

## Chapter 6

### **Investors' criticisms of the regulatory framework and the role of the regulators and gatekeepers**

6.1 This chapter details the views of investors as to who they believe should be blamed for the collapse of Trio Capital. It highlights Trio investors' assumption that the regulatory framework would protect their investment, and their view that the regulators, the gatekeepers and financial advisers have failed them.

6.2 Chapter 3 of this report noted the significant financial losses and emotional distress of the investors who lost money in the collapse. This section presents investors' views as to who is to blame for the collapse of Trio Capital. These views are important for two reasons. First, they are important for the public record: the voice of these investors must be heard. Second, the views give an indication of discrepancies between investors' expectation of regulatory protection and auditing transparency and what these standards actually are. This issue of an 'expectations gap' is dealt with in chapter 7.

#### **Investors' criticism of SMSF framework**

6.3 In explaining why there is a different level of protection for investors in SMSFs, as opposed to investors in Australian Prudential Regulation Authority (APRA) regulated funds, the government has highlighted the trade-off between choice and risk. With Self-managed superannuation funds (SMSFs), there is greater choice and more control in constructing an investment portfolio, but with that comes responsibility to take necessary precautions.

6.4 This phrase derives from a December 2009 publication *Investing between the flags—A practical guide to investing*.<sup>1</sup> Upon releasing the guide, the then Chairman of Australian Securities and Investments Commission (ASIC), Mr Tony D'Aloisio, commented:

It's just a metaphor but when you go swimming at the beach, you will reduce the risk of drowning if you swim between the flags, similarly, when you invest, you will reduce the risk of losing your money if you adopt the

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1 ASIC, *Investing between the flags – A practical guide to investing*, <http://www.moneysmart.gov.au/media/173788/investing-between-the-flags.pdf> (accessed 27 October 2011)

investing behaviours identified in this guide which has been developed over a long period of time.<sup>2</sup>

6.5 Ms Nicole McCann explained that her initial decision to invest in Trio Capital was based on an understanding that the regulatory framework was in place and there to protect her investment. She identified four aspects of this framework:

Number 1: the fund was subject to supervision and due diligence of APRA, the government body charged with providing oversight and governance for financial service providers to minimise the likelihood of financial losses to depositors, policy holders and superannuation fund members. Number 2: the fund manager was appropriately licensed by ASIC, the corporate markets and financial services regulator. Number 3: a long history of public reports made by reputable research houses indicating solid performance of the fund. And No. 4: the financial advice presented to me by my adviser made a clear statement of risks and benefits of investing in the fund. It is my belief that I was entitled to rely upon ASIC and APRA having applied sufficient due diligence in reaching their respective decisions to license fund managers and to approve the fund for Australian marketplaces.<sup>3</sup>

6.6 Similarly, Ms Bent told the committee:

We had our fund managed by a financial adviser and he thought that the way it was invested was not going very well. He called us in to have a discussion with him. He presented the reports of that fund's performance. I remember asking at the time: 'How do we know these people do the right thing and they're credible reports?' His response, which was quite reasonable, was their whole reputation relies on them being credible and accurate with their projections and with their reports. I trusted that. I also trusted that there were a number of regulatory bodies in place. In Australia surely checks and balances are in place looking after those funds and people cannot get licences if they are not of good character and have the skills to run them. Based on that and the reports from these investment houses, we agreed to move out that money.<sup>4</sup>

6.7 The committee heard from some witnesses who suggested that the system would be improved if there was notification as part of the investment documentation that the investor was moving from one part of the regulatory framework covered by compensation to another part that was not eligible for compensation. Ms Julia Fellows told the committee:

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2 Australian Securities and Investments Commission, 'Investing between the flags', *Media Release No. 244*, December 2009, <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-244MR+Investing+between+the+flags?openDocument> (accessed 27 March 2012).

3 Ms Nicole McCann, *Committee Hansard*, Thirroul, 6 September 2011, p. 11.

4 Ms Sharon Bent, *Committee Hansard*, Thirroul, 6 September 2011, p. 16.

Neither my husband nor I ever comprehended that there was less regulatory protection for self-managed funds in pooled investment arrangements than for individual superannuation accounts in industry, corporate or retail funds. Given our conservative approach, we would never have gone down the self-managed path if we had understood that this type of superannuation savings vehicle was not regarded by the Federal Government as deserving of the same safety net protection as other types of superannuation savings arrangements. This fact had never been made known to us – there had been no warning from the Government or the regulators that you invest, however prudently, in your own self-managed fund at your peril. In the event that you are the victim of fraud through absolutely no fault of your own - unlike the rest of the community's superannuation savings – your superannuation savings have no protection whatsoever. This seems contrary to Australia's proud international reputation as a country with guaranteed protection for all superannuation savings. Indeed, it seems incomprehensible to me that the Government would facilitate the establishment of SMSF arrangements to encourage the self funding of retirement, without putting in place the necessary regulatory protection to afford such arrangements security in the event of fraud.<sup>5</sup>

