Review of the regulatory framework for managed investment schemes (MIS Review)

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FSC FINANCIAL SERVICES COUNCIL

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FSC FINANCIAL SERVICES COUNCIL

1. About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, investment platforms and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses. The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange (ASX) and is one of the largest pools of managed funds in the world.

2. Introduction

Australia has a highly regarded funds management industry which is underpinned by a robust regulatory regime and managed investment scheme (MIS) legislation[1] which has served investors and the industry well over the last 25 years. Australia's competitive[2] funds management industry has some of the lowest fees globally.[3]

Whilst the regulatory regime underpinning MIS' works well, investing is not without risk which is widely recognised[4] and supported by the regulatory regime which requires risks to be disclosed clearly and prominently and imposes a range of legal obligations on Australian Financial Services Licensees (AFSLs) (including fund managers) not to (i) make false or misleading statements[5], (ii) engage in misleading or deceptive conduct[6], or (iii) make representations without reasonable grounds[7].

At times, however, MISs have failed. This MIS Review was instituted in the context of recent investor losses arising from the collapse of the Sterling Income Trust (SIT) and Sterling Group. The consultation paper to the MIS Review dated in August 2023 (Consultation Paper) refers to SIT as well as a number of scheme failures which have occurred over 13-15 years ago. The regulatory regime has been subject to extensive review, as well as reform, during this period which have served to strengthen consumer protections. This includes the prohibition on conflicted remuneration, including banning asset-based fees on borrowed amounts and the removal of upfront tax deductions on non-forestry agribusiness schemes which had the potential to distort advice and investment decisions. Together with the quality of advice reforms there have been significant changes to support quality advice and investment outcomes, given the majority of retail consumers access investment products via a financial adviser.[8]

At the same time, there have been significant reforms and regulatory developments governing the regulation and operation of registered MISs over the past ten years including; updated guidance on risk management systems for responsible entities (REs) (ASIC RG 259), strengthening of AFSL requirements with a focus on a wider range of persons as 'fit and proper persons' (ASIC Info Sheet

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[1] Including Chapter 5C Corporations Act 2001 which covers managed investment schemes.

[2] ASIC Report 702 Competition in Funds Management report found that there is effective competition in Australia which is evidenced by new market entrants, innovation and low fees by global standards. See page vii for more information.

[3] Morningstar's Global Investor Experience study found that Australian investors have access to some of the lowest fees globally. See https://www.morningstar.com.au/insights/funds/195763/australia-equal-first-for-low-fund-fees.

[4] ASIC provided https://asic.gov.au/about-asic/news-centre/news-items/considering-an-investment-or-managed-scheme-what-to-look-out-for/.

[5] s1041E, Corporations Act 2001.

[6] s1041H, Corporations Act 2001.

[7] s769C, Corporations Act 2001; s12BB, ASIC Act.

[8] 86% of retail inflows were found to come through an adviser in 2018, Page ix (2021) ASIC Report 702.

240), enhanced breach reporting requirements (ASIC RG 78), providing ASIC with product intervention powers (PIPs) and most notably, the introduction of the Design and Distribution Obligations (DDO) which has introduced significant product governance obligations with a consumer centric focus across the lifecycle of an investment product.

Given these extensive developments, we consider the product failure issues referred to in the Consultation Paper are historical and not reflective of the current environment post these significant reforms. In relation to the more recent failure of the SIT, it is notable that ASIC did not have PIP powers and that the DDO requirements were not in place. Post DDO and PIP a similar product would be required to only be sold to a relevant (and restricted) target market and ASIC would now have swift regulatory tools to prohibit sales to certain retail customers. ASIC Deputy Chair Karen Chester has outlined that "the DDO interim stop orders have become a 'go-to regulatory tool' for ASIC to quickly disrupt and stem poor consumer outcomes'[9] under which ASIC has issued 26 stop orders on investment products in 9 months. As a result of these actions, 12 issuers have amended 18 target market determinations (TMDs) to address ASIC's concerns and 7 products have been withdrawn by issuers.[10] Together with the PIP powers which enables ASIC to address 'market-wide'[11] issues as well as business/product specific issues (which ASIC has used to ban short term credit products), and existing legal obligations, we consider that there are no further changes needed to restrict the sale and distribution of products to retail consumers. As expressly noted in by the Financial System Inquiry (FSI), there is a moral hazard risk that arises if ASIC's PIPs are to be used as a pre-approval process for products "*that is, the perception that if the regulator has not intervened this implies a low-risk product."*[12] Please see the response to **Chapter 2** for further details.

The MIS framework works: Enhancements rather than structural changes

Notwithstanding the current regulatory regime establishing clear obligations and requirements, we acknowledge there may on occasion be a small minority which ignore the rules. The regulatory regime however, cannot regulate against those determined to break the law and at this point it is legitimate to question whether there is appropriate enforcement of the law. Adding further obligations is unlikely to encourage those rogue operators from meeting legal requirements. We consider that investors losses have not been caused by structural flaws with the MIS framework and there have been significant regulatory reforms to enhance consumer outcomes since the product failures referred to in the consultation paper. Proactive and risk-based surveillance by ASIC in this regard is key, as this has both a general deterrence effect as well as the ability to swiftly reduce the risk of consumer harm and detriment.

On RE governance we support the regulatory regime providing flexibility in line with the size, scale and complexity of the business which enables an RE to implement appropriate governance structure and arrangements that take this into account, including whether to have a majority independent RE board or to use a compliance committee. We have fund manager members that use both arrangements, and which respectively value the perspectives provided by independent directors as well as the expertise offered by compliance committees. Further information is included in our response to **Chapter 3** of this submission.

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[9] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-115mr-asic-calls-on-investment-product-issuers-to-lift-their-game-on-design-and-distribution-obligations/.

[10] 23-115MR ASIC calls on investment product issuers to 'lift their game' on design and distribution obligations | ASIC.

[11] See RG272.9, ASIC RG 272: Product intervention power.

[12] See RG 272.5; ASIC RG 272: Product intervention power. https://download.asic.gov.au/media/5633261/rg272-published-17-june-2020.pdf.

We consider there are a number of important opportunities for change including in relation to the wholesale investor test. The FSC is supportive of changes to the wholesale investor test and makes a number of proposed changes including increasing the net asset test for the individual wealth test. We do not consider that changes are needed to the product value threshold or the gross income threshold for the individual wealth test, as these are both sufficiently high in today's terms that the overwhelming majority of adult Australians would not meet the test to be classified as a wholesale investor. Further details are set out in our response to **Chapter 1** of this submission. Further changes to the legislative and regulatory regime, including the need for a product modernisation regime, are set out in the FSC's recommendations and in **Chapter 8** of this submission.

There are other recommendations we make across each of the Chapters in the MIS Review and a high-level summary of the recommendations is included below (with further information in this paper in the relevant sections below).

FSC Recommendations

Chapter 1 – Wholesale client thresholds

Recommendation 1.

- **Retain the product value test -** The product value test of $500,000.
- **Increase the individual wealth test –** Increase the financial thresholds for the individual wealth test to either:
    - Increase to $5 million (including the family home) OR maintain at $2.5 million (exempt the family home) AND
    - Retain the gross income test at $250,000.
- **Improve the sophisticated investor test through regulatory guidance or a safe harbour.**
- **Periodic review and no indexation.**
- **Accompanying these changes should be a two-year transition and grandfathering of existing clients.**

Chapter 2 – Suitability of scheme investments

Recommendation 2: The DDO regime establishes a consumer first approach to product design and distribution, which is supported by a range of regulatory tools available to ASIC (including under PIP) enabling it to take swift action. As such, we do not consider there is a need for further conditions or restrictions on certain investment products when offered to retail clients.

Recommendation 3: ASIC should review its AFSL and scheme registration processes, including the information it captures as part of an AFSL application and scheme registration processes to capture enhanced data points that will lead to either a fast track or slow track registration processes depending on the particular MIS. These enhanced data points will inform risk-based surveillance processes at the outset to be implemented following registration of a MIS.

Recommendation 4: To better streamline review processes and provide applicants with a reasonable period to consider and respond to ASIC requests for amendments to be made to the documents lodged without the application to register the MIS being refused, where ASIC raises new matters towards the end of the 14-day registration period, we recommend the following:

A. Introducing a mechanism to adjust the 14-day registration period where matters are raised by ASIC after the first week of lodgement of an application to register a MIS. For example,

ASIC has 7 days to request changes and the issuer has an additional 7 days to respond. This should be subject to further consultation to identify the best means to implement this whilst retaining the efficiency and certainty provided by a 14-day registration process.

B. Inconsistency among ASIC reviewers should be considered and addressed to ensure a consistent approach is taken amongst reviewers in relation to applications to register MISs. This should be subject to clear ASIC guidance and publicly communicated policy positions. It may also require further training and development of ASIC staff to ensure the ASIC team reviewing scheme registration applications includes experienced staff in the relevant division.

C. ASIC should also consider the appointment of a case officer, similar to practices used by the regulator in Singapore and Hong Kong, which serves as the designated contact point for issuers to engage with in relation to MIS registration processes. This will assist to ensure consistency in ASIC's approach and positions taken on key regulatory and policy issues.

D. ASIC's views on redemption periods and termination clauses should also be made available publicly so that these matters can be taken into account prior to submitting an application to register a MIS. It would also serve to make scheme registration process more efficient.

Recommendation 5: We support the consumer detriment and moral hazard concerns raised by the FSI that would arise from giving ASIC a power to prohibit products from the outset and consider that ASIC should use AFSL application and scheme registration processes to inform risk-based surveillance processes at the outset of an AFSL license being granted and/or scheme registration and use its existing suite of powers to intervene where necessary. ASIC should be appropriately resourced for this.

Chapter 3 – Scheme governance and the role of the RE

Recommendation 6: The regulatory regime provides flexibility in line with the nature, size, scale and complexity of the business enabling an RE to implement an appropriate governance structures and arrangements that take this into account, including whether to have a majority independent RE board or to use a compliance committee. The FSC supports retaining the current flexibility.

As outlined in this submission the expertise provided by the compliance committee framework provides specialised skill and information to REs which use this structure as outlined in more detail in Attachment 1. RE Governance Background Paper. We do not recommend any specific changes to the RE governance or compliance committee frameworks.

Recommendation 7: ASIC should publish its contemporary expectations regarding arrangements expected, or not expected, to be included in a scheme constitution to provide clarity to industry, as well as consistency, in relation to scheme constitution requirements via updates to RG134. This will reduce the need for ASIC to request changes to the constitution as part of the scheme registration process.

Recommendation 8: With ASIC already having the ability to amend scheme constitutions prior to scheme registration, by refusing to register a scheme, it is not considered that ASIC should be given further powers to direct REs to amend scheme constitutions.

Recommendation 9: We recommend that mere non-compliance with a scheme's Compliance Plan be removed from the duties of an RE that attract a civil penalty. This would mean that only material breaches of a Compliance Plan would need to be reported to ASIC instead of all Compliance Plan

breaches (whether material or not). In the alternative, ASIC may impose a civil penalty where there is a material breach of the Compliance plan.

Recommendation 10: The FSC supports the flexibility provided in the RE governance model that enables an RE to choose the right governance model according to the nature, size and scale of the business, including whether to use a majority independent RE board or to use the expertise of a compliance committee. For the reasons outlined in the response to Chapter 4 to this submission, we do not support mandating a requirement to have a majority external board for REs.

Chapter 4 – Right to replace the RE

Recommendation 11: Retaining the ordinary resolution threshold for replacing the RE of a listed scheme is sensible and leaves it on an equal footing with the process for removal of the board of a listed company. The substance of ASIC Class Order [CO13/519], that allows listed fund investors to requisition a meeting to vote on an ordinary resolution to change the RE, should be built into the legislation.

Recommendation 12: We do not consider there is a need to change the current voting thresholds that allow members to replace the RE of an unlisted scheme. We also note a related but separate issue in Recommendation 20, issue 10, that the legislation should formalise ASIC voting relief to remove super funds, custodial or IDPS/Platform holders that do not facilitate voting.

Recommendation 13: The existing regulatory framework already provides various protections against an RE inappropriately making payments or giving benefits out of scheme property. A contract with an investment manager, for example, provides stability in the ongoing operation of the fund – a benefit that should not be discounted.

Chapter 5 – Right to withdraw from a scheme

Recommendation 14: Yes, our view is that the definition of 'liquid assets' in ss601KA(5) and (6) is appropriate and no change is needed.

Recommendation 15: Following the general principle that the law should be able to be understood on its face, common modifications in relief instruments issued by ASIC should be built into the legislation where possible such as relief to allow withdrawals in cases of consumer hardship. Technology neutral investor communication should also be facilitated for withdrawal from MIS deemed illiquid.

Recommendation 16: The redemption provisions under the law are both certain and flexible, and this flexibility is important. Where a mismatch arises between member understanding and the actual right to withdraw, this may be due to misleading disclosure or advertising and ASIC should continue to take appropriate action to ensure existing legal obligations are not breached.

Chapter 6 – Winding up insolvent schemes

Recommendation 17: It is recommended that a legislated product rationalisation mechanism, with tax rollover relief, be established to enable investors to be moved from outdated to contemporary investment funds.

Recommendation 18: We support a statutory limitation of liability, similar to a corporate style limitation of liability for trust-based schemes, provided the RE can recover costs incurred specifically by it as a result of acting as the agent of, or under the direction of, the investor.

Chapter 7 – Commonwealth and State regulation of real property investments

Recommendation 19: We do not see particular issues for investors arising from dual jurisdictional responsibility when regulating schemes with real property. MIS are often invested across a variety of assets, including geographically spread assets, and subject to a variety of laws and regulations. This does not appear to present a problem for other schemes more generally.

Chapter 8 – Regulatory cost savings

Recommendation 20: Table 1 sets out twelve opportunities to modernise and streamline the MIS regulatory framework.

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3. Chapter 1 – Wholesale client thresholds

Current practice

The industry has developed such that product offerings are selectively offered to either wholesale or retail clients. Some products are deemed unsuitable for retail clients given the specific features such as complexity or liquidity or it may be more efficient to offer products to wholesale clients (which may have lower associated regulatory costs that in turn can lower the overall fees charged for such products). Wholesale clients may have access to a wider and potentially more complex range of products which may also have a higher risk or return profile than products offered to retail clients. The consequence of this is that investors who do not qualify as wholesale clients may be missing out on high quality offerings (that is reversing the 'democratisation' of investing, pursuant to which more individual investors are gaining access to investment strategies and asset classes (such as private market asset classes) previously only available to institutional investors.

These products may be very attractive investments to different investor types, such as superannuation funds, which are increasingly using investments such as real assets, to diversify risks of being over exposed to typical investments such as listed equities. Wholesale investments can help boost long term returns which is important for those looking to build their wealth or to support a comfortable retirement in the future.

