The Director

Investment Funds Unit

Retirement, Advice and Investment Division

The Treasury

Langton Crescent

PARKES ACT 2600.

29 August 2023

Dear Director

Review of the regulatory framework for managed investment schemes

Please find attached my submission for this review.

Please note that I am making this submission in my personal capacity and not in any other capacity. The views expressed in my submission are mine alone and based on my personal experience.

I would welcome the opportunity to meet in Canberra or Sydney or via video to discuss any questions you may have on my submission or on any aspect of this review. I understand the need to maintain confidentiality.

Yours sincerely

Review of the regulatory framework for managed investment schemes

Submission from [redacted]

CHAPTER 1. WHOLESALE CLIENT THRESHOLDS

Question

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

Answer

The current values are not inappropriate, but it is a fault in the current legislation that there is no mechanism to adjust for inflation. Not to have such a mechanism diminishes the purpose and efficacy of the provision.

In the case of Question 1, an adjustment for inflation could be on a biennial or longer basis and reflect CPI change over the period. I would be reluctant to consider greater than five years as CPI can increase sharply and lead to periodic distortions, but similarly in periods of low inflation one or two years is too short.

In the case of Question 2, while CPI change is a simple method, it is imperfect for investors, issuers and advisers over shorter periods because of the effect of substantial market movements on investors' assets. For this reason alone, a period of longer than one or two years would be appropriate so as to allow some normalisation to occur.

Question

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?

Answer

All assets that the person is responsible for and holds, in whatever capacity, should be included. This includes, for example, the family home and assets held upon trust, other than as a bare trustee. The test should be one based on responsibility for the asset and not the nature of the asset.

While the question is in respect of an individual, care should be taken to ensure that family-owned special purpose entities such as a trustee company are not disadvantaged.

Question

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?

Answer

(a) At the least, I think they should be included in the initial contract or written advice or communication provided to the client, in any variation to the contract and in subsequent written investment recommendations. It should be prominently displayed in the initial contract and in investment recommendations.
(b) Yes.

CHAPTER 2. SUTABILITY OF SCHEME INVESTMENTS

General Comments

In my opinion, the answer to the issues raised is not to limit what a registered scheme can do, it often has unintended consequences when this is attempted, and it stifles innovation. I say this recognising that there are few of what I consider to be truly innovative schemes, but there have been.

It needs to be recognised that registered schemes are offered to and invested in by a wide range of investors, ranging from the most to the least sophisticated. They can also be listed and unlisted. I have found, and this is not a criticism, that where regulators are given broad discretionary powers to allow or disallow the possible investments of a scheme they are not equipped or the skills to exercise broad discretionary powers, including the power to impose conditions in respect of scheme arrangements. Also, regulatory restrictions, even if subject to discretionary regulator modification powers, are impractical and unnecessarily restrictive, too slow to change and stifle innovation. Common examples of the possible problems of trying to regulate the investment universe includes the risk of prohibiting innovative new hedge products or structures through which real assets such as real estate or infrastructure are held.

It is worth noting that at times there have been structures employed to overcome restrictions, but these are ultimately inefficient, cumbersome and more expensive to operate with the cost, sometimes being the cost of lost opportunity, being borne by investors.

Proper disclosure and the continued refinement of our disclosure laws are fundamental to ensuring suitability of investment products to individual investors. In addition, the design and distribution obligations and their implementation, while not perfect, are a big step towards achieving suitability of investments to individual investors.

I do not see a pressing need to change the current arrangements. Also, I believe that if there was an obligation to require a majority of external directors on RE boards it would create some further

pressure on scheme promoters to ensure suitability of scheme investments. Most independent directors do not want to be associated with a non-viable scheme or one that is not considered suitable for the persons it is sold to.

Question

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

Answer

No

Question

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

Answer

No

Question

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

Answer

There are no reasons for ASIC to refuse to register a scheme on suitability grounds.

CHAPTER 3. SCHEME GOVERNANACE AND THE ROLE OF THE RESPONSIBLE ENTITY

Question

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

Answer

REs, as do all trustees, have suitability, monitoring and supervision obligations in respect of their agents or delegates and REs are also responsible for their actions. Generally speaking, the appointment of agents and delegates can have real and practical benefits for the RE and the scheme. In my opinion however, there are instances where it might be questionable whether such appointments are in the best interests of investors e.g., in a sprawling international group where delegates and functions are located in different countries it can be very difficult to monitor or influence decisions or processes or even remove the delegate; where the RE is in effect making its services as an RE available for hire to third parties for a fee; where a third party delegate is appointed in a foreign country or has some or all of its operations in, or appoints a sub-delegate

located in, a foreign country. I am not suggesting that such arrangements should be prohibited, but greater scrutiny of the arrangements and regular reviews of why they are, or continue to be, in the best interests of scheme members is worth considering and discussing. Care would need to be exercised as forcing change for the sake of change is in nobody's interest. Having a majority of external directors on an RE's board would assist in in addressing some concerns in this area.

