IMAP Independent Thought Podcast
Episode 22: Ongoing DDO obligations for Managed Account providers

Jenny Mulders - Chair of the IMAP Regulatory Group (Source Services), Jesse Vermiglio (Holley Nethercote) and Simon Carrodus (Hamilton Locke) from IMAPs Regulatory Group discuss:

- **Different obligations for different managed account structures**
- **Complaints management**
- **Target Market Determinations (TMDs)**

Moderated by David McDonald, CFA IMAP

IMAP Disclaimer

David McDonald - IMAP: (00:18)
Welcome to this podcast in the IMAP Independent Thought series. Before we begin today, I'd like to acknowledge the traditional owners of this land and pay respect to elders past, present, and emerging. Now, the IMAP podcasts usually focus on investment topics, but today we are taking a regulatory tack and we're going to discuss ongoing DDO obligations for managed account providers. Our moderator today will be Jenny Mulders. Jenny has much more knowledge than I do in this area. Jenny is based in Brisbane and is executive director for compliance for Source Services, and is also the coordinator of the IMAP regulatory working group. Joining Jenny will be Jesse Vermiglio, and Simon Carrodus. Jesse is a partner at Holley Nethercote in Melbourne, and Simon is a partner at Hamilton Locke based in Brisbane like Jenny. I'll hand over to you now, Jenny. Thanks.

Jenny Mulders - Source Services: (01:17)
Thanks, David, as David mentioned, this is about Design and Distribution Obligations (DDO), so we're now 18 months into the regime. And today Simon and Jesse are going to give their views on how we see the regime is working, some of the issues that we're seeing, and what's leading to the various stop orders that have come through from ASIC. Recently, ASIC released a report number 762, which has given us some insight as to how they're performing their surveillance and what their intervention powers are doing. And today I think it will be a good opportunity to get some learning out of this and see how that might apply to managed accounts. So might just kick off with Simon, and talk about some of the particular scenarios on where we've seen designer distribution and the target market determination in managed accounts specifically. And then we'll move on the discussion to the DDO regime

generally. Thanks, Simon.

Simon Carrodus - Hamilton Locke: (02:31)
Thanks, Jenny. I think it's fair to say, so we're approximately 20 months into the DDO regime, and based on report 762, I think it's fair to say that ASIC believes that the industry is barely passing, if not failing thus far. They've specifically asked the industry to lift their game, and the chief area of concern is clearly around TMD's target market determinations. We'll talk a bit later on about how target market determinations apply to MDA providers, or specifically whether or not MDA providers are required to have one and in which circumstances they are and are not. But more broadly, if we look at the broader marketplace, specific to investment products, which of course, that's what MDAs are. ASIC's not happy. They issued a number of stop orders and sorts of issues they've picked up.

Simon Carrodus - Hamilton Locke: (03:34)
The obvious one is a really broad target market, which sort of is almost no target market at all. If it's defined too broadly unsuitable, investor risk profiles, inappropriate portfolio portfolio asset allocation. And what we see there is actually often inconsistency between the way, an investment product is defined, perhaps in the PDs, for example, or elsewhere on the website versus how it's described in the TMD. Unsuitable investment timeframes, again, we see internal inconsistency, that's been a factor in a number of these stop orders, or unsuitable withdrawal features. The other one is just in a number of cases identified where there was either no distribution conditions, which is one of the obligations that you have to include in a TMD. So no distribution conditions or inappropriate distribution conditions.

Simon Carrodus - Hamilton Locke: (04:30)
So I think it's fair to say that, I think the industry was probably struggling early on with these obligations came into rush and there wasn't a great deal of guidance, and we know there was some FSC guidance that ASIC turned out to have a problem with. So it's probably not surprising. I think for the most part, the industry's done their best, but in some extreme cases, perhaps some issuers didn't take it as serious as they should have. That's going to change. I think we'll see issuers across the whole industry tighten up their TMDs and actually take a much closer look about the particular cohorts, for whom their product is not suitable in particular. And the other interesting thing, Jenny, just before I wrap up is I think we're getting to the point now where ASIC's focus is going to be on reviewing TMDs.