Existing wealth thresholds have not kept up with changing wealth patterns among consumers

There is a consistent and increasing evidence base documenting changes in the wealth make up of Australian consumers since the introduction of the wholesale investor test in 2002. For example:

- Research conducted by Associate Professor Ben Phillips from the Australian National University estimated that in 2021, 16 per cent of Australian adults met the individual wealth thresholds to be classified as a wholesale client, compared to 2 per cent of Australian adults in 2002. This modelling predicted that, under the current thresholds, the percentage of Australian adults above the threshold will increase to 29 per cent by 2031 and 44 per cent by 2041.[13]
- A significant number of Australians now invest, with the 2023 ASX investor study finding that 51% of the Australian adult population owns investments outside the primary home and superannuation. Household annual disposable incomes have steadily increased from a mean of $74,356 in 2001 to $101,602 in 2020 as outlined in research published in the Household, Income and Labour Dynamics in Australia (HILDA) Survey undertaken by the Melbourne Institute, Applied Economic and Social Research. See Table 3.1 Household annual disposable incomes 2011 to 2020[14] below.

[13] B Phillips (2021), *Sophisticated Investor Projections*, ANU Centre for Social Research and Methods, p 8, accessed July 2023.

[14]https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0011/4382057/HILDA_Statistical_Report_2022.pdf.

Table 3.1: Household annual disposable incomes, 2001 to 2020

	Mean ($, December 2020 prices)	Median ($, December 2020 prices)	Number of households	Number of people
2001	74,356	64,057	7,281,363	18,824,376
2002	75,464	65,400	7,357,079	19,039,091
2003	75,191	65,187	7,433,838	19,258,414
2004	77,958	67,339	7,505,562	19,468,325
2005	81,492	71,794	7,589,921	19,714,426
2006	85,373	73,594	7,686,360	20,013,529
2007	89,407	77,339	7,836,760	20,382,461
2008	91,665	79,083	8,009,920	20,809,743
2009	95,142	84,147	8,175,735	21,216,949
2010	94,660	81,763	8,298,875	21,521,079
2011	95,026	80,007	8,413,537	21,834,344
2012	96,499	83,559	8,578,027	22,221,454
2013	97,441	83,777	8,737,151	22,594,836
2014	97,045	82,403	8,882,149	22,929,927
2015	96,483	82,048	9,028,434	23,266,630
2016	96,201	82,867	9,192,118	23,656,265
2017	96,906	82,298	9,355,903	24,047,180
2018	97,392	82,458	9,519,919	24,426,212
2019	100,615	84,625	9,683,252	24,801,028
2020	101,602	86,974	9,783,510	25,009,822

- The proportion of Australians educated at bachelor level or higher has also increased over time, which is an important consideration given that university education is strongly associated with financial literacy[15]. In 2021, 43.5% of 25-34 years olds had a Bachelor-level qualification or higher, up from 27% in 2004.[16] When looking at a broader age range in 2022, the ABS reported that 32% of people aged 15-74 years had a bachelor's degree or above.[17]

The key objective of drawing the distinction between retail and wholesale clients is to identify those considered in need of regulatory protection and recognise that individuals with requisite values in assets or income have the knowledge, experience, sophistication or can access professional advice.[18] The wholesale client thresholds also serve as a proxy for individuals which have the means to take on additional risk and also have capacity to bear loss. This is a meaningful distinction between wholesale and retail clients, which is used by other jurisdictions that similarly use wealth thresholds and sophistication measures to distinguish between retail and wholesale clients.

It is clear the existing thresholds should be changed to deliver a more sustainable regulatory framework capable of withstanding changing wealth patterns more reflective of consumers a whole. This can be achieved in different ways each carrying with it consequences for consumers misaligned from the overall intent of ensuring the wholesale and retail classifications reflect the expectations and capacity of the consumers they were designed to protect.

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[15] See page 20, https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0011/4382057/HILDA_Statistical_Report_2022.pdf
[16] See page 16, https://www.universitiesaustralia.edu.au/wp-content/uploads/2022/09/220207-HE-Facts-and-Figures-2022_2.0.pdf
[17] https://www.abs.gov.au/statistics/people/education/education-and-work-australia/latest-release.
[18] See page 16 of the Review of the regulatory framework for managed investment scheme consultation paper.

How the distribution of asset classes has changed under current wholesale test

Treasury have sought examples from industry of asset classes that are uniquely offered to wholesale clients. Previously these kinds of asset classes were only available to institutional investors. The below example illustrates that any changes or revisions to various limbs of the wholesale investor tests could restrict or even preclude access to investment offerings of this kind, that facilitate access to a broader range of investment offerings and facilitate portfolio diversification with access to a broader range of asset classes.

Palisade's Diversified Infrastructure Fund (PDIF)

PDIF invests in infrastructure assets principally located in Australia with up to 20% of the fund invested globally. PDIF invests across multiple infrastructure sectors in assets providing a wide range of essential services and facilities that are fundamental to daily life and vital to the Australian economy including:

- Transport (air and sea)
- Energy (renewable and thermal energy generation, transmission and storage)
- Utilities
- Agri (livestock exchanges)
- Social (defence, justice, health and transport)
- Digital (fibre, communications, data storage)

The fund was established in 2004 and is currently invested in over 20 assets.

Such funds are not offered to retail investors due to the capital call structure used for infrastructure and the lack of liquidity. While it may be possible to structure around these issues, it would result in less efficient investing – so lower returns for investors resulting from an increased cash drag and higher administration costs.

Palisade has found that wholesale investors are able to better manage the capital call nature of unlisted infrastructure (by flexibly managing their own investment portfolio to able to meet a capital call within say 30 days' notice), as well as having appetite for illiquidity (given wholesale investors are typically managing their portfolios over a longer-term time frame) – this is something the retail market would struggle to manage.

Benefits of unlisted infrastructure assets

- long term, low volatility and inflation-linked income streams with little or no correlation to economic cycles which mirror the objectives of the fund, which are to offer long term, low volatility, inflation linked distributions to investors.
- Unlisted infrastructure investment in Australia has historically been dominated by institutional investors (e.g., superannuation, insurance, wealth groups, endowments etc.)
- Unlisted infrastructure plays an important role in broader investment portfolios, including
    - significantly lower volatility or correlation to traditional asset classes (e.g., equities and bonds) and
    - inflation-linked cashflows (due to inflation-linkages within underlying asset revenue structures)
- This is underlined by unlisted infrastructure allocations typically comprising 5-10% of institutional portfolios (and in many cases greater than 10% for long-term portfolios).
- Unlisted infrastructure is also an effective way for investors to participate directly in the next phase of renewable energy buildout in Australia to meet our emissions targets. The ability to attract wholesale capital to fund this buildout is critical to Australia meeting these targets.

Why has unlisted infrastructure been difficult to access?

Unlisted infrastructure has been difficult for investors to access due to two reasons:

- Capital call structure: Unlisted infrastructure typically operates on a "capital call" structure (i.e., investors "commit" to a fund, and then capital is drawn down into the fund periodically (sometimes over the course of 12 or more months) to fund new investment opportunities. This is necessary as investment in unlisted infrastructure can be lumpy in nature, as investments can take as little as 3 months or greater than 12 months from start to finish.
- Illiquidity: Unlisted infrastructure is illiquid in nature (investments can take 3-6 months to sell given the extensive due diligence involved in acquiring assets)

How the wholesale client test should be changed

There are a range of ways the wholesale client test can be changed to maintain the protection of consumers it was designed to protect when it was first introduced which include:

- **Expanding the number of consumers who are not classified as wholesale clients (and therefore are classified as retail clients).**
- **Make it clearer in what circumstances the sophisticated investor test can be used.** At present there is no standardised approach to its implementation and some reluctance given the potential risks to an RE if an investor later claims they should not have been classified as a wholesale client have been classed as retail given it is subjective with no guidance around how to implement it.

Responses to Treasury's questions

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

No. The product value test of $500,000 or more greater should be retained as the existing product value test that is satisfied when the provision of a financial product or the value of the financial product to which the financial service is related equals or is greater than $500,000.[19]

This existing value is satisfactory for several reasons:

- The $500,000 minimum requirement is considerable - retail client would not typically have this amount of money available to invest in a single investment or as a cumulative total value of all products as set out in Corporations Regulation 7.1.19(5). As such, keeping the product value test at $500,000 or more does not compromise the consumer protection framework for retail clients.
- The original basis for this threshold, which was set out Explanatory Memorandum (**EM**) and which is still relevant today, is based on the assumption that persons who can afford to acquire financial products or services with a value above the prescribed amount do not require protection as retail clients, as they may be presumed to have either adequate knowledge of the product or service, or the means to acquire appropriate advice.

ASIC should continue to educate consumers on:

- the distinction between a wholesale and retail client; and

[19] Paragraph 761G(7)(a) of the Corporations Act.

- what it means to be a wholesale investor through guidance, information and education material.

This would include updating the ASIC and MoneySmart website to include information on the distinction between, and what it means to be, a wholesale client and a retail client. ASIC could prepare wholesale client related educational content, similar to the educational content that the ATO has developed for Self Managed Super Fund trustees.

Question 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?

Yes. The financial thresholds for the Individual Wealth Test should be increased as follows (options are put forward on a net asset basis:

- $5 million including certain assets such as the family home.
- If an option is desired to exclude the family home, then the Individual Wealth Test should be set at $2.5 million (excluding the family home). Excluding the family home has the benefit of removing the divide between investors in large cities such as Sydney and Melbourne and those who live in regional areas. The value of a family home in Sydney and Melbourne can substantially contribute to an investor reaching the net assets threshold, so removing the value of the family home from the net assets calculation results in investors in the large cities and regional areas being placed on an equal footing.
- There should be no change to the gross income of at least $250,000 per year in the last financial years.

The FSC notes that this approach would:

- Represent a doubling of the current wealth test to $5 million and the $2.5 million threshold (excluding the family home) recognises increased asset values for Australian homeowners.
- Maintain the $250,000 gross income threshold which is well above the highest marginal tax rate (commencing at $180,000) and which only a limited number of Australian investors would satisfy given that 95% of Australian taxpayers make less than $162,777.[20]
- Result in a simpler overall test that reduces regulatory complexity, and which is more transparent for consumers by making it easier to assess whether an investor is eligible to be to be classified as a wholesale investor.
- Encourage high income individuals to make long-term investments
- Align Australia's regulatory settings with overseas jurisdictions which tend to focus on the individual income of a client. For example, the *US Accredited Investor Test* is satisfied if:
    - An individual with more than $200,000 in annual income for at least two years,
    - A married couple with more than $300,000 in annual income, or
    - A household with more than $1 million in assets,
    - A bank, savings and loan association or other similar financial institution, or
    - An investment firm or trust with more than $5 million in assets.

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?

The individual net asset tests could allow either options:

- $5m including primary residence, or

[20] Grattan's 2023 Budget cheat sheet: How much do Australians earn?.

- $2.5 million excluding the family home

The family home should be excluded from calculating a consumer's suitability under the individual wealth test where the value of their remaining net assets is $2.5 million on the basis that:

- Including the family home would be unnecessarily complex (requiring home valuations) and confusing for consumers in managing their financial affairs.
- The regulatory framework should contemplate future changes in consumer wealth (excluding the family home).
- More closely aligns with the policy intent of the wholesale investor test which is anchored in assessing a consumer's financial capacity and risk appetite for financial decisions.
- Excluding the family home encourages home ownership and aligns with other broader public policy objectives.
- Prevents the family home from being leveraged in the context of a wider investment portfolio or exposing it to undue risk.

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?

The FSC does not support introducing consent requirements for wholesale investors, given the limited benefit of extra disclosure for helping investors understand the risks of being classified as a wholesale client.[21] We also note that the Quality of Advice final report recommendations were made in the context of advised clients being informed about the duties of the advice provider.

The Sophisticated investor test should be strengthened by more ASIC regulatory guidance or a safe harbour

The current mechanism for determining whether a client is a wholesale client on the basis that they satisfy the sophisticated investor is subjective and involves AFSL holders making an independent assessment of their clients' previous experience using financial services and investing in financial products to be treated as a wholesale client. As a result, it is not widely used.

The FSC recommends that the sophisticated investor test be improved through:

- ASIC regulatory guidance (for example through issuance of a Regulatory Guide) establishing examples or principles that should inform the judgement of an AFSL holder in determining a client's suitability to be classified as a sophisticated investor; or

- The introduction of a safe harbour that outlines the steps that an AFSL holder needs to be satisfied on reasonable grounds in order to classify a client as a sophisticated investor to be satisfied by a client and AFSL holder to be considered as sophisticated investor while retaining the overall discretion and flexibility of an AFSL holder to make that determination.

For example, either of these mechanisms could deem a financial planner who provides personal advice as part of their job who meets the education requirements as an investor with previous investing experience who meets the sophisticated investor test.

Other comments

Transition Period

[21] ASIC REP 632 Disclosure: Why it shouldn't be the default

Changes to the wholesale client test will need an appropriate transition period. We are supportive of a two-year transition period after which all new investors would need to meet the revised wholesale client requirements in line with the FSC's proposals.

Investors who meet the current wholesale client tests should be grandfathered and any changes to the wholesale client test in accordance with the FSC proposals should not have retrospective application.

Investors currently categorised as wholesale clients should continue to be treated as wholesale clients in any existing funds they are invested in and be able to re-invest distributions back into the funds and make further investments in the fund without being subject to re-assessment of their eligibility as a wholesale client under any revised financial thresholds. A periodic review of the thresholds every five years could expose investors to those same impacts and would to that end further suggest grandfathering as the thresholds change. As such wholesale client tests should be applied at the point of sale in relation to new investments to minimise unintended or unfavourable investment outcomes driven unilaterally by changes in the wholesale client thresholds.

A failure to grandfather existing arrangement if the thresholds are increased would:

- Generate a scenario where consumers who are classified as wholesale clients under the current law, and that changing during the course of their investment and the assumptions originally driving their decision to invest in a wholesale product no longer applying (e.g., individual wealth test increasing).
- Create a range of uncertain outcomes which can be mitigated by ensuring the law in effect when an investment was made still applies, and while any changes to the law apply to new investments a consumer can agree to. Two scenarios illustrate the impact for investors if such changes were not grandfathered:
  - **Tax:** For instance, if investors no longer meet one of the wholesale client tests and are forced to redeem from a wholesale MIS, there could be unfavourable outcomes for such investors, such as adverse tax consequences, impact to their overall investment strategy, additional costs (e.g. exit fees, transaction costs, cost of advice to identify an appropriate alternative investment), as well as the opportunity costs arising from no longer being able to access the returns offered by the wholesale fund. With the forced exit of these investors from the wholesale fund and where the number of investors redeeming is not insignificant, it is likely there would be adverse impacts to the investors who remain in the fund and the ongoing viability of the wholesale scheme.
  - **Forced redemptions:** A related consideration is the feasibility and legality of implementing forced redemptions where the scheme is non-liquid or subject to lengthy lock-up periods. We are aware that there are existing wholesale funds with lock-up periods of over 5 years, where no redemption requests can be made by investors is able to be processed. Such conditions are disclosed to investors in information memoranda and consented to by investors as part of the application process. There are circumstances where investors may not be able to be redeemed from a wholesale fund even if the wholesale client thresholds change.
- **Mechanism for grandfathering changes to the test:** One way to address this would be to provide that a person should continue be considered a wholesale client in respect of all financial services associated with a product (including an interest in a MIS) that was issued to them at a time when they qualified as a wholesale client. Reasons why this is necessary and appropriate include:

- need for a product issuer to provide ongoing financial services to investors. Such an issuer may only be licensed to provide financial services to wholesale clients and not retail clients.
- ensure all existing investors in a fund can be treated equally, for example with respect to reinvestment of distributions.
- It would also be impractical for the product issuer of a wholesale fund to develop processes for complaints, periodic statements and other aspects of retail client compliance simply because one client would need to be satisfied passed the wholesale client test when they invested is no longer be eligible after regulatory changes. The grandfathering for this purpose would need to persist for the life of the person's investment in that product.
- To ensure that existing investors do not have their interests diluted in a fund where there are additional capital raisings, it would also be important to enable existing wholesale clients to participate in pro-rata offers of new interests in the product by making additional investments in their existing product.

