

**Senate Economics Legislation Committee**

**ANSWERS TO QUESTIONS ON NOTICE**

**Treasury Portfolio**

Budget Estimates

2017 - 2018

**Division/Agency:** Australian Securities and Investment Commission

**Question No:** 106

**Topic:** Managed Investment Schemes

**Reference:** Written

**Senator:** Ketter, Chris

**Question:**

1. Are loans provided to retail investors for investment purposes currently subject to responsible lending obligations? If no, what is ASIC's understanding of the rationale for this.
2. What consumer protections currently apply in relation to Managed Investment Schemes?

**Answer:**

1. No. The *National Consumer Credit Protection Act 2009* (NCCP Act) and *National Credit Code* (the Code) (in Schedule 1 to the NCCP Act) only apply to contracts under which credit is provided to natural persons or strata corporations (consumers) and which is wholly or predominantly for personal, domestic or household purposes or to purchase, improve or refinance residential property for investment purposes. Investment by the debtor (other than investment in residential property) is not a personal, domestic or household purpose (see section 5 of the Code). The licensing and responsible lending requirements in the NCCP Act therefore do not apply to loans for the purpose of investment in financial products, including managed investment schemes.

Preliminary consideration was given to extending the scope of the Code and NCCP Act to cover loans for investment purposes. In 2012, Treasury circulated for comment an Exposure Draft of the National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012. Schedule 3 to the Exposure Draft of the Bill covered investment lending.

Whilst the proposed reforms did not progress, it is uncertain whether, if they had, they would have resulted in the application of responsible lending obligations in relation to loans for the purpose of investment in managed investment schemes operated by properly licensed Australian financial services licensees. Under the Exposure Draft of the Bill, it was proposed to:

- apply the credit licence requirements to persons who engaged in credit activities in relation to investment loans; and
- apply responsible lending obligations only in relation to certain investment loans that have additional risks for consumers, which were identified as:
  - a) loans secured over the family home where the borrower does not appreciate that if the investment does not generate the expected returns, they will need to meet the repayments from other resources and may be at risk of losing their home, depending on their overall financial position; and

- b) loans to finance investments in products being offered illegally, by a person who does not hold an Australian financial services (AFS) licence (where there is a consequent risk the entire investment proceeds will be lost by the consumer).

The provision to retail clients of margin lending facilities is regulated under the Corporations Act 2001. Under Div 4A of Part 7.8 of the Corporations Act, special requirements are applied to providers of margin lending facilities that mirror the NCCP Act's responsible lending inquiry and assessment obligations.

2. The primary regulation governing managed investment schemes is contained in Chapters 5C and 7 of the *Corporations Act 2001* (Corporations Act), supplemented by policies and guidance released by ASIC.

### ***Registration***

A managed investment scheme with more than 20 members must generally be registered by ASIC under s601ED of the Corporations Act if interests are to be offered to retail investors. A managed investment scheme must also be operated by a public company—the responsible entity.

A responsible entity must hold an AFS licence and must prepare the following documents governing the operation of the managed investment scheme before registering the scheme:

- a) a constitution, setting out the legal relationship between members of the scheme and the responsible entity; and
- b) a compliance plan, setting out a range of measures the responsible entity is to apply in operating the scheme to ensure compliance with the Corporations Act and the constitution. If the majority of the directors of the responsible entity are not external, the compliance plan and the responsible entity's compliance with it must be monitored by a compliance committee. The compliance committee must have at least three members and a majority of them must be external. Compliance with the compliance plan is also subject to an annual external audit.

### ***Licensing***

As the holder of an AFS licence, the responsible entity is subject to a number of obligations under s912A of the Corporations Act, including an obligation to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly, to comply with conditions of the licence, and to comply with financial services laws.

As an AFS licensee a responsible entity must meet the base level financial requirements in RG 166. These require the responsible entity to have:

- a) positive net assets and be solvent;
- b) sufficient cash resources to cover 12 months of expenses with cover for contingencies; and
- c) information about compliance with the financial requirements in their annual audit report to ASIC.