Simon Carrodus - Hamilton Locke: (05:21)
So obviously there are trigger reviews, which are required upon the occurrence of a certain event. But, there's also just regular periodic reviews and a TMD has to state when the TMD will be reviewed, and whether that's sort of 12 months, 18 months, two years, we're certainly getting up towards that timeframe. And you know I'm not sure that the industry more broadly is actively reviewing their TMDs the way that ASIC would like them to.

Jenny Mulders - Source Services: (05:55)
Thanks, Simon. Jesse, you know, do you want to just give your, your intro on your view on what you're seeing and probably some of the readings of the stop orders, and what issues are that your clients are facing, and your position.

Jesse Vermiglio - Holley Nethercote: (06:13)
Um, so thanks Jenny. I, I, my view is that it probably doesn't surprise me that, um, that that's the message coming from the regulator about lifting the game and not because, uh, probably

from, from the perspective of, um, that this is a, um, a fairly significant law reform, uh, that, um, that is now in place for the financial services sector. Um, it was introduced during a time period where there was a lot of things going on that sort of whole red October of 2021, where you had a number of different things happening. But probably most importantly is that this is a fundamentally different way of regulating, uh, the financial services sector and, and try to get your head around this sort of outcomes based, um, regime of trying to develop, uh, products that are, um, uh, you know, suitable for a target market. And then, uh, both in the design and then overseeing the distribution, which, uh, those types of obligations have not generally been around.

Jesse Vermiglio - Holley Nethercote: (07:15)
And, and, and as we know, the financial service sectors or regime has been built on a disclosure regime. So conceptually we are talking about a different way of regulating, um, but also, uh, and, and therefore a different way that these obligations actually work in practice. So I think it's just sort of natural that, that people, uh, are trying to, uh, understand and deal with and, uh, how to, uh, how to comply with what are, what is conceptually different, but also quite a technically difficult requirements. Um, and Simon, uh, was spot on against in terms of the, the observations of what the regulator is seeing as, as problems. Um, and, um, and certainly, you know, the, at the beginning of the regime, it really was, you know, or it really has been about low hanging fruit. Um, um, and by that sort of, I mean, um, target market determinations that are, you know, as, as Simon said, overly broad mm-hmm.

Jesse Vermiglio - Holley Nethercote: (08:13)
probably the one that is most interesting to me. And, and you can understand that, that, um, we talk about templates and, and certainly that report made a lot about, uh, templates and maybe industry templates and the over reliance on, uh, on certain templates, um, to a bit, you know, tail wagging the dog. Um, and I think that's probably the most important thing to take out of that report. You know, compliance tools and compliance checklists and templates are wonderful, but really you've gotta knuckle down and figure out for yourself who are the target market is for your products, uh, and then devise, uh, distribution channels that are fit for, uh, for, for those particular target markets. Um,

Jenny Mulders - Source Services: (08:58)
Yeah, I think, um, I suppose is, you know, what some of the comments there are that, you know, we're seeing the failings of the DDO regime and wondering whether that the, you know, the objective of the DDO regime and if there's successes, I mean, there's thousands of financial products, you know, out in the market. Um, ASIC doesn't have the resources to review, you know, all of those products. And so there has to be, you know, some sort of targeting of what they would see as high risk products.

And we're seeing stop orders in the, you know, the C F D territory, the cryptocurrencies, um, superannuation products and, and high risk credit products. Um, I suppose is, you know, what we're, what we're seeing and saying that, you know, manage investment products are being reviewed and, um, you know, and essentially MDAs and managed accounts are a type of managed investment products, but we haven't seen that level of surveillance in that product. In the event that, you know, as the triage process goes down and the, you know, hopefully the success of the DDO regime is, you know, things that probably are, you know, target audience here is, you know, what types of things should, should we be concentrating on looking at, you know, the target market, um, the MDs and, and the activities that those issuers should be doing. So, you know, what is it we would expect, um, to, you know, to be part of that review, um, so that we're satisfying asics, um, requirements. Jesse?

