SUBMISSION TO THE INTERIM REPORT OF THE ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

Institute of Managed Account Professionals Ltd

About the Institute of Managed Account Professionals Ltd (IMAP)

IMAP was established as an industry group in 2008. Its purpose is, "Education, Information and Representation of Managed Account Professionals" and today it comprises over 20,000 subscribers, drawn from specialisations across the financial services including financial advice, investment management, administration and financial technology.

IMAP operates exclusively in Australia and organises a series of conferences, webinars and other educational events. In addition, IMAP organises the annual managed accounts awards event, designed to celebrate best practice and it publishes a quarterly magazine.

IMAP's constituents are drawn from advice, investment management, platform and custody, technology and legal providers.

About Managed Accounts

1. Background

Managed accounts have become a significant part of the means by which personal financial advice is implemented. They allow the separation of roles between advice, portfolio management and administration with each function allocated to a specialist with the result that each is performed in a more professional manner. This is in contrast to the typical advice relationship where advisers select from a broad APL and provide services on a periodic basis.

Over time, the managed accounts industry has evolved significantly, leveraging improvements in operational, investment management and asset management functions, along with advances in technological, to further professionalise, industrialise and revolutionise the management of clients' direct equities portfolios. Managed accounts enable the efficiencies of pooled investments, with the control, transparency and preciseness of a personalised investment portfolio. Managed accounts can provide investors with access to any financial asset, but for retail investors, in practice, typically comprise of ASX listed shares, managed funds, cash, ETFs / LICs / LITs and tradeable fixed interest investments. Clients retain advantages of beneficial ownership of underlying assets in their portfolio (eg. tax implications can be managed at a portfolio level as part of the investment strategy, rather than tax and other expenses being pooled within a unit trust or managed fund structure)

2. Market Size

A number of financial services legal structures – registered managed investment schemes, Managed Discretionary Accounts (MDA), IDPS with standing instructions, IDPS like schemes – can be used to offer a managed account service. Each is subject to its own regulation. Only MDAs must be offered under personal advice to retail clients. The table below shows the FUM associated with the main types of managed account as at 30 June 2018[1]

[1] IMAP research

	30 June 2018 ($BN)	30 June 2017 ($BN)
Registered MIS: SMAs	$20.55	$13.90
Unregistered MIS: MDA	$27.34	$23.37
IDPS & IDPS like	$14.54	$10.70
Total managed accounts	$62.43	$47.97

3. Legal Structures

Managed accounts are currently offered to retail investors in Australia under four legal structures;

1. Unregistered managed investment schemes called “Managed Discretionary Accounts” (“MDA”) Investors make application to these schemes via MDA contracts issued by MDA Providers and, as part of the client subscription, specific investment programs are requested.

   MDA providers in some cases may outsource some services, including administration services, personal financial advice or custodial services. Where the arrangement involves an External MDA Adviser / Custodian, the adviser/custodian are contractually responsible directly to the client.

2. Unregistered managed investment schemes called Investor Directed Portfolio Services (“IDPS”), with standing instructions. Investors make application to these schemes via IDPS guide which are issued by Platform Operators.

   Essentially, through the operational and investment efficiency of a platform structure, IDPSs provide benefits of netting, access to wholesale investments and cost efficiencies. As part of the client subscription, specific model portfolio(s) can be identified and customised as required. As with an MDA, an adviser is required to identify the appropriate investment strategy.

3. Registered managed investment schemes: designed as Investor Director Portfolio Services like (“IDPS like”). Investors make application for an interest in the scheme via product disclosure statements (“PDS”) issued by the Responsible Entity (“RE”).

   IDPS like schemes operate in much the same way as an unregistered IDPS, however, the RE must meet certain additional regulatory compliance requirements, including investment governance. Further, being a registered managed investment scheme, investors can select model portfolios to suit their investment objectives and may be able to access the scheme without personal advice. Platform, custodial and administrative services are managed and procured by the RE.

4. Registered managed investment schemes: designed as Separately Managed Accounts (“SMA”). Generally offered in the form of a Financial Product, Investors make application for an interest in the scheme via product disclosure statements (“PDS”) issued by the Responsible Entity (“RE”).