Periodic review, not indexed

The financial thresholds of the wholesale client tests should be subject to a regular periodic review, for example every five years and should not be indexed. This should be a statutory requirement imposed on the Minister to consult adequately with the public to ensure the values keep pace with changes in demography and wealth patterns of consumers.

The values should not be indexed in line with inflation.

Frequently changing the threshold under indexation would have the following unintended consequences:

- Exclude consumers initially categorised as wholesale clients who suddenly find themselves no longer categorised as retail clients unable to make a wholesale investments.
- A Periodic Review every five years balances the need for certainty and the need for thresholds that can be updated more regularly.
- Increased complexity and compliance costs for product issuers due to frequent updates to the financial thresholds that require ongoing adjustments to compliance systems.
- Isolate the Australian market from overseas regimes creating a further deterrent to foreign investors.
- Indexation each year of the financial thresholds is not fully reflective or a good measure of an investor's overall financial capacity.

Periodic review of the financial thresholds is by contrast a more practical mechanism for achieving the same result. While it would be less frequent than indexation it would avert many of the core issues that would arise unnecessarily due to a requirement for the financial thresholds to be indexed.

The professional investor and small business tests should remain unchanged

Member feedback supports the professional investor test (e.g., the trustee of a superannuation fund which has net assets of at least $10 million) and small business test remain unchanged, on the basis that it is still current and relevant in today's terms. Meeting the policy objective to the framework more responsive to the changed wealth profile of Australian consumers is best satisfied through changes to the IWT in line with the FSC's proposals.

Recommendation 1.

Retain the product value test
The product value test of $500,000 or more should be retained.

Increase the individual wealth test
Increase the financial thresholds for the individual wealth test to either:

- Increase to $5 million (including the family home) OR maintain at $2.5 million (excluding the family home) AND
- Retain the gross income threshold of $250,000 or more per year in the last two financial years.

Improve the sophisticated investor test through regulatory guidance or a safe harbour.
The sophisticated investor test should not be changed but further improved through ASIC regulatory guidance or a safe harbour establishing principles and steps to AFSL holders to assess clients in meeting the sophisticated test.

No changes to the professional investor or small business test
There is no basis for changes to these tests.

Periodic review and no indexation
There should be no indexation of the tests and both the product value and individual wealth tests should continue to be maintained through and prescribed in the Corporations Regulations and be subject to review every five years.

Implementation
Accompanying these changes to the wholesale client tests should be:

- A two-year transition timeframe; and
- Grandfathering of existing clients currently classified as wholesale clients following changes to the regulatory framework (e.g., increases to the individual wealth test) as proposed by the FSC.

4. Chapter 2 – Suitability of scheme investments

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

There is a conditional (and limiting) regime in Australia for retail scheme products as the Design and Distribution Obligations (DDO) requires products to be developed for, and distributed to, particular classes of retail customers.

At this time, there are also no indications that the DDO is failing in its main goal of ensuring product distribution is directed towards appropriate customers, including ensuring that some products are not available to retail customers or otherwise can only be provided with advice.

In addition, ASIC has been a frequent user of its DDO powers to intervene on products that are not, in its view, complying with the DDO rules, and has required many products to implement extensive expansions in the distribution conditions in their Target Market Determinations (TMDs) to ensure the product is better targeted at the appropriate target customers. ASIC also has other regulatory tools available including the Product Intervention Power (PIP) which enables ASIC to temporarily intervene in a range of ways, including to ban financial products and credit products when there is a risk of significant consumer detriment in order to improve consumer outcomes.[22] ASIC can exercise this power even when DDO obligations are being complied with.[23] The scope of the power is on preventing consumer detriment and extends beyond DDO. With these powers ASIC has sufficient power to regulate the sale and distribution of products to consumers.

Some notable uses by ASIC of the DDO and PIP since its inception include:

- Issuance of 82 interim stop orders, where 77 have been lifted following actions following actions taken by the entities to address ASIC's concerns or where the products were withdrawn
- Restriction of the availability of short-term credit contracts and contracts for difference
- Commencement civil penalty proceedings against a number of issuers and distributors
- published surveillance findings in relation to small amount credit contracts (22-352MR), superannuation (22-236MR) and managed investment products (23-115MR)

Additionally, banks have mandated that hybrid securities should only be available to retail customers who have received personal advice. This is the DDO regime working as it is intended – with product issuers themselves making the judgement about which products should be available wholesale only, or retail only under advice.

Whilst the PIPs do not provide ASIC with the ability to refuse the distribution of a product at the outset, it does provide ASIC with proactive powers to reduce the risk of significant consumer detriment upon commencement of distribution. RG272.2[24] states:

> *"The product intervention power enables ASIC to take a more proactive approach to regulating the market and reducing the risk of significant consumer detriment. The power: (a) enables us to respond to problems in a flexible, targeted, effective and timely way; (b) enables us to take action on a market-wide basis; and (c) is available without a demonstrated or suspected breach of the law, which enables us to take action before significant detriment, or further*

[22] https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-272-product-intervention-power/#:~:text=The%20product%20intervention%20power%20is,risk%20of%20significant%20consumer%20detriment.
[23] See RG272.4, ASIC RG272 Product intervention power.
[24] Section 272.2 (2020) ASIC Regulatory Guide 272: Product Intervention Power.

detriment, is done to consumers, so that we can better uphold community expectations on the conduct of firms that issue or distribute products."

In considering whether ASIC should have a power to be used for pre-approval of products, the PIP was never intended for this purpose. RG272.5 states:

"The product intervention power is not intended to be used for pre-approval of products. The FSI explained that this would likely result in moral hazard—that is, the perception that if the regulator has not intervened this implies a low-risk product."

Giving ASIC a power to prohibit certain products from being sold to retail clients would create the moral hazard risk identified by the FSI. Further, there is recognition that legislation cannot be applied broadly to remove all investment risk and the PIP is focused on enabling intervention to mitigate significant detriment. RG272.7 states that:

"By their nature, there will always be risk in financial markets. However, the product intervention power may, for example, enable interventions to mitigate the significant detriment that can arise when consumers are marketed and sold investment products that are inappropriate for their risk profile or when they are unable to understand and/or assess the risk they are taking…"

The position that ASIC's powers should be expanded beyond the DDO and PIP regimes would be implicitly arguing that these two regimes have failed (at least in part) which is an argument without evidence to date. Those arguing for further powers will need to demonstrate how there are substantial gaps in the DDO and PIP regimes (for example, providing an evidence base that the DDO and PIP obligations and powers are insufficient to protect consumers from undue financial risk).

The DDO and PIP regimes are still relatively new regimes and notably were not in place when interests in the Sterling Income Trust (SIT) were issued. If SIT had been subject to the DDO and PIP regimes, DDO would have required SIT to have identified upfront who was in the target market for SIT's complex and novel product and the TMD would also have identified the percentage of a client's portfolio allocation that would have been appropriate to invest in that product (e.g., less than 25%%, 25-50% etc.) and any distribution conditions that may be imposed. SIT and its distributors would have been further required to take reasonable steps to ensure that interests in SIT were only distributed and issued to investors meeting these criteria and requirements. These regimes would have also given ASIC swift mechanisms to respond when concerns were raised, including reviewing the product TMDs to consider whether an appropriate target market for the product was identified, whether the right levels of portfolio allocation were selected and whether the distribution conditions were appropriate.

Given the high risk and complex nature of the product, under the DDO regime, it may have been likely that the SIT product would only be suitable for sale and distribution under strict distribution conditions, such as only being suitable for consumers who have received personal advice, which is likely to have significantly reduced who, and how much was, invested in the product by retail clients.

Given the legal obligations imposed under DDO, and the swift action ASIC is already taking under DDO and PIP, together with existing tools available to ASIC, we consider there is currently no case that powers or regulatory changes are required to restrict certain MIS investments when offered to retail clients. DDO and PIP already enable this to occur both via issuer obligations and regulatory review. PIP is also not limited to DDO, with ASIC being empowered to use PIP if it is satisfied there is

a risk of significant consumer detriment enabling ASIC to ""(a) address market-wide problems or particular business models causing significant consumer detriment, more quickly than law reform; and (b) deal with 'first-mover' issues that may inhibit industry-led responses to products that are causing significant consumer detriment."[25] Further restricting the types of funds that can be sold to retail clients could result in retail clients being unable to access alternative or innovative strategies in Australia. This could impact diversification and returns. Such retail clients may look to alternative ways to obtain similar exposures outside the Australian regulated system.

Similar risks were identified in the 2011 Law Council submission to Treasury on the "Options Paper – Wholesale and Retail Clients" which did not support introducing a complex products test that could stifle positive innovation and increase the costs associated with valid investment products and which, on an overly simplistic basis, assumed that complexity and risk are proportionally related. The submission noted that limiting access may have the effect of denying investors access to products that offer attractive returns, and which may involve less risk than ordinary equity products, while reducing opportunity for diversification of investments.[26] Further restricting products without evidence of the existing ASIC powers and regulatory framework being insufficient (and without a comprehensive review of whether or not there are any insufficiencies) would be preliminary and unwarranted.

It is also worth noting how retail clients access financial products. ASIC Report 702 Competition in Funds Management identified that 5% of funds under management comes from retail clients (which does not include indirect investments held via superannuation)[27] and 86% of retail flows are made via financial advisers.[28] Financial advisers providing advice to retail clients are subject to the best interests duty and are required to take into account the personal objectives, financial situation and needs of individual clients when recommending investment products.

How DDO works in practice

DDO requires product issuers and distributors to ensure products are designed with consumer needs in mind and distributed in a targeted manner. ASIC Report 762 Design and distribution obligations: Investment products (Rep 762), outlines the product design process generally involves: *"identifying a class of suitable consumers for a product, which drives the design of the product; analysing expected distribution methods to determine whether they will likely lead to distribution in line with the target market; robust testing of the product, and determining monitoring and review arrangements for when the product is being distributed."*[29] Following an ASIC review of 12 MIS issuers in relation to their DDO practices, including product design and TMD development processes, ASIC also identified a number of good practices being undertaken by issuers in relation to DDO process oversight which can assist in the development of a better TMD, product stress testing which can help issuers appreciate the range of potential outcomes under different market conditions as well as distributor engagement which can inform a scheme's overall distribution strategy.

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[25] see RG272.9 (2020) RG272: Product intervention power.

[26] Page 6 (2011) Law Council submission to Treasury – Options Paper – Wholesale and Retail Clients. Available here - https://treasury.gov.au/sites/default/files/2020-01/law_council_of_australia.pdf.

[27] Retail investors account for approximately 5% of overall funds under management, which is based on the Australian Bureau of Statistics Managed Funds data release and refers to direct retail ownership only (not indirect ownership through superannuation) Page vi, ASIC Report 702 Competition in Funds Management.

[28] "Retail investors primarily access managed funds through financial advisers — in 2018, 86% of retail inflows came through advisers. Financial advisers strongly influence retail investor choice of managed funds." See page ix, ASIC Report 702 Competition in Funds Management.

[29] Page 6 (2023) ASIC Report 762.

The industry continues to reflect on and incorporate relevant considerations under the DDO regime, the regulators' expectations which are publicised such as those shared in Rep 762, ASIC stop orders and ASIC media releases.

The FSC has also been working with members in the DDO Working Group to consider and incorporate changes to the FSC's TMD Template for funds management resulting in a revised template being finalised in mid-2023. This includes providing more options relating to capital, risk/return, the % range of portfolio allocation, and considerations in relation to distribution conditions.

Whilst most investors select and access products via financial advice[30] we have received feedback that direct investors are also being filtered out of products by certain issuers during the application process online, whereby only a suitable suite of product offerings will be visible to the client based on their responses to DDO customer attribute questions. For example, investors may be asked what asset type they would like to invest in, what their investment objective is, what % of the portfolio this investment would form, as well as investment timeframe and the frequency by which a consumer needs to withdraw their money from the MIS.

These reforms have been both significant and impactful in changing the way products are designed and distributed to investors. We agree with the observation in the consultation paper that the regime "is proving to be an effective gatekeeping mechanism for ensuring products are appropriately targeted towards relevant investors."[31]

The DDO regime is subject to a range of civil and criminal penalties,[32] which includes civil recovery for loss or damage by the client[33] and also enable ASIC to commence civil penalty and civil proceedings for contraventions of the DDO provision.

We consider that DDO places sufficient conditions in relation to scheme arrangements offered to retail clients and that no further conditions or restrictions should be imposed.

Recommendation 2: The DDO regime establishes a consumer centric approach to product design and distribution, which is supported by a range of regulatory tools available to ASIC enabling it to take swift action. As such, we do not consider there is a need for further conditions or restrictions on certain investment products when offered to retail clients.

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

ASIC receives information about the scheme and its responsible entity via the AFSL application and the scheme registration process. ASIC can use this information to adopt a risk-based approach for AFSL application/scheme registration processes and use that information to inform forward looking surveillance processes.

The FSC suggests that ASIC should have additional rights to request sufficient information at the outset to allow it to identify schemes which require more detailed consideration and adopt a fast track and slow track registration process depending on the particular MIS. This would provide a streamlined registration process for REs who meet certain criteria and standards and a slower track for high risk and novel products like SIT.

[30] See page ix, ASIC Report 702 Competition in Funds Management. noting that retail investors primarily access managed funds through financial advisers — in 2018, 86% of retail inflows came through advisers. Financial advisers strongly influence retail investor choice of managed funds."

[31] Page 22, Review of the regulatory framework for managed investment schemes consultation paper.

[32] https://www.corrs.com.au/insights/asic-begins-enforcement-of-design-and-distribution-obligations

[33] Section 994M of the Corporations Act 2001.

The data collected from the registration process would inform ASIC's future surveillance processes with more oversight conducted on new licensees and/or schemes or those that have a prior history of poor regulatory compliance. This means appropriate ASIC resourcing (in terms of the level of skill, experience and staffing numbers) could be devoted to the more 'high risk' or 'novel' REs and MISs at the AFSL application and scheme registration processes.

