4 October 2023

Director, Investment Funds Unit
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The Treasury
Langton Crescent
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By email: misreview@treasury.gov.au

Dear Treasury

MIS Review – Wholesale client thresholds

1. Thank you for the opportunity to participate in the recent roundtable discussion and to respond to the questions raised in Chapter 1 of the *Review of the Regulatory Framework for Managed Investment Schemes – Consultation Paper* (August 2023) (**CP**).

2. Relevantly, I am the author of *Managed Investments Law & Practice* (CCH Australia, looseleaf, 1998 to date) and a co-author of *Securities and Financial Services Law* (LexisNexis, 10th ed, 2021). Both books deal extensively with the matters discussed in the CP. From late 2008 to 2011, I was Senior Executive Leader – Investment Management Stakeholder Team at the Australian Securities and Investments Commission (**ASIC**) and from 2011 to 2013, I was ASIC Regional Commissioner for Queensland. My work at ASIC was often concerned with resolving failures in registered and wholesale managed investment schemes (**MISs**) after the global financial crisis (**GFC**) and that experience informs my remarks. I was also a member of the Corporations and Markets Advisory Committee (**CAMAC**) Working Group for its MIS reference a decade ago, and an adviser to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in 2018. I make this submission in my personal capacity and not on behalf of the professional bodies with which I am affiliated.[1]

3. The CP is necessarily high-level and I will adopt the same approach in my remarks. My intention is to raise alternative ways of approaching the issues, rather than to resolve the law reform question which is more appropriately dealt with through the broader process to be put forward by the Australian Law Reform Commission (**ALRC**) and, hopefully, by a reinstated CAMAC or its statutory successor.[2] My comments are divided into: policy,

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[1] I am also Deputy Chair of the Business Law Section of the Law Council of Australia, a member of the National Corporate Governance Committee of the Australian Institute of Company Directors, and a Consultant at Johnson Winter Slattery.

[2] The case for reinstating CAMAC has been made many times, including by the Law Council of Australia: see, for example, the letter from the Law Council to the then Minister for Small Business and Assistant Treasurer, copied to the Prime Minister and the Treasurer, dated 28 October 2015.

design, transition, and inter-dependence. My answers to the specific questions raised in the CP appear at the end.

Policy

4. My primary focus is on how the retail/wholesale distinction applies to Australian households – that is, to individuals and their private investment vehicles (including self-managed superannuation funds (**SMSF**)) – and small businesses (however defined). The concept of a "professional investor" is conceptually distinct. However, some professional investors currently rely on other limbs of the wholesale investor definition in s 761G of the *Corporations Act 2001* (Cth) (**Corporations Act**) because the definition of professional investor in Corporations Act s 9 is too narrow. I return to this point in paragraph 17.

5. Given the terms of reference for the CP, I will only comment on how the retail/wholesale distinction applies in the context of the sale to Australian households and small businesses of financial products that are interests in MISs. The issue of inter-dependence with other parts of the securities and financial services laws in the Corporations Act, the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**), the *National Consumer Credit Protection Act 2009* (Cth) (**NCCPA**) and the various legislation that applies to financial institutions regulated by the Australian Prudential Regulation Authority (**APRA**) is addressed in paragraphs 30-32.

6. The policy question – how the retail/wholesale distinction should apply to Australian households and small businesses interested in acquiring interests in an MIS – is key. Being treated as retail means that that the household or small business has access to the retail statutory protections (including MIS registration, PDS disclosure, access to dispute resolution, design and distribution obligations (**DDO**), and additional regulation of those who provide financial product advice to them in connection with the MIS).[3] Against this is the cost of regulatory compliance (ultimately borne by the client) and the reluctance of some MIS issuers to offer more complex products (which may be suitable as part of a diversified investment portfolio) to the retail market because of the difficulties of managing the regulatory risks associated with them (particularly as to PDS disclosure and DDO). The rationing of some product types to the wholesale market may be a factor in why some households and small businesses think (rightly or wrongly) that it is "better" to be treated as wholesale because it allows access to cheaper MIS products providing superior returns.