SMAs allow investors to select model portfolios, in line with their objectives, from an investment menu. An SMA builds further on the robustness of the registered managed investment scheme premise, since the RE is ultimately responsible for the effectiveness and governance of the investment options (model portfolios and customisations) that are available via the scheme, regardless of whether an external investment manager, dealer group or adviser is appointed. Whilst providing transparency and flexibility of investment decisions through the selection of model portfolios and assets within the investment menu, SMAs operate more like a financial product in and of themselves, rather than an investment service.

4. **Investment Management in Managed Accounts**

Several standard models have emerged for the management of investments held in managed accounts:

- Investment management is outsourced in full, typically to a research house which manages asset allocation, underlying manager selection and sometimes individual security selection.
- Separate managers are appointed to manage components of a client portfolio under the direction of an investment committee appointed by the RE, MDA Provider or IDPS Operator. Many large well known institutional global asset managers are aligning their product architecture to participate in the opportunity, oftentimes bringing highly competitive pricing. And we also have emerging new specialist businesses eager to compete.
- The advice licensee can also act as investment manager where the business has the relevant skills and experience and authorisations.

Under the managed account structure, the management of the client's portfolio is the legal responsibility of the issuer with the protections that the Corporations Act and relevant regulations provide.

Professional and consistent investment management is thereby provided to all clients in a managed account service equally. Decisions are made in response to market action rather than the typical approach in an adviser directed processes where client outcomes are determined by the randomness of calendar schedules or size of client portfolios, either of which might be the driver of when an adviser can communicate with the client.

Documented investment mandates are required to clearly outline portfolio objectives and risk levels with predetermined mixes and ranges of asset exposures/investment strategies. Through an investment committee, investment professionals are appointed to control weightings to ensure outcomes that are equitable to all clients and in the confidence that the service is delivered consistently.

5. **Summary of Managed Accounts Benefits**

Managed accounts have been adopted as widely as they have and are continuing to grow rapidly because they offer benefits for all parties. These may be summarised as:

For Clients:

- Portfolio management is undertaken by an investment team charged with developing portfolios to a specific mandate. This is likely to lead to a higher standard of professionalism applied to each model portfolio than is generally available from an individual adviser.
- Speed of implementation of portfolio decisions given portfolios are subject to continuing oversight rather than the periodic review which is often the case when clients and advisers meet semi-annually or annually.
- Each client's portfolio can be customised more specifically to their circumstances than is possible through a diversified pooled investment such as a unit trust or is offered by the generalised investment options offered to hundreds of thousands of members in a superannuation fund.
- The client's confidence should increase from the knowledge that the portfolio will continue to be managed in accordance with their predetermined objectives even if they are not available to approve each transaction.
- Reduction in total costs since managed accounts are often associated with a shift to lower cost investments such as directly held portfolios of shares or ETFs or through the portfolio manager arranging for rebates on the cost of managed funds which are credited to each client. In addition, the scale benefit of block trading means lower trading costs than if transactions were implemented on individual holdings.
- Greater transparency of holdings than is offered in pooled investments with technology enhanced user experience delivering immediate relevant personal information.
- Greater transparency of costs both on inception of investment and on an ongoing basis.

For Advisers and Licensees:

- The roles of personal advice and portfolio management are clearly separated, supported by the appropriate licensing and skill set for each role, even if fulfilled by the same licensee and involving compliance with the separate obligations of each authorisation.
- Substantial improvements in the efficiency with which portfolio decisions can be implemented for each client.
- Resultant cost savings in administration leading to lower costs for clients.
- Confidence that portfolio decisions are implemented for all clients more or less concurrently and that no client suffers from being "last in the queue".
- Confidence that portfolios continue to be managed in accordance with the agreed investment objectives. Such investment programs can be constructed with increased flexibility, personal tailoring and sophistication of investment strategy as may be required to meet client objectives.

RESPONSE TO SPECIFIC QUESTIONS RAISED IN THE INTERIM REPORT

Introduction

The Royal Commission has drawn attention to misconduct within the financial services industry and financial advisory businesses which have caused many observers and members of the public to question the fundamental integrity of an industry that ought to be characterised by adherence to fiduciary standards.

IMAP wants to illustrate by reference to five of the "particular issues" raised by the Royal Commission regarding Financial Advice (see Chapter 10, Sect 2 pp 330/1/2) that managed accounts are services that:

- are likely to improve client outcomes,
- lead to a more efficient and sustainable advice profession, the benefits of which are demonstrably passed on to clients in lower costs, and
- support the separation of roles which encourages specialisation and professionalisation.

