

## PROPOSAL TO IMPOSE NTA REQUIREMENTS ON MDA OPERATORS

6 December 2019

**The Investment Managers team considers that there is merit in re-igniting the proposal to introduce net tangible assets (NTA) requirements in relation to MDA operators and MDA operators which hold client assets (as custodian).**

We attach our Project Plan which sets out the timetable and next steps.

### 1. First proposal

MDA operators would be required to meet enhanced capital requirements, similar to those we impose on responsible entities of registered schemes. MDA providers that do not provide custodial or depository (C&D) services must meet tailored cash needs and audit requirements and hold a minimum NTA the greater of:

- a) \$150,000;
- b) 0.5% of the average value of all of the client's portfolio assets of the MDA (and registered scheme and IDPS property) up to \$5 million NTA; or
- c) 10% of average MDA provider revenue.

Our reasons are as follows:

- a) *Growth*: there has been significant growth in the industry recently (see previous papers). We consider this growth may be a response to the FOFA reforms and/or the lower regulatory requirements compared with registered schemes. Increasing the financial requirements will serve as a de facto barrier to entry for insufficiently resourced or committed licensees who might consider becoming MDA operators.
- b) *Industry*: whilst it is not a reason to initiate a proposal, there is a strong industry expectation that ASIC will revisit the policy settings that apply to MDAs.
- c) *Aligning the interests of MDA operators and investors*: Increasing financial requirements for MDA operators will ensure that they are committed to the MDA, have adequate resources to support their offering and also increase the incentives for them to operate their MDA effectively and compliantly.
- d) *Regulatory consistency and prevention of regulatory arbitrage*: It is possible that some licensees offer MDAs rather than registered schemes to circumvent the additional financial requirements. Given similarities in the roles and responsibilities of responsible entities and MDA operators, the imposition of similar capital requirements is warranted and consistent. In CP 200, we stated that it was desirable for MDA providers and REs to meet the same financial requirements because their functions are similar in many key respects.
- e) *Definition*: We can use the CP and RG 166 amendments to more precisely define what ASIC considers an MDA to be.

## 2. Second proposal

We propose to require MDA operators which provide custodial and depository services and external MDA custodians to be subject to the more rigorous NTA requirement and the longer cash flow projections requirements, consistent with the financial resources requirements we impose on other custodians. We would not propose allowing MDA operators to rely on the 'incidental custodial or depository services' authorisation.

Our reasons include those set out in 1(a)-(d) above. In addition:

*MDA operators acting as custodians:* It is common in MDA arrangements for the assets to be held in the client's own name or via an external MDA custodian (for example when the MDA is operated on an IDPS). However, some MDA operators may hold assets in custody for their clients, and so may be offering a custodial or depository service. We see no reason to differentiate such MDA operators from responsible entities which are required to hold either \$10m NTA or engage a custodian which holds \$10m NTA.

## 3. Background

The above proposals have already been approved by ASIC. At RPC at meeting 547 on 13 December 2012, RPC approved consulting on the proposals. CP 200<sup>1</sup> was released on 8 March 2013.

However, at RPC meeting 542 on 7 September 2016, it was agreed that ASIC would not proceed with the proposal to introduce an NTA requirement, principally because of the de-regulatory initiatives on foot at the time. No NTA required was imposed because of the need for regulatory offsets but RPC agreed that ASIC would communicate in public statements that ASIC remains committed to imposing such requirements in the future. See Report on Submissions 496<sup>2</sup> at paragraphs 37-47. ASIC states that:

*We will be reviewing the financial resource requirements over the next two years as additional MDA providers obtain the relevant AFS licence authorisations, and we can assess the impact of other changes to our MDA policy'.*

For proposal 2, ASIC stated that:

*'We have not adopted, at this time, the proposed NTA requirements in CP 200 for MDA providers that provide custodial or depository services. This corresponds with our decision for financial resource requirements for MDA providers generally'.*

## 4. Responses

We expect to receive similar responses to those received to CP 200. For example, it was highlighted that:

- a) The requirements were unnecessary for MDA providers because in an MDA the client holds a direct legal or beneficial interest in the underlying assets. In a registered scheme, the client has an interest in the trust fund as a whole, rather than a specific

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<sup>1</sup> <https://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-200-managed-discretionary-accounts-updates-to-rg-179/>

<sup>2</sup> <https://download.asic.gov.au/media/4028095/rep496-published-29-september-2016.pdf>

beneficial interest in particular assets. Respondents said this means that the consequences of business failure for MDA clients are limited, as it is simpler for them to re-assert control or ownership over the client portfolio assets. Respondents also referred to the prohibition on pooling MDA assets for investment purposes, which is a condition of the relief, as a feature which reduces the risks to MDA clients compared to registered scheme members.

- b) Most respondents were concerned about the cost imposed by the requirements and thought the proposed NTA requirement was too high. Respondents felt that this requirement would benefit larger MDA providers to the detriment of competition and increase the barriers to entry for new MDA providers.
- c) Respondents to CP 200 highlighted the different operating models in the MDA sector. Respondents submitted that different levels of risk are associated with each model and that it is inappropriate to apply the same financial requirements to each. The most common MDA operating models are:
  - **Full service MDA** – providers of these services are responsible for all aspects of the MDA service, including administration and custody.
  - **MDA provider** – these providers are responsible for all aspects of MDA service, excluding custody.
  - **Regulated platform MDAs** – these providers provide investment management and advice but rely on a regulated platform for administration (execution of trades) and custody.

Respondents, in particular, disagreed with the application of the NTA requirements to regulated platform MDAs because the key administrative and custodial functions are undertaken by third party providers. As the third party providers are themselves heavily regulated and subject to significant financial requirements, they said that this significantly reduced the operating risk for the regulated platform MDA.

- d) Imposing new financial resource requirements is inconsistent with the Financial System Inquiry recommendation to strengthen the focus on competition in the financial system. Arguably new financial resource requirements impose significant barriers to the entry of new players and have a disproportionate effect on smaller firms. The Association of Financial Advisers warned that the proposal is likely to lead to many small businesses discontinuing to offer MDA services.
- e) It is inconsistent with our policy rationale for imposing financial resource requirements. One of the key policy rationales for imposing increased financial resource requirements – decreasing the risk of a disorderly wind-up – is not a significant consideration because an MDA client retains the beneficial or legal interest in the client portfolio assets and the clients' portfolio assets cannot be pooled. The client can re-assert control over the underlying client portfolio assets.

We are not persuaded by the above arguments. An NTA requirement helps ensure that the operator is of at least moderate financial substance and reduces the risk of a disorderly wind-up. It is not designed to prevent losses, and the comments in (a) and (e) about the potential losses from business failure are not persuasive. While there would be some cost impact, and therefore an impact on new entrants, this is true for any substantive requirement. On balance,

RPC was convinced that the NTA requirement was appropriate. We will give stakeholders an opportunity to give any new information on cost, different operating models and competition as part of the proposed consultation. We can then discuss these issues in the relevant RPC paper, following a second public consultation.

## Summary page

### Proposed revisions to Managed Discretionary Account policy – Financial Requirements

#### What is the issue?

- 1 Investment Managers (IM) is seeking RPC feedback on its proposal to consult on revising the financial requirements for providers of Managed Discretionary Accounts (MDAs). We propose to align the financial requirements for MDA Providers with the financial requirements under RG 166 *Licensing: Financial requirements* that apply to responsible entities of managed investment schemes and investor directed portfolio services (IDPS) operators.

#### What is your recommendation?

- 2 IM recommends that ASIC should consult on amending the financial requirements for MDA providers as follows:
  - a) increase MDA providers' financial requirements to ensure that they correspond with the requirements that apply to responsible entities and IDPS operators under Class Order [CO 13/760] *Financial requirements for responsible entities and operators of investor directed portfolio services* (essentially, to hold at least \$150,000 net tangible assets (NTA) as defined in [RG 166]);
  - b) apply to MDA operators and their property holding arrangements the same financial requirements that apply to responsible entities;
  - c) apply the financial requirements to an "MDA provider" as defined in *ASIC Corporations (Managed Discretionary Account Services) Instrument 2016/968*; and
  - d) provide a transitional period of 12 months from the date of the new legislative instrument for MDA providers to comply with the new asset holding requirements.
- 3 Implementing the change proposed in paragraph 2 would require the issue of a new legislative instrument, minor and consequential updates to ASIC Proforma PF 209, and revisions to RG 166. (See Attachment A for a draft version of the proposed legislative instrument).
- 4 IM proposes to release a Consultation Paper containing the proposals set out above (see Attachment B for a draft version of the Consultation Paper). IM seeks guidance on its proposal to issue the attached Consultation Paper to consult on this change. As the proposed NTA requirement would only apply to a confined sub-sector (MDA operators) and is similar to existing ASIC policy for responsible entities and IDPS operators, we do not believe that this proposal needs to go to Commission for approval.

#### What are the reasons for your recommendation?

- 5 IM considers that the financial requirements for MDA providers should be increased to match those for responsible entities and IDPS operators for the following reasons:
  - a) to discourage insufficiently resourced or committed licensees from becoming MDA operators (ie some minimum investment into the business - 'skin in the game');

- b) to protect consumers by facilitating the orderly transfer or winding-up of an MDA business where those assets are held by the MDA operator, should this become necessary; and
- c) to maintain regulatory consistency and reduce regulatory arbitrage by MDA operators seeking to avoid current financial requirements applicable to responsible entities.

## How does this relate to ASIC’s priorities?

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| x | 1. Confident and informed investors and consumers |
| x | 2. Fair, orderly and transparent markets          |
|   | 3. Efficient and accessible registration          |

## What are the risks for the achievement of ASIC’s priorities?

- 6 Imposing additional financial requirements will increase the regulatory burden upon MDA providers. In addition, the proposed financial requirements may not prevent or compensate for any actual loss suffered.

## What are the potential effects of your recommendation on competition in the financial system?

- 7 Introduction of the proposed changes to financial requirements will help to ensure a level playing field among MDA providers, responsible entities of registered managed investment schemes and IDPS operators.
- 8 Introducing amended financial requirements for MDA providers will constitute a barrier to entry for new MDA providers and will increase the compliance burden for existing MDA providers. IM intends to seek further information regarding additional potential effects upon competition as part of the proposed consultation process.

# Submission

## A Background

### What is an MDA?

- 9 Under existing ASIC policy (RG 179), an MDA is a facility, other than a registered managed investment scheme (registered scheme) or an interest in a registered scheme, with the following features:
  - a) a person (client) makes contributions;
  - b) the client portfolio assets are managed on an individual basis by another person (MDA provider) at the MDA provider’s discretion, subject to any limitation agreed between the client and MDA provider; and
  - c) the client and the MDA provider intend that the MDA provider will use the client portfolio assets to generate a financial return or other benefit for the client.
- 10 A wide variety of arrangements can constitute an MDA. Industry uses different terminology to refer to services that may have the relevant features of an MDA. For example, products

commonly known by industry and investors as a “separately managed account”, “individually managed account”, “investment advisory program”, “model portfolio” or a “managed discretionary portfolio service” may fall within the definition of an MDA.

- 11 There are also a range of services that are similar to but may fall outside the definition of an MDA. The proposals in this paper are confined to MDAs as currently defined in ASIC RG 179 and which rely (or should rely) on the conditional relief in the Instrument. Other, similar, arrangements like IDPSs already have appropriate financial requirements.
- 12 ASIC considers that an MDA generally falls within the definition of both a ‘managed investment scheme’ in s9 of the Corporations Act and a ‘facility for making a financial investment’ in s763B of the Corporations Act.

### **Current Regulatory Arrangements**

- 13 Under ASIC’s current regulatory requirements, to offer an MDA service to a retail client an MDA provider must either:
  - a) establish and register a managed investment scheme and offer MDA services via that scheme; or
  - b) obtain a licence authorisation permitting them to deal in interests in managed investment schemes limited to MDA services to retail clients in accordance with the relief granted in *ASIC Corporations (Managed Discretionary Account Services) Instrument 2016/968 (Instrument)*.
- 14 The terms ‘MDA provider’ and ‘MDA service’ are defined in the Instrument. The MDA provider provides the MDA services. In broad terms, an MDA provider is an AFS licensee authorised to provide the following financial services in relation to client portfolio assets:
  - a) dealing by issuing various financial products, including interests in managed investment schemes, that are limited to a right to receive MDA services;
  - b) dealing in all the financial products that may be acquired with client portfolio assets under an MDA contract;
  - c) providing personal financial advice to retail clients in relation to MDA services, except where an external adviser has contracted directly with a retail client to provide the financial advice; and
  - d) providing custodial or depository services, except where an external custodian has contracted directly to hold the client portfolio assets with each retail client in the MDA.
- 15 The MDA provider is not required to hold an AFS licence authorising it to provide custodial or depository services if, in relation to the client portfolio assets, either:
  - a) an external custodian has entered into a direct contract to provide custodial or depository services with each client to whom the MDA provider provides MDA services; or
  - b) an external custodian has entered into a direct contract with the MDA provider to provide custodial or depository services; or
  - c) the client retains legal and beneficial title to the assets held in the MDA.

### **Current Financial Requirements**

- 16 Currently, MDA providers which rely upon the Instrument (rather than using a registered scheme structure) are only required to hold surplus liquid funds of \$50,000 and are not subject to NTA requirements. By contrast, responsible entities and IDPS operators are, broadly, required to hold NTA of either:
  - a) if the provider does not engage an external custodian to hold the assets - NTA of the greater of \$10 million, or 10% of the average responsible entity and IDPS revenue; or
  - b) if the provider engages an external custodian – the greater of \$150,000 or 10% of the average responsible entity and IDPS revenue.
- 17 IM considers that this inconsistency is unjustified, given the underlying service is similar from a regulatory and investor protection perspective. Both MDAs and registered managed investment schemes involve the management of client assets where the client has conferred investment discretion on the operator/responsible entity. Both a responsible entity and MDA operator have an obligation to act in the best interests of the investor in discharging this investment management function.
- 18 Given the likely continuing expansion of the MDA sector and other factors discussed in this paper, IM considers that it is now appropriate to strengthen the regulatory framework for MDA services by imposing increased financial requirements on MDA providers. IM considers that revising the financial requirements for MDA providers (to align them with the equivalent requirements for responsible entities and IDPS operators) will promote greater regulatory consistency, reduce the prospect of regulatory arbitrage and provide greater protection for retail clients of MDA services.

### **Previous Consultation**

- 19 ASIC has previously undertaken public consultation regarding the possibility of imposing tailored financial resource requirements upon MDA providers. In March 2013, ASIC published *Consultation Paper 200: Managed discretionary accounts: Update to RG 179* (CP 200). The recommendations in CP 200 included a proposal to increase financial requirements for MDA providers.
- 20 In September 2016, ASIC issued the Instrument and revised RG 179. At that time, ASIC elected not to impose financial requirements for MDA providers in line with the proposals in CP 200, noting that proposed changes had been deferred in light of the Government's deregulatory agenda and a related moratorium on significant financial services regulation. In *Report 496: Response to submissions on Consultation Paper 200: Managed discretionary accounts: Update to RG 179*, ASIC stated that it would revisit the proposal to increase financial requirements for MDA providers after two years (i.e. after September 2018).
- 21 The revised regulatory settings for MDA providers have now been in place for over three years (i.e. since September 2016). During this time, ASIC has been able to assess the impact of these regulatory settings on the financial services industry. It is now appropriate for ASIC to re-evaluate the merits of financial requirements proposals for MDA providers, originally proposed in March 2013, particularly in light of substantial market recent growth and our recent review.

### **MDA Sector Growth**

- 22 Currently, the MDA industry in Australia is experiencing rapid growth when compared with other sectors of the financial services industry. During the 2017/18 financial year, 198 entities held an Australian Financial Services Licence (AFSL) authorisation to deal in interests in managed investment schemes limited to MDA services. This number increased by 26.8% during the 2018/19 financial year to 251. In comparison, during the same period



the number of entities holding an AFSL authorising the operation of a registered managed investment scheme in the capacity of responsible entity decreased by 1.5% and the total number of entities holding an AFSL authorising the entity to deal in interests in managed investment schemes including investor directed portfolio services remained unchanged.

- 23 As at 30 June 2019, according to the [Institute of Managed Account Professionals \(IMAP\) Milliman managed account census results as at 30 June 2019](#), funds under management (FUM) for MDAs represented approximately \$29.24 billion, which is about 0.77% of the total FUM pool of approximately \$3.79 trillion: see [Australian Bureau of Statistics \(ABS\), Report 5655.0: Managed funds, Australia, Sep 2019](#).
- 24 Further, over the last five financial years, the total FUM in managed funds generally has grown by over 50% from approximately \$2.41 trillion as at 30 June 2014 (see [ABS, Report 5655.0: Managed funds, Australia, Jun 2014](#)) to approximately \$3.79 trillion as at 30 June 2019 (see [ABS, Report 5655.0: Managed funds, Australia, Sep 2019](#)).
- 25 In particular, the use of managed accounts, a general category of arrangements that includes MDAs, by financial advisers has grown. In 2018, approximately 30% of financial advisers used managed accounts and this increased to approximately 35% in 2019. Financial planners reported that managed accounts comprised over 31% of their FUM in 2019 and this is expected to increase to 52% in 2022 (per State Street Global Advisors SPDR ETFs/Investment trends 2019 managed accounts report data in the AdviserVoice's article [Managed accounts usage in Australia has almost doubled but education is still lacking](#)).
- 26 Potential reasons for the recent growth in MDAs (and managed accounts generally) include the following:
  - a) the Future of Financial Advice (FOFA reforms)<sup>1</sup> introduced a prospective ban on conflicted remuneration structures, a duty for financial advisers to act in the best interests of their clients, an opt-in obligation and an annual fee disclosure statement. ASIC has received feedback from the industry that these changes have increased compliance costs. We understand that MDAs provide a means by which financial advisers can provide more cost-efficient financial advice. We also understand that MDAs provide a new revenue stream (fees for managing client money) in addition to the revenue from advice services themselves;
  - b) in our experience, AFS licensees have become more conscious of 'advice risk', that is, the risk of liability for advice which may not be in the best interests of investors. This is particularly the case after the Financial Services Royal Commission in 2018. We understand that some firms believe that the delivery of financial advice through an MDA that uses model portfolios designed by the licensee, may reduce advice risk for the licensee because the licensee has more control over the investment selection;
  - c) we understand from industry that MDAs enable investment transactions to be undertaken quickly, either to take advantage of opportunities or protect clients from risk, in contrast to arrangements where a financial adviser does not have a broad investment discretion; and
  - d) there are lower regulatory requirements for an MDA provider compared to a responsible entity of a registered scheme.

