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By email

Dear Director

Submission – Review of the regulatory framework for managed investment schemes – consultation

A Introduction

This submission is made by Herbert Smith Freehills (**HSF**) in response to the consultation paper examining the review of the regulatory framework for managed investment schemes (**MIS**) released by Treasury on 4 August 2023 (**Consultation Paper**).

The Consultation paper seeks feedback on a number of issues, including whether:

(a) the wholesale client thresholds remain appropriate;

(b) conditions should be imposed on certain MIS arrangements when offered to retail clients;

(c) the governance and compliance frameworks could be improved to promote the more effective operation of MIS; and

(d) the rights of investors regarding replacing responsible entities (**REs**) and withdrawing from a MIS are appropriate.

HSF is an international law firm with 24 offices located around the globe and which specialises in, amongst other things, financial services and financial services regulation. We regularly advise in relation to a wide range of issues concerning managed investment schemes, including the topics addressed in the Consultation Paper.

B Wholesale client thresholds

As we outlined in our submission to the Australian Law Reform Commission (**ALRC**) regarding its interim report on Financial Services Legislation (**Interim Report A**) in February 2022, we are generally supportive of any initiatives to simplify and modernise the distinction between wholesale and retail investors. However, we also cautioned that over-simplification could have adverse consequences for industry participants and might deviate from the legislative intention for the distinction that was contained in the Financial Services Reform Bill 2001 (Cth) (**FSR Bill**).

In our submission to the ALRC, we suggested that the purpose of the FSR Bill could be better implemented through:

(a) retaining, but updating, the existing quantum-based exemptions; and

(b) making minor amendments to the sophisticated investor tests.

We have reflected on these proposals below, as part of our responses to the questions posed in Chapter 1 of the Consultation Paper.

As a general comment, we strongly discourage implementing different definitions of "wholesale client" for MIS and for the rest of the *Corporations Act 2001 (Cth)* (**Act**). As noted in the ALRC's Interim Report A, the Act already contains several examples where the same defined term has more than one definition depending on which part of the Act it is applied to.

We consider that all market participants and their advisers would benefit from the Act containing one definition of "wholesale client" applicable for all purposes and classes of financial service, and therefore view our suggestions below as having general application.

We understand that Treasury intends to consult more broadly with other financial services stakeholders who apply and use the "wholesale client" concept (including superannuation trustees, foreign financial service providers and insurers) before implementing any change to the "wholesale client" test in relation to MIS and we would support that broader consultation.

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

As set out in the FSR Bill, one rationale for including the product value exception was that those investing more money are presumed to have the expertise and/or access to professional advice to justify their being treated as wholesale. We understand that this policy remains sound, that the product value test remains relevant today and that this test is particularly valuable to industry participants because it is easy to administer and is a binary test which can quickly and objectively confirm whether a person is (or is not) a "wholesale client".

We do acknowledge that the financial threshold for the product value test has remained constant since its inception over 20 years ago, with the consequence that significantly more Australians are now able to qualify as wholesale clients than were able to in 2001.

We understand that Treasury is considering an uplift of the current threshold from $500k to approximately $850k which reflects a consumer price index (**CPI**) increase from 2001, and we would support that level of increase. We understand that Treasury has received a suggestion to increase to the superannuation transfer balance cap which is currently approximately $1.9 million. We consider that applying that cap as the threshold is too high an uplift and that it would disrupt and distort the market to raise the threshold so significantly.

We support modest ongoing increases to the uplifted financial threshold incrementally from time to time, for example in line with CPI. We would propose a mechanism to increase the financial threshold, ideally every four or five years, so that the inefficiency, disruption and repapering that would be required by annual updates to the threshold can be avoided. Another concern we would have with applying the superannuation transfer balance cap as a proxy for this threshold is that that cap changes each year.

We note that any failure to satisfy an increased financial threshold (both the initial uplift and any subsequent increase) would have serious consequences for both investors and financial service providers. We have considered the potential consequences of wholesale clients being re-categorised as retail clients on financial service providers and investors below:

(a) Financial services providers will need to ensure that, pursuant to the authorisations under their AFSL, they are legally able to continue to provide financial services to their clients. This is particularly problematic where the AFSL holder is not authorised to provide services to retail clients under its AFSL and it may not have the experience to be able to seek a variation of its AFSL, assuming that it has the time to apply for an AFSL variation. This is not a

challenge that can simply be managed by the provider not offering any new financial products to clients who have been re-characterised as retail clients, because MIS trustees may be providing ongoing financial services to their existing clients in relation to existing products, for example:

(1) any communications in respect of the existing financial products which involve the provision of financial product advice;

(2) providing custodial services for the benefit of that retail client (which is particularly relevant for MIS trustees); or

(3) in connection with a withdrawal offer, dealing in financial products where that client disposes of its interests in the MIS.

(b) If the MIS trustee is not authorised to provide financial services to retail clients, would it then have to compulsorily redeem investors who have been re-characterised as retail clients (if it has the power to do so under the MIS constitution), which would then force the investor to exit an investment early, potentially crystallising a loss, terminating the investment exposure and denying the investor the opportunity to continue with the investment and realise it at maturity.

(c) If the MIS trustee is not authorised to provide financial services to retail clients, and is not able to forcibly exit the retail investors, it may then need to wind up the MIS, forcing all investors to exit the investment and potentially crystallising losses on an early termination of the MIS.

In our view investors who have qualified as wholesale clients prior to any changes flowing from the Consultation should be 'grandfathered' as wholesale clients for the purposes of the investments that they hold at the effective date of the changes to the wholesale client test, so that the impact of the changes applies to new investments, after the date of that change, but is not disruptive to existing investors and their investments.

2 Question 2: Should the financial thresholds for the net assets and/or gross income in the individual wealth test be increased? If so, increased to what value and why?

We consider that the qualified accountant's certificate net assets and gross income tests remain justified by the policy reasons underpinning the FSR Bill.

As with the product value test, we would support an increase to the financial threshold for the net assets test in line with CPI since 2001 or some other appropriate measure.

We would caution against any significant increases to the financial threshold for the gross income tests, noting that $250,000 per annum remains a high wage in Australia.[1]

As with the product value test, we consider that there should be grandfathering to smooth the impact of these financial threshold changes and mitigate the disruption and inefficiency that would arise if existing investors were re-categorised as retail clients.

We note that there is currently some confusion in the market as to:

(a) how (if at all) the net assets and gross income tests should be applied to trustees; and

(b) the meaning of control, particularly in the context of section 50AA of the Act.

We consider that this is an ideal opportunity to clarify both positions. Relevant issues are set out below.

Issues with the definition of control

[1] According to Forbes' article, "*Top 12 Highest Paying Jobs in Australia"* (June 2023), someone who earns more than $253,066 is in the top 1% of earners in Australia.

