

Review of the Regulatory Framework for Managed Investment Schemes

Submission to the Australian Government - Treasury

October 2023

Contents

- Introduction 1**
- Executive Summary..... 2**
- Overview 3**
- Managed Investment Scheme complaints 3
- Significant Consumer Detriment 4
- Observations and insights 6**
- Fit for Purpose 6
- Wholesale/sophisticated investor classifications..... 7
- Ensuring Effective Access to IDR/EDR..... 8
- Information and Marketing 9
- Systemic Issue Reporting on MIS 9
- Consultation Questions 10**
- Chapter 1 – Wholesale Client Thresholds..... 10
- Chapter 2 - Suitability of scheme investments 12
- Appendix 12**
- 1. Managed Investment Scheme Complaint Data..... 12



Introduction

The Australian Financial Complaints Authority (**AFCA**) is the independent external dispute resolution (**EDR**) scheme for the financial sector. For over 25 years, AFCA and its predecessor schemes have provided fair, independent, efficient and effective solutions for Australian consumers and small business to have their financial complaints resolved.

In addition to providing solutions for financial complaints, AFCA has responsibilities¹ to identify, resolve and report on systemic issues and to notify the Australian Securities and Investments Commission (ASIC), and other regulators, of serious contraventions of the law. AFCA works closely with ASIC and regularly liaises with it to share complaint insights, to inform and assist its regulatory work.

AFCA's Code Team supports independent committees to monitor compliance with codes of practice in the Australian financial services industry, and to achieve service standards that people can trust.

More broadly, AFCA plays a key role in restoring trust in the financial services sector. Since its establishment on 1 November 2018, AFCA has handled over 367,000 complaints and delivered over \$1.07 billion in compensation to consumers. Its systemic issues work has resulted in 4.8 million people receiving more than \$340 million.

AFCA welcomes the opportunity to provide a submission² in response to Treasury's consultation on its Review of the regulatory framework for managed investment schemes (the Review). We understand the Review will examine whether the regulatory framework for managed investment schemes is fit-for-purpose, identify potential gaps, and consider what enhancements can be made to reduce undue financial risk for investors.

AFCA's submission is informed by our experience and that of our predecessor schemes. This includes our experience in resolving individual complaints related to an investment in a managed investment scheme as well as dealing with systemic issues that arise from these complaints.

¹ Refer to Part C, Reporting Requirements, of ASIC Regulatory Guide 267: Oversight of the Australian Financial Complaints Authority.

² This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.

Executive Summary

AFCA observes that managed investment schemes (MIS) contribute to a diversified investment portfolio for many Australian consumers and play an important role in the country's financial landscape. However, as Treasury's Consultation Paper notes, the MIS sector is extremely diverse with a broad spectrum of investment risk and complexity profiles across a range of schemes.

While MIS related complaints make up a relatively small volume of the total complaints made to AFCA in any given year, and consistently over time, both AFCA and its predecessor schemes have seen first-hand the significant financial impact on consumers, including many retirees, of:

- high profile MIS failures causing harm and loss
- inappropriate advice to invest in high risk and complex schemes
- schemes being wound up after the RE becomes insolvent or advice providers becoming insolvent with little avenue available to consumers to seek redress for inappropriate advice to invest in a MIS or other related issues.
- MIS with poor governance and compliance structures leading to mismanagement and consumer loss.

AFCA supports the Review's efforts to develop a robust and contemporary regulatory system for MIS. In line with these efforts, the Review presents a valuable opportunity to assess and where necessary strengthen consumer protections having regard to previous experience, reports and inquiries. This is essential to rebuilding and maintaining trust in a sector where some Australians have suffered significant financial detriment over an extended period.

AFCA supports a regulatory regime for MIS that:

1. is fit for purpose and recognises the limitations of disclosure or consumer education to overcome inherent product complexity and risk;
2. provides certainty and sets clear responsibilities and accountabilities for all participants in the design, distribution, management and oversight of MIS products; and
3. updates and simplifies wholesale or sophisticated investor exclusions and ensures that informed consent models do not exclude appropriate access to internal dispute resolution (IDR) and EDR.

AFCA's submission outlines key elements of these priorities.

Overview

Financial Year	18-19	19-20	20-21	21-22	22-23	Total
No. of MIS complaints ³	486	1,290	772	694	859	4,101

Managed Investment Scheme complaints

AFCA has received more than 4,000 MIS-related complaints since it was established⁴. Appendix 1 to this submission includes a breakdown of these complaints by scheme type and underlying issue. MIS-related complaints cover all phases of the investment journey from entry into the product through to exit. They can include complaints about:

- initial MIS disclosure documentation or marketing
- financial advice or recommendations to invest in a MIS
- issues relating to an RE's conduct in managing a scheme and responding to investor requests, and ultimately
- instances where the advice provider or RE has ceased operations or become insolvent.

