# Review by Commonwealth Treasury of the Regulatory Framework for Managed Investment Schemes Consultation Questions with Responses Angas Securities Limited AFS License 232479

## Chapter 1 - Wholesale client thresholds

1. Q: **Should the financial threshold for the product value test be increased?**

   A: Yes

   Q: **If so, increased to what value and why?**

   A: Product value thresholds should be abolished altogether or increased to a serious entry level such as $20 million. Registered MIS provide protections for retail investors. Wholesale investor "carve outs" provide scope for unregistered and often disreputable operators to dilute these protections or eliminate them altogether.

2. Q: **Should the financial thresholds for the net assets and/or gross income in the individual wealth test be increased?**

   A: Yes. The Full Court of the Federal Court of Australia in **Mayfair Wealth Partners Pty Ltd v Australian Securities and Investments Commission** [2022] FCAFC170 observed at paragraphs 82 and 83:

   "The appellants repeatedly elide the concept of a "wholesale investor" with a "sophisticated investor" in an ordinary sense of a financially sophisticated person. The elision is invalid. The definition of a "wholesale investor" used in respect of the Mayfair products is only that the person:

   1) wishes to invest $500,000 or more; or

   2) has net assets of $2.5 million or above; or

   3) has a gross income of $250,000 per annum or above for the last two years.

   It cannot be assumed that all people who meet one of those criteria have knowledge or experience in respect of financial products. Nor can it be assumed that that class of person did not include numerous persons who were dependent on the accuracy of the marketing material the appellants chose to promulgate."

   Q: **If so, increased to what value and why?**

   A: Net assets should be $5 million with certain assets excluded (see below). Gross income should be $2.5 million per annum for 2 years. There is a fallacy in equating wealth (however gained) with financial acumen. Successful athletes, actors and musicians are well known examples of wealthy individuals with poor investment acumen. The protections of retail investors ought to be extended to them, not carved out.

3. Q: **Should certain assets be excluded when determining an individual's net assets for the purposes of the individual wealth test?**

   A: Yes

   Q: **If so, which assets and why?**

   A: The family home should be excluded. House prices in Australia now show that a person who buys an ordinary house who pays off the mortgage over term can be left with an unencumbered asset worth $2.5 million without gaining any enhanced understanding of investment principles or risk. Superannuation ought to be excluded. It is already a special class of asset in that it is not available to the trustee of a bankrupt estate. As with rising house prices, accumulating superannuation does not promote any concomitant increase in financial literacy.**Q: If consent requirements were to be introduced, how could these be designed to ensure investors understand the consequences of being considered a wholesale client?**

A: Consent forms can be manipulated easily by unscrupulous product purveyors who prey upon wealthy citizens who lack genuine financial sophistication. Any consent form should be witnessed by a solicitor who must certify independence from the financial product issuer and that the so-called wholesale investor has had loss of rights and protections explained to him or her and appears to understand them.

Q: **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?**

A: Yes

## Chapter 2 - Suitability of scheme investments

4. Q: **Should conditions be imposed on certain scheme arrangements when offered to retail clients?**

A: Yes. The Corporations Act was recently amended to introduce Design and Distribution Obligations to introduce suitable restrictions.

Q: **If so, what conditions and why?**

A: Legitimate schemes will flourish in a fair market with a confident investment environment. There are still outfits who slip through the cracks. But so-called registered schemes exist which are run with minimum compliance generally and no Target Market Determinations in particular.

5. Q: **Are any changes warranted to the procedure for scheme registration?**

A: Yes

Q; **If so, what changes and why?**

A: The practice of "renting" Responsible Entities from unrelated companies who do not manage the scheme ought to be prohibited and actively enforced. The current scheme legislation has replaced the former system of duality with responsibilities shared by a trust and a manager with a single entity directly responsible to scheme members for the scheme's operation. There are many small to medium sized mortgage trusts operating in Australia with the superseded model effectively in place. A fund manager contracts with a Responsible Entity "for hire" and then accepts funds from the public through a number of contrivances including the wholesale carve out. As such operations follow the Mayfair 101 path, investor confidence in the Australian investment is lost.

6. Q: **What grounds, if any, should ASIC be permitted to refuse to register a scheme?**

A: Registration should be refused if the operation is not a licensed and fully compliant single entity with an entire operation directly responsible to the scheme's members for the scheme's operation including holding appropriate insurance cover.