7. These observations lead to the (obvious) conclusion that the retail/wholesale distinction should be neither over- nor under-inclusive.

8. The question is not answered simply by indexing the monetary thresholds included in the current definitions. We need to go back a step and ask when the benefits of providing the retail statutory protections to a particular cohort outweigh the costs. This approach does not treat the threshold as a crude measure of financial literacy, financial sophistication, or the capacity to bear loss. Our experience post-GFC emphatically shows it is none of those things. Instead, it asks who needs the retail statutory

[3] Importantly, both retail and wholesale clients have the benefit of the Australian financial services (**AFS**) licensing regime. This is because an interest in a wholesale MIS is a financial product and the issuer must be licensed to deal in it. It is also worth noting that some wholesale clients have access to dispute resolution through the Australian Financial Complaints Authority (**AFCA**) because the definitions are not aligned.

protections and seeks to design the retail/wholesale distinction to capture that cohort (and that cohort only).

9. I think the cohort that likely benefits the most from the retail statutory protections has three characteristics. The **first** is that it is unlikely to be independently advised, or to have realistic access to independent advice. The **second** is that its financial assets (outside the principal residence or preserved superannuation balances) are unlikely to be of sufficient size to be meaningfully diversified. The **third**, based on Professor Harold Ford's longstanding view about the distinction between retail and professional participants in the securities markets, is that its bargaining power (relative to the MIS issuers) is weak, such that it cannot meaningfully negotiate its own terms or information needs. These are not firm tests, but they describe the cohort that is most at risk from mis-selling or from the collapse of an MIS in which they have invested due to the operator's misconduct or mismanagement.

10. If we accept the proposition in paragraph 9, then the next question is how to design a threshold that captures this cohort, accepting that there will always be blurring at the margins.

11. Having considered both options, I think an objective, rather than subjective, threshold is best. A subjective threshold would involve the MIS issuer or an affiliate determining (for example, based on a financial literacy test or past dealings) that the client ought to be treated as wholesale. An objective threshold would involve a person independent of the MIS issuer (such as another AFS licensee or an accountant) certifying that the client met a predefined wealth measure (or its equivalent). I turn to these design questions now.

Design

12. Given my remarks in paragraph 11, continuing with a bright-line test based on a financial measure of wealth (such as net income or net assets) or business size seems the most practical to implement and administer, and the least open to manipulation by an unscrupulous MIS issuer.

13. A person who satisfies the test should be described as a "certified investor" (not as wholesale or sophisticated, which send an unhelpful message to consumers). The universe of "wholesale" clients for MIS would then comprise professional investors and certified investors.

14. As to the dollar amounts for those wealth measures, they should be determined having regard to the characteristics identified in paragraph 9. For example, if Treasury concludes that financial advice is realistically available to and used by a certain percentage of Australians, it could fix the thresholds by reference to the HILDA data having regard to this consideration. Another possible approach is to segment this client population into high net worth and "mass affluent". Probably, high net worth households should be certified. The open question is whether some or all of the mass affluent should be too.

15. For households, some further considerations then come into play, including;

    a. Should the measures be on a household or individual basis?

    b. Should they include assets in or income from private investment vehicles such as SMSFs and family trusts?

c. Should a net asset threshold include (some or all) the value of the principal residence and any still-preserved superannuation balances held in an APRA regulated superannuation fund, a SMSF or both?

d. If interests in the principal residence are included, how is equity achieved for people who live in cities or regions with lower house values?

e. In what circumstances should a person (or household) be certified despite not meeting the wealth measures? I do not much like the subjective elements of Corporations Act s 761GA, but there may be situations in which an independent AFS licensee or accountant (having regard to their professional duties) could attest to the fact that the person or household meets the wealth measures in substance if not in practice (for example because of the way their financial affairs are structured) and are therefore appropriately certified.

f. Should the certification be renewed every few years, say two or five? If so, what happens to existing clients who fail to meet the required thresholds at subsequent certification dates?

