IMAP Quality of Advice Review Submission

3 June 2022

Institute of Managed Account Professionals Ltd

Contact: Toby Potter

Toby.potter@imap.asn.au

0414443236

Introduction

This submission, made on behalf of The Institute of Managed Account Professionals Ltd, (IMAP) an industry body with a mission of:

"Education, Information and Representation of Managed Account Professionals"

The members of IMAP are active in all areas of retail financial services including:

- AFSL's which provide personal advice,
- Individuals who are authorised representatives of AFSLs,
- MDA Providers,
- Responsible entities of managed investment schemes,
- IDPS and Superannuation platform providers
- Investment managers,
- Investment researchers,
- Investment consultants, and
- Associated organisations such as technology providers and compliance specialists.

This submission addresses those issues which relate to the issue of managed accounts to retail investors and which broadly fall into one of two legal classifications:

- Managed investment schemes – generally called SMAs or Managed Portfolios and issued for access through a platform. For convenience, this is taken to include those issued under IDPS-Like schemes
- Managed Discretionary Accounts (MDA) including those
    - operated on a regulated platform, or
    - where the assets are held on HIN, or
    - which involve a custody arrangement.

The principal purpose for which managed accounts are recommended to retail investors is as a way of:

- efficiently implementing personal advice to invest in a portfolio of assets which would otherwise be acquired as individual investments, and then
- continuing to give effect to transactions which, in the portfolio manager's opinion, are appropriate to maximise the probability of achieving the previously stated objective of the portfolio.

Managed accounts are not a pooled vehicle, each investor owning the underlying investments directly on their own account, however they generally offer common portfolio management based on a model provided by the portfolio manager to the administrator.

Technology advances however allow each client's portfolio to be individualised through exclusions and substitutions for example to accommodate ESG preferences, limitations on holding certain assets or other assets held by the investor.

Consequently, while managed accounts are financial products under The Corporations Act or the specific MDA Legislative Instrument[1], they are more closely linked to the provision of personal financial advice by virtue of:

- individual ownership by each client of the underlying investments,
- the individualisation of the portfolio outlined above, and
- In the case of MDAs, a requirement that they are only offered based on personal advice which is required to be reviewed at least every 13 months.

Most of the questions which are posed in the issues paper relate directly to the creation and delivery of financial advice by an authorised AFSL holder and are outside the scope of this submission which relates to ways in which the use of managed accounts improves the **quality of advice outcomes** rather than the **quality of financial advice** or the **quality of financial product advice** itself.

Our submission does not speak to ways of delivering ad hoc advice more cheaply. Treating personal financial advice as a transactional process – equivalent to obtaining a mortgage – is to fundamentally misunderstand the nature of an advice relationship which covers a broad range of issues that evolve over a considerable period of time.

This submission has been prepared by the Institute of Managed Account Professionals Ltd (IMAP), with assistance from the members of its Regulatory Group and assistance from industry participants. We thank them for their assistance.

Responsibility for its contents rests solely with IMAP.

[1] Legislative Instrument 2016/968

Question 1/2: What are the characteristics of quality advice for providers of advice and consumers

Dimensions of Quality

As the issues paper notes, there is a difference between "financial advice" and "financial product advice", and while much strategic financial advice deals with issues other than those which can be relate to investment decisions e.g. estate planning, tax planning and management, debt reduction and so on, many people approach financial advisers because their personal goals or objectives are most likely to be met through investment action.

This submission relates to those aspects of advice which require an investment recommendation as a substantial component of the advice.

In response to the first two Review questions, we identify below those features of the advice process which determine whether an advice process, its recommendations and its implementation is "High Quality".