## Chapter 3 - Scheme governance and the role of the responsible entity

7. Q: **Are any changes required to the obligations of responsible entities to enhance scheme governance and compliance?**

A: Refer to response to Q6 above. It was not the intention of the legislation that the RE and management functions be split. It is not in the interest of investors (often self-funded retirees nor the Australian Financial System overall) for a specialist entity in Sydney to be Responsible Entity for an operating business in Adelaide with which the Sydney entity has no causal relationship with either the investors or the investments. That is the position now.

Q: **If so, what changes and why?**

A: The abuse of the Authorised Representative role needs to be addressed. It should be restricted as intended to enterprises where the Responsible Entity conducts an actual business which authorizes other entities to represent it. The current fiction of small outfits with a paucity of resources paying an interstate company to act as its Responsible Entity is a loophole that should be closed. That outcome could probably be achieved by enforcement without the need for legislative change.

8. Q: **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?**

A: Yes. This will protect investors and bolster the integrity of Managed Investment Schemes.

9. Q: **Are changes required to the compliance plan provisions to ensure compliance plans are more tailored to individual schemes?**

   A: Yes

   Q: **If so, what changes and why?**

   A: Compliance Plans ought to be the subject of a review by the board of the Responsible Entity every two years. The board ought to be required to certify that the Compliance Plan is fit for the purpose of business conducted by the Managed Investment Scheme(s) of that company.

10. Q: **Should auditors be legislatively required to meet minimum qualitative standards when conducting compliance plan audits?**

   A: Yes.

   Q: **If so, what should these standards be and why?**

   A: ASAE 3100 Compliance Engagements and GS013 Special Considerations in the Audit of Compliance Plans issued by the Auditing and Assurance Standards Board.

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

   A: No. The current arrangements strike an appropriate balance. The roles are different. There are many legal duties on company directors. Many directors and former directors have their own wealth tied up in company enterprises. Others are fully at arm's length. This flexibility is desirable and should be maintained. The Compliance Committee plays a different role. It should comprise a majority of independent members.

## Chapter 4 - Right to replace the responsible entity

12. Q: **Are any changes required to the voting requirements or meeting provisions that allow members to replace the responsible entity of a listed scheme?**

   A: No. MTM Funds is good law. It has stood for over 20 years.

13. Q: **Are any changes required to the voting requirements or meeting provisions that allow members to replace the responsible entity of an unlisted scheme?**

   A: Yes.

   Q: **If so, what changes and why?**

   A: The requirements should mirror those of listed schemes. There is no good reason to differentiate between the two. For example, the voting requirements for a Scheme of Arrangement are the same whether the company is listed or not.

14. Q: **In what circumstances should an existing responsible entity be required to assist a prospective responsible entity conduct due diligence?**

   A: Only by Court Order. These changes are rare. If the existing responsible entity is incompetent, its assistance will be of limited value anyway. If the change is due to some other agenda, the Court is in the best position to adjudicate.

   Q: **What might this assistance look like?**

   A: As determined by the Court to take account of the circumstances of each individual case.

15. Q: **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?**

   A: Yes. Stability is a cornerstone of the Australian Financial System.

   Q: **If so, what restrictions may be appropriate?**

   A: Responsible entity's should be entitled to hold a lien for its unpaid fees and costs over the scheme property up to a ceiling of not more than 5% of the value of the scheme property.

## Chapter 5 - Right to withdraw from a scheme

16. Q: **Is the definition of liquid assets appropriate?**

    A: Yes. The Constitution of the Scheme sets the parameters and these are disclosed in the Product Disclosure Statement. A 7 day liquidity timeframe would render as unworkable any scheme which involved real property. Requiring a mortgage fund (now rendered illiquid because of a short withdrawal period having been imposed) to manage withdrawal requests through periodic “withdrawal offers” made in accordance with the Corporations Act does not produce any beneficial outcome for retail investors. The objective must always be to ensure that the Responsible Entity’s estimate of time projected to realise an asset is reasonable and that there is clear disclosure of that potential withdrawal period in the Product Disclosure Statement and Target Market Determination.

17. Q: **Are any changes required to the procedure for withdrawal from a scheme?**

    A: No.

