Peter Turbach, MDA Guru

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THE SHADES OF GREY IN THE MANAGED ACCOUNTS WORLD

Peter Turbach

There has been a lot of attention by the law makers and the regulators over the last few years in the advice business. Specifically in the managed accounts world, we have seen an impact from FOFA, the updated regulatory guide 179 (RG 179) and now most recently the Royal Commission. As a result, financial advisers, investment managers and MDA providers are like soldiers left walking through a minefield with some choosing to run apocalyptic-style for the hills!

How did we get to such a place and can we navigate out without blowing up? Compounding the problem is that the minefield is made up of grey zones that do not offer a clear pathway to safety.

In efforts to provide guidance, ASIC interprets the laws (i.e. legislative instruments) for us to help identify risks and manage them. In addition, ASIC provides further interpretations in the form of regulatory guides, which are often designed with the aid of the industry. On the most part, it works well although gaps and grey zones can appear as nothing is ever truly defined until it is challenged in a court of law. Lawyers love grey zones and the winners in courts are always the lawyers.

When attempting to define something, things are not always black or white. Try to get ASIC to define an exchange-traded fund (ETF) for example. It can be many things, a managed investment scheme (MIS), a derivative, an exchange-traded security. One practice I know of wanted to advise and deal in ETFs, and had all three of these authorities mentioned, but were advised by lawyers to vary their licence to include 'MIS other'; a costly exercise that basically involves re-applying for your licence. Was this an overly conservative approach by the lawyers? Maybe; was this ridiculous? Probably; however it was required by the practice in order to secure the business.

In the wake of the updated RG 179 issued in 2016, the small MDA advisers/operators that were operating under a 'no action' letter were forced to either vary their AFSL to include MDA authorisations (by October 2018) or move onto an external MDA provider's platform. Some were able to get their variation through without disruption to their businesses. Great! Some chose the latter and some chose to run for hills.

Another strategy that these 'no action' MDA operators could have chosen was to move their clients into a separately managed account (SMA) on a regulated platform. This entailed changing their business from offering an advice service to offering a financial product.

For those that have gone through the exercise of transferring their clients to an external MDA provider and those that chose the SMA route, the grey zones just got greyer. The Royal Commission concentrated heavily on conflicts of interest and the best interests duty (BID). The two go hand in hand.

The quote

How can the MDA provider therefore be responsible for the ongoing advice regarding suitability for the MDA client without even being authorised to do so?

The grey zones

1. Who is responsible for the client's MDA investment program's suitability and can it be managed effectively?

Under the previous RG 179 issued in 2004

When an adviser advised a client into an MDA, they were usually making two recommendations; one into the MDA contract and one on the investment portfolio. This first step is deciding that an MDA is good for the client. The second step is then advising and implementing the portfolio as per the MDA contract. The latter was covered off by their MDA dealing authority and was referred to as the MDA operator component while the MDA advice authority covered off the advising into the MDA and the investment program. All is good and relatively simple from a compliance point of view.

External MDA adviser

As MDA's became more popular so did the utilisation of the external MDA adviser. By outsourcing the MDA operations an efficient model developed in which the MDA operator appointed the financial adviser as an external MDA adviser. In effect the platform acting as the 'MDA provider' using today's terms appoints an adviser to give investment advice over that adviser's own MDA client base. Two lines were drawn separating the advice component from the operating component.

The main issue that arose from this model is who has responsibility for the investment advice component? In most cases the MDA operator is the only entity with any MDA authorisations on its AFSL. There have been some disputes in the past where the external MDA adviser and the MDA operator pointed the finger at each other. This prompted ASIC to look at making changes.