'Control' is relevant for two reasons, namely determining whether:

- the net income or gross assets of controlled trusts or companies can be included in a person's QAC;[2] and
- a trust or company *controlled* by the holder of a QAC can be classified as a wholesale client for the purposes of receiving a financial service.[3]

'Control' is defined in section 50AA of the Act as follows:

> *(1)….an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies.*
>
> *(2) In determining whether the first entity has this capacity:*
>
> > *(a) the practical influence the first entity can exert (rather than the rights it can enforce) is the issue to be considered; and*
> >
> > *(b) any practice or pattern of behaviour affecting the second entity's financial or operating policies is to be taken into account (even if it involves a breach of an agreement or a breach of trust).*
>
> *(3) The first entity does not control the second entity merely because the first entity and a third entity jointly have the capacity to determine the outcome of decisions about the second entity's financial and operating policies.*
>
> *(4) If the first entity:*
>
> > *(a) has the capacity to influence decisions about the second entity's financial and operating policies; and*
> >
> > *(b) is under a legal obligation to exercise that capacity for the benefit of someone other than the first entity's members;*
>
> *the first entity is taken not to control the second entity*.

The above highlighted wording means that a trustee may not technically control the relevant trust because the trustee has fiduciary duties to the trust beneficiaries.

As a general rule:

- this difficulty should not apply where the trustee is a natural person because the 'controller' (the trustee) has no 'members' and therefore section 50AA(4) should not apply;
- where the trustee is a company and the shareholders are the same persons as the trust/SMSF beneficiaries, the control test should be capable of application to a trust/SMSF notwithstanding the different capacities that apply to the shareholders and beneficiaries; and
- where the trustee is a company and the shareholders are not the same persons as the trust/SMSF beneficiaries, the trustee will not technically control the trust for the purposes of section 50AA.

We believe this unusual outcome was not necessarily intended when the regulations were introduced to add the 'control extensions' to the QAC test.

The section 50AA definition of 'control' is primarily used in the Act for determining when a company is a subsidiary or holding company of another company. The 'fiduciary carveout' in section 50AA(4) exists so that shares held by a shareholder in trust for beneficiaries should not form part of the same ownership group. This principle does not have a clear

[2] Corporations Regulation 7.6.02AC.

[3] Corporations Regulation 7.6.02AB.

purpose or meaning in the context of determining whether a person *actually* controls a trust or company, which is the appropriate issue in the context of a QAC.

We would recommend that the concept of control for the purposes of the two extensions to the QAC test is modified to remove the fiduciary carveout and rely instead on the practical control factors already embedded in section 50AA.

Trustees – personal assets or trust assets?

There is no guidance in the Act as to which assets may be included in a QAC, for example, should they include the person's:

- personal assets;
- assets held by the person as trustee of the trust to which the financial service will be provided; and/or
- assets held by the person as trustee of other trusts.

On one view, if a person is expressly and clearly entering into an arrangement or a transaction to acquire or dispose of financial products in its capacity as trustee of a particular trust (including an SMSF), the QAC should cover:

- the assets or income of the relevant trust; and
- not the trustee's own personal assets or assets of other trusts.

However, on a literal reading of the QAC provisions in the Act, the QAC simply needs to address the person's assets or income. On the face of the Act, this will extend to all assets legally or beneficially owned by the person.

We are aware of significantly varied practices adopted by industry participants in this regard and would welcome legislative clarification about what is intended. Our preference would be for all assets held by the person (other than as nominee or custodian) to be capable of inclusion in the QAC.

SMSFs versus other types of trusts

Since the introduction of Chapter 7 of the Act, there has been considerable industry and regulatory debate about whether superannuation fund trustees can be treated as wholesale clients on a basis of a QAC.

It is clear that the provision (ie. issue) of a superannuation product (such as a superannuation wrap account) to a person means that the client must always be treated as a retail client for that issue.[4]

It is also clear that the provision of other types of financial product (such as an IDPS account) can be provided to the trustee of a superannuation fund on the basis of a QAC.[5]

The more challenging question is whether financial services, such as advice and dealing, about, or in respect of, the relevant superannuation fund's investments, can be provided to the trustee as a wholesale client on the basis of a QAC. This is because the legislation effectively provides that when:

- a financial service (other than the provision of a financial product) is provided to a person (other than a trustee of a superannuation fund with at least $10 million in net assets); and
- the service '*relates to a superannuation product*', the service is taken to be provided to the person as a retail client.[6]

[4] Section 761G(6)(a) of the Act

[5] Section 761G(6)(b) of the Act, in particular the words '(other than the provision of a financial product)'.

[6] Section 761G(6)(c) of the Act.

In our view, investment services do not 'relate' to the 'superannuation product' (ie the interest of the beneficiaries in the superannuation fund). Instead, those investment services relate to the *assets* of the superannuation fund itself.

In QFS 150, ASIC adopted a conservative approach to this provision by indicating that such services would be provided on a retail client only basis. However, ASIC revised its position[7] in 2014 by withdrawing QFS 150 and stating it would not take action if the person providing the financial service determined that the trustee is a wholesale client based on the QAC test. While this is helpful, we believe it would provide certainty to industry participants if this revised view could be codified.

Certification of control

As noted above, 'control' is relevant for relevant for two reasons, namely determining whether:

- the net income or gross assets of controlled trusts or companies can be included in a person's QAC (**Extended QAC**);[8] and
- a trust or company controlled by the holder of a QAC can be the relevant wholesale client that receives a financial service (**Controlled Entity**).[9]

In the Extended QAC scenario, the relevant regulation extends the type of assets and income that can be included in the QAC. If the accountant certifies the trust or company as controlled by the QAC holder, then those assets or income may be included without the need for the service provider to 'second guess' whether the trust or company are in fact controlled. This is an effective 'safe harbour' for the recipient of the QAC.

In contrast, the Controlled Entity scenario relates to whether the controlled trust or company can itself qualify as a wholesale client. The regulation in this case refers to control in an objective (and not certified) sense – the question of control does not form part of the certificate for the purposes of the Controlled Entity scenario and therefore does not set up a safe harbour for the recipient of the QAC. This is a curious outcome given that the accountant has already certified control for the purposes of the Extended QAC.

We believe it would be appropriate to align the two relevant regulations so that the relevant accountant's certification of control can also be relied on for the Controlled Entity scenario.

3 **Question 3: Should certain assets be excluded when determining an individual's net assets for the purposes of the individual wealth test? If so, which assets and why?**

The Consultation Paper notes that other jurisdictions do not permit the inclusion of a person's residential home when calculating their net assets.

However, given the level of home ownership in Australia, which is significantly higher than other jurisdictions, particularly Europe, and that for many Australian investors, their residential home may be their primary or main asset, if an Australian investor wanted to leverage the value of their home for the purposes of diversifying their investments then we would invite Treasury to consider a two-fold test, to be applied in the discretion of the qualified accountant of:

(a) a lower net assets threshold if the residential home is excluded (such as $1 million, this number is suggested for illustrative purposes only); and

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[7] ASIC Media Release (14-191MR) https://asic.gov.au/about-asic/news-centre/find-a-media-release/2014-releases/14-191mr-statement-on-wholesale-and-retail-investors-and-smsfs/

[8] Corporations Regulation 7.6.02AC.

