Submission to MIS Review

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Your consultation document poses a number of specific questions about the regulation of MIS. Before addressing some of those questions I will make some general comments.

MIS provide a way for investors to pool funds and obtain an interest in assets of the scheme which may not be available to them as direct investors. They facilitate diversification by investors (such as having an interest in a diversified portfolio of shares) which might not otherwise be available to them due to scale limitations. But, the investor becomes exposed to particular risks such as poor performance of the MIS due to poor management decisions and excessive fees and charges, including by stealth through transactions at adverse prices of the MIS with related parties of the manager.

In principle, MIS should increase the ultimate supply of funds available for investment in particular assets, except to the extent that the alternative forms of investment channels which they replace were directed to similar assets. An important economic question is the extent to which MIS are a more socially efficient channel for investment than alternatives and whether they provide better risk-adjusted private returns to investors in MIS. It is not obvious that due to imperfections in information availability, transparency, and investor financial acumen, that the answers to those question are straightforward.

This leads to an important issue which is not directly addressed in the consultation document. **Why are many activities operated via MIS rather than via alternative legal and operational structures**? Why, for example, were agribusiness MIS schemes operated this way rather than via a corporate business operation? Why are property trusts common rather than via some form of corporate structure for property investments? There are many contributing factors. It may be easier to induce retail investors, often acting on financial advice from related parties to the scheme manager to invest in an MIS. The existence of differences in tax treatment (particularly MIS receiving concessional capital gains taxation treatment) not available to corporates may be another. The ability of the manager of the scheme to maintain control may be higher under an MIS scheme (where the ability of members to remove the manager (the RE) is overly difficult) than under a corporate structure where investors have regular voting rights and a growing share of votes as the entity increases in scale.

Focusing on such issues might provide insight into whether the MIS model should be permitted for particular types of assets classes and investment activities. For example, I have argued previously, based on analysis of agribusiness failures, that **the MIS model, and the Responsible Entity (RE) management/governance model is highly unsuited to activities which involve significant "real" activities and the creation of assets**, rather than cases where investment in existing assets are facilitated.

The current RE model for MIS was introduced in 1998 following a number of MIS failures under the previous model involving a trustee (responsible for looking after the interests; of investors) and a manager of the scheme. It appears to have been prompted by the difficulty in apportioning blame for the failure between those parties, whereas under the RE model there is only one party to bear the blame. **Designing regulation on the basis of easier assignment of blame if failure occurs, would seem to be a strange way of designing an operating and regulatory structure to generate the best outcomes for investors.**

And **the RE model is fundamentally flawed** (reflected in the need for substantial additional regulation).

The RE model requires the RE to put the interests of investors above the RE's interest should there be any conflict. MIS are set up, not out of benevolence towards investors, but because the manager is driven by the scope for making profits by running such scheme(s). Those profits can be derived by efficiently providing services to investors such that fees etc charged, and profit to the operator, are a fair compensation for costs and risks incurred by the operator. They can also be derived by exploiting investors via excessive fees and by other means of transferring value to the managers or their associates. Two simple historical examples suffice to make this point. One is the creation of an MIS in which property held by the manager (or associate) is sold into the MIS at a price well in excess of its true worth. Another is via outsourcing particular activities of the MIS operations to associates and paying fees well in excess of what is fair. When activities and investments are complex, where there is a lack of transparency, where investors are unable to assess the true value and risk involved, and where there are costs for investors in exiting the MIS (or replacing the manager) these types of conflicts of interest between manager and investors can abound. Historically there were also cases of the RE (or its related parties) lending funds to investors in their MIS schemes, with those investors left with substantial debts outstanding when the schemes failed. (A possible solution to this problem of requiring such related party loans to be non-recourse, has been recommended previously but, I believe, not acted upon. An alternative would be to prohibit such lending).

A regulatory model like the RE model which requires profit seeking managers to put the interests of investors above the managers interests is fundamentally conflicted. While some REs may be willing to operate against their own interests in such circumstances, there is no barrier to entry that means that only such types of people/organisations become REs. Moreover, the conflicts can be quite subtle and difficult (except in egregious cases) for investors and regulators to identify, and take actions to inhibit such behaviour. It would be a valuable exercise to study the profit rate of RE's to cast light on whether the RE model enables excess profits to be made from this activity, and thus the extent to which the concerns expressed above are particularly significant**. Assessing the merits of a regulatory model should include examining the extent to which it facilitates excess profits of participants**. It is not sufficient to assume that competition amongst RE's (or with other types of institutions competing for investor funds) will prevent abnormal profits in an area characterised by a lack of transparency, imperfect information and limited financial sophistication of investors.

