BAILEY ROBERTS GROUP

BUILD PROTECT AND PRESERVE

Australian Financial Services Licence No 235656 ABN 30 096 205 604

RESPONSE TO ASIC'S CONSULTATION PAPER 200

APRIL 2013

Written by:

Ian Bailey (CEO)

Leith Thomas (Director)

ALL CORRESPONDENCE
PO BOX 1903
Wollongong NSW 2500
E | enquiries@baileyroberts.com.au
W | www.baileyroberts.com.au

WOLLONGONG OFFICE
128 Church Street
Wollongong NSW 2500
P | 02 4220 1600
F | 02 4226 3530

SYDNEY OFFICES
CBD, Chatswood,
North Sydney

CONTENTS

INTRODUCTION

We believe that the proposals as presented in their current form, risk failing the objectives of Chapter 7 of the Corporations Act (2001) Financial Services and Markets, namely by:-

- **Increasing retail client risk**
- **Increasing retail client cost**
- **Creating inefficiencies**
- **Stifling innovation**
- **Decreasing independent advice**
- **Increasing centralisation of market participants**

ASIC has invited comment to the proposals and questions, as well as seeking respondents to provide alternative approaches that would help ASIC achieve its objectives.

What are ASIC's objectives?

We have endeavoured to understand exactly what ASIC's objectives are (directly from ASIC and from Consultation Paper (CP) 200), however, we have not been successful in this pursuit. Whilst we believe it is crucial for anyone responding to these proposals to have a clear understanding of the objectives in order to give a logical and informed opinion, for the purpose of our response we have resorted to section 760A of the Corporations Act (2001) – ("the Act").

Section 760A of the Act states that the main object of the regulations imposed on Financial Services and markets is to promote:

(a) *confident and informed decision making by consumers of financial products and services while facilitating* ***efficiency****, flexibility and* ***innovation*** *in the provision of those products and services; and*
(b) *fairness, honesty and professionalism by those who provide financial services; and*
(c) ***fair, orderly*** *and* ***transparent*** *markets for financial products; and*
(d) *the reduction of* ***systemic risk*** *and the provision of fair and effective services by clearing and settlement facilities.*

We believe the proposals in CP 200 will fail many of the above objectives. Specifically, our areas of concern are that the proposed changes will:

- limit confident and informed decision making by consumers;
- limit efficiency;
- provide limited flexibility for the multiple risk scenarios;
- stifle innovation by eliminating market participants; and
- increase systemic risk in Australia's financial markets.

…all leading to increased consumer risk, higher cost for consumers and lower choice, as regulation is tailored to favour the large industry players at the unnecessary expense of the smaller players.

This paper is submitted on the basis that an alternative approach to regulating MDA Services may better achieve the objectives of s760A paving the way for; greater consumer services and protection through delivery of lower cost solutions, including second tier benefits such as more accurate Professional Indemnity underwriting of AFSL participants.

We address areas of concern and where possible we provide an alternative approach.

COMMENTS ON ASIC'S REVIEW OF THE MDA SECTOR (p. 9 of CP 200)

<u>Paragraph 14:</u>

ASIC states that over 2011-2012 they have reviewed the growth and development in the MDA sector,... and whether their guidance and relief:-

> ***"facilitated competition and innovation within the MDA sector…***
> ***contained sufficient mechanisms to promote confident and informed consumers".***

Are we to assume that the objectives of RG179 was competition and innovation with confident and informed consumers? If so we believe the proposal will fail these objectives for the reasons discussed within this response.

<u>Paragraph 15:</u>

ASIC have stated that they have conducted research and consulted with the industry.

Understanding the operations of an MDA requires specialist knowledge. It seems the writer of the report does not have industry experience. Unless this research has peer review it must be considered as opinion only. Surely it will create better outcomes if we are all "on the same page". Therefore, the research should be available for review and comment?

<u>Paragraph 18(a):</u>

ASIC's opinion is that the increase in MDA offerings in coming years is due to AFS Licensees adapting to FOFA.

Have ASIC considered that this growth might have something to do with investor requirements changing. The growth of the Self-Managed Superannuation Funds (SMSF) sector, the inability to liquidate managed funds post GFC and the increase in low cost technology to manage MDA portfolios would also seem compelling arguments for change. ASIC's FOFA argument may again be opinion not fact.

The number of SMSFs in Australia has grown from 270,678 funds at June 2004 to 478,263 funds by June 2012. It could be argued that this growth has originated from; the evolution of financial markets, from technological advances, and the desire by Australians to take a more active role in their financial affairs. To this end, in our experience client needs and objectives have evolved to include requiring the following:

- Direct Investments
- Control
- Liquidity
- Cost efficiency
- Knowledge about the investments held
- Better taxation outcomes
- Independent Operators
- Independent advice

As more and more investors have sought the above outcomes, advisers have sought solutions to manage assets efficiently. This includes the ability to act on a discretionary basis. In Consultation Paper 44[1] released in April 2003, ASIC identified several of these as reasons why an investor would use an MDA service.

THE RISKS OF TRANSACTIONS ON A DISCRETIONARY BASIS

In ASIC's original Consultation Paper on MDA Services in April 2003 (Consultation Paper 44), MDA Services were defined as *"…an arrangement such as a trading account through which a person ("the client" gives another person ("the operator) authority to effect transactions using the client's portfolio assets on a discretionary basis (i.e. without prior reference to or approval of the client for each transaction)…"* [1]

This is a very simple and effective general definition.

