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Director
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Sent via email: misreview@treasury.gov.au

Dear Director

AIMA Australia Submission
Review of the Regulatory Framework for Managed Investment Schemes: Consultation Paper

1. About AIMA

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. In addition, AIMA has over 150 local based corporate members including managers and key service providers. For further information, please visit AIMA's website, www.aima.org. AIMA's affiliate association, The Alterative Credit Council (ACC) deals specifically with non-bank and private credit.

As an industry body whose membership is predominantly that of private fund managers, we take a keen interest in the development and enhancement of this part of the industry as well as the asset management industry more broadly. It is with this perspective that AIMA Australia (**AIMA**) make some recommendations for Treasury's consideration in relation to the *Review of the Regulatory Framework for Managed Investment Schemes: Consultation Paper* (**Consultation Paper**).

2. Consultation Paper

The Consultation Paper seeks feedback on a number of different aspects of managed investment scheme (**MIS**) regulation. In this submission, AIMA has focused on aspects of MIS regulation most relevant to our members.

This submission has been prepared by members of AIMA's Regulatory Committee.

Set out below are the questions posed in the Consultation Paper, and AIMA's responses.

3. Executive Summary

AIMA considers that the current regulatory framework for managed investment schemes is generally working well. AIMA members observed that the Consultation Paper does not clearly articulate the issue/problem many of the proposals are trying to address, which makes it difficult to understand why the changes proposed are warranted. Responsible entities of managed investment schemes have had a wave of regulatory change to navigate over the last few years and AIMA urges caution in imposing more regulatory change when some of the new requirements, in particular the design and distribution obligations regime (**DDO**) and product intervention powers, are relatively new and time should be provided to ensure the new regimes are operating as intended.

However, AIMA is supportive of:

- reconsidering the need to increase the thresholds applicable to the wholesale and sophisticated client tests;
- reconsidering the requirement for a tailored compliance plan for each scheme;
- reconsidering the need to give the Australian Securities and Investments Commission (**ASIC**) further powers, especially in light of the extensive powers available to ASIC under the DDO and product intervention regimes (among other things);
- changing the voting thresholds for change of responsible entities;
- introducing a tailored insolvency regime; and
- providing a statutory limitation of liability for scheme members.

AIMA considers the above changes will reduce the regulatory burden and/or assist in the efficient operation of schemes.

4. Detailed Submission

Chapter 1 – Wholesale client thresholds

1. Should the financial threshold for the product value test be increased? If so, increased to what value and why?

<u>AIMA response</u>

AIMA does not support any increase to the financial threshold for either the:

- product price; or
- product value,

tests (both being AU$500,000), other than the potential introduction of a suitable inflation index (e.g., CPI) to the test on a look-forward basis.

By raising the tests above AU$500,000, an investor may risk being overly concentrated in a smaller number of financial products. If an investor wishes to construct a diverse portfolio of investments, this will be harder if the price and/or value tests are increased. Therefore, AIMA does not support any increase to the tests.

Rather than raising the tests above AU$500,000, as an alternative, Treasury ought to consider lowering the tests (e.g., to AU$250,000) and introducing a consent requirement. Please see our below response to question 4 in relation to the consent requirement.

For simplicity, if indexation was adopted, AIMA suggests the product value threshold could be increased in $100,000 increments (e.g., where the threshold starts at $500,000, then once CPI has increased by 20%, the threshold moves to $600,000). Otherwise, indexation of dollar amounts could introduce complexity and uncertainty if adjustments were frequently made to align with changes in CPI.

In the event of any change to the tests, suitable transition arrangements would need to be put in place. AIMA recommends that any changes to thresholds be introduced on not less than 12 months' prior notice. Please also refer to our "General observations" below in terms of grandfathering existing investors in financial products.

Further, we make the following observations with respect to the tests:

a) The carve out of "superannuation-sourced monies" (as defined in regulation 7.1.26 of the *Corporations Regulations 2001* (Cth) (**Corporations Regulations**) from the threshold is not required. Many applicants (and issuers) are unaware that this carve out applies and/or issuers are not able to readily ascertain whether application monies are superannuation-sourced monies. Given the carve out has limited application, we submit that it is confusing and unnecessary, and recommend that it is removed as a carve-out from the test.

b) We support the continued application of regulation 7.1.18(3) of the Corporations Regulations, such that the price test is applied at the time the product is initially acquired. However, if a further acquisition is made of the same product (e.g., additional units in a managed investment scheme pursuant to a distribution reinvestment plan), we welcome clarification that such further acquisition/s (which may be below the AU$500,000 price test) be covered by this provision. While we appreciate there is some flexibility provided for this scenario in the value test under regulation 7.1.19 of the Corporations Regulations, this is only available if the value of the product remains above AU$500,000 (which in varying markets may not be the case).

c) We support the continued application of regulation 7.1.18(4) of the Corporations Regulations. That is, where any part of the $500,000 paid for a product is lent by the issuer of the product, or an associate of the issuer, then that portion of the lent monies cannot be used to calculate the $500,000 amount.

d) We support the continued application of regulation 7.1.17B of the Corporations Regulations, which permits aggregation of the investing entity's investment monies with those of its associates and wholly owned and controlled bodies corporate, provided the monies are being invested at or about the same time.

2. Should the financial thresholds for the net assets and/or gross income in the individual wealth test be increased? If so, increased to what value and why?