AFCA also receives complaints where the complainant disputes that they met the definition of - or were informed about the consequences of being recorded as - a wholesale client or sophisticated investor under the law in order to access and invest in a particular MIS.

Under its Rules, AFCA cannot consider complaints about the management of a scheme as whole. We can also not consider complaints that are merely about poor or under-performance of a MIS and which do not involve a breach of the law by the MIS or any related party the complainant dealt with.

The MIS-related complaints AFCA receive are generally against three entities:

1. the **Financial Adviser** who recommended the product
2. the **Product Issuer**
3. the **Responsible Entity**.⁵

Financial Adviser complaints

The MIS-related complaints AFCA considers against financial advisers tend to focus on whether the recommendation to invest in the MIS was appropriate for the client.

³ For reporting purposes, 'Managed Investment' represents the high level 'Product Category'. Complaints per scheme 'Product' and underlying 'Issue', are shown in Appendix 1.

⁴ This data does not include MIS complaints against financial firms handled by previous schemes (i.e., Timbercorp / Great Southern etc.)

⁵ The RE and Product Issuer can be the same entity.

This includes where the allegation is that the adviser has misrepresented the risks and benefits, key features, fees and charges or future performance of an MIS or that the risk profile of the consumer did not match investment in the MIS.

In these matters, AFCA considers what representations the adviser made and whether these were reasonable given the available information, whether the complainants relied on the representations in making the investment and whether they have suffered a loss as a result.

MIS complaints about financial advisers also include issues about retail/wholesale investor classifications, other best-interests duty issues including suitability and appropriateness of the advice, conflicted advice recommendations and failure to disclose material information.

Product Issuer

Complaints about the product issuer generally relate to issues about disclosure documentation including Information Memoranda, Prospectuses and Product Disclosure Statements (PDS) and also about representations made in marketing or advertisements. These complaints tend to be lodged raising misleading and deceptive conduct issues.

Responsible Entity

Complaints about the RE include issues relating to the distribution of the MIS or the conduct of the operator of the MIS once the investment has taken place. The latter complaints tend to focus on:

1. the application of fees, charges and distributions, redemption/withdrawal decisions
2. the RE's conduct and whether it acted in accordance with the schemes operating rules
3. whether clients were properly classified as wholesale/sophisticated investors and therefore whether the investments should have been accepted by the RE on that basis.

Significant Consumer Detriment

AFCA and its predecessor schemes have received and/or considered many MIS-related complaints where significant consumer detriment has occurred. These include complaints about the following MIS failures, RE and advice providers:

- Sterling Income Trust
- Storm Financial
- Global Mercedes
- Future Asset Management International
- Great Southern and Timbercorp

- The Westpoint group
- The Mayfair group
- Basis Capital.

The circumstances and causes of these failures have been well documented and the subject of numerous Parliamentary and related inquiries, as summarised in the Consultation Paper. Typically, consumers in these failed schemes have been uncompensated for the direct financial losses that they suffered.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) received over 70 submissions specifically referring to financial advice concerning MIS which later failed. The Royal Commission also received over 50 submissions from current or former financial advisers about practices and behaviour within the sector. The Royal Commission's final report said that these submissions raised concerns about the:

- limited redress options for investors in failed managed investments schemes.
- lack of information or communication provided in advance, or before the scheme collapsed.

Compensation Scheme of Last Resort

On 22 June 2023 the Australian Parliament passed legislation establishing a Compensation Scheme of Last Resort (CSLR). The establishment was recommended by the Ramsay Review and had been supported by the Royal Commission.

AFCA and its predecessor schemes have long supported the introduction of such a scheme, and the CSLR will strengthen trust and confidence in the dispute resolution framework for financial services by ensuring that some victims of financial misconduct have access to redress.

The CSLR, which is due to commence in April 2024, will facilitate the payment of up to \$150,000 in compensation to eligible consumers. It will be open to applications from consumers who have an unpaid determination from AFCA relating to personal financial advice, credit intermediation, securities dealing or credit provision.

From April 2020, AFCA paused complaints against insolvent financial firms while awaiting the final scope and establishment of the CSLR. While we note that this review will not consider whether MIS should be brought within the scope of the CSLR, an overview of insolvent financial firm complaints and unpaid compensation is available on AFCA's website, which includes information about paused complaints relating to MIS. This information is effective 1 June 2023 and is provided as one indicative measure of ongoing consumer detriment arising from MIS failures.