In the marketplace, there are a range of different businesses offering a range of different portfolio management related services. Many MDA operators use technologies and solution combinations such as custodians, platforms, and IDPS providers.

The issue, however, is that while an operator trading on a discretionary basis may utilise different solutions, all are not the same. Therefore the only commonality among the different players and MDA Service structure possibilities is the fact that someone is effecting transactions in a client's portfolio on a discretionary basis. This, in essence, is what MDA licensing is all about. One could use a custodian, a platform or an IDPS under an MDA Service. However, one could also use them under a non-MDA Service. Therefore it seems logical to look at the specific consumer risks as they relate to discretionary trading.

We have endeavoured to determine from ASIC what specific consumer risks they are attempting to manage in regards to MDA services. However, we have been unable to ascertain this. As such we will present the issues in such a way that we, and other independent advisers, understand and are consistent with section 760A of the Act.

To identify the specific risks to the consumer we need to:-

a) identify the key elements of the value-chain when a MDA Service is provided; and

b) analyse the risks to the client at each of these points.

A) **Key Elements of the value-chain**

When a retail investor receives financial advice and services relating to their investment portfolio, in a broad sense, this can be broken down into three elements;

1. The advice
2. The investment
3. The ownership structure

ASIC have rightly pointed out that a large range of different structures are emerging in this sector of the market however no matter what type of structure an MDA Operator ultimately uses for an MDA Service, the risks to the investor will be determined by what occurs within each of these three elements of the value chain.

Several proposals within CP 200 seem to indicate to us that there is a misunderstanding on the differences in consumer risks between the different MDA related offerings. ASIC's starting point seems to be trying to create uniform regulation rather than using consumer risk as the starting point. This has resulted in what seems to be "long-bowed" attempts at concluding that starkly different scenarios in the context of consumer risks are somehow "comparable financial products" (p. 53 of CP 200). We will attempt to highlight that the different scenarios are often far from 'comparable'.

B) **Client Risk at each point in the value chain**

1. Advice

Risks here revolve around the appropriateness of the advice for the client. As this is dealt with in sections 766A and 766B of the Act, we will leave this aspect of the value-chain alone for now.

2. Investment

The main types of investments an MDA Service may offer typically include:

- Cash
- Fixed Interest (e.g. bonds)
- Listed securities
- Unlisted Managed Investment Schemes

- CDFs
- Options
- Property syndicates
- Other

Given the different risk characteristics of each investment type and asset class, the risk for investors must differ depending on which investments are used within the MDA Service.

In our opinion, ASIC should place more focus on investment risk in any proposed changes. If an adviser with an authority to operate an MDA service wanted to only recommend cash and government bonds to their clients then one would argue this would be a lower capital risk than say an investment in a derivative. The current licensing regime does not differentiate the lower consumer risk in these investment choices. Surely the discretion to apply investment risk by an operator should be a priority of reform.

Many operators may not want to offer high risk investments, however because no consideration seems to have been given to consumer risk at an investment level, all operators will be treated the same from both compliance risk and insurance risk. The outcomes will mean, higher Professional Indemnity insurance due to bundling, i.e.: all MDA operators treated the same.

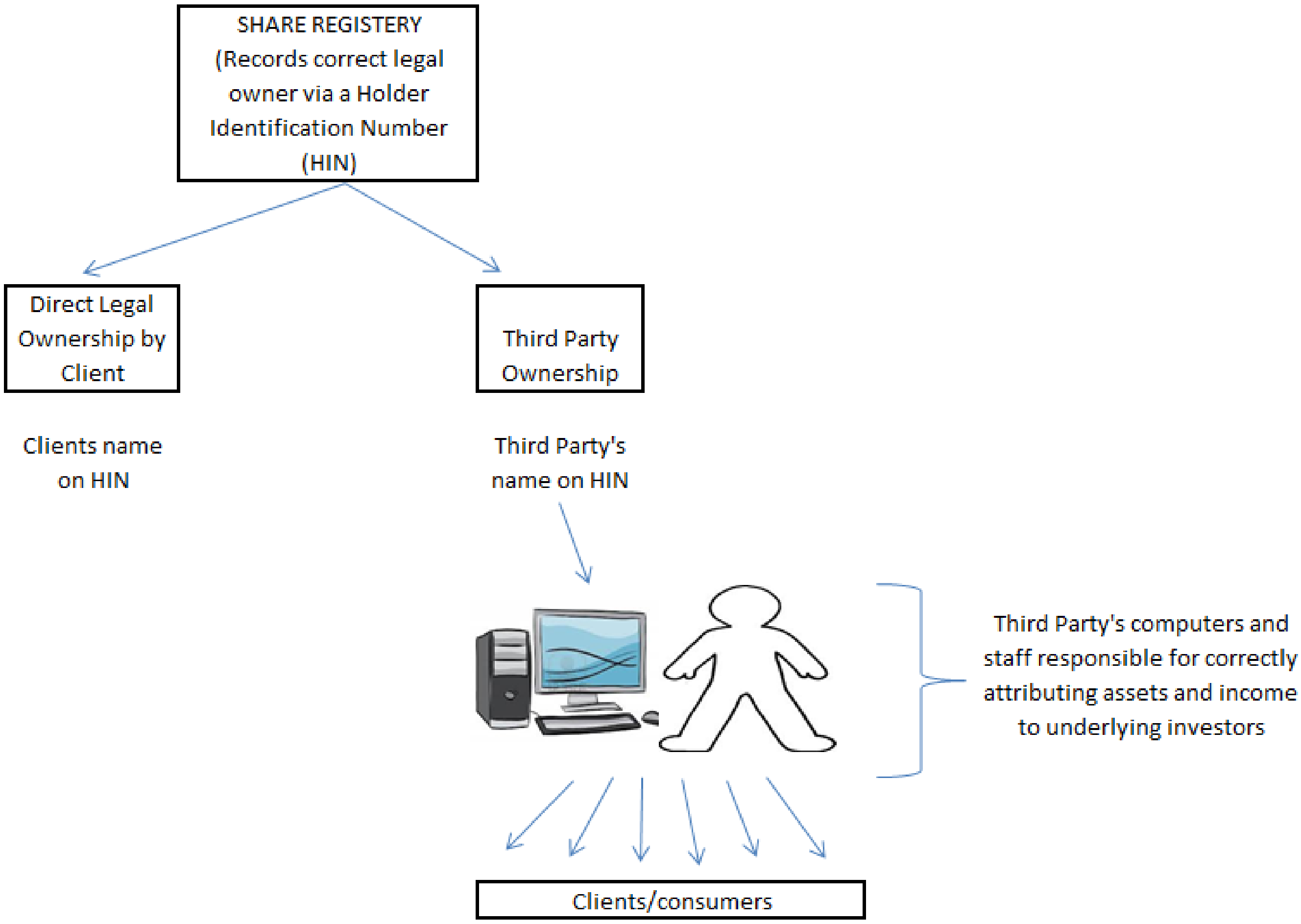
3. Ownership.