This need not be cumbersome. ASIC could review its AFSL and scheme registration forms to capture relevant data such as:

- Have the individuals on the AFSL, RE board and those proposing to operate the MIS (both issuers and promoters) had any previous involvement with failed or collapsed MISs or businesses.
- Do the individuals on the AFSL or RE board have prior experience operating a scheme such as the one proposed to be offered.
- Is the MIS novel or complex or one that involves a standard investment strategy?

ASIC could also monitor data obtained when there is a change of control of a licensee related to the controlling entity and changes in the boards and responsible managers which may occur during the life of the RE/ licensee. This data would be used to inform ASIC's risk management oversight processes. For example, funds flagged as novel or complex like SIT – could be subject to periodic desktop or even shadow shop style reviews.

Recommendation 3: ASIC should review its AFSL and scheme registration processes, including the information it captures as part of an AFSL application and scheme registration forms/processes to capture enhanced data points that will lead to either a fast track or slow track registration processes depending on the particular MIS. These enhanced data points will inform risk-based surveillance processes at the outset, to be implemented following registration of a MIS.

Enhancing ASIC's MIS Registration Processes

There is support for the current 14-day registration period which ASIC has to decide an application to register a MIS. Whilst the timeframe provides efficiency and certainty, the current process also presents some limitations. For example, where ASIC provides suggestions to amend the documents lodged with the application (such as the scheme's constitution or Compliance plan) 11 days after lodgement of the application, issuers may be left with no option but to accept the changes requested due to time constraints (given that ASIC is required by law to make a decision of whether or not to register the MIS within 14 days of lodgement of the application).

Feedback has also raised issues with inconsistent approaches used by ASIC reviewers to scheme registration applications, where similar constitutions to ones previously approved by ASIC are lodged, however dependent upon the person within ASIC reviewing the application, the changes required can vary greatly. There is a need to address inconsistency amongst ASIC reviewers with feedback received that this currently manifests in differing sets of concerns about similar constitutions from different ASIC officers. This should also be subject to clear guidance/policy positions to clarify ASIC's expectations ahead of the formal scheme registration application process. We have received feedback that as part of the scheme registration process, ASIC may ask redemption periods or termination clauses to be revised in scheme constitutions (otherwise the scheme may not be registered). Industry should be made aware of these matters via guidance and prior to submitting an application to register a scheme in order for these matters to be incorporated into relevant documentation at the outset.

See also section 8, item 9.

Recommendation 4: To better streamline review processes and provide applicants with a reasonable period to consider and respond to ASIC requests for amendments to be made to the

documents lodged without the application to register the MIS being refused, where ASIC raises new matters towards the end of the 14-day registration period, we recommend the following:

A. Introducing a mechanism to adjust the 14-day registration period where matters are raised by ASIC after the first week of lodgement of an application to register a MIS. For example, ASIC has 7 days to request changes and the issuer has an additional 7 days to respond. This should be subject to further consultation to identify the best means to implement this whilst retaining the efficiency and certainty provided by a 14-day registration process.

B. Inconsistency among ASIC reviewers should be considered and addressed to ensure a consistent approach is taken amongst reviewers in relation to applications to register MISs. This should be subject to clear ASIC guidance and publicly communicated policy positions. It may also require further training and development of ASIC staff to ensure the ASIC team reviewing scheme registration applications includes experienced staff in the relevant division.

C. ASIC should also consider the appointment of a case officer, similar to practices used by the regulators in Singapore and Hong Kong, which serves as the designated contact point for issuers to engage with in relation to MIS registration processes. This will assist to ensure consistency in ASIC's approach and positions taken on key regulatory and policy issues.

D. ASIC's views on redemption periods and termination clauses should also be made available publicly so that these matters can be taken into account prior to submitting an application to register a MIS. It would also serve to make scheme registration process more efficient.

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

The Financial System Inquiry (FSI) outlined the moral risk that would arise from giving ASIC a power to prohibit certain products from being sold to retail clients (the perception that a product is low risk if ASIC has not intervened). ASIC currently has the power to refuse to register a scheme if the scheme documentation does not meet the relevant regulatory requirements applicable to scheme constitutions and compliance plans. ASIC also has powers to refuse a licence applicable to a RE if the licensee does not meet the regulatory requirements to be granted a license. Please see responses to question 5 and 6 above, supporting ASIC using the AFSL and scheme registration process to inform a risk based oversight approach supported by the existing regulatory regime (including DDO and PIP) and ASIC's suite of existing powers to intervene and stop the distribution of products where necessary. ASIC needs to be appropriately resourced to use its existing processes and suite of powers effectively.

If ASIC is not comfortable with certain products, whom they are being sold to and how they are being sold (for example certain products may have distribution conditions in the TMD), ASIC is empowered to intervene and stop the distribution of products which recently it has been actively doing, having issued over 26 stop orders on investment products in 9 months[34].

The following areas have been identified as factors in ASIC's stop orders;

- "target markets defined too broadly – a factor in 15 stop orders;
- unsuitable investor risk profiles used – a factor in 21 stop orders;
- inappropriate levels of portfolio allocation used – a factor in 10 stop orders;
- unsuitable investment timeframes and/or withdrawal features, not reflecting the product's risks and liquidity profile – a factor in 18 stop orders…and
- inappropriate or no distribution conditions – a factor in 13 stop orders." [35]

[34] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-115mr-asic-calls-on-investment-product-issuers-to-lift-their-game-on-design-and-distribution-obligations/.
[35] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-115mr-asic-calls-on-investment-product-issuers-to-lift-their-game-on-design-and-distribution-obligations/.

As a result of ASIC's actions in this area, 12 issuers have amended 18 TMDs to address ASIC's concerns and 7 products have been withdrawn by issuers.[36]

Where ASIC has concerns, for example regarding the constitution, it already engages with applicants during the scheme registration process in relation to requesting changes to the constitution prior to MISs being registered, such as requesting changes to redemption periods.

There is not sufficient evidence demonstrating that these powers are not working and ASIC requires further powers to refuse to register a scheme. If there are particular concerns regarding the complexity or an investment being novel like the SIT product, this should be identified to ASIC at the point of lodgement of a scheme registration application and ASIC should use the information to adopt a risk-based oversight approach from the outset.

Recommendation 5: We support the consumer detriment and moral hazard concerns raised by the FSI that would arise from giving ASIC a power to prohibit products from the outset and consider that ASIC should use the AFSL application and scheme registration processes to inform risk-based surveillance processes at the outset of an AFSL license being granted and/or scheme registration and use its existing suite of powers it has to intervene where necessary. ASIC should be appropriately resourced for this.

[36] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-115mr-asic-calls-on-investment-product-issuers-to-lift-their-game-on-design-and-distribution-obligations/.

5. Chapter 3 – Scheme governance 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?

Please also refer to response to question 10, in addition to the feedback outlined below.

In January 2022 ASIC published its findings from the review of RE governance arrangements (findings) which reviewed the practices of 10 large REs. The findings shared a number of considerations for REs and their boards to consider in relation to their own governance arrangements but did not make any recommendations for change or identify any poor governance practices.

We are not aware of specific poor governance practices or concerns that ASIC may hold in relation to scheme governance. If there are shortcomings in relation to scheme governance and compliance practices, we would expect ASIC to incorporate this in relevant regulatory guidance, such as *RG 132 Funds Management: Compliance and Oversight* (RG132), which sets out ASIC's expectations of Compliance committees (which we note should be informed by their empirical evidence of shortcomings or limitations in the operation or effectiveness of scheme governance and compliance). The existing regulatory framework supporting scheme governance and compliance is set out in s601JC of the Corporations Act 2001, as well as in RG 132. s601JC sets out the functions of the Compliance committee which are to:

a) monitor to what extent the RE complies with each scheme's Compliance plan and report on its findings to the RE;
b) report to the RE any breaches of the Corporations Act involving a Scheme, or any breach of the provisions included in a scheme's constitution in accordance with s601GA of which the Compliance committee is aware or suspects;
c) report to ASIC if the Compliance committee is of the view that the RE has not taken, or does not propose to take, appropriate action to deal with a matter reported under paragraph (b) above; and
d) assess at regular intervals whether each scheme's Compliance plan is adequate and report to the RE on the assessment, and to make recommendations to the RE about any changes it considers should be made to a scheme's Compliance plan.

This is supported by additional guidance set out in RG 132 which covers:

- Experience, qualifications and competence;
- Appointment of committee members; and
- Performance of functions.

RG132 outlines the obligations of a compliance committee, which includes assessing the adequacy of compliance plans, monitoring compliance with the plan, reporting breaches to the RE and reporting the matter to ASIC if the RE is not adequately addressing a reported breach. The totality of these obligations is often reflected in the Terms of Reference (ToR) of the compliance committee. Commonly, Compliance committees submit their findings to the RE Board, which will include information regarding reported breaches, service provider reports and compliance plan monitoring/oversight activities. Consequently, compliance committees that are established and operate in accordance with existing regulatory guidance provide a high level of independent oversight over the compliance arrangements of registered MISs and have powers to either report directly to ASIC or utilise the whistleblowing mechanisms within entities.

It should be noted that in RG 132.29, ASIC states that for REs *without* a Compliance committee, they expect external directors of the RE to be "particularly vigilant and actively engaged with compliance issues". This guidance suggests that ASIC may consider that Compliance committees achieve a greater level of vigilance and oversight, than external directors on a Board, potentially due to their focused role on risk and compliance. Furthermore, S601JC and RG132 both show that the Compliance committee serves an important role that goes beyond what a board would typically do, i.e., it involves 25specialized skills and experience. RG132.90 specifically states ASIC's expectations that Compliance committee members have current work experience over a number of years in undertaking compliance activities and investigations; and an understanding of regulatory requirements and how they apply. This would not necessarily be the case for independent directors of an RE board.

We do not recommend any specific changes to the RE governance or compliance committee frameworks. ASIC updated RG 132 in June 2022, six months after publishing its findings from the review of RE governance arrangements. The ASIC media release announcing the update of RG 132 and a range of documents, suggest that that it was updated to support licensing and other requirements for corporate collective investment vehicles in 2022[37] and not in relation to providing further guidance or enhanced governance and compliance practices for REs. If there were improvements to be made on an industry wide basis, following the release of the ASIC findings, we would envisage that ASIC would have accordingly updated relevant sections in RG 132 when it released the updated guidance in June 2022. If there are contrary findings, they could form the basis for further amended guidance in RG 132 from ASIC.

Corporate governance theory tends to value the "outside perspective" that independence can provide. Where that perspective is expert and aware of the good governance practices of other REs is, arguably, better. A majority external compliance committee brings those things, particularly given the external members commonly perform that role for more than one RE. It is likely this is why MIS laws were cited in the Final Report of the Financial System Inquiry (Murray Review) as able to provide improved governance outcomes to super funds.

It is noted that superannuation laws do not require a majority of independent directors (nor does APRA's guidance), despite the likelihood that the "other people's money" principle is supercharged by various individual and national interests.

Perhaps the Australian legal position is also informed by the views of the Hon Justice Owen in *Royal Commission into HIH Insurance (Final Report, May 2003) vol 1, 105*:

> *"I think that any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature, corporate governance is not something where 'one size fits all'*.

Recommendation 6: The regulatory regime provides flexibility in line with the nature, size, scale and complexity of the business enabling an RE to implement appropriate governance structures and arrangements that take this into account, including whether to have a majority independent RE board or to use a compliance committee. The FSC supports retaining the current flexibility.

[37] https://asic.gov.au/about-asic/news-centre/find-a-media-release/2022-releases/22-152mr-asic-releases-new-and-updated-guidance-for-corporate-collective-investment-vehicles/.

As outlined in this submission the expertise provided by the compliance committee framework provides specialised skill and information to REs which use this structure as outlined in more detail in Attachment 1. RE Governance Background Paper. We do not recommend any specific changes to the RE governance or compliance committee frameworks.

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?

As part of the scheme registration process, the constitution of the scheme is provided to ASIC. ASIC reviews the constitution at that time and has the ability to request changes to ensure compliance with the law and its policy in RG 134, which we understand occurs from time to time for example in relation to redemption requirements as well in relation to termination and removal clauses.

To provide further clarity at the outset on ASIC's expectations regarding scheme constitution content requirements, it would be helpful if ASIC could provide further regulatory guidance in RG 134 setting out its expectations in relation to constitutions so that industry can include these upfront in a constitution instead of industry having to rely on anecdotal advice from legal firm's experience with ASIC regarding scheme registration applications to avoid being notified of unexpected constitution changes that are required to be made before the scheme will be registered by ASIC.

Recommendation 7: ASIC should publish its contemporary expectations regarding arrangements expected, or not expected, to be included in a scheme constitution to provide clarity to industry, as well as consistency, in relation to scheme constitution requirements via updates to RG134. This will reduce the need for ASIC to request changes to the constitution as part of the scheme registration process.

Given ASIC has the ability to decide to refuse the application to register a scheme and can influence an amendment to a scheme constitution through this process, and requests that prior to scheme registration, we do not consider that there is a need for ASIC to have broader powers to amend a scheme's constitution.

Furthermore, establishing a power to amend a scheme constitution for a forward-looking regime, as part of the development of the CCIV regime, needs to be considered as quite a distinct power and framework specifically for CCIVs that are being set up in the future as distinct from imposing a similar direction power retrospectively to existing constitutions and schemes.

Whilst the consultation paper considers whether certain aspects of the CCIV regime should be applied to the existing MIS framework, we make the following observations:

- CCIVs are a new structure and not widely adopted or utilised at present;
- We are also not aware of ASIC having to use the power it has been granted, to amend a retail CCIV constitution after registration to meet minimum content requirements; and
- It is unclear if there is evidence of shortcomings that warrant ASIC having this power for MISs on a retrospective basis.

Recommendation 8: With ASIC already having the ability to amend scheme constitutions prior to scheme registration, by refusing to register a scheme, it is not considered that ASIC should be given further powers to direct Res to amend scheme constitutions.

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?

Section 601HA of the Corporations Act sets out that the compliance plan of a registered scheme must have adequate measures that the RE is to apply in operating the scheme to ensure compliance with the Corporations Act and the scheme's constitution. Sectio 601HB of the Corporations Act also

notes that a scheme's compliance plan may incorporate, by reference, provisions from the compliance plan of another registered scheme.[38]

Feedback from FSC members notes that there are generally no fundamental differences in the compliance frameworks of, for example an Australian equity fund and a global fixed income fund, as the regulatory and compliance obligations are the same.

Further guidance on the structure and content of compliance plans is already set out in RG 132 which contains clear guidance that compliance processes and structures should be tailored to the MIS and its operator, rather than being generic to merely satisfy a regulatory requirement (RG 132.50) and that when ASIC (as part of a scheme registration application) considers whether a compliance plan contains measures that are adequate, ASIC will look at whether the compliance plan identifies compliance controls that are tailored to the nature, scale and complexity of the MIS (RG 132.146).compliance plan. For larger providers, incorporating controls by reference (IBR) into a single plan (master plan) is a necessity to ensure there is sufficient "detail and certainty' (RG 132.93) in relation to the operation of compliance controls and monitoring procedures. Even where a compliance plan incorporates by reference parts of another compliance plan RE's will consider whether compliance plans can be appropriately incorporated and will generally segregate plans based on asset class (for example, real estate, infrastructure, public markets) even where they have overlapping controls, in accordance with RG 132.92. Given these considerations we do not believe there is a need to have a separate compliance plan for each scheme and that a master compliance plan provides a practical approach.

