FINANCIAL ADVICE ASSOCIATION AUSTRALIA

Tuesday 3 October 2023

Mr Andre Moore
Assistant Secretary
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Retirement, Advice and Investment Division
Treasury
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Dear Mr Moore

Review of the regulatory framework for managed investment schemes

The FAAA welcomes the release of Treasury's consultation paper on the managed investment schemes regulatory framework. It is a significant step forward in ensuring the regulatory settings for this key sector appropriately protects consumers.

This review provides an important opportunity to address weaknesses in the MIS regime, some of which have led to incidents of significant consumer detriment in the past.

This is the first review of the MIS regulatory framework for a significant period of time. The topics within the scope of the review that are of most concern to our members include:

- Whether the regulated wholesale client thresholds are appropriate and will continue to achieve the intent of the classifications into the future,
- If clients should actively provide consent to being treated as a wholesale client,
- If the current consumer protection measures are adequate for wholesale clients, and
- Whether the regulatory framework for managed investment schemes adequately protects vulnerable consumers 'on the boundary' of the retail/wholesale client distinction.

We would welcome the opportunity to discuss with Treasury the matters raised in our submission.

Yours sincerely,

Sarah Abood
Chief Executive Officer
Financial Advice Association Australia (FAAA)

FINANCIAL ADVICE ASSOCIATION AUSTRALIA

Review of the regulatory framework for managed investment schemes

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Introduction

The MIS sector is an important part of the financial services industry in Australia.

When appropriate for a consumer's circumstances, MIS investments can offer significant benefits including:

- a diversified range of investments for consumers,
- lower capital entry levels for investment, for retail clients in particular (e.g. investments in asset classes that they may not otherwise have access to due to the entry size requirements of such investments),
- a more affordable way to build up access to income-generating asset classes such as fixed interest/equity portfolios,
- creating purchase power options for consumers that are otherwise not available, and
- an opportunity for investment diversification for all investors, outside of superannuation.

There is significant consumer demand for this type of investment.

From an economic perspective, the MIS sector is an important source of capital for underlying investment markets.

However, financial advisers see both benefits and challenges with managed investment schemes. The MIS sector has experienced some high-profile failures that have resulted in significant consumer detriment for people invested in those products. While some particular MIS failures led to Parliamentary inquiries and reviews, there has not been a full review of the MIS regulatory regime for some time.

The existing regulatory framework for managed investment schemes varies depending on whether the scheme is offered to retail or wholesale clients.

If offered to retail clients, the responsible entity operating the scheme must:

- hold an AFSL,
- have a scheme constitution which sets out the rights, duties and liabilities of the responsible entity,
- provide an Internal Dispute Resolution solution and be a member of AFCA,
- register the MIS with ASIC,
- be listed on the ASIC register, and
- have a compliance plan which must be audited annually against the scheme's operations.

However, none of these protections exist for those MIS offered to wholesale clients and they therefore have very little regulatory oversight or governance requirements.

The original intent of the legislation was to provide protection for retail clients, while affording regulatory relief for clients with the appropriate level of financial knowledge and skills, and a greater capacity to incur financial loss (wholesale clients) that may come from higher risk complex investments.

A primary concern to our members and their clients is the need to ensure a balanced approach to MIS regulation between protecting vulnerable consumers and the needs of genuine wholesale clients. Of particular concern is the need to ensure that there are better protections for those on the boundary

between retail and wholesale clients – such as those who are asset rich, cash poor, with little capacity to lose money and who may not be financially sophisticated. This cohort is predominately made up of retirees and has been significantly impacted by past MIS misconduct and failures.

Since the wholesale tests came into force, not only have the thresholds not been indexed, the obligations that apply to relevant providers who provide personal advice to retail clients have increased significantly as a result of the following reforms:

- Future of Financial Advice (2012)
- Tax Agent Services Act (2014)
- Life Insurance Framework (2017)
- Professional Standards (2017)
- Hayne Royal Commission (2019 – 2023)

These reforms have created a significant gap between the regulatory burden and costs of providing advice to retail clients versus providing advice to wholesale clients, resulting in a widening of the disparity in consumer protections for retail clients versus wholesale clients, and the emergence of wholesale only advice providers.

The consumer protections that are now relinquished when a person signs up to be treated as a wholesale client are significant and can be life-changing if things go wrong. For some clients, it may absolutely be justified, appropriate and in their best interest to be treated as a wholesale client. For other less experienced consumers, it may be giving up too many protections. This is concerning.

From a financial advice perspective, genuine consumer understanding of the complex structure of MISs and the risks the investment may present are vital to ensure the product is suitable for their client.