- Direct legal ownership; or
- Beneficial ownership through a third party (e.g. custodian, IDPS).

Regardless of the type of structure an MDA Service takes, these are the only two alternatives available for ownership of an asset. Each option has significantly different risk characteristics for a client. We believe that although CP 200 identifies that there is ‘a’ difference, we believe that difference is misunderstood from a risk prospective and therefore misrepresented in the proposals.

In July 2012, ASIC released ‘Report 291’ into Custodial and depository services in Australia. ASIC identified 12 key risks that related to Responsible Entities and Custodians. These risks all existed due to the fact that the legal ownership of assets is held by a third-party rather than the client. Figure one is a graphical depiction showing how this works in practice.

FIGURE ONE



In the table below we list several of the specific risks ASIC identified when a third party owns legal title. We also include several other risks we have identified, and for a comparison, we have included the corresponding risk when a client retains legal ownership of their assets.

Section 760A (a) of the Act seeks to achieve confident and informed decision making by consumers. We believe that anything less than the client understanding the risks we highlight below fails this objective of the Act.

THIRD PARTY HOLDING LEGAL TITLE	RISK(S) FOR CONSUMERS/ INVESTORS	DIRECT LEGAL OWNERSHIP BY CLIENT
ASSETS NOT HELD IN CUSTODY ASIC discovered that many held assets outside the custodial relationship i.e. not on trust for the client but in the name of the third party. ASIC were also told by the industry that this was common industry practice.	• Legal implications in the event of insolvency i.e. who owns the assets? • Leakage of assets • Freezing of client assets until resolved with potential legal costs	• Not applicable to direct legal ownership as it is impossible to occur. • Client assets 100% secure in this regard.
CASH HELD ON DEPOSIT ASIC found that where a custodian was also an ADI, there were instances where client cash was held on deposit at the custodian or in the name of the responsible entity, rather than on trust for the client. While ASIC stated this does not comply with the law, the practice exists as do the corresponding risks.	• Introduces counter-party risk. • Leakage of assets • Legal implications in the event of insolvency i.e. who owns the assets? • Freezing of client wealth until resolved with potential legal costs	• Not applicable to direct legal ownership as it is impossible to occur. • Client assets 100% secure in this regard.
TRANSFER OF ASSETS AND RECORDS ASIC identified that the increased consolidation within the super, managed fund and custodial industry and has noted they expected this to continue.	• As the source records of legal ownership rests with the share registries, when two RE's or custodians merge, it is the third parties that consumers rely on to correctly transfer and allocate assets to each investor. • ASIC are concerned that as assets are transferred between different funds and different custodians,	• Merger and takeover would not put client assets at risk when the client holds legal title. All client assets remain in their own name at all times.

	that there is an opportunity for fraud and 'leakage' of assets and records.	
INSOLVENCY OF THE CUSTODIAN OR SUB-CUSTODIAN ASIC identified that, regardless of the whether relevant compliance requirements have been met, the safety of client assets could be a risk in the event of insolvency of the Custodian or Sub-custodian	• Legally there should not be a risk to client assets but ASIC have found that there is still substantial risk, including where: (a) assets held in another jurisdiction through a related or unrelated sub-custodian will be held under different local practices, and cannot be traced or recovered or are subject to a lien in favour of the sub-custodian or related entity; and (b) the insolvency laws of particular jurisdictions, including those of the custodian's parent company, may not recognise or honour the client's assets as being separate from the custodian's own assets. • In one particular Australian IDPS provider's PDS, it states that in the event of insolvency of the custodian or sub-custodian, "…your assets **should** be returned to you". The use of the word 'should' does not create legal certainty to a client. • In any event, there may be substantial delay in the repatriation of assets and possible legal costs, particularly if the documentation is not adequate.	• There is no risk to client assets in the event of insolvency of the MDA Operator when they legally own assets directly • .The MDA Operator simply relinquishes log in authority to the clients trading and bank accounts. Assets remain in their legal name at all times. • When a client has legal ownership of their assets, they would not need to be **'returned'** as they are not **'taken'** in the first place.