6.8 In evidence to the committee, Mr John Telford noted:

...five months after the Trio collapse...I received a letter from the Taxation Office to say that I was invited to a public seminar for self-managed super funds. I rang them up because I thought they had made a mistake. I told them, 'No, I am in a superannuation fund,' and they checked and said, 'No, you are in a self-managed super fund.' So I went along to that meeting and that is when I discovered the rules and regulations, where the trustee is ultimately responsible for his or her investments and information like that. That is pretty vital information. Why did I not get that before? I was never given the choice that there were two funds, and that one had insurance cover and the other one did not. That is pretty astounding.<sup>6</sup>

6.9 Even more alarmingly, Mr Warren Daley noted that he was moved from an APRA-regulated superannuation fund to an SMSF without any warnings of the higher risk. He told the committee:

In July 2007 when we were moved from a pooled PST [pooled superannuation trust] to a SMSF, we were not advised by Regulators, Auditors, Custodians or Company Directors that we would be excluded from Commonwealth protection in the event of fraud of theft, there was nothing in the PDS [product disclosure statement] advising us of future risk exposure either. Why is it that the matter of Commonwealth sponsored

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5 Ms Julia Fellows, *Submission 12*, p. 1.

6 Mr John Telford, *Committee Hansard*, Thirroul, 6 September 2011, p. 4.

protection is not advised in all PDS or prospectus documentation with the Superannuation Industry?<sup>7</sup>

## **Investors' criticism of the regulators**

6.10 Several submitters expressed frustration at the failure of the regulators and auditors to do their job properly. Mr Norman Upton, a long-time BHP coal miner, told the committee:

The underlying causes of this collapse were fraud and dishonesty. This has already been proven in a court of law. The regulating bodies failed to have measures to protect exposed investors. In my view, ASIC, APRA, and the auditors, directors and regulators of Trio were deficient in their obligation to inform and, when needed, bring corrective measures at the earlier point of time.<sup>8</sup>

6.11 On this final point, Ms McCann was highly critical of the government for 'pointing the finger of blame' at advisers and those who invested through an SMSF, when responsibility should rest with ASIC, APRA, the auditors and industry research houses. She posed the following questions:

How can it be that APRA can be considered to have completed sufficient due diligence checks and ongoing supervision of fund to discharge its statutory responsibility when it was aware for four years that the valuation of the fund could not be substantiated by the principals?

...

What responsibility should be ascribed to the fund auditors (KPMG and WHK) who released an audit report which gave the fund manager Trio a high quality rating only three weeks before the fraud was uncovered?

...

How can ASIC be considered to have properly discharged its obligations to conduct sufficient due diligence checks to provide protection to the Australian investment community when it issued a licence to Shawn Richard, who has since been found by the courts to have had no prior experience or qualifications?

How can the financial planner be solely responsible for the failure when industry research houses such as Van Eyk and Morningstar were providing reports which gave the fund a high rating?

How is it that the government can differentiate between victims of a fraud perpetrated by a group licensed by ASIC and supervised by APRA on the

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7 Mr Warren Daley, *Submission 22*, p. 2.

8 Mr Norman Upton, *Committee Hansard*, Thirroul, 6 September 2011, p. 9.

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basis of whether or not their investment vehicle was a supervised superannuation fund?<sup>9</sup>

6.12 Mr Russell Smith took aim at the role of auditors and APRA in the collapse of Trio Capital:

Auditors are there to do their job...APRA said that there was gross incompetence on behalf of the directors. If there was gross incompetence on behalf of the directors of Trio, then there is gross incompetence on behalf of APRA in not being to apply the same rules themselves to ensure that those audits were done correctly and that the funds were a viable entity.

The auditors over five years received millions of dollars in fees to audit these companies. They audited them and believed and stated that those funds were all there and that Trio Capital was a viable business and entity. Yet, having done those audits, we now find that there was fraud from day 1 of that company. If those audits had been done correctly, we would not have had the problem of fraud and loss of money from investors.

