ENHANCING OVERSIGHT AND GOVERNANCE OF MANAGED INVESTMENT SCHEMES

Equity Trustees

Submission to Australian Government | The Treasury
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Inquiries related to this submission:
Kerryn O'Brien, Chief Risk Officer
KOBrien@eqt.com.au */ 03 8623 5000*

Thank you for the opportunity to provide input to this consultation process.

About Equity Trustees

Equity Trustees (EQT Holdings Limited) was established as an independent trustee and executor company in 1888. EQT Holdings Limited is the ASX listed holding company of the group. EQT Holdings Limited owns and operates six licensed trustee entities comprising two Responsible Entities (REs), two Registrable Superannuation Entity Licensees (RSELs) and two traditional trustee entities.

Equity Trustees is now Australia's leading specialist trustee company. We offer a unique vantage point within the financial services system in our role as trustee supervising ~$283bn of assets in thousands of trusts, managed investment schemes (MISs) and superannuation funds. We help private individuals and families, fund managers and other corporate and superannuation clients grow, manage and protect wealth.

We welcome the opportunity to provide input into consumer protections in the financial services sector. Our company was established to help people take care of their future, and we see this Review as aligned to our purpose.

The group provides fund governance services through its Corporate and Superannuation Trustee Services business unit. Through two subsidiary companies, the group has on issue some 430 MISs, acting as RE for 260 registered managed investment schemes and trustee for 170 unregistered schemes with $130bn funds under management.

Provision of fund governance services is provided by a team of 85 professionals who specialise in fund governance – expertise not matched by any other provider in Australia. The team includes investment professionals, lawyers, risk managers, compliance officers, operational specialists, finance specialists, product specialists and disclosure experts.

Equity Trustees provides registered and unregistered MISs, retail debenture bonds, master/feeder structures, listed structures (open and closed-end), dual sleeve listed/unlisted schemes, active and index strategies and all domestic and global asset classes.

We have grown and evolved the provision of fund governance services in the Australian market since 1998, when the Corporations Act was materially reconfigured to establish the current legislative framework for MISs and REs. Since then, many fund managers have utilised the option of an independent outsourced RE over an "in-house" RE which is integrated with the fund manager. Typically, they choose this option because it is less costly, more efficient and allows them to focus on meeting the investment objective of the MIS.

Page 24 of The Treasury Consultation Paper describes the provision of RE services as "RE for Hire". It should be noted that an RE cannot be hired and the RE appoints the fund manager following extensive due diligence by the RE – and not vice a versa.

Over the last 28 years developing our capability and expertise under the current legislative framework, Equity Trustees has been an integral - and critical – part of fostering efficiency and innovation in the Australian funds management industry. The specialist independent RE model has efficiently facilitated the entry of capable leading global fund managers to the Australian market to provide world class funds management offerings to Australian consumers. The model has also enabled the efficient establishment of new Australian fund managers.

As the Australian superannuation market has grown at a rate materially above global benchmarks, the funds management market has developed at an even faster rate because the Australian equity, bond and real estate markets cannot provide sufficient investment opportunities and diversity, given the disproportionate size of Australia's pension assets.

Overview of our position

Equity Trustees agree that the nature and complexity of the industry is evolving and strongly supports the premise of Treasury's review in ensuring the regulatory environment evolves to ensure investors interests are protected and it continues to be fit for purpose into the future.

Equity Trustees believes the current legislative framework has generally stood the test of time and served the interests of investors well over the last 28 years through a range of market cycles.

Notwithstanding, it is timely and appropriate to consider improvements to the framework in light of recent failures and the failures noted in Treasury's consultation paper of 2023.

It is apparent that the major investment failures in the Australian market over the recent decades, including those involving superannuation have primarily stemmed from failures of REs. Those failures have typically involved REs that have not been independent in nature to the fund manager, have not had appropriate substance of resources and have not properly managed conflicts of interest.