As with all investments, MISs present risks to consumers that they must understand and consider and make informed decisions about. These include:

- The complex structure of the product
    - Even the most basic ‘vanilla’ style MIS can be difficult to understand for the average consumer, and yet many of these products are far from ‘vanilla’. Often involving features such as underlying feeder funds, liquidity constraints, leverage, foreign currencies and financial derivatives, it is very difficult to explain the complex structure of an MIS in a simple consumer-friendly manner to true retail clients. Despite advisers’ best efforts (and lengthy advice documents) in many cases retail clients are effectively relying on the expertise and advice of a specialist to ensure that the product will suit them.
- Liquidity issues
    - One of the most challenging issues for consumers can be liquidity, as many consumers do not truly understand what liquidity means. It is common to find that consumers have an expectation that their funds can be accessed whenever required, irrespective of disclosures in a PDS. The subsequent revelation that underlying investments in the fund (such as infrastructure) may be illiquid and their investment

may be unable to be realised for many months or even years, comes as an unpleasant shock and can be devastating for family finances.

- Market risk
    - Depending on the underlying assets, MISs can be heavily impacted by market risk, over which the responsible entity has limited control. This is something that can be challenging for consumers to understand, despite often extensive disclosure. There is a litany of examples of funds which have been marketed direct to consumers using terms such as 'stable' and 'secure' in circumstances where the underlying asset allocation means the product cannot be either stable or secure. This marketing results in investors forming an inaccurate expectation that their investment would not be at risk.
- Leverage
    - Leverage has been one of the banes of this sector, with many complex funds; e.g. geared equities fund where clients were caught out during the GFC and those related to crypto.
- Tax implications
    - There are tax implications of MIS investments that consumers must take into account.
- Consumer communication and understanding
    - Technical finance jargon is heavily used by product providers, which again impacts consumers' ability to genuinely understand the products.
- Non-standard market products such as long/short funds.

The FAAA supports the MIS sector operating in an appropriate regulatory framework that is in line with community expectations. This must factor in the abilities of the financial advice profession to serve their clients and protect consumers more broadly.

Chapter 1 – Wholesale client thresholds

Generally, the FAAA accepts the recommendation by the ALRC to retain the distinction between wholesale and retail clients.

FAAA members are concerned about consumers who lack the necessary knowledge, understanding and experience of financial matters to make informed decisions as wholesale clients. This includes the category of consumers who do not have capacity to make considered decisions or incur financial loss through high-risk investments. The lack of disclosure and conduct obligations that apply for wholesale clients creates an unacceptable risk for such consumers.

We have considered the implications the current thresholds for wholesale clients present for consumers and whether the thresholds still meet the original policy intent: to provide a barrier to protect retail clients while providing regulatory relief for clients with the appropriate level of financial

knowledge and skills or capacity to incur financial loss that may come from high-risk complex investments. Due to the inclusion of a client's property (such as the principal residence) and a general increase in earnings over the years, with no increase in the legislated thresholds for client classifications, many individuals now fall into the definition of a wholesale client that would not have been the case at the time of the original drafting of the legislation.

A significant concern about the thresholds today is whether they have kept pace with the economic environment: they have not been indexed since they commenced in 2001. For example, the tests currently include residential property, which has increased greatly in value in that time. This has resulted in the wholesale test being applied to a much wider group of consumers, raising significant consumer protection concerns.

The FAAA suggests there must be a balance between protecting vulnerable consumers and the needs of genuine wholesale clients. Importantly, there needs to be better protections for those consumers who currently fall on the boundary between retail and wholesale clients - consumers who are asset rich, cash poor, with little capacity to lose money and who may not be sufficiently financially sophisticated. This is where the current thresholds are failing to meet expectations in protecting consumers.

There must be a high barrier to entry and restrictions into the wholesale client space, to protect vulnerable consumers from being mis-categorised as a wholesale client.

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

In relation to product investment restrictions for genuine wholesale clients - $500,000 is a large amount of money to invest in one product. If the product value test was increased it would impact the ability of genuine wholesale clients to appropriately diversify their investment portfolio, increasing the risk for the client.

The FAAA suggests increasing the product asset test may not be the most effective means to improving protections in relation to mis-categorisation of retail consumers. Please refer to our recommendations below for solutions to address this issue.

The FAAA recommends the product value test remain at its current level of $500,000 and be indexed every 5 years based on AWOTE.

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?

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?

Yes, the net asset value test and the income test should be increased; and certain assets should be excluded when determining an individual's net assets for the purposes of the individual wealth test.

The current individual wealth test is based on the person having net assets of at least $2.5 million or a gross income of at least $250,000 per year in the last 2 financial years, supported by a certificate given by a qualified accountant.

According to modelling undertaken by the Australian National University[1], at the time of the implementation of the wholesale asset/income test in 2002, only 1.9 per cent of the population were eligible to be classified as wholesale clients. However, this figure has risen to 16 per cent in 2021 (3.25 million individuals) and if unchanged could rise to 29.1 per cent of the population by 2031 (6.78 million individuals) and 43.6 per cent of the population by 2041 (11.5 million individuals).

As demonstrated in the table below, when these thresholds are adjusted for CPI, it creates a very different test, possibly more in line with the original intent of the legislation.

Measure	Amount in law	Hypothetical CPI adjusted in 2022
Product value test	$500,000	$852,000
Gross income	$250,000	$426,000
Net assets	$2,500,000	$4,260,000
Professional investor	$10,000,000	$17,600,000

The thresholds have not kept pace with the economic environment as they have not been indexed since they commenced (2001). For example, the asset test includes residential property which has considerably increased over time and resulted in the wholesale test being applied to a much wider group of consumers, raising consumer protection concerns.

