

KEY TOPICS

1. Managed Discretionary Accounts
2. Excessive Transactions
3. Reporting to ASX

ASX Market Rules

1. 7.10

Cross-reference

1. ASIC Policy Statement 179
2. ASIC Class Order 04/194

Guidance Note History

Issued:
16 November 2005

- Previously:
- 1 December 2004
 - Guidance Note 2/98 “Discretionary Accounts”

MANAGED DISCRETIONARY ACCOUNTS

Purpose

This Guidance Note assists Market Participants to interpret the ASX Market Rules (“the Rules”) relating to Managed Discretionary Accounts (“MDAs”) for Retail Clients.

It applies to those Market Participants operating MDAs under ASIC Class Order 04/194.

Background

The obligations relating to the establishment and operation of MDAs are primarily governed by ASIC and are established in ASIC Class Order 04/194, ASIC Policy Statement 179 “Managed Discretionary Account Services” (“PS179”) and in Australian Financial Services Licence conditions.

The MDA requirements in the Rules are reflective of the obligations under the Corporations Act, Class Order 04/194 and PS179.

ASIC has established licensees’ obligations for supervision of MDA services provided to Retail Clients regarding:

- management of MDAs;
- suitability of MDA portfolios;
- trading of options;
- reporting to clients; and
- internal controls for the operation of MDAs.

ASX has considered the specific circumstances of its markets. As a result, the Rules include requirements relating to:

- compliance with the ASIC requirements and provision to ASX of reports required thereunder;
- the requirement for MDAs operated for Retail Clients which involve DTP Products or Warrants to be operated by Accredited Advisers;
- the management of conflicts of interest where the Market Participant is also the issuer of Quoted Products;
- excessive transactions; and
- Unprofessional Conduct.

In this regard the Market Rules do not conflict with ASIC's requirements, rather they provide an additional level of investor protection in relation to transactions occurring on ASX's markets.

Participant to Determine and Manage Its Own Risk

Operation of MDAs has the potential to be a high-risk activity for a Market Participant requiring close attention to the management, control and supervision of discretionary account activity. Market Participants are responsible for ongoing compliance with the Rules. Market Participants are also responsible for all actions and omissions of their employees. It is the obligation of each Market Participant to identify and implement internal controls to manage their regulatory risk and comply with the Rules. Each Market Participant must have in place effective mechanisms to manage compliance and supervisory policies and procedures reasonably designed to achieve compliance by the Market Participant with the Rules relating to MDAs. Where contraventions (or potential contraventions) are discovered the Participant must have the means available to take appropriate action.

In particular, all Participants should constantly be vigilant to ensure that client's instructions are recorded and followed. Where a MDA is operated, ASX would expect an internal compliance program would be monitoring trading on those MDA accounts.

Excessive Transactions

The Rules prohibit a Market Participant from entering into Market Transactions on an MDA for a Retail Client where the size or frequency of the Market Transaction/s is considered excessive having regard to the investment objectives, financial situation and needs of the client and the relevant markets. This prohibition needs to be considered in line with the Market Participant's obligation to act honestly and in the best interest of the client, exercise due care and diligence and give priority to the client's interests.¹

Excessive transactions cannot be established by any precise formula and each situation must be judged on a case-by-case basis. However, one process that may be used to determine whether transactions were excessive could be:

- Determination of the investment objectives, financial situation and needs of the client;
- Determination of objective measures used to quantify the size or frequency of trading;
- Comparison of the size or frequency of trading with the investment objectives, financial situation and needs of the client; and
- Determination of whether or not the size or frequency of trading is reasonable having regard to the investment objectives, financial situation and needs of the client.

¹ See PS179.34, 35 and 38.

For example, if a Retail Client has the investment objectives of long-term orientation, wanting the value of the portfolio to grow over time, wanting to invest in blue-chip, “leading” and steady shares and wanting fully franked dividends, criteria which may be applied to determine whether or not trading was excessive in this situation may include, but not be limited to, whether:

- The stock was in the ASX 100 or producing a significant net profit after tax at the time of the trade;
- The stock was sold within 30 days of purchase and a fully franked dividend was not received;
- The trade resulted in a fully franked dividend being received; and
- The trade was contrary to the investment objectives, financial situation and needs of the client.