We believe these dimensions are:

- Articulation and clarification
  - A quality advice process results in clear articulation of the client's goals and objectives and confirms that these are capable of being achieved
- Probability of success
  - A quality advice, investment recommendation and implementation process increases the probability that the client's goals will be achieved
  - Probability of success is largely determined by a robust investment process undertaken by people with appropriate expertise
- Timeliness and equity
  - A quality advice and implementation process should deliver advice that is timely in circumstances, be able to be executed in a timely manner and investors should be dealt with fairly relative to the adviser's other clients – a FASEA requirement
- Accommodation of client constraints
  - Quality advice and its implementation accommodate the constraints which apply to the client. This may include matters such as ESG preferences or tax considerations
- Comprehensiveness
  - A quality advice process should be able to accommodate multiple goals and constraints
- Transparency
  - It should be apparent to clients what they hold and the way in which it relates to their personal goals and constraints
- Cost / Value
  - A quality advice process should be able to be delivered at a reasonable cost, compared to other equivalent services,
  - A quality advice process considers the cost of transactions and the underlying investments in the investment selection process, and
  - The client should believe that the service, including the underlying investments, represents value
- Risk appropriateness

- A quality advice process should result in a portfolio which is consistent with the client's risk tolerance as understood by the adviser after appropriate enquiry. This is a special form of constraint
- Delivery through time
    - Advice relationships are generally intended to operate over an extended time period. This is implicit in the law and ASIC's recognition of "ongoing fee arrangements". A quality advice and implementation process should be one which is able to operate at a consistent level of quality on a continuing basis for as long as the adviser / client relationship persists.

Evidence Base for Identifying Quality Of Advice Outcomes

IMAP believes that the use of managed accounts by advisers is a materially superior way of delivering and implementing advice than the traditional method which relies on an initial SOA supplemented by subsequent ROAs for each portfolio adjustment. We identify a number of these dimensions of quality where the use of managed accounts is particularly superior to the traditional method of creating and updating advice.

Portfolios and the Probability of Success

Probably the most critical measure of quality is whether the client's goals will be achieved and central to achieving this is certainty that the client's portfolio is actually in alignment with the intended portfolio.

Key elements of ensuring that the portfolio is most likely to meet the client's goals are a systematic investment process, undertaken by portfolio managers of appropriate skill. This is a requirement of any AFSL as required by the Corporation's Act.

To delegate portfolio decisions to an individual adviser, even with the assistance of model portfolios is to invite a result that varies widely between clients with similar goals or risk profiles.

This variation frequently arises as a result of difficulties in reaching clients in a timely manner to recommend and implement change.

This chart (Figure 1) compares the variance from target of manually implemented portfolios, accomplished through an annual client review, with those implemented through a managed account (SMA). In this example, the study's authors noted that following a model change in March

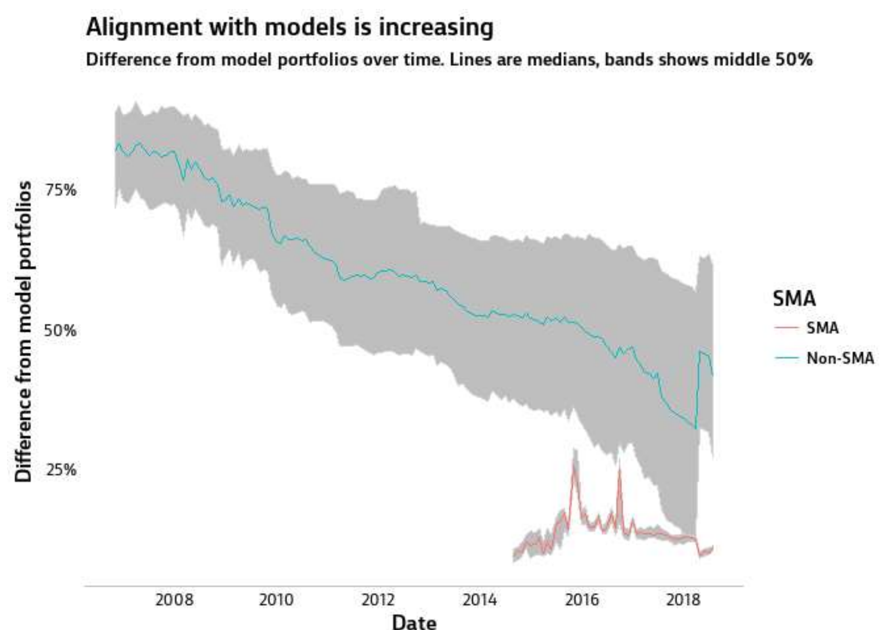

Figure 1:Source Aequitas Investment Partners

IMAP
Institute of Managed Account Professionals

2018, variance from the model in manual portfolios was substantial and "could take over a year to reverse"[2]

So, even though portfolios, over a 10 year time period gradually became more "compliant" a market event could not be dealt with by the traditional process.