The following graph from the Australian Bureau of Statistics (ABS) is indicative of the significant and continuous increasing property values across Australia since December 2011.

Source: Australian Bureau of Statistics, Residential Property Price Indexes: Eight Capital Cities December 2021

[1] Source: https://insideinvestor.com.au/wholesale-investor-boom-sparks-concerns

The significant changes in the housing market are important considerations for the wholesale thresholds. As stated in the ANU research:

> *The analysis that we undertake does indicate that in the years between 2002 and 2018 the potential pool of sophisticated investors is dominated by the wealth component. With strong house price and superannuation fund growth there is an increasingly large share of households and individuals with a stock of net wealth greater than $2.5 million. Incomes, even today, are very rarely beyond $250,000 for even one given year.*[2]

The lack of indexation or review applied to the original measures has resulted in the values in the tests falling behind the growth in the Australian economy, housing and investment market, household wealth, and wage growth.

There needs to be a level of consumer responsibility for investment decisions, however the FAAA suggests the wholesale tests should be supplemented by the clients making declarations to demonstrate informed consent.

The FAAA recommends both the net asset value test and income tests be retained with the following amendments:

- The *Net Asset Value Test* should:
    - be increased and required to be indexed in line with AWOTE and increased in multiples of $5,000 increments every five years.
    - reflect the value of the Transfer Balance Cap (TBC), currently $1.9 million and associated indexation of this, applied to the individual (e.g. $1.9m); or doubled for a couple (e.g. $3.8m combined). This should be an alignment to the value and indexation of the TBC however, to avoid unintended consequences of government changes to the TPB on the wholesale test, it should not be formally tied to the TBC.
    - exclude the net asset value of the home (principal place of residence) - excluding the home is simple to do. Excluding the principal place of residence will not add complexity as it is exempt from CGT and a well-understood term by industry and consumers, which simplifies the classification for the purposes of the wholesale test. It also provides greater fairness in how the test is applied, considering the huge difference in house prices across the country. Excluding the principal place of residence from the wholesale test, removes the advantage some genuine wholesale clients have over others purely because of their location, as indicated by the ABS data above.
- The *Income Test* should be:
    - based on the individual's income of the prior 2 years, based on the ATO's income tax assessment of income
    - increased to $350,000

[2] Associate Professor Phillips, B. (October 2021) *Research Note: Sophisticated Investor Projections*, ANU Centre for Social Research and Methods

- indexed in line with AWOTE and increased in multiples of $5,000 increments every five years.

The FAAA recommends the introduction of an obligation that would apply to providers not to treat a client as a wholesale client where there are reasonable grounds to question the evidence that has been provided to demonstrate qualification with the wholesale client wealth test, or if there are grounds to believe that the client does not understand the product(s) or the basis for being treated as wholesale.

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?

The FAAA supports the introduction of informed consent to be treated as a wholesale or sophisticated investor, in line with QAR recommendation 11:

> *The Corporations Act should be amended to require a client who meets the assets and income threshold and who has an accountant's certificate to provide a written consent to being treated as a wholesale client.*
>
> *The written consent should contain an acknowledgment that is given before they are provided with a financial product or service that:*
>
> - *the advice provider is not required to be a relevant provider and accordingly they will not have to comply with the professional standards;*
> - *the advice provider will not have a duty to give good advice or to act in the best interests of the client under the Corporations Act;*
> - *the advice provider is not required to give the client a product disclosure statement or financial services guide; and*
> - *the client will not be entitled to complain about the advice under the AFS licensee's internal dispute resolution procedures or to AFCA.*
>
> *The existing consent requirements for sophisticated investors should be amended to require a written acknowledgement in the same terms.*
>
> *The objectives of this reform are to ensure that wholesale clients who meet the assets and income threshold and sophisticated investors are aware of and agree to the protections they lose by not being a retail client.*

In line with the Government's intention to still require some form of advice record, the consent should also acknowledge the lack of any documentation that a wholesale client will receive with respect to the advice being provided.

A wholesale client warning, clearly and specifically detailing the consumer protections that will be forfeited as a wholesale client, must be provided prior to informed consent being given and before a financial service or product is provided. Consideration should be given to a prescribed wholesale client warning to standardise the information provided to consumers and ensure it appropriately, clearly and simply explains the risks, and the protections that will be lost.

Informed consent to be treated as a wholesale client must be individual informed consent – i.e. both parties of a couple must individually provide informed consent.

The existing consent requirements for sophisticated investors should also be amended in line with QAR recommendation 11.

Additional feedback on wholesale / retail definitions

Accountant certificate

The FAAA is aware of calls to

- remove the requirement for an accountant to provide a certificate certifying that a client meets the net assets and income tests and can be deemed a wholesale client.
- transfer the requirement to provide a certifying certificate to financial advisers.