<u>AIMA response</u>

AIMA does not support any increase to the financial threshold for either the:

- Net assets; and/or
- Gross income,

tests in the individual wealth test, other than the potential introduction of a suitable inflation index (e.g., CPI) to the test on a look forward basis. For simplicity, if indexation was adopted, AIMA suggests:

a) the gross income threshold be increased in $50,000 increments (e.g., where the threshold starts at $250,000, then once CPI has increased by 20%, the threshold moves to $300,000); and

b) the net assets threshold be increased in $500,000 increments (e.g., where the threshold starts at $2.5 million, then once CPI has increased by 20%, the threshold would move to $3 million).

Otherwise, indexation of dollar amounts could introduce complexity and uncertainty if adjustments were frequently made to align with changes in CPI.

In the event of any change to the tests, and for ease of implementation and to limit any compliance burdens (e.g., to allow time for the accountant's certificate templates to be updated), AIMA recommends that any changes to thresholds be introduced on not less than 12 months' prior notice. Please also refer to our "General observations" below in terms of grandfathering existing investors in products.

The Consulting Paper highlights the existing tests used in the United Kingdom (which uses an annual income of GBP100,000 and net assets of GBP250,000, subject to certain exclusions) and the United States (which uses an annual income of US$200,000 and net assets of US$1 million, subject to certain exclusions), which AIMA notes are more onerous than those used in Australia.

Rather than increasing the individual wealth test, AIMA supports either:

- a reduction in the individual wealth test; and/or
- introduction of consent requirements (see our below response to question 4 in relation to the consent requirement).

The current individual wealth test (particularly the net assets test) favours Generation Boomers and older. Whereas many of those within Gen Z and younger generations are not yet asset rich, but may still be sophisticated investors. Younger investors who self-educate and who are prepared to invest in wholesale products with a longer investment term and greater risk tolerance, ought not be penalised due to a structural deficiency in the Australian housing market. Therefore, a lower test with a consent requirement, may be more suitable to this category of investors.

Further, any increase to the tests may exclude women and other minority groups from being able to invest in products that are more readily available to wholesale clients, such as early stage investing products. Surely this outcome is not desirable. Therefore, a lower test with a consent requirement, may be more suitable to these categories of investors.

Finally, if any assets are to be excluded from the individual wealth test (please see our below response to question 3), then AIMA supports a corresponding reduction to the current tests.

3. Should certain assets be excluded when determining an individual's net assets for the purposes of the individual wealth test? If so, which assets and why?

AIMA response

While we acknowledge that certain jurisdictions exclude some assets from the individual wealth test, such as the family home, superannuation or insurance benefits, AIMA generally does not support this approach.

AIMA notes the individual wealth test is conducted on a "net" basis. If assets are to be excluded (which AIMA does not support), then it makes it harder to know what liabilities ought to be excluded.

Further, as a practical matter, if certain kinds of assets are excluded from the test, then investors' status might fluctuate between a wholesale client and retail client classification based upon their acquisitions and disposals of those types of assets. For example, if the family home is excluded from the wealth test, an investor might be a retail client, but then they could become a wholesale client under the wealth test temporarily if they were to sell that property and live in a rented premises for a period of time, before purchasing another property (and potentially becoming a retail client again).

Excluding the family home from the individual wealth test could lead to poor consumer outcomes by encouraging excessive leveraging in order for someone to qualify as wholesale client. For example, an owner of say a $6 million mortgage free property would not be classified as a wholesale client if the asset is excluded from the individual wealth test, but could borrow $3 million against that property to invest in financial products (leaving net equity of $3 million in the family home) and be characterized as a wholesale client.

As noted above, if any assets are to be excluded from the individual wealth test, then AIMA supports a corresponding reduction in the current tests. We note the United Kingdom's test (with excluded assets) is GBP250,000 and the United States test (with excluded assets) is US$1 million.

However, rather than introducing exclusions on assets to be used in the individual wealth test, AIMA supports the introduction of consent requirements (please see our below response to question 4).

4. If consent requirements were to be introduced:

- ***(a) How could these be designed to ensure investors understand the consequences of being considered a wholesale client?***
- ***(b) Should the same consent requirements be introduced for each wholesale client test (or revised in the case of the sophisticated investor test) in Chapter 7 of the Corporations Act? If not, why not?***

AIMA response

Rather than increasing any of the thresholds for the product price, product value or the individual wealth tests, AIMA supports leaving the tests as they are (or reducing the thresholds – please see above responses) and introducing a consent requirement for these tests.

The consent requirements should require the applicant to acknowledge and agree to the following:

a) they can make their own investment decision/s (or have otherwise received professional advice);
b) they understand the merits, value and risks of the proposed investment;

c) they have not been provided, and are not required to be provided with, a regulated disclosure document in connection with the offer of the relevant financial product;
d) they may not receive or benefit from the same consumer protection provisions that would apply if they were to invest in the financial product as a retail client (that exist under the *Corporations Act 2001 (Cth)* (**Corporations Act**) and the *ASIC Act 2001 (Cth)*); and
e) on this basis, proceed to invest in the product accepting they will not be treated as a retail client for the purposes of the Corporations Act.

AIMA supports the retention of the existing sophisticated investor exemption under section 761GA of the Corporations Act. However, AIMA submits that any consent requirement that's introduced for the revised product price, product value or individual wealth tests should operate separately from the sophisticated investor exemption (under section 761GA of the Corporations Act), as the sophisticated investor exemption already requires:

- a sufficient level of engagement between the Australian financial services licensee and the relevant client in relation to that client's financial products/services experience; and
- the client to sign a written acknowledgement in relation to them (in effect) not receiving the same treatment as a retail client under the Corporations Act.