[9] Corporations Regulation 7.6.02AB.

(b) a higher net assets threshold if the residential home is included, (such as $3.5 million, again suggested for illustrative purposes only).

4 **Question 4: If consent requirements were to be introduced: (a) How could these be designed to ensure investors understand the consequences of being considered a wholesale client? (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?**

In our view, while the consent requirements promulgated by the Quality of Advice Review dealt specifically with financial product advice, and are not directly applicable to the MIS sector we do support the principle behind similar consent requirements for wholesale clients in the MIS sector.

Consents could be particularly useful when used in conjunction with the product value and the qualified accountant's certificate tests.

We consider that relevant consent requirements could include acknowledgements and consents in relation to some of the matters contained in the Quality of Advice Review, and other aspects of wholesale client status, such as:

(a) having received warnings that retail client regulatory and legal protections will not apply to them;

(b) not receiving a product disclosure statement (**PDS**);

(c) not having recourse to the Australian Financial Complaints Authority;

(d) not having the benefit of the design and distribution obligations (**DDO**) and understanding that the MIS issuer is not required to consider the suitability of the financial product for the investor;

(e) they understand that the value of an investment in a MIS can go down as well as up, that past performance is not a guarantee of future performance and that there is no guarantee that the investor will be able to recover the amount they invested in the MIS;

(f) they accept and understand the liquidity arrangements of the MIS (e.g. open-ended, closed-ended, redemption periods) and the risk that investors may not be able to sell their interests in the MIS at such times, or on such terms, as they had requested; and

(g) they accept and understand that as the MIS investors are wholesale clients they are not investing in a registered managed investment scheme and that the MIS they are investing in is not subject to the registered MIS rules under chapter 5C of the Corporations Act.

We propose that any such consent requirements should not apply to professional investors given their businesses and their level of sophistication and investment experience.

Of course introducing a requirement for wholesale client consents could give rise to administrative burdens and more paperwork for both MIS issuers and their clients so we suggest that the consent forms are as user-friendly as possible including:

(h) combined with the MIS application form, so that an additional form is not needed; and

(i) capable of being signed in the same way as the MIS application form, which may be by electronic signature.

Other observations – sophisticated investor test

As we noted in our submission to the ALRC, in our experience the sophisticated investor test has not been heavily utilised.

However, we consider that the sophisticated investor test may continue to provide some utility and to serve a purpose to cover a situation where a person is clearly knowledgeable about financial products (e.g. an industry professional) but does not satisfy the financial threshold or have a qualified accountant's certificate.

In our submission to the ALRC we queried whether the subjective element of the test could be replaced by:

(a) a prescribed, objective list of factors and attributes that an AFSL holder is required to run through with the client; and

(b) a list of attributes, qualifications, experience or characteristics of an investor which tend to suggest that person is a sophisticated investor.

We recognise that producing a standard form checklist to contain these lists (which could then be tailored for certain categories of financial product or service) would require a substantial investment of time by ASIC and the AFSL community and that the benefit of undertaking this work would need to be weighed up in light of the likely take up rate.

We are aware of conflict management concerns raised in relation to the use of the sophisticated investor test by product issuers. While all AFSL holders are required to have adequate arrangements to manage conflicts, we would not object if Treasury proposed to limit the use of the sophisticated investor test to use by AFSL holders who are independent of the product issuer.

C Suitability of MIS investments

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

We note the discussion in the Consultation Paper regarding the suitability of particular assets for registered schemes, and the comparisons with other collective investment vehicles across the world (such as the EU undertakings for the collective investment in transferable securities (**UCITS**)). The Consultation Paper draws out specific concerns relating to risky, illiquid, or speculative investments.

We do not support the adoption of a UCITS-style regime which would impose substantial investment restrictions on registered schemes in Australia. We note that the EU's regulatory regime has, since the publication of UCITS, been supplemented by product intervention and product suitability regimes. As part of these product-focused rules, investment firms are required to assess the suitability of each product more thoroughly and assess whether their clients are suitable for higher risk, longer term or other complex instruments. We also note the recent establishment of the long-term assets funds in the EU, which are designed to give retail clients access to long-term, illiquid assets (something which is not as permissible under the UCITS regime).

Since October 2021, Australia now has a product suitability regime through DDO which we consider to be a sufficient, and more appropriate, tool to facilitate retail investors investing in products which are likely to be suitable for them.

ASIC has substantial powers in this area (such as its stop orders and enforcement powers in relation to DDO, and its separate product intervention powers introduced in 2020), which are proving to be effective tools and shaping the behaviour and suitability awareness of industry participants through the high profile stop orders and intervention undertaken by ASIC. DDO and product intervention powers are relatively new but in our experience they are already having a significant impact and are driving change, so we propose that any suggestion that those new reforms should be supplemented with asset restrictions should be assessed in a couple of years time when their impact will have had time to 'wash through' the MIS sector.

A blanket ban on certain asset classes for MISs would effectively restrict a significant proportion of Australian investors from participating in their choice of a range of financial

products which offer different investment characteristics than low risk, highly liquid assets, and the opportunity to diversify their investment portfolio. We do not consider that restricting access to the market in such a manner is necessary or desirable. For example, many unlisted wholesale MISs offer long-term exposure to real estate and infrastructure assets which are generally illiquid but have the potential to produce strong and steady distributions and/or capital gains at the maturity of the MIS, and those commercial features are sought after by many investors as part of a diversified portfolio, despite the limited liquidity of the investment.

Recent global economic, political, pandemic and conflict events have illustrated that any investments can lose money at any time. As such, we consider that it is inadvisable to create a list of suitable and unsuitable assets for investment by registered MISs or unregistered MISs. Further, prescribing underlying assets could create a false impression that the permitted assets are 'safe bets' and lead to a general lowering of investment returns as investors place their investment savings in the 'recommended' asset classes which are low risk and high liquidity but generally generate lower returns.

If the goal is to seek to mitigate the impact of downturns or underperformance on investors, we would invite Treasury to consider how this may be best achieved through educating investors including in relation to improve investors' financial literacy, including with respect to risk, balancing risk and reward profile, diversification, liquidity etc. Would ASIC be able to add more educational resources to its moneysmart website ? Disclosure of these resources could be incorporated into the PDS content regimes so that they are to hand when an investor considers an investment decision.

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

At a high level, we consider the scheme registration process currently works well. We consider that the 14-day period for ASIC's approval gives industry participants certainty, whilst also giving ASIC an opportunity to properly evaluate applications.