The FAAA supports the requirement for a client's financial circumstances to be certified as meeting the income or asset test to be treated as a wholesale client. Requiring a professional to verify client information is a vital safety net for consumers and emphasises the importance of being classified as a wholesale client. Clients should also be required to declare that they meet the wholesale client test.

Feedback from FAAA members highlights concerns that transferring the accountant certificate requirement in s761G to financial advisers may increase consumer risk as it would remove separate additional professional consideration/review of the client's circumstances in relation to the wholesale client tests. The treatment of a consumer as a wholesale client must be undertaken with due care and consideration.

For advised clients, the 'accountant's certificate' provides an additional layer of protection for the client to be certified by another professional who is not their financial adviser. While some wholesale clients have a financial adviser, some wholesale clients do not and would be required to access an accountant or tax agent for the certificate, in order to invest in products directly with the provider.

While the additional professional assessment provides an important consumer protection for advised clients, it may be beneficial for consumers to be able to choose to see either an accountant or a financial adviser for a certificate. Financial advisers may make a decision not to do this, or to ask their clients to seek the certificate from their accountant. Financial advisers may also consider charging to fulfil this requirement, similar to the accountants' fee methodology of charging for their time.

Currently financial advisers have no access or restricted access to Government and other systems in order to verify a client's income information for the wholesale client test certification. Accountants can verify client income information through their access to the ATO Portal.

FAAA members have highlighted the need for the certification requirements to focus on client choice and the best interest of the client, rather than speed of compliance and regulatory process.

However, should a decision be made to share the accountant certificate obligation with financial advisers, to be able to verify a client's circumstances in meeting the wholesale client thresholds, all financial advisers would require access to the ATO Portal to enable them to view client information to be verified for certification.

The FAAA would oppose the application of the certification requirement to financial advisers unless all advisers were given access to the ATO Portal.

A similar obligation would need to apply to the client to provide verifiable documentation to the financial adviser, such as lodged tax returns, group PAYG certificates, superannuation statements, etc, and a declaration by the client to confirm that they meet the wholesale client criteria. This could be provided as part of the informed client consent recommendation above (QAR Recommendation 11).

Sophisticated investor definition

There is a level of concern that some MIS providers may be inappropriately and directly selling to 'on-the boundary investors', who are vulnerable consumers, high risk and potentially faulty schemes, by gaining client consent to be treated as a sophisticated investor, if they do not meet the wholesale investor thresholds. However, there is a lack of data to understand the accuracy and extent of this issue.

To address this issue, the Act would need to be amended to require clients to sign an enhanced consent document, and also to make a declaration that they have the knowledge and experience to be treated as a 'sophisticated investor test'.

The FAAA would further suggest that consideration should be given to an obligation that would apply to providers not to treat a client as a wholesale client where there are reasonable grounds to question the evidence that has been provided by the client to demonstrate qualification with the sophisticated investor test, or if there are grounds to believe that the client does not understand the product(s) or the basis for being treated as a wholesale client.

Transition arrangements

The FAAA suggests appropriate transition arrangements must be considered as part of any changes to the retail/wholesale client provisions with consideration of the impact of the changes on consumers and investment holdings.

The FAAA suggests the following requirements to simplify transition arrangements:

- the wholesale test only applies at the time an investment is made or advice is given.
- existing wholesale clients should not be required to meet the new thresholds unless a new wholesale product investment is made by the client (excluding an additional/'top up' of an existing investment).

- investments made under previous wholesale thresholds should not be subject to the new threshold limits.

- for advised clients, a professional financial adviser should re-assess the wholesale client status as needed to ensure it is in the best interest of the client to be treated as wholesale, particularly if a 'life event' occurs, but no later than every 5 years.

- a new accountant's certificate should only be required under the new threshold for new wholesale clients; or if an existing wholesale client's circumstances change or if they make a new investment.

This would remove the need for continuous monitoring or for people to sell down investments, which would be impractical and have potential significant investment and tax implications for consumers.

Chapter 2 – Suitability of scheme investments

The FAAA supports the availability of registered managed investment schemes as an appropriate investment option for retail clients.

It is difficult and not in the best interest of consumers to exclude certain asset classes from MIS registration and availability for retail clients – there are appropriate MIS investments in each asset class that offer benefits for retail clients.

In identifying an appropriate regulatory framework for MISs, it is important to consider how such structures are used by different types of consumers as a vehicle to facilitate investment in a variety of assets. While MISs offer retail clients access to a broader range of investments and an ability to diversify across different asset classes, genuine wholesale clients often pool funds to invest in assets via small scale MISs.

As discussed in our introduction, there are a number of benefits and risks to MISs.

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

The FAAA supports the obligations for MISs to be ASIC registered and meet the registration requirements to be offered to retail clients.

The consideration of prohibiting asset classes for retail clients must be based on risk. However, stakeholders' perception of risk will vary – for example, the Regulator's view of the risk of asset classes, versus a fund managers' definition of the risk of their product, versus a consumer understanding of risk, versus a planner view of product risk, will all vary.

While the following were considered by FAAA members as higher risk investments, there was always an exception to each class of product, making it a viable and beneficial investment option for a retail client in some circumstances.