16. For small business, the question is which of the different thresholds (relating to two of three measures of employee numbers, revenue, and assets) used across different parts of the regulatory framework is the appropriate one. Again, this requires further research and analysis.

17. A technical issue can arise for subsidiaries, controlled entities, joint venture vehicles, or stand-alone structuring vehicles that are part large businesses or financial institutions, as a result of different test designs (think of the inadvertent extension of the coverage of the unfair contract term provisions to large-business affiliates as a result of the definition design adopted in the recent UCT reforms). In practice, these vehicles are currently treated as wholesale in most situations by satisfying the minimum investment threshold (currently $500,000) on which I comment in paragraph 18. It would be better to amend the definition of professional investor (to which these vehicles are conceptually related) to ensure that the small business definition (wherever it is set) does not inadvertently sweep them up.

18. As a result of my ASIC experience, I have strong objections to the minimum investment test. I have seen it drive very poor consumer outcomes and I think it should be removed.

19. In one case, a financial adviser in a prominent Australian bank advised an older, widowed client to liquidate all her investments to be able to acquire a structured product, issued by the bank, which required a minimum investment of $500,000. When the product failed, she was undiversified and lost everything. Similar practices occurred in a number Gold Coast mortgage funds, where existing clients in a registered MIS were individually targeted and duchessed by the MIS issuers to move all their wealth (for example, by selling investment properties or securities held outside the MIS) into a wholesale MIS promising (but not delivering) lower costs or superior returns. The problem again is lack of diversification. This practice was particularly prevalent when the destination product purported to offer an annual percentage rate of return (usually expressed as a percentage with an asterisk, indicating it was nothing but an empty aspiration) and therefore was seen as a potential income stream. It is true that financial services laws have been tightened since 2008, but the risk remains from unscrupulous MIS issuers who can argue (under this test) that the client is wholesale at the time the product is acquired and therefore that, for example, the DDO laws do not apply.

20. I am aware my request in paragraph 18 is unlikely to be popular with industry and will create a compliance headache (the minimum investment test being very clean for a product issuer in, for example, a private placement) but I do ask Treasury to consider it.
21. As a general comment on design, the thresholds should be as simple as possible, with as few alternative approaches as possible. I understand that many reputable MIS issuers and intermediaries rarely rely on some of the existing thresholds (for example, Corporations Act s 761GA) because they are considered unreliable or to pose an unacceptable compliance risk. Hopefully this consultation will make this apparent, in which case those alternative approaches could be removed.
22. It is also important that Australia adopt an internationally credible and comprehensible, if not consistent, approach in setting the threshold. This benefits Australians by encouraging international firms to enter the market and compete in an environment that makes intuitive sense to them.
23. Wherever the monetary amounts for the wealth measures are fixed, they should be subject to indexation to avoid us confronting the same issue after the next significant market reversal.

Transition

24. Any change to the retail/wholesale distinction will have a significant impact on the financial services industry and be expensive to implement. That is a given. It will require significant systems changes. It will also result in some households or small businesses that are currently considered wholesale falling out of that category. This will inevitably lead to complaints from both sides, and to political complexity.
25. A change to the wealth measures (increasing the dollar amounts and indexing them in future) is likely to be less disruptive than removing some parts of the current test altogether (which I argue for in paragraphs 18 and 21) or changing the type of test (for example, from objective to subjective as described in paragraph 11). That is also obvious.
26. However, if there are compelling policy reasons to make the change, it should be done. Otherwise (as in all parts of the financial services laws) poor legislative design in the past, which creates the very complexity that makes transition so difficult, dooms us to being saddled with defective or sub-optimal regulation forever.
27. If a change is made, it may be appropriate to grandfather existing wholesale clients into the new regime, at least for a substantial period.
28. It is also appropriate to stage any change within the broader project to fix the law design problems with the existing financial services laws to be recommended by the ARLC.