Member feedback notes that there may also be tailored measures and controls in compliance plans that are designed to ensure that the specific risks involved in operating MISs with unique features such as borrowing, short selling, being listed or otherwise exchange traded are appropriately managed and monitored. Even where controls are incorporated by reference from another compliance plan, specific obligations or control wording will be incorporated as required (e.g., geared vs non-geared funds), to ensure there is the right level of specificity and tailoring.

We consider that the compliance plan requirements are clear and are supported by extensive regulatory guidance set out in RG 132. ASIC's recent RE governance review did not identify any industry wide issues in relation to compliance plans or make any recommendations for change in this respect. [39]

Furthermore, if ASIC has concerns regarding compliance plans, s601HE(2) of the Corporations Act provides ASIC with the power to direct the RE to modify the scheme's compliance plans and also requires the RE to lodge the modified compliance plan with ASIC.

If there is a need to further tailor compliance plans to individual schemes this can be addressed via amended regulatory guidance in RG 132.

Compliance plans and Breach Reporting

Compliance plans give rise to breaches being reported to ASIC under the new breach reporting regime that are one off, immaterial and of no consequence or impact to investors. This is taking up valuable resources and costs which could be directed to in more meaningful tasks. By way of an example ASIC Corporations, Credit and Superannuation (Internal Dispute Resolution) Instrument

[38] See ASIC Governance of responsible entities Report issued in 2022 for more information. https://download.asic.gov.au/media/kyogkr35/governance-of-responsible-entities-slide-pack-tagged-20220128.pdf

[39] See page 22 ASIC Governance of responsible entities presentation (2022).

2020/98 has been released by ASIC to note that a breach of enforceable provisions of RG271 relating to internal dispute resolution procedures are not reportable to ASIC however, despite this, issuers still need to report these as they may result in a breach of the compliance plan (which involves a breach of s601FC(1)(h) of the Corporations Act, a civil penalty provision which is deemed significant and therefore automatically reportable to ASIC). compliance plan. All breaches of civil penalty provisions are reportable breaches, there is no materiality threshold. This means a simple breach, such as undertaking a task one day after the stated timeframe in the compliance plan becomes a reportable breach. Further the lack of any threshold/significance test for reporting of compliance plan breaches means this effectively results in over-reporting and is not aligned with other breach reporting requirements. Overreporting may also be impacting compliance plan audit reports with inconsistencies in compliance statements. For example, if there is a breach of a compliance plan obligation, which has been reported as required, has the RE overall been compliant with the compliance plan?

To address this, it is recommended that mere non-compliance with a compliance plan be removed from duties that attract a civil penalty so that only material breaches of a compliance plan are reported to ASIC. Consideration can also be given to ASIC imposing a civil penalty where there is a material breach of the Compliance plan.

In addition, administratively, the ASIC submission requirements for compliance plans and associated prescribed form are out of date. Compliance plans are one of the few documents that ASIC requires to be signed by the directors of the RE in wet ink and lodged by post. See Table 1, issue 5 below for additional submissions on this point.

Recommendation 9: We recommend that mere non-compliance with a scheme's compliance plan be removed from the duties of an RE that attract a civil penalty. This would mean that only material breaches of a compliance plan would be reported to ASIC instead of all compliance plan breaches (whether material or not). In the alternative, ASIC may impose a civil penalty where there is a material breach of the compliance plan.

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?

Auditors are currently subject to professional standards that they are required to meet. Auditors are required to report annually to ASIC an opinion on whether an RE has complied with the relevant compliance plan for registered MIS and associated compliance plan continue to meet the requirements of Part 5C.4 of the Corporations Act. Auditors typically apply the Standards on Assurance Engagements ASAE 3100 Compliance Engagements, is the standard formulated by the Auditing and Assurance Standards Board. Adding further qualitative standards on auditors in the law is likely to result in further regulatory burden and cost for fund managers, without any additional benefit, given that the responsibility for meeting regulatory obligations rests with the RE.

RG 132.200 clearly sets out ASIC's expectation that compliance plan auditors should follow general auditing principles when conducting compliance plan audits. While we acknowledge that this is not a legislative requirement, this requirement is set out in ASIC regulatory guidance, which is generally well understood within the funds management industry.

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

We are supportive of the existing legislative framework which accommodates a variety in the nature, scale and complexity of REs, their operations and the MIS they operate. is the current optionality is

appropriate and desirable, given the retail funds landscape is a highly competitive and innovative sector, delivering benefits to investors.

The current regulatory regime provides flexibility and enables an RE to determine whether to appoint a majority independent RE board or to utilise the skills, experience and compliance expertise that is offered by a compliance committee. The compliance committee, with a majority of external members, acts as an appropriate check on the role and responsibilities of the RE Board in respect of MISs. The experience of our members is that the compliance committee is an effective and efficient assessor of the operation of MIS' compliance plan. The compliance committee is also a valuable filter of issues for the RE Board (such as having oversight of both third party and related vendors) and its external members often give valuable guidance to the RE and its operations.

Feedback from members is that they value the higher levels of transparency and communication, such providing the minutes of compliance committee meeting for consideration by the RE board, and RE board representative directors attending compliance committee meetings to understand matters of interest. The REs legal and compliance functions often attend compliance committee meetings to support appropriate governance and transparency of the compliance committee. In smaller organisations, the compliance committee also augments internal governance functions.

Among our membership, we observe that such flexible governance arrangements provide an efficient allocation of resources, without the increased costs typically involved with operating a RE Board with a majority of (or all) independent directors (including scarcer independent directors commanding high fees). Those increased costs are ultimately borne by unitholders of a fund in fees or cost recoveries. By their nature, our members observe that the costs of a majority independent RE board exceed those of a compliance committee with a majority external membership.

We support the flexibility offered by the existing legislative regime. We have members who utilise majority independent RE board which value the perspectives provided by independent directors. We also have members who have a majority of internal directors and benefit from the expertise offered by a compliance committee.

Feedback from members also observes the following particular points of differences or limitations that a majority of (or an all) independent directors RE board present in contrast to compliance committees:

- Higher total costs to engage and operate a majority independent RE board, the costs of which are ultimately borne by unitholders. These costs may not be offset by other efficiencies that may become available, such as removing the compliance committee.
- REs often need to have documents signed or approved by the board at short notice. Having a majority of independent directors can greatly add to the complexity of running a business. A longer lead time may be needed with the provision of papers, further background material, the signing of agreements, documents or forms and the time taken for decisions to be made in relation to matters arising that affect the interests of investors in a MIS. This is commonly due to the additional processes, timeframes and effort required to properly inform independent directors in each case.
- Typically directors have a broad range of skillsets, whereas independent compliance committee members have quite specific compliance experience and bring a robust review and deep dive into compliance matters; and
- a compliance report and compliance matters may take up only a smaller proportion of a RE board meeting whereas a compliance committee meeting will be a dedicated and in-depth review and discussion on a much more lengthy pack of compliance reports and papers.

We make the observations above not to discourage the use of majority independent RE boards which are utilised, and valued, by a number of FSC members but to highlight there are differences between the two RE governance structures. From a director's duty perspective, the obligations are the same for an executive director as for an independent director and from an RE Board perspective, having a different board composition of independent or executive directors doesn't necessarily assure a different or a better outcome for members.

As is the case for a majority independent RE Board, the compliance committee must be served by a culture of compliance, openness, collegiality and accountability. The nature and quality of reporting to the compliance committee, and reporting from the compliance committee back to the RE board (if required), is critical.

Corporate governance theory tends to value the "outside perspective" that independence can provide. Where that perspective is expert and aware of the good governance practices of other REs is, arguably, better. A majority external compliance committee brings those things, particularly given the external members commonly perform that role for more than one RE. It is likely this is why MIS laws were cited in the Final Report of the Financial System Inquiry (Murray Review) as able to provide improved governance outcomes to super funds.

It is noted that super laws do not require a majority of independent directors (nor does APRA's guidance really press this), despite the likelihood that the "other people's money" principal is supercharged by various individual and national interests.

Perhaps the Australian legal position is also informed by the views of the Hon Justice Owen in *Royal Commission into HIH Insurance (Final Report, May 2003) vol 1, 105*:

> *"I think that any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature, corporate governance is not something where 'one size fits all'.*

Finally, it is noted that the Securities Exchange Commission - in its Report of December 2006 following a review of the merits of requiring mutual fund boards to have an independent chair and at least 75% independent directors – found that there was no consistent evidence that chair or board independence is associated with lower fees and/or higher returns for fund shareholders in the cross-section assessed.

Further information on RE governance and the role of compliance committee is included in Attachment 1 of this submission.

Recommendation 10: The FSC supports the flexibility provided in the RE governance model that enables an RE to choose the right governance model according to the nature, size and scale of the business, including whether to use a majority independent RE board or to use the expertise of a compliance committee. For the reasons outlined in the response to Chapter 4 to this submission, we do not support mandating a requirement to have a majority external board for REs.

6. 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?

The substance of ASIC Class Order [CO13/519], that allows listed fund investors to requisition a meeting to vote on an ordinary resolution to change the RE, should be built into the legislation.

Retaining the ordinary resolution threshold for removal of the RE of a listed trust seems sensible, as it leaves it on an equal footing with the process for removal of the board of a listed company. It is noted that adopting a special resolution threshold for change of RE in this context would align the MIS with the CCIV, but there is a policy question whether maintaining the rights of activists or other groups of unitholders to readily remove the RE of a listed trust is more important than making a change that would tend to preserve the stability of ongoing management of a listed fund.

Recommendation 11: Retaining the ordinary resolution threshold for replacing the RE of a listed scheme is sensible and leaves it on an equal footing with the process for removal of the board of a listed company.

The substance of ASIC Class Order [CO13/519], that allows listed fund investors to requisition a meeting to vote on an ordinary resolution to change the RE, should be built into the legislation.

Question 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?

In our view, the current requirement for an extraordinary resolution to replace the RE of an unlisted scheme is appropriate. Although this is a high voting threshold, a RE, having invested much time and expense in establishing the managed investment scheme, should be able to operate with some degree of security of tenure.[40] An extraordinary resolution requires a meaningful proportion (at least 50% of the total votes that may be cast by entitled unitholders, including those who are not present at the meeting in person or by proxy) of eligible unitholders to participate in the decision to remove the RE. By contrast, a special resolution could be passed by a small proportion of unitholders who participate in the vote, and who do not represent the views of the broader investors of the scheme.

It is also relevant that, by operation of section 253E of the Corporations Act, the RE of an unlisted scheme and its associate would typically not be eligible to vote on such a resolution.

Investors have utilised these provisions to change the RE of a number of unlisted schemes including in relation to Willmott Forests Ltd in 2011 where investors met and resolved to appoint Primary Securities Ltd as replacement RE when Willmott Forests went into liquidation and receivership,[41] as well as with unitholders successfully voting to replace Becton as the RE with Century Funds Management in relation to Diversified Direct Property Fund and the Becton Office Fund No.2.[42]

When considering the circumstances that may lead to investors seeking to replace an RE it is important to note that there may be legitimate reasons that can lead to investors being unhappy. Whilst not a common occurrence, there may be broader market conditions impacting a fund that require an RE to seek to pause distributions or restrict withdrawals for a certain period of time, in order to protect the interests of members of the scheme as a whole. These legitimate and necessary

[40] Moodie and Ramsay, Managed Investment Schemes: An Industry Report (2003), p75.
[41] https://primarysecurities.com.au/wp-content/uploads/2017/12/Press-Release.pdf.
[42] https://www.smh.com.au/business/becton-loses-two-funds-20100909-1539w.html.

steps are not taken lightly, and whilst they are made in the best interests of members as a whole, they can also lead to investors in the scheme not being satisfied with the RE.

This may lead to investors calling a meeting to seek to replace the RE of the scheme. Requisitioning a meeting requires a relatively low threshold of unitholders holding at least 5% of votes able to be cast or at least 100 unitholders who are entitled to vote, with a higher threshold of an extraordinary resolution required to replace the RE. We consider that the current extraordinary resolution threshold required for unlisted schemes is reasonable to preserve the broader interests of investors in the scheme.

This reduces the risk to investors that unitholder(s) with at least 5% of the votes able to be cast on the resolution will seek to remove an RE in furtherance of a 'hostile takeover' which may be solely motivated by commercial factors of an incoming RE rather than in consideration of the fiduciary obligations held by the incumbent RE to act in the best interests of members.

ASIC describes the importance of the existing protections (in the context of s601FL) to safeguard member interests, where a change of RE cannot be effected by "too few members" set out in RG136.75[43] provides that ASIC grant relief from the requirement to hold a member's meeting for a change of RE such as where it relates to a change to a related body corporate of the RE, or a significant percent of interests in the scheme are held by investment platforms which have a non-voting policy. We are supportive of these provisions and would not envisage a change to RG 136 in this regard.

The 50% extraordinary resolution threshold can be difficult to achieve where a fund is particularly widely held, or a large number of a fund's units are held through investment platforms (who are technically the unit holder of the MIS with the voting rights, but who may not offer the facility to cast votes directed by the platform members). As it is a directed service, the platform cannot vote without directions. It can be impossible for an RE to retire in these circumstances, even if it would be in best interests of members for that to occur, for example because the RE is winding down its funds operations. Thus, it is necessary and appropriate for ASIC to grant relief from extraordinary resolution threshold in these circumstances.

We note that an RE that chooses to retire can only propose a replacement RE if it is in members' best interests.

This is distinct from a unitholder requisitioned meeting whereby parties other than the incumbent RE are not subject to statutory duties to only convene meetings and propose resolutions that are in members best interests. This is an important distinction to bear in mind regarding voting thresholds.

For these reasons, and subject to Recommendation 20 issue 10, we do not consider there is a need to change the voting thresholds that allow members to replace the RE for an unlisted scheme. Recommendation 20, issue 10, identifies the voting challenges that arise from IDPS/Platform, super fund or custodial holders where investors typically abstain from voting or do not respond in a timely manner to vote. To address this issue, the recommendation for issue 10 is that the legislation should formalise ASIC voting relief to remove super funds, custodial or IDPS/Platform holders that do not facilitate voting.

We appreciate that members of a CCIV may remove and replace a corporate director by way of special resolution. However, we do not think this means the same threshold should also apply to a registered scheme. The replacement of a corporate director of a CCIV applies to the CCIV as a whole,

[43] Regulatory Guide 136: Funds Management: Discretionary Powers.

and not to individual sub-funds of the CCIV. Unlike the members of a registered scheme, the members of a sub-fund are unable to change the corporate director of their sub-fund only. This structural difference means that the voting thresholds for changing a RE and a corporate director do not necessarily need to be aligned.