- Contracts for difference

- Derivatives - except for where it is incidental to the running of a fund

- Crypto – as it is currently not regulated
- Agriculture schemes
- Investment opportunities that aren't part of the regulated asset classes
- Unlisted versus listed investments.

As discussed in the introduction, the most significant risk of MISs to retail clients is the liquidity and governance of the scheme.

The FAAA notes that other jurisdictions have incorporated conditions for certain scheme arrangements that generally ensure more diversified and liquid options are offered to retail clients, as summarised in Box 4 of the consultation paper. While we see a role for such conditions, the FAAA provides no recommendations in this regard.

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

There is a community perception that if a MIS is registered with ASIC, the registration means the Regulator has undertaken an assessment of the suitability of the scheme. This is obviously an erroneous assumption, however it is often reinforced by the use of ASIC registration in MIS marketing material.

This inaccurate assumption creates a community expectation gap which can influence consumers' investment decisions with potentially poor outcomes. This gap should be addressed to enhance consumer understanding and clarify the role of MIS Registration. A clear consumer warning on the ASIC MIS Register and within PDSs may be helpful in this regard.

Registration requirements for MISs for retail clients

The FAAA suggests the following enhancements to the registration obligations to improve the governance of retail MISs and deliver better outcomes for consumers.

ASIC vetting of schemes

As discussed in the consultation paper, most registered retail MISs are required to hold an AFSL. ASIC is required to 'vet' the entity / responsible manager of the MIS through the AFSL application process.

As is the case now, the FAAA suggests that ASIC should not be obliged to 'vet' schemes through the MIS application process. However, there is a need to strengthen the Regulator's role in improving the governance of retail MISs.

The FAAA recommends:

- there should be a responsibility on ASIC to weed out 'bad apple directors and RMs'. This should include ASIC actively cross-referencing its own datasets to verify the suitability of the key decision-making representatives in MISs.

- the ASIC responsible manager checks in the AFSL application process should be expanded to the retail MIS Compliance Committee Members and Investment Committee Members. This should include appropriate skills/knowledge requirements for committee members.

- the establishment of an annual fit and proper person test declaration process for retail MIS responsible managers, Compliance Committee Members and Investment Committee Members.

- strengthening the regulatory requirements for retail MISs to establish investment guidelines and robust decision-making processes, approvals and reporting for the scheme.

- Prohibit MISs' promotion of ASIC registration.

These recommendations are discussed below.

Annual Fit and Proper test

There should be an annual fit and proper test and declaration requirement for the reporting entity, all directors and members of the retail MISs' compliance and investment committees. The 'fit and proper' requirements should be in line with those set in RG2 and RG105.

Appropriate ASIC action should be required if an entity is unable to provide the annual fit and proper declarations.

MIS Compliance Committee and Investment Committee

MIS compliance/investment committee members do not have the same skills/knowledge requirements as responsible managers. While ASIC vets responsible managers through the AFSL licensee application process, there are no requirements (e.g. Fit & Proper test, knowledge/skills) and no vetting of compliance/investment committee members.

Some MISs rely heavily on the Compliance Committee, rather than the directors of the scheme. Compliance Committees also oversee compliance with all obligations of retail MISs and often help with the decision process and operation of the scheme. Similarly, the Investment Committee commonly oversee critical investment and operational decisions.

The FAAA recommends that members of retail MIS compliance and investment committees must have knowledge/ skills/ experience relevant to the underlying asset and primary purpose of the scheme; and be subject to an annual 'fit and proper' test and declaration.

Section C of RG 105: *Licensing – Organisation Competence, The five options for demonstrating knowledge and skill*, may be a good starting point for identifying appropriate requirements.

Investment decision making

The primary function of a retail MIS is to operate as an investment structure/vehicle. A key issue in past MIS failures has been governance practices around investment decisions within the scheme. FAAA members are concerned about the level of scrutiny of the investment decision making

process and management, and whether investment decisions are being made in the best interest of retail scheme members.

Strong governance is needed to enhance consumer protection and should include:

- the responsible entity should not be too distant from the investment decision making process
- appropriate scheme investment guidelines and requirements covering reporting and robust decision-making processes and approvals
- the responsible entity, compliance and investment committee members must act in accordance with the primary purpose of the scheme, the risk of the investments they are responsible for and making decisions about.

Holding out provisions

FAAA members have raised concerns that some registered MISs hold themselves out as being 'ASIC regulated' as a marketing tool. This type of promotion of registration is misleading as some consumers assume ASIC has vetted and approved the scheme and therefore 'endorses' the MIS as a good investment.

The FAAA recommends a 'holding out' prohibition be placed on registered MISs that prohibits schemes from using ASIC registration as a marketing tool to influence consumer investment decisions. Schemes should only be allowed to state the ASIC registration number (ARSN).

PDS and disclosure

The effectiveness of disclosure requirements on protecting consumers has been widely debated. However, the FAAA supports the use of disclosure requirements as one important means of encouraging consumer understanding and enhancing protections. The structure of retail MISs and the disclosure around them could be enhanced to improved consumer understanding.