Accordingly, our submission strongly supports enhancements that:

- Ensure the independence of the RE from the investment manager by requiring a majority of external directors on the RE board,
- Increased minimum capital requirements for the RE to at least $2million to be commensurate with the responsibility and accountability of the role of the RE and lead to participation of higher quality, more committed REs of substance.
- Prohibit the RE from investing or lending money to companies that are controlled by a member of the RE Board or companies that are related bodies corporate of the RE, however legislation needs to be very specific, to not prohibit common industry structures designed for legitimate efficiency reasons
- Implement reporting frameworks for all MISs (not just registered MISs) to improve ASIC's ability to identify poor governance practices earlier and reduce the likelihood of future failures on the scale of Shield and First Guardian.

We welcome the Minister's initiative to seek consultation in respect of governance of MISs. We also note this is the Government's first tranche of a broader agenda to strengthen consumer protections in the superannuation and financial services sector following the collapse of the Shield and First Guardian Master Funds.

This reform consultation is particularly important because it is clear that the failure of the RE of both the above schemes was the critical point of failure for those two schemes, that enabled the losses to be incurred.

We trust that these observations are useful in informing Treasury's considerations to enhance the oversight and governance of MISs in the future and welcome consultation with Treasury in respect to this submission or any other aspect of MIS reform.

Sincerely,

Mick O'Brien

Managing Director

EQT Holdings Limited

Proposal 1:
Enhancing the regulatory framework for compliance

1. Views of proposal to enhance the compliance framework for MIS

1.1 Introducing stricter compliance plan requirements, such as requiring a detailed description of the nature of the scheme and its investment strategy, and information outlining how significant risks will be identified, monitored and managed

Equity Trustees agrees that compliance plans should require a detailed description of the nature of the scheme and its investment strategy and information outlining how significant risks will be identified, monitored and managed.

We note Treasury's comments relating to compliance plans and the apparent absence of tailoring to individual schemes. As Treasury identifies, incorporating other registered schemes compliance plans by reference is easier to administer and reduces costs borne by investors including RE, administration / unit registry, custody and audit fees.

The primary reason for incorporation by reference is typically driven by common controls for the key compliance obligations. For example, a simple Australian equities MIS will typically require the same control framework to be applied as another Australian equities MIS. As a result, it is both appropriate and efficient to incorporate by reference in such instances.

As an RE, Equity Trustees utilises a master compliance plan to capture common controls for key compliance obligations in the interest of efficiency. Where schemes present different risks they will typically have additional controls in place, which are incorporated for that scheme in addition to the master compliance plan.

Different controls are required where there are distinct structural, procedural or risk features within the scheme that require reflection in the compliance plan. For example, where the MIS is listed on an exchange, or; where it contains highly illiquid assets such as property. In these instances, a compliance plan that incorporates controls by reference (assuming base controls are relevant to the scheme), should be supplemented by specific controls relevant to that scheme.

Equity Trustees believes the current arrangement of allowing incorporation by reference strikes an appropriate balance to describing the control environment and managing costs to investors. However, provision of explicit guidance in line with the above may aid the industry and guard against inappropriate generic incorporation by reference.

1.2 Amend the liability framework for compliance plans, such that liability attaches only to material contraventions of a plan, to incentivise higher quality plans

Equity Trustees supports Treasury's proposal in relation to amending the RE and officer duties and liabilities in sections 601FC and 601FD to remove the liability for a non-material breach of the compliance plan. We agree that an approach to accountability and liability based on materiality is appropriate to incentivise higher quality compliance plans that focus on material risks, thereby preventing material issues occurring.

Equity Trustees submits that amending the liability framework to centre on materiality will necessitate guidance on what would constitute a material contravention to ensure a consistent approach to assessing materiality is taken across the industry.

1.3 Make existing audit and assurance standards mandatory for auditors of compliance plans

Equity Trustees is supportive of clarifying audit standards, however any changes to the existing approach should be mindful of balancing increased audit scope which would result in potentially materially higher fees for members and the benefit of such changes for members.