Further, AIMA notes that if the thresholds for meeting existing wholesale client tests are increased, product issuers may be more inclined to avail themselves of the sophisticated investor test in section 761GA of the Corporations Act. AIMA considers there is an inherent conflict with the test because, for example, it is in the interests of a product issuer to certify an investor (as a sophisticated investor) so that the product issuer can accept that investor's funds into their product and increase their assets under management. This issue is relevant to other kinds of financial products as well as MISs. Anecdotally, AIMA observes that some product issuers are reluctant to rely on the sophisticated investor test because of the compliance risk associated with the subjectivity of the assessment criteria.

General Observations

AIMA observations

Finally, AIMA makes the following observations:

- should there be any increase to the wholesale client thresholds (which we do not support for the reasons set out above), AIMA strongly encourages Treasury to indefinitely "grandfather" existing investors in products who are invested at a particular point in time. For example, any existing investors in financial products as at a particular date (e.g., upon commencement of the relevant changes) are deemed to remain a wholesale client, provided they continue to satisfy the current wholesale client test/s at all relevant points in time. This is particularly important for products that may be partially or entirely illiquid or subject to lock up terms. Further, existing investors in financial products which allow further investment (either by ad hoc top ups or reinvestment distribution plans) should be permitted to add to their investment if they continue to satisfy the current wholesale client test/s at all relevant points in time;
- some financial service providers who are only authorised to provide financial services to wholesale clients may need to vary their Australian financial services licence (**AFSL**) in order to continue to provide financial services to those of their existing clients who may no longer fall within any of the wholesale client definition. Sufficient transitional provisions would need to be introduced to factor in time to vary AFSLs (which we know can take considerable time) and obtain any retail specific authorisations that may be required. ASIC will likely need to consider its resourcing requirements to assess any influx of AFSL variations applications it will receive as a consequence of any changes;

- there is complexity and some confusion within the current provisions which are used to determine whether an investor is a wholesale or retail client for a particular purpose, including the use of the expression "in connection with a business" used in subsection 761G(7) without providing any context or interpretational aid; and
- additional categories of wholesale clients may be considered in line with foreign jurisdictions. For example, non-residents of Australia ought to be considered wholesale clients if they meet certain consent criteria. By adding this additional category of wholesale client/s, AIMA is of the view that this may assist in attracting further foreign investment into Australian-domiciled MISs.

Chapter 2 – Suitability of scheme investments

5. Should conditions be imposed on certain scheme arrangements when offered to retail clients? If so, what conditions and why?

AIMA response

AIMA does not support the introduction of additional conditions on certain scheme arrangements when offered to retail clients, as it is of the view that such additional conditions would restrict a retail investor's ability to diversify their investment portfolio and there are already existing restrictions in the form of the DDO regime.

Consider, for instance, retail investors who want to invest in riskier assets (e.g., investing in a private equity fund, which is a registered scheme) as they have a longer investment timeframe and wish to diversify their investment portfolio. If additional conditions were imposed on registered schemes such that a retail client would be unable to invest in registered schemes with these kinds of underlying assets, the investment universe for retail clients would be smaller (than they currently are) and, in turn, their ability to diversify their portfolio would be reduced.

In light of the client-centric focus of DDO, the required disclosures under the DDO regime (including the target market determinations), and the significant financial product intervention powers granted to ASIC under the DDO regime, AIMA believes that the imposition of any additional conditions on certain scheme arrangements when offered to retail clients would be unnecessary. Further, given that the DDO regime has only been in place for a few years, AIMA respectfully submits that more time needs to be given for the effects of the DDO regime to play out in the market before imposing any additional conditions on scheme arrangements (noting that it will take time for retail clients to understand the impact and operation of the DDO regime).

AIMA also notes that ASIC has developed tailored disclosure guidance (which can include disclosure principles and benchmarks) for the issuers of MISs that hold certain types of assets (for example, unlisted property funds, infrastructure entities and hedge funds), which is intended to assist retail client investors in making an informed investment decision with a strong awareness of potential investment risks. These additional disclosure obligations provide additional safeguards for certain schemes offered to retail clients.

Additionally, AIMA recommends that funding is allocated to initiatives that promote financial literacy among the general population. Equipping individuals with the necessary education and tools for informed decision-making is, in AIMA's view, more effective than relying solely on regulatory disclosure frameworks.

6. Are any changes warranted to the procedure for scheme registration? If so, what changes and why?

AIMA response

AIMA does not believe that any changes are warranted to the procedure for scheme registration, and does not support the introduction of additional criteria for ASIC to assess whether a scheme should be registered or not.

In particular, AIMA is of the view that the current procedure for scheme registration is sufficient, and that the current 14-day timeframe that ASIC has to register a scheme is an adequate amount of time for ASIC to make a decision as to whether the scheme should be registered or not. Given the significant amount of information that ASIC is given to assess whether a scheme should be registered, it is in a unique position to use that information to proactively address any issues with such a scheme before it is registered *and* accepts retail clients (i.e., in accordance with the existing regulatory powers that ASIC has).