If it has not already been, or planned to be, undertaken then there should be a review of the laws applying to fiduciaries, focussing particularly on schemes that are not trusts, to determine if the codification of duties that has occurred in the Corporations Act needs to be enhanced.

Question

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?

Answer

Yes, so long as the power cannot be used retroactively to revoke or change a modification or exemption that was previously relied upon by the RE. It should be a discretionary power granted to ASIC. The power should not be a broad power and should only be able to be used where a material variation to the minimum requirements is to the disadvantage of investors or there is a material deviation from the regulatory intent.

Question

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?

Answer

In my opinion, a compliance plan must, in addition to the matters covered in the Consultation Paper, be drafted having regard to not only the nature of and the investments contemplated for the scheme but also have regard to and reflect the systems, processes, structure, policies and authorisations, risk and compliance regime and third-party delegations of an RE Group. A compliance plan forms part of the risk and governance arrangements of an RE and can't be looked at in isolation. This does not mean that a compliance plan for a scheme cannot incorporate another plan for a Group scheme or be based on a precedent or refer to and rely upon other documented processes or policies of the RE or its group.

It is also not practical to have detailed procedures or processes contained in or repeated in a plan or across a large number of compliance plans and in doing so would make the plans unwieldy and impossible for directors to approve. It could also be detrimental to the RE and / or its group and members of a scheme if confidential or proprietary information is contained in a public document.

The question that needs to be asked is whether a compliance plan is fit for purpose and is forming part of the overall risk management and governance arrangements of the RE, including those

required by the Corporations Act? A Compliance Plan should also be considered having regard to the scale and resources of the RE and any parent group. Good compliance plans do all of this.

It is not unreasonable to require plans to be updated to ensure currency and to have as part of that process, and the initial approval of a plan, a certification by the Plan Auditor that it is reasonably fit for purpose having regard to the matters I have covered. This would require an independent third party to have regard to the whole risk and compliance framework adopted by the RE and any parent group. As any RE has primary obligations, it can be very difficult for directors alone, whether non-independent or external, to make adverse determinations in respect of any compliance arrangements of the parent or other members of the group and to make change. This is particularly so where there are major delegations by the RE to other members of the group.

Question

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?

Answer

I see no reason why assurance standards relevant to compliance plans do not have the force of law.

Question

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

Answer

I do not support the concept of compliance committees and I believe that the benefits of a majority of external directors outweighs the detriments, if any, of abolishing compliance committees.

Compliance committees have a very narrow function, provide limited independent oversite and have limited powers. It is a largely an after the event function and it has no influence over any rectification or remediation required following a breach. It is also impossible for a compliance plan and a compliance committee to address or consider the positive obligations of an RE or its board to act in the best interest of the scheme's members.

I strongly support the requirement for a majority of external directors. Where there is not a majority of external directors it is very difficult, if not impossible, for the board to ensure that an independent mind is brought to all decisions free from influence, in whatever manner, of or by the company or the group. It is, amongst other reasons, important to be able to question and stand up to a domineering CEO or parent entity or other group executives, including those offshore,

especially those who may not appreciate, or care to understand, our local requirements and obligations.

The importance of a strong compliance culture and an understanding of why risk management and compliance are important and cannot be understated. This is something that a compliance committee can, unlike independent or external directors, have little, if any, influence on.

There are decisions decisions made by non-external directors which should never have been made or are otherwise regrettable.

It is also the case, in matters where officers of a group are board members of an RE or trustee, that the board is required to make decisions which could be against the group's interests. In such instances hostile investors will question their independence and argue they are conflicted. This has occurred despite the directors having at all times acted properly and establishing appropriate conflict management protocols and arrangements. It can place such directors in an invidious position and it is unfair. Resigning does not address the problem, unless independent directors are appointed in their place.

As an external director of an RE I have been subject to attempts, including threats, for me to change my position or make certain decisions, which to ignore or dismiss for an employee director would be career ending. It has led, together with two other external directors, me being intentionally placed in a position by the parent, after our decision was considered at an extraordinary general meeting of members, where I had no option but to resign. It was a removal dressed up as a resignation.