Inter-dependence

29. My remarks concern the retail/wholesale distinction as it applies to the MIS industry. But as the CP rightly points out, the distinction is relevant in many other contexts. With respect, this is not the right setting within which to consider the policy implications of a broader shift. Nor is it desirable to change the retail/wholesale distinction for MIS alone.
30. There is a relationship (somewhat imperfect) between the retail/wholesale distinction and the securities laws, in particular Corporations Act s 708. Care must be taken not to make changes to the former without considering the implications for stapled entities or the risk of regulatory arbitrage between the two regimes.

31. There is a broader issue at stake here, about the current regulatory settings for financial consumer protection in Australia. If households or small businesses that acquire or dispose of investment products (including MIS interests) are considered "consumers" of those products in the broadest sense, then it seems appropriate to harmonise this part of the law with other laws that divide the universe of buy-side participants in the financial services and products markets into consumers and non-consumers (or, for ease, retail and non-retail).

32. What is the policy reason for treating someone as retail in one of these contexts, but not another? Can the various definitions of consumer used in the ASIC Act be harmonised with each other and with the retail/wholesale distinction? In the NCCPA? In the rules that determine eligibility for dispute resolution by AFCA? This reinforces the case for a coherent single financial consumer law (like the Australian Consumer Law that applies outside the financial sector) that deals with these definitional questions consistently unless there is a clear policy distinction to be made.

Conclusion

33. Treasury is right to revisit the retail/wholesale distinction which, as the CP points out, has been the subject of several failed reform attempts in the past. I hope my remarks are helpful and that the project will be carried forward in conjunction with the ALRC's broader recommendations to improve the financial services laws.

34. My answers to the specific questions in the CP are as follows:

    a. ***Question 1***. I think the product value test should be abolished – see paragraph 18.

    b. ***Question 2***. I think the financial thresholds should be increased if research and analysis of the considerations in paragraph 9 support such a change. I also think an independent AFS licensee or accountant should confirm that the person meets the relevant wealth measure (unless the person is willing to provide their past two years' tax returns to the MIS issuer, which is objective but perhaps not ideal).

    c. ***Question 3***. There may be a case for excluding some or all of the principal residence or preserved superannuation held in an APRA regulated fund (see paragraph 15c) but I do not have a strong view. It depends on a deeper analysis of the considerations in paragraph 9.

    d. ***Question 4***. I do not see any benefit in producing a consent requirement. The same behavioural factors that lead a person to choose a wholesale MIS will likely lead them to confirm they wish to be treated as wholesale, so it is otiose. There is nothing in past regulatory experience to suggest additional disclosure will give them pause.

35. If you would like to discuss these remarks further, please let me know.

Yours faithfully

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9 October 2023

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Dear Treasury

MIS Review – The regulatory framework

1. Thank you for the opportunity to participate in the recent roundtable discussion and to respond to the questions raised in the *Review of the Regulatory Framework for Managed Investment Schemes – Consultation Paper* (August 2023) (**CP**). I have provided my submissions on Chapter 1 of the CP – dealing with the retail/wholesale client distinction as it applies to managed investment schemes (**MISs**) – separately.

2. As noted in that submission, I am the author of *Managed Investments Law & Practice* (CCH Australia, looseleaf, 1998 to date) and a co-author of *Securities and Financial Services Law* (LexisNexis, 10th ed, 2021). From late 2008 to 2011, I was Senior Executive Leader – Investment Management Stakeholder Team at the Australian Securities and Investments Commission (**ASIC**) and from 2011 to 2013, I was ASIC Regional Commissioner for Queensland. I was also a member of the Corporations and Markets Advisory Committee (**CAMAC**) Working Group for its MIS reference a decade ago, and an adviser to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in 2018. I make this submission in my personal capacity and not on behalf of the professional bodies with which I am affiliated.[1]

3. The CP adopts a high-level approach and I will do the same.

Business models suitable for MIS regulation

4. I begin by commenting on what types of arrangements should be eligible for registration as MISs. It includes a radical proposal in paragraph 11.

