CHOICE

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Consultation paper

Submission to the review of the regulatory framework for managed investment schemes

ABOUT US

CHOICE is the leading consumer advocacy group in Australia. CHOICE is independent, not-for-profit and member-funded. Our mission is simple: we work for fair, just and safe markets that meet the needs of Australian consumers. We do that through our independent testing, advocacy and journalism.

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CHOICE welcomes the review of the regulatory framework for managed investment schemes. Improving the regulation of these schemes is essential to protect consumers as the losses from inappropriate investments in managed investment schemes can be devastating. In particular, it is essential that consumers are appropriately classified as retail or wholesale clients and that ASIC has appropriate powers to refuse to register a scheme where there is a risk of significant consumer detriment. It is also important that consumers have rights to withdraw from schemes that reflect their expectations.

Strengthening the regulation of managed investment schemes is only one step towards appropriately protecting consumers in this market. CHOICE continues to advocate for the government to include managed investment schemes in the compensation scheme of last resort. People bankrupted by failed investments must be able to receive full financial compensation when dispute resolution rulings are found in their favour, regardless of whether the responsible financial firm continues to operate.

The collapse of Sterling First highlights the need for reform

CHOICE believes it is important that the consumer voice is amplified in this policy debate. In this respect, we draw the review's attention to the case studies of consumer harm from the collapse of the managed investment scheme Sterling First outlined below. Sterling First involved older Australians being encouraged to pay hundreds of thousands in upfront fees for long-term property leases, marketed as a more affordable option than entering into retirement village arrangements.

Marsha Barber and her husband sold their home in a retirement village and entered into the Sterling First Scheme, under the belief that they would spend the rest of their lives in guaranteed accommodation.

"We've lost $126,000 roughly," Marsha shared with CHOICE. "*Emotionally it became very difficult for me because my husband had developed Alzheimer's and he could not understand what was going on. So I pretty well coped with things alone and looked after him at the same time.*"

Annette Taylor was also affected by the collapse of Sterling First, she lost her entire savings of $220,000 and was forced to live off the age pension, half of which went towards her rent. Prior to entering the investment scheme, she owned her own home.

When she read in the news that Sterling First had gone into receivership, *"I felt absolutely sick,"* Annette shared. "*Our money was supposed to be in a trust fund, protected. That was my impression of what a trust fund is. Where was our money going? That's what I'd like to know. To do this to pensioners, some in their 80s and 90s... it's just shocking, and the government has* *done absolutely stuff all to help us. It has destroyed me. I just want the money back and to get on with my life.*"

Make changes to wholesale client financial thresholds that limit the number of people that qualify

The individual wealth and product value tests ('dollar-based tests') for wholesale client eligibility all use financial thresholds that have not been updated since introduction of the thresholds in 2001. Originally, the dollar based tests were designed to allow *'those who are better informed and better able to assess the risk involved in financial transactions to participate in wholesale markets under a lighter touch regulatory regime*'[1]. An increasing number of people now qualify as wholesale investors.[2]

As these thresholds have not been updated since 2001, many people are finding themselves eligible for wholesale client arrangements even though they may need and expect the protection afforded to retail investors. CHOICE supports adjusting the financial thresholds in the dollar-based tests to ensure that a relatively small proportion of people are eligible to be a wholesale client and that it is not widely accessible.

The family home should be excluded from any asset thresholds. With a substantial increase in property prices in the last few decades, the wealth someone possesses is not an appropriate assessment of whether a person requires retail client protections. Including the family home as an asset pushes many people into the category of wholesale investors but does not necessarily correlate with sophisticated financial capability. Removing the family home from asset thresholds is another means of ensuring that only those who are informed and knowledgeable are able to become wholesale investors.

CHOICE also supports the indexation of the financial thresholds going forward. An indexation mechanism should be introduced that automatically updates on a periodic basis. This could occur at a frequency set by legislation of no longer than every five years. CHOICE believes that an automatic indexation process will be preferable to requiring periodic review by an agency as the effectiveness of any review will depend heavily on the resourcing and competing priorities of any agency conducting a review.

CHOICE also recommends requiring that an individual must meet 2 of the 3 financial thresholds in the dollar based tests to be treated as a wholesale client. There is a substantial risk that people may find themselves somewhat accidentally satisfying one threshold and therefore qualifying as a wholesale client, while still requiring retail investor protection. For example, a

[1] Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), paragraph 2.27
[2] B Phillips, 2021, Sophisticated Investor Projections, ANU Centre for Social Research and Methods, p 8

person that has come into a large inheritance may satisfy the net assets test or the product value test, but this is not necessarily a good indicator that they do not require retail investor protection. Requiring that a person meet 2 out of 3 dollar based threshold tests will help reduce the risk that consumers are incorrectly classified as retail or wholesale investors.