We consider that the current registration process is preferable to an alternative notification process whereby ASIC is not required to review a constitution but can then direct the responsible entity of the MIS (**RE**) to make changes to the constitution for the following reasons:

(a) the current process gives more certainty to REs and investors as to the terms of the constitution at the date of launch of the relevant registered MIS;

(b) a power for ASIC to direct the RE to amend the constitution is, in our view, problematic. To force constitution changes on REs after a MIS has been launched would give rise to a level of business uncertainty that we expect most REs would find difficult to manage and could deter future launches of MIS; and

(c) a process based on fixing defective constitutions post-launch would not protect investors who had acquired interests in the scheme at launch, particularly if there is a period of time before ASIC intervenes.

We acknowledge, however, that the current registration process could be streamlined in the following ways:

(d) achieving greater consistency in approach to MIS documentation would deliver timing, operational and cost efficiencies for REs, particularly for those which have a 'group' style of constitution and where ASIC's approach to amendments needed to the 'group' constitution for registration to be effected varies from application to application. If ASIC does not already have an escalation point within the ASIC registration process to a team that has visibility over all registration applications and ASIC's 'house view' and current practices, then perhaps that would be a process change which may assist ?

(e) in our view, there is often a disconnect between the level of detail of the content requirements of a scheme's constitution under the Act and under ASIC's regulatory guidance (RG 134). Having more objective criteria (e.g. as to adequacy established through new Corporations Regulations), which expand upon, and codify, the content requirements contained in the Act may assist in terms of promoting efficiency, consistency and more predictable outcomes for industry participants, and may assist ASIC in completing its review within the prescribed timeline?

(f) in order to allow REs sufficient time to respond efficiently to changes requested to the constitution, if ASIC could implement a policy of providing its issues/required amendments to the scheme documentation by a fixed time, ideally 2 business days before the end of the 14 days application processing period, that would be very helpful.

On a separate note, we understand that some investors may not understand that ASIC's approval of a MIS for registration is the completion of a legal step without any review or consideration of the MIS' investment strategy, management or prospects and that some investors have placed false confidence from the scheme's registered status (which would be exacerbated if ASIC or Treasury were to publish a list of "approved" investments or asset classes, as noted above).

We consider that it could be made clearer to investors in a MIS PDS that the registration of the MIS does not mean that ASIC has approved the investment strategy of the scheme, or verified the competence of the RE, and that ASIC gives no opinion or recommendation on an investment in the MIS. This warning could be added to the PDS content requirements for both long form and short form PDSs and could be prescribed as a warning which needs to be prominent e.g. on the front cover or inside front cover page.

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

As noted above, we consider that the current regime is appropriate and, subject to our proposals to streamline the review process, we do not have any other recommendations to amend it (including with respect to ASIC's powers to refuse to register a scheme).

D MIS governance and the role of the responsible entity

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

In our view, no changes are required. We note that the Act already prescribes a range of obligations on REs which are aimed at promoting good governance, such as:

(a) the obligations under Chapter 5C, not only on the RE but also on the directors and officers of the RE;

(b) as a holder of an AFSL, the obligations contained in Chapter 7 including the duties of an AFSL holder under section 912A of the Act, almost all of which are now civil penalty provisions; and

(c) the standard conditions on the RE's AFSL.

In our view, enhancements to scheme governance and compliance cannot be achieved through imposing further legislative or regulatory obligations.

Increased monitoring, supervision and oversight by ASIC may be a more effective and efficient way to improve standards of governance and compliance across the MIS sector.

9 **Question 9: Should ASIC be able to direct a responsible entity to amend a scheme's constitution to meet the minimum content requirements, similar to the CCIV regime?**

We note that ASIC already has adequate powers to review a constitution, and request changes, prior to the MIS' registration. We do not support a power for ASIC to be able to direct an RE to amend a MIS constitution following that MIS' registration.

As noted in our response to question 6 above, there is a significant degree of difference between the Act and ASIC's regulatory guidance regarding the content requirements for a MIS constitution. The current registration process enables ASIC to require that a constitution include a provision or level of detail which ASIC considers to be consistent with RG 134 but which is not specifically required by the Act but post registration ASIC should not be in a position to require such changes.

We would not support a position where ASIC could direct an RE to amend the MIS constitution after registration, likely after the MIS has been launched and marketed, and investment sought from investors. . To force changes on REs after a MIS has been launched would give rise to a level of business uncertainty that we expect most REs would find difficult to manage and could deter future launches of MIS.

10 **Question 10: Are changes required to the compliance plan provisions to ensure compliance plans are more tailored to individual schemes? If so, what changes and why?**

We do not consider that changes are required to the compliance plan provisions. Compliance plans are already required to be "adequate", which we consider necessarily incorporates an element of "tailoring" to the individual scheme.

The requirements in the Act are supported by ASIC's detailed regulatory guidance relating to compliance plans (RG 132). We note that RG 132 was updated in July 2018 and June 2022, which (in our experience) has resulted in a significant increase in the length and complexity of compliance plans. We do not consider that further changes in this area are warranted or desirable at this stage.

11 **Question 11: Should auditors be legislatively required to meet minimum qualitative standards when conducting compliance plan audits? If so, what should these standards be and why?**

As a general observation, in our experience auditors are robust in their review of an RE's compliance plan.

We would defer to the audit industry for their views as to whether minimum standards are appropriate (e.g. whether auditors should be required to hold specific qualifications or maintain a specific level of continued professional development in AFSL compliance).

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

A RE currently has the choice to have:

(a) a majority of external directors and no compliance committee; or

(b) a minority of external directors and a compliance committee.

We favour this flexibility which allows REs to apply board and compliance arrangements which suit their circumstances, resources and business needs. We regularly work with REs who apply both of these models and have seen that both models can work well and have benefits and disadvantages, and that there is no one clear model which is superior.

The role of a RE board is far broader than that of a compliance committee - there are a range of matters that a board considers which do not necessarily require the "detached supervision" that independent directors may bring. This gives rise to three distinct considerations:

(c) comingling the usual functions of the board and compliance functions and dismantling a compliance committee might dilute the overall compliance function and the supervisory role that the independent directors are intended to undertake;

(d) independent directors, whose backgrounds tend to not be in compliance roles, may lack detailed MIS experience and the expertise required to deliberate on operational and commercial MIS compliance matters. In our experience, RE boards comprise individuals with significant skill and experience across many facets of industry but compliance committee members are generally drawn from compliance backgrounds and have a depth of experience and knowledge in relation to MIS compliance matters and are adept at asking the probing questions of management needed to be effective in that compliance role. It may be in members' interests for day-to-day decisions to be made by experienced directors and for the compliance activities to be undertaken by those with that specialist compliance knowledge and skill; and

(e) in the context of REs, a compliance committee has specific monitoring and reporting obligations which are arguably better served through dedicated meetings of that committee, rather than pervasively in all board meetings.

An RE's directors are subject to a range of legal duties (e.g., their directors' duties under the Act and their fiduciary duties at common law, including the specific duty to prioritise the interests of members). We consider that these duties are sufficient to ensure that directors make decisions that are free from personal influence or bias, without needing the board to comprise a majority of independent directors.