5. The predecessor to the MIS regime, dealing with the offer and operation of arrangements in which people acquired "prescribed interests", was adopted in the mid-20th century as an anti-avoidance mechanism. It was intended to prevent the practice by promoters of selling financial investments that were not shares in a public company, thereby avoiding the prospectus and other disclosure requirements that applied to public

[1] I am also Deputy Chair of the Business Law Section of the Law Council of Australia, a member of the National Corporate Governance Committee of the Australian Institute of Company Directors, and a Consultant at Johnson Winter Slattery.

companies that issued securities by way of an "offer to the public". It was modelled on the debenture laws, requiring the appointment of an independent trustee for interest holders, inclusion of some prescribed investor protection covenants in the constituent documents (usually a trust deed), appointment of the promoter as its manager, and the usual transparency requirements such as annual reporting. This regime was significantly amended in 1991 (following the collapse of the property trust sector, including the large Estate Mortgage group) and then replaced in 1998 by the current Chapter 5C of the *Corporations Act 2001* (Cth) (**Corporations Act**). The history of the regime (including its further development and the development of the financial services law that complement it) is explained elsewhere.[2]

6. The history is relevant because it demonstrates why "enterprise schemes" (to use the CAMAC language) are caught by the regime.

7. Over the last half-century, a confluence of corporate law, fund governance and taxation factors made the MIS form attractive to Australian promoters of collective investment vehicles such as managed funds.[3] These include factors such as the availability flow-through tax treatment and the non-applications of capital maintenance laws.

8. Managed funds give rise to different governance consideration from trading corporations; this typically justifies the different mechanisms used in collective investments regulation here and abroad to address the agency problem from those in corporate law (such as member election of directors and annual general meetings). Within the managed fund sector, open-end and closed-end funds raise different governance considerations. I mention these below.

9. The definition of "managed investment trust" (**MIT**) used in taxation law is a reasonable approximation of this sub-category of MISs. Of course, not all MISs are managed funds, and not all managed funds are MISs.[4]

10. The governance framework comprising the registration requirement in Corporations Act ch 5C and the Australian financial services (**AFS**) licensing regime in Corporations Act pt 7.6 is tolerably well-suited to MISs that are MITs for tax purposes, subject to the observations I make below. However, it is not well-suited to arrangements that involve carrying on a trading business, as the experience unwinding the collapsed silvaculture MISs after the global financial crisis clearly demonstrated. The lack of a sensible framework for dealing with insolvency in such enterprises, the (potential) unlimited liability of members, the inadequate arrangements for replacing failed responsible entities (**REs**), the false comfort given to members by the notion of licensing and registration by the Australian Securities and Investments Commission (**ASIC**) and the concept of a "trust", and members' lack of understanding of the nature of their rights ("but they are my trees – why can't I just go harvest them myself?") all exacerbate the problem.

[2] PF Hanrahan, CCH, *Managed Investments Law & Practice* (at Release 62) ¶2-100 to ¶2-950.

[3] Managed funds are arrangements in which external contributors' money is pooled and invested by the fund operator, or a portfolio basis, in financial instruments issued by other entities (such as governments, financial institutions or corporations) or other income-producing assets). See P Hanrahan, "Directors as Monitors in Collective Investment Schemes" in R Teele Langford, *Corporate Law and Governance in the 21st Century – Essays in Honour of Professor Ian Ramsay* (Federation Press, 2023) 112.

[4] Consider listed investment companies, superannuation funds, investment-linked insurance bonds, notified foreign passport funds, and corporate collective investment vehicles (**CCIVs**).

