Submission to Treasury - Review of regulatory framework for managed investment schemes.

by John Aldersley 28th September 2023

Introduction – my background

For 49 years across two jurisdictions, I have been variously a merchant banker, stockbroker, financial planner, media investment commentator, and most relevantly, conceived of and helped develop and launch the first retail registered managed investment scheme (RMIS) that was not a unitised product in Australia, ShareInvest, in 1994. It was limited to clients receiving personal advice on entry and ongoing.

In 1996 I introduced DirectPortfolio, a RMIS targeted at self-directed retail and wholesale investors. This offered both retail and wholesale investors the opportunity to directly invest (with or without the help of an external adviser), in the financial product. In 2005 I bought the ShareInvest scheme from its new global owner and offered the two schemes together, combining them under the one responsible entity. In 2007 I sold and "retired" but in 2013, following past client pressure, Aldersley Capital commenced managing a model portfolio on a well-known retail M.I.S. So I'm still active.

My key observation from 1996-2007 was self-directed clients readily recognised the benefits to them of the financial product whereas planning groups were extremely slow to grasp the concept and benefits offered. I put that down to the inexperience of financial planners in handling direct shares for clients or themselves. Their experience was in unitised products, selected from their dealer group product list, which in turn relied on research houses, many of whom lacked real understanding of the true investment risks facing some financial products.

The self-directed investors commonly stated they had no time for these run of the mill advisers offering personal advice who followed this pattern. They didn't want personal advice or indeed much general advice. They just wanted a better way to own direct shares. Although we did, via free general educational advice, alert them generically to ways of maximising the tax effectiveness of their investments with us, through having a structure such as a Self-Managed Super Fund etc. I think we saved Treasury millions in Centrelink payments over the years by creating sufficient asset gains that, instead of an ultimate dependence on full Centrelink pensions in retirement, at best they get a part pension and most don't even get that – they have instead joined the ranks of the self-funded retirees.

Today, experienced advisers are being progressively squeezed out of the personal advice regime for their smaller clients by the plethora of new regulations designed well intentionally to improve the quality of advice given.

In addition, the major entrenched M.I.S platforms commonly only accept new retail applications from advisers who provide personal advice – effectively closing the door to experienced investment - oriented advisers who only provide general advice to retail clients.

One solution is to reclassify eligible clients as wholesale clients. However, the only test they seem to accept is the $2.5m net assets test plus regular accountant's certificate.

Once within a retail scheme, a continuing education process through newsletters, video briefings etc can gradually train inexperienced emotional retail investors into thinking like a cold unemotional fund manager and learn that volatility can be an opportunity as well as a risk.

I am concerned the regulations treat retail and wholesale responsibilities as polar opposites. I think all professionals owe a duty of care and must have the best interests of their client at heart, regardless of whether it is a retail or wholesale client.

In my ideal M.I.S. world, wholesale and retail clients co-mingle freely, along with personal advice, general advice or no advice as their circumstances and needs dictate.

Thresholds for Wholesale Clients – my views

The Consultation Paper notes there are five Principal ways a client can be deemed wholesale, but in practice only one is commonly available in the M.I.S space that I operate in.

2.1. Product Value test – s761G(7)(a)

There is ambiguity in the M.I.S financial product space. While an investor investing $500,000 in a unit trust and being issued units will be regarded as wholesale under this test, an investor investing in an IDPS-like or registered managed investment scheme (RMIS) that allows for Managed Accounts, may not. The ambiguity probably arises because the R.E. has to decide if the client can be deemed a wholesale client because they have invested $500,000 in their financial product, or whether they are best not, because within the financial product the R.E. may have to deal for them in lesser amounts in each security.

While not privy to the policies within all the current generation of retail M.I.S., it seems they do not include the value test in their definition of a Wholesale Client.

Unregistered M.I.S Operators of discretionary Wholesale Schemes take a more pragmatic approach and generally do accept the Value test upon entry into the M.I.S. financial product.

There remains industry uncertainty over the treatment of Self-Managed Super Funds on two counts. At one point it was widely considered that they had to have $10m in assets to be deemed wholesale, a ridiculous situation. I understand somewhere deep in the regulations this $10m requirement is now exempted and the product value test or net asset test is now accepted for SMSF.

However, there is a view that if two individual trustees, who are both wholesale, invest funds on behalf of the SMSF then it should be treated as retail because there is no one controlling trustee. This does not apply if the individuals set up a corporate trustee structure for the SMSF. To avoid an incredibly wasteful effort some clarification is required on this too.

Recommendations on Value test

1. Clarify that the Value test applies to retail IDPS and RMIS, and wholesale M.I.S. By investing $500,000 in an eligible financial product, the client can be deemed wholesale within that financial product (if they choose to), for as long as they remain in the financial product.

2. Clarify that a SMSF satisfies the Product Value test even if it has two (or more) individual trustees.

3. Introduce that a written consent form is required outlining the consequences of being classified as a wholesale client, signed off by the client and their adviser or, if investing as a self-directed investor, between the client and the Promoter or Product Provider.

2.2. Individual Wealth Test

Is currently satisfied when the client can demonstrate at least $2.5m in net assets or a gross income of at least $250,00 a year. This has remained unchanged since 2001.

The percentage of investors qualifying under this Test has risen from just 2% in 2002 to 16% of all adults in 2021.