Recommendation 12: We do not consider there is a need to change the current voting thresholds that allow members to replace the RE of an unlisted scheme. We also note a related but separate issue in Recommendation 20, issue 10, that the legislation should formalise ASIC voting relief to remove super funds, custodial or IDPS/Platform holders that do not facilitate voting.

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?

This process is already appropriately dealt with in section 601FR of the Corporations Act regarding books and records, which requires a former RE to hand over books and provide reasonable assistance to the new RE, which is consistent with a retiring trustee's obligation to vest trust property in the new trustee. It does not seem commercially viable or reasonable to impose a requirement for due diligence information to be provided by an incumbent trustee when they are being removed in hostile circumstances. We do not consider that change is needed on this point.

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?

The consultation paper recognises that the REs right to be paid fees and recover expenses such as to pay an investment manager out of scheme property must be included in the scheme's constitution and must be available only in relation to the REs proper performance of duties as set out in s601GA(2) of the Corporations Act.

Our understanding is that ASIC will also require constitutions to be amended for a range of reasons prior to a MIS being registered, including in relation to termination and removal fees. There is no ability for the RE to have the right to be paid fees or be indemnified for liabilities or expenses out of scheme property if it not in the proper performance of its duties and if it is not specified in the constitution. For these reasons we do not consider this to be a current issue.

What would be of assistance however is if ASIC publicly shared its expectations in relation to termination and removal fees in RG 134 so that there is a common and consistent understanding of the requirements across the industry.

There is a fundamental difference between an open-ended fund where scheme members can simply redeem if they are dissatisfied with an RE or fund. For a closed ended fund, there may be situations where scheme members may be disgruntled and since they cannot redeem, their option is to seek to remove and replace a RE.

REs have a legitimate commercial interest in retaining their role in operating a fund where they have expended their resources to establish and grow it, unless their behaviour is so poor that they should be removed by a vote of members (see question 13). Further, it is not necessarily in members' best interests to have the fund destabilised by replacing its management, unless there are substantive grounds to do so. A minor change that could be made to the regime would be to require contracts between the RE for a scheme and other parties to (regardless of whether they are a related party or not) to include reasonable termination clauses e.g., termination for gross negligence or insolvency.

The ASX listing rules generally limit the duration of management contracts to 5 years unless a waiver is granted, but that is part of a generally higher level of scrutiny and shareholder rights that exist in that context.

Recommendation 13: The existing regulatory framework already provides various protections against an RE inappropriately making payments or giving benefits out of scheme property. A contract with an investment manager, for example, provides stability in the ongoing operation of the fund.

7. 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?

Yes, our view is that the definition of 'liquid assets' in subsections 601KA(5) and (6) is appropriate and no change is needed.

The existing drafting in Part 5C.6 of the Corporations Act provides both certainty and flexibility. The certainty comes from the fact that the liquidity test in subsection 601KA(4) is quantitative (a registered scheme is liquid if liquid assets account for at least 80% of the value of scheme property) rather than a qualitative test referring to the ordinary meaning of 'liquid' (which would require judgement calls and make consistent behaviour across the industry more difficult). In normal circumstances, the current thresholds would operate such that funds are liquid when they can fund redemptions. The flexibility comes from the fact that it is not mandatory to give members a right to withdraw in a particular timeframe, so the redemption terms can be set in the constitution to match the expected period for buying and selling the fund's proposed portfolio of assets (sections 601KA and 601GA(4) of the Corporations Act).

As noted in the consultation paper, some other jurisdictions limit the types of assets that may be held by open-ended funds that offer redemptions, such that only certain prescribed highly liquid investments may be held by those funds.

By contrast, and consistent with the principles-based framework under the Corporations Act, the definition of 'liquid assets' gives the RE flexibility to establish open-ended registered schemes (offering redemption facilities to members) that may hold a variety of assets. Importantly, however, in order for any other property to be considered 'liquid', the RE must reasonably expect that the property can be realised for its market value within the period specified in the scheme's constitution for satisfying withdrawal requests. In other words, a scheme may be 'liquid', even if it does not hold highly liquid assets, provided that the period for satisfying withdrawal requests under the constitution is sufficient to enable the relevant assets to be realised for their market value. The terms of the redemption facility offered to members must 'match' the liquidity characteristics of the underlying investments of the scheme. This has enabled registered schemes that hold real property, private credit, infrastructure and other assets to be established with redemption facilities for members, allowing for greater diversification and choice for retail investors. The redemption facilities offered by these types of schemes are typically limited (e.g., redemptions can be made quarterly, rather than daily; there may be a maximum limit on the dollar amount that may be redeemed; and/or the RE may have the right to satisfy requests on a partial or staggered basis).

The consultation paper notes that the 'period specified in the scheme's constitution' for satisfying redemption requests is not prescribed and is at the discretion of the RE, subject to its overarching duties including the obligation that withdrawal provisions be fair to all members. In RG 134, ASIC has acknowledged that the timeframe between acceptance of a withdrawal request and the date for payment of the withdrawal amount to a member whose interests have been redeemed 'will vary depending on the characteristics of the registered scheme and the operational practices of the RE' (RG 134.223).

The consultation paper also refers to the 2014 CAMAC discussion paper, which described this discretionary process in determining liquid assets as imprecise, difficult to verify independently and a possible source of instability by enabling a RE to specify any realisation period in the constitution, without limit. CAMAC suggested it may be useful to introduce a clearer or more objective test for liquidity (such as an asset that can reasonably be expected to be realised for its book value within 7

business days). Our concern with this approach is that it would significantly limit the types of registered schemes that could offer redemption facilities of any kind.

The concerns raised in the 2014 CAMAC discussion paper are addressed in the following ways:

- (**Duties of RE**) Subsections 601KA(6) requires the RE to 'reasonably expect' that the relevant property can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid. This imposes on the RE an objective standard for determining whether an asset should be classified as a 'liquid asset'. The decision to classify as asset as a 'liquid asset' is also subject to additional duties including the duty to ensure that the right to withdraw, and any provisions in the constitution setting out procedures for making and dealing with withdrawal requests, must be fair to all members (s601GA(4)), as well as the REs duty under s601FC(1)(b) to exercise the degree of care and diligence that a reasonable person would exercise if they were in the REs position.

- (**RG 259**) In RG 259, ASIC has issued detailed guidance on its expectations of responsible entities in relation to scheme liquidity and withdrawals (paras [46] – [48], [91] – [98]). ASIC expects risk management systems of fund operators to include a liquidity risk management process, designed to ensure that there are adequate financial resources to meet the financial obligations and needs of the fund operator and the funds operated:

  > *'At the fund level, we expect this will include stress testing or scenario analysis [i.e. a 'what if' exercise that examines what may happen if certain risks materialise ([RG 259.94])]… We also expect it will include fund operators assessing available liquidity management tools and considering whether these are appropriate to use. For example, redemption fees, suspension of withdrawal requests, redemption gates (a limit on the amount of redemptions), in specie transfers (transferring assets of an equivalent amount instead of providing cash proceeds), swing pricing (applying higher transaction costs adjustments on redemptions, reflecting the lack of an offsetting issue of fund interests or shares), minimum or maximum limits on withdrawals, or satisfying withdrawals on a partial or staggered basis.'* (RG 259.48)

- RG 259 also provides examples of measures that responsible entities may consider in managing liquidity risk (paras [152] – [155]). For example, fund operators are encouraged to establish appropriate internal thresholds for liquidity, which are proportionate to the redemption obligations and ongoing commitment of the funds, as well as tools to identify an emerging liquidity shortage before it occurs and ongoing assessments of the liquidity profile of the assets and liabilities of the funds. RG 259 also recommends appropriate disclosure in PDSs of fund investor redemption rights, liquidity risks, the liquidity management process and if the fund operator has the power to use any liquidity risk management tools. Responsible entities should also implement processes that ensure that the frequency of dealing in units in the fund and investor redemption rights are compatible with the fund's liquidity profile, investment strategy and portfolio composition.

- (**Enhanced disclosure requirements for certain types of registered schemes**) ASIC has issued specific guidance for disclosure to retail investors in unlisted property schemes (RG 46) and, mortgage schemes (RG 45). There are disclosure principles and benchmarks set out in RG 46 and RG 45 relating to withdrawal arrangements. RG 46 requires PDS disclosure relating to the circumstances in which investors can withdraw, the maximum withdrawal period allowed under the constitution for the scheme (with a requirement that this disclosure should be at least as prominent as any shorter withdrawal period promoted to investors)

and any significant risk factors or limitations that may affect the ability of investors to withdraw from the scheme (including risk factors that may affect the ability of the RE to meet a promoted withdrawal period) (RG 46.104 – RG 46.107). RG 45 also requires similar PDS disclosures (RG 45.104 – RG 45.114), and there is also benchmark disclosure (on an if not/why not basis) relating to withdrawals, which is intended to address the transparency of the REs approach to withdrawals of investments when the scheme is liquid and when the scheme is non-liquid (RG 45.64 – RG 45.71). For example, there are benchmarks that the maximum period allowed for in the constitution for the payment of withdrawal requests is 90 days or less, and that the RE will pay withdrawal requests within the period allowed for in the constitution. More broadly, in addition to the benchmarks and disclosure principles under RG 46 and RG 45, there are prohibitions under the Corporations Act for misleading and deceptive statements in PDSs and marketing documents (s1041E and s1041H). If a RE represents, expressly or impliedly, that it expects to be able to satisfy withdrawal requests within a particular period, it must have reasonable grounds to make that representation (particularly if a longer period is specified in the scheme's constitution).
- **ASX AQUA Rules.** A number of our members are responsible entities that have MIS products known as exchange traded fund (ETF) which are admitted to trading on ASX under the AQUA Rules. For an ETF that tracks a particular index or benchmark comprising of non-Australian underlying securities, ASX during the product approval process, applies a 'look through' lens whereby the RE has to provides information which shows that such underlying securities are listed on the ASX or an ASX recognised exchange and must be continuously quoted. This new ETF product approval process provides ASX with comfort as to the liquidity of the underlying securities.

ASIC has recently undertaken targeted surveillances of responsible entities and registered schemes in relation to liquidity risk management processes, including during the COVID-19 period and has found that

- Generally, the redemption features offered by the funds reviewed in the fixed-income and property sectors were satisfactorily matched to the liquidity of the underlying assets. In 3 (out of 37) funds, there was a significant mismatch between redemption features and asset liquidity (i.e. the liquidity of the underlying assets did not support the short redemption terms offered to consumers) (ASIC MR 20-218, *ASIC tells fund managers to be 'true to label'* (22 September 2020)); and
- During the COVID-19 period (June – November 2020), the liquidity frameworks of the responsible entities reviewed were generally adequate; all funds had multiple ways available to manage investor liquidity, such as the right to suspend or stagger redemptions, to charge and adjust redemption fees and to borrow money to pay redemptions. Also, overall, liquidity risks and redemption rights were appropriately disclosed to investors (ASIC MR 21-091 *ASIC review finds retail managed funds responded well to COVID-19 challenges in 2020* (30 April 2021)).

Recommendation 14: Yes, our view is that the definition of 'liquid assets' in subsections601KA(5) and (6) is appropriate and no change is needed.

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

In their standard operation, the provisions work well with further information below outlining how this works in practice. During the GFC the freezing of funds gave rise to greater regulator/industry co-operation and the development of hardship relief and ASIC regulatory guides. Such hardship

relief, including the ASIC hardship relief provided in response the Covid-19 pandemic, would not be possible under a buyback regime analogous to the more restrictive corporate share buyback provisions. Although mandatory withdrawal rights are not provided as contemplated as IOSCO, the greater ability to manage liquidity together with the enhanced duties of the RE (including as a fiduciary), regulator support and facilitative legislation arguably achieve superior investor outcomes. Examples of favourable outcomes included the return of the majority of the principal invested in mortgage funds ultimately terminated during or shortly after the GFC.

However, following the general principle that the law should be able to be understood on its face, common modifications in relief instruments issued by ASIC should be built into the legislation where possible. This includes relief to allow withdrawals in cases of consumer hardship.

Withdrawal procedures

In general, the withdrawal requirements will be specified in the fund constitution at a strict legal level, then most of the operational provisions will be disclosed within the fund's PDS. In addition to the normal withdrawal processes, a PDS will also typically disclose the maximum period allowed for in the constitution for satisfying withdrawal requests. For instance, it may state "fund withdrawals will typically be processed within [X] days, up to a maximum of [Y] days.

The standard withdrawal procedure from a liquid unlisted fund

Unitholders may request to withdraw some or all of their units in a fund by completing a withdrawal form or giving a duly authorised written notification in a form acceptable to the RE. Certain investor types can also request to withdraw online. A minimum withdrawal amount will apply, unless the withdrawal relates to all the units held by that unitholder. In addition, if the withdrawal request results in the residual balance falling below the minimum, the RE may treat the redemption request as a request to redeem all of the investor's units in the fund.

The RE will outline in which situations it will accept withdrawal requests, for instance they must signed by the authorised signatories for the investment who have been duly nominated by the investor. The RE also need to consider privacy, AML and fraud as part of their withdrawal procedures.

Standard payment terms

The RE will normally pay withdrawal proceeds within [X] Business Days of accepting a valid withdrawal request, however the relevant fund's Constitution may specify a longer timeframe to satisfy redemptions. Withdrawal requests will generally be met from cash resources or by the disposal of investments in a fund. The RE may satisfy withdrawal requests by the transfer of assets (rather than cash) to the unitholder ('in specie' transfer'). If agreed to by the RE and a unitholder, investments that relate to an 'in specie' transfer will be valued on the date units are cancelled. All costs including any applicable stamp duty and other taxes incurred as a result of the transfer will be payable by the unitholder. Advance notice is usually required for all 'in specie' transfers.

Cut-off times

The RE will provide cut-off times in the fund PDS. Withdrawal requests received by the relevant cut-off time on a Dealing Day and accepted by the RE will normally be processed at the redemption price calculated for that Business Day. Where a withdrawal request is received after the relevant cut-off time on a Dealing Day, the withdrawal request will normally be treated as being received on the following Dealing Day. For some funds, the RE may require a longer notice period, for example one Dealing Day to process a withdrawal request. These extended notice periods usually apply where the market has different settlement periods.

Staggering of withdrawals

Where the RE believes it is in the best interests of unitholders and the constitution allows for staggering of redemptions, the RE may satisfy a withdrawal request by staggering the withdrawal dates. This means that a withdrawal request may be processed progressively over a period as outlined in the Constitution, at the withdrawal price calculated on the Business Day on which each partial withdrawal is processed. This is an important liquidity management tool and enables the RE to have the flexibility to step-in to ensure unitholder equity.

Suspension of withdrawals

In very limited circumstances the RE can determine to suspend redemptions. For example, the RE may suspend the withdrawal of units in a number of circumstances including where it is impractical to calculate the current unit value, due to, for instance, the closure of a securities exchange or as otherwise required by law.

There is an opportunity to streamline investor communication to be technology neutral where an MIS is deemed illiquid, whereby withdrawal requires multiple posted notices to investors with every withdrawal period. The communication to investors in this regard should be revised to be technology neutral in line with how modern investors interact with their investments.