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<sup>1</sup> In June 2012 reforms were introduced into the *Corporations Act 2001* by the [Corporations Amendment \(Future of Financial Advice\) Act 2012](#) and [Corporations Amendment \(Further Future of Financial Advice Measures\) Act 2012](#). These reforms included the best interest duty, ban on conflicted forms of remuneration, opt-in obligation and changes to ASIC's licensing and banning powers.

## 2018-19 Review of MDA Sector

- 27 In 2018-19, IM carried out a high-level review of a sample of MDAs. In broad terms, the review was carried out for the purpose of assisting ASIC to understand the MDA sector, including identifying key trends and risks of harm in the sector. The scope of the review included the collection of limited fee data, but did not include an assessment of whether MDA providers were complying with the terms of the Instrument.
- 28 We observed in our review that there are low barriers to entry in the MDA sector. We identified in our review that it is possible that a licensee may offer an MDA, rather than a registered scheme, to circumvent the more onerous financial requirements that apply to the responsible entity of a registered scheme. Given the similarities in the roles and responsibilities of responsible entities and MDA providers, we considered that, as observed in CP 200, it would be beneficial for MDA providers and responsible entities to observe similar financial requirements.
- 29 We anticipate that the MDA sector will continue to grow, extrapolating recent growth rates into the near term. If more retail clients invest in MDAs and the amount invested in MDAs increases, potentially in preference to a registered scheme or an IDPS, an increasingly significant proportion of funds under management could be invested in MDAs. Given the prevalent use of MDAs and continuing growth, we are concerned that the current financial requirements for an MDA provider may not be adequate and are no longer fit for purpose. ASIC is concerned that a significant proportion of the assets under management are invested in structures that may not have a reasonable level of capital support.
- 30 We consider that these reasons support the proposition that an MDA provider should be made subject to financial requirements that are similar to those imposed on a responsible entity of a registered scheme or an IDPS operator. This would help ensure a level playing field, which is consistent with ASIC's duty to consider the impact of its actions on competition in the financial system (*ASIC Act 2001*, s1(2A)).

## Current MDA providers and financial requirements

- 31 Of the 251 entities which held an AFSL during 2018/19 authorising the provision of MDA services:
- a) 23 entities (9.2% of the 251 entities) were also authorised to operate registered managed investment schemes and/or IDPSs and therefore were subject to the financial requirements for operators of registered managed investment schemes and IDPSs set out in RG 166; and
  - b) 228 entities (90.8%) were not authorised to operate registered managed investment schemes or IDPSs and therefore were not subject to the financial requirements for operators of registered managed investment schemes and IDPSs set out in RG 166.

## B Issues analysis and recommendation

### Issue 1: Should ASIC consult on amending the financial requirements to impose additional requirements relating to NTA, cash needs and audit requirements?

- 32 We seek RPC's feedback on whether ASIC should consult on imposing a framework of financial requirements (including NTA, tailored cash needs and tailored audit requirements) upon MDA providers that is equivalent to that currently imposed on responsible entities and IDPS operators. The current requirements for MDA operators and for responsible entities are set out in paragraph 16 above.

**Option 1 (Recommended)**

- 33 IM recommends that ASIC should consult on imposing on MDA providers (as defined in RG 179 and the Instrument) financial requirements that are similar to the requirements that apply to responsible entities, consisting of:
- a) the standard solvency and positive net assets requirement that currently applies to all AFS licensees (including MDA providers);
  - 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) an NTA requirement similar to that which applies to responsible entities, the value of which depends on whether the responsible entity engages an external custodian to hold the client assets.
- 34 IM proposes that ASIC imposes the following minimum NTA requirements:
- a) For MDA providers that do not provide custodial or depository services - the greater of:
    - (i) \$150,000;
    - (ii) 0.5% of the average value of all client portfolio assets of MDA services provided, up to \$5 million NTA; or
    - (iii) 10% of average MDA provider revenue, with no maximum NTA
  - b) For MDA providers that provide custodial or depository services - the greater of:
    - (i) \$10 million; or
    - (ii) 10% of their average MDA provider revenue with no maximum NTA.
- 35 We will propose a transitional period of 12 months from the date of the new legislative instrument for MDA providers to comply with the new financial requirements. The proposed legislative instrument is included at Annexure A to the paper.
- 36 We propose to use the term “client portfolio assets” in the Instrument. In broad terms, the term client portfolio assets refers to financial products and other property that are the client’s contributions, or are borrowed or raised for the purposes of the MDA service, or that are derived directly or indirectly from the client’s contributions or funds raised or borrowed for the purpose of the MDA service.
- 37 We propose to define ‘average MDA provider revenue’ by applying the approach that was used in [CO 13/760] to the definition of ‘average RE and IDPS revenue’ and in [CO 13/761] to the definition of ‘average revenue’. In broad terms, this approach involves an average revenue amount being calculated from revenue amounts from recently-completed financial years and a forecast of revenue for the financial year to date
- 38 In determining average MDA provider revenue, an MDA provider should include the revenue of persons performing the functions relating to an MDA for which the MDA provider is responsible (e.g. including functions outsourced to other entities).

**Option 2**

- 39 Alternatively, ASIC may choose not to amend the financial requirements for MDA providers. In this case, MDA providers would remain subject to the existing solvency and surplus liquid funds requirements.

**Option 3**

- 40 Alternatively, ASIC may choose to amend the financial requirements for MDA providers by imposing a different NTA requirement (e.g. \$75,000 or \$300,000).

**Reasons in favour of recommended option**

- 41 IM considers that the potential benefits of imposing NTA requirements upon MDA providers include:
- a) with capital at risk, the MDA provider may be more likely to be appropriately resourced (with sufficient investment and compliance expertise) and take seriously its obligations under the RG and Instrument;
  - b) ensuring that MDA provider maintains sufficient financial resources may reduce the risk of disorderly or non-compliant wind-up in the case of business failure; and.
  - c) to maintain regulatory consistency across comparable sectors of the financial services industry, any NTA requirements to be imposed upon MDA providers should be equivalent to those already imposed upon responsible entities and IDPS operators.
- 42 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. Enhanced NTA (capital) requirements would ensure that MDA providers 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.
- 43 The proposed NTA requirement for MDA providers generally provide some level of assurance that, if an MDA provider does fail, there is some money available for the orderly transition to a new MDA provider or the transfer of the clients' assets to the client (where these assets are held by the MDA provider) or as the client directs.
- 44 Whilst the functions of an MDA provider and a responsible entity differ in some respects, in most key aspects they are similar. Both are typically primarily responsible for managing investments and making discretionary investment decisions on behalf of investors. This fundamental similarity in the functions of an MDA provider and a responsible entity suggests that both types of licensee should be subject to similar financial resource requirements.

**Reasons against recommended option**

- 45 The submissions in response to CP 200 covered a range of arguments against the proposals to impose increased financial requirements for MDA providers. The arguments and our responses are below.

<ul style="list-style-type: none"> <li>• The financial requirements are unnecessary for MDA providers because in an MDA the client holds a direct legal or beneficial interest in the underlying assets. In contrast, in a registered scheme, the client has an interest in the scheme</li> </ul>	<p><i>Response</i></p> <p><i>We consider that the proposed financial requirements will help to ensure that an MDA provider is of at least moderate financial substance and reduce the risk</i></p>
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<p>property as a whole, rather than a beneficial interest in particular assets. The argument was that the consequences of business failure for MDA clients are limited, as it is simpler for them to re-assert control or ownership over the client portfolio assets;</p>	<p><i>of a disorderly winding up of the MDA provider's affairs. In the event of a winding up of an MDA provider, there may be difficulties in clients re-asserting control or ownership over client portfolio assets where these are held by the MDA operator.</i></p>
<ul style="list-style-type: none"> <li>• The compliance costs of meeting the financial requirements are high and would benefit larger MDA providers to the detriment of competition and increase the barriers to entry for new MDA providers;</li> </ul>	<p><i>Response</i></p> <p><i>In light of the commercial similarities between an MDA and a registered scheme, we consider that it is appropriate that the operators of both types of investment vehicles are subject to similar financial requirements. Whilst we recognise that introducing the proposed financial requirements will increase compliance costs for MDA providers, the more rigorous financial requirements are justified because of how important it is for an MDA provider to have at least moderate financial substance and to attain regularity parity with responsible entities in respect of their financial requirements.</i></p> <p><i>We note the potential effect upon competition of the proposed changes but believe that increased compliance costs are justified in order to protect retail investors.</i></p>
<ul style="list-style-type: none"> <li>• There is a broad variety of arrangements that satisfy the concept of an MDA and, as different risks apply to each type of MDA, imposing a set of financial requirements for all types of MDAs would not be appropriate. In particular, some submissions disagreed with the application of the proposed financial requirements to regulated MDA platforms because the key administrative and custodial functions are undertaken by third-party service providers. According to this argument, as the third-party service providers are subject to a rigorous regulatory framework, including financial requirements, the operating risks of the regulated platform MDA are significantly reduced; and</li> </ul>	<p><i>Response</i></p> <p><i>Regardless of the business model used, ASIC considers that in order to prevent regulatory arbitrage all types of MDA providers should be subject to the same financial requirements. Licensing has advised that, an entity which already has \$150K to satisfy its NTA requirement in its capacity as RE and/or IDPS operator will not need to have an additional \$150K to also act as an MDA operator..</i></p>

<ul style="list-style-type: none"> <li>• One of the key policy rationales for imposing increased financial resource requirements—decreasing the risk of a disorderly wind-up—is not a significant consideration because an MDA client retains the beneficial or legal interest in the client portfolio assets and the clients’ portfolio assets cannot be pooled. The client can re-assert control over the underlying client portfolio assets.</li> </ul>	<p><i>Response</i></p> <p><i>In the event of a winding up of an MDA provider there may be difficulties in clients re-asserting control or ownership over client portfolio assets. Imposing the proposed financial requirements will reduce the potential for business failure and associated risk to clients.</i></p>
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### Potential Industry Impact

- 46 Financial Advisers Team (FA) notes that financial advice firms sometimes use MDAs for the following purposes:
- a) to service clients who are difficult to contact due to overseas travel or living in remote parts of Australia, where the MDA structure allows advisers to re-balance funds or re-invest dividends without seeking further client instructions; and
  - b) to allow advisers to re-invest their elderly clients’ term deposits upon maturity. For such clients, providing advice about a maturing term deposit via a Statement of Advice is not cost-effective for the client and an MDA is one way to keep these costs low.
- 47 FA also considers that some financial advisers may currently be using MDAs to justify their value proposition post-FOFA. Financial adviser conduct in this context has included the use of more complex client portfolios and the tying of a client to an adviser in circumstances where a simple generic managed investment scheme may achieve the same outcome for the client at a lower cost and with greater portability.
- 48 FA advised that they would expect industry resistance to the proposed NTA changes, and their adoption will likely result in small financial advisors no longer offering MDA services. FA observed that the proposed financial requirements may result in smaller advisers using third party MDA arrangements or attempting to disguise their discretionary services as general advice or execution only. In the latter case, this will be difficult for ASIC to monitor.
- 49 We expect there to be resistance to the proposals from some of the lower resourced, smaller entities which may struggle to raise the relevant capital. Nonetheless, we consider the benefits of the proposal outweigh the detriment that may be caused by some of the smaller players exiting the MDA space.

### **Issue 2: Should ASIC consult on amending the financial requirements to include higher NTA requirements for AFS Licensees providing custodial or depository services with respect to MDA portfolio assets?**

- 50 The current financial requirements for custodians and for responsible entities and IDPS operators holding scheme or IDPS property are set out in [CO 13/760] and [CO 13/761].
- 51 Currently, entities performing a custodial or depository function with respect to registered schemes or IDPS assets are subject to higher financial requirements when compared to those responsible entities or IDPS operators not holding such assets.
- 52 Currently, no equivalent higher financial requirements apply to a licensee holding client portfolio assets with respect to MDA services, whether the licensee is an MDA provider or an external custodian of MDA assets.

- 53 We consider that in order to provide adequate protection to MDA clients, and to provide regulatory parity with entities performing a custodial or depository function with respect to registered schemes or IDPS assets, equivalent higher financial requirements should be applied to licensees holding client portfolio assets with respect to MDA services

**Option 1 (Recommended)**

- 54 IM recommends that ASIC should consult on amending the financial requirements relating to the provision of MDA services by AFS Licensees to include the following requirements:
- a) MDA custodians must meet the same requirements that apply under [CO 13/761] to providers of custodial or depository services that are not incidental providers. This includes the requirement to hold NTA of \$10 million, or 10% of average revenue, whichever is higher;
  - b) MDA providers that are also responsible for holding client portfolio assets must meet the same requirements as those that apply under [CO 13/761] to responsible entities that hold scheme property. This includes the requirement to hold NTA of \$10 million, or 10% of average revenue, whichever is higher, unless the MDA provider arranges for the client portfolio assets to be held by a person licensed to provide a custodial or depository service (and that is not an incidental provider) or a body regulated by the Australian Prudential Regulation Authority (APRA);
  - c) the NTA requirements outlined in paragraph (b) above will not apply to an MDA provider where the client retains legal and beneficial title to the client portfolio assets— in this scenario, the MDA provider would be subject to a lower NTA requirement of the greater of \$150,000 or 10% of average revenue;
  - d) MDA providers who are responsible for holding client portfolio assets would not fall within the definition of ‘incidental provider’, as defined in [CO 13/761]. This means these MDA providers would not be able to fulfil their NTA obligations by meeting the reduced minimum NTA requirements for incidental providers of custodial and depository services; and
  - e) we will provide a transitional period of 12 months from the date of the new legislative instrument for MDA providers to comply with the new asset holding requirements.

**Option 2**

- 55 Alternatively, ASIC may choose not to amend the financial requirements for licensee holding client portfolio assets with respect to MDA services. In this case, MDA providers who hold client portfolio assets would remain subject to the existing solvency and surplus liquid funds requirements only.

**Reasons in favour of recommended option**

- 56 Similar to issue 1 above, the key reasons are:
- a) ensuring adequate equity capital is invested in the firm;
  - b) ensuring adequate resources to enable orderly wind up; and
  - c) ensuring parity with custodian rules for MISs and IDPSs.
- 57 As a licensed custodian, an external MDA custodian should have to comply with the applicable NTA requirement under ASIC Class Order [CO 13/761]. The application of the existing custody requirements under [CO 13/761] leaves open the prospect that an external MDA custodian will be an ‘incidental provider’, as defined in [CO 13/761], and will only be required to hold NTA of the greater of \$150,000 or 10% of average revenue. In contrast,

under [CO 13/761], a licensed custodian that is not an incidental provider has to hold NTA of the greater of \$10 million or 10 % of average revenue.

- 58 In line with the policy principles that support increased financial requirements for MDA providers, we consider that an external MDA custodian should be required to comply with the more rigorous NTA requirement. This is the ‘higher NTA requirement’: the greater of \$10 million or 10% of average revenue. As a consequence of this approach, an external MDA custodian should not be allowed to rely on the incidental provider definition and, as a result, should not be allowed to rely on the ‘lower NTA requirement’ of the greater of \$150,000 or 10 % of average revenue.
- 59 In the situation where an MDA provider holds client portfolio assets, rather than using an external MDA custodian, we consider that the MDA provider may be offering a custodial or depository service. In this case, we consider that the MDA provider should also be held to the higher NTA requirement in [CO 13/761] for the custodial or depository services the MDA provider provides to MDA clients. As part of our proposal to impose the higher NTA requirement, we consider that an MDA provider should not be able to rely on the incidental provider definition.
- 60 In our proposal to apply the higher NTA requirement, we see no reason to differentiate between an external MDA custodian and an MDA provider that holds client portfolio assets. In both cases, the entity that provides a custodial or depository service should be held to the same financial requirements, including NTA, that we impose on other custodians. Under [CO 13/760], the responsible entity of a registered scheme normally has to satisfy the higher NTA requirement or they must engage a custodian that meets the higher NTA requirement. We consider that it is appropriate to apply a consistent approach to the financial requirements of a responsible entity and an MDA provider. In our view, the optimum method to achieve this result is for the higher NTA requirement to apply to an external MDA custodian and to an MDA provider that holds client portfolio assets.
- 61 We consider that in determining average MDA revenue, an MDA provider should include the revenue of persons performing the functions relating to an MDA for which the MDA provider is responsible (e.g. functions outsourced to other entities).