However, if changes were made to the procedure for scheme registration such that ASIC was given more powers or provided with more time to consider a scheme's registration application, AIMA is of the view that this may have a negative impact on the number of schemes seeking registration and would raise concerns around ASIC's ability to consider scheme registration applications in line with the significant powers that ASIC already has under the current regulatory regime. That said, if ASIC was given more time to consider a scheme's registration application, AIMA is of the view that ASIC should be required to raise any issues they had with the application at least 7 days before the time by which ASIC needs to provide their decision – to give the applicant a reasonable opportunity to consider and respond to the issues raised. Currently applicants are often only given a day or two to respond to any questions raised by ASIC during the process.

Finally, AIMA acknowledges that ASIC is not equipped, and nor should ASIC be expected, to vet MIS business models or predict (with any accuracy) whether any particular investment strategy will ultimately be successful.

7. What grounds, if any, should ASIC be permitted to refuse to register a scheme?

AIMA response

AIMA is of the view that ASIC should not be granted any additional powers to refuse to register a scheme, as the current regulatory regime already affords ASIC sufficient powers in this respect.

Currently, ASIC may refuse to register a scheme if it appears to ASIC that the scheme registration application does not comply with section 601EA of the Corporations Act, the proposed responsible entity is not a public company with an AFSL,[1] the scheme's constitution does not meet the content requirements of section 601GA or is not legally enforceable,[2] the scheme's compliance plan does not satisfy the content requirements in section 601HA or there are insufficient arrangements in place in relation to the audit of the compliance plan[3] (among other things).

Given the extent of the above powers, and the significant post-scheme registration powers that ASIC has under the DDO regime (please see our response to question 5), AIMA does not believe that ASIC needs any further powers to refuse to register a scheme, and that any additional powers on this front may act as a deterrent to those that are looking to register a scheme.

AIMA also notes that:

- ASIC does not review the constitutions of companies before registering them; and
- ASIC cannot reasonably be expected to prevent the failure of an MIS or its responsible entity.

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[1] *Corporations Act 2001* (Cth), s601FA.
[2] *Corporations Act 2001* (Cth), s601GB.
[3] *Corporations Act 2001* (Cth), s601EB(1)(h) and 601HG.

<u>Chapter 3 – Scheme governance and the role of the responsible entity</u>

8. Are any changes required to the obligations of responsible entities to enhance scheme governance and compliance? If so, what changes and why?

<u>AIMA response</u>

The compliance plan sets out adequate measures for the responsible entity to ensure the scheme complies with its constitution and the Corporations Act. It is proposed that the requirement for a registered scheme to have a compliance plan be re-considered in light of the following:

a) The requirement for a compliance plan only applies to registered MISs and retail CCIVs, and not to any other financial products. The requirement for a compliance plan may be a historical remnant of the requirement for proposed trustees of the former prescribed interest schemes to submit compliance plans to the predecessor of ASIC, which is carried through as a requirement for registered schemes and, more recently, as a requirement for retail CCIVs. As the managed investment scheme industry has matured in the last few decades, there is no reason why registered MISs should be singled out to ensure compliance through a compliance plan while other types of financial products (which also target retail investors) do not have such a requirement.

b) To effectively deal with compliance risk for registered MISs, the compliance system should be able to reasonably detect any breaches of law or constitution in advance. In the context of a compliance plan, a breach that is picked up through a compliance control in the compliance plan may actually mean that the compliance plan is an effective part of the responsible entity's compliance system in detecting such breaches, but such a breach is also considered to be a breach of the responsible entity's obligations under section 601FC(1)(h) of the Corporations Act which is a reportable breach to ASIC. It is not logical for a responsible entity to be 'penalised' for being in breach of its obligations when it has a compliance plan that is effective in detecting breaches and dealing with compliance risk. Therefore, the concept of a compliance plan should be revisited in light of this anomaly, and if the compliance plan requirement is removed and the responsible entity is required instead to have adequate compliance systems in place, a system that contains compliance controls that is able to detect breaches will be viewed as positive (which is in line with what compliance systems are supposed to do).

c) The requirement for individual compliance plans to be drafted and approved on a per scheme basis is antiquated. We recommend ASIC promptly assess the practicality and benefit of individual compliance plans. Whilst the spirit and intent of an individual compliance plan itself is sound, the administrative burden and financial cost associated with the administration of ~4500 individual plans is enormous. The cost benefit outcome is not commercial, nor is the concept of individual compliance plans adding material value, given the majority of responsible entities leverage a small number of base plans mapped to repeatable and broad control measures.

A more efficient approach, based on sound application of risk management principles, would see a single annual audit of a responsible entity's overall risk and compliance management system akin to the approach applied by APRA under CPS220. This would, of course, require an independent audit from an appropriately independent assurance firm, and would allow for a far deeper consideration of a responsible entity's arrangements across risk, compliance, culture, product governance

arrangements and, importantly, resilience. This would create cost savings across the industry, whilst lifting the level of assurance to something that is more substantive and meaningful.

If the intent of the legislation and regulations, coupled with regulatory guidance, is seeking to ensure a responsible entity maintains a robust risk and compliance framework, we suggest a single overall (deeper and more meaningful) audit would be of significant benefit. There are many responsible entities who have substandard risk management framework arrangements, so the focus should be more on risk management and product governance arrangements. The issue is that oversight and control varies substantially and the bar needs to be raised on risk management, rather than tick and bash compliance which is where we have landed.

Finally, and without limiting our response above, AIMA considers that existing legislation and regulations generally work effectively, bearing in mind that it will never be possible for regulation to prevent or deter all instances of misconduct or to remove all risks associated with the making of any particular investment.

9. Should ASIC be able to direct a responsible entity to amend a scheme's constitution to meet the minimum content requirements, similar to the CCIV regime?

