ASIC Australian Securities & Investments Commission

ASIC MINISTERIAL SUBMISSION TO THE HON STEPHEN JONES MP, ASSISTANT TREASURER & MINISTER FOR FINANCIAL SERVICES

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MANAGED INVESTMENT SCHEMES

TIMING: FOR INFORMATION ONLY

PURPOSE

This briefing:
- provides an overview of the funds management industry, its regulation and the potential harms to investors;
- provides an overview of ASIC's regulatory work in relation to the funds management industry; and
- outlines potential regulatory changes to better protect consumers from financial loss while balancing the need for a competitive funds management industry.

This briefing follows your meeting with the ASIC Chair on 13 July 2022 and recent discussion with Treasury.

KEY POINTS

- Australia's $2.7 trillion funds management industry is complex and diverse. The industry provides investment management services to both retail and wholesale investors, with investment products ranging from simple, low-risk products through to highly speculative, high-risk products.

- By international standards, the Australian regulatory regime for funds management is open and liberal. Provided that an appropriately licensed entity operates a managed investment scheme and adequate disclosure is made of the nature, benefits and risks of the scheme, almost any type of investment can be sold to Australian retail clients.

- Over the years, we have seen a number of high-profile managed investment scheme collapses, including a number of agribusiness schemes, Westpoint and Sterling. All of these scheme collapses have resulted in significant financial losses to retail investors.

- Against a backdrop of global inflationary concerns and rising interest rates, assets classes are being repriced. This may result in future significant underperformance or failure of an increasing number of managed investment schemes.

- In order to better protect retail and unsophisticated wholesale investors, ASIC considers that the Government could consider regulatory reforms which would have the effect of:
  - s 47C [redacted];
  - improving the liquidity and withdrawal regime for schemes;
  - establishing a tailored insolvency regime in the event of scheme collapses;
  - enhancing ASIC's powers to collect data from the sector to increase transparency about the sector and improve the targeting of ASIC's regulatory action; and
  - amending the definition of "wholesale" client. This is a broader issue and is the subject of a separate brief.

- ASIC has discussed these potential reforms with Treasury and we understand that there is likely to be a review into the regulation of managed investment schemes in 2023. ASIC looks forward to working with Treasury and participating in this review.

Karen Chester
Deputy Chair
M: s 22 [redacted]

Joanna Bird
Executive Director, Financial Services and Wealth
M: s 22 [redacted]

A. OVERVIEW OF THE FUNDS MANAGEMENT INDUSTRY AND ITS REGULATION

1. The funds management industry in Australia is large and growing. There are approximately 435 responsible entities, 3,640 registered managed investment schemes and 1,832 wholesale trustees. The total value of all assets held in managed investment schemes is approximately $2.7 trillion with 5% of overall funds under management held by retail clients and 54% of all superannuation assets invested in managed funds.[1]

2. In a managed investment scheme:
   - multiple investors contribute money or money's worth and get an interest in the scheme. "Interests" in a scheme are a type of financial product and are regulated under the Corporations Act);
   - money from the different investors (often many hundreds or thousands of investors) is pooled together or used in a common enterprise; and
   - a "responsible entity" (also referred to as a "fund manager") operates the scheme. Investors do not have day-to-day control over the operation of the scheme.

3. Managed investment schemes cover a wide variety of arrangements and underlying assets. Some examples of managed investment schemes include:
   - financial asset schemes, such as cash management trusts, Australian equity (share) schemes, international equities schemes and exchange traded funds (ETFs);
   - property schemes;
   - mortgage schemes;
   - commodities schemes;
   - crypto-asset schemes;
   - litigation funding schemes;
   - agricultural schemes;
   - horse-breeding and horse racing schemes;
   - time-sharing schemes; and
   - management rights and serviced strata schemes.