Jesse Vermiglio - Holley Nethercote: (10:40)
Sure. I would really be taking out the findings of that report and really going through your TMD and DDO process. So stress testing or testing the extent to which how broad that target market is understanding whether or not, your risk profiles that you have in place in terms of the product, and the suitability of that product. You know, an interesting one for me was that we went through a process with a client to have an interim stop order removed, and even just the characterisation of the risk profile of the product, there was a mismatch in the eyes of the regulator with the client as to the actual risk profile.

Jesse Vermiglio - Holley Nethercote: (11:31)
So taking stock and understanding, where does my product fit in sort of that risk spectrum? But you know the other one that also has been a common feature of the stop orders has been the level of portfolio allocations and, to what extent, or where is the sweet spot for portfolio allocations for particular products. So I think there's, a lot to take out of that particular report. And certainly in the investment product space, I think there's a lot to do. And, as this regime matures, I think you'll find that more and more of the industry will be better placed to deal with or to actually implement these types of expectations that the regulator has as to how DDO is administered.

Jesse Vermiglio - Holley Nethercote: (12:40)
Probably the only other thing that I will add is that certainly this is, (and I probably didn't mention this before), but, this is a really, really important regulatory tool for the Regulator. So, I was able to go to the annual forum last year, and DDO was probably mentioned in each and every one of the presentations at the ASIC forum. So for them, it really is a regulatory tool that they want to lean heavily on. And I just think with time, it will just permeate through not just the higher risk areas. We are at the beginning of the regime, where's the most harm? Let's see where we can use DDO, but you will see them testing the DDO regime more broadly throughout the market.

Jenny Mulders - Source Services: (13:45)
So is it fair to say, as much as we've seen some failings and we've seen that in reality, the success of the DDO regime is probably that the regulator has had the ability to put those stop orders in, and Simon, you've probably got something to add in this part of the discussion.

Simon Carrodus - Hamilton Locke: (14:09)
I just wanted to throw in on the back of Jesse's comments, (which I agree with), is that if I was preparing for whatever is the next wave from ASIC of this surveillance, because as Jesse said, they've tackled the low hanging fruit. It hasn't been that difficult for them because of the confusion coming out of Red October with so much regulatory change. But if I was a product issuer for the TMD, and I was preparing for this next phase, I'd do something unusual, and that's, is I would think about which customers, which investors is my product not suitable for, who shouldn't invest in this? Now, that's a bit of an unusual way for product issuers to think about their product. And usually they're, they're creating something and building something that they think is fantastic and should be suitable for a whole cohort of clients, whether it's SMSF, investors, retirees, pre-retirees, wealth builders, and what have you.

Simon Carrodus - Hamilton Locke: (15:02)
I think for it to be meaningful, and to satisfy ASIC's understanding of what is compliant, you

probably need to really turn your mind to, okay there are cohorts who should not invest in this product. It's not suitable for them. And the weather rubber really hits the road there. In my experience is where you have, let's say two issuers, one issuer has two products or two portfolios side by side with I the identical or almost identical TMD. Now, the reality is that the way that those two products are described in the PDs, and flyers will be different, right? So why do they have the same TMD? And I've been through this, if those two products that are being sold and marketed differently have the same, whether it's a growth or a high growth, or it's a balanced / conservative or whatever, or it's a Aussie shares income versus Aussie shares, if they have the same TMD, then something's wrong.

Simon Carrodus - Hamilton Locke: (15:59)
So either the products are the same, which is unlikely, or more likely, you haven't actually given enough thought to the cohort that should probably invest in the Aussie shares income and not the Aussie shares and the cohort that should probably not invest in the Aussie shares income. They should invest in the Aussie shares in a lot of cases. So you know it's no one's fault, but I think, again, you know, first crack at this in October of 2021, product issuers just sort of said, oh, well this is pretty good, and this pretty accurately describes the cohort without actually looking at the one next to it and saying holy moly, these two are actually identical. Again, that makes life pretty easy for ASIC. I think they can come in and say, well, hang on a minute. You've got two separate funds. You'r marketing material and your PDs describe them differently. Why do they have the sameTMD?