Responsible entities must also meet a net tangible assets (NTA) requirement, with requirements for holding cash or cash equivalents and liquid assets.

Generally, a responsible entity must hold at all times minimum NTA of the greater of \$10 million, or 10% of the average responsible entity and investor directed portfolio

service (IDPS) revenue, for each registered managed investment scheme operated, unless the responsible entity uses a custodian.

If a custodian is used, the responsible entity must hold at all times minimum NTA of the greater of:

- a) \$150,000;
- b) 0.5% of the average value of scheme property of the registered managed investment scheme(s) it operates (if any) up to \$5 million NTA; or
- c) 10% of the average responsible entity revenue.

### ***Statutory obligations***

The responsible entity and its officers are also subject to a number of specific statutory obligations in Chapter 5C of the Corporations Act. Under s601FC, the responsible entity of a registered managed investment scheme must (among other obligations):

- a) exercise the degree of care and diligence that a reasonable person would exercise if they were in the position of the responsible entity;
- b) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests; and
- c) if a managed investment scheme is to be offered to retail investors, prepare a Product Disclosure Statement (PDS).

The Corporations Act also provides in section s912B that AFS licensees must have adequate arrangements for compensating retail clients and consumers for loss or damage due to breaches of the financial services laws.

The Corporations Regulations mandate that the key form of compensation arrangement required by a licensee is adequate professional indemnity insurance (PII). Regulatory Guide 126: *Compensation and insurance arrangements for AFS licensees* (RG 126) sets out the key features a PII policy must have for it to be 'adequate'.

ASIC and others including industry associations, FOS and consumer groups have raised the shortcomings of PII as a compensation and consumer protection mechanism in a number of government inquiries and reviews including the FSI. PII is designed to protect licensees against business risk, not to provide compensation directly to investors and financial consumers. It is a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources, but has some significant limitations, including where there are insolvency issues or multiple claims against a single licensee. Also, insurers who provide PII cover operate on a commercial basis, giving rise to issues including practical availability.

ASIC does not "approve" PII arrangements and does not require evidence of annual or other periodic renewal of PII cover. We do, however consider AFS licence applicants' PII arrangements (at the time of the license application), conduct surveillance on licensees as risk warrants, and maintain a dialogue with stakeholders regarding any issues that might give rise to regulatory risk that licensees may not hold adequate PII.

### ***Disclosure***

The Corporations Act requires disclosure in the form of a product disclosure statement (PDS) for offers of interests in a managed investment scheme to retail investors. The PDS must be clear, concise and effective, and specifically disclose key risks and

information which may have a material influence on a retail investor's decision to invest. The Corporations Act does not prescribe or proscribe particular product features or characteristics, provided the nature of the investment is disclosed in the PDS.

The PDS is only lodged with ASIC if it is for a managed investment scheme which will be able to be traded on a financial market. For unlisted managed investment schemes, a "PDS In-Use" notice is lodged to advise ASIC that the PDS has been used in a recommendation, issue or sale situation for the first time. The PDS document is not lodged with ASIC.

A responsible entity of a managed investment scheme must also provide ongoing disclosure to investors in the event of significant events (s675), material changes to a matter which would be required to be specified in a PDS (s1017B) and periodic statements to members who acquired their interests as retail clients (s1017D).

The particular risks associated with borrowing to invest have been noted in relation to agribusiness managed investment schemes in Regulatory Guide 232: *Agribusiness managed investment schemes: Improving disclosure for retail investors* (RG 232), which sets out benchmark and disclosure principles against which disclosure is required.

We consider that the inherent risks for investors in agribusiness schemes mean that the information in the benchmarks and disclosure principles should be addressed prominently in any Product Disclosure Statement (PDS), updated in ongoing disclosure as material changes occur (e.g. in a supplementary PDS) and supported by any advertising material. Disclosure Principle 2 requires disclosure if the responsible entity or a related party offers or arranges finance for investors. This is intended to improve the consistency and quality of disclosure by the responsible entities of agribusiness schemes and to enhance investor confidence.