We also consider that requiring REs to have a majority of independent directors would have practical implications, such as:

(a) increasing costs of the RE's operations, which would need to be passed on to MIS members. We submit that, if there were to be a requirement to have an independent board (which we do not consider to be warranted and do not support), that this requirement should be limited to large MIS whose gross assets exceed a threshold, which would be better able to absorb such costs; and

(b) potential over-boarding of directors, where a small number of best-in-class non-executive directors are appointed to a large number of RE boards. Over-boarding reduces the capacity of each director to devote the necessary time to each RE, which reduces their ability to effectively scrutinise board performance.

For the reasons set out above, we submit that REs should not be required to have a majority of external board members and that the current regime be retained.

E Right to replace the responsible entity

13 Question 13: Are any changes required to the voting requirements or meeting provisions that allow members to replace the responsible entity of a listed scheme?

No changes are required in our view specifically for listed schemes.

However we consider that there would be certainty and efficiency gains if sections 253E, 252B(1) and 252D(1) of the Act were to be amended as follows:

(a) **Section 253E**: we request that Treasury considers amending this section to reflect the judicial interpretation set out in *AMP Life Ltd v AMP Capital Funds Management Ltd & Anor*[10], i.e. that none of the RE or any of its associates can

[10] [2016] NSWCA 176

vote on a resolution where *any of them* has an interest in that resolution or matter; and

(b) **Sections 252B(1) and 252D(1)**: we submit that these sections should be amended to empower members to requisition a meeting to consider an ordinary resolution (in addition to special and extraordinary resolutions), provided that the relevant thresholds set out in these sections have been satisfied.

14 Question 14: Are any changes required to the voting requirements or meeting provisions that allow members to replace the responsible entity of an unlisted scheme?

We note that unlisted MIS take many separate forms, including open-ended and closed-ended, fixed term fund structures.

Where a MIS is open-ended (i.e. investors have a right to redeem on a regular basis), the process to remove an RE is less relevant as investors who no longer support the RE can exit the MIS.

Where a MIS is closed-ended (i.e. investors are typically locked in for a fixed period), the removal of an RE may be a more pertinent issue for investors. However, such MIS structures are typically used for illiquid, long-term assets, where early removal of an RE is likely to be financially detrimental to that RE who may have incurred and absorbed considerable costs in establishing and promoting the MIS in the expectation of being able to receive management fees for a period.

We consider that both this background, and the need to balance the commercial interests of both REs and investors are all relevant factors when considering removal rights for unlisted MISs.

Currently a change of RE proposal for an unlisted scheme requires an extraordinary resolution, passed by at least 50% of the total votes held by members of the scheme who are entitled to vote.

Historically we have seen examples of change of RE proposals failing to be passed in relation to some widely held MISs because of unitholder voting apathy and the no voting policies of platform operators. In recent times, including after the reforms promoting online meetings, we have not observed change of RE proposals failing to be passed so we query whether historic concerns about the difficulty of achieving an extraordinary resolution hold true today.

If any reforms were contemplated for the change of RE process we would encourage:

(a) the undertaking of some statistical analysis in relation to how many extraordinary resolutions are proposed and fail and how many are proposed and passed over the last say 5 years; and

(b) any change to be moderate. Significant change would risk making the role of an RE more tenuous, which could destabilise the market. We would not propose any changes to the voting threshold for wholesale MISs or closely-held MISs. If, following further consultation with the industry participants, it was found that the current extraordinary resolution threshold creates a genuine barrier for members of widely held MISs (e.g. where an MIS has 200 or more members) to be able to replace an RE, we consider that this could be addressed through amending the threshold to remove an RE to a special resolution (i.e. a 75% majority of members who are able to vote and do vote for the resolution).

We also submit that standard ASIC relief in respect of meetings to replace an RE in favour of a related body corporate of the RE should be codified, for example:

(c) as an alternative to a meeting, the RE should be able to notify members of a proposed change of RE to a related body corporate of the RE which will occur without a meeting on a specified date unless a specified number or percentage

of members request a meeting or a ballot by returning a form included with the notification; and

(d) a meeting should not be required where none of the members may vote because of the operation of section 253E of the Act.

15 Question 15: In what circumstances should an existing responsible entity be required to assist a prospective responsible entity conduct due diligence?

We note that the Act already provides for an outgoing RE to hand over books and records to the new RE following a change of RE.

In the context of whether an incumbent RE should assist a prospective RE to take over the management of the MIS we submit that the statutory obligations of an incumbent RE including to act in the best interests of the MIS members and prefer the interests of members provide adequate protection for investor in a MIS and do not need to be supplemented by a duty to allow a competitor RE to undertake due diligence on the RE's arrangements and the MIS's contracts and assets.

The incumbent RE has a reasonable and legitimate commercial interest in protecting its management role and not allowing competitors to access confidential MIS information.

We submit that requiring all incumbent REs to assist potential replacement REs with due diligence exposes MIS members to the risk that prospective REs may seek a change of management in their own best interests, for financial gain for the RE's shareholders or with a view to gaining access to commercially sensitive information and for motives that are unrelated to the best interests of the MIS investors.

The prospective RE has other methods at its disposal to be able to undertake due diligence:

(a) in the event that some MIS investors are not happy with the incumbent RE, 100 members or members holding 5% of the units can requisition a general meeting and move a resolution to require the RE to allow a prospective RE to access the books and records of the MIS. If that resolution is passed, that is an indication of the best interests of the members and the RE would need to comply with that resolution under its best interests of members duty;

(b) a prospective RE can readily access the register of members of a registered MIS under section 173 of the Act and use the register to contact unitholders to gauge the level of support for a change of RE and to requisition such a meeting; and

(c) a prospective RE can use the register to source sellers of units and then convene the meeting itself once it acquires 5% of the units.

We also consider that a prospective RE has other means at its disposal to obtain information about the relevant MIS, such as:

(d) for listed registered schemes and for unlisted registered schemes that are disclosing entities (i.e. have more than 100 members and offered the units under a PDS), the RE's continuous disclosure obligations require the disclosure of information that would have a material effect on the price or value of the units; and

(e) all REs or trustees of MISs are subject to the obligations to keep any PDS on issue up to date under section 1012J of the Act and to provide updates to unitholders about material changes and significant events under section 1017B of the Act.

Together these disclosure obligations would result in a flow of information which would assist prospective REs to assess the value and risks associated with the relevant registered schemes.

16 Question 16: Should there be restrictions on agreements that the responsible entity enters into or clauses in scheme constitutions that disincentivise scheme members from replacing a responsible entity?