The risk of inappropriate resignation or removal of external directors of an RE needs to be addressed. It needs to be recognised that many, if not a majority, of REs are subsidiary companies. The threats maybe real or implied. I do not favour removing or restricting the rights of shareholders to remove a director. One possible solution is, subject to appropriate protections, an external director who is removed or retires must provide to ASIC the reasons for his or her retirement or removal. ASIC should be required to consider the reasons and be able to make further enquiry and take appropriate action. Consideration will have to be given to what is appropriate action, but it could be publicity, greater scrutiny and increased surveillance of the board's decisions, enforceable undertakings, fines, loss of licence, etc.

Others may suggest that a group could lose control over its subsidiary if there is a majority of external directors, but there are ways to minimise or effectively remove this risk, if there is one. For others, they may argue it does not fit their business model, but if closely examined those arguments do not carry any real weight.

CHAPTER 4. RIGHT TO REPLACE THE RESPONSIBLE ENTITY

Question

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?*

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?

Answer

Removal of an RE is a serious matter which can have material implications for the scheme and members as well as adverse consequences for the RE. It can also be, and has been on occasions, a very emotive decision. It is a difficult area in which to reach a sensible compromise between some investors desire for change and the reasonable rights of the RE.

It is important that the threshold for removal not be set too low, in which case the views of a few large, but not necessarily better informed, members can outweigh a larger number of smaller members. Of course, if the threshold is too high then the rights of the majority can be too easily frustrated.

Also, the current provisions preventing related parties from voting needs to be reconsidered. At present, where the related party holds the interests in a fiduciary capacity or has fiduciary obligations, there is a removal of valuable rights to participate in the decision as to who should manage their investment. To ignore the obligations of these scheme members to act in the best interests of those to whom they hold the obligation is unjust and disenfranchises those to whom the obligation is ultimately owed. This includes where the fiduciary obligation is imposed by statute.

If it is determined that there cannot be a blanket exemption to the prohibition in such cases, then a process could, for instance, be imposed requiring the scheme member to obtain independent advice having regard to the member's circumstances and not being general voting advice on the resolution provided to subscribers, before it makes its decision whether to vote to support or reject the proposed change or abstain.

As for the type of resolution, I see no reason for different voting thresholds for listed and unlisted schemes and in my opinion a special resolution strikes the best balance. In making this comment I have also been mindful that in takeovers of trusts, which usually involves some sort of scheme of arrangement, in addition to the resolution to change the RE there are also resolutions to give effect to the takeover and often to effect changes to the target scheme's constitution, all of which have different voting thresholds. While it is convenient to say that in these cases the voting thresholds for all these resolutions should be the same, I am not convinced there needs to be alignment as there may be other changes to, for instance, to the target scheme's constitution which are not essential to the proposed takeover but are still linked to it and possibly adverse to members' interests.

Question

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?

Answer

This is an issue where the level of due diligence that maybe required and the need for it is greater in some schemes e.g., real asset schemes such as real property and infrastructure schemes or structured products, than in other schemes. It generally does not arise in hostile takeovers of schemes. Takeovers of schemes always involve a change of RE, unless the acquiring RE and target RE are the same company, in which case they are usually friendly and any required due diligence and conflicts can be managed.

It should also be remembered that what is often asked for in these cases is not essential to determining whether to act or not act as the new RE. Further, there is considerable information already available. See also my response to question 16.

While it can be difficult for a potential incoming RE, that difficulty has to be weighed against the potential harm to the scheme and its' members in providing confidential information, particularly as there is always the risk of competitors fishing for information. Confidentiality provisions are not necessarily appropriate or effective.

Further, it can't be ignored that changing an RE is a costly and disruptive process for the scheme. It is also extremely time consuming and it is much easier in these circumstances for the board of the RE if there is a majority of external directors. The board has a primary obligation to always act in the best interests of investors and can determine whether or not the incurring of the necessary costs to run a process to enable a decision to be made by the board as to whether the retirement of the RE is in the best interests of members. If it does run such a process and there is a decision to retire then a limited due diligence can be undertaken. This will further require the board to consider what is a reasonable limited due diligence having regard to the best interests of the scheme's members.

In certain matters I have been involved in as an external director, we have allowed selected potential new REs to be provided some limited information in order to refine their bids, but this has always happened before we called a meeting to change the RE, if one was called. If we did decide to change the RE, we granted limited due diligence to the company we were prepared to recommend as the new RE.

I have also found that each proposal to change an RE is unique and whether it is hostile, friendly or part of a takeover of the scheme is irrelevant. Obviously, if it is friendly then the parties can and do agree on what is required for any due diligence to occur and the RE must decide what of the information requested is actually provided. If it is hostile, then why should it be any different to say a hostile takeover of a company where the potential acquirer has to rely upon its own enquiries?