18. Q: **Is there a potential mismatch between member expectations of being able to withdraw from a scheme and their actual rights to withdraw?**

    A: Potential mismatch is an imprecise concept. The answer will vary from case to case.

    Q: **If so, how might this be addressed?**

    A; The law does not require changing. Any potential issue can be managed through enforcement of proper disclosure in the Product Disclosure Statement.

## Chapter 6 - Winding up insolvent schemes

19. Q: **Are any changes required to the winding up provisions for registered schemes?**

    A: Possibly desirable. Not essential.

    Q**: If so, what changes and why?**

    A: Voluntary Administration procedures implemented by the Harmer Report might minimize the need for court applications.

20. Q: **Would a tailored insolvency regime for schemes improve outcomes for scheme operators, scheme members and creditors?**

    A: Yes

    Q: **Are there certain aspects of the existing company and CCIV insolvency regimes that should be adopted?**

    A: Yes.

21. Q: **Should statutory limited liability be introduced to protect personal assets of scheme members in certain circumstances?**

    A: No

    Q: **If not, why not?**

    A: Limited liability may lead to a mismatch with creditor expectations.

## Chapter 7 - Commonwealth and state regulation of real property investments

22. Q: **Do issues arise for investors because of the dual jurisdictional responsibility when regulating schemes with real property?**

    A: No

## Chapter 8 - Regulatory cost savings

23. Q: **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?**

    A: Compensation arrangements for Australian Financial Services Licence holders are primarily dealt with in section 912B of the Corporations Act and Reg 7.6.02AAA Corporations Regulations. ASIC's RG 126 deals with "Compensation and Insurance arrangements for AFS licensees" and summarizes legal and regulatory requirements. Professional Indemnity cover must be "adequate". Table 4 to RG 126.54 suggests cover should be approximately equal to actual or expected revenue (up to $20 million).

However, Responsible Entities are subject to the specific Professional Indemnity licence requirements imposed by PF 209. This requires Responsible Entities to "maintain an insurance policy covering professional indemnity and fraud by officers that...covers claims amounting in aggregate to......$5 million". This is nearly double the level of cover suggested by Table 4 to RG 126. However, PF 209 is said to be subject to "individual circumstances".

The state of the Professional Indemnity insurance market in Australia for the financial sector is shrinking. AIG, one of this nation's last remaining PI insurers (for investment management and financial planning), withdrew from the Australian PI market in September 2022. AIG has stopped writing PI business for AFS Licensees. This is a major problem for many Responsible Entities for whom AIG has been the primary PI insurer for many years. The problem is accentuated for smaller Responsible Entities subject to the PF209 requirements where those requirements comfortably exceed the requirements otherwise suggested by RG126.54.

Apart from industry behemoths, complying Responsible Entities are now compelled to seek their requisite PI cover in overseas markets, despite it being doubtful that the constitutional power to compel such an outcome exists. There are underwriting agents operating in Australia on behalf of foreign principals - but it is no evident that any will take on increased capacity sufficient to cover AIG's current market share.

There is little or no tension in premium pricing unless insurance is sought offshore. The lack of competition and the compulsory nature of the PI cover leaves Responsible Entities open to premium gouging, even if cover is offered. The overseas PI market seems to have a general appetite for writing Australian financial institutions risks and has shown to be more competitive.

The looming crisis in Australia has received widespread coverage in various industry publications. Although most Responsible Entities do NOT provide financial advice, the history of PI insurance for financial advisers is none the less instructive. Financial planners and other licensed advisers are broadly grouped in the same sector as Responsible Entities, with advisers seeking cover from the same insurers. According to an article by Laura Dew writing for Money Management on 22 June 2022 (https://www.moneymanagement.com.au/news/financial-planning/consumers- risk-licensees-opt-cheaper-pi) almost every single licensed adviser has experienced year on year increases in its PI insurance premium regardless of claims history.

Because of the factors discussed, securing "adequate" cover in Australia for Responsible Entities conforming to RG 126.54 is very tough (and unnecessarily expensive} but is much easier than securing the $5 million cover currently mandated by PF 209. In our submission, PI cover held for $2.5 million is "adequate" for all Responsible Entities. PF209 should fall into line as to the amount of PI cover required by providing that cover is adequate if it conforms to RG 126.54

**ANGAS SECURITIES LIMITED**

ACN 091 942 728; AFSL 232479