1.4 Require responsible entities to notify ASIC of the appointment, removal or resignation of committee members

Equity Trustees notes Treasury's comments in relation to the opportunities to improve compliance committees. Equity Trustees primary position in regard to compliance committees is outlined in Proposal 2 below. However, Equity Trustees supports:

a. ASIC receiving event-based alerts, including notifications of changes to compliance committee members.
b. Updating RG 132 Funds Management: Compliance and Oversight, to require the RE to document a skills matrix that demonstrates the committee has the skills, experience and resources to undertake its role in an independent manner to the appointed fund manager.
c. Additional requirements with regard to the independence of committee members, such as requiring executives to be operationally independent to the appointed fund manager, particularly in relation to:
    - Oversight of investment management activities of the fund manager
    - Oversight of the compliance activities of each MIS; and
    - Promotion and distribution activities in relation to each MIS.

Equity Trustees does not support prescribing:

a. Specific sets of skills as this may vary depending on the schemes and risk profile governed by the RE.
b. Specific requirements in relation to committee proceedings such as the frequency of meetings, and reporting processes to the Board. Equity Trustees submits that these requirements should remain flexible to account for differences in REs and the funds they oversee, and that matters such as frequency of compliance committee meetings and how they report to the Board should be appropriate to the circumstances of the RE.

2. Should the framework for compliance plans be amended to include more specific content requirements?

Equity Trustees supports strengthening compliance plans by introducing minimum content standards and mandating plan elements to the extent these are not already included in ASIC's Regulatory Guide or simply by strengthening the guidance. Any amendments to requirements for compliance plans should avoid duplication of requirements included in other documents such as product disclosure statements, scheme constitutions, target market determinations and investment management agreements.

3. Who should set and enforce standards for compliance plan audits?

Equity Trustees does not have a view on who should set and enforce standards for compliance plan audits, albeit notes there are already structures in place governing audit standards that would appear to be appropriate.

4. Are any other changes required to strengthen the compliance framework?

There are requirements in the international regulatory environment, in some of the more advanced retail funds management markets in the world which are worth considering in the Australian context that would offer the potential for material improvement in the protection of member interests. For example, the Central Bank of Ireland, one of the primary jurisdictions for collective investment vehicles in Europe, have specific requirements relating to:

- Delegate oversight (where key functions of Scheme operation are outsourced or delegated to third parties) and
- Designated persons accountable to the Board of the governing entity performing specific key managerial functions being:
    - Capital and financial management
    - Operational risk management
    - Fund risk management
    - Investment management (which must be performed separately from operational and fund risk management functions)
    - Distribution
    - Regulatory Compliance.

In performing these functions single individuals may perform multiple functions but those responsible for investment management cannot perform operational or fund risk management functions which in our view is a sensible segregation of duties between a RE and an investment manager.

5. What would the impacts of the proposals be, including compliance costs?

In respect to compliance costs this is dependent on the nature of the changes which Treasury and the Government adopt. For example, a decision to move away from incorporation by reference in Compliance Plans and adoption of enhanced audit requirements are both likely to have a material cost to members which would need to be considered in the light of member benefit.

The cost of Equity Trustees' proposals above are likely to be more moderate and targeted at improved member protection with some increase arising from the Designated Persons proposal in 4 above (to the extent these roles are not currently conducted within RE's).

Proposal 2:
Require responsible entities of registered MIS to have a majority of external directors on the board and remove the option of having a mandatory compliance committee instead

6. Should responsible entities be required to have a majority of external board members?

Equity Trustees agrees with Treasury's comments that it is considered better practice for the majority of directors on a board to be non-executive and independent.

We strongly agree with the Treasury proposal to require a majority of external directors on the board of a responsible entity. We note that if this proposal is implemented the need for a compliance committee with a majority of external directors falls away and there would be no need to mandate the requirement for a compliance committee. Some boards may prefer to maintain such committees in order to retain focus and expertise, however this should not be mandated.

A number of the failures Treasury reference in the consultation paper and the consultation paper of 2023 (such as Shield, First Guardian, Trio, Timbercorp and Great Southern) utilised "in-house" or integrated REs and we believe did not have a majority of external directors – a key factor leading to poor outcomes for investors.

Furthermore, we propose the definition of external director in the legislation be amended to clarify the important and critical characteristic that the director is only considered external if also external to appointed investment managers, whether or not those investment managers are related body corporates. This would address one of the key issues where conflicts of interest have arisen in failed schemes.