Total open complaints against insolvent Firms	Total number of financial firms	Total consumer claim amounts
4,875	54	\$693,573,439

Primary business	No. of firms	No of complaints	Total claim amount
MIS Operator / Fund manager	6	272	\$ 28,074,948
Timeshare operator	1	13	\$ 61,867

Please note: Claim amounts and outcome amounts are estimates only and may be subject to change for a number of reasons, including further validation.

If material change is to occur in the MIS regulatory environment, reforms will likely need to extend further than resetting current thresholds, forms and definitions. We are therefore interested to understand the full extent of measures that might be applied to the regulatory regime to reduce the likelihood of repeat issues causing consumer harm in the MIS sector.

Observations and insights

Fit for Purpose

AFCA considers a MIS regulatory regime that is fit for purpose should at its core include measures to protect retail investors from the distribution of high-risk and complex MIS that by their nature are likely not to be fully understood by many consumers and/or meet their risk tolerances or objectives.

In line with this position, AFCA supports the retention of current consumer protections and related regulatory reporting requirements. This includes access to EDR and remediation. It also includes design and distribution obligations requiring relevant providers to report to product issuers if a substantial amount of distribution (MIS or otherwise) is occurring outside the target market or if distribution outside the target market is causing significant consumer harm.

AFCA observes a direct link to consumer protections that this reporting provision provides for MIS and other products. We therefore caution against any reversal of this reporting requirement, as recommended in a recent report to the Government.⁶

⁶ Recommendation 12.2 Quality of Advice Review – Final Report (pg. 142)

AFCA also observes that the current regulatory regime provides an excluded conduct exemption for personal advice providers in relation to target market determinations. When a distributor provides personal advice, it is not required to take reasonable steps that will, or are reasonably likely to, result in distribution of a financial product being consistent with the target market determination.⁷

Further, we note that ASIC's Design and Distribution: Investment products Report 762 (Report 762)⁸ outlines issues identified in target market determinations for MIS and more broadly across investment products. The report indicated many issuers assumed a target market can be defined on the basis that consumers would hold the investment product as part of a well-diversified portfolio. ASIC confirmed issuers should not make this assumption and that a product should be assessed as if it could be held on a stand-alone basis.

Based on our observations of MIS-related complaints, including where there has been significant detriment stemming from the provision of advice to invest in high risk and complex MIS, we support ongoing consideration of how current exemptions for personal advice providers interact with good consumer outcomes.

Wholesale/sophisticated investor classifications

The Review will consider what legislative thresholds should be met for a person to be classified as a wholesale client or sophisticated investor, and what form of authority should be provided by the client to record this designation. AFCA believes that these thresholds should be increased and we note the commentary and research in the Consultation Paper which shows in particular, how the objective thresholds are now being satisfied by a significantly larger cohort of Australians.

An important related issue is ensuring that financial firms are diligently and genuinely assessing whether a client meets the relevant thresholds and effectively explaining to consumers the consequences (including the removal of a suite of retail consumer protections) of being recorded as a wholesale client or sophisticated investor.

AFCA has observed the impact on consumers when they are incorrectly or inappropriately classified. AFCA has also considered complaints where clients entering investments as wholesale investors, because of the operation of the product value and wealth tests, displayed a genuine lack of understanding or awareness about:

- how the product or scheme invested in worked in practice;
- the related and underlying risks of the product;
- the fact they had been classified as a wholesale client; and
- the reduction in consumer protections associated with the classification.

⁷ 994E(3) and the definition of 'excluded conduct' in s994A(1) and RG274.200

⁸ [ASIC Report 762: Design and Distribution: Investment products](#)

This experience suggests caution about assuming that individuals being assessed as meeting these tests are financially literate and always have the knowledge, experience or means to take on the additional risks typically commensurate with wholesale investments.

We also note ASIC's concern about retail investors being 'reclassified' at a point in time without merit, in order to gain access to a particular product⁹. We have seen this theme in complaints lodged at AFCA. We consider that a decision or assessment about whether a client meets the definition of a wholesale or sophisticated investor should not be left to investor attestations and passive acceptance by the advice provider or RE. Rather, it should be an active decision by the advice provider or RE after considered assessment and ensuring records are maintained to demonstrate the context in which consent was obtained.