Under the updated RG 179 (issued 2016)

The new RG clearly makes the MDA provider responsible for two aspects of the investment manager's advice. Like that of a responsible entity (RE) being responsible for an SMA, the provider is responsible for making sure the investment selection and weightings are in adherence to the MDA investment program. The provider is also responsible for the MDA client's suitability to the investment program. So how does an MDA provider that acts more like an administrative platform possibly know this without knowing the client? Well, it can't. It is entirely the MDA provider's risk that the adviser is conducting at least an annual review to ensure suitably or make appropriate changes. This can be hard enough to manage internally as a dealer group let alone externally as an administrative platform.

Many advisers wishing for the efficiencies of MDAs choose to be an appointed external MDA adviser as they are not required to hold any MDA authorisations on their AFSL. So long as they have authority to give advice and deal in MIS, they are ok to advise and transact monies on their client's behalf into an MDA arrangement via a statement of advice. The logic used here is that an MDA is in fact a type of MIS (but with relief from providing a PDS and requiring a RE). To act as an appointed external MDA adviser, the adviser only requires advice authorisations for the investment types utilised within the MDA investment program. Under the old regime there were a lot of grey zones which have now been clarified to some extent.

The question now arises: does the MDA provider need an authority to give advice on MDAs? While this has not been tested in a court of law, the answer appears to be 'no, it does not'. So this begs the question: how can the MDA provider therefore be responsible for the ongoing advice regarding suitability for the MDA client without even being authorised to do so? The shades of grey just get greyer…

2. If you are recommending your client into your SMA, is there a conflict of interest and are you adhering to the client BID?

For those not running for the hills, varying their AFSL's or utilising an external MDA provider the SMA option appeared less hazy as they ran into the opened and welcomed arms of the regulated platforms. Operationally it would have made sense for those under the 'no action letter' as their clients were already on the platform. The only hurdle was their acceptance by the platform provider to act as the RE over the new SMA. If accepted, great!

Now as an adviser you suddenly find yourself in the product manufacturing business. Your investment portfolio that you used to direct your clients into is now a product. So how do you advise clients into your product without conflicts of interest and adhering to your BID? As a reminder, the BID requires advisers to put the clients' interests above their own.

Conflicts of interest occur. They happen … it is ok! The main thing is how we manage them that counts, and always ensuring that the BID is met for each client. In the case of SMAs it's all about the fees and how they are charged. This is one of those shady grey areas and depends on which platform you talk to as to the best way to manage it. Here are some ways in that I have seen how platforms suggested such conflicts could be managed before the Royal Commission:

- Ongoing investment management fees are not taken directly out of the SMA's internal cash account but are taken from another cash account attached to the platform.
- Don't put all the client's assets that are on the platform in the SMA but spread them around
- Don't call the ongoing fee an 'investment management fee' but call it something else like an 'administrative fee'
- No ongoing fees are debited from the SMA or the platform. Instead the platform invoices the advice business a combined amount that includes all platform costs and SMA management costs. The advice

business pays the invoice to the platform and invoices the client appropriately adding in a margin.

In a post-Royal Commission environment do any of the above examples manage the conflict appropriately? The last point should, as there are no ongoing fees but only charges for work completed. Obviously, this is a less attractive way to manage the advice business' cash flows and could possibly end up costing clients more.

When recommending your SMA product to your clients are you acting in the best interests of your client? No matter how great you think your investment model is there will be someone else out there with better market performance and lower fees. Emphasis needs to be placed on whether you have given the client the means to be able to make an informed decision. Does your FSG explain your value proposition and can you prove that the client received and understood it? What is your process and how did you inform and educate the client, and is it documented?

For many advisers that want to utilise managed accounts in today's minefield they need to look at how they want to manage their client's investment portfolios first and then build efficiencies around that. Categorise your client base as what is good for some would not be in the best interests of others. Define the value proposition to each client base so that you can articulate it to your clients, so they can make an informed decision. This also helps you to charge the appropriate amount to cover costs. An SMA model may be a great low-cost solution for a certain client set while an MDA may be better for another. It is also not unheard of to manage a portfolio utilising both SMAs and MDAs and still be cost efficient. **FS**