PAGE 330: CAN CONFLICTS OF INTEREST AND DUTY BE MANAGED?

IMAP recognises that actual or potential conflicts of interest may arise for advisers, advice licensees or managed account providers. Those conflicts include, through the recommendation of managed accounts, preference for a managed account product or service in which:

- the advice licensee or a related party has a financial interest in the managed account service, the underlying investments or associated transaction revenue ("in house product"), or
- The adviser benefits from operational benefits and consequent practice efficiencies to the adviser, or
- The managed account service is offered as part of a broader service by a key service provider, such as a platform, but has an investment selection which is of necessity a subset of all available investments.

Each of these representative conflicts gives rise either to a direct financial interest on the part of the adviser or advice licensee or an indirect benefit through an improvement to the operational efficiency of the advice business.

The Treasury Submission on Key Policy Issues 13 July 2018[2] identifies three generic sources of conflict:

- The remuneration structure of financial advisers...;

[2] https://financialservices.royalcommission.gov.au/publications/Documents/Treasury-background-paper-24.pdf paragraph 166

- Financial advice business models, and incentives to create ongoing advice relationships with customers; and.
- Integrated business models that combine financial advice with other financial products and services.

The types of conflict we list above are examples of the third issue identified by Treasury.

Substantial work has already been undertaken by ASIC and other Government agencies to identify and address conflicts and the way these are treated by advisers and financial product manufacturers. These include the FoFA reforms, the Royal Commission, ASIC 2018 Report 562 *Financial Advice: Vertically integrated institutions and conflicts of interest*, increased powers for ASIC, impending changes to Design and Distribution obligations.

As a result, in recommending managed accounts there are more protections for retail investors than apply in other areas of retail financial services. These include:

- Fiduciary standard Best Interest obligations of Responsible Entities and MDA Providers
- Best Interest Duty obligations of providers of personal advice to retail clients
- Extensive disclosure of fees under RG97 both initially and on an annual basis
- Obligations on Superannuation Trustees to review products offered through their platforms

We note that Treasury is of the view [3] that the actions taken to date and heightened awareness by AFS Licensees, “act to mitigate the misconduct risks involved”

Given the extensive consumer protections in place, we maintain that, in regard to managed accounts, conflicts of interest and duty can be effectively managed.

[3] Ibid paragraph 205

PAGE 330: HOW FAR CAN, AND HOW FAR SHOULD, THERE BE A SEPARATION BETWEEN PROVIDING FINANCIAL ADVICE AND MANUFACTURE OR SALE OF FINANCIAL PRODUCTS?

PAGE 331: SHOULD FINANCIAL PRODUCT MANUFACTURERS BE PERMITTED TO PROVIDE FINANCIAL ADVICE?

- **At all?**
- **To retail clients?**

ASIC provides AFS Licence authorisations to issue financial products – registered managed investment schemes, MDA's or IDPS - to those AFS Licensees which have adequate resources to provide these services, whose staff have appropriate knowledge and experience, and which meet other conditions, for example Net Tangible Assets (NTA).

ASIC provides a set of authorisations related to the provision of personal financial advice to retail clients.

Each set of authorisations is accompanied by specific conditions as well as the general requirements to comply with the law and relevant regulations. Responsible Entities and MDA Providers have explicit and substantial obligations to act in the best interest of clients. These product obligations are in addition to the obligations that apply to the way in which advice is to be provided.

It is not inappropriate that a single AFS Licensee, or related entities which are both AFS Licensees, should hold the authorisations to issue interests in financial products or to provide advice, so long as the organisation complies with all the legal obligations attendant on the authorisations they hold.

The law requires an adviser to comply with the Best Interest Duty (s961B(1), s961 G and s961 J in respect of giving personal advice to retail clients on in-house products. Advice licensees must ensure that advisers comply with these regulations.

IMAP does not support restricting the rights of an appropriately authorised AFSL to provide personal financial advice to retail clients in respect of managed accounts with which it, or a related entity might be associated. This is because;

- the advantages of managed accounts articulated elsewhere in this document represent material benefit to the clients, and
- managed accounts should be viewed as a way of implementing advice rather than an investment in their own right, even though the law considers a managed account as a separate financial product from the underlying investments.