**Reasons against the proposed option (and in favour of the status quo)**

- 62 As set out above, the submissions received by ASIC in response to CP 200 included a number of arguments against the proposals to impose increased financial requirements for MDA providers. These arguments and our potential responses are set out above under Issue 1 at paragraph 45, and relate generally to:
- a) increased compliance costs resulting from the proposed changes;
  - b) anti-competitive effects of imposing uniform financial requirements across the MDA sector;
  - c) low risk to clients upon windup of MDA services due to the fact that clients may assert ownership or control over assets.
- 63 As set out above, we consider that these arguments do not adequately reflect the importance of protecting MDA investors by requiring MDA providers holding client portfolio assets to comply with an adequate capital standard, or the need to maintain regulatory consistency between holders of MDA client portfolio assets and scheme property
- 64 As with the recommended proposal in Issue 1 above, we consider that the primary reasons in favour of the proposed option relate to the need to provide additional protection to MDA clients and to remove the present inconsistency between financial requirements for licensees holding MDA client portfolio assets and licensees holding registered scheme or IDPS assets.



## **C Regulatory Impact Statement**

- 65 IM notes that a RIS will be prepared, following the consultation process. We note the observations of FA and expect that we will receive further data/information during consultation on the impact of the proposed change.

## **D Consultation**

- 66 IM has consulted internally with FA, FR&A and Strategic Policy and these teams have indicated in-principle support for the proposed changes. IM has also sought input from Licensing, Markets and FR&A.
- 67 IM proposes to issue a Consultation Paper (See Attachment B).

## **E Implementation**

- 68 IM proposes to include a 12- month transition period in the Instrument (See Attachment A).

## **F Communication**

- 69 IM proposes to issue a media release accompanying the Consultation Paper. A further media release is planned that will include a report summary of the feedback received and ASIC's final position in relation to the proposals.



**ASIC**  
Australian Securities &  
Investments Commission

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## **ASIC Corporations (Managed Discretionary Account Providers—Financial Requirements) Instrument 2020/\_\_\_**

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I, <insert name>, delegate of the Australian Securities and Investments Commission, make the following legislative instrument.

Date 2020

[DRAFT ONLY – NOT FOR SIGNATURE]

<signature>

<insert name>

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## **Part 1—Preliminary**

### **1 Name of legislative instrument**

This is the *ASIC Corporations (Managed Discretionary Account Providers—Financial Providers) Instrument 2020/\_\_\_*.

### **2 Commencement**

This instrument commences on the day after it is registered on the Federal Register of Legislation.

Note: The register may be accessed at [www.legislation.gov.au](http://www.legislation.gov.au).

### **3 Authority**

This instrument is made under paragraph 926A(2)(c) of the *Corporations Act 2001*.

### **4 Definitions**

In this instrument:

*Act* means the *Corporations Act 2001*.

## Part 2—Declaration

### 5 Financial requirements for MDA providers and MDA custodians

Part 7.6 (other than Divisions 4 and 8) of the Act applies in relation to a financial services licensee as if that Part were modified or varied by, in Division 3 of that Part, inserting the following Subdivision:

**“Subdivision A—Financial Requirements: MDA providers and MDA custodians**

**912AI Application**

- (1) This Subdivision applies to a financial services licensee that is:
- (a) an MDA provider (see section 912AJ);
  - (b) an MDA custodian or external MDA custodian (see section 912AK).

- (2) In this Subdivision:

*adequately secured*, in relation to a financial services licensee, means:

- (a) secured by an enforceable security interest over a financial product (other than a financial product issued by the licensee or its associates) if:
  - (i) the financial product is:
    - (A) regularly traded on:
      - (I) a financial market (as defined in subsection 767A(1) and disregarding subsection 767A(2)) operated by a market licensee or a financial services licensee other than the licensee or its associates that, in the reasonable opinion of the licensee, produces sufficiently reliable prices to assess the value of the security provided by the security interest; or
      - (II) an approved foreign market; or
      - (B) an interest in a registered scheme for which withdrawal prices are regularly quoted by the responsible entity of the scheme and the licensee believes on reasonable grounds that withdrawal may be effected within 5 business days; and
    - (ii) the market value of the financial product is:

- (A) if the financial product is a debt instrument—at least 109% of the amount owing; or
  - (B) otherwise—at least 120% of the amount owing; or
- (b) secured by a registered first mortgage over real estate that has a fair market valuation of at least 120% of the amount owing; or
  - (c) owing from an eligible provider; or
  - (d) secured by an enforceable security interest over amounts owing to another financial services licensee which themselves are adequately secured.

**adjusted assets**, in relation to a financial services licensee, means the value of total assets as they would appear on a balance sheet at the time of calculation made up for lodgement as part of a financial report under Chapter 2M if the licensee were a reporting entity:

- (a) minus the value of excluded assets that would be included in the calculation; and
- (b) minus the value of any receivable that would be included in the calculation, up to the amount that the licensee has excluded from adjusted liabilities on the basis that there is an enforceable right of set-off with that receivable; and
- (c) minus the value of any assets that would be included in the calculation that are encumbered as a security against liability to a person that provides a security bond to ASIC up to the amount of the bond; and
- (d) minus the value of any assets that would be included in the calculation that may be required to be applied to satisfy a liability under a credit facility that is made without recourse to the licensee up to the amount of that liability excluded from adjusted liabilities; and
- (e) plus the amount of any eligible undertaking that is not an asset.

**adjusted liabilities**, in relation to a financial services licensee, means the amount of total liabilities as they would appear on a balance sheet at the time of calculation made up for lodgement as part of a financial report under Chapter 2M if the licensee were a reporting entity:

- (a) minus the amount of any liability under any subordinated debt approved by ASIC in writing; and
- (b) minus the amount of any liability that is the subject of an enforceable right of set-off, if the corresponding receivable is excluded from adjusted assets; and

- (c) minus the amount of any liability under a credit facility that is made without recourse to the licensee; and
- (d) plus the value of any assets that are encumbered (other than assets that are encumbered merely to support a guarantee provided by the licensee) as a security against another person's liability where the licensee is not otherwise liable, but only up to the lower of:
  - (i) the amount of that other person's liability; or
  - (ii) the value of the assets encumbered; and
- (e) plus the maximum potential liability of any guarantee provided by the licensee.

**amount** of an eligible undertaking means the amount that remains payable in accordance with the undertaking at the relevant time despite any amount previously paid under the undertaking less any amount that would be repayable as a liability by the licensee if money were paid.

**approved foreign market** has the meaning given by section 9.

Note: The definition of **approved foreign market** is notionally inserted by ASIC Corporations (Definition of Approved Foreign Market) Instrument 2017/669.

**average revenue**, in relation to a financial services licensee, means:

- (a) for a licensee in its first financial year—the licensee's forecast of its revenue from the calculation date for the remainder of the first financial year, pro-rated to a 12 month period; and
- (b) for a licensee in its second financial year of being authorised to provide the relevant financial service—the aggregate of the licensee's:
  - (i) estimate of its revenue for the second financial year to date; and
  - (ii) forecast of its revenue for the remainder of the second financial year; and
- (c) for a licensee in its third financial year of being authorised to provide the relevant financial service—the average of:
  - (i) the aggregate of the licensee's:
    - (A) estimate of its revenue for the third financial year to date; and
    - (B) forecast of its revenue for the remainder of the third financial year; and

- (ii) the licensee's revenue for its second financial year in which it was authorised to provide the relevant financial service; and
- (d) for all subsequent financial years of a licensee—the average of:
  - (i) the aggregate of the licensee's:
    - (A) estimate of its revenue for the current financial year to date; and
    - (B) forecast of its revenue for the remainder of the current financial year; and
  - (ii) the licensee's revenue for the last preceding financial year; and
  - (iii) the licensee's revenue for the second preceding financial year.

**calculation date**, in relation to the average revenue of a financial services licensee, means the day on which the licensee is authorised to provide the relevant financial service.

**cash or cash equivalents** means:

- (a) cash on hand, demand deposits and money deposited with an Australian ADI that is available for immediate withdrawal; and
- (b) short-term, highly liquid investments that are readily convertible to known amounts of cash that are subject to an insignificant risk of changes in value; and
- (c) the value of any eligible undertaking provided by an eligible provider; and
- (d) a commitment by an eligible provider to provide cash upon request within 5 business days:
  - (i) which will not expire within the next 6 months and which cannot be withdrawn by the provider without giving at least 6 months written notice to the person to whom the commitment is made; and
  - (ii) in relation to which any cash provided is not repayable for at least six months.

**clearing participant** means a participant (as defined in section 761A in relation to a clearing and settlement facility) in the licensed CS facility operated by ASX Clear Pty Limited (**ASX Clear**) that is required to comply with, and complies with, the operating rules of ASX Clear that impose financial requirements, taking into account any waiver of those requirements by ASX Clear.



**client** in relation to a MDA provider means a person who enters into an agreement with the provider for the provision of MDA services.

**client contributions** means contributions of money or money's worth made by a client by either:

- (a) paying or giving ownership of property to the MDA provider or an external MDA custodian; or
- (b) giving the MDA provider or an external MDA custodian power to undertake transactions relating to property through a power of attorney, an arrangement for the MDA provider or an external MDA custodian to be a signatory on an account of the client or otherwise.

**client portfolio assets**, in relation to a client, means financial products, money or other property that is:

- (a) client contributions of the client; or
- (b) borrowed or raised for the purposes of the MDA service provided to the client; or
- (c) derived directly or indirectly from financial products, money or other property referred to in paragraph (a) or (b).

**eligible custodian** means:

- (a) an Australian ADI; or
- (b) a market participant or a clearing participant; or
- (c) a sub-custodian appointed by a person referred to in paragraph (a) or (b).

**eligible provider**:

- (a) for the purposes of section 912AJ (MDA providers)—means:
  - (i) an Australian ADI; or
  - (ii) the government of the Commonwealth or of a State or Territory government or the government of a country that is a member of the Organisation for Economic Co-operation and Development or an agency or instrumentality of such a government; or
  - (iii) a foreign deposit-taking institution:
    - (A) that is regulated by a regulator approved in writing by ASIC for this purpose; or
    - (B) approved in writing by ASIC for this purpose; or

- (iv) an Australian CS facility licensee within the meaning of section 761A; or
- (v) an entity approved by ASIC in writing for the purpose of this subparagraph;
- (b) for the purposes of section 912AK (MDA custodians and external MDA custodians)—means:
  - (i) an Australian ADI; or
  - (ii) an entity approved by ASIC in writing for the purpose of this subparagraph.

***eligible undertaking***, in relation to a financial services licensee, means:

- (a) an enforceable and unqualified undertaking by an eligible provider, expressed to be irrevocable without the written consent of ASIC, to pay, on written demand by the licensee, a certain amount (disregarding any part previously paid or any amount that would be repayable as a liability by the licensee if money were paid); or
- (b) an undertaking approved in writing by ASIC as an eligible undertaking.

***excluded assets***, in relation to a financial services licensee, means:

- (a) intangible assets (excluding, for the avoidance of doubt, a deferred tax asset); and
- (b) receivables from, or assets invested in, any person who:
  - (i) is an associate of the licensee; or
  - (ii) was an associate of the licensee at the time the liability was incurred or the investment was made; or
  - (iii) became liable to the licensee in connection with the acquisition of interests in a managed investment scheme operated by the licensee; and
- (c) assets:
  - (i) held as a beneficial interest or an interest in a managed investment scheme; or
  - (ii) invested in a superannuation product in respect of which the licensee or an associate may exercise any form of power or control; and
- (d) receivables from a trustee of a trust in respect of which the licensee or an associate may exercise any form of power or control;

but, despite anything in the paragraphs above, does not include the following:

- (e) a receivable mentioned in paragraph (b) or (d):
  - (i) to the extent that it is adequately secured; or
  - (ii) to which all of the following apply:
    - (A) it is receivable as a result of a transaction entered into by the licensee in the ordinary course of its business on its standard commercial terms applicable to persons that are not associated with the licensee on an arm's length basis;
    - (B) no part of the consideration in relation to the transaction is, in substance, directly or indirectly invested in the licensee;
    - (C) the value of the receivable (before any discount is applied) is not more than 20% of the assets less liabilities of the licensee; or
  - (iii) to which all of the following apply:
    - (A) it is receivable from an insurance company that is a body regulated by APRA and results from a transaction entered into by the licensee in the ordinary course of its business on its standard commercial terms applicable to persons that are not associated with the licensee on an arm's length basis;
    - (B) the licensee has no reason to believe that any amount invested in the licensee would not have been invested if the transaction that caused the receivable had not taken place or were not at the time of the investment expected to take place;
    - (C) the licensee has no reason to believe that the recoverability of the receivable will materially depend on the value of an investment by any person in the licensee;
    - (D) the total value of the receivables under this subparagraph is not more than 60% of the adjusted liabilities of the licensee disregarding this subparagraph; or
  - (iv) to which ASIC has given its consent in writing to the licensee treating the receivable as not being an excluded asset; or

(v) to the extent that it is owing by way of fees from, or under rights of reimbursement for expenditure by the licensee out of property of or in relation to:

- (A) a superannuation entity;
- (B) an IDPS;
- (C) a registered scheme,

to the extent that the receivable:

(D) exceeds amounts invested by the entity, IDPS or scheme in, or lent (other than by way of a deposit with an Australian ADI in the ordinary course of its banking business) directly or indirectly by the entity, IDPS or scheme to:

- (I) the licensee; or
- (II) a body corporate the licensee controls; or
- (III) a body corporate that controls the licensee; or
- (IV) a body corporate that the licensee's controller controls; and

(E) if receivable by way of fees, represents no more than the amount of fees owing for the previous 3 months; and

(F) if receivable under rights of reimbursement for expenditure by the licensee, has not been receivable for more than 3 months; and

(f) an asset mentioned in paragraph (c) to the extent it is a managed investment product unless any part of the amount invested is, in substance, directly or indirectly invested in the licensee.

***external MDA adviser*** means a financial services licensee who:

- (a) is authorised to provide financial product advice to a person as a retail client; and
- (b) directly contracts with a person as a retail client to prepare or review an investment program where:
  - (i) the investment program is, or is intended to be, included in an MDA contract; and
  - (ii) the MDA contract is between the person and another person, who is an MDA provider.

**external MDA custodian** means a financial services licensee who:

- (a) is authorised to provide custodial or depository services and to deal on behalf of people as retail clients; and
- (b) directly contracts with a person as a retail client to provide custodial or depository services for MDA services provided to the person by another person who is an MDA provider.

**first financial year**, in relation to a financial services licensee, means the financial year of the licensee in which the calculation date occurs.

**IDPS** has the same meaning as in ASIC Class Order [CO 13/763].

**IDPS property**, in relation to an IDPS, means property acquired or held through the IDPS, other than property held by a client of the IDPS.

**liquid assets**, in relation to a financial services licensee, means:

- (a) cash or cash equivalents other than a commitment of the kind referred to in paragraph (d) of the definition of **cash or cash equivalents**; and
- (b) assets that the licensee can reasonably expect to realise for their market value within 6 months,

that are free from encumbrances and, in the case of receivables, free from any right of set-off.

**market participant** means a participant in a licensed market.

**MDA contract** means a written contract between an MDA provider and a person as a retail client setting out the terms and conditions on which the MDA provider provides a MDA service to the person.

**MDA custodian** means an MDA provider who is also responsible for holding client portfolio assets.

**MDA provider** means a person who holds an Australian financial services licence that authorises:

- (a) dealing by way of issue in either or both of:
  - (i) interests in managed investment schemes that are limited to a right to receive MDA services; and
  - (ii) miscellaneous financial investment products that are limited to a right to receive MDA services; and
- (b) dealing in all the financial products that may be acquired with client portfolio assets under the MDA contract; and

- (c) except where an external MDA adviser has contracted directly with each retail client to whom the MDA provider provides MDA services to provide financial product advice relating to the investment program—providing personal advice to people as retail clients in relation to the MDA; and
- (d) except where an external MDA custodian has contracted directly with each retail client to whom the MDA provider provides MDA services to hold each client portfolio asset that is a financial product or a beneficial interest in a financial product—providing custodial or depository services,

in relation to those client portfolio assets.

Note: The licence may authorise dealings in other interests in managed investment schemes or miscellaneous financial investment products.

**MDA service** means a service provided by an MDA provider with the following features:

- (a) a person (*client*) makes client contributions; and
- (b) the client agrees with the MDA provider that the client portfolio assets will:
  - (i) be managed by the MDA provider at its discretion, subject to any limitation that may be agreed, for purposes that include investment; and
  - (ii) be held legally or beneficially by the client; and
- (c) the client or the MDA provider intend that that the MDA provider will use client contributions of the client to generate a financial return or other benefit for the client (even if no such benefit is in fact generated).

**NTA** means adjusted assets minus adjusted liabilities.

**relevant financial service**, in relation to the calculation of average revenue:

- (a) for a financial service licensee that is an MDA provider—means the financial services mentioned in the definition of **MDA provider**;
- (b) for an MDA custodian or external MDA custodian—means a custodial or depository service.

**revenue**, in relation to a financial services licensee:

- (a) for a licensee that is an MDA provider—means:

- (i) the licensee's revenue within the meaning given by the accounting standards; and
- (ii) to the extent it is not the licensee's revenue within the meaning of the accounting standards—any amount paid or payable out of client portfolio assets for the performance of the obligations imposed on the licensee as an MDA provider in connection with the MDA services it operates, even if those obligations are performed by another entity;

Note: An amount under subparagraph (ii) excludes any audit fees paid or payable to an auditor engaged to meet any audit requirements under the Act.

- (b) for a licensee that is an MDA custodian or an external MDA custodian, and not an MDA provider—means the revenue of the licensee within the meaning given by the accounting standards.

**stapled group** means the group of entities consisting of:

- (a) one or more stapled issuers who are issuers of securities or managed investment products that must be transferred together; and
- (b) all wholly-owned entities of the stapled issuers.