Ensuring Effective Access to IDR/EDR

The Quality of Advice Review (QOA Review) has also considered issues relating to the classification of wholesale clients. The QOA Review's Final Report¹⁰ recommended that the *Corporations Act 2001* (the Act) be amended to require a client who meets the assets and income threshold and who has an accountant's certificate to provide a written consent to be treated as a wholesale client. It also recommended that the written consent should contain a prior acknowledgment that the client will not be entitled to complain about the advice under the AFS licensee's IDR procedures or escalate to EDR. The QOA Review also recommended that the sophisticated investor acknowledgement be prospectively aligned with this approach.

AFCA has issued determinations in favour of complainants where financial firms failed to adequately explain or misrepresented the implications of being recorded as a wholesale client.¹¹ It is therefore critical for consumers to have access to IDR and EDR where they consider a financial firm has inappropriately classified them, and for AFCA to be able to consider its jurisdiction based on the specific circumstances presented in the complaint.

If written consent forms were structured as set out above, there is a risk that consumers with issues of this nature may be dissuaded or prevented from lodging an IDR complaint or if lodged, escalating it to AFCA if they remain dissatisfied. In these circumstances, any substantive issues around informed consent or whether the client in fact met the relevant wholesale thresholds would likely not be identified, remedied, or reported to the regulators.

⁹ ASIC Consultation Paper 332 and reference in ALRC Report 137 (Interim Report A)

¹⁰ [QOA Review Final Report - Recommendation 11](#)

¹¹ Examples – Determinations. 907346, 841469, 680249, 767914, 713625

We note that the Independent Review of AFCA conducted by Commonwealth Treasury in 2021 also recommended (Recommendation 6) that:

“AFCA exclude complaints from sophisticated and professional investors, unless there is evidence that they have been incorrectly or inappropriate classified” (emphasis added).

This recommendation is consistent with our commentary above, designed to preserve AFCA jurisdiction where this is appropriate.

Information and Marketing

It is crucial consumers are provided with clear and transparent information on MIS risks and complexities, to support informed decision making. MIS should also not be marketed or distributed to consumers inconsistent with their risk appetite, personal objectives, or capacity to provide informed consent.

AFCA sees first-hand the result of MIS PDS and related scheme and advice documents that are too long and complex, and in a format that impacts informed consent (i.e. consumers’ understanding of product design, risks, complexity and relevance to their circumstances). While these issues are prevalent across the financial system, more work is needed to ensure that disclosure and advice documents are relevant and useful.

AFCA also supports recent ASIC surveillance and findings that fund managers do more to ensure that their products are ‘true to label’ acknowledging the important influence that promotional material and marketing can have on consumer decision making.

Systemic Issue Reporting on MIS

Through AFCA’s (and its predecessor schemes) reporting obligations, several MIS-related systemic issues and possible serious contraventions (previously serious misconduct) have been identified arising out of complaints and been reported to ASIC. These include cases where:

- a financial firm failed to exercise a duty of care when acting as administrators for a managed investment scheme. This issue led to significant remediation of approx. \$500,000 to 103 consumers.
- It appeared a MIS was operating and being promoted to retail consumers but had not been registered.
- A time-share operator provided misleading advice to many clients by way of template wording in Statements of Advice.

SI Case study

Several clients were affected by the generic disclosure of risks associated with investing in the MIS. Further, when promoting the MIS to potential clients during investment seminars, representatives made potential misleading statements.

In the related determination that led to the systemic issue investigation, the ombudsman concluded that the financial firm's representative initially misled the applicant by telling them it was impossible to lose by investing in the MIS.

The ombudsman also noted that the PDS made no mention that the investment risks were significantly magnified by being highly leveraged. In this regard, it was not sufficient for the PDS to simply say investment performance and security were not guaranteed. Gearing risk was a key risk of investing in the MIS and should have been highlighted.

The matter was referred to ASIC as representing serious misconduct.¹²

Consultation Questions

Chapter 1 – Wholesale Client Thresholds

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

The current thresholds have not been updated since the Financial Services Reform legislation was enacted more than 20 years ago. AFCA supports consideration of increases in each/all of the product value test, net assets test and income test to

¹² Determination and serious misconduct report to ASIC was made by AFCA predecessor scheme the Financial Ombudsman Service. Serious misconduct notifications were the precursor of current notifications of serious contraventions.

ensure that underlying policy objectives are maintained. However, we also acknowledge that:

- The operation of the multiple definitions and thresholds is confusing and seems, based on submissions and feedback provided to AFCA, to not be universally or well understood by financial firms or consumers
- Asset and financial thresholds are meant to assist in protecting most consumers from being exposed to more complex and high-risk investments, however, AFCA has frequently seen these thresholds are a poor proxy for consumer understanding and they can also fail as a proxy for financial resilience.
- While investors who meet these tests may be able to sustain higher losses than other investors, this is not the same as being financial literate or losses being without significant impact, including in cases where a person attains money through inheritance, the sale of their home or release of superannuation and are making high impact financial decisions for the first time.

