

DDO guidance on distribution of managed funds

This document is guidance about issues relating to the distribution of managed funds under the Design and Distribution Obligations (DDO) under the Corporations Act 2001 (Cth) (the Act). It is a matter for each user of this guidance to consider their individual situation and to comply with the new regime. This guidance is not exhaustive and does not necessarily cover all obligations under the DDO regime. Whether a business uses this guidance, in whole or in part, is a decision for each business. There is no requirement or expectation that any business uses this document.

This document does not form legal advice.

Introduction

The DDO regime is intended to help customers obtain appropriate financial products by requiring issuers and distributors to focus on consumers when designing and distributing products. Consequently, the DDO regime focusses on reducing risks of harm to individual consumers.

In particular, the regime requires issuers to identify which classes of customers are in the target market for a product, and then requires both issuers and distributors (other than financial advisers) to take reasonable steps to direct distribution towards customers inside that target market. This should reduce the risk that financial customers enter products that they are not suitable for.

In this context, members of the Financial Services Council (FSC) have identified several areas where additional DDO guidance to product distributors could be of assistance.

1. Portfolio view

Question: How should a Target Market Determination (TMD) be considered where a managed fund is being held as part of an investment portfolio? For instance, if a customer wishes to have a portfolio that is overall low risk/return portfolio, then does that mean all the products in the portfolio should be low risk – and products that are not low risk are outside target market? And similar for other portfolio characteristics such as high risk/return, income distribution, investment timeframe, liquidity?

Answer:

The TMD should be considered against the intended use of the relevant component of the investment portfolio and not against the customer's desired characteristics of the whole portfolio.

Therefore, a high risk/return product can legitimately be a component of a portfolio that is overall low risk/return. If a fund meets the customer's requirements for the relevant portion of the client's portfolio, then the distributor could legitimately classify the customer as being in the target market for that component of the portfolio.

As part of portfolio construction, distributors, including financial advisers, can legitimately determine different parts of a customer's portfolio should have different characteristics, such as a portfolio could have part allocated to low risk/return products, another part to medium risk/return and the remainder to high risk/return products. Similarly, some parts of a portfolio may have higher desired liquidity than other parts, and some may have more

FSC guidance for distribution of managed funds

capital growth, longer investment timeframe and so on. In each case, investment products should be assessed against the relevant component of the overall portfolio.

For example, an adviser may be constructing a portfolio with 30% of the portfolio allocated to high risk/return products and 70% allocated to low risk/return. In this case, 70% of the portfolio could be assessed against a customer need of low risk/return, and a product rated suitable for low risk/return is potentially suitable for that part of the portfolio (contingent on other characteristics of the product). These products may not be suitable for the remaining 30% of the portfolio.

Conversely, the remaining 30% of the portfolio should be assessed against a customer need for high risk/return, with a high risk/return product potentially suitable for that part of the portfolio, and potentially not suitable for the remaining 70%.

In this example, it may be the case that a portfolio that is 30% high risk/return products and 70% low risk/return products is assessed by the adviser as having all the products in the portfolio suitable for the customer (ie none of the products are assessed as being outside the target market) – but the assessment should be done on each product based on its suitability for the relevant component of the portfolio, and importantly should include all the characteristics of the products in the portfolio, not just risk/return.

This is encapsulated in the FSC's TMD template for managed funds which includes these words:

A consumer (or class of consumer) may intend to hold a product as part of a diversified portfolio (typically with an intended product use of satellite/small allocation or core component). In such circumstances, the product should be assessed against the consumer's attributes for the relevant portion of the portfolio, rather than the consumer's portfolio as a whole. For example, a consumer may seek to construct a conservative portfolio with a satellite/small allocation to growth assets. In this case, it may be likely that a product with a High or Very High risk/return profile is consistent with the consumer's objectives for that allocation notwithstanding that the risk/return profile of the consumer as a whole is Low or Medium. In making this assessment, distributors should consider all features of a product (including its key attributes).

Not all published TMDs will include this paragraph above, but that should not prevent distributors (including advisers) taking account of the principles in this paragraph.

Some examples of how this approach may operate:

- An adviser is constructing a portfolio for a client wishing to receive regular income distribution. The adviser determines that a small part of the portfolio can be allocated to irregular income products, and includes in the portfolio two managed funds that provide irregular and uncorrelated income distribution, even though these two funds are rated red (outside target market) for income distribution. As long as these two products meet the needs of the relevant part of the portfolio, the adviser classifies the customer as inside target market for that part of the portfolio.
- An adviser has a client with a conservative portfolio that includes a small allocation to high risk/return products, and includes in this component of the portfolio a growth fund. The adviser recommends the client replace this growth fund investment with another growth fund. The adviser assesses that the replacement growth fund will meet the needs of the small allocation of the client's portfolio to

FSC guidance for distribution of managed funds

high risk/return products. The adviser classifies the customer as being inside the target market for the growth fund, even though the fund is rated red (outside target market) for low risk/return.

- Based on advice, a client wishes to increase their portfolio allocation to high risk/return products. As part of rebalancing the portfolio, the adviser removes some low, medium and high risk funds and adds other low, medium and high risk funds. After the change, the portfolio consists of low risk products in the low risk component of the (adjusted) portfolio, medium risk products in the medium risk component, and so on. The adviser classifies the customer as being inside the target market for all the funds in the portfolio, even though some of the funds may be outside the target market for a customer seeking high risk/return.

Note the above does not mean that distributors can ignore TMDs when constructing portfolios, and certain parts of TMDs need to be applied on a product by product basis, in particular distribution conditions and reporting requirements.

Also importantly, distributors providing personal financial advice should consider the TMD in connection with the adviser Best Interests Duty in Part 7.7A of the Act when advising the client.

2. Distribution outside of Target Market

Question: Should distributors always prevent distribution that is outside of the target market as identified in the Target Market Determination (TMD)?

Answer: Not always. There will be good reasons to prevent distribution that is outside target market in a range of circumstances, however, there is no requirement under the Act for distributors to prevent all distribution that is outside target market.

In particular, the DDO does not require an individual suitability test for every customer – so the regime does not require issuers and distributors to assess each customer against the TMD for the relevant product.

Instead:

- Distributors who provide personal financial advice must follow the Best Interests Duty, and in that context determine whether or not distribution to a person outside of target market is appropriate.
 - ASIC specifically contemplates financial advisers distributing outside target market, see RG 274.203: “It may be appropriate for a financial adviser to advise a consumer outside of the target market to acquire a financial product, when acquisition would be in the best interests of the consumer.”
- Distributors who do not provide personal financial advice should take reasonable steps to ensure distribution conduct is consistent with the TMD (the exact legal wording is in s994E(3) and (5) of the Act). In some cases, it may not be a ‘reasonable’ step to stop all distribution to consumers who are outside a target market.

The Act specifically envisages circumstances where distribution outside a target market can occur, see s994E(4): a distributor “is not taken to have failed to take reasonable steps for the purpose of paragraph (3)(d) merely because a retail client who is not in the target market for the product acquires the product.”

FSC guidance for distribution of managed funds

However, we do note ASIC discourages distribution to customers outside of target market:

- “a distributor must have effective systems and processes in place that are reasonably likely to avoid this result [distribution outside of target market]”. (RG 274.174).
- “[If a distributor is aware a customer is outside target market] The distributor is not prevented from ultimately selling the consumer a financial product in such circumstances, provided reasonable steps are taken: see s994E(4). However, a product that has been sold to consumers on multiple occasions when consumer harm is likely to result can indicate a failure to meet reasonable steps obligations.” (RG 274.197).

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