CORPORATE ACTIONS ASIC have stated that Corporate Actions are one of the most significant operational risk areas for custodians.	• When Corporate Actions occur, the registry reflects the changes on the legal owner's holdings. Custodians then need to correctly apply these changes to each individual investor within the custodian account which is merely an internal record and then they need to report on this correctly. • There is a client risk in that entitlements may not be correctly attributed to each beneficial interest. • There is a risk that the client may not be able to audit their assets effectively.	• As the registry applies the correct changes to each legal owner, an operator of a direct legal ownership type service merely updates the records from the registry. • If they were to wrongly account for this, there would be no effect on the client's assets as everything is auditable back to the Share Registry.

The point of the above table is not to berate third party ownership but rather to ensure that all participants clearly understand the differences and the risks of each. In our opinion, the risks to consumers when they do not hold legal ownership (i.e. hold a beneficial ownership) are broadly speaking, greater than if clients held legal ownership. We wonder if the objectives within section 760A (a) of the Act of promoting *confidence and informed decision making by consumers* would not be enhanced if these important distinctions were made.

As a practical insight into a key distinction, *HSBC Custody Nominees (Australia) Limited* for example, are the largest shareholders on Commonwealth Bank holding over 224 million shares as at 3 August 2012. That is, HSBC is the legal registered owner of all of these shares at the Share Registry (it is HSBC's name on the HIN). HSBC's assets and legal rights can all be audited back to the Share Registry however for the beneficial client/consumer using HSBC custodial services; they are relying on HSBC's internal computer system and staff to ensure:

a) the shares they are entitled to are there when they want them to be
b) that dividends are correctly attributed to them correctly
c) that corporate actions are attributed to them correctly.

To account for and audit their holdings, investors are forced to rely on HSBC provided information. This is in contrast to an MDA Service where the client retains legal title of the assets. Everything is auditable to the Share Registry. An MDA Operator's role in this regard is to simply report on what the Share Registry records provide. As ASIC rightly pointed out in Consultative Paper 194 *"clients of a custodian characteristically place significant trust in the Custodian to safeguard and administer their assets"*[2]. When clients retain legal title of their assets, there is no such risk.

Paragraph 7(f) of CP 200 states that an *"MDA Operator must not permit a client's assets to be pooled with other assets to enable an investment to be made…"*. While the regulation does not seem to specifically extend to the situations such as those given here where one HIN is the legal owner of 224 million shares on behalf of potentially tens to hundreds of thousands of clients, there exists risks in need of consideration. Again, to conclude that the consumer risk in these structures in somehow 'comparable' with one where the clients maintain legal ownership or throw away type statements such as those stated on page 28 of CP 200 that the risks lie with the smaller operators, is just plainly inaccurate.
An analysis of ASIC's Enforceable Undertakings (EU) Register shows a substantial amount of individuals and organisations that would be considered to be "large players". If the argument that big meant lower risk held true, ASIC's EU Register would look very different!

Objective of s 760A (d) of the Act – reduction of Systemic risk

In ASIC Report 291, ASIC identified that as at 31 December 2011, approximately $1.82 trillion of assets of Australian investors were held in custody. ASIC expect this to triple over the next 15 years to $6.4 trillion in part due to the increase in superannuation guarantee contributions.

ASIC have also discovered that the substantial majority of these assets are concentrated with only a small number of custodians. Namely, 84% of all assets held in custody are held by just six custodians and 100% of all assets held by just 13 players. Just three controlled 65% of all custodial assets as at 31 December 2011.

To give you an idea of what this means in practice we will give you an example of a prominent custodian in the Australian market to raise a potential issue for consideration. Please note that while we use an example of a specific company this by no way is meant to conclude or imply this specific business is breaching the law or is doing any activity that is untoward. We merely use it as a case in point.

<u>Example</u>

HSBC Custody Nominees (Australia) Limited are the **largest legal owner of 18 out of the top 20 largest companies on the Australian Share market (ASX)**. They are the second largest shareholder in the other two. Please note that we limited our research to just the top 20.

List of companies in which HSBC custodian is the largest shareholder:

COMPANY	SHARES HELD AT LAST REPORTING DATE
Commonwealth Bank	224,434,908
BHP Billiton	541,484,877
Westpac Bank	513,847,518
ANZ Bank	496,877,028
National Australian Bank	378,019,172
Telstra	2,051,414,797
Woolworths	199,819,843
Wesfarmers	151,460,429
Woodside Petroleum	123,613,279 (2nd largest shareholder)
CSL Limited	120,295,887
RIO Tinto	89,470,664

Westfield Group holding	725,987,840
QBE	366,282,151
Newcrest	285,243,166
Suncorp Limited	264,104,729
AMP Limited	586,408,158
Origin Energy	188,444,810
Brambles	390,442,585
Macquarie Group	66,394,008
Fortescue Metals	234,751,550 (2nd largest shareholder)

These companies represent 60% of the overall market capitalisation of the All Ordinaries Index. How many investors sit underneath the custodian's HIN and the other small number of custodians in the Australian market is unknown but we suspect it is at the least, well into the hundreds of thousands.