Specifically, we propose a modified definition based on the existing Section 601JA (2)(a) and (b) of the Corporations Act which says:

> A director of the responsible entity is an external director if they: (a) are not, and have not been in the previous 2 years, an employee of the responsible entity or a related body corporate *or an appointed investment manager*; and. (b) are not, and have not been in the previous 2 years, an executive officer of a related body corporate *or an appointed investment manager*; and ……..

Looking forward, the application of best practice governance arrangements will ensure the interests of investors are, appropriately protected underpinning investor confidence in MIS structures as the industry continues to grow.

7. Are there enough external directors available in Australia to meet this proposal?

Equity Trustees believes that there are adequate number of directors who will be able to satisfy being external and are independent from investment managers to allow adequate skills and capability on boards. There is a significant pool of external members of compliance committees that could transition to RE boards.

8. Are any other changes required to address conflicts of interest and ensure independent oversight of MISs?

Equity Trustees propose that there are additional opportunities to enhance the governance of MISs including:

a. Codifying senior accountable roles within the RE and designated functions for oversight of investments, compliance (including Design and Distribution Obligations and reportable situations), and distribution/promotions, all with direct reporting lines to the RE Board (or its Compliance Committee) in line with our response to Q4.
b. Expanding ASICs data collection as outlined in Proposal 5 would also increase transparency and ability to oversight any actual or potential conflicts.

9. What would the impacts of the proposal be, including compliance costs?

Legislating changes to governance structures will likely increase costs in director fees. However, there will be offsets through the reduction in compliance committee costs if they were no longer mandated. The introduction of external requirements for Board Directors should improve the outcomes for investors by ensuring independent oversight and protection of their interests and the increased cost would not be material

Proposal 3:
Prohibit responsible entities of registered MISs from conducting related party transactions with limited exceptions

10. Should responsible entities of MISs be prohibited from investing or lending money to companies that are controlled by a member of the responsible entity's board or companies that are related bodies corporate of the RE? What exceptions would be required?

Equity Trustees notes Treasury's comments that conflicted arrangements involving related party transactions (specifically related party loans) have occurred in relation to significant industry failures, such as the Shield and First Guardian MIS's.

We strongly agree that responsible entities of MISs be prohibited from investing or lending money to companies that are controlled by a member of the responsible entity's board or companies that are related bodies corporate of the RE.

We agree with the above proposal, however legislation needs to be very specific, to not prohibit common industry structures designed for legitimate efficiency reasons, i.e. fund of fund structures interposed vehicles and master/feeder structures. These structures allow for efficient implementation allowing investment managers to not replicate an investment strategy and therefore minimise cost to investors and are a particularly important mechanism for Australian investors to access overseas investments efficiently. As noted in the paper, it is common for feeder funds to invest in other underlying funds related to the same investment manager and in the vast majority of cases these arrangements do not lead to investor harm.

. These types of structures require a range of requirements to protect investors:

- Confirmation of arm's-length pricing and detailed disclosure of fees at both feeder and master fund levels
- Outline of the relationship between the feeder fund, master fund and investment manager,
- Outline key risks associated with the feeder fund including liquidity, taxation or currency risks
- Clear disclosure around feeder fund withdrawal terms and their flow through impact to the MIS
- Independent valuation/fairness opinions where appropriate, and
- Enhanced disclosure to ensure appropriate transparency in the assets of underlying vehicles.

11. Are any other changes required to ensure investment decision making by the RE is in the best interests of scheme members?

The critical aspect of governance and investment decision making by an RE is that the RE has independence to the investment manager, achieved via either being an independent entity or by the RE board having a majority of external directors, that are external to the investment manager. In the less common structure where an RE does not appoint a separate investment manager, then the same principle should apply, in that the external directors of the RE are not involved in the investing activity and are in effect external to the investing activity.

12. What would the impacts of the proposal be including compliance costs?

Our proposals would not result in material increase in costs.

13. Where a RE has a separate investment manager should the investment manager be prohibited from being a related party?

We strongly believe it would be unworkable for the industry, to prohibit the appointment of an investment manager that is a related party of the RE. The vast majority of the industry is structured in a manner where the investment manager is a separate entity to the RE and is a related party of the RE. If there continues to be no prohibition, it means the requirement for a majority of external directors on the RE board is essential.

