It’s now or never

Are you DDO ready?

Michael Blomfield,
Chief Commercial Officer, Iress

There are two pieces of legislation coming into effect in 2021 that will have dramatic effects on the financial services profession, and the entire industry needs to decide how it's going to manage these changes–together.

If you're in the financial services industry, there are two key dates I hope are circled, underlined and highlighted in your 2021 calendar: 1 July and 5 October.

Respectively, those two dates mark when advisers must annually renew their fee arrangements with clients and when the Design and Distribution Obligations (DDO) regime starts. These are separate pieces of legislation, focusing on separate areas of compliance, but both require an unprecedented level of connection, communication, record-keeping and (ideally) collaboration across the entire value chain.

Before we examine why this is the case, it's worth recapping what both of these reforms entail.

Annual renewal

The fee consent components of the Financial Sector Reform (Hayne Royal Commission Response No. 2) Bill 2020 require that ongoing fee arrangements be renewed annually, rather than every two years, and that fee disclosure statements must be 'forward-looking'– that is, they must project out the fees charged and services provided by the adviser for the following year, and written consent must be obtained by the client.

Advisers will have up to 60 days from the 'anniversary' period to issue these statements. There are some exceptions to these rules–consent isn't required in circumstances relating to deductions from basic deposit products or from accounts linked to a credit card - but overall, these changes represent a substantial increase in the volume of record-keeping and cost projection required from advice businesses.

Note that records of consent and projections of annual fees must be visible to (or verifiable by) not just the adviser and client, but also ASIC and potentially other third parties like platforms and Managed Account providers.

DDO

Regarding the second piece of legislation: if the annual fee renewal requirements seem like a major challenge for advice businesses, the DDO regime represents a level of complexity that will reverberate throughout the entire financial services industry.

DDO creates a fundamental shift in how financial products are built and delivered to clients and members.

DDO requires product issuers to design products that are consistent with the likely objectives, financial situation and needs of the consumer for whom they are intended from 5 October 2021.

The Act requires that:

- Product issuers design financial products that are consistent with the likely objectives, financial situation and needs of the consumers for whom they are intended (the target market), and take reasonable steps to ensure investors outside the target market are unlikely to acquire a product. Issuers include, but are not limited to, asset managers, insurers, operators of investment platforms, trustees of superannuation funds and banks.

- Distributors must take reasonable steps to distribute financial products to the target market. Distributors (including personal advice distributors) are also obligated to report complaints, significant dealings and information specified by the product issuers.

The consequences of not complying with these requirements are significant, with the legislation allowing for civil penalties up to $200,000 for individuals and $1 million for corporations, as well as potential criminal sentences.

For product issuers (Issuers), platforms (Issuers and Distributors) and AFSL licensees selling financial products to consumers (Distributors), DDO legislation requires that there be sharing of information and that all three participants monitor product dealings against the Target Market Determination (TMD) provided by the product issuer.

> **When you consider that DDO applies to nearly all regulated financial products in Australia–everything from insurance policies to managed funds investments held on platforms–it's difficult to imagine any business or person in this industry who won't be affected by this legislation.**

Show your work

If there was a single key industry failure identified during the Royal Commission it was one of record-keeping and transparency. Even in circumstances where one could reasonably assume a business was acting in accordance with its customers' best interests, there were numerous cases where said business had little-to-no evidence to back it up. Records were often lost, fragmented across disparate systems, stored in hard-to-access warehouses, and sometimes never made in the first place.

That's what these two pieces of legislation are designed to address, regardless of the additional compliance burden placed on the industry.

Make no mistake, though: that burden, for lack of a better term, will be significant. If you want to estimate the additional work that's going to be required for the industry to be compliant with the DDO regime, start with a baseline number of hours you, individually, think will be occupied by these changes. Multiply that by the number of planning businesses in Australia, then by the number of platforms, then by the number of product manufacturers of all types.

When you add in the annual fee renewal requirements, it becomes clear this is a massive issue that needs solving–especially since ASIC has specified that it expects compliance from 'day one'.

The source of truth

Consider the breadcrumb trail for a single target market definition (TMD). The TMD is, effectively, an artefact that evidences a product manufacturer has contemplated a product's suitability for a specific classification of retail investor. If giving personal advice, a planner is

then required to consider if the client sits within the classification defined in the TMD for any products recommended. While ultimately a planner is held to the higher bar of the Best Interest Duty they still need to record the fact of this test, and maintain records of all dealings so that they can report this to the Product Issuer. The planner also needs to maintain awareness of changes and any new or withdrawn TMDs to ensure they don't recommend products without a current TMD. But there's more. The platform needs to verify this as well, or have the planner certify that the product recommendation was provided under personal advice, as they don't want to be holding something in breach of the DDO rules.

Ideally, this will result in fewer circumstances where, say, an 81-year-old is invested in an aggressive long-short fund. But what if that 81-year-old has been advised by a planner to invest in a long-short fund because it is a small percentage of a family trust which will be inherited by their 13-year-old grandchildren? In an exception to the TMD such as this, it will need to be recorded and the fact that the product was recommended under personal advice also recorded. And that's not even taking into account whatever changes may be made to the original TMD following a review.

Blockchain to the rescue?

As you can imagine, this all requires interconnectedness on a scale we've never contemplated before. Moreover, that level of interconnectedness can't be supported by or achieved via the basic set-and-forget messaging frameworks or databases operated using different systems and standards across thousands of businesses throughout the country.

That approach simply won't cut it in the age of DDO and annual ongoing fee arrangements. The industry needs a new way for organisations to talk to each other—and to record the fact of this. And despite its association in the popular imagination with cryptocurrency fads, that solution might just be blockchain. In the past, I've described blockchain as a brilliant solution to a problem that didn't exist. Well, the problem is finally here, which is why Iress's blockchain-based solution for DDO will be ready to use from the moment the new regime kicks in.

A blockchain is essentially a means of storing and recording information in a digital ledger that's distributed across any system that accesses it. No single party can, therefore, modify or 'lose' a particular data-point, such as a decision that a piece of advice is consistent with a particular TMD. It's this immutability that facilitates ongoing, permanent verification of all records necessary to demonstrate compliance with DDO and consent for the renewal of annual advice fees.

Ultimately, though, the fact that this 'source of truth,' distributed to and verifiable by all interested parties (including the regulator), is blockchained based is by-the-by. Our vision is an industry utility connecting all parties—from adviser desktop to platforms and everything in between. So if you're an adviser recording your decision with respect to a product's TMD, you won't even know you're using it. You'll be using the same systems you always have.

A fresh approach is required

> **Advice fee consent and DDO represent a challenge no traditional system or process in this industry can overcome, or that one party can solve in isolation.**

They both require an unpredictably large, as-yet unknown set of parties to connect with one another, verify information and maintain permanent, immutable records.

If there has been any silver lining that's emerged from the inadequacies of record-keeping as revealed in the Royal Commission, it's the fact that we, as an industry, have learned that we need a better way of communicating with each other and maintaining a (digital) paper-trail. And if there were any doubts about that, the law is now forcing our hand.

These aren't challenges we can tackle on a piecemeal basis. From 1 July and 5 October, we're all in– permanently. It's now or never.

For more information

Visit
iress.com/ddo

Email
ddo@iress.com.

ddo@iress.com
www.iress.com