To the extent that structural separation is mandated, managed accounts should be exempt because of the benefits they provide clients in the implementation of the advice received.

PAGE 331: SHOULD AN AUTHORISED REPRESENTATIVE BE PERMITTED TO RECOMMEND A FINANCIAL PRODUCT MANUFACTURED OR SOLD BY THE ADVICE LICENSEE (OR A RELATED ENTITY OF THE LICENSEE) WITH WHICH THE REPRESENTATIVE IS ASSOCIATED?

- **At all?**
- **Only on a written demonstration that the product is better for the client than comparable third party products?**

An AFS Licensee which is appropriately authorised to issue interests in a managed account is bound by explicit best interest obligations in respect of the operation of the managed account. We are not aware of regulatory action over the 14 years since the MDA regulations were issued resulting from these obligations being breached by MDA Providers or Responsible Entities in regard to managed accounts.

The adviser and advice licensee are already bound by obligations in making the recommendation which include demonstrating how the recommendation is appropriate given the client's objectives, a comparison with the client's current circumstances and consideration of other alternatives. Where the managed account is an in-house product all the Best Interest Duty obligations, s961B (1), s961G and *s961J* require a demonstration of "additional benefits".

The question includes "…**manufactured or sold by the advice licensee (or a related entity of the licensee) with which the representative is associated?"** Implicit in this is an assumption that the product will create a financial benefit for the advice licensee. However, the conflicted remuneration regime generally prohibits Advice Licensees from receiving a benefit from the managed account issuer where they act as portfolio manager for a managed account service and where the benefit could reasonably be expected to influence the financial product advice provided to the retail client.

Where the advice licensee or a related entity charges, for example, a portfolio fee to retail clients for managing the portfolio within the managed account, and the fee is deducted from the client's account, ASIC RG246 Conflicted and other banned remuneration (issued 7 December 2017), provides an explicit process for obtaining the client's clear consent for authorising these payments. ASIC expects such consent to be "genuine, express and specific.".

RG246.68-70 requires "…a client's consent could be expressly sought in a separate and distinct section of the terms and conditions agreed by the client…"

There are a considerable number of instances where as a result of developing a managed account service either as MDA Provider, RE or portfolio manager, the advice licensee has been able to deliver a cost reduction for clients compared to an advised portfolio with individual client implementation. This arises as a result of a combination of:

- scale benefits in negotiation with managers or administrators or custodians,
- use of investments which they did not believe were practical prior to the centralized administration managed accounts provide,
- integration of advice and portfolio management costs.

Any benefits obtained from underlying managers must be passed in full to the retail client or generally attract the conflict remuneration prohibition. This contrasts with the situation which applies for example in fund of funds unit trusts, sometimes considered an alternative to use of managed accounts, where discounts to investment management fees are retained by the issuer of the retail unit trust.

IMAP asserts that, in respect of managed account services, as a result of the protections in place for retail investors, an adviser should be permitted to provide personal advice on a service with which the advice licensee is associated.

PAGE 347: IS STRUCTURAL CHANGE IN THE INDUSTRY NECESSARY?

The Treasury submission to the Royal Commission[4] notes that there has been substantial work by regulators in eliminating the potential for conflicts of interest to lead to poor consumer outcomes. In paragraph 205, Treasury notes that structural changes in the advice industry and recent or imminent reforms, heightened awareness and increased ASIC attention mean that the misconduct risk arising from vertical integration should be mitigated.

IMAP concurs with this view.

As we have noted elsewhere, there are substantial protections available through the current law which apply, in particular, to the provision of managed accounts to retail investors. Principal among these are:

- Best Interest obligations of Responsible Entities, MDA Providers and IDPS Operators
- Best Interest Duty obligations of providers of personal advice to retail clients
- Extensive disclosure of fees under ASIC RG97 Disclosing fees and costs in PDSs and periodic statements (issued 29 March 2017) both initially and on an annual basis
- Transparency of holdings required under reporting obligations – MDA Services and IDPS platforms
- Reporting of all transactions within 48 hours – MDA services and IDPS platforms
- Obligatory personal advice for retail clients seeking MDA Services, including annual review of the continuing suitability of the service
- An obligation on MDA Providers, before providing the service to retail clients, to "have no reason to believe that the proposed service is inappropriate" (MDA) even where the personal advice has been provided by an appropriately authorised AFSL
- Annual investor statements, fee reporting and audit reports
- Obligations on Superannuation Trustees to review products offered through their platforms.