Recommendation 15: Following the general principle that the law should be able to be understood on its face, common modifications in relief instruments issued by ASIC should be built into the legislation where possible such as relief to allow withdrawals in cases of consumer hardship. Technology neutral investor communication should also be facilitated for withdrawal from MIS deemed illiquid.

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?

See our comments in Question 17 above.

If such a misunderstanding arises, we do not consider that is because of the structure of redemption arrangements under Part 5C.6, but may be because disclosure to investors has been inadequate or misleading. There is a risk that disclosure may be inadequate not because there is too little, but because there is too much detail in documents provided to investors, without a simple, clear message. In this regard, reforms to take the product disclosure statement (PDS) back to its original intent of being a much simpler document than a prospectus, and to remove the 'boiler plate' language that takes up most of the 8 page shorter PDS for a simple MIS, would be a worthy step in allowing the 'story' of a product to be told more simply and clearly to investors.

Specifically in relation to redemptions, a PDS or other material should explain up-front to investors both the standard time for processing redemptions, and also the maximum period of time that the RE is permitted to take to satisfy withdrawal requests under the MIS's constitution. ASIC has taken action against product issuers for misleading conduct where the redemption terms which were advertised did not align with the redemption terms set out in the constitution. Such action was based on problems with disclosure, not the fund's redemption terms.

As noted above, the redemption provisions in Part 5C.6 are both certain and flexible, and that flexibility is important. In papers published in July 2023, IOSCO and the Financial Stability Board (FSB) commented on the potential for global systemic risk from a mismatch of redemption terms and the ability to sell assets in open-ended funds. They encourage the use of liquidity management tools and "anti-dilution" arrangements, including suspensions, redemption gates and in-kind redemptions.

It is also suggested that redemption prices should factor in not just normal transaction costs but also market price effects of redemptions.

As the consultation paper points out, both the US and Europe impose specific requirements around time and volume of withdrawals for specific types of funds, and arguably those regimes are the focus of the FSB/IOSCO concerns. Australia's system is much more flexible, generally allowing the fund constitution to set redemption terms to match the fund assets. This is more consistent with the aims of the FSB/IOSCO policy. It allows fund terms to be adaptable and protects continuing investors in a fund from harm when others exit.

Australia should maintain its flexible system and address any mismatch issues through improved disclosure to investors.

Further, the DDO and PIP regime also supports appropriate distribution of less liquid funds and provides ASIC with powers regarding the improper distribution of less liquid funds. Instead of mandating further disclosure, the DDO stipulates that both issuers and distributors undertake 'reasonable steps' that are reasonably likely to result in financial products reaching consumers within the defined target market of the issuer. ASIC has effectively exercised its powers under both the DDOs and PIPs frameworks to ensure that less liquid funds are distributed appropriately and has provided targeted feedback to the industry.

ASIC Report 762: Design and distribution obligations: Investment product released in May 2023 noted that "*inappropriate intended investment timeframe and/or withdrawal needs in the target market was a factor in 18 stop orders. For example, an issuer stated that consumers requiring 'annual or longer' withdrawal rights were in the target market despite the product not having any withdrawal rights before the end of the fixed term. ASIC's intervention resulted in the issuer amending the target market so that those consumers who needed the right to withdraw money before the end of the fixed term of the product were outside the target market.* "

ASIC expects that any limitations on redemptions are clearly reflected in the target market for the product, noting in Report 762: *" Where there are limitations on the redemptions for an investment product, these should be clearly reflected in the target market for the product. For example, an issuer should not include in the target market investors who have a need to withdraw money from a product every three months, when the issuer only offers redemptions to investors twice a year. Similarly, if meeting redemptions is at the issuer's discretion, the TMD should not indicate that the product is suitable for investors who need unconditional withdrawal rights."*

These powers and legal obligations support appropriate distribution of products and require any limitations on redemptions to be clearly incorporated in the product's target market.

Recommendation 16: The redemption provisions under the law are both certain and flexible, and this flexibility is important. Where a mismatch arises between member understanding and the actual right to withdraw, this may be due to misleading disclosure or advertising and ASIC should continue to take appropriate action to ensure existing legal obligations are not breached.

8. 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?

Subject to Recommendation 20, issue 3, no we do not consider changes are required to winding up provisions for registered schemes.

We understand that there were a number of complexities relating to the wind of up failed agribusiness schemes which collapsed around the time of the Global Financial Crisis. These were common enterprise contract based schemes which faced a unique set of circumstances. What was not clear was what was the scheme property of these contract-based schemes. There were remedies available to all the stakeholders including legal action taken by investors. The courts made their determinations in relation to a number of agribusiness investor led class actions which provides precedent for such schemes.

We note however that we consider this issue is unique to agribusiness schemes which is largely a historical issue given that we are not aware of agribusiness schemes being offered or recommended for investment by financial advisers post the GFC.

The removal of conflicted remuneration and upfront tax deductions for non-forestry agribusiness schemes [44] abolished many of the incentives that had the potential to distort investment decisions. This was coupled with the introduction in the best interest duty, duty of priority and prohibition on asset based fees being charged on borrowed amounts which reduce the potential for a conflict of interest in relation to financial product advice.

These have been significant regulatory developments since the GFC which have enhanced consumer safeguards.

In relation to winding up outdated schemes more generally, we note that a legislated product rationalisation mechanism which provides tax rollover relief would enable investors to be moved from outdated to contemporary investment funds. Whilst changes to the CCIV regime are not a part of this consultation process, we note rollover relief is important for CCIV take up, with limited adoption expected in the absence of such relief. Rollover relief not only serves investors transitioning into a new fund, it also provides important scale benefits for the fund. Without the necessary scale, the costs to administer a CCIV may be prohibitive.

Recommendation 17: It is recommended that a legislated product rationalisation mechanism, with tax rollover relief, be established to enable investors to be moved from outdated to contemporary investment funds.

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?

The CCIV applies to a company structure and the challenges on insolvency of trusts are different. They cannot be addressed by a corporate insolvency regime because the trust is not a separate legal person.

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

This was recommended by multiple prior inquiries. We would support this applying to trust based schemes in the form of a "corporate style limitation of liability" (where investors are not held liable

[44] Paragraph 2.45-2.47, Parliamentary Joint Committee on Corporations and Financial Services Inquiry Aspects of agribusiness managed investment schemes 2009.

for the obligations of the RE). However the change should not limit the ability of an RE to recover amounts from an investor where the investor has caused a loss or cost to the trust through their actinon or inaction for example, requesting a special form of transfer or bespoke report, or where an unjustified objection to a tax statement has caused expenses.

Trust deeds may have provisions to recover costs incurred by investors and where, because of the nature of the cost incurred, it appropriate for the trustee to recover the cost specifically from the investor than from broader trust assets which all unitholders effectively pay for, for example in relation to stamp duty costs specifically agreed and incurred in relation to an individual investor see Question 17 for further details.

Recommendation 18: We support a statutory limitation of liability, similar to a corporate style limitation of liability for trust based schemes, provided the RE can recover costs incurred specifically by it as a result of acting as the agent of, or under the direction of, the investor.

Given the state-based trustee legislation, it will be critical that a uniform national approach is adopted. Secondly, noting the differences between a trust and the trustee and a company and board it will be equally critical to ensure that the simplicity and other advantages of a trust structure are, as far as is practicable, not negated or diminished by a corporate style limitation of liability provisions (refer to the earlier comments regarding liquidity and withdrawals).

9. 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?

We do not see that there are particular issues that arise for investors from dual jurisdictional regulation of real property. MISs are often invested across a variety of assets, that are geographically spread, and subject to a variety of laws and regulations that apply to these assets and schemes. This does not appear to present a problem for other schemes more generally.

In relation to the SIT, whilst there were two different regulatory bodies having jurisdiction over different components, ASIC in relation to the MIS and the Western Australian Department of Mines, Industry Regulation and Safety in relation to the lease arrangement, ASIC's November 2021 submission to the Sterling Inquiry identified that the losses were primarily caused by product and organisational complexity, mis-priced products and a fall in the residential property market.[45]

Whilst these are factors that may have caused investor losses in SIT, there is nothing specific to SIT or the dual jurisdictional responsibility which prevented ASIC oversight over SIT. That is to say that ASIC has oversight over managed investment schemes that invests in real property, which included the SIT.

It is notable that neither DDO and PIP were in place when the SIT failed. If DDO and PIP were in place when SIT was sold, these tools would have given ASIC swift mechanisms to respond when concerns were raised, including reviewing the product's TMD to consider whether an appropriate target market for the product was identified, whether the right levels of portfolio allocation were selected and whether the distribution conditions were appropriate.

Given the high risk and complex nature of the product, under the DDO regime, it may have been likely that the SIT product would only be suitable for sale and distribution under strict distribution conditions, such as only being suitable for consumers who have received personal advice (and not permitting direct investment in SIT to investors who have not received personal advice), which is likely to have significantly reduced who, and how much was, invested in the product by retail clients. The implementation of the DDO and PIP regime already has, and continues to, fundamentally reshape how funds management products are distributed and their impact on the industry cannot be understated.

We also note our earlier comments in response to Question 6 that it would be helpful for ASIC to use AFSL and scheme registration processes to inform risk- based surveillance processes from the outset, which may involve periodic spot checks of novel and complex schemes such as SIT to ensure these products adhere to DDO requirements.

Recommendation 19: We do not see particular issues arise for investors arising from dual jurisdictional responsibility when regulating schemes with real property. MISs are often invested across a variety of assets, including geographically spread assets, and subject to a variety of laws and regulations. This does not appear to present a problem for other schemes more generally.

[45] Paragraph 1 (2021) ASIC submission to Senate Inquiry into Sterling Income Trust.

10. Chapter 8 – Regulatory cost savings

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

The following table sets out twelve opportunities to modernise and streamline the managed investment scheme regulatory framework.

Table 1.

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
1	Trivial breaches of compliance plan reportable	All breaches, including trivial breaches of the compliance plan are reportable because compliance with a Compliance plan is a civil penalty provision (CPP). This results in trivial/immaterial breaches being reported. Compliance plans give rise to breaches being reported to ASIC under the new breach reporting regime that are one off, immaterial and of no consequence or impact to investors. This is taking up valuable resources and costs which could be addressed in more meaningful way. By way of example ASIC Corporations, Credit and Superannuation (Internal Dispute Resolution) Instrument 2020/98 has been released by ASIC to note that a breach of enforceable provisions of RG271 are not reportable to ASIC however, despite this, we are still needing to report these as they are breach of the Corporations Act. The same applies to obligations noted in the compliance plan that are not core obligations but are caught under s601FC(1)(h.)	To amend the breach reporting obligations so that a compliance plan breach is not automatically reportable. We recommend that non-compliance with a compliance plan be removed from the duties that attract a civil penalty. This would mean that only material breaches of a compliance plan would be reported to ASIC instead of all compliance plan breaches (whether material or not).
2	Simple MIS Definition	The "Simple MIS definition" is tied to the use of simple PDSs (8 pager short form) which is not simple to manage in volatile times. A simple MIS requires at least 80% of fund assets to be reasonably expected to be realised at market value within 10 days. This liquidity based rule tied to market liquidity of assets within 10 days drives the	Proposal is to have a cure period: • providing a minimum of 30 days, and up to a maximum period. • or a more open-ended approach that is, a cure period based on at least the anticipated length of market anomaly. alternative approaches could also include:

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
		type of PDS to be used for disclosure whereas the other liquidity (liquid scheme) rule in s601 KA is tied to the time specified in the fund constitution for satisfying redemption requests which is generally much longer than 10 days (e.g., 60 days). Adverse effects of changing a fund's PDS from short form to long form, even if in prevailing market conditions it would be considered as a "liquid" scheme under s601KA of the Corporations Act, create unnecessary: • confusion and "spooking" of investors (in particular retail investors) – e.g., fear of lack of apparent fund liquidity, when investors are notified of a long form PDS replacing a short form PDS resulting in: o loss of investor confidence o the real possibility of a spike in redemptions; and o investors' unnecessarily crystallising significant loss; disruption to business of the RE - resource demanding to change PDS from short form to long form (PDS preparation/verification/comms) as well as ongoing extra effort to monitoring the 80/20 liquidity threshold for simple MIS in challenging markets. See Attachment 2. MIS Definition FSC response to ASIC questions 2020.05.21	• dropping the 10 Days requirement altogether and simply requiring schemes offered under Short Form PDSs to ensure at least 80% of every schemes' assets to be held in liquid investments (in accordance with s601KA of the Corporations Act); or • instead of requiring funds to continuously test the proportion of liquid assets held, to require that such testing be applied by Responsible Entities on a periodic basis, for example on the date of issue of the PDS and every 12 months, so that the disclosure is driven by the nature of the assets and not short-term market liquidity issues; • use of continuous disclosure to update investors about short-term liquidity issues rather than the rigid and relatively cumbersome requirement of changing a fund's PDS from short form to long form. In this regard, unless PDS templates are pre-prepared and regularly reviewed from a due diligence perspective, it is likely that Responsible Entities would find it very difficult to issue a long form PDS promptly to ensure ongoing compliance
3	Efficient means for exiting/redeeming legacy investors out of a fund	There is no efficient mechanism for exiting a small trail of retail investors out of a fund which does not require constitution change and provided fiduciary obligations are met. These investors may no longer have an adviser attached/be receiving ongoing advice that would be considering contemporary investment/portfolio allocation needs. These small / legacy schemes could be subject to: - higher fees (I.e. costs are spread over a lower base), and	To have an efficient way for legacy investors to be exited/redeemed out of funds.