Jesse Vermiglio - Holley Nethercote: (16:49)
I'd probably just add one other thing to that is the why !... often times the TMDs are ticking off on a whole lot of things, but they fail in the fundamental thing of explaining why this product is suitable for this particular target market, and whether it's because they're following a template or because they're ticking off on the requirements that the regulator has. And it just misses that really main point of explaining in a layman's way why the target market is suitable. And I think if I only had a dollar for every time I thought where is the explanation for the why, I think that's another one to take out.

Simon Carrodus - Hamilton Locke: (17:40)
The "Why will set you free, right, Jesse ?

Jesse Vermiglio - Holley Nethercote: (17:42)
That's right. ,

Jenny Mulders - Source Services: (17:46)
I suppose there's one thing that is important for the managed account sector here is about whether or not, you know, we even need a TMD, and Simon, you touched on that earlier, and whether we're any closer after what we've seen from the report to understand in what cases an MDA provider needs to have a TMD, or doesn't need to have a TMD at all. When can it not have a TMD? And for those who do have a TMD, the review period is probably coming up. So what do they need to think about if they're going to review it? And for those who have elected not to have a TMD maybe they should consider that their review period is up and they need to review that. So Simon, did you want to kick off with what your thoughts are at the moment?

Simon Carrodus - Hamilton Locke: (18:41)
Yes sure. I think we all agree that in many ways in terms of not just the legislation, but the

asset guidance on DDO, I mean SMA is a bit different, because they are caught under the responsible entity regime. But I think certainly MDAs, and specifically MDA providers are kind of the forgotten cohort really. There's not a lot to go on. You know, we've reached out to ASIC for some specific guidance and some comfort around that. But ASIC hasn't been willing to provide that. Fair to say that most legal advisers that I know who work with MDA providers all agree on the position that if the MDA provider is offering custody, or providing custody for the MDA assets, then they will be caught by the regime.

Simon Carrodus - Hamilton Locke: (19:39)
They will be required to produce and of course, comply with and review the TMD. But if as is the majority of cases, the MDA providers are not providing custody, and that is outsourced, well, it's not even strictly outsourced. The customer opens an account with a platform, and that platform provides admin reporting and custody. Then strictly speaking, the obligation to prepare, and comply with, and review a TMD does not apply to the MDA provider. We're confident in that view, and I know that a lot of other legal advisors in this space are, but we don't have any clarity or confirmation from ASIC on that front.

Jesse Vermiglio - Holley Nethercote: (20:30)
Yeah the only thing I'd add there is I think the lack of guidance I think is really unhelpful. The journey to get to where we are is that obviously MDAs weren't contemplated in the legislation. And then last minute you had some regulations that bring in custody, and the way in which those regulations were sort of made to bring in custody was to link the custody service to the product and then, and then essentially pin on that product, the need for a TMD and the DDO obligation. So if you have custody as part of the product, then essentially, the product would also be caught by the DDO regime. And I think Simon just mentioned, you can have a number of different arrangements as to how custody service could actually be part of the product.

Jesse Vermiglio - Holley Nethercote: (21:40)
And you may not have the MDA provider using a custody provider for custody services. It might be through a platform. I think the concern though more broadly is that ASIC would take a view that even if the MDA provider is disconnected from the custody arrangement, that they will find, or that they will think that the MDA is part of and should be part of the DDO regime. And I think that's where the risk lies at the moment. And where certainly more guidance or at least some clarification from the regulator or not.

Simon Carrodus - Hamilton Locke: (22:27)
I agree, Jesse and I think perverse, I think that if ASIC came out with clear guidance or a clear statement on that front that custody, whether provided by the platform or not, you know is a key feature of an MDA, therefore we think MDA providers should prepare a TMD. I think the industry would welcome it. We'd have certainty, and I think we'd all adjust pretty quickly. In fact, I think most MDA providers probably did prepare a TMD for October 2021. So I really think what the MDA provider cohort wants is certainty on this front, because if ASIC's got a firm view that it applies, great. Tell us and we'll comply.