Unprofessional Conduct

“Churning” on a MDA is an indicator of Unprofessional Conduct. “Churning” is trading of a size or frequency with the effect of generating excess commissions. “Churning” on a MDA may be an indicator of excessive transactions and vice versa. “Churning” cannot be established by any precise formula and each situation must be judged on a case-by-case basis. However, one process that may be used to determine whether “churning” has occurred could be:

- Recording and review of the brokerage, commission or management fee earned during a quarter as a percentage of the opening value, closing value and change in value of the MDA portfolio for the quarter;
- Recording and review of the value of all market transactions for the quarter as a percentage of the opening and closing value of the MDA portfolio for the quarter;
- Recording and review of the value of the market transactions for each Quoted Product for the quarter as a percentage of the opening value, closing value and change in value of that Quoted Product for the quarter;
- Recording and review of the value of each Quoted Product at the close of the quarter as a percentage of the closing value of the MDA portfolio for the quarter;
- Comparison of the size or frequency of trading with the investment objectives, financial situation and needs of the client; and
- Determination of whether or not the size or frequency of trading is reasonable having regard to the investment objectives, financial situation and needs of the client.

Unauthorised Discretion

ASX considers discretionary trading outside the terms of an agreement with a client and/or where no MDA agreement is established as “unauthorised discretionary trading”. All Participants, whether offering MDA services or not, should be on the look out for unauthorised discretionary trading.

ASX considers unauthorised discretionary trading to be a serious matter for the purpose of Rule 28.2.3 which may result in breach of Rule 7.4.1 and/or a charge of Unprofessional Conduct. It may also be a breach of a condition of the Market Participant’s Australian Financial Services Licence. ASX would expect that, if unauthorised discretionary trading were detected, the Participant would take appropriate disciplinary action against the representative concerned.

Simple Price Discretion

ASX interprets simple price and/or time discretion on a specific order (or series of orders) given by a Retail Client to not be discretionary trading for the purpose of the Rules relating to MDAs provided that the instruction and extent of the discretion in respect of each order is recorded on the Trading Record as required by Rule 4.10.1.²

Trading On Behalf Of A Family Member

ASX interprets trading on an account operated under a third party authority given by a spouse or family member to a representative of a Market Participant where the representative of the Market Participant is not a party to the account³ to constitute an MDA account for the purpose of the Rules. In this regard ASX notes PS179.17 which states that if the arrangements under which a person carries out discretionary trading as an agent of another person are private arrangements (eg private arrangements using a power of attorney given by a family member), they may not be covered by PS179. This is because the person may not be carrying on a business to attract the licensing requirements under the Corporations Act. However, if a representative of a licensee undertakes discretionary trading on behalf of a family member of the representative, that trading would generally be part of the financial services business conducted by the representative’s principal (ie the licensee).

² See also PS179.19

³ For example, joint accounts, family trust accounts where the representative of the Market Participant is trustee or family company accounts representative of the Market Participant is a director would be considered accounts where the representative of the Market Participant is considered to be a party to the account.

On 8 December 2004 ASIC advised the Securities and Derivatives Industry Association that:

“Until ASIC advises you further, ASIC does not intend to take enforcement action for failure to comply with the provisions from which relief is given under the MDA policy or have appropriate license authorisation against a licensee. This applies only when the non-compliance is merely because the licensee’s representatives provide discretionary trading services to their immediate family members.”

Similarly, until further notice, ASX does not intend to take enforcement action for failure to comply with the interpretation of the Market Rules (set out above) regarding trading on an account operated under a third party authority given by a spouse or family member to a representative of a Market Participant where the representative of the Market Participant is not a party to the account⁴.

Reporting to Clients

The reporting obligations in relation to MDAs are additional to the standard reporting requirements for all products contained within the Rules. For example, it is still necessary to provide Confirmations, Monthly Statements, Notifications of Exercise or Assignment, etc to all clients, within the timeframes set out in the Rules, irrespective of whether or not an MDA is operated for that client.

Reporting to ASX

Reports provided to ASX pursuant to Rule 7.10 should be addressed to

The Manager
Compliance Services
Australian Stock Exchange Limited
Level 1
Exchange Centre
20 Bridge St
Sydney NSW 2000

Qualification

ASX has published this Guidance Note to promote commercial certainty, and assist Market Participants. Nothing in this Note necessarily binds ASX in the application of the Rules in a particular case. In issuing this Note ASX is not providing legal advice and Market Participants should obtain their own advice from a qualified professional person in respect of their obligations. ASX may replace this Guidance Note at any time. Readers should contact ASX to ensure they have the latest version.

⁴ For example, joint accounts, family trust accounts where the representative of the Market Participant is trustee or family company accounts representative of the Market Participant is a director would be considered accounts where the representative of the Market Participant is considered to be a party to the account.