We consider that there are already sufficient protections in the Act and the ASX Listing Rules which would make it difficult for REs to enter into such an agreement, such as:

(a) for listed registered schemes, the ASX requirements as to these types of arrangements informing the ASX's decision as to whether an entity is suitable for listing;

(b) for unlisted registered schemes, the disclosures in the PDS should cover the material contracts of the MIS and the terms of the RE's appointment, including any fixed term, automatic renewal rights or termination fees;

(c) once the registered scheme has been established, any attempt by the RE to amend the constitution to entrench its position would need to comply with the RE's duty to act in the best interests of members; and

(d) in the case of a RE entering into a long-term management agreement with a related party, in an attempt to entrench the current RE, that related party contract needs to be on arm's length or approved by members by virtue of sections 601LA and 601LC of the Act. In addition, as an AFSL holder, the RE needs to consider its duties regarding conflicts management when entering into such related party contracts.

If the RE makes it too difficult for it to be replaced as the RE of a new MIS it is launching (e.g. through a management agreement termination fee), that may deter investors from invest in the MIS, so there are also commercial and market checks and balances which naturally limit REs putting arrangements in place to disincentivise the removal of the RE.

What constitutes a reasonable or appropriate degree of termination protection for an RE will depend on the facts of the relevant scheme, such as the liquidity profile, the returns profile and the level of resources expended by the RE to establish and grow the scheme. In our view, a one-size-fits-all approach is not appropriate.

F Right to withdraw from a MIS

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

While MIS issuers have largely adapted to the current 'liquid'/'non-liquid' regime, we consider that there are aspects of the definition of liquid assets that would benefit from further clarification, namely:

- when the RE should test for whether the scheme is liquid;
- the meaning of "period specified in the constitution for satisfying withdrawal requests"; and
- the reference to "them" in s601KA(5).

The changes we have outlined in this answer to question 17 should be read in conjunction with changes to the withdrawal procedures and labelling of the 'liquid'/'non-liquid' regime, which we have outlined in questions 18 and 19 below.

When the RE should test for whether the scheme is liquid

Section 601KA(3) of the Act provides that the RE must not allow members to withdraw from the scheme otherwise than in accordance with sections 601KB to 601KE "if the scheme is not liquid".

Section 601KA(3) does not specify when the RE needs to test whether the scheme is liquid. As currently drafted, if a previously liquid scheme ceases to be liquid at any time

during the withdrawal timeline between members submitting requests for redemption and the payment of the amount owed to the redeemed unitholder, there is uncertainty as to whether the RE is required to cease processing the member's withdrawal.

In this respect, we note that in *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd* (2008) 67 ACSR 297 Austin J held that members' right to redeem units depends on whether the scheme is liquid on the redemption date (i.e. the date the unit was to be cancelled). This approach was also followed in *AvSuper Pty Ltd v Commonwealth Managed Investments Ltd* (2020) 81 ACSR 228.

To require liquidity to be tested by REs at this late stage introduces significant operational risks for REs who have received redemption requests and commenced the sale of assets to meet those requests, particularly for schemes that invest in longer term assets (e.g. infrastructure projects or real estate) which offer periodic redemption windows.

We submit that:

- section 601KA(3) of the Act should specify the time at which the 'liquid'/'non-liquid' test is conducted by the RE; and
- the time to test for 'liquid'/'non-liquid' in respect of a redemption of a unit should be at the cut-off time for withdrawal requests relating to the redemption of that unit (ie not on the date the unit is to be cancelled).

We submit that this approach to the timing of determining liquidity is consistent with the purpose of the section, which is to prevent some members withdrawing from a scheme in circumstances which could be prejudicial to remaining members, and protects against disruption in financial markets which could arise if the RE is under a legal obligation to sell illiquid assets quickly to satisfy redemptions: see *MacarthurCook Fund Management Ltd v TFML Ltd* (2014) 254 CLR 168 at [24] – [27].

The meaning of "period specified in the constitution for satisfying withdrawal requests"

Where a scheme invests in longer term assets and offers liquidity by way of periodic liquidity windows and the RE has outlined its plans to the scheme's members to sell specific assets to fund the particular liquidity window, the statutory provisions should not operate to prevent the RE from implementing that plan once the cut off time for submitting withdrawal requests has elapsed.

To do otherwise risks the RE liquidating investments to fund the withdrawal requests and then being faced with a situation where the RE is unable to complete the withdrawal process and the remaining assets of the scheme ceasing to be 'liquid assets' under the statutory definition.

We submit that section 601KA(6) should specify when the period commences and when the period ends.

Withdrawal procedures for schemes that invest in longer term assets which utilise periodic redemption windows typically involve:

- investors submitting requests for redemption;
- a cut off time for submitting requests;
- the RE considering and either accepting or rejecting the request for redemption received before the cut off time;
- processing the redemption, which usually involves cancelling the units at the applicable redemption price. At this stage the relevant member ceases to have investment exposure to changes in valuation of the MIS units; and
- payment of the amount owed to the redeemed unitholder.

The concept of 'the period specified in the constitution for satisfying withdrawal requests' is uncertain for schemes that invest in longer term assets and which utilise periodic redemption windows.

In this respect Austin J in *Basis Capital* and Barrett J in *ING Funds Management Ltd v ANZ Nominees Ltd* (2009) 72 ACSR 67 each found that the 'period' was the period from the date of redemption to the date stipulated in the funds' constitution for payment of the redemption proceeds following the redemption.

ASIC's interpretation of the fairness requirement in withdrawal procedures, as set out in RG 134, is that the constitution must provide that generally former members will be paid redemption proceeds within 21 days from the redemption date being the date when they cease to hold an interest in the registered scheme. This has resulted in ASIC requiring constitutions to mandate a not more than 21 day period at the time ASIC registers a scheme, regardless of whether the period specified in the constitution is otherwise compliant with s601GA(4).

To define the period in this way overlooks the commercial reality that REs will usually implement liquidity risk management procedures which will anticipate redemption demand and plan any necessary asset sales accordingly in accordance with their statutory obligation to have adequate risk management arrangements under section 912A(1)(h).

We submit that the legislation should make it clear that "the period specified in the constitution for satisfying withdrawal requests" commences at the time a request for redemption is received (or, if later, the cut off time for members to submit redemption requests) to the redemption date and is not the time period applied in *Basis Capital*.

The reference to "them" in s601KA(5)

The use of the plural term 'them' in section 601KA(5) creates further uncertainty. If a scheme holds marketable securities, the RE may reasonably expect that it would be able to realise some of those marketable securities at market value to meet the actual redemption requests it has received. However, it may be a different matter for the RE to realise all of its marketable securities at market value. Similarly, the RE of a scheme that holds a portfolio of real estate property may reasonably expect that it would be able to realise each property in isolation but would not expect to be able realise all of its real property assets at the same time.

The legislative drafting in section 601KA(5) contrasts with s601KA(6), which uses the singular 'property' and 'the property' and which is clear that the test should be conducted for each singular asset. It would be helpful if section 601KA(5) could be amended to be consistent with 601KA(6).

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

We submit that the procedures for withdrawal should be changed by:

- making the changes outlined in question 17 above and question 19 below;
- aligning the specific requirements with the general principle that withdrawal provisions must be fair to all members;
- aligning concepts and definitions; and
- distinguishing schemes that offer unconditional rights to withdraw from other schemes.