11. My radical proposal is this. Rather than treating the MIS regime as a mechanism by which any business model – however unsuited to the particular and unique governance framework created by Corporations Act ch 5C – can find a pathway to a public offering, **future registration of MISs should be restricted to schemes that are MITs for taxation purposes**.
12. Of course, this is a radical proposal. But it does not mean that other types of enterprises cannot exist and cannot be offered to the public. It just means that they must do so under a governance regime that is better suited to their business model than one designed for managed funds. This will make certain types of tax-driven investment schemes unviable, but that is not necessarily a bad thing. Indeed, it may reduce the opportunity for primarily tax-driven structures being sold into the retail markets. And of course, unlike the AFS licensing requirement, the MIS registration requirement only applies if the members of the MIS will include more than 20 retail investors.[5] So wholesale arrangements would be unaffected by my proposal.
13. Limiting registration to MIS that are MITs for tax purposes would allow the regulatory regime to be refined and simplified, resulting in reduced complexity and potential cost savings.
14. The balance of my submission heroically assumes that this radical proposal is adopted. So I mostly confine my comments to how we could improve the existing laws as they apply to retail MIS that are MITs for tax purposes. My comments cover:
    a. liquidity requirements and withdrawal arrangements in MISs (like mortgage funds) that perform a maturity transformation function
    b. disclosure for the offer of interests in listed MISs and stapled securities
    c. consistent application of the AFS licensing requirement to wholesale and retail collective investment scheme operators
    d. the MIS registration process
    e. compliance plans, compliance plan audits, and compliance committees
    f. replacing the responsible entity
    g. member remedies
    h. winding up, and
    i. MISs linked to the right to occupy property.
15. My answers to the specific questions in the CP are in paragraph 41.

Liquidity and withdrawal in open-end MISs

16. An open-end MIS is offered to investors on the basis that they will be able to redeem their investments during the life of the MIS, either on a continuous basis or during redemption windows. The constitution of the MIS will typically specify the amount of notice that a member intending to redeem must give, and often allow the RE to redeem the members' interests more quickly if scheme liquidity (for example, from cash derived from new fund inflows) allows.

[5] Of course, this over-simplifies Corporations Act s 601ED: see Hanrahan (n 2) ¶10-200 to ¶10-370.

17. I am concerned that the current laws give too much discretion to REs, particularly where the MIS is performing a maturity transformation function. Part of the problem comes from REs operating their MISs on the basis that the redemption period will, in the ordinary course, be much shorter than the period fixed (presumably by reference to the nature of the underlying assets, its gearing and so on) in the constitution. This creates an expectation that the invested funds will be more readily available than is actually the case, particularly if a significant market event or change in investor confidence in the MIS or the RE causes a spike in redemption requests.
18. This is, of course, a prudential problem that has systemic implications.[6] Greater coordination between ASIC and the Australian Prudential Regulation Authority (**APRA**) is probably needed in designing ASIC's regulatory approach to liquidity management.
19. One option may be to amend the law to require that the redemption notice period specified in the constitution of an MIS must be adhered to and cannot be abridged. If a material percentage of assets of the MIS are illiquid, this must be taken into account in fixing the required notice period. The notice period will send a clear signal to potential investors about the nature of the product they are being offered.
20. Where an MIS suspends redemption on the basis that (in the RE's opinion) it is no longer liquid, the suspension should be conducted under the supervision of ASIC. The board of the RE should be required, during the period of the suspension, to regularly confirm the basis on which its assessment of the liquidity of the MIS is made, and its plans for restoring liquidity as quickly as the best interests of the members allows. There may even be the case for the appointment on an independent person to supervise the suspension. The period for which redemptions can be suspended before the MIS is placed into liquidation could be legislated, to prevent a lingering "zombie funds" problem.

Offering listed MISs and stapled securities

21. Closed-end listed MISs, including MISs that form part of a stapled entity, are a special case and give rise to different information considerations from open-end and other closed-end MISs.[7] These listed MISs include many major A-REITs and infrastructure MISs.
22. The takeover laws in Corporations Act ch 6 – 6B and the ownership disclosure laws in Corporations Act ch 6C apply to listed MIS (see eg Corporations Act s 604), as do the Listing Rules of the relevant exchange.
23. It should also be the case that the disclosure laws in Corporations Act ch 6D apply to offers of interested in MIS that are or will be listed, to the exclusion of the Product Disclosure Statement regime in Corporations Act pt 7.9. This is because the nature of the information required by Corporations Act ch 6D is more appropriate for a listed investment. It would also eliminate the needless complexity, for stapled entities, that results from complying with two different disclosure regimes, with different requirements and liability rules, for the same product.

