDA (under the no-action exemption):-

- *Investments are in client's own name (custody difference)*
- *Transparency. The client can monitor directly with the regulated platform, exactly what is happening in their portfolio on a daily basis.*
- *Typically a long-term personal relationship between client and advisor/MDA operator – so high levels of trust through years of delivering to expectation – and track record of personal ethical behaviour as assessable directly by the client.*
- *Regulated mechanisms exist to prevent fraud – assets in clients name – advisor has no authority/mechanism to transfer funds into their own accounts.*

Proposed new financial requirements

C1 **We propose that MDA operators should be subject to updated financial requirements that are similar to the financial requirements that have applied to responsible entities of managed investment schemes since 1 November 2012 and that we have proposed to apply to platform operators, as outlined in Regulatory Guide 166 Licensing: Financial requirements (RG 166)** (revised version forthcoming). We also propose to apply to MDA operators the same financial requirements as proposed to apply to responsible entities having regard to scheme property holding arrangements. In particular, we propose that MDA operators should meet:

(a) the standard solvency and positive net assets requirement that applies to all AFS licensees;
(b) a tailored cash needs requirement similar to the requirement that applies to responsible entities;
© a tailored audit requirement similar to the requirement that applies to responsible entities;
and

(d) a net tangible assets (NTA) requirement similar to that which is proposed to apply to responsible entities.

We need to understand what the implications are of RG166 if it is applied to us as proposed.

Net tangible assets (NTA) requirement	MDA operators that do not provide custodial and depository services must hold at all times minimum NTA of the greater of: (a) $150,000; (b) 0.5% of the average value of all of the client's portfolio assets of the MDAs you operate up to $5 million NTA; or (c) 10% of your average MDA operator revenue with no maximum NTA. MDA operators that provide custodial and depository services must hold at all times minimum NTA of the greater of: (a) $10 million; (b) 10% of your average MDA operator revenue with no maximum NTA. Note: See proposals C3–C4 for further information about the proposed financial requirements for external MDA custodians and MDA operators that provide custodial and depository services.

- *$150K may be difficult for some small AFSLs. I assume this needs to be over and above cash flow compliance requirements. So in a practical sense, the amount of assets that a small AFSL might need to hold may well be far more that $150K. So this seems like a bit of needless duplication/doubling up of financial obligations.*
- *0.5% average MDA portfolio size – this may be difficult for many small AFSLs.*
- *10% of your average MDA revenue – cannot see this as a problem.*

Rationale

52 It is important that MDA operators maintain adequate financial resources to operate their MDAs effectively and compliantly. We consider that it is appropriate for AFS licensees that are managing investors' money, and making discretionary investment decisions on behalf of investors, to have **sufficient** equity within their businesses.

Sufficient for what? It should not be arbitrary. It should be designed to solve some particular problem/issue.

53 While increased financial requirements will not prevent MDA operator failure, they will facilitate the orderly transfer or winding-up of the MDA business, if that becomes necessary.

What ASIC is actually doing here, is ***highlighting how very different a small dealer operating an MDA through a regulated platform is from (say) an MDA operator with custody or a managed investment scheme because if the small dealer's business fails, the client can simply walk away to find another advisor to take over their account, because all the funds are in the clients own name, and the advisor simply needs to appoint another advisor.*** *So there seems to be not good reason to impose additional financial requirements on a small dealer operating an MDA through a regulated platform.*

This is an absolutely key point.

ASIC has failed to identify any good reason (or evidence) for these small AFSLs being required to have additional financial requirements.

54 While the functions of an MDA operator and a responsible entity differ in some respects, in many key aspects they are similar. Both are typically primarily responsible for managing investments and making discretionary investment decisions on behalf of investors. In addition, some MDA operators elect to structure their MDA offering as a registered scheme. These operators are already subject to the higher financial requirements that apply to responsible entities. For these reasons, it is desirable that MDAs and registered schemes are subject to similar financial requirements.

I do not think that is a reasonable or robust argument. ASIC is saying that, just because some MDA operators operate as a registered investment scheme, totally different sorts of businesses (small AFSLs operating MDAs through a regulated platform) should be regulated as registered investment scheme. That is not reasonably justifiable – at all. It is like saying that since Iran decides to be a Muslim country, every other country should be required to be Muslim!!!!!

The ASIC line of argument here is only as valid as saying that – "financial planners using MDAs and financial planners not using MDAs, in many aspects are similar – because they are both managing client portfolios. For this reason, it is desirable that financial planners using MDA and financial planners who don't use MDAs should be subject to similar financial requirements." It seems that ASIC does not agree with this logic, but the logic in this is as robust as ASIC's logic.

55 Enhanced capital requirements will ensure that MDA operators are adequately resourced and committed to their MDA business, and also increase the incentives for the operator to strive to operate the MDA effectively and compliantly.

This seems like superficially like good motherhood but ASIC does not seem to be presenting any evidence that this assertion has any real foundation.

56 In our consultation with current MDA operators, most operators also identified small, inadequately resourced and inexperienced operators as one of the greatest risks within the MDA sector. Our proposal seeks to address this concern.

What evidence has ASIC got for believing that small AFSLs are "one of the greatest risks within the MDA sector." It sounds like the big guys have just been lobbying to get rid of the competition from small businesses in this space. Surely consumer's should have choice in this rather than being forced to pay the expensive prices of the big guys.

57 If the MDA operator is a responsible entity, average responsible entity revenue, as defined in Class Order [CO 11/1140] Financial requirements for responsible entities , is included in MDA operator revenue. We will adopt a similar approach to MDA operators that are also IDPS operators. MDA operators who are also responsible entities or IDPS operators can utilise the same capital to meet their multiple financial resources requirements; however, they must ensure that this capital is sufficient to meet the requirements of each obligation.

Unclear as to ramifications.