The FAAA recommends that PDS(s) of an MIS should require director approval that all information included in the PDS is accurate, complete, meets legal requirements, and is written in plain language to enhance consumer understanding.

Content requirements of MIS PDSs should include:

- a clear warning upfront in the PDS (first page) about the risk of MISs as an investment for a retail client.
- the primary purpose of the vehicle should be disclosed in the PDS.
- the impact of the risks on potential investment return.
- a clear and consumer-friendly explanation of liquidity and the potential impact on accessing funds, drafted in plain language without industry jargon – this could potentially be prescribed wording to ensure a consistent explanation, that facilitates a common understanding amongst consumers.

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

ASIC should be permitted to refuse to register a scheme if the responsible entity, its responsible manager, Board directors, or members of its Investment Committee or Compliance Committee, or related parties:

- do not meet the fit and proper person test (proposed above)
- have been banned
- have signed an EU with ASIC
- are currently being investigated by a regulator or law enforcement agency
- have unpaid determinations with AFCA, or
- have filed for bankruptcy.

ASIC should be required to cross-reference its own datasets (at a minimum) to verify the suitability of the key decision-making representatives of a scheme prior to registration and to verify annual 'fit and proper' declarations.

Additional feedback on scheme suitability and registration

Registration of wholesale MISs

As previously mentioned, we are concerned about the protection of consumers who fall on the boundary between retail and wholesale clients – those who are asset rich, cash poor, with little capacity to lose money and not financially sophisticated – particularly in relation to accessibility of unregistered MISs.

We accept that there needs to be an element of personal responsibility with any investment. However, it is unacceptable that risky, illiquid MISs can be established and marketed to consumers and not be subject to regulatory requirements and have minimal regulatory oversight and minimal consumer protections.

To ensure better protections for consumers on the boundary between retail and wholesale clients, information about the MIS should be provided to ASIC to enable the Regulator to identify potential issues at the MIS before a catastrophic failure occurs and impacts investors.

We encourage the government to consider a light-touch registration model for what has previously been unregistered MISs (see below).

However, any changes to the existing requirements for the wholesale and sophisticated investor tests will have consequences for other consumers, such as genuine wholesale clients. These consequences must be considered to ensure a balanced approach is recommended.

FAAA member feedback suggests that genuine wholesale clients often have an entrepreneurial mindset and seek to improve their return on investment by investing with friends in higher-risk opportunities they are comfortable with. This may include a group of friends pooling their funds to invest in assets (e.g. racehorse, investment property etc) via an unregistered MIS.

If there was a requirement to register such schemes, this might create an unnecessary regulatory burden for such schemes which should not be the focus of the proposed wholesale MIS registration. An exemption should apply to such arrangements.

The FAAA recommends wholesale MISs that exceed a small-scale offerings threshold exemption (below), should be required to be registered with and regulated by ASIC. This should be a simplified registration system with light-touch regulation. For example:

- ASIC registration – to improve transparency, all wholesale MISs (that exceed a small scale offerings threshold exemption below) included on a public wholesale MIS database to allow consumers to search for a product and determine its legitimate existence (versus scam)
- Annual return lodged with ASIC – late submission of financial returns should raise a flag with ASIC as a lead indicator of issues with the MIS and it should investigate. The annual return might include the number of clients/investors, investment focus and amount of AUM/FUM.
- Stronger consumer warnings with informed client consent at time of investment in the product.
- A limited EDR membership based upon the appropriateness of the classification to be treated as a wholesale client (see below).

The FAAA recommends an exemption for small scale MISs, similar to the provisions in the *'small scale offerings of managed investment and other prescribed financial products (20 issues or sales in 12 months)'* under s1012E, from the proposed simplified registration and light-touch regulation of wholesale MIS.

The FAAA would have concerns about the cost impost on wholesale MISs and genuine wholesale clients if the full registration and regulatory requirements were applied to wholesale MISs.

<u>AFCA membership of registered MISs – retail and wholesale</u>

Currently AFCA can assess complaints from consumers about being incorrectly categorised as a wholesale client if the provider is licensed to provide products/services to retail clients and is therefore a member of the scheme.

Wholesale only MISs and wholesale only advice providers are not required to be registered with AFCA. This leaves a gap in the protection of vulnerable consumers who may be sold wholesale MIS investments as they meet the current wholesale threshold as they are 'asset rich and cash poor'.

The FAAA recommends AFCA's jurisdiction should be expanded through a limited category to include wholesale MISs and wholesale only advice providers. AFCA's jurisdiction over these providers should be limited to the consideration of complaints of inappropriate classification as a wholesale client. We acknowledge that this would require material changes to the core obligations for AFSLs with authorisations to provide services to wholesale clients only.

Chapter 3 – Scheme governance and the role of the responsible entity

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

FAAA members are concerned that some responsible entities are too distant from the investment decisions being made within some MISs. The responsible entity must understand the risk of the investments they are responsible for.