4. Managed investment schemes offered to retail clients that have more than 20 members or are promoted by a person in the business of promoting schemes must be registered with ASIC and are subject to additional regulation under Chapter 5C of the Corporations Act. Schemes offered to wholesale clients only are not required to be registered (i.e. unregistered schemes).

5. ASIC's role in relation to regulating managed investment schemes includes:
   - assessing Australian financial service (AFS) licence applications submitted by entities seeking to be operators of registered and unregistered managed investment schemes;
   - assessing applications for registration of managed investment schemes;
   - exercising ASIC's administrative powers in relation to AFS licences and disclosure;
   - providing guidance to industry;
   - providing relief from provisions of the Corporations Act where necessary and appropriate;
   - undertaking proactive and reactive supervision and surveillance activities into operators' conduct and compliance with disclosure obligations; and
   - taking regulatory action in response to non-compliance with the laws administered by ASIC.

6. ASIC's specific focus areas in relation to the regulation of the funds management industry for the 2022/2023 financial year are outlined below in Part C of this paper.

7. Importantly, ASIC's role does not involve preventing all consumer losses or ensuring compensation for consumers in all instances where losses arise. ASIC's underpinning statutory objectives, regulatory tools and resources are not intended or able to prevent many of the losses that retail investors and financial consumers will experience. This is true of every financial market regulator.

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[1] These figures are sourced from ASIC's industry funding model data and the report *Competition in Funds Management* (September 2021) prepared by Deloitte Access Economics on ASIC's engagement. The superannuation data cited does not categorise the domicile of the managed funds and may include offshore investment.

8. **Attachment A** provides a more comprehensive overview of the managed investment scheme regulatory framework.

B. HARMS

9. By international standards, the Australian regulatory regime for funds management is open and liberal. The heavy reliance on disclosure to protect consumers means that, provided an appropriately licensed entity operates a managed investment scheme and adequate disclosure is made of the nature, benefits and risks, almost any type of scheme can be sold to Australian retail clients. In comparison, under overseas regulatory regimes, certain high-risk and illiquid schemes are restricted from sale to retail clients or the sale is subject to additional constraints (such as investment composition and reporting obligations).

10. Time and again, we have seen complex and/or high-risk managed investment schemes sold to consumers who did not understand the risk of financial loss and a number of these schemes have gone on to collapse. In some situations, the responsible entity may have complied with all relevant obligations; in others misconduct was involved. However, in both cases, consumers still lost considerable sums. Some examples include:

Name	Number of investors	Size of collapse $ (m)
Timbercorp Securities Limited	18,400	1,095
Great Southern Managers Australia Limited	47,000	1,800
FEA Plantations Limited	14,000	426
Rewards Projects Limited	8,000	291
Willmott Forests Limited	8,000	400
Gunns Plantations Limited	48,984	1,800
Trio Capital Limited	6,090	176
Sterling Income Trust	566	37.5
Mayfair 101 IPO Wealth Fund	180	86

11. In each of the above examples, the collapse of the schemes has had a devastating social, emotional and financial impact on investors, many of whom were inexperienced investors, and especially in the case of retirees and the elderly, not in a position to recover from their losses.

C. ASIC'S FOCUS AREAS FOR THE FINANCIAL YEAR 2022/2023 (FY 2022/2023)

12. Absent data collection powers (see below), ASIC's regulatory work in the funds management sector is resource intensive, largely reactive and with an inevitable time lag. In FY 2022/2023, ASIC's focus areas in regard to the managed funds industry will include:

    - **Compliance with the Design and Distribution Obligations (DDO)**. DDO came into effect on 5 October 2021. These obligations require financial product firms to design products that meet the needs of consumers and ensure those products are being targeted to the right consumers. Our actions will include testing compliance with DDO and taking regulatory action where we see non-compliance. By way of example, ASIC recently placed interim stop orders on three financial firms in response to deficiencies in the target market determination (TMD) for their products. A TMD is a mandatory public document that sets out the class of consumers a financial product is likely appropriate for (the target market). It also sets out matters relevant to the product's

distribution and review. The three financial firms did not appropriately identify the consumers they intended to target or did not have a TMD, which meant the products may have been marketed and sold to retail investors for whom they were not appropriate or too risky. The stop orders prevented the firms from issuing managed investment scheme interests and shares to retail investors until the deficiencies had been remedied;