It is clear from the experience of this organisation over a 10 year period that clients will have experienced unacceptable variability of return as a result of the variation of their portfolios from the target model. This makes it impossible for an adviser to state with confidence what the likely outcomes of any further advice might be.

In the chart below (Figure 2), a study[3] based on the simulation of rebalancing to strategic weights over a 20 year period shows enormous variation in annual return depending on which week of the

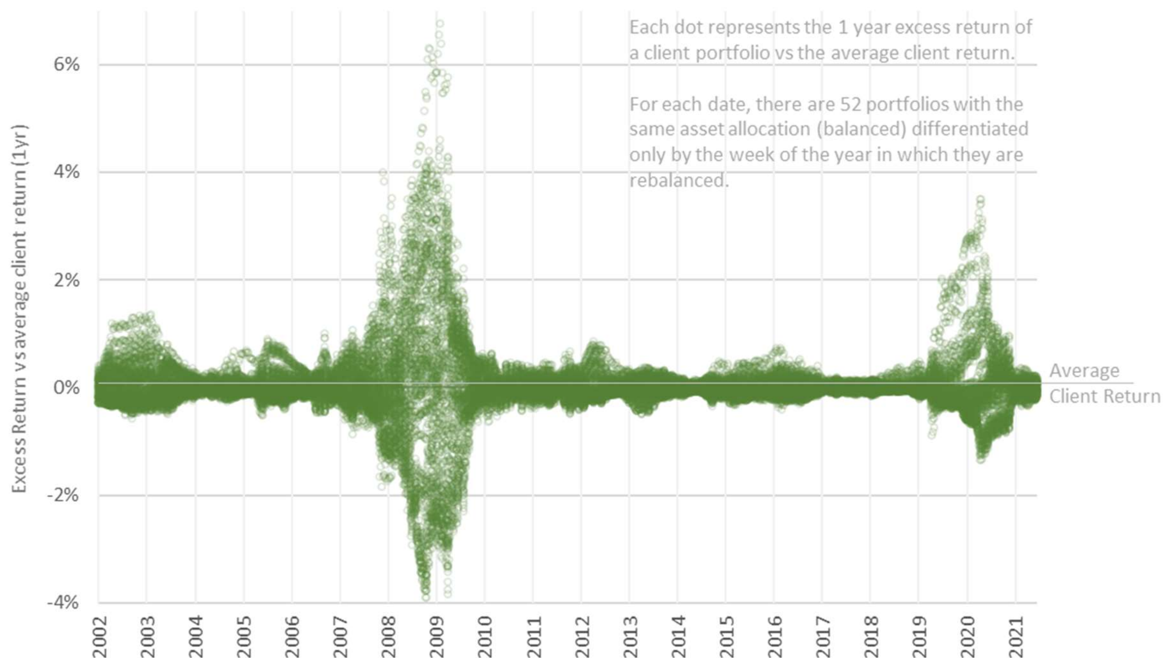

Figure 2 Source: Philo Capital Advisers

year clients, notionally in the same portfolio were rebalanced. In the extreme example (2009) these timing variations generated a 9.8% variation in returns between investors solely based on the week of the year in which rebalancing is undertaken. Even in less extreme periods however, variations between clients are substantial and 34% of the time over the entire 20 year period, week of the year variation in return are 1% or greater.

High quality advice of necessity means advice with a sound basis for estimating the probability that client returns will be achieved in an expected time frame based on market risk and return characteristics without the offsetting factor of randomness of implementation.