**stapled issuer** means an entity a security or managed investment product of which under the terms on which it is traded on a prescribed financial market or under the constitution of the entity or under the terms of issue, must be transferred together with a security or managed investment product of one or more other entities.

**value** means the value of assets determined as follows:

- (a) in the case of assets that would be recognised in preparing a balance sheet for members under Chapter 2M—the value as if at that time such a balance sheet was being prepared; and
- (b) in the case of any other scheme property or IDPS property—its market value.

### **912AJ Adequate financial resources for MDA providers**

- (1) This section applies to a financial services licensee that:
  - (a) is an MDA provider; and
  - (b) is not:
    - (i) a body regulated by APRA that is not required to comply with paragraph 912A(1)(d); or
    - (ii) a market participant; or

- (iii) a clearing participant.
- (2) A financial services licensee covered by subsection (1) that complies with this section is taken to comply with conditions (if any) of its licence that relate to:
- (a) a cash needs requirement; and
  - (b) net tangible assets that apply because it is an MDA provider; and
  - (c) the obligation to lodge an opinion by a registered company auditor on the financial requirements for licensees that are authorised to operate an MDA service to the extent the opinion is for a part of a financial year or other period during which the licensee was covered by subsection (1).

Note: The conditions on the licence may include other requirements in relation to having available adequate financial resources for the purposes of paragraph 912A(1)(d).

#### *Cash needs requirement*

- (3) The licensee must:
- (a) prepare a projection of the licensee's cash flows over at least the next 12 months based on the licensee's reasonable estimate of what is likely to happen over this period; and
  - (b) have the projection approved at least quarterly by the licensee's directors as satisfying the requirements of paragraph (a); and
  - (c) document the calculations and assumptions used in preparing the projection, and describe in writing why the assumptions are appropriate; and
  - (d) update the projection of the licensee's cash flows if:
    - (i) the projection ceases to cover at least the next 12 months; or
    - (ii) there is reason to suspect that an updated projection would differ materially from the current projection or show that the licensee was not meeting the requirements in subparagraphs (i) and (ii) of paragraph (e); and
  - (e) document whether, based on the projection of the licensee's cash flows, the licensee:
    - (i) will have access when needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months; and
    - (ii) will hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or



greater than the current amount the licensee is required to hold in cash or cash equivalents under subsection (6).

*Net tangible assets*

- (4) The licensee must hold at all times NTA of:
- (a) if subsection (5) applies—at least the greatest of:
    - (i) \$150,000; or
    - (ii) an amount of up to \$5 million, being 0.5% of the average value of all the client’s portfolio assets of the MDA services provided by the licensee; or
    - (iii) 10% of average revenue of the licensee;
  - (b) otherwise—at least the greater of:
    - (i) \$10 million; or
    - (ii) 10% of average revenue of the licensee.
- (5) This subsection applies if, in relation to each MDA service operated by the licensee, an external MDA custodian provides custodial or depository services for MDA services provided by the licensee.
- (6) The licensee must hold at all times:
- (a) in cash or cash equivalents in an amount that is at least the greater of:
    - (i) \$150,000; or
    - (ii) 50% of the amount of NTA that it is required to hold under subsection (4); and
  - (b) liquid assets in an amount that is at least 100% of the required NTA.

Money that is in an account held by the licensee for the purposes of section 981B cannot be counted towards either requirement. Other cash or cash equivalents that are also liquid assets can be counted for both paragraph (a) and (b).

*Audit opinion on financial requirements*

- (7) The licensee must lodge with ASIC a report (the *audit opinion*) by a registered company auditor addressed to the licensee and ASIC for each financial year of the licensee and any other period that ASIC directs in writing that states whether, during any part of the period for which the licensee was covered by subsection (1):

- (a) in the auditor's opinion, the licensee:
  - (i) complied with paragraph (3)(b) and subsections (4) and (6) and other financial requirements in conditions on its licence; and
  - (ii) had at all times a projection that purports to, and appears on its face to, comply with paragraph (3)(a); and
  - (iii) correctly calculated the projection in paragraph (3)(a) on the basis of the assumptions the licensee used for the projection; and
- (b) following an examination of the calculations, assumptions and description prepared under paragraph (3)(c) and relied on by the licensee in complying with paragraph (3)(a), the projections prepared under paragraph (3)(a) and the document prepared under paragraph (3)(e), the auditor has no reason to believe that:
  - (i) the licensee did not have adequate systems for managing the risk of having insufficient financial resources to comply with subsections (4) and (6) and other financial requirements in conditions on its licence; or  

Note: Paragraph 912A(1)(h) requires a licensee (other than a body regulated by APRA) to have adequate risk management systems.
  - (ii) the licensee failed to comply with paragraph (3)(c); or
  - (iii) the licensee will not have access when needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months; or
  - (iv) the licensee will not hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or greater than the current amount the licensee is required to hold in cash or cash equivalents under subsection (6); or
  - (v) the assumptions the licensee adopted for its projection in paragraph 3(a) were unreasonable.
- (8) The audit opinion must be lodged:
  - (a) for each financial year of the licensee—with the balance sheet that the licensee is required to lodge under section 989B; and
  - (b) for any period of time that ASIC directs—by no later than the date ASIC directs in writing the audit opinion to be lodged.

**912AK Adequate financial resources for MDA custodians and external MDA custodians**

- (1) This section applies to a financial services licensee that:
  - (a) is an MDA custodian or an external MDA custodian; and
  - (b) is not:
    - (i) a body regulated by APRA that is not required to comply with paragraph 912A(1)(d); or
    - (ii) a market participant; or
    - (iii) a clearing participant.
- (2) A financial services licensee covered by subsection (1) that complies with this section is taken to comply with conditions (if any) of its licence that relate to:
  - (a) a cash needs requirement; and
  - (b) net tangible assets that apply because it provides a custodial or depository service; and
  - (c) the obligation to lodge an opinion by a registered company auditor on the financial requirements for licensees that are authorised to provide a custodial or depository service to the extent the opinion is for a part of a financial year or other period during which the licensee was covered by subsection (1).

Note: The conditions on the licence may include other requirements in relation to having available adequate financial resources.

*Cash needs requirement*

- (3) The licensee must:
  - (a) prepare a projection of the licensee's cash flows over at least the next 12 months based on the licensee's reasonable estimate of what is likely to happen over this period; and
  - (b) have the projection approved in writing at least quarterly by the following persons as satisfying the requirements of paragraph (a):
    - (i) if the licensee is a body corporate—the directors of the licensee;
    - (ii) if the licensee is a partnership or the trustees of a trust—the partners of the licensee or the trustees;

- (iii) if the licensee is a natural person—the person; and
- (c) document the calculations and assumptions used in preparing the projection and describe in writing why the assumptions are appropriate; and
- (d) update the projection of the licensee’s cash flows if:
  - (i) the projection ceases to cover at least the next 12 months; or
  - (ii) there is reason to suspect that an updated projection would differ materially from the current projection or show that the licensee was not meeting the requirements in subparagraphs (i) and (ii) of paragraph (e); and
- (e) document whether, based on the projection of the licensee’s cash flows, the licensee:
  - (i) will have access when needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months; and
  - (ii) will hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or greater than the current amount the licensee is required to hold in cash or cash equivalents under subsection (5).

*Net tangible assets*

- (4) The licensee must hold at all times NTA of at least the greater of:
  - (a) \$10 million; or
  - (b) 10% of average revenue.
- (5) The licensee must hold at all times:
  - (a) cash or cash equivalents in an amount that is at least 50% of the NTA that it is required to hold under subsection (4); and
  - (b) liquid assets in an amount that is at least 100% of the required NTA.

Money that is in an account held by the licensee for the purposes of section 981B cannot be counted towards either requirement. Other cash or cash equivalents that are also liquid assets can be counted for both paragraph (a) and paragraph (b).

*Audit opinion*

- (6) The licensee must lodge with ASIC a report (the *audit opinion*) by a registered company auditor addressed to the licensee and ASIC for each financial year of the licensee and any other period that ASIC directs in

writing that states whether during any part of the period for which the licensee was authorised to provide a custodial or depository service:

- (a) in the auditor's opinion, the licensee:
  - (i) complied with paragraph (3)(b) and subsections (4) and (5) and other financial requirements in conditions on its licence; and
  - (ii) had at all times a projection that purports to, and appears on its face to, comply with paragraph (3)(a); and
  - (iii) correctly calculated the projection in paragraph (3)(a) on the basis of the assumptions the licensee used for the projection; and
- (b) following an examination of the calculations, assumptions and description prepared under paragraph (3)(c) and relied on by the licensee in complying with paragraph (3)(a), the projections prepared under paragraph (3)(a) and the document prepared under paragraph (3)(e), the auditor has no reason to believe that:

- (i) the licensee did not have adequate systems for managing the risk of having insufficient financial resources to comply with subsections (4) and (5) of this section (if applicable) and other financial requirements in conditions on its licence; or

Note: Paragraph 912A(1)(h) requires a licensee (other than a body regulated by APRA) to have adequate risk management systems.

- (ii) the licensee failed to comply with paragraph (3)(c); or
- (iii) the licensee will not have access when needed to enough financial resources to meet its liabilities over the projected term of at least the next 12 months; or
- (iv) the licensee will not hold at all times during the period to which the projection relates in cash or cash equivalents, an amount equal to or greater than the current amount the licensee is required to hold in cash or cash equivalents under subsection (5); or
- (v) the assumptions the licensee adopted for its projection in paragraph (3)(a) were unreasonable.

- (7) The audit opinion must be lodged:
  - (a) for each financial year of the licensee—with the balance sheet that the licensee is required to lodge under section 989B; and
  - (b) for any period of time that ASIC directs—by no later than the date ASIC directs in writing the audit opinion to be lodged.”.

## Part 3—Transitional

### 6 Application

#### *MDA providers*

- (1) This instrument applies to an MDA provider as follows:
  - (a) notional subsections 912AJ(1) to (6) of the Act, as inserted by section 5 of this instrument, apply from the day that is 12 months after the commencement of this instrument;
  - (b) notional subsections 912AJ(7) and (8) of the Act, as inserted by section 5 of this instrument, apply to each financial year of the MDA provider commencing on and after the day that is 12 months after the commencement of this instrument.

#### *MDA custodians and external MDA custodians*

- (2) This instrument applies to an MDA custodian or an external MDA custodian as follows:
  - (a) notional subsections 912AK(1) to (5) of the Act, as inserted by section 5 of this instrument, apply from the day that is 12 months after the commencement of this instrument;
  - (b) notional subsections 912AK(6) and (7) of the Act, as inserted by section 5 of this instrument, apply to each financial year of the MDA custodian or the external MDA custodian commencing on and after the day that is 12 months after the commencement of this instrument.

#### *Definitions*

- (3) In this section:

*external MDA custodian*, *MDA custodian* and *MDA provider* have their respective meanings given by notional section 912AI of the Act, as inserted by section 5 of this instrument.

**ASIC**Australian Securities &  
Investments Commission

CONSULTATION PAPER 000

# Managed discretionary account providers: Financial resource requirements

April 2020

## About this paper

This consultation paper sets out ASIC's proposals to increase the financial resource requirements for the providers of managed discretionary accounts (MDA providers).

We propose to apply the new financial resource requirements by a new legislative instrument and minor changes to [Pro Forma 209 Australian financial services licence conditions](#) (PF 209). We also propose to update our guidance in [Regulatory Guide 166 Licensing: Financial requirements](#) (RG 166).

Note: The draft ASIC instrument and Pro Forma 209 is available on our website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp) under CP 000.

## About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

## Document history

This paper was issued on **23 April 2020** and is based on the legislation as at the date of issue.

## Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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## The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on financial resource requirements for MDA providers. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section C, 'Regulatory and financial impact'.

### Making a submission

You may choose to remain anonymous or use an alias when making a submission. However, if you do remain anonymous we will not be able to contact you to discuss your submission should we need to.

Please note we will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any personal or financial information) as confidential.

Please refer to our privacy policy at [www.asic.gov.au/privacy](http://www.asic.gov.au/privacy) for more information on how we handle personal information, your rights to seek access to and correct personal information, and your right to complain about breaches of privacy by ASIC.

Comments should be sent by **29 May 2020** to:

<insert name>, <insert job title>

<ASIC group>

Australian Securities and Investments Commission

GPO Box 9827

Brisbane QLD 4001

email: [insert dedicated e-mail address to be established]

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### What will happen next?

<b>Stage 1</b>	<b>30 April 2020</b>	ASIC consultation paper released
<b>Stage 2</b>	<b>29 May 2020</b>	Comments due on the consultation paper
<b>Stage 3</b>	<b>Mid-September 2020</b>	Subject to the outcome of the consultation and the approval of the Office of Best Practice and Regulation, a new legislative instrument, revised PF 209 and updated RG 166 released

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## A Background to the proposals

### Key points

Recently, the managed discretionary account (MDA) sector has experienced significant growth, particularly in the financial adviser context. It is anticipated that the MDA sector will expand substantially in the foreseeable future.

We consider that the existing financial requirements that apply to MDA providers are insufficient and no longer fit for purpose, particularly given the continuing growth of the MDA sector.

This paper will reintroduce the proposals in [Consultation Paper 200 Managed discretionary accounts: Update to RG 179 \(CP 200\)](#) to impose increased financial requirements on MDA providers.

### ASIC's current approach to MDAs

- 1 An MDA means a facility, other than a managed investment scheme (registered scheme) or an interest in a registered scheme, with the following features:
  - (a) a person (client) makes contributions;
  - (b) the client portfolio assets are managed on an individual basis by another person (MDA provider) at the MDA provider's discretion, subject to any agreed limitation; and
  - (c) the client and the MDA provider intend that the MDA provider will use the client portfolio assets to generate a financial return or other benefit for the client.
- 2 There are a wide variety of arrangements that can constitute an MDA. Industry uses different terminology to refer to services that *may* have the relevant features of an MDA. For example, products commonly known by industry and investors as a 'separately managed account', 'individually managed account', 'managed account', 'investment advisory program', 'model portfolio' or 'managed discretionary portfolio service' may fall within the definition of an MDA: see [Regulatory Guide 179 Managed discretionary accounts](#) (RG 179) for a detailed description of the arrangements that may constitute an MDA.
- 3 We consider that an MDA generally falls within the definition of both a 'managed investment scheme' in s9 of the *Corporations Act 2001* (Corporations Act) and a 'facility for making a financial investment' in s763B of the Corporations Act.

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- 4 We provide relief for MDAs offered or issued to retail clients in [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#). If an MDA provider enters into a contract with a client to provide an MDA and complies with certain conditions, relief is available under the instrument from the following requirements:
- (a) the requirement in s601ED(5) of the Corporations Act that the MDA must be registered;
  - (b) the requirement to prepare a Product Disclosure Statement (PDS) under Pt 7.9 of the Corporations Act; and
  - (c) the securities disclosure and related provisions in Pts 6D.2 and 6D.3 of the Corporations Act for securities held on behalf of the client under the MDA.

- 5 The terms ‘MDA provider’ and ‘MDA service’ are defined in [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#). The MDA provider provides the MDA services. In broad terms, an MDA provider is an AFS licensee authorised to provide the following financial services in relation to client portfolio assets:
- (a) dealing, by issuing various financial products, including interests in managed investment schemes that are limited to a right to receive MDA services;
  - (b) dealing, in all the financial products that may be acquired with client portfolio assets under an MDA contract;
  - (c) personal financial advice to retail clients about MDA services, except when an external MDA adviser has contracted directly with a retail client to provide the financial advice; and
  - (d) custodial or depository services, except when an external MDA custodian has contracted directly to hold the client portfolio assets with each retail client in the MDA.

Note: Instead of offering an MDA under our relief, you may provide these services through a registered scheme.

- 6 The MDA provider is not required to hold an AFS licence authorising it to provide custodial or depository services if, in relation to the client portfolio assets, either:
- (a) an external MDA custodian has entered into a direct contract to provide custodial or depository services with each client to whom the MDA provider provides MDA services; or
  - (b) an external MDA custodian has entered into a direct contract with the MDA provider to provide custodial or depository services—in this case, the relevant licence authorisation will be held by the external MDA custodian.

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- 7 Currently, MDA providers are not required to hold any level of net tangible assets (NTA) under their Australian financial services licence. In contrast, responsible entities and investor directed portfolio service (IDPS) operators are, broadly, required to hold NTA of:
- (a) the greater of \$10 million or 10% of MDA revenue, if the provider does not engage an external custodian to hold the assets; or
  - (b) the greater of \$150,000 or 10% of MDA revenue, if the provider engages an external custodian.
- 8 We consider that it is inconsistent from a regulatory perspective to impose a set of conditions on one part of the financial services industry and not the other, when the underlying service is substantially similar (i.e. managing client money to generate an investment return without the client having day-to-day control of the investment decisions).
- 9 Our proposals in this paper only relate to MDAs as defined in paragraph 1 of [RG 179](#). Arrangements such as managed accounts and separately managed accounts may, depending on the structure, be regulated as:
- (a) an MDA; or
  - (b) a registered scheme or IDPS, and would be subject to the financial requirements that apply to those arrangements.
- 10 Our recommendations in [CP 200](#) (published March 2013) included a proposal to increase financial requirements for MDA providers. In September 2016, when we issued [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#) and revised [RG 179](#), we elected not to increase the financial requirements for MDA providers in line with the proposals in [CP 200](#). In [Report 496 Response to submissions on CP 200 Managed discretionary accounts: Update to RG 179](#) (REP 496), we took the position that it was difficult to assess the potential impact of the financial requirements proposals because of a lack of clarity in the MDA sector. We considered that our previous no-action positions for MDAs caused this lack of clarity. We stated that we would revisit the proposal after two years (after September 2018).
- 11 The revised regulatory settings for MDA providers have now been in place for over three years. During this time, we have been able to assess the impact of these regulatory settings on the financial services industry. It is now appropriate for us to re-evaluate the merits of the financial requirements proposals for MDA providers that were originally proposed in March 2013, particularly in light of the recent substantial market growth.

