9th March 2020

Product Regulation

Strategic Policy

Australian Securities and Investments Commission

By email: product.regulation@asic.gov.au

Dear Sir/Madam,

SUBMISSION TO THE DESIGN & DISTRIBUTION OBLIGATIONS REGULATIONS CONSULTATION

We are pleased to submit the following information in response to the consultation questions around the Design & Distribution Regulations in Consultation Paper 325 dated December 2019.

Yours faithfully,

A.Gluskie, Director, agluskie@whitefunds.com.au

Listed Investment Companies & Trusts Association Ltd

The Listed Investment Companies and Trusts Association (LICAT) is the industry body representing the interests of Listed Investment Companies (LICs), Listed Investment Trusts (LITs) and investors holding interests in one or more LIC or LIT. It is a non-profit company founded in 2012 with a standard non-profit constitution and an elected board of directors.

LICAT has 50 members representing over 75% of the market capitalization of the LIC/LIT sector and more than 700,000 underlying investors.

OVERALL Regulatory & Financial Impact

While we can endorse the regulator's well-meaning objectives, we see significant structural flaws in the proposed Design& Distribution Obligations Regulations.

We have sought to address this in detail in the subsequent sections of this submission, however our overarching concerns are:

1. The legislation holds **Issuers legally and financial responsible for the actions of Distributors**, despite issuers having no realistic practical means of controlling distributors. This is surely an inappropriate mismatch of obligation and capability.
2. If Issuers are expected to exercise the type of detailed control over Distributors that ASIC expects, **the implications are problematic:**
    a. Every single issuer would be forced to conduct detailed reviews, vetting and micro-management on hundreds of advisory groups and tens of thousands of advisers (every issuer has to duplicate each other's work)
    b. Advisers would be subject to detailed reviews, vetting and micro-management from hundreds of Issuers (at the same time)
    c. The costs of this inefficient process would be astronomical and must certainly be a vast percentage of an investor's entire asset value
3. Should Issuers be expected to control and be financially responsible for distributors, **it is likely that this would encourage them to bring distribution in-house,** re-introducing all the risks of vertical integration and eliminating all the checks and controls provided by intermediated markets made up of independent providers.
4. When examined in detail and in practice, we contend that for the vast majority of mainstream investment products, **this legislation is either not realistically implementable in the form intended, or only capable of implementation in a form which is unlikely to benefit investors yet likely to raise costs for investors.**
5. **It would be vastly more sensible and efficient to adopt a regulatory structure whereby the functions of checking, controlling, auditing and regulating distributors are performed adequately once for each distributor – so that issuers and investors can then rely on the work of those distributors.**

    This would prevent the unnecessary duplication of the actions of checking and audit of distributors that this legislation proposes. Issuers and investors can then rely on those distributors to properly provide their services.

C1, C2, C3, C4, C5: Target Market Definition Guidance

We do not consider that the guidance currently addresses the complexities of products with a wide target market.

Products with a wide target market could include investment products offering exposure to primary asset classes such as cash, fixed interest, property and shares, where both the underlying asset and investment product structure are non-complex, common and well-understood.

Investment products with a wide-target market:

- **Have legitimate application for a very wide spread of investors and investor types across an almost unlimited number of combinations of "common investor characteristics.**

  That is, these products if applied appropriately, have at least some application in a well-constructed portfolio for many (but not all) high income and low income investors, high wealth and low wealth investors, high risk appetite and low risk appetite investors, old and young investors etc

- **Yet may also be unsuitable where applied inappropriately across many, many combinations of "common investor characteristics".**

  For example, a product may become unsuitable when 8 common investment characteristics combine in a certain manner, yet may be suitable if the same 8 characteristics combine in a different way, or may be suitable where 7 characteristics are combined in the same way and one differentially. The point being that there are many permutations and combinations that could create unsuitability.

Accordingly we consider the following problems require consideration.

PROBLEM 1: It is not possible to correctly define suitability, or non-suitability, for a wide-target-market-product by reference to a "Class"

We recognise the understandable regulatory intent is to define a target market in terms of one or two common characteristics "classes. However as noted above, because there are far too many combinations of common investor characteristics ("classes") needed to define suitability or unsuitability**, it is not feasible, or possible, to accurately define** the target market in such a simplistic, generalised way.

We would contend that many issuers will not consider a simple "Class" description to be a sufficiently accurate summary of suitability, and accordingly will have no option but to use alternate and necessarily more complex target market descriptions.