[2] Client Portfolio Management: Risk and return analysis of implemented portfolios" Aequitas Investment Partners

[3] Unfair Rebalancing Philo Capital Advisers May 2022

Portfolios and the Importance of Timeliness

In another study[4], the impact of delay in the implementation of investment decisions was assessed, again over a 20 year period. The results of this showed that a structured investment decision making process could be expected to add 1.1% p.a. in alpha to retail investor portfolios from asset allocation decisions – no allowance was made for active investment management.

However, a delay of 4 weeks in implementation would subtract 50% of that value and a delay of 3 months would reduce value added by 80%.

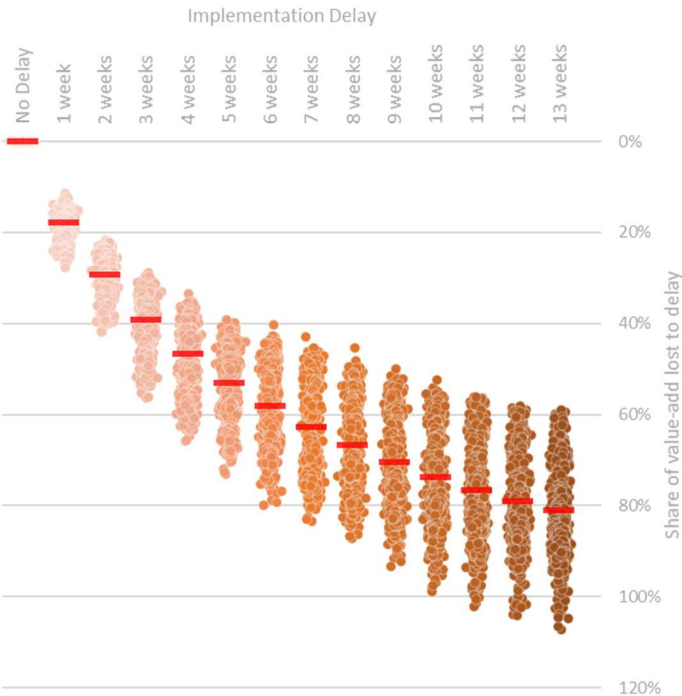

Figure 3 Source: Philo Capital Advisers

Summary

Investment results are achieved through time, by systematic processes of portfolio management, applied by people with the requisite skill, operating in accordance with explicit portfolio mandates and supported by administration processes which allow timely error free implementation.

This process will allow economies of scale to be passed on to clients in a way which has not been achieved under traditional advice models. Highly professional portfolio management is now available to retail investors through managed accounts at very low costs – as little as 10bp.

The adviser has an essential part to play in articulating client goals and ensuring that client specific constraints such as ESG preferences are incorporated into portfolios

The regulator must ensure that cost impediments of the type identified elsewhere in this paper are reduced and that its behaviour encourages the use of systematically managed services such as SMAs and MDAs.

[4] Cost of Delay Philo Capital Advisers June 2020

Question 8: How much is the cost of meeting the regulatory requirements a result of what the law requires and how much is a result of the processes and requirements of an AFS licensee, superannuation trustee, platform operator or ASIC

We identify a fundamental conceptual flaw in several areas of the law and of its enforcement by ASIC which add significantly to the cost of advice and of service provision by participants such as platforms, MDA Providers and investment managers.

Broadly this may be defined as "Creation of overlapping compliance obligations that are redundant, expensive and confusing" and we identify a number of examples of this which specifically relate to managed accounts.

The principle at issue here is that the actions of one AFSL – for example preparing advice or collecting fees to which they are entitled - is then subject to the supervision or duplication by another participant. Each of the examples referenced below involve conduct obligations which fall on the initial, advice providing AFSL. Failures on their part are therefore subject to breach reporting. Notwithstanding this, separate regulations also impose on a second AFSL a documentation or checking process which is completely redundant and frequently requires inconsistent timing or process. Detecting and correcting failures of advice process should properly be the obligation of the regulator.