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## Growth in the MDA sector

- 12 The MDA sector and managed accounts more generally have experienced significant growth in recent years. As at 30 June 2019, according to the [Institute of Managed Account Professionals \(IMAP\) Milliman managed account census results as at 30 June 2019](#), funds under management (FUM) for MDAs represented approximately \$29.24 billion, which is about 0.77% of the total FUM of approximately \$3.79 trillion: see [Australian Bureau of Statistics \(ABS\), Report 5655.0: Managed funds, Australia, Sep 2019](#). The FUM for MDAs has nearly tripled over the last three financial years. According to the [IMAP managed account FUM survey](#), as at 30 June 2016, the FUM in MDAs was approximately \$10.22 billion.
- 13 Further, over the last five financial years, the total FUM in managed funds has grown by over 50% from approximately \$2.41 trillion as at 30 June 2014 (see [ABS, Report 5655.0: Managed funds, Australia, Jun 2014](#)) to approximately \$3.79 trillion as at 30 June 2019 (see [ABS, Report 5655.0: Managed funds, Australia, Sep 2019](#)).
- 14 In particular, the use of managed accounts, a general category of arrangements that includes MDAs, by financial advisers has grown. In 2018, approximately 30% of financial advisers used managed accounts and this increased to approximately 35% in 2019. Financial planners reported that managed accounts comprised over 31% of their FUM in 2019 and this is expected to increase to 52% in 2022.

Note: See the State Street Global Advisors SPDR ETFs/Investment trends 2019 managed accounts report data in the AdviserVoice's article [Managed accounts usage in Australia has almost doubled but education is still lacking](#).

- 15 Potential reasons for the recent growth in MDAs (and managed accounts generally) include:
- (a) the Future of Financial Advice (FOFA) reforms which introduced a prospective ban on conflicted remuneration structures, a duty for financial advisers to act in the best interests of their clients, an opt-in obligation and an annual fee disclosure statement. ASIC has received feedback from the industry that these changes have increased compliance costs. We understand that MDAs provide a means by which financial advisers can provide more cost-efficient financial advice. We also understand that MDAs provide a new revenue stream (for managing client money) in addition to the revenue from advice services themselves.

Note: In June 2012, the FOFA reforms were introduced into the *Corporations Act 2001* by the [Corporations Amendment \(Future of Financial Advice\) Act 2012](#) and [Corporations Amendment \(Further Future of Financial Advice Measures\) Act 2012](#). These reforms included the best interests duty, ban on conflicted forms of remuneration, opt-in obligation and changes to ASIC's licensing and banning powers.

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- (b) our observations are that AFS licensees have become more conscious of ‘advice risk’ (i.e. the risk of liability for advice which may not be in the best interests of investors). This is particularly the case after the Financial Services Royal Commission in 2018. We understand that some firms believe that the delivery of financial advice through an MDA that uses model portfolios designed by the licensee, may reduce advice risk for the licensee because the licensee has more control over the investment selection;
- (c) the feedback we have received from industry that MDAs enable investment transactions to be undertaken quickly, either to take advantage of opportunities or protect clients from risk, in contrast to arrangements where a financial adviser does not have a broad investment discretion; and
- (d) the fact that there are lower regulatory requirements for an MDA provider compared to a responsible entity of a registered scheme.

## Review of the MDA sector

- 16 In 2018–19, we carried out a high-level review of a sample of MDAs that were sold on platforms to help us understand the MDA sector, including identifying key trends and risks of harm in the sector. This review did not include a review of the platform on which the MDA was sold. The scope of the review included the collection of limited fee data, but did not include an assessment of whether MDA providers were complying with the terms of the [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#). Further, the review did not include a review of client advice files and whether financial advisers are recommending the MDA itself and the underlying products in compliance with their best interest and related duties.
- 17 In our review, we observed that there are low barriers to entry in the MDA sector. Currently, MDA providers are only required to hold surplus liquid funds of \$50,000 and are not subject to NTA requirements. We identified that it is possible for a licensee to offer an MDA rather than a registered scheme to circumvent the more onerous financial requirements that apply to the responsible entity of a registered scheme. In light of the similarities in the roles and responsibilities of responsible entities and MDA providers, we consider that, as observed in [CP 200](#), it would be beneficial for MDA providers and responsible entities to comply with similar financial requirements.
- 18 We anticipate that the MDA sector will continue to grow, extrapolating recent growth rates into the near term. If more retail clients invest in MDAs and the amount invested in MDAs increases, potentially in preference of a registered scheme or an IDPS, an increasingly significant proportion of FUM

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could be invested in MDAs. In light of the prevalent use of MDAs and continuing growth, we are concerned that the current financial requirements for an MDA provider may not be adequate and are no longer fit for purpose. ASIC is concerned that a significant proportion of the assets under management are invested in structures that may not have a reasonable level of capital support.

- 19 We consider that these reasons support the proposition that an MDA provider should be made subject to financial requirements that are similar to those imposed on a responsible entity of a registered scheme or an IDPS operator. This would help to ensure a level playing field, which is consistent with our recently introduced duty to consider the impact of our actions on competition in the financial system: see s1(2A) of the *Australian Securities and Investments Commission Act 2001*.

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## B Updating the financial resource requirements for MDA providers

### Key points

We are proposing to:

- increase MDA providers' financial requirements to ensure that they correspond with the requirements that apply to responsible entities of managed investment schemes and IDPS operators under [Class Order \[CO 13/760\] Financial requirements for responsible entities and operators of investor directed portfolio services](#);
- apply to MDA operators the same financial requirements that apply to responsible entities for scheme property holding arrangements;
- apply the financial requirements to an MDA provider as defined in the [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#);
- provide a definition for 'client portfolio assets';
- provide a definition of 'revenue' that is designed for an MDA provider (including where the MDA provider holds client portfolio assets) or an external MDA custodian;
- ensure consistency with financial requirements for providers of custodial and depository services by making MDA providers comply with new asset holding requirements; and
- provide a transitional period of 12 months from the date of the new legislative instrument for MDA providers to comply with the new asset holding requirements.

### New financial requirements

#### Proposal

B1 We propose to:

- (a) apply to MDA providers financial requirements that are similar to those that apply to responsible entities of managed investment schemes;
- (b) apply to MDA providers scheme property holding arrangements that are similar to the requirements that apply to responsible entities. In particular, we propose that MDA providers should meet:
  - (i) the standard solvency and positive net assets requirement that applies to all AFS licensees;
  - (ii) a tailored cash needs requirement similar to the requirement that applies to responsible entities;

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- (iii) a tailored audit requirement similar to the requirement that applies to responsible entities; and
  - (iv) a NTA requirement similar to that which applies to responsible entities (the value of which depends on whether the responsible entity engages an external custodian to hold the client assets); and
- (c) apply the financial requirements to an MDA provider as defined in the [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#). Under this approach, we propose to replicate existing definitions of terms in the instrument, such as ‘MDA service’ and ‘MDA contract’, in a new legislative instrument and to make minor and consequential changes in [PF 209](#).

Note 1: The proposed legislative instrument is set out Appendix 1 of this paper.

Note 2: If we proceed with this proposal, we will provide a transitional period of 12 months from the date of the new legislative instrument for MDA providers to comply with the new financial requirements.

Note 3: See Table 1 for more details of the proposed financial requirements.

#### *Your feedback*

- B1Q1 Do you agree with our proposal that MDA providers should be subject to similar financial requirements to those that apply to the responsible entities of managed investment schemes? If not, why not?
- B1Q2 Do you agree that this proposal is appropriate, given the level of risk carried by MDA providers? Why or why not?
- B1Q3 Do you think that there are any circumstances (e.g. when MDAs are hosted on a platform such as an IDPS) when an MDA provider should be subject to lower financial requirements? If so, please provide details.
- B1Q4 Are there any practical problems with the implementation of this proposal? If so, please provide details.
- B1Q5 Please provide an estimate of the costs that you anticipate will flow from this proposal. In support of your estimate, please explain your rationale and any underlying assumptions.
- B1Q6 Please explain whether you consider that the proposal will be likely to result in a net benefit to MDA clients. Please set out your rationale and any underlying assumptions.
- B1Q7 Are there other options, other than the proposed financial requirements for MDA providers, available to implement adequate safeguards regarding the financial substance of an MDA provider?
- B1Q8 Are there any circumstances in which the proposed financial requirements should not apply? If so, please specify.

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- B1Q9 Do you agree with our proposed approach of replicating the definitions from the instrument, such as ‘MDA service’ and ‘MDA contract’, in determining the scope of entities that fall under the defined term ‘MDA provider’ and that are subject to the proposed financial requirements? Alternatively, should the terms ‘MDA provider’ and ‘MDA service’, as defined in the instrument, be revised or clarified for the purpose of defining the entities that will fall under the proposed financial requirements? If so, please explain.
- B1Q10 Do you consider that our proposal in B1Q9 will correctly capture the different arrangements that exist in this space (e.g. model portfolios and separately managed account arrangements)? If not, why not?
- B1Q11 What impact will the proposal have on other managed account services that are not an MDA service (as defined by the instrument)? Should any other managed account services be covered by the proposal?
- B1Q12 Are there any form of managed accounts that are not going to be subject to an enhanced NTA requirement after these reforms? If so, should they also be subject to an enhanced NTA requirement?
- B1Q13 Would a 12 month transitional period be sufficient time for MDA providers to comply with the new requirements? If not, please explain why a longer period may be required.

**Table 1: New financial requirements for MDA providers**

Financial requirements that you must meet	How to meet this requirement
Standard solvency and positive net assets requirement	See paragraphs 32–34 of <a href="#">RG 166</a> . Note: These requirements apply to all AFS licensees.
Tailored cash needs requirement	<p><b>Projection</b></p> <ol style="list-style-type: none"> <li>Prepare a projection of your cash flows over at least the next 12 months based on your reasonable estimate of what is likely to happen over this term. Note: You can take into account, for example, the following factors in preparing your projection if you reasonably believe they are likely to be available: assets you hold at the time the projection starts that can be used to pay your liabilities; and inflows you may receive, including income from your business, amounts that you may borrow (e.g. under an overdraft) and amounts that you may receive from an eligible provider under an eligible undertaking.</li> <li>Document your calculations and assumptions on which the projection is based, and describe in writing why they are the appropriate assumptions. Note: We expect that the written description of your calculations and assumptions will vary according to the nature, scale and complexity of your business.</li> <li>Update your projection of cash flows when:               <ol style="list-style-type: none"> <li>those cash flows cease to cover the next 12 months;</li> <li>there is a material change; or</li> </ol> </li> </ol>

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Financial requirements that you must meet	How to meet this requirement
Tailored cash needs requirement— <i>continued</i>	<p>(c) you have reason to suspect that an updated projection would show that you were not meeting items 5 or 6 below.</p> <p>Note: A 'material change' is a change for which it would be reasonable for you to plan by updating your cash flow projection.</p> <p>4. Have your cash flow projection approved by the board of directors, or other governing body if applicable, at least quarterly as satisfying the requirements of this cash needs requirement.</p> <p><b>Financial resources</b></p> <p>5. Show, based on your projection of cash flows, that you will have access as needed to enough financial resources to meet your liabilities over the projected term of at least the next 12 months, including any additional liabilities you project will be incurred during that term.</p> <p>6. Demonstrate, based on the projection of your cash flows, that you will hold at all times during the period to which the projection relates, in cash or cash equivalents, an amount equal to or greater than the current amount you are required to hold in cash or cash equivalents. For MDA providers, cash or cash equivalents means:</p> <ul style="list-style-type: none"> <li>(a) cash on hand, demand deposits and money deposited with an Australian authorised deposit-taking institution (ADI) that is available for immediate withdrawal;</li> <li>(b) short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value;</li> <li>(c) the value of any eligible undertaking provided by an eligible provider; and</li> <li>(d) a commitment to provide cash from an eligible provider that can be drawn down within five business days and has a maturity of at least six months.</li> </ul>
Tailored audit requirement	<p>Your audit report must include statements by a registered company auditor addressed to you and ASIC that, for the relevant period:</p> <ul style="list-style-type: none"> <li>(a) in the auditor's opinion, you: <ul style="list-style-type: none"> <li>(i) complied with the NTA requirements (see below) and any other financial requirements applying to you;</li> <li>(ii) had, at all times, cash flow projections (covering at least the following 12 months) that purported to, and, on their face, appeared to demonstrate your solvency; and</li> <li>(iii) correctly calculated the cash flow projections based on the assumptions you based them on; and</li> </ul> </li> <li>(b) following an examination of the documents you relied on to create your cash flow projections, the auditor has no reason to believe that: <ul style="list-style-type: none"> <li>(i) you did not satisfy s912A(1)(h) of the Corporations Act for managing the risk of having insufficient funds to meet the NTA requirements (see below) and any other financial requirements that applied to you;</li> <li>(ii) you failed to prepare cash flow projections as required, failed to have these projections approved by your board or governing body or failed</li> </ul> </li> </ul>

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Financial requirements that you must meet	How to meet this requirement
	<p>to document the calculations used in creating the cash flow projections and explain why they were appropriate; and</p> <p>(iii) the assumptions you used to create the cash flow projections were inappropriate.</p> <p>Note: We refer to the auditor statements in paragraph (a) as 'positive assurance' and the statements in paragraph (b) as 'negative assurance'. We expect that when giving negative assurance for the purposes of paragraph (b), the auditor will take into consideration any information from the audit for positive assurance.</p>
NTA requirement	<p>MDA providers that do not provide custodial and depository services must hold at all times a minimum NTA the greater of:</p> <ul style="list-style-type: none"> <li>(a) \$150,000;</li> <li>(b) 0.5% of the average value of all of the client portfolio assets of the MDAs you operate, up to \$5 million NTA; or</li> <li>(c) 10% of your average revenue with no maximum NTA.</li> </ul> <p>MDA providers that provide custodial and depository services must hold at all times a minimum NTA the greater of:</p> <ul style="list-style-type: none"> <li>(a) \$10 million; or</li> <li>(b) 10% of your average revenue with no maximum NTA.</li> </ul> <p>Note: See proposals B5–B5(b) for further information about the proposed financial requirements for external MDA custodians and MDA providers that provide custodial and depository services.</p>
Other requirements	Depending on the financial products and services you offer, you must meet any other requirements set out in <a href="#">RG 166</a> that apply to you.

## Background information

- 20 The proposed NTA requirements for MDA providers involve the concept of 'average revenue'. In calculating average revenue, an MDA provider should include the revenue of persons performing the functions relating to an MDA for which the MDA provider is responsible (e.g. functions outsourced to other entities).

## Rationale

- 21 This explanation for the proposed financial requirements for MDA providers relates to proposals B1 and B2.
- 22 There are three key reasons for the proposed financial requirements:
- (a) to ensure that MDA providers have adequate financial resources to meet operating costs (e.g. the costs of ensuring compliance with the Corporations Act) throughout the duration of their MDA services. We consider that it is appropriate for AFS licensees that are managing

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- investors' money, and making discretionary investment decisions on behalf of investors, to have sufficient equity within their businesses;
- (b) to provide some level of assurance that, if an MDA provider does fail, there is sufficient money available for the orderly transition to a new MDA provider or the transfer of the clients' assets to the client (where these assets are held by the MDA provider) or as the client directs; and
  - (c) to achieve parity with the financial requirements that apply to a responsible entity or IDPS operator, which will in turn reduce regulatory arbitrage by MDA operators seeking to avoid current financial requirements applicable to responsible entities or IDPS operators. MDAs and registered schemes both involve the investment management of client assets where the client has conferred investment discretion on the operator. A responsible entity and a MDA provider are both required to act in the best interests of the investor in discharging this investment management function. These fundamental similarities suggest that an MDA provider, and a responsible entity should both be subject to substantively the same financial resource requirements.

## How we will define key terms

### Proposal

- B2** For the purposes of proposal B1, we propose to define 'client portfolio assets' using the definition of this term in [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#).

Note: In broad terms, client portfolio assets refers to financial products and other property that are the client's contributions, or are borrowed or raised for the purposes of the MDA service, or that are derived directly or indirectly from the client's contributions or funds raised or borrowed for the purpose of the MDA service.

- B3** We propose to define 'revenue' as:
- (a) for a licensee that is an MDA provider that does not hold client portfolio assets:
    - (i) the licensee's revenue within the meaning given by the accounting standards; and
    - (ii) to the extent it is not the licensee's revenue within the meaning of the accounting standards—any amount paid or payable out of client portfolio assets for the performance of the obligations imposed on the licensee as an MDA provider in connection with the MDA services it operates, even if those obligations are performed by another entity; and

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- (b) for a licensee that is an MDA provided that holds client portfolio assets, or an external MDA custodian—the revenue of the licensee within the meaning given by the accounting standards.

**B4** We also propose to define ‘average revenue’ as:

- (a) in the first financial year in which the licensee is first authorised to provide the relevant financial service, the licensee’s reasonable forecast of its revenue from the date it was first authorised for the remainder of the first financial year pro-rated to a 12-month period;
- (b) in the next financial year after the first financial year in which the licensee was first authorised to provide the relevant financial service, the average of the aggregate of the licensee’s:
  - (i) actual revenue for the second financial year to date, plus reasonable forecast of its revenue for the remainder of the second financial year; and
  - (ii) revenue in the first financial year from the calculation date pro-rated to a 12-month period;
- (c) in the second financial year after the first financial year in which the licensee was first authorised to provide the relevant financial service, the average of:
  - (i) the aggregate of the licensee’s revenue for the financial year to date and reasonable forecast of its revenue for the remainder of the financial year;
  - (ii) the licensee’s revenue for its previous financial year; and
  - (iii) the revenue in the first financial year in which the licensee was first authorised to provide the relevant financial service from the date of that authorisation pro-rated to a 12-month period; and
- (d) for all subsequent financial years, the average of:
  - (i) the aggregate of the licensee’s revenue for the current financial year to date and reasonable forecast of its revenue for the remainder of the current financial year;
  - (ii) the licensee’s revenue for the last preceding financial year; and
  - (iii) the licensee’s revenue for the second preceding financial year.