PROBLEM 2: The concept that suitability can be defined by one or two common characteristics "Classes" is inconsistent with the fundamental premise behind all other personal advice regulation that "all investors are different" and may result in poor advice and damage to investors – particularly for wide-target market products

The basic premise underpinning all personal financial advice (and its regulation) is the recognition that all investors have different objectives, circumstances and needs. That is, suitability or non-suitability can only be determined by consideration of a multitude of complex factors.

It follows that there would be significant risks to investors in wide target-market products that would stem from defining suitability through generalised classes (which by their nature will be inaccurate):

- Investors for whom the product is truly unsuitable, but who fall into the inaccurate generalised "Class" may be lured or advised into an unsuitable product;
- Investors for whom the product is truly suitable, but who fall outside the inaccurate generalised "Class" may fail to invest in the product that suits them.

PROBLEM 3: Issuers of wide-target market products would have no option but to define the target market by reference to the product characteristics stated in the PDS

Because suitability for a wide-target market product cannot be limited to a simplistic, generalised "Class" of investor, issuers would have no option but to define the Target Market along the following lines.

"The Target Market for this product are investors:

- *(a) seeking access to XYZ asset class*
- *(b) for whom a product with the risk and benefits of this product and asset class are suited to the specific needs, objectives and circumstances of the investor (such risks and benefits being fully outlined in the PDS)"*

We strongly contend that a Target Market definition along the lines above does nothing other than restate the obvious, and most certainly does not assist either an investor or adviser.

We recognise that it would be possible to expand this definition to highlight a small number of the primary risks and benefits for a product as follows:

"The Target Market for this product are investors:

- *(a) seeking access to XYZ asset class*
- *(b) whose specific needs, objectives and circumstances can accommodate the primary risks associated with this asset class and product being [v, w, x, y and z].*

A full summary of the risks and benefits of this product are contained in the PDS."

We contend that the latter version carries the risks associated with the extraction of partial information from a PDS. That is, information on risks and benefits is best presented in full so that users can judge the significance and relevance of risks to their particular situation and can assess and weigh risks against benefits.

C.8 Reasonable Steps for Issuers Guidance

PROBLEM 1: It would be materially structurally inefficient and cost inefficient for each issuer to be obliged to heavily pre-vet the quality, experience and systems of thousands of advisors and advisory groups and to monitor and supervise the ongoing actions of the same (and for each advisor to be vetted by hundreds of issuers)

The Guidance provided suggests that issuers would be expected to vet the quality, experience and systems of all distributors, and to monitor and supervise the ongoing actions of those distributors. We highlight the astronomical problems with this:

(a) A process of vetting the quality of an advisory business, and its advisors, is an extremely complex and detailed exercise which if performed properly would typically require a detailed audit taking many days to perform. Even doing this exercise for a single advisory group would be prohibitively expensive. For an issuer to do this over hundreds of advisory businesses would take enormous volumes of time and come at a huge cost.

(b) There would also be a very material level of work involved in satisfying ASIC's Guidance for issuers to review the detailed client bases, investor types, remuneration arrangements and advisory services (for hundreds of advisory businesses and thousands of advisers). Once again this would take days of review just to be addressed for a single advisory business, and vastly more for hundreds of advisors.

(c) There would also be a further weight of work required to request, receive and monitor complaints reports from advisory groups, with hundreds of reports having to be submitted, even if those reports showed a nil level of complaints.

(d) Simultaneously the processes above would place a reciprocal burden on each advisory group and their advisors who would be subject to hundreds or thousands of audits and reviews at an exceptionally detailed level from product issuers, and at the same time have to submit hundreds or thousands of monitoring reports back to issuers. This is clearly not viable and clearly not efficient.

<u>We cannot stress strongly enough, how unrealistic, impractical and inefficient such processes would be.</u> We contrast this with the statement in the Consultation Paper at 28 "We expect that compliance…should not be onerous….the design and distribution obligations will require only minimal changes".

A sensible, logical and efficient regulatory structure to ensure the quality, experience and systems of distributors must embrace a single source of regulation, audit, vetting and certification of those distributors, on which investors and issuers may rely.

If there are any perceived deficiencies in the regulation, audit, vetting and licensing of distributors then that problem needs to be remedied by improving the single source of audit, vetting, licensing and quality control at the distributor.

It is clearly not appropriate and unrealistically inefficient to try and solve such a problem by having multitudes of Issuers re-auditing the same items.