Jenny Mulders - Source Services: (23:17)
Sure. Thanks guys. I think in the report there's a couple of things that ASIC did mention and said what they thought was being done well and the good practices. They talked about the process oversight, so making sure that you had senior management and operational staff involved in developing the TMD so that it was logical and fit for purpose. Product testing so

actually looking at a micro level and seeing who is actually investing in the products. Applying some stress tests on if it's a managed investment scheme, and to make sure that what you are stating in the TMD as the objective is actually the objective that is in the outcome. And the other part was the distributor engagement. So making sure that you understand who your distributors are, and how to engage with them so that they understand what to do. So I suppose, was there any kind of surprises in there about we expected to see being done well or being done poorly?And whether there's any feedback from the product providers or from the regulator that you might have some insights on?

Jesse Vermiglio - Holley Nethercote: (24:47)
I might start, I thought the observations around distribution were actually a bit of a surprise. And probably because before we had DDO really the obligations around distribution were left to the distributor who would normally in most cases have their own AFSL. And so product issuers, or manufacturer issues the product and the distributor distributes the product. And really there was a very clear line there between who had responsibility for what. And sure at a higher level, there's reputational issues associated with the distribution of product. And so the product issuer really wants to know that it's being done properly. But now you've got real significant obligations with some real teeth. And I think having product issuers that are more closely overseeing the distribution practices of the distributors, I think is a great outcome. And the way in which, and how quickly the industry comes to ensure that it is taking place and that there are compliance processes in place to ensure that reasonable steps are being taken to ensure that the product's are being distributed to the target market that's in the TMD. Yes I think that's good,

Jenny Mulders - Source Services: (26:15)
Simon.

Simon Carrodus - Hamilton Locke: (26:16)
I'll just add that I did read with interest, I think it was four or five days ago last Friday, that ASIC has finally issued a stop order to a distributor. So they issued a media release preventing "My Trade" from opening CFD accounts for clients. Now that's again a cross section there between TMDs and also CFDs. (We're doing all the acronyms here.), we know that CFDs are also a focus area for the regulator, particularly over the last 18 months, but this is specifically in relation to ASIC's position that the distributor, "My Trade" wasn't taking reasonable steps, to distribute the product in accordance with the target market determination. So that's after a whole whole series of stop orders against issuers, and now we've got one against a distributor as well.

Jenny Mulders - Source Services: (27:18)
Awesome. Anything else we can add in here that might help our listeners? Otherwise I'll hand over to David?

Simon Carrodus - Hamilton Locke: (30:32)
Really quickly from me, just just to leave the listeners with a reminder, if you're on the advice side, and of course we're talking about advisors who advise on managed accounts. But more broadly, if you're on the advice side, you know, of course you don't strictly need to take reasonable steps to distribute products in accordance with the TMD if you're providing personal advice. But in reality, we know that if a complaint goes to AFCA, they will look at it. And there's even a statement there and the guides around the fact that we expect advisors to look at the TMD, as part of their compliance with best interest duty. And just that reminder

about reporting any complaints up to the issuers and significant dealings. And of course, on the issuer side the advice would be get used to reviewing your TMDs, you're allowed to change them. In fact, you have to, they're not "set and forget". And either you've got , a series of complaints or significant dealing notifications or the products change, or even internally you've decided, we need to review this TMD and make it a little bit tighter or, you know, add something or delete something from it. You're allowed to do that, and you should be in the habit of doing that. So it's a sort of a constantly evolving document that's fit for purpose.

David McDonald - IMAP: (31:50)
I think I'd better jump in there, and wrap our discussion up. It's been a great discussion. The topic is obviously very important for providers of managed accounts. So I'll finish up by thanking Jenny Mulders, Simon Carrodus and Jesse Vermiglio for what has been a very great, and obviously very topical discussion today. And finally, just a reminder of some upcoming IMAP events in the week beginning 26th of June, we are holding our "Mid-year review" webinar series, which is titled, "So How's it Going in 2023?", These webinars, which will be on Monday, Wednesday, and Friday of that week, looking at how markets have performed so far this year, what are the key issues affecting different asset classes and also the outlook for the rest of the year. Also, IMAP is holding our annual Advice in Action conferences in July 2023. This conference focuses on issues that impact advice businesses, and conferences will be held in Melbourne on the 18th of July, Sydney on the 20th and Brisbane 25th of July. Details on the Conference are on our website, and you can register there. Thank you.