When the original limits were set in 2001 a large number of clients who considered themselves sophisticated investors back then were forced into retail schemes or carried on managing their own share portfolios. The direct ownership of shares had reached over 50% of the population at its peak.

While an increase in house prices has been the major reason for the increase to 16% of all adults by 2021, this does not appear to me to be an alarming percentage, and has probably served to bring the eligible number more into line with reality.

I cannot think of more than a couple of retired clients who would satisfy the $250,000 a year gross income rule.

While an objective test is always more desirable than a subjective test for statistical analysis, there is an imperfect correlation between the net wealth or gross income of a person and their financial sophistication.

The Review Paper suggests that the objective tests could be supplemented by more information being provided to the client about the consequences of seeking and accepting their wholesale status, in terms of what they give up by not being retail clients. I think there is merit in this argument.

Recommendation – Individual wealth test

1. No urgency to disrupt things by changing the threshold for the Assets or Income tests,
2. The recommendation of the Quality of Advice Review has merit, that a written consent signed by both the adviser and the client should outline the consequences of being treated as a wholesale client compared to being a retail client in a similar product (both positive and adverse factors).
3. The Review limited its recommendation to clients being advised. I think the scope should be broadened to include self-directed investors who seek to invest in a wholesale product without seeking any advice.

2.3. Small Business Test

Is satisfied when the financial product is provided for use in a business that is not a small business as defined. I've never had occasion to think about what this means or use it.

2.4. Professional Investor test

Do clients who are qualified financial advisers and have an AFSL in their business qualify as Professional Investors? The way the Act is worded suggests only their Licensee company can claim to be a professional investor. This needs clarifying to include anyone who is an authorised representative.

2.5. Sophisticated Investor test

Is satisfied when an eligible financial product or service is being provided and an AFS licensee is satisfied on reasonable grounds that the client has previous experience in using financial services and investing in financial products that allows the client to assess the merits, value, risks and information about the product or service.

This is a more recent innovation. It accords with practices in other jurisdictions. While it introduces subjectivity, I consider it a good step in the right direction. I have a number of clients who have followed me through thick and thin through changes of M.I.S as various owners departed, and they have up to 31 year's of experience in investing in M.I.S, both as wholesale and retail, yet today don't qualify as wholesale under any other test.

Sadly, this test is also mired in controversy and I suspect not widely used because of it. Who is responsible for signing the form and having reasonable grounds for considering the investor passes the Sophisticated test? The legislation says the licensee, and in some dealer groups only the Principal can sign the form. As they've probably never met the client, they must trust the judgement of their authorised representative who does. In my experience, as advisers are forced to change dealer groups and take their clients with them, the answer has often been no, in the too hard basket.

A Licensee should only appoint an authorised representative they respect and trust, as they must abide by the law pertaining to the Licensee anyway. The law should make it clear that the Licensee, or their authorised representative may sign the form. The internal compliance regime within the Licensee should suffice to self-manage this process.

At present the client receives a written statement of the reasons provided by the licensee before or when the product or service is being provided, and also signs a written agreement that the adviser has not provided a PDS, any other document expected of a retail client, and the adviser has no other obligation to the client as they would if they were a retail client.

Should a client wish to invest in a retail registered M.I.S as a wholesale client, then this appears to be impossible under the present legislation unless the adviser deliberately avoids providing a PDS or any other document that they would normally get as a retail client (section 761GA (f)(i)-(iii).

In my world, both retail and wholesale/sophisticated investors should be able to invest in the same registered M.I.S.

Does the legislation anticipate that the wholesale client has the experience and acumen to download and peruse the PDS without the adviser doing so? I suspect instead it was not anticipated that a wholesale client might seek to invest in a retail scheme, so the regulation was put in to emphasise that the adviser will not be giving a PDS. It seems an unnecessary regulation.

My recommendation is that the written statement focuses on the consequences of investing as a wholesale client instead of a retail client, and points out both the negative and the positive aspects.

Best interests of client

The Review Paper says that one of the consequences of being a wholesale client is their financial product provider is not obligated under the Conduct obligations applying under Part 7.7A, which requires advisers providing product advice to act "in the best interests of their clients". I would have thought all licensed persons have an obligation to act ethically and with the best interests of their clients in mind, whether dealing with retail clients or wholesale clients. If that is not the case then the law should be modified so it is. But there is a trade-off. It's not always in the client's best interest to pay less rather than more. If I charge nothing, I cease business. So somewhere in the regulatory process there must be the concept of what a reasonable person considers the best interests of the client to be.

Managing Conflicts of Interest

This might be outside your review but it's important background. In 2006 I spoke at a Managed Accounts conference in Miami, Florida. The Americans were amazed that we were economically offering $5000 minimum entry to active model portfolios of 10-20 securities while they couldn't justify clients with even US$1 million. They still can't.

I explained the reason was we deliberately sought to be within the regulatory system, whereas they were seeking to stay as far from it as possible. And that was the difference.

The decision of our regulator (ASIC) to recognise that conflict of interests inevitably exist in the relationships between client and fund manager/adviser/promoter/responsible entity, but that it's in the best interests of the public that these conflicts be managed instead of avoided, is the difference.

Without such a supportive regulatory regime, managed accounts would not exist for retail clients. I am concerned that the "ethics" movement is putting this excellent policy under threat. It is the reason why our retail MIS regime is the most envied and successful of the four jurisdictions I have experience of, namely Australia, the USA, the UK and India.

John Aldersley

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