Note: In determining average revenue, an MDA provider should include the revenue of persons performing the functions relating to an MDA for which the MDA provider is responsible (e.g. functions outsourced to other entities).

*Your feedback*

B4Q1 Do you agree with our proposed definition of ‘client portfolio assets’? If you think that ‘client portfolio assets’ should be defined using an alternative definition, please supply that definition and outline why it is preferred.

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B4Q2 Do you agree with our proposed definition of ‘average revenue’? If you think that ‘average revenue’ should be defined using an alternative definition, please supply that definition and outline why it is preferred.

### Rationale

- 23 If the MDA provider is a responsible entity, ‘average responsible entity revenue’, as defined in [\[CO 13/760\]](#), is included in the licensee’s average revenue. We will adopt a similar approach to MDA providers that are also IDPS operators. MDA providers who are also responsible entities or IDPS operators can use 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.
- 24 We propose to use the definition of ‘client portfolio assets’ in [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#). The reasoning for our proposal (to apply the higher NTA requirement to an MDA provider that also holds client portfolio assets) is set out in paragraphs 30 and 31.
- 25 The definition of ‘average revenue’ adapts the definitions of ‘average RE and IDPS operator revenue’ in [\[CO 13/760\]](#) and ‘average revenue’ in [\[CO 13/761\]](#) to an MDA provider or an external MDA custodian. This approach ensures the the licensee’s revenue under the accounting standards is used in calculating the licensee’s average revenue. For an MDA provider that does not hold client portfolio assets, the revenue calculation includes any amount paid or payable out of client portfolio assets for the performance of the obligations imposed on the licensee as an MDA provider in connection with their MDA services, even if those obligations are performed by another entity.

## Ensuring consistency with financial requirements for providers of custodial and depository services

### Proposal

B5 We propose that:

- (a) external MDA custodians must meet the same requirements that apply under [\[CO 13/761\]](#) to providers of custodial or depository services that are not incidental providers. This includes the requirement to hold NTA of \$10 million, or 10% of average revenue, whichever is higher;

Note: In determining average revenue, an MDA provider should include the revenue of persons performing the functions relating to an MDA for which the MDA provider is responsible (e.g. functions outsourced to other entities).

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- (b) MDA providers that are also responsible for holding client portfolio assets must meet the same requirements as those that apply under [\[CO 13/761\]](#) to responsible entities that hold scheme property. This includes the requirement to hold NTA of \$10 million, or 10% of average revenue, whichever is higher, unless the MDA provider arranges for the client portfolio assets to be held by a person licensed to provide a custodial or depository service that is not an incidental provider or a body regulated by the Australian Prudential Regulation Authority (APRA);
- (c) the NTA requirements outlined in [B5(b)] will not apply to an MDA provider where the client retains legal and beneficial title to the client portfolio assets;

Note: in this scenario, the MDA provider would be subject to a lower NTA requirement of the greater of \$150,000 or 10% of average revenue.

- (d) MDA providers who are responsible for holding client portfolio assets do not fall within the definition of 'incidental provider', as defined in [\[CO 13/761\]](#).

Note: We will make this explicit in the [ASIC Corporations \(Managed Discretionary Account Services\) Instrument 2016/968](#). This means these MDA providers would not be able to fulfil their NTA obligations by meeting the reduced minimum NTA requirements for incidental providers of custodial and depository services; and

Note: In determining average revenue, an MDA provider should include the revenue of persons performing the functions relating to an MDA for which the MDA provider is responsible (e.g. functions outsourced to other entities).

- (e) we will provide a transitional period of 12 months from the date of the new legislative instrument for MDA providers to comply with the new asset holding requirements.

#### *Your feedback*

- B5Q1 Do you agree with our proposal that external MDA custodians must meet the same requirements as those that apply under [\[CO 13/761\]](#) to providers of custodial or depository services? If you disagree, please explain why.
- B5Q2 Please provide an estimate of the costs that you anticipate will flow from this proposal. In support of your estimate, please explain your rationale and any underlying assumptions.
- B5Q3 Do you agree with our proposal that MDA providers responsible for holding client portfolio assets must meet the same requirements as those that apply under [\[CO 13/761\]](#) to responsible entities that hold scheme property unless the MDA provider arranges for the client portfolio assets to be held by a person licensed to provide a custodial or depository service? If you disagree, please explain why.
- B5Q4 Do you think an amount lower than \$150,000 is appropriate? If so, please explain.

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B5Q5 Do you agree that 12 months is sufficient time for MDA providers to comply with the new requirements? Alternatively, please explain whether a longer period may be required.

## Rationale

- 26 Retail investors in managed investment schemes place significant reliance on arrangements made by responsible entities, IDPS operators and MDA providers for safe custody of their assets. Therefore, our proposals are designed to ensure that external MDA custodians and MDA providers who hold client portfolio assets have robust and well-resourced custodial arrangements. Adequate custodial arrangements mitigate the risk of the winding up of an MDA provider and the potential adverse consequences for an MDA client seeking to access their investments. Our proposals are intended to ensure that an external MDA custodian or an MDA provider that holds client portfolio assets, as the case may be, will be required to hold the same level of NTA as a non-incidentual provider custodian.
- 27 There are three key reasons for the proposed financial requirements:
- (a) to ensure that custodians for client portfolio assets have sufficient equity within their businesses;
  - (b) to provide some level of assurance that, if a custodian does fail, there is sufficient money available for the orderly transition to a new custodian; and
  - (c) to achieve parity with the financial requirements that apply to a custodians for registered schemes.
- 28 As a licensed custodian, an external MDA custodian will have to comply with the applicable NTA requirement under [\[CO 13/761\]](#). The application of the NTA requirements under [\[CO 13/761\]](#) leaves open the prospect that an external MDA custodian will be an ‘incidentual provider’, as defined in [\[CO 13/761\]](#), and will only be required to hold NTA of the greater of \$150,000 or 10% of average revenue. In contrast, under [\[CO 13/761\]](#), a licensed custodian that is not an incidentual provider has to hold NTA of the greater of \$10 million or 10 % of average revenue.
- 29 In line with the policy principles that support increased financial requirements for MDA providers, we consider that an external MDA custodian should be required to comply with the more rigorous NTA requirement for non-incidentual custodians. This is the ‘higher NTA requirement’: the greater of \$10 million or 10% of average revenue. As a consequence of this approach, an external MDA custodian should not be allowed to rely on the incidentual provider definition and, as a result, should not be allowed to rely on the ‘lower NTA requirement’ of the greater of \$150,000 or 10 % of average revenue.

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- 30 In the situation where an MDA provider holds client portfolio assets, rather than using an external MDA custodian, we consider that the MDA provider may be offering a custodial or depository service. In this case, we consider that the MDA provider should also be held to the higher NTA requirement in [\[CO 13/761\]](#) for the custodial or depository services the MDA provider provides to MDA clients. As part of our proposal to impose the higher NTA requirement, we consider that an MDA provider should not be able to rely on the incidental provider definition.
- 31 In our proposal to apply the higher NTA requirement, we see no reason to differentiate between an external MDA custodian and an MDA provider that holds client portfolio assets. In both cases, the entity that provides a custodial or depository service should be held to the same financial requirements, including NTA, that we impose on other custodians. Under [\[CO 13/760\]](#), the responsible entity of a registered scheme normally has to satisfy the higher NTA requirement or they must engage a custodian that meets the higher NTA requirement. We consider that it is appropriate to apply a consistent approach to the financial requirements of a responsible entity and an MDA provider. In our view, the optimum method to achieve this result is for the higher NTA requirement to apply to an external MDA custodian and to an MDA provider that holds client portfolio assets.

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## C Regulatory and financial impact

- 32 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) ensuring that MDA providers are adequately resourced and able to provide financial services to clients of an MDA effectively and compliantly;
  - (b) providing suitable safeguards to MDA clients; and
  - (c) facilitating commercial enterprise in the MDA sector within reasonable parameters.
- 33 Before settling on a final policy, we will comply with the Australian Government’s regulatory impact analysis (RIA) requirements by:
- (a) considering all feasible options, including examining the likely impacts of the range of alternative options that could meet our policy objectives;
  - (b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and
  - (c) if our proposed option has more than a minor or machinery impact on business or on the not-for-profit sector, preparing a Regulation Impact Statement (RIS).
- 34 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 35 To ensure that we are in a position to properly complete any required RIS, please give us as much information as you can about our proposals or any alternative approaches, including:
- (a) the likely compliance costs;
  - (b) the likely effect on competition; and
  - (c) other impacts, costs and benefits.

See ‘The consultation process’, p. 4.

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## Appendix 1: Proposed new legislative instrument

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## Key terms

Term	Meaning in this document
AFS licence	<p>An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services</p> <p>Note: This is a definition contained in s761A.</p>
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act
ASIC	Australian Securities and Investments Commission
client portfolio assets	Client portfolio assets, as defined in <a href="#">ASIC Corporations (Managed Discretionary Account Services) Instrument 2016/968</a>
[CO 13/763] (for example)	<p>An ASIC class order (in this example numbered 13/763)</p> <p>Note: Legislative instruments made from 2015 are referred to as ASIC instruments.</p>
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
CP 200 (for example)	An ASIC consultation paper (in this example numbered 200)
custodial and depository service	<p>The service provided under an arrangement between the provider and the client, or between the provider and another person with whom the client has an arrangement (whether or not there are also other parties to any such arrangement), under which a financial product, or a beneficial interest in a financial product, is held by the provider in trust for, or on behalf of, the client or another person nominated by the client unless the service is not a custodial service under s766E(3) of the Corporations Act.</p> <p>Note: This is a definition contained in s766E of the Corporations Act for the term custodial or depository service provider.</p>
Div 2 (for example)	A division of the Corporations Act (in this example numbered 2), unless otherwise specified

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Term	Meaning in this document
external MDA adviser	An AFS licensee authorised to provide financial product advice to retail clients who directly contracts with a retail client to prepare or review an investment program where: <ul style="list-style-type: none"> <li>the investment program is, or is intended to be, included in an MDA contract; and</li> <li>the MDA contract is between that client and another person, who is an MDA provider</li> </ul>
external MDA custodian	An AFS licensee who directly contracts with a retail client to provide custody services relating to an MDA operated by an MDA provider
financial adviser	An AFS licensee or its representative who provides personal advice
FOFA	Future of Financial Advice
IDPS	An investor directed portfolio service as defined in <a href="#">Class Order [CO 13/763]</a> <i>Investor directed portfolio services</i> or any instrument that amends or replaces that class order
investment program	A document that forms part of the MDA contract and which contains information about the nature and scope of the discretions that the MDA provider will be authorised and required to exercise, any significant risks associated with the MDA contract, the basis on which the MDA contract is considered to be suitable for the client and warnings about the importance of any limitations relating to the MDA contract that the client must consider before signing the MDA contract
managed discretionary account	An arrangement that involves a person (an MDA provider) managing a portfolio of assets for a client on an individual basis, and where the client gives the MDA provider the authority to make and implement investment decisions on their behalf, without the MDA provider seeking approval from the client for each decision
managed investment scheme	Has the meaning given in s9 of the Corporations Act.
MDA	Managed discretionary account
MDA contract	A contract under which an MDA provider provides an MDA service to a retail client
MDA provider	MDA provider, as defined in <a href="#">ASIC Corporations (Managed Discretionary Account Services) Instrument 2016/968</a>

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Term	Meaning in this document
MDA service	<p>A managed discretionary account service where:</p> <ul style="list-style-type: none"> <li>the client gives the MDA provider money or money's worth (client contributions);</li> <li>the MDA provider has the discretion to invest in financial products using client contributions without prior reference to the client for each transaction; and</li> <li>the MDA provider manages the client's investments as a discrete portfolio belonging to that client</li> </ul> <p>Note: A detailed definition is contained in <a href="#">ASIC Corporations (Managed Discretionary Account Services) Instrument 2016/968</a>.</p>
NTA	Net tangible assets
PDS	<p>A Product Disclosure Statement—a document that must be given to a retail client for the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act</p> <p>Note: See s761A for the exact definition.</p>
PF 209 (for example)	An ASIC pro forma (in this example numbered 209)
Pt 7.7A (for example)	A part of the Corporations Act (in this example numbered 7.7A), unless otherwise specified
registered scheme	A managed investment scheme that is registered under s601EB of the Corporations Act
Representative (of an AFS licensee)	<p>Means:</p> <ul style="list-style-type: none"> <li>an authorised representative of the licensee;</li> <li>an employee or director of the licensee;</li> <li>an employee or director of a related body corporate of the licensee; or</li> <li>any other person acting on behalf of the licensee</li> </ul> <p>Note: This is a definition contained in s910A of the Corporations Act.</p>
retail client	A client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations
RG 166 (for example)	An ASIC regulatory guide (in this example numbered 166)
s912A (for example)	A section of the Corporations Act (in this example numbered 912D), unless otherwise specified
wholesale client	A client who is not a retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations

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## List of proposals and questions

Proposal	Your feedback
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**ASIC**

Australian Securities & Investments Commission

PRIVATE AND CONFIDENTIAL

INTERNAL REPORT – ASIC ONLY

# Discretionary Accounts - Industry Review Report

September 2019

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## A Key terms

1 The following words when used in this report have the following meaning:

***Discretionary Account*** means a product offered by an issuer with the following features:

(a) a person (*client*) makes client contributions; and

(b) the client agrees with the issuer that the client portfolio assets will:

(i) be managed by the issuer as a discrete portfolio and at its discretion, subject to any limitation that may be agreed, for purposes that include investment; and

(ii) be held legally or beneficially by the client; and

(c) the client or issuer intend that that the issuer will use client contributions of the client to generate a financial return or other benefit for the client (even if no such benefit is in fact generated).

A discretionary account includes: SMA, MDA, Managed Accounts, Individually Managed Account and White Label or Private Label MDA or any other arrangement with the above features.

***Financial Adviser*** means a representative authorised to provide personal financial product advice in relation to a SMA, MDA, Managed Accounts, Individually Managed Account and White Label or Private Label MDA or any other arrangement with the above features.

***FUM*** means funds under management.

***IMAP*** means the *Institute of Managed Account Professionals*, the industry association for advisers, managers, providers and other businesses actively involved in offering of discretionary accounts.

***Instrument 2016/968*** means *ASIC Corporations (Managed Discretionary Account Services) Instrument 2016/968*.

***Investment Manager*** means the person or entity responsible for the development and implementation of the Model portfolio. Investment Manager may be internal or

external, including the appointment of a third-party sub-adviser and portfolio consultants.

**Limited MDA Providers**

means MDA Providers that use to rely on ASIC's no action position for MDAs operated on a regulated Platform and were exempt from the licensing regime. On 1 October 2018, they transitioned to the AFS licensing regime and are now regulated under Instrument 2016/968.

**Managed Portfolio**

means a managed investment scheme or a facility with the following features:

- a. a client makes contributions to purchase a portfolio of assets;
- b. the client has the sole discretion to decide what (but not necessarily when) assets will be acquired or disposed of with limited exceptions (e.g. where there is a standing instruction) or may direct that an amount of money be invested in specific investments available through the scheme; and
- c. the client intends the assets to generate a financial return or other benefit for the client.

**MDA**

means a service provided by a MDA Provider with the following features:

- (a) a person (*client*) makes client contributions; and
- (b) the client agrees with the MDA Provider that the client portfolio assets will:
  - (i) be managed by the MDA Provider at its discretion as a discrete portfolio, subject to any limitation that may be agreed, for purposes that include investment; and
  - (ii) be held legally or beneficially by the client; and
- (c) the client or the MDA Provider intend that that the MDA Provider will use client contributions of the client to generate a financial return or other benefit for the client (even if no such benefit is in fact generated).

**MDA Provider**

means a person who holds an Australian financial services licence that authorises:

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- (a) dealing by way of issue in either or both of:
  - (i) interests in managed investment schemes that are limited to a right to receive MDA services; and
  - (ii) miscellaneous financial investment products that are limited to a right to receive MDA services; and
- (b) dealing in all the financial products that may be acquired with client portfolio assets under the MDA contract; and
- (c) except where an external MDA adviser has contracted directly with each retail client to whom the MDA Provider provides MDA services to provide financial product advice relating to the investment program—providing personal advice to people as retail clients in relation to the MDA; and
- (d) except where an external MDA custodian has contracted directly with each retail client to whom the MDA Provider provides MDA services to hold each client portfolio asset that is a financial product or a beneficial interest in a financial product—providing custodial or depository services,

in relation to those client portfolio assets.

means the report made by Investment Trends entitled *Managed Account Reports 2018, April 2018 (ASIC use only)*

(also called Managed Models) means a notional portfolio of assets that is managed by an Investment Manager and is replicated in clients' discretionary account.

means either:

- a. an Investor Directed Portfolio Service as defined in ASIC Class Order [CO 13/763]; or
- b. an IDPS-like Scheme as defined in ASIC Class Order [CO 13/762].

through which a discretionary is offered or provided to the client.