We point to the following examples:

DDO applying to investment products issued under personal advice

It is questionable whether the DDO regime will ever achieve any useful outcome of any sort in relation to clients who make investments as a result of receiving personal advice. The legislation partially exempts advisers from its provisions – on the reasonable grounds that the obligations relating to the provision of advice include an "appropriateness" test - but requires that they ensure there is a TMD, captures them in a requirement to report significant dealings which even Treasury cannot define[5], and requires them to report complaints. It imposes on issuers a set of compliance burdens which may be appropriate for products such as credit cards, car insurance or investment products sold directly to investors but contribute nothing to improving the quality of advice.

Recommendation

All obligations in relation to DDO should be terminated in respect of providers of personal advice and on issuers in respect of products issued as a result of a retail investor receiving personal advice.

This recommendation would significantly reduce costs for Advice AFSLs, platforms and product issuers in respect of distribution through advice channels, without affecting the obligations of issuers dealing directly with retail investors.

[5] Revised Explanatory Memorandum 1.80 Consistent with existing provisions of the Corporations Act, 'significant' is not defined for the purposes of the new obligation. The meaning of significant is intended to take its ordinary meaning in the context of the new provision.

Fee Consent (Also relevant for Question #61)

The requirements to obtain fee consent for advice fees drawn from superannuation have created substantial cost on advisers, platforms and MDA Providers and are reported by advisers to have caused significant concern to clients that they are being double charged.

Advisers are required to obtain appropriate consent from clients for fees they charge, typically done as part of the SOA and then annually as ongoing consent. Failure to obtain appropriate consent for the deduction of fees would constitute a breach for the advice AFSL.

However, the platform superannuation fee consent obligations require a quite separate document. The positions taken by platforms, apparently arising from concern about ASIC interpretation, has lead to completely unnecessary additional impositions imposed by platforms including:

- Fee consent for advice fees deducted from IDPS accounts
- Fee consent being required to be obtained annually
- Fee consent required for all MDA accounts operated on a regulated platform even where advice is provided by an external MDA Adviser i.e. not the MDA Provider

The repeated, but different fee consent requirements lead to investor confusion.

This recommendation would significantly reduce costs for Advice AFSLs, advisers and platforms without reducing investor protection in relation to the fees for which they are liable.

Recommendation

Elimination of the fee consent requirements for platforms on the grounds that the client consent requirements of advice AFSLs provide sufficient authorisation payment.

If fee consent continues to be required, ASIC to approve a proposal from industry participants for a standard fee consent form, similar in concept to fee disclosure under RG97, included in SoAs and accepted by all platforms

MDA SoA Review

In the 2016 reissue of the Regulatory Guide 179, ASIC introduced a new requirement, not included in the original Class Order, that where an External MDA Adviser prepares a Statement of Advice, the MDA Provider

"review the SOA given in relation to that investment program before entering into the MDA contract, and not enter into the contract if you have reason to believe that the MDA is not appropriate to the client's relevant circumstances"[6].

This is a significant extension by interpretation of the requirement in the relevant law that

"The licensee must have no reason to believe that:
(a) the investment program does not comply with the requirements for a Statement of Advice in Subdivisions C and D of Division 3 of Part 7.7"[7] .

It gives rise to the ridiculous situation that an AFSL (the MDA Provider) who does not need to have an authorisation to provide personal advice to retail clients is "checking the work" of an AFSL who does

Recommendation

ASIC amends RG179.174 to repeat the wording of s912AEB (7) (a) in the Legislative Instrument rather than apply its own interpretation of the law.

[6] RG179.174
[7] S912AEB (7) (a)

IMAP
Institute of Managed Account Professionals

have that authorisation. The obligations on the External MDA Adviser to provide appropriate advice are fully provided for under their existing obligations as an AFSL providing personal financial advice.

This recommendation would significantly reduce costs for Advice AFSLs, advisers and MDA Providers without reducing client protections.