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
		- sub-optimal investment outcomes (they may lack economies of scale in regard to their ability to negotiate competitive fees, and may not be able to access certain assets due to FUM constraints, or may not be able to diversify as well as a larger MIS). It would be helpful to have an industry wide approach f exiting these members which would reduce compliance and regulatory burden.	
4	Product modernisation mechanism	The modernisation of legacy investment products has been a long- standing issue for industry and consumers, as they are no longer issued to new retail customers and over time the number of remaining few customers gradually decreases. These legacy products generally have higher fees and inferior product features as compared to more modern products. Current legal and tax settings (e.g., unwanted imposition of Capital Gains Tax (CGT) make it difficult to transfer consumers into modern products. These legacy products, especially with minimal residual number of investors, impose an unnecessary cost and compliance burden generally because of the need to retain applicable law/regulation as well as issuers maintaining relevant infrastructure. It would be highly preferable to remove any such obstacles to expedite removal of redundant laws and issuer's infrastructure. Also, investors affected could transfer to more current "equivalent" financial products with better returns and lower fees.	The government facilitate a product modernisation mechanism to enable investors to move out of outdated products into contemporary investment products with rollover tax relief, such that investors do not occur capital gains tax because of the product rollover. We note the importance of ensuring that, for the purposes of any new roll-over provisions, all key terms are defined or that any technical key terms that have not been defined are considered to have received adequate judicial consideration. No specific integrity or other measures should be required as the rollover provisions will be subject, inter alia, to the relevant anti-avoidance (Part IVA) provisions and subsequent amendments. Moreover, the potential sequential operation and interaction of other rollover (or other) provisions of the relevant tax legislation should be taken into account to avoid unnecessary complexity and unintended consequences.
5.	Streamline regulatory filings with ASIC	Compliance plans and compliance audit reports are unable to be lodged with ASIC electronically and each form must be submitted in hard copy with wet signatures.	To support greater efficiency and reduce unnecessary costs we recommend streamlining regulatory filings with ASIC: • All online electronic lodgements and if possible,

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
		This process is not technologically neutral and utilises inefficient and costly processes which have not kept up to date with contemporary practices and means of communication.	consolidate the filings under one online tool. • Currently, some lodgements are done via the ASIC Reg Portal and others via the AFSL portal.
6.	Transition wet signature requirements to e-signatures and docusign tools	Electronic signatures are recognised and permissible legally, yet not accepted by ASIC for regulatory filings such as compliance plan submissions. A part of the challenge presented by wet signatures is the requirement for all directors of the RE to sign the compliance plan which can be logistically difficult to obtain under flexible or remote work arrangements or from external directors. Using DocuSign or other forms of electronic signatures would be far more efficient.	Transition wet ink signature requirements to e-signatures and docusign tools
7.	Provision of investor contact details should be mandated via CHESS and not voluntary	Product issuers are commonly unable to communicate with exchange traded product investors electronically as provision of investor email addresses and phone numbers for example, is a voluntary data field in CHESS and not mandatory. We understand from the ASX that of the approximately 3 million HIN accounts less than 2% have an email address, which results in the ASX posting paper holding statements to the vast majority of investors. Investors will generally provide their relevant contact details and identification documentation to their broker to set up their trading account through which the investor acquires their ETP. The broker sends relevant client information such as the name, address, investment to the registry provider and the product issuer can then access that information via the registry provider. This enables the product issuer to send periodic statements and other material to the investor either by	The provision of investor email addresses by brokers via CHESS should be mandated. Until legislative addressed, it is unlikely that the provision of email addresses for all investors will occur.

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
		mail or also electronically. Feedback from members is that they receive very low number of email addresses from brokers via CHESS. This impedes the ability to communicate with investors electronically and also incurs unnecessary costs associated with printing/mailing investment related information via physical mail.	
8.	Contemporary investor communication delivery	Default investor communications should be contemporary which is no longer via hard copy/physical mail. The default position for receiving investor communication should be via electronic means with investor provided the option to opt out and receive communication via postal address. Further, once the client has been informed of the option of not opting into communication via post, and has not exercised this right within the relevant period, there should not be a further requirement (such as ASIC's publish and notify method) to advise the client each time the statement/information is available on online.	Update investor communication which reflects current and contemporary practices; • Default investor communication should be via email. • Postage should be opt-in, not opt-out. • Investors should be able to access key information via a range of electronic mailboxes such as via their investor portal with the registry providers or their nominated email address.
9.	Fast tracked scheme registration	Where an RE is licensed, has previously registered a MIS, and is registering a new scheme with the same compliance plan and constitution, this should be a streamlined and fast-tracked ASIC process to reduce costs and administrative burden.	ASIC should develop fast tracked scheme registration processes for fund managers which have a track record of previously registering an MIS. This should include the allocation of an ASIC case officer for each scheme registration or AFSL process to ensure continuity and consistency.
10.	Formalising ASIC voting relief	Currently it is very difficult to change the RE of an MIS due to platforms not being able to vote or facilitate voting. ASIC commonly provides voting relief (via applications?) to remove super funds, custodial or IDPS/Platform holders from voting where they do not facilitate voting	Legislation should formalise ASIC voting relief to remove super funds, custodial or IDPS/Platform holders that do not facilitate voting.

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
11.	Client Money Rules (s 1017E) for Schemes that process applications monthly	S1017E of the Corporations Act requires a product issuer to issue a product immediately after receiving application monies or return the money to the applicant within 30 days if the product cannot be issued. A breach of this obligation is a reportable breach to ASIC. This can be problematic for schemes that process applications on a monthly basis if the application monies are received at the start of the month or if there are short delays in issuing the units, as it leaves little or no time for the product issuer to issue the product within 30 days. In this situation where the product issuer is unable to issue the units within 30 days, it is required to return the money to the investor otherwise it is a breach of s1017E and reportable to ASIC. This adds administrative burden for the product issuer in having to return funds to the client and is not a good experience for the client if they have funds returned and are required to reapply.	Some form of relief from this requirement for funds that accept and process applications monthly (or for longer periods)
12.	Adopting electronic documentation	Current requirements for the provision of periodic statements to clients, for example, are prescriptive. Section 1017D(6) Corporations Act 2001 provides that periodic statements must be given (a) in writing; (b) electronically; or made available in any way as agreed with the person; or a way specified in the regulations or legislative instrument. Whilst ASIC RG221 makes it permissible to provide periodic statements in electronic format under the 'publish and notify method,' the understanding is that it also involves a requirement to notify investors, for example by sending an email, of the availability of the periodic statement (PS) online. This approach is prescriptive and not as flexible as the technology neutral approach	Disclosure documentation, such as the periodic statements, should be able to be provided to investors in a technologically neutral way including electronically as the default position. If investors would like to receive physical documentation, this should occur on an opt in basis.

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
		recently implemented in the *Corporations Amendment (Meetings and Documents) Act 2022* (Reforms). The Reforms enables responsible entities of a registered scheme, a company or a disclosing entity to give meeting related documents to a person electronically or in physical form[46]. This includes information such as notice of meetings, notices of a resolution, minute books to be provided in a technologically neutral manner including by; • sending the document in physical form; • giving the document to the person by using electronic means (e.g., sending an email); • providing the person, in physical or electronic form, with details sufficient to allow them to view or download the document electronically (e.g., by giving them a card or sending them an email with a link to a website); or • in any other permitted way (e.g., in a way permitted by a more specific provision which deals with how a particular type of document is sent to a person or in a way which is set out in a company's constitution).[47] Under the Reforms reports and documents prescribed in the regulations[48] are taken to be sent if they are made readily available on a website.[49] Responsible entities are required to let members know annually, via a notice, that they can elect to receive documents in physical or electronic form or that they can choose not to be sent the documents.	

[46] Paragraph 1.42 Explanatory Memorandum of the Corporations Amendment (Meetings and Documents) Bill 2021.
[47] See. paragraph 1.51-52Explanatory Memorandum of the Corporations Amendment (Meetings and Documents) Bill 2021.
[48] Which is a report mentioned in section 314 (annual financial reporting by companies, registered schemes and disclosing entities to members) or is in a class of documents specific in regulation made for the purposes of this paragraph, see section 110D(3) of the *Corporations Amendment (Meetings and Documents) Act 2022.*
[49] See Paragraph 1.53 Explanatory Memorandum of the Corporations Amendment (Meetings and Documents) Bill 2021.

Item	Issue (and any relevant legislation or regulatory provision)	Problem	Suggested solution/ask
		This is a flexible and practical approach for the provision of documents to members and investors, as well as maintaining investor choice on their preferred means for receiving relevant communication (whether via physical form or electronically). We would be supportive of a similar technologically neutral approach being used for the provision of periodic statements.	

Recommendation 20: Table 1 sets out twelve opportunities to modernise and streamline the MIS regulatory framework.

11. Attachment 1. RE Governance Background Paper

RE Governance

Background

The FSC has closely considered the experience of its members who are responsible entities (REs) of registered managed investment schemes (MIS) in delivering fit-for-purpose MIS to investors. This included members who had experience and insights from ASIC's RE governance thematic review in 2020/21. This was also informed by regulation of collective investment vehicles in other jurisdictions in which some members operate.

Summary observations

The FSC and its members observed the following:

1. Low rate of failure of MIS causing investor harm since inception of the current regulatory settings and the failures are idiosyncratic (generally due to egregious individual behavior, misleading or inadequate disclosure materials and promotional activities), rather than thematic or systemic;
2. ASIC has rarely found it necessary to intervene in the operation or governance of MIS and the findings and recommendations from the RE governance thematic review were modest in nature;
3. ASIC actions with respect to MIS were commonly allegations of misleading or deceptive claims or statements in respect of MIS, such as recent "greenwashing" and "truth in labelling" actions;
4. Flexibility in RE governance arrangements has served the market and investors well, in terms of effective MIS operation and investor protection.

General comments about different RE governance models

Existing laws (including AFSL requirements) mandating the governance requirements for REs and MIS currently accommodate variety in the nature, scale and complexity of RE's business operations and the MISs operated. This is appropriate and desirable, given the retail funds landscape is a highly competitive and innovative sector, delivering benefits to investors. Further, trust law duties (and the rights they afford to investors), still govern REs and MIS (unlike CCIVs).

Any new policy direction that would require REs to have a majority of (or all) independent (external) directors, rather than compliance committees with a majority of external members, would result in increased market concentration and consolidation, with reduced competition and innovation. It is likely to accelerate the use of professional trustee companies by asset managers and potentially be a barrier to entry for new managers.

There is a limited pool of suitable independent directors (or candidates) in the market, to serve on RE boards and/or super trustee boards. There are approximately 420 REs and 96[50] RSE licensees. We have observed that serving on multiple trustee boards is generally not favored (either by independent directors or regulators), given the conflicts of duty it can give rise to for independent directors and, as such, there would be a further risk of inappropriate directors being appointed in order to satisfy regulatory requirements.

[50] https://download.asic.gov.au/media/ezolwtee/2021-22-actual-levies-summary-published-28-nov-2022.pdf.

It is worth noting that superannuation is prudentially regulated, having regard to its mandated nature and policy objectives, and corporate trustees of super funds are not required to have a majority of independent directors.

Why not change RE governance requirements fundamentally?

Where the RE board comprises only or mostly executive directors, the advantages our members have observed are that executive directors:

- are already well informed of how the MIS are invested and operated, at every level;
- understand deeply how and why the MIS is developed, promoted and distributed by the RE; and
- are nimble, decisive and timely in responding to matters affecting the interests of investors, given their strong pre-existing knowledge of all aspects of the MIS that they are responsible for. This is highly beneficial when acting to ensure the best interests of investors, particularly in times of uncertainty (e.g., market volatility).

In the absence of a RE board with a majority of independent (external) directors, the compliance committee, with a majority of external members, acts as an appropriate check on the role and responsibilities of the RE board in respect of MIS. The experience of our members is that the compliance committee is an effective and efficient assessor of the operation of the MIS, in accordance with compliance plans. The compliance committee is also a valuable filter of issues for the RE board (such as with oversight of both third party and related vendors) and its external members often give valuable guidance to the RE and its operations.

The compliance committee must have sufficient standing to ensure it is effective. It is noted by members that the RE board together with the compliance committee – as is the case for a majority independent board – must be served by a culture of compliance, openness, collegiality and accountability. Of course, the nature and quality of reporting to the compliance committee, and reporting from the compliance committee back to the RE board (if required), is critical. Feedback from members is that higher levels of transparency and communication, such providing the minutes of compliance committees for consideration by the RE board, and RE board representative directors attending compliance committee meetings to understand matters of interest. The REs legal and compliance functions often attend compliance committee meetings to support appropriate governance and transparency for the compliance committee. In smaller organisations, the compliance committee also augments internal governance functions.

To the extent that ASIC has identified any weaknesses in the elements of an effective compliance committee, we recommend that addressing these at that level is the appropriate and proportionate response.

The compliance committee is required to report to ASIC if it is of the view that the RE does not take appropriate action in response to a matter raised by the compliance committee [51]. It can also engage professional advisors, at the reasonable expense of the RE [52].

The nature and duties of compliance committee members (rather than directors, with attendant fiduciary duties), does not necessarily limit an individual to membership of one REs compliance committee. In fact, there can be mutual benefits for membership of more than one compliance

[51] Section 601JC(1)(c) Corporations Act.
[52] Section 601JC(2) Corporations Act.

committee where good industry practices can be shared and adopted internally (provided confidentiality is appropriately maintained.

Among our membership, we observe that such flexible governance arrangements provide an efficient allocation of resources, without the increased costs typically involved with operating a board with a majority of (or all) independent directors (including scarcer independent directors commanding high fees). These increased costs are ultimately borne by unitholders (investors) in fees or cost recoveries. Our members observe that such costs exceed those of a compliance committee with a majority external members. The local operations of global organisations have emphasised that they particularly value these benefits to their organisations (i.e., having a majority of external compliance committee members instead of a majority of independent directors), in order to participate in the local market. This has benefited Australian investors, who have access to some of the lowest funds management fees by global standards.[53]

We support the flexibility offered by the existing legislative regime. We have members which utilise majority independent RE Board which value the perspectives provided by independent directors.

Feedback from members also observes particular points of differences or limitations that a majority of (or all) independent directors include:

- Higher total costs to engage and operate the RE board and its proceedings that are ultimately borne by unitholders. These costs may not be offset by other efficiencies that may become available, such as removing the compliance committee; and
- A longer lead time may be needed with provision of papers, further background material and time taken for decisions to be made in relation to matters arising that affect the interests of investors. This is commonly due to the additional processes, timeframes and sheer effort required to properly inform independent directors in each case.

Executive Directors may also have a deeper level knowledge and experience, providing effective and efficient filtering of information and issues for the RE board, together with the valuable guidance provided by compliance committees.

Past reviews of RE governance

For completeness, we acknowledge prior reviews that considered RE governance.

CAMAC reported on MIS in 2012, following its consideration of issues thrown up by distressed schemes. This tended toward a separation of trustee and manager roles, as was the case in Australia previously. This appeared to have subsequently lost favor with CAMAC.

CAMAC's discussion paper of 2014 tended toward a corporate structure for collective investment vehicles. This proposal has been met, but CCIVs have not been embraced by the market (and it appears this trend is unlikely to rapidly change at this stage).

The Parliamentary inquiry into the collapse of Trio made broad ranging recommendations, including to improve the oversight and operation of compliance plans and compliance committees. They focused on the content of compliance plans, compliance plan audits, the skills and experience of compliance committee members, specific governance arrangements for compliance committees and regulatory oversight of compliance committees. These recommendations may be more relevant and appropriate to Treasury's current considerations, acknowledging the broader issue of conflicted

[53] Morningstar Global Investor Experience Study 2019 - https://www.morningstar.com.au/insights/funds/195763/australia-equal-first-for-low-fund-fees.

remuneration is now addressed, but the regulation or oversight of self-managed super funds is limited.

Following those reviews and the Financial System Inquiry, ASIC's preference for "merit" regulation appears to have been comprehensively met with design and distribution obligations and a product intervention power. It is a matter for ASIC to regulate and apply those tools on a "merit" basis, where it sees evidence of misconduct or greatest risk to investors.

In summary, there may remain some opportunities to improve oversight and audit of compliance plans and aspects of compliance committees, but we are not aware of a cogent basis on which to revive the concerns of CAMAC and ASIC that were informed by the scheme failures and misconduct that adversely impacted investors prior to the prohibition of conflicted remuneration and the design and distribution obligations and a product intervention power, to remove the flexibility that the compliance committee can appropriately offer.