29 September 2023

Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Submitted via email: MISReview@treasury.gov.au

Dear Sir/Madam,

Review of the regulatory framework for managed investment schemes

Chartered Accountants Australia & New Zealand (CA ANZ), CPA Australia, the Institute of Public Accountants and the SMSF Association (the Joint Associations) welcome the opportunity to provide comments on the review of the regulatory framework for managed investment schemes consultation.

The Joint Associations support a strong regulatory framework that seeks to improve investor outcomes, promote investor confidence, and maintain financial stability while supporting choice, competition, and innovation in the market.

While we recognise that managed investment schemes (scheme) are already subject to a range of compliance and governance obligations, we have also seen the significant impact the collapse of a scheme can have on investors such as Trio Capital and more recently the Sterling Income Trust.

The Joint Associations believe there are amendments that could be made to the current scheme to enhance the governance and compliance of schemes, as well as improve investor understanding and protections.

Importantly, this must include amending the current wholesale client tests, which have not been amended since first being implemented over two decades ago.

When first implemented, it was assumed approximately 2 per cent of Australian adults in 2002 would meet the individual wealth tests to be classified as a wholesale client, compared with 16 percent in 2021. If unchanged, modelling predicts this will increase to 29 per cent by 2031 and 44 per cent by 2041[1].

Examples such as Mayfair, which took advantage of the product value test to avoid disclosure obligations and inappropriately marketed their investments to be a similar risk profile to bank term deposits[2], further support the need to increase the current wholesale client tests to ensure appropriate consumer protection mechanisms are in place.

Our detailed responses are contained in the Attachment.

---

[1] B Phillips (2021), Sophisticated Investor Projections, ANU Centre for Social Research and Methods, p 8, accessed July 2023.
[2] ASIC investigation into Mayfair 101, 10 October 2022

For any questions in relation to this submission, please contact Keddie Waller, Senior Manager Public Practice, Financial Planning and Ethics Policy at CPA Australia via email keddie.waller@cpaaustralia.com.au

Yours sincerely

Tony Negline
Superannuation and Financial Services Leader
Chartered Accountants Australia and New Zealand

Elinor Kasapidis
Head of Policy and Advocacy
CPA Australia

Vicki Stylianou
Group Executive Advocacy and Policy
Institute of Public Accountants

Tracey Scotchbrook
Head of Policy and Advocacy
SMSF Association

ATTACHMENT

1. Wholesale client thresholds

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

The Joint Associations recommend that the product value test should be increased to $1million and indexed in line with Average Weekly Ordinary Times Earnings (AWOTE), but only increased in $100,000 increments.

The financial threshold for the product value test has not been increased since it was first introduced approximately three decades ago.

As stated in the *Wholesale and Retail Clients Future of Financial Advice Options Paper* in 2010[3] the level of $500,000 was considered a low level and within the reach of an increasing number of Australians, given that in June 2010 the median value of a house in Australia was $558,540. By comparison, in June 2023 the median capital city house price was $1,049,812[4].

Examples such as Mayfair, that took advantage of the product value test to avoid disclosure obligations and inappropriately marketed their investments to be a similar risk profile to bank term deposits[5], further support the need to increase the product value test to ensure appropriate consumer protection mechanisms are in place.

An indexing mechanism for the threshold will also ensure the test remains relevant into the future.

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?

The financial thresholds for both the net assets and gross income tests should be increased, noting again neither threshold has been increased since implementation.

The Joint Associations recommend that the net assets test should increase to $4 million to reflect the impact of increases in asset values, inflation and wages since the threshold was first introduced. It should also be indexed in line with AWOTE, but only increase in $250,000 increments.

The gross income financial threshold should increase to $350,000 and indexed in line with AWOTE, but only increase in $25,000 increments.

Both financial thresholds should have specific exclusions as noted in our response to question 3.

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 wealth tests were originally included as high net wealth often accords with high financial literacy. However, correspondingly higher financial literacy likely results from actually dealing with financial products. High wealth in illiquid assets may not reflect a high level of comfort in financial assets by an individual.

Net assets test

The individual's principal place of residence should be excluded when determining their net assets for the purposes of the individual wealth test, as it is not an asset an individual should risk having to realise should their other investments fail. Further, for some individuals it may be their only significant asset and therefore arbitrarily inflate their financial wealth position or dealings with financial products.

---

[3] Wholesale and Retail Clients Future of Financial Advice Options Paper, January 2011, p.5
[4] Domain, June 2023 House Price Report
[5] ASIC investigation into Mayfair 101, 10 October 2022

An individual's superannuation benefits that are subject to preservation should also be excluded, as the individual does not have access to these benefits at the time of determining if they meet the individual wealth test.