MDA Annual Fee Disclosures

Where MDA services are provided on regulated platforms, ASIC relieve the MDA Provider of a reporting requirement. This was a welcome move in the 2016 review of MDA regulations. However, the annual fees statement requirements remained. These are modelled on the IDPS requirements and effectively duplicate them.

Recommendation

ASIC amends RG179.197 to require the MDA Provider to report only its own fees for providing the MDA service, following the Legislative Instrument.

"However, you must inform the client about the total management costs and any other fees and costs associated with your MDA service over the relevant reporting period, calculated on the same basis as required for disclosure in the FSG. This means you must take into account all the fees and costs for your service, and any fees and costs for the regulated platform will be an interposed vehicle through which you invest client portfolio assets"[8]

This requirement under RG179 is an ASIC interpretation of the law and a considerable extension of the relevant section of the law s912 AEF 4 (a).

It has the ridiculous result that a client who has an MDA Service on a regulated platform receives:

1) All fees which are deducted in cash are reported within 48 hours in the client's platform cash statement, which is available online on a continuing basis and includes:
    a) Advice fees
    b) Platform fees
    c) Portfolio management fees / MDA fees
    d) Brokerage or other transaction charges
2) The platform is required to provide an annual statement which aggregates each of:
    a) Advice fees
    b) Platform fees
    c) The costs associated with the investments which the client held and other costs such as brokerage, stated as dollar values. Note this includes investments which are not subject to the MDA service
3) The MDA Provider is required to provide an annual statement which aggregates each of:
    a) The MDA Provider's fees
    b) Platform fees
    c) The costs associated with the investments which the client held and other costs such as brokerage all stated as dollar values

Since the platform will almost always hold assets for the client which are not part of the MDA service the numbers reported under 2 (c) and 3 (c) are almost invariably different and if there is a period of the year when the client holds platform assets but is not included in the MDA service then 2 (b) and 3 (b) will also be different.

[8] RG179.197

As both the platform annual report and the MDA Provider's report must be received by 30 September and are typically provided in the last two weeks of September, allowing time for underlying investment fees to be aggregated, clients receive multiple versions of reporting which while purporting to report the same thing often include different values and containing data to which, with the exception of the dollar value of underlying investment costs, they had online access throughout the year.

Unsurprisingly, Advisers report that this is frequently confusing and leads to concerns by clients that they are being overcharged or that their service providers are "making mistakes".

This recommendation will significantly reduce costs for MDA Providers, lead to more timely reporting to clients and significantly reduce confusion about the costs of the service they are receiving.

ASIC Funding Levy – A Cost Plus Approach with Seemingly Arbitrary Allocations

The cost for AFSLs has risen at a rate significantly in excess of the rate of inflation. Over the period from introduction of levies in the 2017-18 year levies imposed on the 200 to 250 MDA providers have risen from $0.742m in aggregate to $2.4m in aggregate, a rise of 48% annual rate of increase.

Recommendation

ASIC meets with industry bodies and participants to explain the basis for its allocation of costs.

Complaints relating to MDA recorded by AFCA were nil in the six months to December 2021 and 4 in the 6 months to June 2021, implying a high level of satisfaction among clients whose portfolios are in excess of $50bn.

The 2021 cost of approximately $10,000 per Licensee is a significant impost and bears no relation to the consumer harm from this segment of the managed account market. It amounts to 10% of the levy imposed on Responsible Entities ($25.204m) against a pool of asset of only 3.4% [9] the size.

The estimates of the next levy released on 6 June 2022 makes this even worse with an estimate of $2.8m levy on MDA Providers ($10,292 each) compared to $20.749m for all Responsible entities. This amounts to a levy of 13.5% of the amount levied on Responsible Entities with an implied pool of assets of $1.64 Tn i.e. MDA assets account for 3.1% of the assets held by Responsible Entities.