These obligations are more substantial than those which apply to other financial products and will be supplemented by the Design and Distribution requirements. Given the "personal" nature of personal financial advice these obligations are more likely to result in informed decisions by retail

[4] Treasury Submission on Key Policy Issues 13 July 2018

clients than any information which an issuer of a financial product could provide under a general advice constraint.

IMAP asserts that structural separation of advice from product manufacture, at least in regard to the operation of managed accounts, would be likely to be counterproductive for several reasons;

1. Encouragement of "General Advice" models resulting in substantial deterioration in advice quality
2. Reduction in efficiency of implementation of advice with resultant deterioration in outcomes for clients
3. Reduction in the ability of organisations to develop service models which meet client needs or meet the costs of technology development.

1. General Advice

There are many examples of financial product manufacturers and sales organisations which currently operate under a general advice model. These include:

- much stockbroking activity where written recommendations to buy, accumulate, hold, sell etc do not consider the suitability for any particular client's circumstances.
- many superannuation funds, including industry funds, which for example encourage account consolidation without regard to insurance consequences, relative suitability for the client of the investment option being redeemed compared to the new investment, comparative cost or performance

General advice, by definition, does not take the client's circumstances into account and frequently amounts to little more than selling.

Product manufacturers would presumably be able, and indeed required, to continue to provide General Advice in regard to their products. The Best Interest Duty obligations which apply to the provision of personal financial advice, do not apply to General Advice. These do not:

- consider the personal circumstances of the client; and
- require the advice provider to comply with the best interest duty obligations.

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2. Reduced Efficiency of Implementation

While technically managed investment schemes, managed accounts are effectively "implemented advice". They represent an efficient way for the adviser and advice licensee to maintain the client's portfolio in line with the initially agreed objectives.

The result of the adoption of managed account programs is that client portfolios have been subject to continuing review and adjustment by professional investment committees in a way which is not possible when all changes are implemented manually.

This has been achieved for costs generally less than 0.2% p.a. and has frequently been accompanied by cost reductions for the client from:

- the use of directly held listed investments which would not otherwise be practical in an advice practice,
- pressure on investment managers to reduce investment fees for managed account clients[5],
- use of lower cost investments such as ETFs, and
- reduction in costs of administration.

Without the ability to develop managed account programs, advice licensees and advisers would continue to operate manual, inefficient transaction processes.

3. Continuing Industry Development

Advice, like all areas of commercial activity, is subject to, and benefitting from, substantial technology change. This has involved substantial costs of adoption, while contributing to an overall fall in the cost to serve. The result has been an evolution in business models, integrating technology to better meet client needs and provide portfolios which accommodate their personal circumstances in far more nuanced ways than is possible with say, a small set of risk-based investment pools.

This trend will continue and is likely to accelerate.

To continue to provide "high quality" personal financial advice which is accessible and affordable, as intended by the FoFA reforms, the regulator needs to ensure that it supports models which allow advice businesses to be sufficiently profitable to support investment in development. At the same time, it needs to do this in a way which ensures conflicts are appropriately managed and clients make informed decisions.

For the reasons outline above, IMAP believes that banning AFS Licensees which provide personal advice from also being associated with or directly providing managed accounts would result in poorer outcomes for retail investors.

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This submission was prepared with the assistance of the IMAP Regulatory Group, Adam Seccombe – Chair.

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Appendix

Key Roles and Specialisations in Managed Accounts

Role/Specialisations	Principal Function
Adviser – the individual	• Personal recommendations and advice • Suitability assessments • Strategy development and relationship management
Advice Practice – the business	• Operational functionality (in case of "robo" may include automating role of adviser) • Record keeping • Corporate responsibilities
Licensee – the dealer group	• Deliver scale benefits for pricing requisite services • APL maintenance/management • Compliance monitoring
Investment Management	• Model portfolio constructions • Asset allocation • Manager selection • Security selection • Strategy implementation • Client Remodel/rebalance incl customisations
Administration	• Custody • Book of record • Clearing / Settlement • Transaction processing • Reporting
Managed Account Issuer Type	• Responsible Entity • MDA Provider • IDPS Operator