Gross income test

The gross income financial threshold should exclude capital gains, employment termination payments and franking credits, as these amounts do not represent the individual's regular gross income and can significantly inflate an individual's financial income.

Certificates issues by a qualified accountant

Accountants' certificates are no longer fit for purpose and should be removed. The adviser or product issuer should be responsible for ensuring that it is appropriate for a client to invest outside the retail client protections. Members across our associations are reporting a significant increase in requests for certificates, from both clients and increasingly non-clients.

The increased use and reliance upon accountants' certificates are of concern. Recent matters managed by Australian Financial Complaints Authority (AFCA) have highlighted the overreliance, by some, on accountants' certificates. There is a perception that the holding of an accountant's certificate removes risk for the advisor or product provider and instead, shifts that risk to accountants.

The existing retail client compliance burden is seeing a growing trend in the use of the wholesale and sophisticated investor regimes as a means of alleviating regulatory burden. This should occur only where it is appropriate in the client's circumstances.

The legislative framework for the provision of financial advice has significantly changed since the wholesale and sophisticated investor regimes were first introduced. Unless they are licensed to provide financial advice, an accountant is prohibited from providing personal financial advice. This includes advice to not invest in or dispose of a financial product.

This is problematic where it is clear to an accountant that it is inappropriate for the client to be moved away from the retail client environment. A conflict arises as the accountant has a duty to act in the best interests of the client and comply with Accounting Professional Ethical Standards Board APES 110 *Code of Ethics for Professional Accountants.*

Where there are no avenues available to clients for compensation, any litigation for damages can be run against the accountant, seeking access to their professional indemnity (PI) insurance. Noting that not all PI policies will insure accountants for the provision of this service. We are therefore concerned that the quantum of contingent liabilities residing in the system is significantly high. This is despite the intention that accountant's certificates are to be a pure statement of fact. The risk to accountants is high and the interaction of the law and their obligations highly conflicted.

In line with other professions, whether a client satisfies the requisite financial threshold, and has the appropriate knowledge, experience and risk appetite, should be determined by the adviser making the recommendation or the product issuer.

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 Joint Associations support the introduction of consent requirements which would clarify that a client must specifically acknowledge instances when they will be classed as a wholesale client and ensure that they understand they will not receive the benefit of protections provided to retail clients.

This would ensure that clients are more engaged in their financial product investments, and more aware of the protections and disclosures to which they are specifically entitled. Advisers and intermediaries would also be held to a higher standard of care and required to provide more frank and open communication with their client about their legal entitlements.

The obligation on the adviser or intermediary should be to obtain informed written consent from their client before any financial product advice or service is provided.

A standard opt-in form should be developed, written in plain English, to ensure consistency and transparency of the important information the client should be aware of before considering if they should provide written informed consent.

The form should clearly state the consequences of being treated as a wholesale client, including:

- the adviser is not required to comply with the professional standards applicable to financial advisers
- the adviser does not have a duty to act in the best interests of the client under the *Corporations Act 2001*
- the adviser is not required to provide the client a product disclosure statement, financial services guide or statement of advice, and
- the client will not be entitled to complain about the advice under the AFS licensee's internal dispute resolution procedures or to AFCA.

The need for this disclaimer also highlights a significant gap in the regulation of wholesale advisers.

Currently, there are no minimum education or training standards to be authorised as a wholesale adviser and as stated above, wholesale advisers do not have to comply with the best interests duty or the Code of Ethics.

ASIC has also estimated that for the 2022-23 financial year, the cost of its regulatory oversight for the 1,817 entities providing only wholesale advice will be $34,000 compared to an estimated $56 million for 2,655 entities providing personal advice to retail clients on relevant financial products.

While outside of the scope of this consultation, we believe this demonstrates a clear regulatory gap that warrants a review of the investor protections and regulatory oversight for this sector.

(b) Should the same consent requirements be introduced for each wholesale client test (or revised in the case of the sophisticated investor test) in Chapter 7 of the Corporations Act? If not, why not?

The objective of implementing consent requirements is to ensure an individual is appropriately informed and understands the risks of being treated as a wholesale client, including those consumer protections they will lose access to if treated as a wholesale client.

The Joint Associations believe for consistency in consumer protection and as a matter of best practice, the obligation to obtain informed written consent should be applied to all wholesale client tests, with the exception of the professional investor test given the higher threshold to be considered a wholesale client under this test.

2. Suitability of scheme investments

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

The Joint Associations acknowledge that product design and distribution obligations (DDO) have only been recently introduced and are aimed at providing further retail client protections. Although we note that the examples provided in the consultation paper as evidence as being an effective gatekeeper mechanism relate to pet insurance products, not managed investment schemes.