***MDA Report***

***Model Portfolios***

***Platform***

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***SMA***

means a separately managed account, registered non-unitised managed investment scheme or a facility with the following features:

- a. a client makes contributions to purchase a portfolio of assets;
- b. the client's assets are managed by the responsible entity to track a Model Portfolio; and
- c. the client intends the assets to generate a financial return or other benefit for the client.

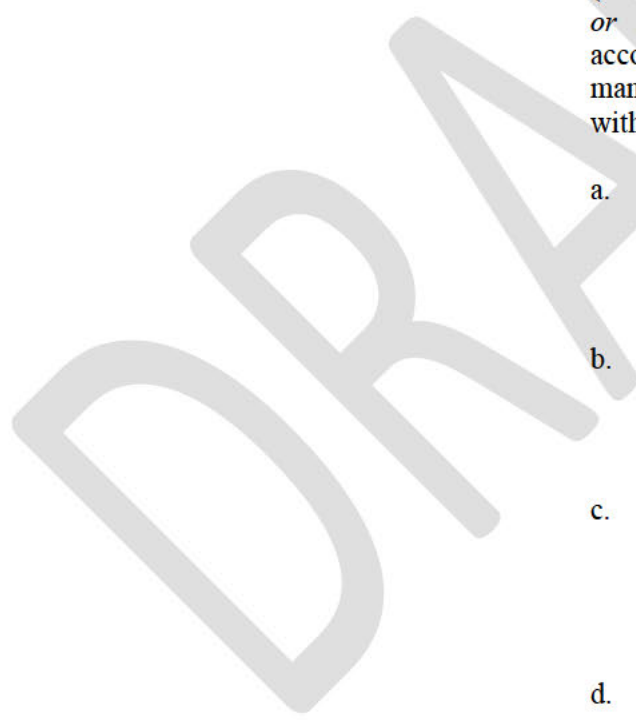
***Target Entities***

18 Platform operators, MDA Providers and dealer groups that were served s912C Notices in relation to this Project. The summary of the Target Entities analysis is in Appendix 1.

***White Label MDA***

(also called *Private Label MDA, Managed Models or Tailored Portfolios*) means a discretionary account offered via a non-unitised registered managed investment scheme or MDA or a facility with the following features:

- a. a client makes contributions to purchase interests or other assets and provides prior consent for their interests or other assets to be managed on a discretionary basis;
- b. the client's assets are managed by a responsible entity or MDA Provider (as applicable) to track a Model Portfolio;
- c. the Model Portfolio is offered under the brand of and constructed to reflect the investment philosophy and style of a specific Financial Adviser or dealer group; and
- d. the client intends the assets to generate a financial return or other benefit for the client.



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## B Introduction

### The Project

- 2 The Investment Managers (**IM**) team commenced a project for the business planning year 2018-2019 to review discretionary accounts that are sold on Platforms (the **Project**). The purpose of the Project was primarily to assist IM's understanding and increase IM's knowledge of discretionary account product offerings in the market. Areas of focus were the structure under which discretionary accounts are offered, the products issued, Investment Manager structures and arrangements, industry growth drivers, conflicts of interest, fee arrangements and risks associated with discretionary accounts. The Project will inform IM's awareness of potential harms and risks that may influence future market developments in discretionary account offerings that we may proactively address through regulatory action, consumer-focused communication, messaging and/or warnings to the public.
- 3 This report outlines IM's research and observations on the state of the discretionary account industry, risks and high-level recommendations on possible changes to the MDA policy settings.

### Project Scope

- 4 The Project scope:
- a review of MDAs that are sold on Platforms.
  - a review of publicly available resources on the discretionary account industry to identify structure, products, trends, fees, and current and emerging risks.
  - surveillances on a sample of Platforms, MDA Providers and Financial Adviser dealer groups to identify structure, discretionary accounts product offered, investment manager composition/arrangements, conflicts of interest and fee arrangements.
  - consider action(s) to address any concerns identified through industry engagement or enforcement action.
  - make an internal report or consumer focused communication to educate retail investors on the features, benefits and risks of investing in discretionary accounts.
- 5 The Project did not include in its scope nor consider any of the following matters:
- a review of MDAs that are not sold on Platforms.

- a review of Platforms or IDPSs;
- any surveillance of any breach identified as a result of the Project;
- compliance by Target Entities with *Instrument 2016/968* or *ASIC Regulatory Guide 179 - Managed Discretionary Account Services (RG 179)* or a full review of RG 179 and *Instrument 2016/968*;
- review of client advice files and whether Financial Advisers are recommending the products in compliance with their best interest duties; and
- any collection of industry data, apart from limited fee data, therefore the Project is not in a position to verify or validate any assumptions about the costs, fees, and any value for money proposition of discretionary accounts.

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## C What are Managed Discretionary Accounts<sup>1</sup>

- 6 An MDA is an arrangement that involves a person (the MDA Provider) managing a portfolio of assets for a client on an individual basis. Industry uses MDA as an umbrella term to refer to a MIS offering (SMA), some IDPS offering (Managed Portfolio) and bespoke and consolidated account offerings by brokers and Financial Advisers (Individually Managed Account or a Unified Managed Account). ASIC, on the other hand, considers all forms of individualised arrangement with discretionary element as MDA (Refer: RG 179.2) irrespective of the name but the relief under *Instrument 2016/968* only applies to a MDA provider and carves out products issued by registered manage investment schemes.
- 7 There are some features, however, which are common to all discretionary account arrangements:
- (a) the provider or issuer has the discretion to invest in financial products using client contributions without prior reference to the client for each transaction. This discretion must be exercised in accordance with an agreed investment program; and
  - (b) each client agrees with the provider or issuer that assets derived directly or indirectly from the client's contributions are managed as a discrete portfolio belonging to the client. However, in most discretionary accounts the provider or issuer applies the same investment decisions to the accounts of multiple clients.
- 8 ASIC considers an MDA is both a managed investment scheme and a facility for making a financial investment. We regulate an MDA as a financial product but also has elements of financial service, being the provision of personal advice, and dealing in a financial product. The provision of an MDA to a retail client is likely to involve the provision of a financial product (or products), consisting of the MDA itself and the underlying financial products that the MDA invests in, and/or the provision of one more financial service (including the provision of financial product advice).
- 9 Under our current regulatory requirements, to offer a discretionary account to a retail client an issuer must either:
- (a) establish and register a MIS and offer SMAs or White Label MDA via that scheme; and
  - (b) obtain a licence authorisation permitting them to offer MDAs or White Label MDAs to retail clients in accordance with the relief granted in *Instrument 2016/968*.

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<sup>1</sup> RPG submission: Regulatory requirements for MDA Providers, RPG Meeting 542

For purposes of this report and proposed work in FY 2019/20, we are concerned primarily with (b) because the structure has no specific capital requirements, specific competency requirements and has been carved out from subsection 601ED(5) and Part 7.9 of the Act.

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## D Investments within discretionary accounts

- 10 Investments within a managed account normally follow a Model Portfolios.
- 11 Based on data from the MDA Report, the assets held in investor's portfolio comprise of 43% direct equities (domestic and international), 12% unlisted managed funds, 14% ETFs, 7% cash/term deposits, 9% fixed income and 9% other listed investments. Investment Managers primarily focus on liquid assets to allow them to rebalance easily.
- 12 Consistent with the data above, the results of our surveillance of the Target Entities, including those from dealer groups that are developing their own White Label MDAs, show that the underlying assets of Model Portfolios are primarily listed direct equities and managed funds.
- 13 There is a high allocation of managed funds, including ETF, in investor's portfolios. Furthermore, a SMA is set-up as a non-unitised managed fund. SMAs comprise 34% of all discretionary account FUM<sup>2</sup> as at December 2018.

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<sup>2</sup> Source: IMAP.

## E The discretionary account industry snapshot

14 IMAP has reported as at 30 June 2019, FUM in discretionary account is at **\$71.383 bn** (an increase of \$9.263bn on the 31 December 2018 FUM total of \$62.12 bn). The Net Funds Inflow for 31 Dec 2018 to 30 June 2019 has doubled on the previous 6-month period to **\$4.43bn** or 7% increase on total FUM<sup>3</sup>.

15 The non-platform Target Entities' FUM is \$5 bn and the Platform Target Entities reported \$19 bn in FUM<sup>4</sup>.

16 The discretionary account FUM for the 2018 calendar year shows a significant slowing in the rate of growth (4 to 4.5%), in contrast to the preceding 12 months where FUM grew at almost 38% p.a.

17 In a Morgan Stanley report in 2016, the discretionary account industry FUM was expected to grow at approximately a 35% *Compound Annual Growth Rate* from 2017 to 2020, increasing to \$60 billion by 2020<sup>5</sup>. Despite recent low growth, the discretionary account sector has exceeded this projection in late 2018. While no long-term forecast has been published recently, commentators have highlighted regulatory uncertainty and a larger focus on technological development as factors contributing to the slower growth.

18 35% of planners now say they use discretionary accounts - up from 30% in 2018. In three years' time, Financial Advisers expect discretionary accounts to comprise over half their total FUM (52% on average, up from 31% today)<sup>6</sup>.

19 While discretionary accounts have operated in the Australian wealth management market since the mid-1990s, it is only during the last eight years that they have become mainstream and over the past 3 years that it has grown exponentially. The reason for the growth are:

- The Global Financial Crisis saw investors look for more transparent investments;
- Advisers wanting to add more value or perceived value to the client, and provide a more involved service (for which they can charge fees);
- Rapid developments in platform technology; and
- Regulatory changes<sup>7</sup> that required fee for service remuneration.

<sup>3</sup> IMAP: <https://www.imap.asn.au/publications/latest-news>

<sup>4</sup> Source: Responses from our s912C notice to non-platform Target Entities.

<sup>9</sup> Morgan Stanley Research Asia Insight June 22, 2016.

<sup>6</sup> State Street Global Advisors SPDR ETFs/Investment Trends 2019 Managed Accounts Report.

<sup>7</sup> Particularly, the Future of Financial Advice (FOFA) reforms in 2012-2013, which introduced further changes in the form of:

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- a. a ban on most conflicted remuneration structures, including commissions and volume-based payments, in relation to advice about a range of retail investment products; and
  - b. a duty for financial advisers to act in the best interests of their clients and place the best interests of their clients ahead of their own; and
  - c. continuing professional development requirements.

## F Industry participants

### Financial Adviser and Financial Adviser dealer groups

- 20 Financial Advisers' recommend managed accounts to investors. Financial Advisers need an Australian Financial Services Licence advice authorisation to provide advice to clients on MDAs (for MDAs) or MIS (for SMAs), as well as to be able to act as an Investment Manager limited to the type of investments they are authorised under the MDA contract or the PDS.
- 21 Of all the financial planners and advisers in Australia, 11% are bank branch network, 33% are affiliated with a dealer group, 32% are independent and 24% own an AFS Licence<sup>8</sup>. The discretionary account take-up among planners that are affiliated with a dealer group is higher and with dealer groups with higher FUM.

### MDA Investor profile – Industry

- 22 According to Investment Trends, there are currently 2.7 million Australians who are currently receiving financial advice and 2.1 Australians who are aged 45 and above who would like to get financial advice within the next 2 years<sup>9</sup>.
- 23 Of the 2.7 million Australians currently receiving advice, 35% or 945,000 are invested in discretionary accounts<sup>10</sup>. It is projected that this will rise to 51% by 2021<sup>11</sup>. As such, half of the investors going to a Financial Adviser are likely to be put into a discretionary account.
- 24 In the Street Global survey of 700+ advisers, 27% of advisers think managed accounts are suitable for balances of \$100,000 or less, while the vast majority (58%) believe it is appropriate for affluent clients (with investible assets of \$250,000 to \$1 million)<sup>12</sup>.

<sup>8</sup> Investment Trends – the future of the Platform and Wealth Management Industry Presentation at the 19<sup>th</sup> Annual Wraps, Platform and Master Funds Platform Conference.

<sup>9</sup> Investment Trends – the future of the Platform and Wealth Management Industry Presentation at the 19<sup>th</sup> Annual Wraps, Platform and Master Funds Platform Conference.

<sup>10</sup> Investment Trends entitled *Managed Account Reports 2018, April 2018 (ASIC use only)*.

<sup>11</sup> Investment Trends entitled *Managed Account Reports 2018, April 2018 (ASIC use only)*

<sup>12</sup> Evolution of the Managed Accounts Sector Brings New Benefits for Planners and Clients - State Street Global Advisors SPDR ETFs/Investment Trends 2019 Managed Accounts Report.



## MDA Investor profile – Target Entities

- 25 While we can't draw comment on the industry as a whole, from the Target Entities we surveyed, it appears that the average client of the Target Entities is over 50 years old with a before tax income of \$140k and over \$350k invested. The average income of clients varied between MDA Providers from \$100k **Section 45** to over \$170k (**Section 45** estimate based on response).
- 26 While age and investment demographic information was provided by most of the MDA Target Entities, only 4 operators provided a response about client income, one of which only provided an aggregate average. We understand that in most cases that this information is available but not easily accessible.

## Platforms

- 27 Platforms provide access and technology that deliver discretionary accounts. As at 30 June 2019, there are 93 Australian Financial Services Licensees authorised to operate a Platform. We are unsure how many of these entities are operating one but there are, however, 20 major Platforms that are owned by 12 entities. 16 of the 20 offer discretionary accounts:

Platform	Provider	Feature platforms (not scored)	Provider
AMP Flexible Super	AMP	managedaccounts.com.au	managedaccounts.com.au
North	AMP	Powerwrap	Powerwrap
Asgard eWRAP & Elements	BT Financial Group	Praemium	Praemium
BT Panorama	BT Financial Group	Spitfire	Spitfire
BT Wrap	BT Financial Group	Wealth02	Wealth02
CFS FirstChoice	Colonial First State		
CFS FirstWrap	Colonial First State		
HUB24	HUB24		
IOOF Pursuit Select & Focus	IOOF		
Linear	managedaccounts.com.au		
Macquarie Wrap & Accumulator	Macquarie		
Mason Stevens	Mason Stevens		
MLC MasterKey	NAB/MLC		
MLC Wrap	NAB/MLC		
Netwealth	Netwealth		
OneVue	OneVue		
Perpetual Private Wrap	Perpetual		

- 28 Netwealth is the most widely used discretionary account Platform (IDPS with related party RE that offers SMA and White label MDAs), closely followed by Praemium (IDPS and RE that offers SMA), Macquarie Wrap (IDPS with related party RE that offers SMA and White label MDAs), HUB24 (IDPS that offers Model Portfolios) and MLC (IDPS with related party RE that offers SMA). As a result of the Royal Commission vertical integration issues, we understand that more Financial Advisers are looking for more independence

from the Platforms, which could mean, Netwealth and HUB 24's (who are non-bank-affiliated Platforms) market share is expected to rise.

- 29 The non-platform Target Entities regularly review internal and external Platforms for onboarding and monitoring based on several factors. This review includes factors such as Platform functionality, product offerings/investment menus, costs, scale and technology, and corporate structure and administrative capabilities. The dominant factors across the responses focus on how the capabilities and functionality of the Platform are relevant to the clients. Investment menus and Platform tools were the most common priorities.

## Investment Managers

- 30 The share of discretionary accounts flows invested through external managers has risen at the expense of dealer group or practice run models, with external managers now receiving 58% of flows, on average (up from 52% in 2017). Financial Advisers use a wide variety of Investment Managers and MDA Providers as part of their discretionary account advice, with Morningstar IM (used by 11%), DNR Capital (9%) and iShares/BlackRock (5%) being the most widely used<sup>13</sup>.
- 31 Most of the Target Entities have internal Investment Managers which take responsibility for reviewing investments, and approving products and Model Portfolio. In most Target Entities, Model Portfolio development is also managed internally. Some Target Entities use research houses to consult in the development and implementation of the Model Portfolio<sup>14</sup>. However, the Target Entities also offer access to the products in related-party or third-party Platforms in addition to their own Model Portfolio.
- 32 The top five drivers of Investment Manager selection amongst our Target Entities are:
- Investment philosophy 41%
  - Low cost 40%
  - Dealer group preference 39%
  - Past performance 38%
  - Brand/reputation 36%.

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<sup>13</sup> MDA Report, p 15.

<sup>14</sup> Section 45

- 33            Some Limited MDA Providers or small adviser groups do not have internal Investment Managers and do not charge investment management fees. There are 47 entities that are Limited MDA Providers.

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## G Benefits of discretionary accounts

### Non-economic benefits of discretionary accounts

34 Based on our research, discretionary accounts are perceived to deliver the following key non-economic benefits both for Financial Advisers and investors relative to traditional advice or MIS. However, some of the advantages listed below may be overstated and must be balanced by the additional 'clipping of the ticket' that an MDA Provider can charge (in addition to any Platform fees and of course the management expense ratio of any pooled vehicle). Critically, advice to move from a pooled vehicle (super or non-super) into an MDA account, on a Platform or otherwise, may itself be conflicted advice because the MDA Provider may be motivated by the additional fees it can charge.

#### *Key Benefits to Financial Advisers*

- (a) *More efficient advice business model* - Reduces administration burden on advisers allowing advisers to have more time to spend in discussing goals and strategy with clients. Financial Advisers estimate they save 12.4 hours per week on portfolio management tasks by using discretionary accounts<sup>15</sup> than traditional advice.
- (b) *Increases sales for advisers* – digitally savvy advisers who embrace social and digital channels outperform their peers by 200% and 80% of social advisers gained new clients with an average assets gain attributed to social media use of \$4.9m<sup>16</sup>.

#### *Key Benefit to Investors*

- (c) *Enhanced Transparency* – although more of a benefit in using a platform and more emotional than real, investors can easily access the details and performance of their investment on a single dashboard<sup>17</sup>, i.e. an investor can see where their money is invested and when investment decisions are implemented on their behalf and can see what is driving the performance or underperformance in their accounts. The Platform functionality also provides consolidated information about investor

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<sup>15</sup> MDA Report, p.15.