If an audit company is held responsible and accountable for what they are doing, then these sorts of things will not have the potential to occur in the future. If they were held accountable for those funds and would have to pay the losses that were incurred, then I am sure that the audits would be done properly...If the legislation is changed and they are held accountable and responsible for their actions, then these frauds et cetera will potentially not happen. Therefore, there will not be the reliance on governments to support either part 23 type actions or, down the track, to have to help out pensioners and retirees who have lost their moneys and so have to go onto pensions.<sup>10</sup>

6.13 Mr Shayne Bonnie, who has lost significant superannuation savings as part of a SMSF investment in the Astarra Strategic Fund (ASF), was also critical of the action and inaction of the regulators and auditors. In evidence to the committee, he noted:

APRA said...they did not respond when Trio could not provide valuations. Multiple times Trio did not give them valuations and there was no action taken. If they had taken action at any stage back then, then we would never have invested in Astarra, because we invested after the valuations were not received. ASIC, of course, licensed Shawn Richard. We know what has happened there. Research houses were giving glowing reports on Astarra. The research was presented to us by Tarrants. It was no different from research that you would see for BlueScope, BHP or Rio. The reports were glowing. Auditors were signing off on Trio. KPMG signed the most recent audit a couple of weeks before ASIC froze the fund. Now you have Trio directors in front of the courts. The auditors are supposed to be auditing the

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9 Ms Nicole McCann, *Committee Hansard*, Thirroul, 6 September 2011, p. 11.

10 Mr Russell Smith, *Committee Hansard*, Thirroul, 6 September 2011, p. 2.

process. These guys obviously were not following the process, and yet KPMG were telling us that they were.<sup>11</sup>

6.14 Mr Nicholas McGowan, who with his wife established a self-managed superannuation fund with a significant portion invested in ASF, was also scathing of ASIC. He told the committee:

Our losses have come about by investing in a fund that was licensed by ASIC a licence, I understand, that was one of only 13 such licences granted the other such licences being granted mainly to banks. This licence was given to Shawn Richard a young Canadian traveller who claimed to have a finance degree from a Canadian university later to be proven a false statement. For ASIC to grant such a licence I would have expected that this fact would be cross-checked. The fact has emerged since that Richard was also connected to several suspect companies, schemes and individuals who had already been involved in defrauding investors in many other countries which was also not investigated by ASIC prior to giving him such a licence. If this had been done, surely the licence to manage investor funds would not have been granted.

...

To be defrauded by a government licensed fund means that we have no faith in a financial regulatory system, which we thought was the best in the world. We also feel that the government has a duty to reimburse all investors in Trio Capital funds, given that a government body in ASIC has allowed this fund to operate under a licence granted by them. The fund has been acknowledged as a fraud by Minister Shorten when he announced the compensation package for investors through APRA regulated superannuation funds. Our view was further strengthened and our disappointment heightened when we learned that APRA and ASIC had concerns about the unit pricing of the fund on three separate occasions, all prior to us investing, and nothing was done to intervene in the operations of the managed fund. If action had been taken and the fund frozen and investigated at the time, then all of us here today would not have lost the money we have.<sup>12</sup>

### **Investors' criticism of the auditors**

6.15 The committee heard from several individual investors in Trio Capital that the gatekeepers failed to do their job properly. Chapter 4 noted that two of the three regulators apportioned significant blame for the collapse of Trio to the gatekeepers. It also noted the gatekeepers' rejection of these arguments.

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11 Mr Shayne Bonnie, *Committee Hansard*, Thirroul, 6 September 2011, p. 7.

12 Mr Nicholas McGowan, *Committee Hansard*, Thirroul, 6 September 2012, p. 17.

6.16 Several submitters were highly critical of the role of the auditors in the collapse of Trio Capital. Mr Colin Warne, notably, wrote that:

Each auditor stated that they were satisfied that the financial statements represented a true and fair account of the financial affairs of the fund...[but]...for six years, the funds issued audited financial statements that, arguably, were a fabrication.<sup>13</sup>

6.17 Another submitter, who withheld their name, stated:

In our opinion the examination of the roles ASIC, APRA and the auditors such as KPMG & WHK played needs to be examined, these parties as far as we are concerned failed in their Duty of Care to the investors. They did not undertake or apply correct procedures or protocols when it came to compliance and/or auditing.<sup>14</sup>

6.18 Similarly, Mr Smith argued in his submission:

In my opinion you are starting at the wrong end by focusing on the Financial Planners, instead of beginning your examination on the role, effect and impact of ASIC, APRA and the auditors such as KPMG & WHK who all failed in their Duty of Care to the investors. They did not undertake or apply correct procedures or protocols when it came to compliance and/or auditing.<sup>15</sup>

6.19 He directed further criticism at the auditors in his verbal evidence to the committee:

I went through a financial planner organisation and, as in my statement to the committee, I do not hold anything against the financial planner. I believe they could not have done any more than they did to understand what the market was and what the companies were that they were investing in. They did their due diligence. They relied on all of the reports that came from either ASIC, APRA or the auditing companies to ensure that the investments were sound and correct.

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You rely somewhat on looking at the documentation in terms of your return on those investments. We did receive statements on a regular basis as to where we were at with our investments. Those were being supplied through Trio to our financial planner and then on to us. Again, those statements were audited.<sup>16</sup>

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13 Mr Colin Warne, *Submission 38*, p. 2.