Recommendations

1. Adjust the wholesale investor financial thresholds
2. Exclude the family home from asset thresholds
3. Automatically index the wholesale investor financial thresholds on a periodic basis
4. Require people to meet 2 of 3 financial thresholds

Consent requirements should be consistent and should be complemented by a requirement to obtain independent advice

The wholesale client tests do not require any written acknowledgment from a person confirming that they are waiving their rights as a retail client. CHOICE recognises that there are limits to any consent or disclosure based protection, but we support the standardisation of these consent requirements across the sophisticated investor and wholesale client tests. Ensuring a minimum standard for consent and disclosure may better enable people to recognise and understand the consequences of not being treated as a retail client. The content and form of any consent documentation should be designed and tested with consumer research and CHOICE recommends that Treasury is appropriately resourced to do this.

However, there are limits to what this kind of disclosure-based protection can achieve and the protection can be undermined by unscrupulous advisers or sellers of financial products.

To protect against this, the consent regime should require consumers to obtain independent advice about the consequences of being treated as a wholesale or sophisticated investor before signing any consent documentation. This will protect against anyone feeling pressured to sign the consent without understanding the consequences by bringing an independent person and inserting a potential break into the sales process. This condition could build on the existing requirements for an accountant’s certificate, but could also be extended to lawyers.

Recommendations

5. Standardise consent across the wholesale investor and sophisticated investor tests
6. Consumer test the content and form of any consent documentation
7. Require independent advice before signing the consent documents

ASIC should be able to refuse to register a scheme if there is a significant risk of consumer harm

People investing in a registered managed investment scheme will often view ASIC's registration of the scheme as an endorsement of the product. In reality, ASIC registration indicates that the scheme has met various technical requirements and ASIC's decision to register the scheme does not involve considering the suitability of the product.

This leads to mismatch between consumer expectations and the protections afforded by the regulatory regime. As noted by the Senate Economics References Committee in relation to Sterling First:

"Many victims highlighted that they may not have been involved with the Sterling Group had they known…that ASIC registration of a managed investment scheme is not an endorsement of the product."[3]

CHOICE believes that the best way to address this mismatch in expectations is to **make scheme registration a genuine consumer protection**. This is consistent with the general shift in the financial services regulatory regime from one being focussed on disclosure to 'product regulation', as demonstrated by the introduction of the product intervention power and design and distribution obligations. This review of the regulatory regime for managed investment schemes is an opportunity to modernise the regulation of these schemes to be consistent with the broader shift in regulatory approach to financial products.

At a minimum, CHOICE recommends that ASIC be empowered to refuse to register a scheme if it is satisfied that the product is likely to result in significant detriment to retail clients. This ensures ASIC has the same powers at the point of registration, as it does after a product is on the market (with the product intervention power), to stop distribution of a potentially harmful managed investment scheme.

CHOICE also supports empowering ASIC to **only** register schemes that it considers suitable for retail investors. This could be supported by a regulation making power for government to specify the kinds of novel, high-risk or illiquid investments that are considered inappropriate for retail investors, or that are only appropriate if certain conditions are met. This framework will help to 'future proof' the managed investment scheme regulatory regime by ensuring that there is a mechanism to prescribe or limit certain investments in registered schemes, similar to approaches followed internationally.

[3] The Senate Economics References Committee, 2022, Sterling Income Trust, Commonwealth of Australia, p54.

Strengthening ASIC's regulatory powers in relation to managed investment schemes must also be accompanied by an appropriate increase in ASIC's resourcing.

Recommendations

8. Give ASIC the power to refuse to register a scheme if there is a significant risk of consumer detriment
9. Require ASIC to consider the suitability of the scheme's investment for retail clients as part of scheme registration
10. Introduce a regulation making power for government to prescribe that kinds of investments that are considered inappropriate for retail investors
11. ASIC should be resourced to effectively administer any expanded role in scheme registration

The definition of liquid schemes should match consumer expectations

Currently, the constitution of a managed investment scheme could effectively define anything to be 'liquid'. This is clearly inconsistent with the general understanding of a liquid investment which implies an easy conversion to cash.

CHOICE supports a more prescriptive and objective definition of liquidity, to be introduced into the Corporations Act. Ideally, this definition should be informed by consumer research to understand what people expect when they are told an investment is liquid. In the absence of such research, the Government could consider adopting a definition similar to the one proposed in the consultation paper: '*money, bank accepted bills and assets that can reasonably be expected to be realised for their book value within 7 business days*'.

Recommendations

12. Amend the definition of liquid asset in the Corporations Act to introduce a more prescriptive and objective definition of liquidity
13. Conduct consumer research to understand consumer expectations in relation to 'liquid' investments