The objective of section 760A (d) of the act is "*the reduction of* ***systemic risk….***"

Based on the 12 April 2013 closing price of the businesses noted above, the collective value of HSBC's holdings in them was nearly $149 billion. What would be the impact to the wealth of Australian investors if HSBC or one of the other large custodians say became insolvent or had an issue with their computer systems or another major operational issue?

If an MDA Operator allowing direct legal ownership became insolvent for example, there would be no effect on client assets.

Any proposal on discretionary licensing that serves to imply a risk with, and therefore place an increased burden on those MDA Operators whose clients retain direct legal ownership, will only serve to breach section 760 A of the Act by stifling innovation while continuing to promote clients towards, what is arguably, higher risk structures operated by a concentrated number of large institutions, therefore increasing the systemic risk of the overall financial system.

Clearly a system that does not rely on custody provides better investor risk outcomes.

We also understand prior to releasing CP 200 that ASIC consulted ten MDA Operators and related parties. We wonder how many of these parties operated their businesses where clients retained legal ownership rather than just beneficial ownership? We also wonder how many represented those parties who are singled out as being small and of higher risk to enable them to respond?

ALTERNATIVE APPROACH TO REGULATING MDA SERVICES

We propose that MDA Operators allowing direct legal ownership be exempt from the financial requirements proposed as the proposal will eliminate new innovative and skilled players. There is no ASIC research that proves increased financial standards will decrease investor risk, if increased financial requirements are deemed necessary ASIC should provide detailed research to justify same.

1. Direct invested MDA services should be **clearly** identified as such by license conditions, this would also allow decreased P.I insurance in recognition of the lower risk.

2. That MDA operators are licensed based on the investment type, rather than one size fits all.

    a. MDA that use CFD's would rate higher on the risk scale, and as such could be properly identified by P.I insurers.
    b. MDA operators that used unlisted unregulated schemes would also have a higher risk weighting.

3. Audit should not be required for direct investment MDA's, or a System Audit is required if direct MDA operators are providing reports to clients that give accounting, and taxation information.

In reality the consultation process should be about investor risk. It is difficult to understand the risks perceived by ASIC from the paper, as mentioned efforts to find out these perceived risk on direct basis met with little success. We are all aligned in one area we want better outcomes for investors. Better outcomes should mean cost efficient innovative solutions, many solutions are far better than restricting solutions to those with deep pockets. If MDA operators are limited by a price to entry barrier rather than a risk barrier we will get another poor solution.

We feel that ASIC has not consulted enough alternative players in the MDA space to get a comprehensive understanding of what the possibilities are.

Our business has spent 5 years developing a technology solution that allows bulk direct trading, double entry accounting, tax calculations including CGT reporting, WEB access, document storage and a host of other features. This application delivers a lower cost solution and would enable most competent advisers to run an

MDA service in their own right at a lower cost structure. The point is we would have not ventured on this innovative project if the proposals were in force at the time we decided to build. We believe the proposals fail in that they will discourage innovation.

The remainder of our submission deals with the substance of the paper and comments on the changes suggested.

RESPONSES TO ASIC PROPOSALS

B – Resolving the two outstanding no-action positions

PROPOSAL B1

We do not have a position on this proposal.

PROPOSAL B2

We do not have a position on this proposal.

PROPOSAL B3

We do not have a position on this proposal.

PROPOSAL B4

> **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 licensees that wish to undertake this activity will need to obtain the relevant AFS licence authorisations.

Our Response:

There is no rationale statement as to the investor risk that ASIC is trying to avert. Could we have a clear indication of the risks and then discuss why the changes need to be made in light of the investor risk?

Whilst this does not affect our business, we see no reason to change based on the information provided. In today's environment it would be possible to argue that there is less investor risk if all AFSL holders could use regulated platforms on a discretionary basis without MDA approval.

Do not agree with the proposal, ASIC needs to provide more factual information to allow an informed discussion.

ASIC's rational in paragraph 47 states:

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.

Our comments on this rationale:

Is ASIC implying that some operators feel that alternative no action systems place them at an economic disadvantage. Our assumption would be that it gives the client/investor a lower cost opportunity. The strong argument for maintaining or even eliminating MDA licensing on regulated platforms is that it would be in keeping with the aims of section 760A (a) of the Act.

ASIC's rational in paragraph 49 states:

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.

Our comments on this rationale:

The fact that ASIC consider that the new platforms offer similarities to MDA operators has nothing to do with client/consumer risk. Again, there is no substantiation of the risk factors. Advisers currently design portfolios, the ability to change these efficiently and effectively is what investors want. ASIC's approach would result in increased costs, increased risk and poorer client outcomes.

<u>PROPOSAL B5</u>

We do not have a position on this proposal.

PROPOSAL B6

We do not have a position on this proposal.

PROPOSAL B7

We do not have a position on this proposal.

C – Updating financial requirements for MDA operators

ASIC's Key Point states:

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.

Our response:

What research has ASIC undertaken to justify the above statement? It would be good to understand the relationship that ASIC places in regard to financial capacity to operational ability. The inference is bigger is better, the same logic did not seem to work in the GFC.