We also submit that:

(a) the rolling withdrawal offer standard relief that is offered by ASIC in ASIC RG 136 should be codified in the legislation; and

(b) there should be an avenue for registered schemes that only have wholesale client members to obtain regulatory relief from Part 5C.6 of the Act.

Other concepts to be aligned

There is also inconsistency between the idea of a 'right to withdraw' in section 601GA(4) and 'satisfying withdrawal requests' in sections 601KA(5) and (6).

Not all schemes that offer a right to make withdrawal requests necessarily give members a right to withdraw, particularly where the decision to accept or reject requests is at the discretion of the RE.

We submit that section 601GA(4) should be redrafted to include 'the right to make withdrawal requests'. As it currently stands, this position is the interpretation adopted by ASIC in RG 134 at paragraph 203, but which does not have force of law. It would be better for this to be made clear in the legislation itself or in the regulations.

Distinguishing schemes that offer unconditional rights to withdraw

We further submit that there should be additional requirements for schemes that offer unconditional rights to withdraw on a daily basis – in our view, it should be expected that those types of schemes must only hold assets that are highly liquid at all times as an unconditional right to withdraw means that many liquidity management tools (e.g. the right to cap or suspend withdrawals) cease to be available.

19 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 are not aware of investors who have experienced a mismatch in their expectations and their actual rights in relation to MIS withdrawals but such a mismatch is always possible, particular if an investor does not read or understand the PDS for the MIS and does not receive personal advice.

If Treasury identifies that such mismatches are occurring on a regular or significant basis then we would invite Treasury to consider if such mismatches may be addressed through:

- replacing the term 'liquid' in Part 5C.6 of the Act with a different term which is less likely to result in investors' confusion between the statutory concept of 'liquid' and the ordinary course concept of liquidity;
- prescribing PDS content requirements in relation to liquidity and liquidity warnings eg to include a prominent note to the effect that while a MIS may be liquid for the purposes of the Act, that does not mean that an investor can redeem at any time and setting out a summary of the limits on their redemption rights and the timing for redemption request processing and payment; and
- more detailed guidance from ASIC in relation to how liquidity limitations and factors may be addressed in the definition of the target market and in distribution conditions under DDO.

Replacing terminology

ASIC defines liquidity risk management in RG 259 as a process designed to ensure there are adequate financial resources to meet the financial obligations and needs of the funds operated by a fund operator.

The statutory concept of a 'liquid' scheme in s601KA is different from the concept of operational liquidity described in RG 259, particularly where there is a period specified in the constitution for satisfying withdrawal requests.

The statutory concept's technical approach to 'liquidity' focuses purely on realising assets within a set time, and does not take into account the broader factual matrix surrounding the process of liquidating non-cash assets and redeeming investors, for example the

ability of REs to manage liquidity by new inflows or by drawing down debt. By focussing only on realising assets, it does not take account of other operational hurdles to redeeming investors, such as whether under the RE's financing covenants, the proceeds of sale of scheme assets need to be used to pay down debt before any balance can be paid to the redeeming unitholders.

In practice there can be many situations where:

(a) schemes have sufficient liquid assets to meet existing redemption requests but are not able to do so because less than 80% of their assets meet the statutory definition of 'liquid asset'; or

(b) schemes technically do meet the statutory definition of 'liquid' but are unable to process the volume of redemptions received because it is impractical to realise the number of assets required.

The consequence of a scheme ceasing to be 'liquid' for the purposes of section 601KA is that the RE must not allow members to withdraw from the scheme otherwise than in accordance with ss601KB to 601KE.

However, just because a scheme remains 'liquid' for the purposes of section 601KA does not mean that members have the right to withdraw on request, without restriction, and on short notice.

If there are mismatches in expectations and understanding arising as a result of the terminology used, a combination of changing that terminology and additional disclosure may reduce those mismatches occurring.

We note for completeness that:

- if a scheme is not 'liquid' for the purposes of the Act, that is not necessarily a bad thing for an investor, and may be an incident of having investment exposure to long-term assets such a real estate or infrastructure, where the investment is chosen by the investor after having weighed up its reduced liquidity against its risk/return and distribution profile;
- depending on the asset classes of the MIS, it may be entirely reasonable and appropriate for the RE to apply a long redemption period and that may be satisfactory for investors seeking access to those asset classes;
- the legal consequence of a scheme not being 'liquid' is not necessarily appropriate because it means that all long-term asset funds will need to offer withdrawal offers instead of redeeming one investor, which may not be in members' best interests; and
- replacing the term 'liquid' and using other terms which describe the redemption rights of investors may assist the relevant scheme to be marketed with fewer mismatches in liquidity expectations. Alternatively, schemes that describe themselves as liquid could be required to use industry standard terms to summarise their redemption periods and time to redemption payment (eg weekly, monthly, quarterly and annually).

In our view, provided that appropriate disclosure is made, a registered scheme that invests in long-term assets should be able to offer withdrawal rights to one or more investors with a lengthy withdrawal period (e.g. 2 years or more) without the need to make a withdrawal offer to all investors.

In addition, in normal market conditions, the RE of such long-term asset funds should not be restricted by the legislative framework from offering limited, capped liquidity to investors funded by other sources of liquidity (e.g. inflows from new applications) without the need for a formal withdrawal offer.

G Winding up insolvent MIS

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

In our view, no. Section 601GA(1)(d) of the Act requires the constitution of a registered scheme to make adequate provision for winding up the scheme. In the case of unit trusts, we consider that this is sufficient to require the constitution to provide for procedures to address the RE realising scheme property, paying creditors and distributing the balance (if any) to scheme members pro rata to their interests in the scheme.

We note that managed investment schemes by their nature are not separate legal entities. Properly analysed, where the scheme takes the form of a unit trust, scheme liabilities are personal liabilities of the RE and the RE has a right of indemnity out of scheme property for the liabilities, which may be subrogated by creditors of the RE, subject to the contractual limitations of liability in the contract with the creditor. If the liabilities of the RE exceed the RE's assets (one of the assets being the right of indemnity), it is the RE that is insolvent and as a public company, the Act applies to the RE's insolvency.

Where the liabilities attributed by the RE to the scheme exceed scheme property, we consider that it should be open to the RE to consider that the purpose of the scheme cannot be accomplished and that the RE may take steps to wind up the MIS under section 601NC of the Act.

For so long as the RE is not also insolvent at that time, there should be no requirement for external administrators to be involved.

Where the RE is also insolvent, any winding up of the scheme will be undertaken by the external administrators of the RE.

We make no comment on contract schemes and expect that what would be appropriate in the circumstances will depend on the nature of the contract scheme.

21 Question 21: Would a tailored insolvency regime for schemes improve outcomes for scheme operators, scheme members and creditors? Are there certain aspects of the existing company and CCIV insolvency regimes that should be adopted?