AIMA response

Given that ASIC ensures that the constitution of a registered scheme must meet the minimum content requirements during the registration process of the scheme, and any subsequent changes to the minimum content requirements would most likely adversely affect members rights, a special resolution of scheme members would need to be passed for such amendments to be effective. It is not easy for such a resolution to be passed in for a registered MIS. The existing mechanism in relation to the amendment of a registered MISs constitution is sufficient to protect members interests, without the need for ASIC to have additional power to give directions to the responsible entity to amend a registered MIS' constitution.

If members do vote to pass a special resolution to amend a registered MIS's constitution, then they're indicating that they are in favour of the amendments and, conceivably, indicating that such amendments are in their best interests. For these reasons, allowing ASIC to make directions to change the constitution back to meet the minimum content requirements may actually be contrary to the best interests of the members of that scheme.

Finally, AIMA notes that, under section 1223C of the Corporations Act, ASIC has the power to direct the corporate director of a CCIV to modify the CCIV's constitution to ensure that certain content requirements are sufficiently addressed. However, the content requirements for a CCIV constitution are not entirely consistent with the content requirements for an MIS constitution, and there are matters which an MIS constitution is required to address that do not apply to a CCIV constitution. For these reasons, AIMA does not believe that giving ASIC the power to direct a responsible entity to change a registered MIS's constitution – for consistency with ASIC's powers under section 1223C of the Corporations Act – is appropriate, and may carry broader implications.

10. Are changes required to the compliance plan provisions to ensure compliance plans are more tailored to individual schemes? If so, what changes and why?

AIMA response

As noted in our response to Question 8, we query why registered schemes are singled out to ensure compliance through a compliance plan while other types of financial products (which also target retail investors) do not have such a requirement. However, if the requirement to retain a compliance plan remains, AIMA does not support the more tailored approach.

Compliance plans should contain high level controls to allow for flexibility to operate each registered MIS to which they relate. Overly prescriptive plans or specific tailored plans will lead to a number of undesirable outcomes, including:

a) **An increase in reportable breaches to ASIC** - A responsible entity is required to adhere to the compliance plan under section 601FC(1)(h) of the Corporations Act. The fact that the compliance plan is legally binding, the non-compliance of which will result in a reportable breach to ASIC, suggests that, as a matter of prudence and to allow flexibility for the responsible entity to operate the scheme, overly prescriptive or specific requirements in the compliance plan should be avoided.

b) **Qualified audit opinions** – If compliance plans are to be more tailored to each scheme, with some compliance plans being less prescriptive than others in certain areas due to the difference/s in underlying assets or operational processes, there is a risk that auditors may conclude that certain plans may not be 'adequate' under section 601HA of the Corporations Act when compared to other more detailed plans.

c) Operational difficulties – An overly prescriptive compliance plan may result in operational difficulties, or a potential breach of the plan, if there are changes to the operational aspects of the scheme that are not within the control of the responsible entity.

11. Should auditors be legislatively required to meet minimum qualitative standards when conducting compliance plan audits? If so, what should these standards be and why?

AIMA response

There is merit for auditors to meet minimum qualitative standards when conducting compliance plan audits as, currently, different auditors have different standards when providing their audit opinion. Any standards imposed would need to be measurable, objective and quantitative, to remove the element of subjectiveness that is currently prevalent across different auditors.

12. Should responsible entities be required to have a majority of external board members, similar to the CCIV regime?

AIMA response

The current regime allows for a responsible entity to either have a board with a majority of external board members, or have a compliance committee along with a board. Although there is merit in aligning this with the CCIV regime, as it is well understood and recognised internationally that diversity and independence on Boards promotes stronger governance, maintaining the status quo allows for flexibility – especially for smaller responsible entities that may not be able to have a majority of external board members.

Practically, it is not easy for all responsible entities to have sufficient external board members. It is challenging to find external people with the right skillsets to be a director on the board of a responsible entity, especially where the responsible entity operates schemes that invest in different types of assets. In addition, with potential personal liabilities being attached to a director, not many people with the relevant background will be willing to take up an external board member role if they are not

involved in the day-to-day business of the responsible entity. There are also increased costs for the responsible entity to engage a sufficient number of external board members, such as the fees payable to the external member and higher director and officer insurance premiums for the responsible entity. Although the removal of the compliance committee (for consistency with the CCIV regime) will further streamline governance and compliance for a responsible entity, such a removal also eliminates an extra layer of compliance oversight for the responsible entity.

As a general observation, AIMA considers that if greater parity between the registered MIS and CCIV regimes is the legislative objective, then a requirement for at least half (as opposed to a majority) of the directors of the responsible entity to be independent could achieve this objective. However, if Treasury's concern is more that compliance committees are not effective as they could be, then it may be appropriate to revisit the ability of the compliance committee to influence the affairs of the registered MIS. Treasury may also consider whether there ought to be any minimum competency and/or capability requirements for the board of directors of the responsible entity and/or compliance committee.

Chapter 4 – Right to replace the responsible entity

13. Are any changes required to the voting requirements or meeting provisions that allow members to replace the responsible entity of a listed scheme? If so, what changes and why?

Members of a listed MIS are able to replace the responsible entity by ordinary resolution. While AIMA would normally support consistent thresholds between listed, quoted and unlisted MISs, we appreciate there are practical implications for listed MISs that need to be considered. For example, the approval threshold for a change of responsible entity of a listed MIS is currently on an equal footing with the approval threshold for a takeover of a listed company.