The allocation of costs is completely disproportionate and appears arbitrary. The table below highlights that:

Internal costs assessed to MDA Providers are 15% - 20% of the costs assessed to Responsible Entities, despite MDAs accounting for 3% of FUM managed by Responsible Entities

Increase in costs in this area, including capital expenditure has risen 133% while engagement with the MDA Providers has fallen between 80% and 100%. If indeed there is a problem in the area – not something that IMAP or its members are aware of – and not something that complaints to AFCA suggests, industry engagement should be increased at a commensurate level to internal costs.

IAP's experience is that despite regular requests to meet, this has been difficult to arrange.

If indeed ASIC is spending an amount equivalent to 16% of its total internal costs and capital expenditure for Responsible Entities – a $1.6 Trillion sector – on MDAs, it suggests that, as an organisation it has lost sight of its priorities.

[9] ASIC Funding levy model for RE's implies a pool of assets of $1.511 Tn. IMAP research as at December 2021 identified MDA assets of $52 bn.

Expense	Responsible Entities 2021 - 22 Levy Cost recovery levy 2021-22	MDA 2021-22 as % of RE 2021-22 Levy	MDA Providers 2021-22 Levy Cost recovery levy 2021-22	MDA Providers 2020-21 Levy Cost recovery levy 2020-21	Change in MDA Levy 2021 to 2022	% Change 2021 to 2022
Supervision and surveillance	$2.127	0.6%	$0.013	$0.175	-$0.162	-93%
Enforcement	$2.253	49.2%	$1.109	$0.134	$0.975	728%
Other regulatory activities						
Industry engagement	*$0.635*	0.6%	*$0.004*	*$0.024*	-$0.020	-83%
Education	*$0.002*	0.0%	*$0.000*	*$0.005*	-$0.005	-100%
Guidance	*$0.872*	0.7%	*$0.006*	*$0.062*	-$0.056	-90%
Policy advice	*$1.508*	0.6%	*$0.009*	*$0.053*	-$0.044	-83%
Indirect costs						
Governance, central strategy and legal	*$2.081*	15.7%	*$0.326*	*$0.163*	$0.163	100%
IT support	*$1.919*	16.2%	*$0.311*	*$0.117*	$0.194	166%
Operations support	*$1.228*	18.4%	*$0.226*	*$0.097*	$0.129	133%
Property and corporate services	*$2.053*	18.1%	*$0.372*	*$0.205*	$0.167	81%
Total operating expenditure	**$14.678**	16.2%	**$2.377**	**$1.035**	$1.342	130%
Allowance for capital expenditure	$1.478	16.4%	$0.242	$0.091	$0.151	166%
Less costs funded by own-source revenue	-$0.180		$0.000	$0.000	$0.000	
Adjustment for prior year (under or over recovery)	-$0.005		$0.045	$0.058	-$0.013	
Total levy to recover costs	**$15.971**	16.7%	**$2.664**	**$1.184**	$1.480	125%
Statutory Levy	*$4.778*		*$0.136*			
Total from table	**$20.800**	13.5%	**$2.800**	**$1.184**	$1.616	

IMAP
Institute of Managed Account Professionals

Question 83: What further actions could ASIC, licensees or professional associations take to improve the quality, accessibility or affordability of financial advice?

Summary

We have only addressed in detail a number of issues which determine the Quality of Advice received by retail investors.

The point in selecting these issues has been to highlight that personal advice is in general, not an episodic, transactional purchase by a retail investor but a process based service acquired over time, where the results are expected to accrue over time. Knowledge of markets tells us that gains are achieved in brief bursts and a service that delivers quality has to be available to investors on a continuing basis.

Recommendation

ASIC should actively facilitate the use of managed account structures including MIS (SMA) and MDA in order to achieve higher quality outcomes for retail investors.

It is not good enough for advisers to cycle through clients on a quarterly, half yearly or annual basis, making changes to portfolios based on a random review cycle.

ASIC should therefore conduct its regulation processes so as to ensure that an appropriate level of skill is dedicated to both the creation of advice and its implementation.

ASIC should ensure that its staff are well informed in the various ways in which managed accounts are operated. This has not always been the case and nor has it been available for industry engagement.