- **Sustainable-finance-related practices**. We will take action to prevent harms arising from greenwashing and support effective climate and sustainability governance and disclosure. Our actions will include the oversight of sustainability-related disclosure and governance practices of managed funds. ASIC undertook a 'greenwashing' review of a sample of superannuation and investment products and identified some areas for improvement. Following our review, we recently issued Info Sheet 271: *How to avoid greenwashing when offering or promoting sustainability-related products*. Info Sheet 271 is designed to assist issuers in meeting their existing obligations. s 37(2)(b), s 47C, s 47E (d) [redacted];

- **The marketing of managed funds**. We will continue to take action against misleading risk and performance marketing materials. We have recently conducted a large surveillance which found that some fund managers need to do more to ensure the investment performance representations in their marketing materials are appropriate, As a result of our surveillance, thirteen investment funds managers have voluntarily corrected their marketing materials and practices across nineteen funds. s 37(2)(b), s 47C, s 47E (d) [redacted]

- High-risk property schemes. We will continue to prioritise reports of misconduct and breach reports in relation to property schemes. Where we see mismanagement of property schemes including responsible entity failures, we will take enforcement action. It is important to note, that while ASIC cannot stop corporate collapses, we can take enforcement action in relation to misconduct connected with a collapsed scheme;

- Crypto-asset schemes. We will supervise and assess the product disclosure statements and target market determinations of crypto-asset schemes. s 37(2)(b), s 47C, s 47E (d) [redacted]; and

- s 37(2)(b), s 47C, s 47E (d) [redacted]

13. Where ASIC has received sufficient information to become concerned that a managed investment scheme is not being run in the best interest of members, or the responsible entity is not complying with its conduct obligations, ASIC will consider regulatory action.

14. Regulatory action can include administrative action, such as the suspension or cancellation of an AFS licence or placing stop orders on disclosure documents and advertising material, or taking enforcement action, such as civil or criminal proceedings, including proceedings to wind-up the scheme.

D. PRIORITY AREAS FOR LAW REFORM TO ASSIST CONSUMER PROTECTION

15. The need for reforms to the regulation of the funds management industry has long been discussed and has been the subject of various inquiries such as the Corporations and Market Advisory Committee's (CAMAC) review of managed investment schemes.

16. At a minimum, ASIC considers that the reforms outlined below should be considered by Government as part of any review as they go to the heart of protecting consumers.

Restrictions on the sale of interests in managed investment schemes to retail clients

17. We remain concerned about the sale of interests in managed investment schemes to retail clients who do not understand the nature of the scheme and relevant investment risks. While DDO assists product issuers and sellers to identify and limit distribution to a target market, our regime does not go so far as other jurisdictions to restrict the sale of riskier schemes to retail clients.

18. Based on our regulatory experience, managed investment schemes that have increased complexity and/or involve highly speculative investments carry a high risk that retail investors will lose some or all of their money.

19. For example, in the case of **Sterling,** retail investors were sold a highly complex "lease for life" where their long-term tenancy was linked to the performance of an investment. Investors were told that the returns from their initial lump sum payment would be sufficient to cover the rent on their long-term lease and that they would not be asked to make any other payments towards rent. This product was both novel and high-risk. Many of the investors were elderly and did not understand the complexity and risk of the product they were sold. When Sterling collapsed, many investors lost both their life savings and their home.

20. s 47C [redacted]

21. s 47C [redacted]

Liquidity and withdrawal regime for registered managed investment schemes

22. We remain concerned about the liquidity and withdrawal regime (liquidity regime) for registered managed investment schemes under Chapter 5C of the Corporations Act.