So, to my mind **the first fundamental question is in what circumstances does the RE model make sense**. If the MIS is, for example, investing in equities listed on (eg) the ASX, then it may be suitable. It is easy to observe values of underlying assets, identify if the asset choices of the RE add value (particularly if asset holdings are disclosed), and assess (by comparison with other funds) whether operating costs are efficient and fees charged are fair. But at the other end of the spectrum, such as agribusiness, infrastructure trusts, property ownership/management/development, other legal models may be more suitable. These might be a standard corporate form, listed investment company, corporate collective investment vehicle (CCIV) or others – and **part of this review should consider why MIS and the RE model are chosen for activities to which they are not ideally suited**. It

would also be worth examining whether the prior (or some similar, improved) model of an independent trustee for MIS is not worth reconsidering. (I note that unlisted Wholesale Equity Schemes operate with a trustee and manager structure - although the trustee is a related body corporate of the manager).

Turning to some of the questions asked.

Chapter 1
There is clearly an incentive for those linked to particular investment schemes to classify retail investors as wholesale or sophisticated etc. At the very least, the thresholds for such classifications should be increased significantly. But a more fundamental and, I think, useful change would be to require that provision of such classification services could only be done by an entity which is not in anyway linked with the MIS either via contractual arrangements or by receiving commissions or fees from the MIS.

I do not know whether there is any centralised database of individuals who have been accredited as being wholesale/sophisticated investors. If not, there may be merit in establishing such a regulatory (confidential) database (with compulsory reporting) such that the regulators can better identify over time what changes might be needed to the various thresholds and identify entities which may be inappropriately providing accreditation.

Chapter 2
As discussed above, there are various pooled investment schemes which involve significant complex business operational activities which are not suited for open-ended MIS schemes, nor the RE model, available to retail investors. This is also the case where the investments are illiquid with no regular market prices available, and the value of the units based on directors' or others' valuations. The notion that "fair" prices can be determined on a regular basis enabling investors to fairly redeem or buy new units on demand is clearly ludicrous. This is reflected in the limitations on "illiquid" MIS providing redemption facilities. Such schemes, if offering ready redemption facilities, are thus also prone to runs, requiring freezing of units, as has been seen several times in the past including after the GFC. (I note that ASIC previously produced data on the amount of investors' funds still frozen, but I have not been able to identify a recent figure. However AIOFP was recently reported as producing a list of 92 failed or frozen MIS with $13.7 billion of funds under management, many of which were frozen at or just after the time of the GFC. However there appear to have been around 10 in the last decade). That these have not been resolved completely after such a long time suggests problems with the methods for winding up such schemes. But more recent failures raise the question of whether the RE model for MIS permits an excessive number of unsuitable entrants and schemes to enter the MIS market.

It is also worth noting that the restrictions on investors in existing non-liquid schemes, and thus exerting some market discipline on the RE, indicates a need for better arrangements for enabling investors to replace the RE.

Chapter 3
The data in Figure 1 of the consultation document indicates that there are a smallish number of REs operating large numbers of MIS each, and a larger number of REs operating one or a small number of MIS. The role of a compliance committee for the RE would seem to be of a different order of magnitude between these groups, suggesting that a different model (resources of the compliance committee, membership (external), etc) might be warranted for "larger" REs compared to smaller REs. A problem with REs which operate many interrelated schemes was apparent in the agribusiness failures, where funds of the various schemes became intermingled with each other and with those of

the corporate business also undertaking those business activities and acting as RE. Compliance issues for large REs can thus be more complex if there is any interrelationship between the various MIS

Chapter 4
A fundamental requirement of scheme's constitution and other legal arrangements should be that no "poison pill" arrangements (such as continuation of fees to a displaced RE) should be allowed.

Chapter 5
Defining liquid assets is complicated, since liquidity may vary over time – particularly in a time of crisis. With ongoing financial innovation, the range of assets having liquidity properties can change over time. One option would be to use as a definition the range of assets which are eligible for use in repurchase operations at the RBA, plus securities which trade on specified exchanges (such as the ASX).

Chapter 6
Any MIS taking funds from retail investors should be required by legislation to have statutory limited liability for members. Since members have no scope to influence activities, and have less effective voting power than in the case of shareholders in a listed company, it is anomalous that shareholders have limited liability but members of an MIS do not. With many retail investors having limited financial acumen (and almost certainly not having read or understood arrangements specified in the MIS constitution or other documents), investor protection would appear to demand guaranteed limited liability.

I hope that you find the above comments useful, and would be happy to discuss further if you wish.

Yours sincerely
Kevin Davis
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