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[6] This is the classic "shadow banking" problem. See P Hanrahan, "Exchange Traded Funds in the Shadow Banking Sector" in I Chui and I MacNeil (eds) *Research Handbook on Shadow Banking – Legal and Regulatory Aspects* (Edward Elgar, London, 2018).

[7] Remember that ASX listing is different from having an MIS interest quoted on the ASX Quoted Asset (**AQUA**) market.

24. There may also be a case to exclude MISs from the DDO regime in the limited circumstances in which (if it were a company) it would be exempted by Corporations Act s 994B(3) and (4).

AFS licensing requirements

25. It is appropriate that all collective investment scheme operators doing business in Australia are AFS licensed. This is probably the law already, subject to some specific exclusions (which should be retained). But the drafting in Corporations Act pt 7.1 div 4 could be improved by defining “operating a collective investment scheme” as a distinct financial service. For this purpose, a collective investment scheme would include a (retail or wholesale) MIS, a registrable superannuation entity, a statutory fund for an insurance or friendly society investment bond, a CCIV, and an investment company of the kind described in Corporations Act ss 766C(5) and 994B(4). The obligations of an AFS licensee (and the relevant provisions of the *Australian Securities and Investments Commission Act 2001* (Cth)) would thereby clearly apply to the provision of that service.

Compliance plans, compliance plan audits and compliance committees

26. The requirement for compliance plans and for audit of those compliance plans is, in my view, now outdated. The science and art of risk management in the areas of conduct, compliance and operational risk have matured significantly over the last 25 years. It would be better to do away with the requirement for a compliance plan in favour of a more sophisticated approach to risk management required under Corporations Act s 912A(1)(d), modelled on current best practice guidelines and APRA’s regulatory approach in this area.
27. In most MISs that have failed, the compliance plan auditors have been spectacularly inept. That their insurers routinely settle claims before their ineptitude is aired in court should not obscure that fact.
28. There is little evidence that compliance committees add much value when an RE is (through avarice or incompetence) mismanaging the MIS. It may be better simply to legislate the requirement for a majority external RE board (as was done for corporate directors of CCIVs) as the responsibilities of directors are more comprehensive and coherent.

Scheme registration process

29. There is probably little value in having ASIC check an MIS constitution for compliance with the law. It could ask instead for a certificate from the RE’s lawyers that they have reviewed the constitution and consider that it meets the content requirements in the legislation and ASIC policy. ASIC’s approach to reviewing constitutions is not always consistent.
30. I have recommended removing compliance plans in favour of a more sophisticated risk management framework. There may be some benefit, if its capacity in this area is lifted with additional resources, in having ASIC assess the adequacy of risk management arrangements on an ongoing basis.
31. When an MIS is registered, it should be classified by scheme type in a manner that reflects existing industry practice. This is for three reasons: first, to allow ASIC to make sure that the name and description of the MIS is not misleading to potential investors; secondly, to allow more accurate industry-level statistical and data-driven insights; and

thirdly, to allow ASIC to take a cohort-based approached to surveillance and regulatory guidance.

Changing responsible entities

32. Changing the responsible entity of a listed or unlisted MIS is a change-of-control transaction. Conceptually, it should be treated as such. Any policy questions as to member involvement in these changes should be viewed through the lens of existing takeovers and scheme of arrangement laws.
33. The exception is where the incoming responsible entity is and will remain a related body corporate of the incumbent RE; in this case it may be appropriate to allow the change to occur administratively.
34. It would be desirable to amend the trustee laws to ensure that appropriate payments and indemnities on RE replacement do not fall foul of prohibitions relating to corrupt payments on a change of trustee.
35. The law for the appointment of a temporary RE does not achieve the outcome intended for it. In circumstances where an incumbent RE resigns or is removed (including by regulatory action) without being replaced, the law should allow for the appointment of a registered liquidator to take over the operation of the MIS with a view to finding a replacement RE (the appointment of which must be put to a vote of members) or winding up the scheme.