<u>We would strongly contend that issuers and investors should be entitled to expect that those parties licensed and authorised to provide advice on a product are competent to do so.</u>

PROBLEM 2: If, as noted above, it is reasonable for issuers to expect that those parties licensed and authorised to provide advice on a product are competent to do so, ASIC Guidance must clearly state this, and also state what, if any, further reasonable steps are required.

In determining what are further reasonable steps, we note that even relatively non-complex requirements, once performed by every distributor on every advisor (on a regular basis), become exceptionally cumbersome and involve a significant volume of additional work. Once again, requiring multiple distributors to do this rechecking is far less efficient and less rational than having strong adequate checks performed by a single entity once for each distributor prior that distributor being certified as capable.

The inefficient and cumbersome nature of this can be seen in the important example of distributor licence authorisations.

If Issuers are expected to check distributor/advisor licence authorisations:

(a) Every adviser would have to submit copies of their licence/authorisation to hundreds of issuers

(b) Every adviser would have to regularly re-submit copies of their licence/authorisation to hundreds of issuers to prove the authorisation remains current

(c) Where authorisation or licences do not describe the product with sufficient granularity, advisers would need to submit a second more detailed authorisation to hundreds of issuers on a regular basis

(d) Every issuer having to read/review and check tens of thousands of adviser authorisations (in detail) and to recheck these on a regular basis to ensure currency and to follow up any errors, inconsistencies or omissions

(e) Once multiplied across thousands of advisers per issuer, and thousands of issuers the administration burden becomes immense

The cost of this process alone would be extremely significant, and would materially raise costs for investors.

The objective of ensuring that those advising on product are authorised to do so, **is far more efficiently performed through the proper regulation and audit of distributors and advisers,** instead of requiring thousands of issuers to cumbersomely re-check tens of thousands of advisers for basic elements of fundamental compliance.

PROBLEM 3: If ASIC places responsibility on Issuers for the quality and acts of distributors, the only practical method of achieving this would be for many Issuers to move distribution in-house. This would appear to encourage vertical integration and all its associated risks for investors (ie it creates a far worse problem than it seeks to solve)

In the prior sections we have shown that to a very large extent it is completely impractical, inefficient and in many cases simply not possible for Issuers to control the work of independent advisory groups.

If, however Issuers are made legally responsible for distributor actions, one of the few genuine ways they could provide meaningful control of that distribution would be to move away from the use of external independent distributors, and instead to use in-house distribution.

This would appear to be a very unattractive outcome for both regulators and investors, due to the many known problems associated with vertical integration. (We highlight that the primary cause of improper advice resulting in investor loss has historically stemmed from vertically integrated businesses which by their nature do not provide independent investment advice.)

PROBLEM 4: Issuer vetting of marketing materials of distributors is again extremely inefficient to the point of not being possible.

ASIC's guidance indicates that issuers would be expected to pre-vet marketing materials of distributors. This is not viable in practice.

A product issuer may utilise many distributor groups (in some cases this may be hundreds), the majority of whom produce their own distribution materials, being research, summaries, commentaries, presentation, in many different forms, and in many cases including variations tailored to the needs of differing investor cohorts. The time and cost of having all these materials submitted to an issuer (pre issue) and then having them amended and rechecked prior to approval would be astronomically high.

This time and cost would also impact on distributors who would be submitting, amending and corresponding with hundreds or thousands of product issuers.

The time and cost of the expected process would be so excessive as to be non-viable for investors (who would ultimately bear the cost).

The only way Issuers could effectively control marketing materials would be to mandate the use of one or two issuer-prepared materials (which would resemble a key features summary in the PDS), and prohibit any other distributor level commentary. This outcome is not necessarily a good one for investors.

A material negative for investors from this is that distributors would be prohibited from tailoring materials to suit the specific needs of differing investor cohorts.

As the resulting marketing materials merely mirror the PDS, it is highly likely such a policy would merely result in PDS's becoming the only allowable or viable distribution document.

PROBLEM 5: It is not possible to monitor or vet distributor outcomes and data during a listed product issue (such as a LIC/LIT/REIT) as there will clearly be no meaningful data available

ASIC Guidance suggests issuers would be expected to monitor data during an issue to ensure distribution is consistent with the target market. As a listed entity issue takes 2-4 weeks and the issue only occurs at the single final point, there will not be any data available during the issue period.