For the reasons in the answer to question 20, we consider that a tailored insolvency regime is not required or appropriate.

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

For unit trust schemes, the limitation of liability of members is dealt with by:

(a) appropriate provisions in the unit trust deed: see *McLean v. Burns Philp Trustee Co Pty Ltd*, [1985] 2 NSWLR 623; and

(b) state Trustee Acts e.g. section 100A of the *Trustee Act 1925* (NSW).

We would be supportive of introducing a provision in the Act similar to section 100A of the *Trustee Act 1925* (NSW) for schemes structured as unit trusts. This would protect unit trust MIS members where the limitation language was not included in the MIS constitution.

For contract schemes, where the scheme member may be the contracting party, the issues may be different (for example, the member may specifically pledge their assets) so any such limitation of liability regime would not work.

H Commonwealth and state regulation of real property investments

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

The issues that arose in the Sterling Income Trust case study appear to have come about because the RE misunderstood the effect of State law and failed to make proper disclosures to investors.

While the administration of the registered scheme is subject to the Act, the assets of the scheme will be subject to the relevant local law.

We note that the Act already contains provisions regarding the proper disclosure of material risks in the PDS and requiring the RE to act with reasonable care and diligence in managing the scheme's assets. These provisions ought to suffice in this regard.

We also note that there may be jurisdictional issues (e.g. under the Australian Constitution and the reservation of powers) to address if provisions were sought to be introduced in the Act which impact on reserved matters for State parliaments.

I Regulatory cost savings

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

We consider that the regulatory framework could be modernised and streamlined in the following manner:

(a) transitioning away from ASIC's requirement for wet-ink signatures, to permitting forms, document and other submission to be signed electronically (including by way of DocuSign and other similar technologies). We note that electronic signatures are now recognised, and are legally permitted, across Australia. Requiring wet-ink signatures can cause delays, additional costs and inefficiency which should not arise in the modern world of global financial services providers;

(b) removing ASIC's requirement for certain documents to be witnessed (eg statements of personal information to support an AFSL application) where those documents are not deeds and are not required by law to be witnessed;

(c) we would welcome the requirement for compliance plans and compliance audits to be lodged with ASIC in hard copy to be removed. This process, which uses inefficient, costly and environmentally less friendly processes, is out-of-step with modern practices; and

(d) we would also support any amendments to increase efficiency in the filings process, such as requiring all electronic lodgements and accompanying documentation to be submitted through the same online portal, rather than using a combination of different portals and postal systems.

We consider these changes could be made across the regulatory framework, including for all ASIC forms, rather than just the MIS sector.

We also consider that the content requirements for a PDS could be revisited to simplify the disclosure document and make it easier to read and understand. The order of information in a short form PDS may benefit from being rearranged to give prominence to certain provisions of the relevant registered scheme, such as:

- key features (e.g. subscription frequency and pricing, redemption frequency and periods, investment policy); and
- key risks including any arrangements limiting the ability to remove the RE,

accompanied by a more flexible and user-friendly approach to fee disclosure, but we appreciate that PDS disclosure review would be a large and time consuming project.

As noted above, there may be some opportunities to supplement the PDS content tests to:

- clarify the role of ASIC in approving the registered scheme and that the registration of the MIS does not mean that ASIC has approved the investment strategy of the scheme, or verified the competence of the RE, and that ASIC gives no opinion or recommendation on an investment in the MIS; and
- provide liquidity warnings and a prominent note to the effect that while a MIS may be 'liquid' for the purposes of the Act, that does not mean that an investor can redeem at any time and setting out a summary of the limits on their redemption rights and the timing for redemption request processing and payment.

J Tidying up changes

We would also like to take this opportunity to make the following suggestions on drafting improvements in relation to the MIS provisions.

- In section 9 of the Act, paragraph (e) of the definition of managed investment scheme contains the phrase "and to the body corporate that promotes the scheme". The meaning of "promote" in this context is not clear. We suggest either deleting this entire phrase, amending it to "and to the trustee of the scheme" or defining "promote".
- In section 9 of the Act, the definition of "interest" means a right to a benefit produced by the scheme "(whether the right is actual, prospective or contingent and whether it is enforceable or not)". This definition therefore includes applicants, transferees, optionholders and lenders (to whom security over an interest is granted). Given that a "member" is defined as someone holding such an interest, it is possible that more than one person can be a member in respect of the same "unit". This would entitle each of those persons to rights attaching to membership, e.g. the right to attend meetings and vote. Similarly we understand that ASIC considers that a person who has applied for an issue of units, but whose application has not been processed or approved, has an interest in the MIS. We do not consider these outcomes to be desirable, or to be the legislative intention, and would, therefore, suggest deleting "(whether the right is actual, prospective or contingent and whether it is enforceable or not)".
- As set out in our response to question 13 above, we suggest that:
  - ordinary resolutions be included in sections 252B(1) and 252D(1) of the Act; and
  - section 253E be redrafted to conform to its judicial construction (i.e. if the RE or an associate of the RE has an interest, neither the RE nor any associate of the RE can vote).
- We note that, pursuant to section 601FJ of the Act, a change of RE is not effective until it is registered on ASIC's register of REs. However, as that register cannot be searched by the public, REs and investors do not know exactly when the change of register takes effect by ASIC and RE's counterparties do not know when the change of RE became effective. We submit, therefore, that section 601FJ should be amended to include a mechanism so that time of change of RE is readily ascertainable.
- We note that section 601FM(1) does not specify the voting threshold where the scheme is listed. We note that common law has determined the appropriate voting threshold is an ordinary resolution. We also note that ASIC Class Order CO 23/681 enables listed fund investors to requisition a meeting to vote on an

ordinary resolution to change the RE. We suggest incorporating the Class Order into the Act.

- We consider that the deemed assumption of rights, obligations and liabilities of the outgoing responsibly entity by the incoming RE under sections 601FS and 601FT of the Act are generally working well. However, we consider that it would be helpful if these sections were amended to ensure that any inherited liability is limited to the extent to which the liability can be indemnified out of scheme property.
- As a general proposition, consideration could be given to incorporating a statutory limitation of a RE's liability to the extent to which the RE can be indemnified out of scheme property. Such an amendment would recognise that the financial entity is the scheme and not the scheme plus the RE.
- We submit that the reference to "rights" in section 601GC(1)(b) should be amended to "interests" to conform to High Court construction[11]. In *Lewski*, it was held that the word "rights" in this context means "interests".

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Thank you for providing us the opportunity to comment on the Consultation Paper. If you would like to discuss the matters raised in this submission, please contact any of us at the details below.

Yours sincerely

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Herbert Smith Freehills LLP and its subsidiaries and Herbert Smith Freehills, an Australian Partnership ABN 98 773 882 646, are separate member firms of the international legal practice known as Herbert Smith Freehills.

[11] *Australian Securities & Investments Commission v Lewski & Anor* [2018] HCA 63 (***Lewski***)