Proposal 4:
Amend the framework for setting financial requirements for responsible entities, such as setting more specific requirements

14. Should more specific financial resource requirements be imposed on responsible entities (in addition to the general obligation to have adequate resources under section 912A(1)(d) of the Corporations Act)?

Equity Trustees notes Treasury's comments in relation to minimum cash requirements and minimum net tangible asset (NTA) requirements, which are not currently designed to ensure MISs are able to absorb unexpected losses or to maintain the ongoing viability of schemes.

Equity Trustees observe that the subject of the NTA requirements is not part of the scope of this consultation, however it is central to consumer protection and international competitiveness.

Equity Trustees submits that capital requirements are essential, however in their current form they do not support improved performance or the safe development of the financial system.

RG 166 NTA requirements are currently as follows:

Table 11: NTA requirements for responsible entities

Type of responsible entity	NTA requirement
You are a responsible entity only **OR** You are a responsible entity and also an IDPS operator or corporate director of a retail CCIV **AND** You satisfy any of the requirements relating to custody in RG 166.223(a)–RG 166.223(d).	**1** You must hold at all times minimum NTA of the greater of: (a) $150,000; (b) 0.5% of the average value of fund assets (based on scheme property of the registered scheme(s) you operate **OR** all scheme property, IDPS property and CCIV assets, as applicable) up to $5 million NTA; or (c) 10% of your average revenue.
You are a responsible entity only **OR** You are a responsible entity and also an IDPS operator or corporate director of a retail CCIV **AND** You do not satisfy any of the requirements relating to custody in RG 166.223(a)–RG 166.223(d).	**2** You must hold at all times minimum NTA of the greater of: (a) $10 million; or (b) 10% of your average revenue. Note: As a result of s766E(3)(b), the operation of a registered scheme or the holding of scheme assets by a responsible entity is not a 'custodial or depository' service. Consistent with the focus of regulation of the operation of registered schemes being on the responsible entity, we impose the responsibility for ensuring adequate financial standing of custodians for registered schemes on the responsible entity.

When compared to international jurisdictions, we recommend changes to capital requirements. The UK, Luxemburg and Ireland regulatory regimes all have capital requirements that have a higher minimum capital requirement and escalate in line with assets under supervision. Some other jurisdictions also have a cap on capital.

As an example, UK, Irish and Luxembourg UCITS Management Companies capital requirements are:

	UK	Ireland	Luxembourg
Minimum	€125,000 initial capital	Higher of: - €125,000 initial capital + Additional Requirement (if required) - Fixed Overheads Requirement	- €125,000 fully paid-up initial capital - Maintain sufficient own funds relative to AUM and prior year expenses (no explicit cap cited)
Maximum	0.02% of AUM above €250m (cap €10,000,000 total)	0.02% of AUM above €250m (cap €10,000,000 total)	N/A

To address this shortcoming while still achieving ASIC's regulatory objectives, we strongly believe Treasury should consider the following:

a. Introduce a higher minimum capital requirement. This amount must be adequate enough to cover for an orderly transition of the RE, or wind up of a scheme, if this was required. In our experience such processes can take a number of resources up to one year to fully complete. Our view is that the $150,000 current minimum is inadequate to protect investors in such circumstances. We strongly recommend a minimum of at least $2 million in capital. We also believe that a higher minimum capital requirement is commensurate with the responsibility and accountability of the role of RE and a higher minimum capital requirement would result in higher quality, more committed REs of substance.

b. Amend the NTA calculation methodology to align with the earning of revenue across the value chain (thereby attempting to align the capital holding with the source of operational risk). For example, in the case of the RE amending the calculation from 10% of licensee revenue plus any amounts paid payable to agents for services performed on the licensee's behalf to operate the MIS (RG166.220), to 10% of the RE's fee with the remaining capital held proportionately across the value chain. This change can be made if the minimum capital requirement is increased to $2 million.

c. In addition, the current regime can result in unnecessarily large capital requirements for larger scale REs. For example, EQT currently is required to hold $94 million in capital under the existing regulations, well in excess of international caps. This can restrict continued investment in innovation which can support a robust financial system and protect investor outcomes. We recommend a maximum that better reflects the costs of an orderly transition of RE, or wind up of schemes. A cap of $20 million would align with international jurisdictions.