A change of RE is a more profound and of greater consequence than the removal of directors and I think that, having regard to our existing disclosure laws, allowing for the appointment of a temporary RE is a sensible safety net if another RE is not prepared to accept the risk without further due diligence.

Question

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?

Answer

In my view there should be no restrictions on REs entering into agreements with external parties that may inhibit scheme members from replacing the RE. An RE must before entering into such agreements determine if entering into the agreement is in the best interests of members. Further, as has been acknowledged, there are sound commercial reasons for including such provisions, which usually bind all parties that such provisions can apply to.

It should be remembered that these agreements can and do operate at different levels and assets are frequently held in subsidiary entities which may not be wholly owned or in which a minority interest is held, even though the minority interest is a substantial asset of the head scheme. It would not be practical to, or necessarily effective, to try to legislate to include subsidiary entities or entities where a minority interest is held.

Disclosure of these arrangements is critical for enabling members, any proposed replacement RE and their respective advisers to make informed decisions. That means that there should be not provisions prohibiting the disclosure of the existence of the agreement, its parties and key terms in respect of the disincentive only. If there are such provisions then their existence should be prohibited or be deemed to have no effect. If there is proper disclosure, which has often been resisted, it enables all interested persons to approach the relevant parties to seek consent or at least talk to those parties to the arrangement from whom consent is required. It also greatly assists in any due diligence that maybe required.

I do not favour provisions in constitutions that disincentivise the removal of the RE. I do agree with limited provisions permitting an RE recovering the reasonable costs, including out of pocket costs, of establishing the scheme, so long as the amount recovered is calculated on an amortised basis over a maximum of 5 years from the first offer of securities in the scheme to the date of retirement.

CHAPTER 5. RIGHT TO WITHDRAW FROM A SCHEME.

Question

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

Answer

The answer to the first part of this question is yes. What is important is having strong measures in place to monitor liquidity and valuation of assets, particularly unlisted assets, at times of market volatility or disruption.

As we do not limit the types of assets that can be included in a scheme it is appropriate to leave the definition unchanged. To try and be prescriptive where there is no limit on the range of investments is impractical, is likely to be expensive to implement and could lead to limiting competition.

I have found that the current provisions have not been unworkable, even in times of major market disruption, so long as the constitution has a reasonable period, having regard to the nature of the scheme and its investments, to effect redemption requests. Those who tend to have difficulties are those who do not have strong valuation processes and policies and/or have a redemption period in their constitutions or promise a redemption period in their offer documents that fails to recognise a reasonable period of time to complete the sale of assets while the market for the assets is disrupted.

Question

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

Answer

The answer to the first part of this question is no. This is not to suggest that they are perfect and there maybe others who have had particular problems with the current arrangements which may warrant a change.

Question

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?

Answer

Where this has occurred, it is largely because of poor disclosure. Strong enforcement, including the DDO provisions, and reconsideration of penalties is what is required.

CHAPTER 6. WINDING UP INSOLVENT SCHEMES

Question

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

Answer

A well drafted scheme constitution should give an RE an absolute power to wind up the scheme. Such a provision should always enable the RE to act if the scheme becomes unviable. Unfortunately, many schemes do not have such a provision and therefore I think it is necessary to legislate to enable an RE to wind up the scheme if the scheme should become insolvent. Insolvency is a well understood concept and should be defined accordingly, assuming that the RE has not lost its right of indemnity.

Question

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?

Answer

While there are other circumstances that can lead to a scheme being unviable, the winding up of an insolvent scheme is particularly difficult for an RE as there is no certainty it will recover its costs for doing so, in particular it's out of pocket expenses. This has resulted in a reluctance by RE's to step in and do what they can effectively and efficiently do. They are better placed than other third parties to do so.

One simple change would be to allow an RE of an insolvent scheme to have priority over other scheme creditors, whether secured or not i.e., those who have a security interest in all or any of the scheme property or those merely relying on the RE's right of indemnity, on the recovery of its fees and out of pocket expenses for the winding up. If there is to be an additional fee over and above its fee for running the scheme for acting on the winding up then that fee needs to be reasonable and able to be reviewed by a third party. I do not suggest that fees charged by insolvency practitioners is necessarily a relevant benchmark.

Question

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

Answer

A well drafted constitution should have addressed this issue however, it may not be effective in all instances. It would be sensible to introduce this concept so long as it is one that can be opted out of as there may be a requirement in certain instances for liability not to be limited.

CHAPTER 7. COMMONWEALTH AND STATE REGULATION OF REAL PROPERTY INVESTMENTS.

Question

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?

Answer

I have not experienced any material issues.