AIMA also notes that, in the context of a stapled group comprising a listed company and a listed MIS, a takeover proposal might be accompanied by a proposed change of responsible entity, and therefore AIMA understands the requirement to have parity of voting thresholds to approve the change of responsible entity and approve the takeover. In this instance, we support the existing voting thresholds for listed MISs.

14. Are any changes required to the voting requirements or meeting provisions that allow members to replace the responsible entity of an unlisted scheme? If so, what changes and why?

AIMA response

The requirement to approve a change of responsible entity of an unlisted MIS by an extraordinary resolution of members often represents a very significant hurdle. This may be because:

a) members may not be proactive about voting; and
b) there can be circumstances where:
    1) some members may be associates of the responsible entity which is seeking to retire/being removed, and may therefore be prevented from voting as a consequence of the operation of section 253E of the Corporations Act; and/or
    2) a significant portion of the interests in the MIS may be custodially held, including via an investor directed portfolio service/platform arrangement. Consequently, the legal entity which is the member recorded on the register may not necessarily be in a position to vote the interests it holds on behalf of the beneficial owners (e.g., where it has not been able to obtain voting instructions).

We therefore advocate for alignment across all resolution mechanisms for unlisted MIS, as having differing thresholds is both confusing and cumbersome. Simplicity is required to ensure that responsible entities are not entrenched within structures. Notwithstanding this, there is a need to address the distortion that occurs where platform providers hold significant percentages of units in a scheme on issue. It is often the case that platform providers have policies in place that see them refrain from voting on such matters, with the effect being that the pool of available votes that could be cast are drastically reduced. This often sees very sound proposals to replace a responsible entity fail, which leads to incumbency, and, in some cases, is not in the best interests of unitholders.

To address the above concerns, AIMA considers the appropriate voting threshold to change the responsible entity of an unlisted MIS to be a special resolution (i.e., at least 75% of votes cast by entitled members must be in favour).

Further, AIMA notes the corresponding approval threshold to replace the corporate director of a CCIV is a special resolution. Under the CCIV regime, AIMA observes that if there is low voting participation in meetings, shareholders who hold a relatively small proportion of the shares on issue could be in a position to change the corporate director, even where it may not necessarily be in the best interests of shareholders as a whole. To avoid a similar outcome for unlisted MISs, Treasury might consider introducing a higher than usual quorum for a meeting of members to consider a change in responsible entity (i.e., the percentage of members who must vote) coupled with a special resolution threshold. But care needs to be taken to ensure the percentage of members is not set too such that issues of investor apathy or platform holdings remain a concern.

15. In what circumstances should an existing responsible entity be required to assist a prospective responsible entity conduct due diligence? What might this assistance look like?

<u>AIMA response</u>

Under the current legislative framework:

a) the existing responsible entity, for so long as it holds that office, has statutory duties, including a duty to act in the best interests of members; and
b) if the change of responsible entity is to proceed, section 601FR of the Corporations Act (in its current form) requires the outgoing responsible entity to:
    1) as soon as practicable, give the incoming responsible entity any books in its possession or control which the Corporations Act requires to be kept in relation to the MIS; and
    2) give the incoming responsible entity other "reasonable assistance" to facilitate the transition.

In reality, it is a fine balance to manage as a change requires a unitholder vote and there may be times where unitholders and investment managers are at odds. That said, any prudent responsible entity should be able to provide reasonable assistance to a potential incoming responsible entity in circumstances where the threshold requirements to initiate a meeting/vote have been met. Assistance should take the form of the outgoing responsible entity providing details of the following once a vote is called:

- ☐copies of all disclosed events and notifications;
- ☐details of breaches reported to ASIC, and any live matters that may in fact be reportable;
- ☐overview of any material matters that have been recorded as arising as a result of risk and compliance monitoring arrangements;
- ☐complaints register;
- ☐details of any litigation pertaining to the scheme in the last three years;

- ☐three years' worth of all relevant statutory audit reports and financial statements;
- ☐all relevant regulatory correspondence pertaining to the scheme;
- ☐funds under management, number of unitholders and past performance;
- ☐liquidity profile of the scheme (including the current liquidity analysis);
- ☐confirmation of professional indemnity insurance; and disclosure in respect of run off provisions where appropriate; and
- ☐all service provider contracts that will novate to the incoming responsible entity, subject to approval being received.

16. Should there be restrictions on agreements that the responsible entity enters into or clauses in scheme constitutions that disincentivise scheme members from replacing a responsible entity? If so, what restrictions may be appropriate?

AIMA does not consider there to be any need to introduce legislative change here, as the following provisions within the existing regulatory framework appear to be operating effectively:

a) the statutory duties of a responsible entity under section 601FC of the Corporations Act, in particular the duty to act in the best interests of scheme members;
b) section 601GA(2) of the Corporations Act, which provides that:
    1) the responsible entity may only receive payment or indemnification out of scheme property if the constitution expressly permits it;
    2) any such payment or indemnification is only available in relation to the proper performance of the responsible entity's duties; and
    3) any other agreement or arrangement which purports to confer such a right on the responsible entity has no effect;
c) the related party transaction regime under Part 5C.7 of the Corporations Act (which modifies Chapter 2E of the Corporations Act for a registered MIS); and
d) for an ASX listed MIS, the requirement under ASX Listing Rules 15.16 for a fixed term management contract to be for no more than five years, unless otherwise approved by the ASX.