14 Name withheld, *Submission 13*, p. 1.

15 Mr Russell Smith, *Submission 4*, p. 1.

16 Mr Russell Smith, *Committee Hansard*, Thirroul, 6 September 2011, p. 3.

6.20 Mr Shayne and Mrs Tracey Bonnie were also critical of the role of the auditors:

Auditors signed off on Trio. KPMG signed off on the most recent audit a few weeks before ASIC froze the fund. Trio directors are currently in front of the courts because of the way they ran their business and yet the auditors were telling us back then that Trio was compliant.<sup>17</sup>

*Committee view*

6.21 The committee believes that the capacity of auditors to identify and highlight fraud is limited. This is apparent from the evidence provided by the auditors' themselves to this inquiry. Based on the auditors' role in the Trio Capital case, the criticism expressed by many investors towards the audit certification process is very much understandable.

### **Investors' criticism of financial advisers**

6.22 Unsurprisingly, many Trio Capital investors vented their frustration at financial advisers given that they invested on the basis of their adviser's recommendation. Mr John Telford told the committee that:

Most of the people that are affected that I know of put their trust in a professional financial adviser. So I got on the telephone and I phoned around to different people that I know and I checked with people in a self-managed super fund and people in a regulatory fund, and most of them agreed with my misunderstandings of what I was in. I thought I was in superannuation. I did not even know that I was in a self-managed superannuation fund. If I had heard the name 'self-managed', I would not have thought that to be a noun or a product—something happening rather than a product. Also, I talked to people from both camps and nobody knew about fraud insurance or fraud or that your money can disappear. So I think that, on the one hand, the government bailed out for the regulatory and that was just a stroke of luck for those people that happened to be in the APRA regulated. For us that are missing out it seems like a difference was made out of information not available before this crisis happened in the first place. I would like to see that established—that there really is no difference between the two lots of investors.<sup>18</sup>

6.23 Another submitter, who asked for their name to be withheld, noted the difficulty of understanding the financial investment:

I regret not being more financially sophisticated myself. Unfortunately I trusted the professional financial advisers in the way I trust medical

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17 Mr Shayne and Mrs Tracey Bonnie, *Submission 1, Supplementary Submission (b)*, p. 4.

18 Mr John Telford, *Committee Hansard*, Thirroul, 6 September 2011, p. 4. See also Mr John Telford, *Submission 66*, p. 1.

professionals. In the same way that it is unreasonable to expect members of the public to have in-depth knowledge of neurosurgery, so is it unreasonable to expect members of the public to have in-depth knowledge of sophisticated and confusing financial matters. All of my energy has gone into trying to raise two children to become decent law-abiding citizens. I was mother and father to them. I did this while working fulltime instead of going on a parenting pension.

I tried to educate myself on financial matters but simply did not have the time or energy to succeed.<sup>19</sup>

6.24 Ms Julia Fellows, on behalf of her mother, wrote:

Unfortunately, neither my husband nor I were particularly knowledgeable at that time about complicated investment matters and so we put a high degree of trust in Mr ... as our investment manager.<sup>20</sup>

6.25 Mr Rodney Denniss, another SMSF investor in Trio, was asked whether upon moving his funds out of an industry fund to invest as an SMSF, he sought any advice from the industry fund about the risks. He responded:

No, I did not. I just jumped at the opportunity to have some kind of input rather than having no input. When the opportunity arose, that was my intention. I just wanted to get a seat to have a look at what was going on. I guess I mainly wanted to have some kind of small involvement. I am sure I thought I would do better.

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I thought there was a slightly greater risk, but there is a risk in just generally investing each year. There is a risk element when I adjust the portfolio every year. If decisions were made to go with my adviser or to balk at something and say, 'Maybe not that. Maybe something else,' not knowing what it was, if I balked at something I would say that. This might be a naive belief and it seems that it is, but I thought that everyone in a super fund in Australia was pretty safe because we have regulatory bodies.<sup>21</sup>

6.26 Mr Denniss noted that no one had told him that as an SMSF he was not entitled to the same level of regulatory protection as APRA-managed funds. He did not ask about the level of regulatory protection he would receive as an SMSF as he assumed that given the compulsory superannuation system, the protections would be uniform.<sup>22</sup>

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19 Name withheld, *Submission 62*, p. 2.

20 Ms Julia Fellows, *Submission 12*, p. 1.

21 Mr Rodney Denniss, *Committee Hansard*, Thirroul, 6 September 2011, p. 21.

22 Mr Rodney Denniss, *Committee Hansard*, Thirroul, 6 September 2011, pp 21–22.

6.27 These issues of SMSF investor knowledge and understanding are revisited in chapter 7. They represent a significant challenge for the financial advice industry and for ASIC and the ATO.