<sup>16</sup> The Putnam Social Adviser Survey, July 2016 for 1018 US Advisers.

<sup>17</sup> Evolution of the Managed Accounts Sector Brings New Benefits for Planners and Clients - State Street Global Advisors SPDR ETFs/Investment Trends 2019 Managed Accounts Report

assets. This structure works well for technologically savvy clients who demands that all their financial transactions be accessible through a smartphone or app, all transactions be transparent, do not want to be involved in every portfolio decision and wants their Financial Advisers to be easily accessible and engaging. 58% of 170 financial planners surveyed by Investment Trends use this as the selling point to clients.

From our reading of some disclosure documents of MIS, it is not the case that all investors receive full transparency of the assets as some Investment Managers elect to disclose only the top 5 holdings, to maintain the confidential proprietary nature of the intellectual property. In any event, it seems reasonable for MDAs to provide transparency as there is usually a small number (less than 20) different securities in a Model Portfolio and a handful of other assets, if any. By contrast, a managed fund may have several 1000 different securities, as well as complex interposed entity structures, which can make full portfolio holdings disclosure problematic.

- (d) *Investors have more control* – investor can set investment parameters and rules regarding how their portfolio are managed, including investment exclusions and substitutions, trade sizes and tax preferences as compared to traditional MIS where investors can't tailor their portfolios based on their individual needs and risk profile.

Although this benefit is weakened by the premise of discretionary accounts that the client is giving up control and giving broad discretion to the MDA operator, this benefit is still argued on the basis that the discretion to the MDA Provider is not that broad – i.e. the discretion has to be within the investment strategy agreed to by the client (e.g. client wants his money invested in balanced model portfolio) and the MDA Provider discretion is limited to the rebalancing of the portfolio within the investment strategy chosen.

The counter argument to this is that pooled managers can, and should, manage taxation events in the pooled vehicle equitably so that there is no detriment to remaining investors. Pooled vehicles are generally used as a long-term investment strategy so that short term market, fund in-flows/out-flows and taxation events have less of an impact over the long term.

*Portability* – Although may not necessarily be unique to MDAs, investors can move from one model manager to another or manage the account themselves without selling the assets and consequently triggering capital gains or buy-spread cost<sup>18</sup>. The assets can also be

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<sup>18</sup> Ibid, page 47.

transferred from one Platform to another without cost, except some Platforms might not accept the transfer<sup>19</sup>.

## Dollar value in investing in MDAs

35 There is currently no discretionary account fee and performance data released by a research house which makes comparison with fees and performance of discretionary accounts and managed funds possible.

36 We also found that the complex and unique nature of the discretionary account structures and offerings make comparisons of discounts and features difficult to benchmark. Further, a range of people (e.g. AFS licensee's investment manager, or a consultant who works with advice practices) may negotiate discounts from fund manager. These discount agreements will also be confidential and commercially sensitive to disclose.

37 However, we understand that investment in discretionary accounts generally attract three type of fees with potential cost savings (as applicable) when compared to managed funds:

- **Advice Fee** – fees payable to a Financial Adviser for the initial and ongoing advice. Financial Advisers don't charge more for putting their client into discretionary accounts. On the contrary, we understand that some Financial Advisers pass the administrative savings (e.g. not having to prepare Statement of Advice each time a portfolio is rebalanced) to their clients by charging lower advice fees for clients in discretionary accounts than clients that are not in a discretionary account.
- **Product or service-related fees** – fees that attach to the product like: investment fee (fee to Investment Manager), performance fee (fee where Model Portfolio outperforms the benchmark) and **transaction** fee (fees payable for cost incurred in the execution of trade and separate from the brokerage fee). All financial products, including managed funds, attract product related fees. It has been submitted to IM by industry that product fees for discretionary accounts are in certain instances cheaper than managed funds product fees. IM, however, has no conclusive data on product fees of MIS and MDA to be able to

<sup>19</sup> Section 45

compare whether product fees for discretionary accounts are in certain instances cheaper than managed funds product fees.

As an example, assume managed fund and MDA both offer the same Australian equities and managed fund portfolio (**Portfolio**) constructed by external portfolio manager Lonsec:

- The purchase price for Portfolio is cheaper in a MDA than managed fund because some MDA Providers get a 25 to 30% discount from the headline retail rate<sup>20</sup>. Platforms can get discounts too – and this may not be unique with discretionary accounts;
- Because of the structure and regulatory requirements under which managed funds operate, managed funds incur expenses like securities dealing, financial reporting, legal and compliance cost and share registry that are ultimately passed on to investors as part of the fees. These expenses are not incurred by MDA Providers. As such, investors pay less product related fees for MDAs than managed funds. In addition to these expenses, some small MDA Providers or Limited MDA Providers who do not have Investment Managers do not incur Investment Management fees. Hence, because the Indirect Cost Ratio (ICR) for running a managed fund may be more than the ICR for running a MDA, investors can get the same Portfolio in a MDA cheaper than in a Managed Fund. This argument submitted to IM by industry may be flawed as underlying transaction costs (broking, registry) will still occur. Savings of financial reporting costs and compliance costs may be false economy. IM, however, has no conclusive data on operational cost incurred by managed funds and discretionary account providers and what percentage of the cost are absorbed by the business and passed on to consumers to be able to compare whether product fees for discretionary accounts are in certain instances cheaper than managed funds product fees.
- managed funds may charge other service fees like RE termination fee, withdrawal fees, switching fee, in-specie transfer fee which MDAs do not charge.
- **Platform Fee** – These are fees that are payable to the Platform in payment for the technology and administration services. A table of the dollar amount of administrative fees charged by 15 Platforms is provided in Appendix 3.

An investor will incur a Platform fee whether a portfolio is purchase through a managed fund or a MDA structure for as long as purchase was made in a Platform. If the purchase was made outside the Platform

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<sup>20</sup> Advisers using managed accounts to squeeze managers, Financial Planner, 29 March 2019: <https://www.professionalplanner.com.au/2019/03/advisers-using-managed-accounts-to-squeeze-managers/>

and through a managed fund, then this is the extra fee that attaches when an investor buys in a MDA structure.

IM, however, has no conclusive data on product and operational cost incurred by managed funds and discretionary account providers and what percentage of the cost are absorbed by the business and passed on to consumers to be able to make a definitive determination on the value for money proposition. The MDA Project did not really examine the fee structures in depth, and we did not survey a representative number of MDAs to get a consensus on fees. The MDA Project only looked at 8 MDA Providers and adviser groups.

We also expect that individualised discretionary portfolios will be less likely to achieve economies of scale, so the cost may be higher cost.

38 Even assuming that the cost on paragraph 4(a) above and paragraph 4(b) in both managed funds and MDA are the same, it is submitted to ASIC by industry that the net tax position of an investor in a MDA is better than net tax position of an investor in a managed funds, especially where the Portfolio is comprised mostly of Australian equities and ETF, because investors only pay capital gains for when assets are held and are able to offset gains with other income tax losses in the calculation of their person income tax. IM did not receive a tax advice on this and is unable to substantiate this view.

39 Finally, it was also been submitted by Lonsec, an external investment manager for REs and MDA Providers, that the ability to rebalance portfolios as soon as market moves as compared to the time it takes (i.e. could be days or months) to rebalance where individual instructions are needed to obtain, minimises losses for investors. IM is of the view that this may be true in most instances as it would take time for the Investment Manager to communicate to advisers the need to rebalance – for advisers to get instructions from all of their clients – and for instructions to be communicated back to the platform for execution and the market may have moved again by then.

40 As such, considering paragraphs 36 to 38 above, IM is of the view that it is plausible that purchasing the Portfolio through a discretionary account rather than through a managed fund can result in better financial outcome for investors in certain instances. However, IM has no conclusive data on product and operational cost incurred by managed funds and discretionary account providers, and what percentage of the cost are absorbed by the business and passed on to consumers and the individual tax impact comparison between investors in managed funds and discretionary accounts to be able to make a definitive determination on the value for money proposition. The MDA Project did not really examine the value proposition in-depth and we did not survey a representative number of MDAs to get a consensus on fees and did not look at PDS disclosures on fees and cost. The MDA Project only looked at 8 MDA Providers and adviser groups and the



fee data we gathered were limited to nature of, basis of the fee and how investors paid for fees and not the quantum of the fees.

## Best interest determination

- 41 Whether or not a discretionary account service is financially more beneficial to an investor than holding interest in equities directly or holding interest in a balanced fund is ultimately a question of whether the product is in the “*best interest of the client*” that has to be determined by the adviser or other intermediary of the client in view of the client’s risk preference and preferences. Some aspects of the value proposition are subjective, and it is hard to draw conclusions based on data.

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## H Complaints

42 ASIC received 39 discretionary account related complaints from the period commencing 29 September 2016 to 30 June 2019. The date of 29 September 2016 was considered as it marked the commencement of the instrument *Instrument 2016/968*.

NATURE OF THE COMPLAINT	Number
Client losses due to failure of RE/MDA Provider and Financial Advisers to act in the client's best interests	10
MDA Providers not reporting performance of model or actual investor portfolios	8
Unauthorised MDA service	21

43 On review, it was ascertained that the 10 complaints reporting losses due to failure of RE/MDA Provider to act in client's best interests were clients/reporters who received financial advice from Financial Advisers who were not sufficiently trained or experienced in advising on discretionary accounts.

44 On review, it was ascertained that the 8 complaints reporting MDA Provider non-reporting of model or actual investor portfolios performance were primarily a compliance oversight (i.e. computer systems generated reports) that were subsequently remediated, or potential misleading offerings from unsolicited callers.

45 On review, it was ascertained that the 21 complaints reporting unauthorised MDA services including three cases where international offerings were being solicited without ASIC approved reliance on class order relief as a foreign financial services provider. A number of other cases were internal reports from Licensing or subjects close to the reported entity.

46 Given low numbers of the Complaints and the nature of the complaints in relation to the number of REs and MDA Providers, it appears that there is no widespread dissatisfaction or issues being reported to ASIC in relation to the discretionary accounts. We note that these figures are in the back of a robust financial market.

## I Risks and Recommendation

47 Risks are inherent in the provision of all types of financial services and products. We considered the various risks specific to the provision of discretionary accounts (as opposed to risks that attaches to any financial product or service, including discretionary accounts<sup>21</sup>). The risks and proposed action for each risk are detailed below:

- (a) *Low barriers to entry* - MDA Operators, unlike REs and IDPSs, are not required to hold NTA. They are only required to hold a Surplus Liquid Funds of \$50,000.

It is recommended that when we consider making changes to RG 166 and impose NTA requirement to MDA Providers similar to REs and IDPSs and think about whether an exemption should be given to or less NTA be required of Limited MDA providers (See also RPG submission to MDA Review 2016).

- (b) *Lack of understanding* - There is a lack of understanding in the market around differences between discretionary account structure and

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<sup>21</sup> Risks attaching to MDAs and any other financial product and service, includes:

- a. ***Misleading advertising*** - There is an increased risk of presenting misleading or deceptive past performance figures for MDAs. This is because MDA providers sometimes advertise performance of model portfolios that may be different to the performance of actual portfolios and advisers are offering a bespoke service<sup>21</sup>.
- b. ***Technology risk, including navigational issues and tracking errors*** - This is where a client's account portfolio performance does not exactly 'track' the performance of the theoretical model portfolio even when it is fully replicating the model. This can occur due to factors such as technology limitations and minimum parcel sizes for underlying investments making it impractical to buy or sell the exact number of securities to match the model. There is a risk that investors will lose money as a result of the error.
- c. ***Client loses due to the failure of the Financial Adviser's to act in the client's best interests*** - This includes product suitability, value for money of recommended product, investment risk and concentration,
- d. ***Conflicts*** relating to vertical intergration, remuneration and conflicts arising from product manufacturer also being involved in product distribution via in-house channels, such as related platforms, dealer groups and Financial Advisers.
- e. ***Clients are not aware of the fees or whether or not fees charged complies with FOFA*** - fees or other cost leakages that may not be apparent to clients (e.g. brokerage fees, cash rate margin, non-product fees e.g. insurance, orphan fees) and whether fees comply with FOFA or conflicted remunerations. These issue was raised in Royal Commision.

products and service<sup>22</sup>, how the products or service are regulated and the requirements or risk for each offering<sup>23</sup>. The complexity of the structures involving multi-players and multi-layered fee arrangements is also not aiding consumer understanding. If consumers don't understand what they are being sold, there is a risk that Financial Advisers might abuse their discretion.

It is recommended that we release a consumer focus communication regarding MDAs in Money Smart as an immediate short-term solution and recommend that RG 179 be revised to create certainty in regulatory settings.

- (c) *Operational risk (including fraud)* – there is a risk that the person who exercises discretion over investor's money misappropriates funds/assets, over-sells assets without obtaining client approval and churns client's portfolios to obtain brokerage fees in the guise of portfolio rebalancing. This risk is heightened with the lack of compliance and legal support.

It is recommended that we look into the requirement relating to discretion in RG 179 to ensure that investors are aware of the scope of authority given to the MDA provider.

- (d) *Underperformance* – Financial planners are attempting to design and implement discrete discretionary portfolios to outperform major institutional fund managers. It will be difficult to outperform, net of fees and costs, compared to conventional funds. As such, there is a risk that the model will not perform as investors expected.

It is recommended that we require MDA Provider to report on the performance of the model, performance of the actual portfolio and compare the performance of the actual portfolio against a benchmark annually in RG 179.

- (e) *Potential for loss* - As with managed funds, investment in discretionary accounts also carries a risk that investors lose their money due to the failure of the RE or MDA Provider to perform its fiduciary duty to act in best interests of investors. This duty covers the development<sup>24</sup> and

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<sup>22</sup> Products are called SMA, MDA, IMA, UMA, Managed Portfolio and the service can be called: managed account, discretionary account, managed discretionary account, guided portfolio service and portfolio management.

<sup>23</sup> Source: [https://www.fsadvice.com.au/media/library/FS\\_Advice/FS\\_Advice\\_-\\_Understanding\\_and\\_selecting\\_managed\\_account\\_services\\_-\\_Par.pdf?3ffaa](https://www.fsadvice.com.au/media/library/FS_Advice/FS_Advice_-_Understanding_and_selecting_managed_account_services_-_Par.pdf?3ffaa)

<sup>24</sup> Development means that the model portfolio true to label, e.g. growth portfolio has growth assets in it, or low risk portfolio has predominantly low risk assets in it. It also includes RE and MDA provider's obligation to regularly

implementation<sup>25</sup> of Model Portfolios, supervision of Investment Managers, monitoring the provision of financial advice in relation to its products and compliance by financial advisers with its best interest duties, training requirements and FOFA, effective risk management systems to manage risks and having robust corporate governance procedures.

It is recommended that RG 179 be revised to articulate what best interest means in the provision of MDA service or in the offering of a MDA product consistent with policies that applies to REs, including under RG 259 and RG 134.

- (f) *Potential for loss* – due to the lack operational controls and risk management, qualification and training requirements on Investment Managers in the development and implementation of Model Portfolios, including qualifications relating to the underlying asset class. We have also found RE's and MDA Providers for hire who are not effectively monitoring the Investment Manager of the dealer group who are distributing products under its Australian Financial Services License.

It is recommended that RG 179 be revised to include ASIC's expectations on the qualifications of Investment Committee and on the governance procedures that needs to be put in place over Investment Managers. There is a need for this guidance in view of the wide difference in standards between the big end of town and the smaller advice and broker firms. However, any proposed guidance should consider the impact it will have on small operators who currently have no Investment Manager and are more service providers than product issuers.

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supervise and monitor its Investment Committee or dealer group Investment Committee and monitor Model Portfolio performance, liquidity and weighting.

<sup>25</sup> Implementing model portfolios includes obligation to ensure that the Model Portfolio is still true-to-label, i.e. in terms of its performance, risk label, diversification, liquidity and it continues to suit the strategy, risk profile and investment horizon of the investors invested in it. It also includes Re's and MDA Provider's obligation to regularly supervise and monitor its Investment Committee or dealer group's Investment Committee and ensure that Model Portfolio is true to form and performing if it is to continue to be listed in the product list.

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## J Further work for 2019-2020 financial year

- 48 In the 2019-20 financial year, IM will consider and implement changes to ASIC's guidance and legislative instruments in relation to MDAs and similar arrangements. This work will be carried out under the *Revisiting policy settings in MDA regulatory guides* project (project ID B09). For this project, Section 22 is the Project Sponsor and Section 22 and Section 22 are the Project Co-Leads.
- 49 The findings and recommendations detailed in this Report will be the starting point for the project work in 2019-20. The objective of the project is to raise standards amongst operators of MDAs and similar arrangements for the ultimate benefit of consumers.
- 50 The 2019-20 project will include updates to ASIC's guidance in RG 179 and RG 166, plus amendments to Instrument 2016/968. We plan to issue a Consultation Paper in January 2020 in relation to the planned changes to Regulatory Guides and legislative instruments. We intend to publish the revised Regulatory Guides and issue new or amended legislative instruments between June 2020 and September 2020.
- 51 The following matters are excluded from the scope of the 2019-20 project:
- (a) a review of any advice files;
  - (b) a consideration of the fees and costs disclosure by Platforms in RG 97, which is part of a separate project;
  - (c) any surveillances of MDA Provider;
  - (d) Platforms generally (including IDPS operators), including any surveillances; and
  - (e) consideration of the policy settings relating to Platforms in ASIC Regulatory Guide 148 – *Platforms that are managed investment schemes and nominee and custody services*, which may form part of a future Business Plan.