Some retail MISs have a compliance committee but not an investment committee. The compliance committee of some retail MISs also lack investment expertise. This is concerning to our members as investment expertise is needed to understand the validity of investments to protect investors. Committee membership should not be just compliance expertise.

The FAAA suggests consumer protections would be enhanced if there was greater scrutiny of investment decision-making processes and management within retail schemes.

Scheme investment guidelines should be appropriate to ensure robust decision-making processes and reporting to the Board on investment decisions. Compliance obligations for retail MISs should include independent oversight of the investment decisions being made. This could be achieved by including the scheme's investment committee in the compliance plan and auditing obligations for retail MISs.

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?

Yes, ASIC should be given powers to direct a responsible entity of a retail MIS to amend a scheme's constitution to meet the minimum content requirements, similar to the CCIV regime.

The Responsible Entity is responsible for the constitution of the scheme. It should be part of the Regulator's assessment of the Responsible Entity for registration purposes. Once registered, it should be the responsibility of the auditor to assess whether the MIS is acting in accordance with its constitution.

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?

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?

A generic compliance plan used by a responsible entity operating multiple MISs can provide a solid outline of the plan, however in our view, has limitations.

As investments should be specific to each MIS, experienced MIS auditors should be able to assess compliance with a plan that is specific to the individual MIS's performance, risks, and financial analysis.

However, FAAA members are concerned that auditors are not required to detail where there is non-compliance with the Act unless it is systemic (RG132.201). The scope of the required audit addresses auditing of compliance with the plan, not so much the appropriateness of the structure of the underlying investments, investment decisions, or operation of the scheme, or if the compliance plan is good.

Audits should move away from a tick-a-box approach to a broader analysis of the scheme's performance. The auditor should be independent.

The FAAA suggests MIS auditors should:

- have subject matter understanding of the scheme and investment they are auditing, rather than just legal compliance expertise
- be required to identify emerging risks and consider the broader risks to investors – for example, if the scheme's liquidity is at risk.
- be independent of the responsible entity of the scheme and the scheme's accounting firm.

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

Applying the 'independence of directors' requirements in the CCIV regime to registered MISs may be problematic for shareholder owned entities. Hence, requiring Compliance Committees and/or Investment Committees to have a majority of independent members may be a more pragmatic approach.

This may be as simple as a declaration as to the independence of the committee members as part of registration process, with an appropriate penalty attached to the enacting provision.

Chapter 4 – Right to replace the responsible entity

The FAAA has no comments in relation to Chapter 4.

Chapter 5 – Right to withdraw from a scheme

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

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

15. 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?

Liquidity is a key consumer risk of an MIS investment. Section 601KA of the Corporations Act defines liquid schemes/assets as:

> *Liquid schemes*
>
> > *(4) A registered scheme is liquid if liquid assets account for at least 80% of the value of scheme property.*
>
> *Liquid assets*
>
> > *(5) The following are liquid assets unless it is proved that the responsible entity cannot reasonably expect to realise them within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid:*
> >
> > > *(a) money in an account or on deposit with a bank;*
> >
> > > *(b) bank accepted bills;*
> >
> > > *(c) marketable securities (as defined in section 9);*
> >
> > > *(d) property of a prescribed kind.*
> >
> > *(6) Any other property is a liquid asset if the responsible entity reasonably expects that the property can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid.*

The FAAA supports this definition however, there is often a disconnect between the legal and industry understanding of liquid assets/schemes, and a consumer's interpretation of liquidity. This disconnect often comes to the fore during times of crisis (either for the client or a more widespread systemic crisis like the GFC).

Liquidity is also subject to change in crisis events such as the GFC, which significantly impacted the liquidity of products – products that were considered to have 'liquid assets' prior to the GFC, did not have liquid assets during the GFC.

This issue is exemplified as most scheme constitutions include extended redemption periods of up to a year or longer.

Member feedback suggests consumer understanding of a liquid investment implies an easy conversion to cash when they need it. Consumer protection could be enhanced by addressing the apparent gap between the meaning of liquid schemes/assets for the purposes of the Corporations Act,

and consumers expectations and understanding of liquidity, rather than developing a new definition of liquid assets/schemes. Matters that could be considered include:

- Simplifying consumer messaging, for example:
    - can I get my money back – yes in ordinary circumstances
    - Liquidity of an MIS can change in a crisis – e.g. during the GFC products that were considered to be liquid were no longer liquid
    - What is a redemption period, and will it stop me from accessing my funds when I need them? What are my rights and limitations under the scheme's redemption period and rules?
- Reviewing scheme marketing - schemes marketed as 'liquid' signal an expectation that investors can obtain a timely redemption when withdrawing from a scheme
- Considering the appropriateness of redemption periods - some schemes have lengthy timeframes in the scheme's constitution for satisfying withdrawal requests (for example, up to 365 days or sometimes longer). Redemption periods and scheme liquidity should be clearly disclosed and explained upfront, prior to a client agreeing to invest in a MIS investment.

Chapter 6 – Winding up insolvent schemes

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

17. 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?

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

Yes, a statutory limited liability should be introduced to protect personal assets of scheme members that is in line with similar requirements in the Corporations Act for companies.