PROPOSAL C1

Proposal

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;

(c) 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.

See Table 2 for more details of the proposed financial requirements.

C1Q1 Do you agree with our proposal that MDA operators should be subject to similar financial requirements to those that apply to the responsible entities of managed investment schemes? If not, why not?

No, If client investments are directly held there is significant difference to risk associated with MIS's. Directly held investments cannot be bundled at any stage. The proposals only add costs and limit opportunity and innovation.

C1Q2 Do you agree that this proposal is appropriate, given the level of risk carried by MDA operators? Why or why not?

No. Again the risks are not defined. ASIC consistently states risk as a factor but has not defined the risks in a clear and concise manner. We would argue that for directly held assets the risks are most likely lower for a discretionary client than a non-discretionary client, particularly if operators have high level technological capabilities that have now been developed.

In our endeavour to try and ascertain what ASIC believe are the precise risks we have looked at the NTA requirements to try and gain insight. It appears that ASIC believe that client risk is related to:

a) The average value of client portfolios; and
b) The revenue of the firm (in reality the size of FUM)

When we apply this to the real world, we are still struggling to see what the risk to the client would be in a direct legal ownership structure.

Linking NTA requirements to average client value implies that risk is related to the size of each individual clients portfolio balance. So if an MDA Operator had one client with a $100,000 portfolio balance or five thousand clients with $100,000 balances, this logic implies there is no greater risk to client assets in either scenario.

Linking NTA requirements to revenue of the firm then suggests that risk to client assets increases when the overall Funds under Management increase. If clients hold legal title to assets, what is the increased risk to the existing clients if say a new MDA client is added to the service?

Paragraph 51 of ASIC Consultative Paper 194 regarding Financial Requirements for custodians, states that the focus of the new approach to financial requirements is on operating risk, with average revenue used as a proxy for operating risk.

Paragraph 52 goes on to explain what ASIC means by operating risk:

Provider [custodians] operate in an environment with inherently high levels of operating risk. This is due to the large volume of daily transactions, the diversity of assets and the number of jurisdictions involved, the complexity of systems and products and the high level of manual intervention required to perform many processes. AFSL operating in these markets may be exposed to a risk of financial loss due to operational failures.

Paragraph 53 goes on to say:

Setting the required level of NTA at 10% of average revenue will help to ensure that the level of financial resources each provider holds corresponds to the size of its business and therefore to the size of its operating risk exposure.

We fail to see how any of the assumed risks relate to discretionary trading. These risks would be there regardless of whether transactions were entered into under a discretionary or non-discretionary license.

By applying requirements on this basis it also assumes that everyone operates at the same efficiency. For example, paragraph 52 above suggests that one area of operational risks lies in the amount of manual intervention required. What if one operator has the technology to have tasks carried out automatically where others need to do them manually? There is clearly a difference in the risks of these two operators yet the proposed approach assumes from a regulatory perspective they are the same risk.

Additionally, in reality what is NTA of 10% of revenues really going to cover? If you are suggesting that risks with legal ownership increase with revenue increases, lets say an MDA Operator is generating $10,000,000 of revenue per year. Assuming they are charging 1% of FUM this would result in total FUM being $100,000,000. How far is $1,000,000 in NTA really going to go in terms of rectifying a non-compliance correlated loss across portfolios?

Looked at on an individual client level, assume we have one hundred $1,000,000 clients. There would be a measly $10,000 each for every $1,000,000 in client assets.

It makes more sense to focus on the investment type, ownership structure and operational capabilities to eliminate whatever risks ASIC perceives, as once they occur, trying to limit the damage beyond PI cover after the fact would often be useless.

C1Q3 Are there any practical problems with the implementation of this proposal? If so, please give details.

Yes. More compliance and less efficiency. Marginalisation of industry leading to monopolistic outcomes which in the long term disadvantages clients/consumers.

C1Q4 Are there any circumstances in which the proposed financial requirements should not apply? Please specify.

Yes: MDA operators provide service on a directly held asset basis. New systems to market will allow operators to access applications that will rebalance, account, and trade using investor directly held assets.

PROPOSAL C2 –

C2Q1 Do you agree with our proposed definition of 'client's portfolio assets'? If you think that 'client's portfolio assets' should be defined using an alternative definition, please supply that definition and outline why it is preferred.

This is a difficult proposal to respond to as ASIC have not mentioned why they believe a client's portfolio should be defined as 'financial products'. There is nothing stated in the rationale? Can ASIC provide more detail?

C2Q2 Do you agree with our proposed definition of 'average MDA operator revenue'? If you think that 'average MDA operator revenue' should be defined using an alternative definition, please supply that definition and outline why it is preferred.

No. The definition of revenue implies gross revenues. If some services are subcontracted then it appears from this definition they will be caught. For example the portfolio administration may be subcontracted to another MDA operator, will this be counted twice?

ASIC's rationale in paragraph 53 states:

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.

Our comments on this rationale:

This is not rational. If the MDA operator uses direct investment options, all assets are in the client name and no further action or involvement is required. Hence this argument does not hold for direct investment clients.

ASIC's rationale in paragraph 54 states:

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.

Our comments on this rationale:

We have already discussed above why we believe there is very little comparison that could be made between custodian and non-custodian services.

