Submission to ASIC – Consultation Paper 388

Net Tangible Assets Requirement for Responsible Entities

Submitted by: Affluence Funds Management Limited

Submitted by: [redacted], Director

Date: 17 April 2026

1. Introduction

Affluence Funds Management Limited (Affluence) welcomes the opportunity to provide feedback on Consultation Paper 388.

Affluence is an Australian-based investment manager operating registered managed investment schemes primarily for retail and wholesale investors. Our funds are structured with a strong focus on alignment of interests with investors, including targeting regular income, lower than average volatility, a performance-based fee structure and a capping of direct administration costs.

We currently manage approximately $100 million in total assets across three registered managed investment schemes and one smaller wholesale scheme. I have more than 20 years of experience in the financial services industry in various senior roles within responsible entities across a range of sectors, including both listed and unlisted products.

As a boutique responsible entity, we are directly impacted by any changes to NTA requirements. Our perspective reflects both the practical realities of operating within the current regulatory framework and the likely behavioural responses across the broader industry.

2. Overarching Position

Affluence supports modest, targeted reform. However, we do not support material increases in NTA requirements. In our view, the current framework broadly meets its objectives. Significant increases are likely in our view to lead to reducing competition, increasing costs for investors, and most importantly, driving activity into less regulated wholesale structures.

3. Practical Impact and Quantitative Considerations

To assist ASIC in assessing the regulatory and financial impact of the proposed changes, we provide the following practical observations.

Any material increase in NTA requirements would require responsible entities to allocate additional capital that must generate an appropriate return on equity. In practice, NTA capital is typically held in low-risk, highly liquid assets, which are unlikely to generate returns above approximately 4–5% per annum.

However, equity capital generally requires a return closer to 12–15% to be commercially viable. This creates an unavoidable gap that must be recovered, most likely through higher fees charged to investors.

In our case, we currently operate a performance-based fee structure with no fixed management fee and a capped cost ratio of 0.25% per annum. A substantial increase in NTA requirements would likely require us to reconsider this model, including introducing fixed fees or increasing the cost cap. This would represent a direct increase in costs to investors, particularly in periods of lower performance.

More broadly, we expect that material increases in NTA requirements would lead to:

- Consolidation of responsible entities into a smaller number of larger providers, which has the potential to significantly reduce competition.
- Increased use of external responsible entity service providers, concentrating risk.
- Migration of funds from retail to wholesale structures.

The last of these is particularly important. In our experience, a large proportion of investors in retail schemes already meet the legal definition of wholesale investors. Increasing the regulatory burden on retail schemes without addressing wholesale settings is likely to accelerate a migration of products to the more likely regulated, less capital intensive, wholesale regulatory environment.

This would have the unintended consequence of significantly reducing investor protections, as wholesale schemes are not subject to the same requirements for registration, disclosure, custody or governance as retail schemes.

4. Responses to Consultation Questions

B1Q1 – Feedback on Option 1

Affluence supports CPI indexation in principle, but only from the time of the most recent ASIC review in 2023. At the time of that review, ASIC stated, *"Following consultation, ASIC formed the view that CO 13/760 and LI 2022/449 were operating effectively and efficiently, and continued to form a necessary and useful part of the legislative framework."*

Applying CPI increases from 2013 introduces a large one-off retrospective increase that is not justified by current conditions or risks.

B1Q2 – Is CPI appropriate?

Yes, we agree CPI is appropriate. We believe the trimmed mean is the most appropriate CPI measure, since it removes large price movements in either direction and provides a better measure of underlying inflation.

B1Q3 – Alternatives

Not applicable.

B1Q4 – Impact

The increases proposed by ASIC under Option 1 would have no impact on our business or our scheme members. Likewise, our proposal to limit CPI increases to post 2023 would also have no impact. Our current concessional NTA requirement (as we appoint a third-party custodian to hold scheme assets) is approximately $500,000. This would not change under Option 1.

B1Q5 – Indexation mechanism

We support ongoing periodic indexation of thresholds.

B1Q6 – Competition

We do not believe the proposals under Option 1, nor our proposed adjustment, will materially reduce competition.

B1Q7 – Practical issues

The timeframe for release of periodic changes would need to be coordinated to account for delayed release of CPI data by the Australian Bureau of Statistics and ASIC's regulatory requirements. For this reason, it may be best to increase CPI with a lag. For example, increased thresholds to apply from 1 January each year, based on CPI for the prior financial year.

B2Q1 – Feedback on Option 2

We strongly oppose increasing the $150,000 minimum to up to $1 million or applying a minimum requirement per scheme. There is no evidence that the current NTA thresholds are materially inadequate. No compelling rationale has been established for an increase in the minimum NTA of the scale contemplated under B2(a) or B2(b).

The changes proposed amount to an increase in minimum NTA of up to 566% (under B2(a)) and an uncapped increase under B2(b). This represents an extraordinary increase for smaller responsible entities, with little rationale.

There are clear scale benefits in operating multiple schemes and higher levels of AUM, and an effective doubling of the minimum requirement for each scheme makes little sense.