Further, the required Target Market Determination (TMD) for a financial product can be several pages in length and overwhelming for a retail client who may have low financial literacy and/or little

experience in investing in a financial product, noting not all individuals will seek professional advice and may directly invest in a product.

Research[6] also shows that disclosure and warnings can be less effective than expected, or even ineffective, in influencing consumer behaviour and in some instances, such as Sterling Income Trust, what was a complex contract-based scheme was marketed and sold to retail clients as retirement living.

While disclosure has its limitations, we believe enhancements could be made to the current obligations so potential investors are made aware of important information they should consider before investing in a scheme. This could include a one-page disclosure at the front of the Product Disclosure Statement (PDS) that states:

- the risk rating for the scheme, noting the standard risk measure for superannuation investment risk issued by the Australian Prudential Regulation Authority could be leveraged to develop this framework
- the suggested timeframe to investment in the product in years
- the liquidity of the fund, and
- if the investor has the right to withdraw from the scheme and if so, the specific withdrawal procedures.

The information could be colour-coded to help the individual better understand the key details about the scheme, which should be written in plain English and could be designed to have a standard format.

The key information could also be incorporated into promotional material for the scheme, noting that many individuals do not read the PDS or to address potential poor behaviour such as misrepresenting the complexity of the product, as was the case in the Sterling Income Trust.

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

To register a scheme, the proposed responsible entity must:

- be a registered Australian public company
- hold an Australian financial services (AFS) licence authorising the responsible entity to:
  - operate the scheme (either an ‘in-kind’ scheme authorisation or ‘named-scheme’ authorisation)
  - provide any other relevant financial services in relation to the scheme and its underlying assets.

The responsible entity must also submit an application to ASIC that identifies the kind of scheme that is being registered, along with the scheme’s compliance plan that should consider issues such as compliance controls that will respond to the identified compliance obligations, risks and objectives.

Registered schemes are also required to meet financial obligations, as the holder of an AFS licence, which include that:

- the entity must be solvent at all times
- sufficient resources are available to meet anticipated cash flow expenses, and
- information about compliance with these financial obligations must be included in the annual audit report.

[6] ASIC REP 632 Disclosure: Why it shouldn’t be the default, 14 October 2019

Given this, we believe it is reasonable for an individual considering investing directly into an ASIC registered scheme, that holds an ASIC issued AFS licence, to take a level of comfort that the company has had an appropriate level of assessment and oversight from the regulator, such that it is appropriate for the scheme to be commercially operating.

However, in its submission to the Parliamentary Joint Committee Inquiry into the collapse of Trio Capital Limited in 2011, ASIC stated:

> *Consistent with the economic philosophy underlying the FSR regime, ASIC does not take action on the basis of commercially flawed business models. A significant feature of a number of collapses leading to investor losses is flawed business models—that is, models that could only prosper if asset prices continually rose and debt markets remained open and liquid. Responsibility for flawed business models lies with management and the board.*

While this statement is some years old, we question the appropriateness of the current regulation and oversight of registered schemes if a commercially flawed business can be 'approved' and offered to the community. Of further concern is that often these products are complex and high risk, yet they are marketed directly to consumers through seminars and targeted advice.

We also question if this approach aligns with the Government's statement of expectations for ASIC that it promote the sound functioning of capital markets and the corporate sector for the benefit of businesses and households.

ASIC has administrative and regulatory mechanisms to address poor disclosure and DDO, however these enforcement mechanisms only come into force after the scheme is already in the market.

The Joint Associations recommend amendments are made to the registration process that requires ASIC to:

- consider the suitability of the scheme's offering for retail clients, and
- assess the nominated directors of the scheme to determine if they are appropriately qualified for their role, have previously been involved with a failed scheme or insolvent business, leveraging the Director identification number to aid in this assessment.

Further consideration must also be given to the scheme registration process to enable ASIC to refuse the registration of a scheme if it believes the registration will or likely will result in significant consumer detriment. This would act as a proactive measure to help prevent schemes that are highly likely to fail from being registered.

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

The Joint Associations recommend that ASIC should be permitted to refuse to register a scheme:

- if the directors of the scheme have previously been involved with more than one failed scheme or company that has become insolvent, and
- where the responsible entity for the scheme has outstanding financial statements and auditor opinions, noting that failure to comply with reporting obligations can be an indicator of a poor compliance culture.

As stated above, further consideration must also be given to the scheme registration process to enable ASIC to refuse the registration of a scheme if it believes the registration will or likely will result in significant consumer detriment. This would act as a proactive measure to help prevent schemes that are highly likely to fail from being registered.

3. Scheme governance and the role of the responsible entity

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

It is our understanding that ASIC only assesses if the professional indemnity insurance (PII) cover is appropriate for an AFS licensee at time of application or as part of a surveillance activity.