We would argue if investments are held directly the operations are more likely an appropriately qualified adviser using technology and efficient systems to gain better client outcomes. Again we believe a proper review of the real risks rather than assumptions would give better outcomes in this review.

ASIC's rationale in paragraph 55 states:

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.

Our comments on this rationale:

We are unsure if there is a complete understanding by ASIC as to what is required and the associated cost of the different structures. New technology is significantly lowering the costs and bringing much greater efficiency to this space. Resources are not defined however we would place the following for consideration:-

a. Skill Set to select the investments appropriate for the Investor (should be covered under AFS licensing approval).
b. Accounting Package to correctly account for Investor assets:-
    i. Purchase and sales
    ii. Income and expenses
    iii. Taxation including CGT
c. Reporting.

Currently software applications are coming to market that will provide these facilities at low cost. Imposing capital requirements will not increase skill set or accounting ability but again bring cost, limit competition and serve consumers poorly.

ASIC's rationale in paragraph 56 states

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.

Our Response:

Which operators did ASIC consult with? This statement holds the same logic as asking Woolworths who is a risk in the supermarket industry. Naturally Woolworths will identify competitive competition. This statement seems void of fact and should not be used as part of the argument.

PROPOSAL C3

> **Proposal**
>
> C3 We propose that external MDA custodians must meet the same requirements as those we propose to apply under CP 194 to providers of custodial or depository services that are not incidental providers. This includes the requirement to hold net tangible assets (NTA) of $10 million, or 10% of average revenue, whichever is higher. In determining average revenue, an MDA operator should include the revenue of persons performing the functions relating to an MDA for which the MDA operator is responsible (e.g. functions outsourced to other entities).

They are a clearly higher risk to client assets than the alternative direct ownership. We do not have an opinion on suitability of financial requirements to mitigate this risk. In an ideal world consumers would be made aware of the risks and the market would dictate what they expect a custodian to hold in NTA rather than the government dictating it.

PROPOSAL C4

As C3 above.

D – Improving Disclosure for MDA Investors

PROPOSAL D1

> **Proposal**
>
> **D1** We propose to refine our conditions relating to the MDA contract, investment program and financial advice to make it clear that:
>
> (a) the investment program that forms part of the MDA contract must contain an investment strategy;
>
> (b) the invest strategy must contain sufficient detail to permit an opinion to formed on the suitability of the investment program for a particular client;
>
> (c) the investment program forms part of the MDA contract;
>
> (d) the MDA operator or an external MDA adviser must provide personal advice about the MDA contract, *including the investment program*, on an annual basis. This personal advice must meet the conduct and disclosure obligations under Pt 7.7 and Pt 7.7A of the Corporations Act that apply to personal advice (including the obligation for the AFS licensee or its authorised representative to prepare and provide a Statement of Advice (SOA) or record of advice, and the obligation for the advice provider to act in the best interests of the client, provide appropriate advice, warn the client where advice is based on inaccurate or incomplete information, and prioritise the interests of the client), and must contain advice about whether the MDA contract for that client, *including the investment program*, continues to be suitable in light of the client's personal objectives, needs and relevant personal circumstances.

Your logic seems clear and of benefit.

PROPOSAL D2

> **Proposal**
>
> **D2** We propose to clarify that the FSG and MDA contract must contain information about the fees and costs of the MDA in a manner that is consistent with Sch 10 of the Corporations Regulations.

We have no issue with this, other than to say we don't see how disclosing fees in the FSG will help clients "*make a better, more informed decision…*". We see the MDA Contract as the vital document that stipulates in no uncertain way, the terms and conditions of the MDA Service.

If it was the number of times a fee was disclosed that helped clients "*make a better, more informed decision…*" why not create regulation to have to disclose fees five times, ten times, fifteen times?

We would suggest there are instances where the same fee is mentioned twice, clients can interpret this to mean separate fees.

PROPOSAL D3

> **Proposal**
>
> D3 We propose to require the FSG for the MDA to provide a description of the operation of outsourcing arrangements that apply to the MDA, where relevant. This description should cover:
>
> (a) the entities involved and the functions they perform; and
>
> (b) how outsourced arrangements will be monitored.

Seems like a soundly based proposal.

PROPOSAL D4

> **Proposal**
>
> D4 We propose to require both the FSG and the MDA contract to contain information about how the client may terminate the MDA contract including:
>
> (a) how the instruction to terminate must be communicated;
>
> (b) how long it will take for the termination to take effect; and
>
> (c) how the MDA assets will be disposed of, or transferred to the client, if those assets are not held directly by the client.

We have no problem with having this in the MDA Contract but why would it need to be in the FSG? This would just create more inefficiencies and cost. If after reading information regarding termination of the MDA Contract the client is not happy with the terms, they will not sign the MDA Contract. Why force it to be in both? More reading for the client, potential for more confusion, more cost for MDA Operators all for what benefit to the client?

PROPOSAL D5

> **Proposal**
>
> D5 We propose to require that the length of time required by an MDA operator for the termination to take effect must be no longer than is reasonably necessary.

Like most proposals in CP 200, we do not see why they need to be regulated by anything other than a well-informed free market but generally speaking; we have no issue with this proposal.

ASIC's rationale in paragraph 67 states:

To run their MDAs effectively and efficiently, MDA operators should have policies and procedures in place to ensure the orderly exit of clients from MDA contracts….