15. Should the MIS financial requirements (including the net tangible asset requirement for responsible entities) continue to be set by ASIC using its exemption and modification powers in the Corporations Act or should the requirements be set out in primary legislation or regulations?

Equity Trustees has no preference on where the MIS financial requirements are specified.

16. Should the objectives of the MIS financial requirements be specified in primary legislation or regulations to provide more clarity about the purpose of the requirements?

Equity Trustees has no preference on this query but acknowledges that additional clarity on legislative purposes can only be helpful.

17. Are any other changes to the framework for determining MIS financial requirements required?

Included in response to Q14.

18. What would the impacts of the proposal be including compliance costs?

Our proposals are varied and implementation costs would require exploration depending on what changes may be adopted. Increased minimum capital requirements will increase costs to investors or reduce profitability to the RE and/or the investment manager, if the servicing cost of the capital is not passed through to the investor as an increased price.

Proposal 5:
Increase ASIC's data collection powers on the retail MIS sector

19. Should a new legislative framework be introduced for the recurrent collection of data by ASIC on MISs?

Equity Trustees notes Treasury's comments that there is limited data available on the retail MIS sector, impacting on ASIC's ability to perform its regulatory oversight.

Equity Trustees believes that increasing ASIC's access to data on the retail MIS sector in the form of recurrent data collection and event-based alerts to ASIC would enable earlier risk detection and supervisory responses as part of ASIC's surveillance activities and for industry participants knowledge. We also strongly encourage Treasury to consider that data should be collected on all MISs, not just registered MISs. The advantage of this would be that the data would provide a complete picture of the investment market as it relates to collective investment vehicles.

REs and their appointed custodians, administrators and registry providers would require a transition period to be able to provide the data.

20. What types of recurrent data could help to detect risks including conduct or fund level risks in the retail MIS sector?

We propose collection of information for MIS data on a semi-annual basis including the following:

- Funds Under Management (FUM)
- Inflows
- Outflows
- Asset Allocation
- Liquidity profile
- Leverage
- Service providers appointed to provide services to the scheme
- Number of investors.

21. What data should be collected about MISs?

We would also propose collection of the following information for MIS data on a semi-annual basis;

- Details of holdings in other MISs (to allow industry double counting to be assessed)
- Proportion or amount of FUM owned by superannuation funds (to allow an assessment of the superannuation industry's investment in MISs).

22. What event notifications should be provided to ASIC? For example, should there be a notification when redemptions are frozen or suspended?

We propose data for the rapid inflows also be collected (which would require definition).

It could also be useful to leverage the APRA data collection framework for superannuation funds, although we recognise that the reporting requirements for MISs would be substantially simpler.

23. What would the impacts of the proposal be including compliance costs?

Any additional data collection will come with additional administrative costs by REs, custodians, administrators and registries, and we do not expect the additional costs to be material to investors. The data is clearly available, and the benefit of efficient centralised data collection outweighs the minimal additional costs.

Proposal 6:
Alerts to ASIC about superannuation switching

Equity Trustees are responding in our capacity as a RE. We defer questions about alerts to ASIC about superannuation switching to responses from superannuation RSE Licensees.

EQT Holdings Limited
ABN 22 607 797 615
T (03) 8623 5000 | F (03) 8623 5200 | equity@eqt.com.au
Registered office: Level 1, 575 Bourke Street, Melbourne VIC 3000
Melbourne, Sydney, Adelaide, Brisbane and Perth
www.eqt.com.au

Main operating entities: EQT Holdings Limited (ABN 22 607 797 615), Equity Trustees Limited (ABN 46 004 031 298 AFSL 240975), Equity Trustees Superannuation Limited (ETSL) (ABN 50 055 641 757 AFSL 229757), Equity Trustees Wealth Services Limited (ETWSL) (ABN 33 006 132 332 AFSL 234528) and Australian Executor Trustees Limited (ABN 84 007 869 794 AFSL 240023).