The requirement to have enough financial resources to operate for the near term is already provided for under the Cash Needs Requirement calculation. Generally, the greater the operating costs for a responsible entity, the greater the Cash Needs Requirement will be.

B2Q2 – Preference

In the absence of a more detailed study which clearly justifies higher minimum thresholds and the rationale for them, we do not support either proposed option.

B2Q3 – Amount

Maintain current levels, indexed from 2023.

B2Q4 – Proposal appropriate

No. Option 2 is not appropriate. There is no clear rationale for increased minimums. There is no clear link between increased minimums and improved outcomes. In particular, it appears this proposal would have had no impact on the largest recent scheme failures.

B2Q5 – Impact

The impact on Affluence would depend on the proposal adopted.

Any additional NTA required to be held by a responsible entity must be held in such a way that returns on that capital are limited. This is because it is likely that 50% of the extra requirement will be held in cash or cash equivalents, earning a relatively low return. The other 50% is likely to be held in conservative or capital stable investments (e.g., short duration bonds), which will also earn a low return. As a result, any responsible entity needing to provide extra capital will be seeking a return on that capital, most likely by way of a higher fixed fee for the relevant scheme.

Any collective total increase in capital required across the industry must be considered in light of the additional cost it will impose on investors through higher fees or other costs, and the likelihood that the additional capital would ever be used in the future to improve investor outcomes (for example, as a result of the failure of a responsible entity, which is relatively rare). We believe that the cost to investors of any material increase in required NTA across the industry will substantially exceed the benefits that may accrue in the future as a result of the failure of a responsible entity that was required to hold additional capital, and needed to use that additional capital for the benefit of investors.

For Affluence specifically, under B2(a), our NTA requirement would increase by up to $500,000 above the current level we are required to hold. In addition, we always seek to maintain a buffer above our requirement, as we expect most responsible entities would. So, the maximum effective additional NTA requirement could exceed $500,000. This would likely require us to raise additional capital for the business. We would require a return on that capital, and we would likely need to consider either the introduction of a fixed fee, or a removal or increase in the current admin cost cap we provide to our schemes.

Alternatives to raising additional capital could include outsourcing the responsible entity role for one or more schemes, winding up one or more schemes, or transitioning one or more schemes to a wholesale (unregistered) scheme. Each of these alternatives would have implications for investors, including higher costs if the responsible entity function were outsourced, return of capital/loss of opportunity on a wind-up, or forced redemption of retail investors on a conversion to wholesale. We suspect many other responsible entities would face similarly hard choices. Some smaller responsible entities may choose or be required to close down entirely.

Under B2(b), our NTA requirement would not be impacted currently, as the minimum for three schemes which we currently run would be $450,000, slightly below our current requirement of approximately $500,000. However, it would significantly impact our ability to form new schemes, at least without seeking a higher fee to compensate us for the additional capital cost.

B2Q6 – Competition

The impact on each responsible entity will depend on the level of increase, and the number of schemes. Undoubtedly across the industry, a substantial increase in NTA requirements will lessen competition, increase costs, and reduce choice for investors. Broadly speaking, the larger the minimum increase, the greater the impact will be.

A number of our strategies are effected, at least partly, by investing in funds or listed vehicles run by third party managers (both wholesale and retail). In our experience, some of the best returns can come from smaller funds, run by boutique managers with talented investment teams. Any initiative which makes it harder to form, and run, these types of funds, will have a detrimental impact on investor choice and returns over the long term.

B2Q7 – Practical issues

We see few practical issues with implementing Option 2. We just think it is a bad idea.

B3Q1 – Feedback on Option 3

Broadly speaking, we prefer a moderate increase in the cap as contemplated under our modified Option 1. However, Option 3 could be a viable alternative. While we agree that operating risk associated with growth of funds under management does not stop above a certain threshold, the additional risk is marginal. Thus, if a higher cap were to be contemplated, we would suggest that the percentage of fund assets required to be held would need to be substantially reduced under a tiered system.

By way of example, an amendment to maintain the ratio at 0.5% of the average value of fund assets up to $1 billion (equal to $5 million) and an additional amount equivalent to 0.1% of the average value of fund assets above $1 billion might make sense. Thus, for a $2 billion asset pool, the responsible entity would require NTA of $6 million.

B3Q2 – New cap

We do not have a fixed view on this issue. It may be appropriate not to have any cap, though this would probably need to be phased in over time.

B3Q3 – Objectives

Both Option 1 (with escalation from 2023) and some modified version of Option 3 may be appropriate. Any significant increase in the maximum should be phased in over time.

B3Q4–B3Q6

The changes will have no immediate impact on our business.

Moderate changes have limited impact on the industry, but large increases could increase costs for investors and marginally reduce competition.

We do not see any practical difficulties with pursuing a tiered approach as we have suggested, as an alternative to Option 1.

B4Q1 – Cash and liquid assets

Current liquidity requirements are appropriate and are not required to be materially altered.