Our comments on this rationale:

If this is required to run an "*MDA effectively and efficiently"* why does ASIC feel that they need to regulate this? Why wouldn't an MDA Operator already do this?

ASIC's rationale in paragraph 68 states:

Disclosing these policies to the investor upfront will ensure that investors know what they must do if they wish to terminate the MDA…

Our comments on this rationale:

If ASIC believe disclosing this will solve the problem, why not, instead of requiring an MDA Operator to give advice to an MDA client every 13 months, allow us to contract with the client in the following way:

"We actively manage your portfolio of assets every day using our MDA Service. If we ever deem this service to cease being appropriate to you, we will notify you immediately".

Surely this approach would create what section 760A(a)'s aim of "*facilitating **efficiency**, flexibility and **innovation"*** because at the moment it breaches it in this regard.

E – Other modifications to our Guidance and Relief

ASIC's Key Point states:

Some MDA operators make discretionary investments in products or arrangements that could incur losses that are greater than the amount invested in the product or arrangement, and would therefore require additional client contributions to cover the loss. We are seeking feedback on three alternative proposals, which seek to ensure that MDA investors are adequately informed about the specific risks involved when their MDA operator has discretion to invest in products or investment strategies with non-limited recourse.

Our response:

This is really getting to the crux of the issue of investor risk. Our assessment of the real risk of MDA's is bulk exposure of a group of investors to differing risk products. ASIC seems only to be concerned with non limited recourse. Total loss, unregulated, and other high risk investments do not seem to be discussed but left as a matter for the adviser. Since many advisers wish to use discretionary trading to provide better outcomes and efficiency the current proposals will effectively eliminate skilled innovative independent solutions. From the very onset we have proposed that MDA licensing should be risk based, the higher the risk the higher the barrier to entry for the operators, this would give a fair and equitable solution to both advisers and clients. More importantly P.I insurers will be able to differentiate risk, instead of making all consumers pay more.

PROPOSAL E1

Proposal

E1 We propose to modify our conditions of relief under one of the three options listed below:

(a) in situations where an MDA operator may invest an MDA client's portfolio assets in non-limited recourse arrangements, the MDA operator is required to include a specific risk warning in the MDA operator's FSG and in each client's investment program, which outlines the additional risks to the client as a result of their MDA investing in non-limited recourse arrangements. The MDA operator will also be required to disclose in the investment program the degree of leverage that may be employed, the types of products used and the MDA operator's policies in relation to communicating and meeting margin calls and closing positions at a loss;

(b) in situations where an MDA operator may invest an MDA client's portfolio assets in non-limited recourse arrangements, the MDA operator is required to seek express consent from the MDA client on each occasion when the MDA operator is proposing to invest in such a product or arrangement, and not to invest in any such product or arrangement where express consent has not been obtained; or

(c) MDA operators are prohibited from investing retail client's portfolio assets within an MDA in non-limited recourse arrangements.

We do not use these investments, nor intend to but we believe restricting someone ability to engage an MDA Operator to manage their assets on this basis would be oppressive and take away civil liberties. We are advocates of letting the individual decide provided they are fully informed of the risks.

Additionally, is this not solved by the current licensing structure (e.g. Knowledge and Experience) and advice requirements (suitability)?

PROPOSAL E2

We do not have a position on this proposal at this stage.

PROPOSAL E3

We do not have a position on this proposal at this stage.

PROPOSAL E4

We do not have a position on this proposal at this stage.

PROPOSAL E5

We do not have a position on this proposal at this stage.

PROPOSAL E6

We do not have a position on this proposal at this stage.

F – Updated regulatory guidance

PROPOSAL F1

Other than what we said above about financial products, we do not have a position on this proposal at this stage.

PROPOSAL F2

We do not have a position on this proposal at this stage.

PROPOSAL F3, F4, F5 and F6

(FOFA, Best Interest, Fee Disclosure and Opt-in)

Our clients have 24/7 online portfolio access, they cannot only run reports disclosing all fees real time but they can also physically see the fees coming directly from their bank accounts. They can then directly audit these transactions. We propose that MDA Service providers offering these facilities be exempt. Given that this is technologically possible, we see the annual fee disclosure as an inferior solution as it discourages a level of fee disclosure as comprehensive as ours.

In regards to opt-in; as we have said, we actively manage client portfolios daily, clients can log in 24/7 to view portfolio activity (including all source documents that are in their legal name), they receive the contract note every time a share trade is placed, we send monthly investment updates, in addition to having phones calls and face to face meeting throughout the year. We believe that our clients are of sound mind, are provided on line research and information that enables them to determine if they want to stay with our MDA Service. This will create inefficiencies and is commercially detrimental having to raise this every year.

Our electricity and gas provider is Origin Energy. We pay them ongoing. They do not require us to sign a letter each year asking us to opt-in every year. One, we wouldn't want this extra burden on us as consumers and two, it would be a significant cost for Origin.

If however, Origin said "regulators force us to send you an opt-in form every year however as a free citizen you are in a position to avoid having the burden of attending to this every year and having to charge you to ask you each year, you can choose to waive it indefinitely or for a period of your choice"

How about we let the client decide?

PROPOSAL F7

We do not have a position on this proposal at this stage.

REFERENCES

[1] ASIC Consultation paper 44,April 2003, p 9

[2] ASIC Consultation Paper 194 – Financial Requirements for custodial or depository service providers, p. 10