23. Problems with the current regime were highlighted in the CAMAC Discussion Paper, *The establishment and operation of managed investment schemes* (March 2014). Examples of liquidity issues within managed investment schemes were evidenced during the **GFC** and to some extent during COVID 19. During the GFC, **97 schemes were frozen and suspended withdrawals**. Approximately 250,000 investors lost access to around $25 billion in funds for, on average, 7 years. This had a very real financial impact on these investors.

24. Investors' ability to withdraw from a registered scheme currently depends on whether the scheme is "liquid" or "illiquid." A scheme is "liquid" if liquid assets account for at least 80% of the value of scheme property. Certain prescribed assets (such as money with a bank and marketable securities) are classified as "liquid assets". Critically, any other property is a "liquid asset" if the responsible entity reasonably expects that the property can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests. This means that a responsible entity can include a lengthy period for satisfying redemptions in the constitution (e.g. up to 365 days or longer) and classify a scheme as "liquid" in disclosure, marketing and other communications to investors even though its assets would not generally be considered liquid (such as property, infrastructure and loans).

25. At a minimum, we suggest that the liquidity regime in Chapter 5C is reviewed to introduce a more precise and transparent distinction between liquid and illiquid schemes.

External administration and replacement of responsible entities

26. We remain concerned about the absence of an adequate insolvency regime for managed investment schemes in Chapter 5C and the effectiveness of the current regime for replacing responsible entities in the event of compliance failures and collapses. Problems with the current regime were highlighted in the CAMAC Report, *Managed Investment schemes* (July 2012). Based on our experience, the collapse of a scheme can have devastating outcomes for investors, and we anticipate this to be more of an issue in the next few years given economic conditions.

27. The winding up provisions that exist in Chapter 5C contemplate the orderly winding up of a viable scheme. There is an absence of clear provisions in the Corporations Act governing how the scheme should be managed in the event of insolvency of the responsible entity and/or the scheme becomes unviable, including how members and creditors should be dealt with.

28. Where a scheme is unviable court orders must be sought. This is generally costly and lengthy and results in further financial loss to investors. By way of example, the administration of **The Prime Retirement and Aged Care Property Trust** (Prime Trust) commenced in October 2010 and is still ongoing. Over 9,613 investors have been impacted and it is anticipated that only a very small amount will be returned to investors.

29. There are also limitations on the ability of ASIC or members to initiate a timely change of responsible entity in circumstances where there are compliance concerns in relation to the responsible entity. It is extremely difficult to find a replacement or temporary responsible entity given the restrictions on access the scheme's books and records and transfer of liabilities to the incoming entity.

30. We support the introduction of a comprehensive statutory external administration scheme for managed investment schemes, similar, to that which applies to companies. We also recommend a review of the restrictions that apply to members when they wish to remove the responsible entity. This would assist ASIC and/or members to intervene and replace the responsible entity where appropriate to protect the interests of members or scheme property.

Enhanced data on managed investment schemes to understand the nature of the sector and relevant risks

s 37(2)(b), s 47C, s 47E (d)

[redacted]

33. Providing ASIC with increased general powers to collect data on the sector would enable ASIC to monitor targeted liquidity, exposure and counterparty risks; detect and gain important insights into emerging risks; identify key linkages (allowing scenario analysis); assist compliance with international standards and minimise industry burden in responding to requests via ASIC's formal notice powers.

ASIC FOI 071-2024

Review of the definition of "wholesale client"

34. We remain concerned that the current broad definition of "wholesale client" facilitates the sale of interests in unregistered managed investment schemes to some clients that really require the additional regulatory protections that apply to "retail clients" under the Corporations Act. The need for reform to the "wholesale client" definition is the subject of a separate briefing. See ASIC Ministerial Briefing *2022/018 Retail client, wholesale client and sophisticated investor definitions* sent to the Assistant Treasurer's office on 17 August 2022.