For the purposes of the investor wealth test, it appears reasonable to exclude an individual's superannuation and primary residence. This reflects the maturation of the Australian superannuation system and the significant growth in average Australian house values over time, and again appears to be consistent with the original underpinning policy objectives.

From an AFCA complaints-handling perspective, it is the individual context in which client consent is sought and obtained that will determine whether a particular consumer genuinely understood the implications of and agreed to their classification.

Recommendation 11 of the Quality of Advice Review Final Report recommends certain consents that could be provided to an advice provider by a client to be treated as a wholesale investor (meeting the income and assets tests).

Our view is that these consents may not on their own meaningfully demonstrate informed consent, including a clients' understanding of the implications of entering a product on this basis. We suggest that consent requirements should include/be accompanied by other records that demonstrate the extent of conversations and communication with clients and whether, for example, the client was offered time to consider the implications before proceeding to provide consent.

We refer also to the comments above about ensuring that a consent form does not seek to preclude all access to dispute resolution.

Chapter 2 - Suitability of scheme investments

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

AFCA observes this question should likely be expanded to also consider whether certain MIS (by virtue of their investment or risk profile) should be restricted to wholesale/sophisticated investors where imposed conditions are not likely to result in measurably reducing the risk of harm to retail clients.

Appendix

1. Managed Investment Scheme Complaint Data

Between 1 November 2018 and 30 June 2023, AFCA received 4,101 Managed Investment Scheme complaints.¹³ AFCA records these complaints into specific product names (or scheme types). The products constituting the largest volume of complaints and the associated issue type are provided below.

A proportion of MIS complaints involve entities that entered administration or liquidation.

Mixed Asset fund complaints¹⁴

Issue	No. of complaints (1,438)
Failure to act in client's best interests	266
Inappropriate advice	265
Failure to follow instructions/agreement	201
Service quality	157
Incorrect fees/ costs	136
Misleading product/service information	133
Failure to provide advice	70
Account administration error	53
Interpretation of product terms and conditions	33
Unauthorised transactions	31

¹³ MIS complaints cover advice to invest in MIS, complaints about the RE and the MIS issuer and can have multiple issues.

¹⁴ Multiple managed investments or mixed funds. (Investment portfolio potentially involving various managed investments).

Property Funds

Issue	No. of complaints (609)
Misleading product/service information	298
Failure to act in the clients' best interests	97
Inappropriate advice	72
Failure to follow instructions/agreement	60
Insufficient product/service information	56

Cash Management Accounts

Issue	No. of complaints (544)
Service Quality	101
Failure to follow clients' instructions	67
Failure to act in the clients' best interest	52
Inappropriate advice	46
Incorrect fees/costs	46

Timeshare

Issue	No. of complaints (331)
Misleading product/service information	101
Service quality	35
Interpretation of product terms and conditions	32
Inappropriate advice	25
Incorrect fees/costs	22

Investor Direct Portfolio Services

Issue	No. of complaints (257)
Failure to act in clients' best interests	45
Service quality	42
Inappropriate advice	41
Incorrect fees/costs	22
Account administration error	22

Australian Equity Funds

Issue	No. of complaints (175)
Failure to follow instructions/agreement	28
Failure to act in the clients' best interests	26
Service quality	22
Inappropriate advice	19
Incorrect fees/ costs	13

Primary Production schemes

Issue	No. of complaints (141)
Incorrect fees/costs	69
Inappropriate advice	29
Failure to act in clients' best interests	12
Inappropriate debt collection action	11
Unconscionable conduct	6

International equity funds

Issue	No. of complaints (114)
Failure to follow instructions / agreement	41
Interpretation of product terms and conditions	19
Service quality	11
Failure to act in clients' best interests	7
Incorrect fees / costs	6

MIS complaint outcomes

Outcomes (and closure stage)	Percentage
Assessment	1%
Conciliation	2%
Decision in Favour of complainant	5%
Decision in Favour of Financial Firm	4%
Discontinued	13%
Negotiation	14%
Outside Rules	29%
Preliminary Assessment in Favour of complainant	2%
Preliminary Assessment in Favour of Financial firm	2%
Resolved by Financial Firm	29%