Member remedies

36. It is not clear that the remedy in Corporations Act s 601MA has much utility, given other remedies available under Corporations Act ch 9.
37. It is not conceptually clear why the oppression remedy available to shareholders in a company under Corporations Act pt 2F.1 is not also made available to members of a registered MIS.

Winding up

38. There may be benefits in putting in place a statutory regime for winding up MISs (and sub-funds of CCIVs). However, this should be done as part of a broader review of Australia's insolvency regime (and note my radical proposal in paragraph 11, which will allow the regime to be tailored to MISs that are MITs).[8]

MIS linked to the right to occupy real property

39. These arrangements should be denied registration. They create an unacceptable risk to participants. Also, they are not (except indirectly) financial products in the true sense, and should not be regulated by ASIC. There is no reason to regulate timeshare under the MIS regime (other than historical accident) and these arrangements could and should appropriately be dealt with elsewhere (ideally, under the Australian Consumer Law or tenancy laws).
40. Of course, offering these arrangements (if they fall within the statutory definition of an MIS) without registration would breach the law – that is the point.

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[8] See Commonwealth of Australia Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency in Australia* (July 2023) Chapter 14.

Conclusion

41. My answers to the specific questions in the CP are as follows:

    Question 5. I think registration should only be available to MISs that are MITs for taxation purposes. This is the subset of MISs for which the governance arrangement required under Corporations Act ch 5C are most suitable. Other arrangements that fall within the wide statutory definition of an MIS[9] would need to be differently structured (for example, as public companies) to avoid contravening the prohibition on operating an unregistered retail MIS.

    Question 6. Yes. See paragraphs 29-31.

    Question 7. ASIC does not have discretion to refuse to register a company if the applicant for registration meets the statutory criteria. In theory at least, scheme registration should be the same. This recognises that registration is primarily intended to give ASIC a regulatory line-of-sight on these arrangements, not as a form of blue-sky regulation that goes to the viability or suitability of the MIS for an investing public. (This needs better investor education, to understand the nature of registration.)

    Question 8. There may be scope for further refinement, but the settled body of law that has developed around the core obligations should not be unduly disrupted.

    Question 9. No.

    Question 10. I recommend removing the compliance plan requirement in favour of a more sophisticated approach to risk management, modelled on contemporary APRA approaches and built into the AFS licensing regime (see Corporations Act s 912A(1)(d)).

    Question 11. I also recommend removing compliance plan audits.

    Question 12. Yes.

    Questions 13 - 16. See paragraphs 32-35. It is very important to change the temporary RE regime to allow the appointment of a registered liquidator instead in those circumstances.

    Questions 17 – 19. I recommend that a constitution for a registered MIS be required to specify a notice period for redemptions, linked to the nature of the MIS, and that an RE should not be permitted to redeem before the notice period has expired. If the RE fails to manage the liquidity of the MIS so as to meet its redemption obligations, the consequences in paragraph 20 should follow.

    Questions 20 - 21. Yes, as part of a broader review of the insolvency laws. Note that restricting MIS registration to MITs will simplify the regime.

    Question 22. Yes, so long as registration is limited to MITs.

    Question 23. It should be illegal to offer an investment scheme that is linked to the right to occupy property. Arrangements that allow rights to partial occupancy (like timeshare) should be separately regulated by the ACCC and State Fair Trading agencies.

    Question 24. Yes, in particular through changes to ASIC's approach to scheme constitutions and the abolition of mandatory compliance plans in favour of a more sophisticated approach to risk management.

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[9] Interpreted in the manner set down by the Full Federal Court in *LCM Funding Pty Ltd v Stanwell Corporation Limited* [2022] FCAFC 103.

42. It is appropriate for any work to amend the MIS laws, if it is recommended, to be folded into a broader review of the financial services laws including the laws regulating other forms of collective investment schemes currently offered in Australia. This will likely be recommended by the Australian Law Reform Commission and placed into the hands (hopefully) of a reinstated CAMAC or its statutory successor.

43. If you would like to discuss these comments further, please let me know.

Yours faithfully

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