B4Q2 – Option 1 cash

It would make sense to increase the minimum cash requirement in line with our suggested Option 1 methodology (escalation from 2023).

B4Q3 – Option 2/3 cash

We do not support Option 2. We prefer our modified Option 1, to Option 3.

Whatever Option or variation is ultimately chosen, it makes sense that the minimum cash amount and proportional allocation required to cash/other liquid assets be maintained. So, for example if the maximum cap were increased to $6.9 million, holding 50% in cash and the balance in other liquid assets would make sense.

B4Q4 – Calculation

Current liquidity requirements are appropriate and should not be materially altered.

B5Q1–B5Q2 – Transition

A transition period is essential. The amount of the increase will determine the appropriate length.

Increases in line with our preferred approach can be implemented within 6 months.

Larger increases will require a minimum of 12 months. This is because responsible entities that are affected are likely to have to undertake structural changes to meet the requirements (e.g., capital raising, business restructuring, fund restructures/wind ups etc.). It would be difficult to implement such changes within 6 months, given the requirements to understand the changes, obtain advice, make business decisions and implement the changes. For many responsible entities, particularly boutique businesses, the changes required will be fundamental.

B6Q1–B6Q2 – Alternatives

We do not have any further alternative suggestions.

C1Q1 – Concessional NTA

We strongly support retaining the concessional framework where custodians are used.

The current process works reasonably well across the industry. The separation of assets is an important feature of retail managed investment schemes. Removing the concessional framework would have two consequences.

For those responsible entities that could meet the higher requirement, it would be significantly more efficient to hold assets in house and no longer appoint an external custodian. That has substantial risk implications for investors, with increased risk of fraud, misuse of assets or mistakes leading to investor loss.

For all other responsible entities, including Affluence, such a change would call into question the viability of the business. In our case, we would need to make some very difficult decisions about whether to continue a business we have developed over 10+ years, built around a strong alignment with investor needs. Our only viable alternatives would likely be appointing an external responsible entity, transitioning all our retail schemes to wholesale schemes, winding the business up or selling to a larger operator. All of those would potentially have negative implications for investors in our funds.

C1Q2 – Changes

No material changes are required in our view.

D1Q1–D1Q3 – IDPS/CCIV

We support alignment between requirements for responsible entities, IDPS operators and corporate directors of CCIVs.

D2Q1–D2Q3 – Other licensees

We are not aware of any particular difficulties with the requirements for licensed custodial service providers.

Greater priority should be given to reviewing wholesale structures where regulatory gaps are more significant.

D3Q1

The significant and increasing gap between NTA and other requirements for wholesale schemes vs retail schemes are of significant concern to us. ASIC and/or the Government must consider introducing more stringent requirements for wholesale operators, in order to address the current regulatory arbitrage.

In the course of our business, we review a wide range of financial products from both retail and wholesale managers. We see three core issues:

The level of NTA required for wholesale managers can be as little as $50,000, while assets under management is often in the billions, and effectively can be unlimited. This minimal NTA requirement needs to change.

Disclosure for wholesale funds can be extremely poor. Key areas requiring reform are disclosure of fees and costs and disclosure of fund performance. Fee and cost disclosure standards applicable to retail schemes should be extended not only to wholesale schemes, but also to other investment entities, such as Listed Investment Companies. Performance disclosures need substantial reform. We regularly see performance disclosures that we consider misleading or deceptive. Examples include showing performance before fees and costs, showing selective performance periods, comparison with inappropriate benchmarks and showing total returns instead of annualised returns. Disclosure of performance should be standardised across all types of investment entities.

Finally, the financial thresholds for qualification as a wholesale investor need reform. This issue has been looked at previously, but nothing has been done. In particular, the assets limb of the test needs to be reviewed, and the principal place of residence excluded from the test.

These changes need to be made prior to any substantial increase in NTA requirements for responsible entities coming into effect. Otherwise, the likely impact will be a significant movement away from retail schemes into wholesale schemes, and a significantly higher risk of funds being mis-sold to investors.

5. Conclusion

Affluence supports a measured and evidence-based approach to reform of the NTA framework. But in our view, the current framework already broadly achieves its stated objectives, as ASIC concluded in 2023.

While there is merit in maintaining the real value of thresholds through CPI indexation and considering modest adjustments at the upper end, there is no clear justification for material increases to minimum NTA levels or structural changes such as per-scheme requirements.

Doing so would risk producing outcomes that are contrary to ASIC's objectives. In particular, they are highly likely, in our view, to reduce competition, increase costs for investors, and encourage migration into less regulated parts of the market. The larger the increase in NTA requirements, particularly at the smaller end of the market, the larger the adverse impacts are likely to be.

We consider that a more effective regulatory priority would be to address the significant disparity between retail and wholesale regulatory frameworks.

We would welcome the opportunity to engage further with ASIC on these issues. Together with my colleagues at Affluence, I am passionate about achieving the best possible outcomes for investors. We are happy to help in any way we can.

Yours faithfully

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Director, Affluence Funds Management Limited