More importantly, MISs should be covered under the Compensation Scheme of Last Resort (CSLR). While we note that the CSLR is out of scope of this Review, we re-iterate the need for the recently legislated CSLR to be expanded to assist in protecting all consumers from unpaid AFCA determinations and not be restricted to the following financial products and services:

- personal advice on financial products to retail clients
- credit intermediation
- securities dealing

- credit provision.

Consumers who have invested in products outside of these provisions, such as a Managed Investment Schemes (MISs), will not be protected by or able to access compensation from the CSLR. To ensure the CSLR satisfies the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission), the scope of the CSLR should align with those licensees who are legally required to be a member of AFCA as a requirement of their license conditions, including:

- Australian Financial Services (AFS) licensees who provide financial services to retail clients (who must be a member of AFCA) (a912A(1)(g) and s912A(2)(c) Corporations Act 2001); and,

- Australian Credit licensees (s47(1)(i) National Consumer Credit Protection Act 2009).

As the responsible entity for a registered MIS must hold an AFS licence, such an expansion of scope will ensure that when an entity is authorised to operate an MIS and provides financial services to retail clients, consumers investing in the MIS will be protected through coverage by the CSLR.

Chapter 7 – Commonwealth and state regulation of real property investments

Concerns about Real Property MISs stems from high profile collapses of fundamentally flawed schemes that were available some time ago, including agri-schemes prior to the GFC, Westpoint, and Trio/Astarra. While these collapses were significant and caused a high level of detriment for impacted consumers, in contrast there were many real property MISs that have continued to perform well for retail investors over the last two decades.

Real property MISs can be an appropriate investment for retail clients as they offer benefits for retail clients that come from direct property ownership, such as capital growth and rental income, without the large capital outlay and burdens associated with maintaining a property.

Unregulated MIS

The FAAA is concerned that highly complex, high-risk real property schemes continue to be marketed directly to consumers through seminars, targeted advertising and general advice. We note consumer warnings about property and investment scheme spruikers on both ASIC's MoneySmart website and the ACCC's Scamwatch, demonstrating that even with the improvements under the DDO, unlicensed and unregistered operators are still targeting retail clients. Some FAAA members have also provided feedback of pro-bono advice they are providing to consumers who have experienced detriment by investing in such schemes at a seminar.[3]

Protecting retail consumers targeted through seminars, targeted advertising and general advice from an unregistered MIS is a much more difficult issue and we suggest should be a priority. This is where the most significant consumer detriment can occur.

[3] The FAAA will provide case studies to Treasury on request.

Unregulated MISs often sit outside the financial services industry and law and pose the greatest harm to vulnerable consumers 'on the boundary' between retail/wholesale clients, particularly SMSF trustees. The government should consider a mechanism to identify such schemes and issue stop orders to protect consumers. Such schemes are unregulated and fall outside the DDO, however, they are still registered companies operating under company law. Consideration should be given to the powers of the Regulator within the scope of corporate law, including whether ASIC has the power to investigate and issue immediate stop and cease orders on unregistered schemes.

The FAAA suggests ASIC investigate a mechanism that would allow it to run automated scanning of social media and other mediums to identify inappropriate, misleading and deceptive promotion of unregistered schemes operating outside the law and targeting vulnerable consumers.

Consumer restrictions/protections to invest in real property MIS

The FAAA understands many of the concerns about Real Property MISs stem from past failures, particularly Sterling Trust. However, we would suggest that this is a rare 'absolute worse' case and question if Sterling was correctly described as a property scheme given the underlying investment was a lease arrangement not a 'bricks and mortar' property asset. It was a flawed product.

Well-structured real property MISs offer significant benefits for retail clients. The FAAA suggests a measured and proportionate response is needed. Rather than imposing stricter rules for how financial advisers advise on real property MISs, the focus should be on scheme governance and improving consumer understanding of the potential risks, liquidity issues and consideration of investments appropriate for their circumstance, as recommended above.

Additional disclosure specific to real property MISs, could include appropriate consumer-friendly messaging/warning about:

- the risk of attributing a significant portion of one's finances to a single high-risk investment
- consumer diversification considerations when investing in real property MISs, suggesting only 10-15% of consumer funds be invested in property.

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

No. Feedback from financial advisers who consider Real Property MISs as part of a client's investment strategy have stated that the dual jurisdictional responsibility of regulating property schemes does not create issues for clients or advisers.

It is widely understood that property investment is regulated under State and Territory law, and financial services fall under the Commonwealth law. This is evident in the member feedback we received regarding the regulatory environment for Real Property MIS which suggested that consumers understand the demarcation of jurisdictions with the property as the underlying asset being regulated

at the state level; and the scheme, as the actual investment vehicle being a financial product regulated under the Federal law.

Chapter 8 – Regulatory cost savings

20. 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?

The FAAA suggests the focus should be on putting in place appropriate governance requirements for all registered retail schemes; plus the simplified registration and light-touch regulation of wholesale MISs proposed above. This may involve identifying inefficient existing requirements that could be either addressed or streamlined under improved governance obligations.