Further, the imposition of any new restrictions may conflict with provisions of other agreements which the responsible entity has already signed with third parties (e.g., lenders, joint venture parties or other stakeholders), which would cause unnecessary issues for responsible entities.

<u>Chapter 5 – Right to withdraw from a scheme</u>

17. Is the definition of liquid assets appropriate? If not, how should liquid assets be defined?

<u>AIMA response</u>

In AIMA's view, the definition is appropriate.

However, AIMA considers that referring to schemes as liquid or illiquid is confusing and is not consistent with the ordinary meaning of liquid in the context on investments. For example, AIMA notes the concept of "liquid" in the context of Part 5C.6 of the Corporations Act does not necessarily correspond with the more commonly understood meaning of "liquid" (in an

investment context). Accordingly, AIMA recommends that the term liquid should be replaced with another term, and the terminology used in Part 5C.6 be altered to avoid the use of the term "liquid", to avoid potential confusion.

18. Are any changes required to the procedure for withdrawal from a scheme? If so, what changes and why?

AIMA response

In AIMA's view, the procedure works well and this is supported by ASIC (please see ASIC Media Release 21-091: *ASIC review finds retail managed funds responded well to COVID-19 challenges in 2020*).

ASIC already expects that fund operators will assess available liquidity management tools and considering whether these are appropriate to use (under *ASIC Regulatory Guide 259: Risk management systems of fund operators* (**RG 259**) and *ASIC INFO 159*). Specifically, under paragraph RG 259.48 of RG 259, ASIC also identifies numerous such tools including redemption fees, suspension of withdrawal requests, redemption gates (a limit on the amount of redemptions), in-specie transfers (transferring assets of an equivalent amount instead of providing cash proceeds), swing pricing (applying higher transaction costs adjustments on redemptions, reflecting the lack of an offsetting issue of fund interests or shares), minimum or maximum limits on withdrawals, or satisfying withdrawals on a partial or staggered basis. AIMA considers that the use of these should be contemplated by the Corporations Act.

AIMA also notes that ASIC provides hardship relief in the case of frozen funds for members suffering financial hardship. AIMA considers this relief sensible, but as a general matter recommends that provisions which facilitate hardship withdrawals ought to be incorporated into the Corporations Act rather than separate ASIC legislative instruments.

Given the above, AIMA considers that the current regulatory settings for the withdrawal procedures are appropriate, but could be fine-tuned to address liquidity management as noted above.

19. Is there a potential mismatch between member expectations of being able to withdraw from a scheme and their actual rights to withdraw? If so, how might this be addressed?

AIMA response

ASIC expressly contemplates that fund operators will assess available liquidity management tools (such as suspension of withdrawals, redemption gates, minimum or maximum limits on withdrawals, and satisfying withdrawals on a partial or staggered basis (as mentioned in our response to question 18)) and consider whether these are appropriate to use.

Further, ASIC expressly acknowledges in INFO 159 that "Freezing a scheme is often a prudent measure to protect the interests of all members", and it is the responsible entity's duty to act in the best interests of members as a whole (rather than in the best interests of individual members).

This is primarily a matter of disclosure, and prohibitions on misleading or deceptive conduct are intended to deter responsible entities and other intermediaries from making unsubstantiated claims about the ability of members to withdraw from an MIS. Further, although relatively new, the potential mismatch can also be addressed through the DDO regime, which require investors' liquidity needs to be taken into account in determining the target market for a financial product. AIMA believes this makes it considerably more difficult to market an MIS to investors, if those investors may need to withdraw their funds in a timeframe that is shorter than the timeframe in which the responsible entity estimates it will take them to process withdrawal requests.

Chapter 6 – Winding up insolvent schemes

20. Are any changes required to the winding up provisions for registered schemes? If so, what changes and why?

AIMA response

AIMA is in favour of changing the winding up provisions for registered schemes by creating a tailored insolvency regime for managed investment schemes generally. See further our response in Question 21 below.

Otherwise, AIMA believes that the current regime provided for in Part 5C.9 of the Corporations Act is appropriate (including the flexibility allowed by following the provisions set out in the scheme's constitution in accordance with Section 601NA of the Corporations Act, and the ability to apply to the Court for directions on how wind up an unviable scheme).

21. Would a tailored insolvency regime for schemes improve outcomes for scheme operators, scheme members and creditors? Are there certain aspects of the existing company and CCIV insolvency regimes that should be adopted?

AIMA response

AIMA believes a tailored insolvency regime for insolvent schemes will provide more clarity, certainty, and consistency for scheme operators, scheme members, and scheme creditors on procedures to wind-up an insolvent scheme.

As mentioned in the Consultation Paper, the 2012 Corporations and Markets Advisory Committee (**CAMAC**) report recommended that the Corporations Act should regulate the winding-up of an insolvent scheme in a manner comparable to the regulation of the winding-up of an insolvent company.[4] Prior to the 2012 CAMAC report, the Australian Law Reform Commission's General Insolvency Inquiry Report No 45 (1988) recommended that there be a legislative regime for the winding-up of trusts. Despite these recommendations, no such regime has been enacted.