As a result, awarded compensation by the AFCA will often remain unpaid due to insufficient, unsuitable or no PII held by the AFS licensee, noting this is a key driver for the establishment of the Compensation Scheme of Last Resort (CSLR) – noting schemes are excluded from the scope of the CSLR.

In contrast, registered tax agents and BAS agents are required to provide details of their PII policy at time of application and must demonstrate at renewal of their registration that they continue to hold appropriate PII that meets Tax Practitioners Board requirements.

The Joint Associations recommend that ASIC adopt a similar model for AFS licensees, which would include those who are responsible entities for schemes. This model would have many benefits, including:

- ensuring that the AFS licensees continue to hold appropriate PII cover
- sending a signal to all participants that the regulator will be proactively regulating this obligation, motivating some non-complaint, or at risk, AFS licensees to retain appropriate cover
- ensuring awarded AFCA claims can be paid, and
- providing insight to the regulator on trends and issues that may be occurring in the PII market.

The Joint Associations also recommend that ASIC require all AFS licensees to submit their PII cover details as part of their existing annual compliance obligations. ASIC should audit a random sample across market participants to ensure there is adequate consumer protection for the users of financial products and advice, which would also limit the costs associated with introducing this new obligation.

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?

We believe it is appropriate that ASIC should be able to direct a responsible entity to amend a scheme's constitution to meet the minimum content requirements.

This will help address the risk of the responsible entity amending a scheme's constitution following registration, so it fails to meet statutory content requirements and provide ASIC with an alternative enforcement action other than deregistering the scheme.

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?

The Joint Associations recommend the *Corporations Act 2001* expressly requires compliance plans to be tailored to the specific scheme. This requirement should be specifically stated in section 601HA under 'Contents of the compliance plan' which should go some way to preventing high level content that addresses the minimum obligations, without detailed procedures for ensuring compliance.

Much of the detail provided in Section C – Compliance plans of Regulatory Guide 132 *Funds management: Compliance and management* (RG 132) is appropriate and relevant to the development of tailored compliance plans. However, we note that ASIC currently does not review and approve compliance plans against RG 132. We suggest section 601HA is amended to require ASIC to review and approve compliance plans.

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?

It is unclear to us as to what is meant by “minimum qualitative standards”. We presume this term refers to the assurance standards that are applicable in the conduct of compliance plan audits.

Based on this presumption, we recommend not using this term but the more commonly used term “audit and assurance standards”. On this basis, yes, we recommend the *Corporations Act 2001* expressly requires compliance plan audits to be conducted in accordance with the applicable auditing and assurance standards issued by the Auditing and Assurance Standards Board (AUASB), which in this case would be ASAE 3100 Compliance Engagements.

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

We do not have any specific comments in response to this question.

4. Right to replace the responsible entity

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

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?

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?

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?

We do not have any specific comments regarding the right to replace the responsible entity.

5. Right to withdraw from a scheme

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

We do not believe the current definition of liquid assets is appropriate and does not align with the general understanding that liquid investment implies easily converted to cash.

The Joint Associations recommend that the objective test of liquidity as suggested by the Corporations and Markets Authority Committee (CAMAC) should be adopted:

- liquid assets as money, bank accepted bills and assets that can reasonably be expected to be realised for their book value within 7 business days.

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

We do not have any specific comments in regard to this 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?

We believe that there is a potential mismatch between member expectations of being able to withdraw from a scheme and their actual rights to withdraw.

Further, to our comments in question 5, to address this a one-page disclosure statement at the front of the Product Disclosure Statement (PDS) could be implemented which includes in plain English the specific withdrawal procedures for the scheme.

The key information could also be incorporated into promotional material for the scheme, noting that many individuals do not read the PDS.

6. Winding up insolvent schemes

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

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?

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

We do not believe that there are any changes to the winding up provisions for registered schemes which would have a material impact on the outcome, including for investors.

Rather, we believe the focus should be on ensuring a better regulatory framework and oversight to look to minimise the risk of a registered scheme becoming insolvent.

7. Commonwealth and state regulation of real property investments

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

The collapse and outcomes of the Sterling Income Trust highlights the issues that can arise for investors because of dual jurisdictional responsibility with real property.

Consideration could be given to requiring the compliance plan for the scheme to address this issue and if it is a risk for the scheme, how this is being addressed.

8. Regulatory cost savings

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

We strongly support recommendations and proposals made by the Australian Law Reform Commission in response to the review of the legislative framework for Corporations and Financial Services Regulation.

The existing legislative framework for corporations and financial services regulation is unnecessarily complex, fails to communicate fundamental norms, and hinders compliance[1]

It is our expectation that a simplified financial services regulatory environment will lead to a more efficient and cost-effective financial services industry.