CAMAC proposed that such a tailored regime should:

a) include a definition of an insolvent scheme in legislation;

b) introduce a voluntary administration regime for insolvent schemes;

c) suspend the powers of the responsible entity to operate the scheme;

d) require that an incumbent responsible entity or temporary responsible entity provide reasonable assistance to a prospective responsible entity in certain circumstances;

e) give the Court a general power to adjust the duties and liabilities of a temporary responsible entity to particular circumstances;

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[4] CAMAC MIS Report July 2012 p 193; Sterling Income Trust report p 69.

f) give the Court the power to wind-up a scheme if it is insolvent; and

g) provide for a statutory order of priorities in the winding-up of a scheme – based on that provided for companies in section 556 of the Corporations Act and adjusted, where necessary, for schemes — and provide a first priority for payments to a temporary responsible entity,

which is in line with what the existing company and, the more recently introduced, CCIV insolvency regimes adopt. Consistent with the approach taken in other sections of this submission (with some exceptions), AIMA believes that (to the extent possible) there should be consistency across the legal regimes that apply to CCIVs and MISs. Further, AIMA considers an insolvency regime should apply for all MISs (both registered and unregistered), as this would avoid divergence of outcomes between registered and unregistered MISs and/or unnecessary costs associated with making court applications.

22. Should statutory limited liability be introduced to protect personal assets of scheme members in certain circumstances? If not, why not?

AIMA response

AIMA considers that the common law creates some uncertainty about when, and how, it is possible to ensure that investors in MISs are protected against unlimited liability. This legal uncertainty is not in the interests of creditors or members.

AIMA supports the introduction of a statutory limited liability provision for scheme members, whereby the Corporations Act would confer limited liability on members of an eligible scheme on the winding-up of the scheme, in the same manner as shareholders of a company, except to the extent that the inherent nature of the scheme or any scheme provision imposes any form of liability on members of the scheme beyond their initial contribution.[5]

Current industry practice is to seek to provide for limited liability of scheme members in the scheme constitution (generally to the extent of their unpaid capital commitments). Statutory limited liability would give greater protection to scheme members, and provide greater certainty to scheme creditors.[6]

As raised in the 2012 CAMAC report, as scheme members, by definition, do not have day-to-day control over the operation of the scheme, they should not be personally liable for debts incurred by the responsible entity as operator of the scheme[7]. Consequently, their liability in the event of the insolvency of the scheme should be limited to any unpaid portion of the amount that they had agreed to contribute to the scheme.[8]

AIMA also supports the view raised in the 2012 CAMAC report that the principle of limited liability should not be subject to any contrary provision in the scheme constitution. The benefits of protection for individual scheme members, and certainty for

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[5] https://treasury.gov.au/sites/default/files/2019-12/camac_liability_of_members_of_mis_march_2000.pdf p 7.
[6] CAMAC MIS Report July 2012 p 199.
[7] The lack of day-to-day control by the members is an essential element of the definition of a managed investment scheme (section 9, Corporations Act).
[8] CAMAC MIS Report July 2012 p 201.

scheme creditors, would be undermined if the position could be reversed in the scheme constitution, particularly where that occurs by subsequent amendments to the constitution.[9]

Chapter 7 – Commonwealth and state regulation of real property investments

23. Do issues arise for investors because of the dual jurisdictional responsibility when regulating schemes with real property? If so, how could they be addressed?

AIMA makes no comments on behalf of its members.

Chapter 8 – Regulatory cost savings

24. What opportunities are there to modernise and streamline the regulatory framework for managed investment schemes to reduce regulatory burdens without detracting from outcomes for investors?

AIMA notes the efficiency of the current legislative regime for MISs could be improved by addressing the issues outlined below.

Reporting of compliance plan breaches

As noted earlier in this submission, the effect of paragraphs 912D(4)(b) and 601FC(1)(h) of the Corporations Act is that any breach of a compliance plan, irrespective of its level of materiality, gives rise to a "reportable situation", which the responsible entity must notify to ASIC. This is the case because subsection 601FC(1) of the Corporations Act is a civil penalty provision (and therefore a breach of any limb of this subsection is automatically reportable). ASIC must therefore be notified of breaches of the compliance plan which are inconsequential, and AIMA does not consider this to be a productive use of the finite resources of the responsible entity or ASIC. Potential ways to address this issue include:

a) providing that paragraph 601FC(1)(h) is not a civil penalty provision; or

b) amending the Corporations Regulations to prescribe section 601FC(1)(h) as one of the civil penalty provisions which will not automatically give rise to a "reportable situation" if it is breached.

Signature requirements for compliance plans and constitutions

Currently there is an inconsistency between the following signature requirements which could be resolved:

a) under section 601HC of the Corporations Act, the compliance plan (and any amended plan), must be signed by all directors of the responsible entity; and

[9] CAMAC MIS Report July 2012 p 200.

b) under section 127 of the Corporations Act, any two directors or one director and one company secretary may execute the constitution on behalf of the responsible entity.

It can be difficult at times to obtain all the signatures of a responsible entity's directors. AIMA therefore submits that, if the compliance plan is retained for registered MISs, then the bespoke requirement of section 601HC of the Corporations Act should be abolished.

Rationalisation of ASIC legislative instruments

AIMA observes that some aspects of the current legislative framework are located in ASIC legislative instruments which modify the operation of the Corporations Act. To improve navigability and reduce unnecessary complexity, AIMA welcomes a review of the ASIC legislative instruments relating to MISs to consider whether or not the relevant modifications should remain part of the legislative framework. Where it is determined that an ASIC legislative instrument should remain part of the legislative framework then, where practicable, the Corporations Act itself should be amended (and the ASIC legislative instrument revoked).

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Yours faithfully

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(on behalf of Michael Gallagher & Nikki Bentley – AIMA Australia Chair regulatory Committee)