Executive summary

Superannuation in Australia is held and managed under the *Superannuation Industry (Supervision) Act 1993* (SIS Act). In June 2011, the total value of Australian superannuation assets was $1.34 trillion: 60.7 per cent of these assets was held in superannuation funds regulated by the Australian Prudential Regulation Authority (APRA); a further 30 per cent was held by self-managed superannuation funds; and the remaining 10 per cent comprised of exempt public sector superannuation schemes and the balance of life office statutory funds.[1]

In recent years, there have been three major financial collapses in Australia: Trio Capital, Westpoint and Storm Financial. In response to the collapse of Storm Financial, the Parliamentary Joint Committee on Corporations and Financial Services ('the committee') recommended extensive reforms to the regulation of the financial advice industry in Australia. Many of those recommendations have now been passed in the House of Representatives as part of the Future of Financial Advice (FoFA) reforms).

This inquiry has investigated the collapse of Trio Capital, which was the largest superannuation fraud in Australian history. Roughly $176 million in Australians' superannuation funds is lost or missing from two fraudulent managed investment schemes: $123 million from the Astarra Strategic Fund and $53 million from the ARP Growth Fund. Trio Capital was the 'responsible entity' for both schemes.

In the committee's view, the Trio collapse raises distinct, and in some ways more troubling, issues than those raised by the collapse of Storm Financial and Westpoint. Westpoint and Storm involved Australian investors being persuaded to put their money into investment vehicles which were much higher risk than was appropriate for—or understood by—most of the investors. Trio involved a fraud.

Nearly 6,090 Australians invested in Trio and lost their money despite the legislation in place under the SIS Act. 5,400 of those Australians had their money invested in Trio through APRA-regulated superannuation funds. Under the provisions of Part 23 of the SIS Act, investors in APRA-regulated funds received compensation totalling nearly $55 million. This was financed through a prepaid levy on all APRA-regulated superannuation funds.

Of the remaining 690 Trio Capital investors, 415 were direct investors and around 285 investors were in self managed superannuation funds (SMSFs). Under the SIS Act, these investors are not eligible for compensation: the Act excludes SMSFs from

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1 Australian Prudential Regulation Authority, *Australian Superannuation Bulletin: Statistics, June 2011*, issued 29 February 2012, p. 5 http://www.apra.gov.au/Super/Publications/Documents/June%202011%20Annual%20Superannuation%20Bulletin.pdf (accessed 1 May 2012).

financial assistance where certain superannuation entities have suffered loss as a result of fraudulent conduct or theft.

As this report discusses, the committee is extremely troubled by both the nature and the scale of the Trio Capital fraud, and the impact they have had on the lives of hundreds of Trio Capital investors. The committee has received substantial evidence from some of those investors detailing their considerable financial losses and the physical and emotional toll of these losses have had on them and their families. In many cases, Australians who had saved for many years to provide for their retirement were defrauded of the entire balance of their retirement savings. It is particularly saddening that this fraud appears to have fallen heavily on many people who had made particular and conscientious efforts over many years to accumulate and manage savings so that they would not be required to rely on the pension.

The issue of compensation

While the committee respects the courage and testimony of those who reported their losses to the inquiry, it does not believe it is prudent at this time to protect SMSF investors from losses to theft and fraud in the way that APRA-regulated superannuation fund investors are covered under the SIS Act. SMSFs typically have more control over, and choice in their investment strategy and portfolio than investors in APRA-regulated superannuation funds.

These benefits of investing in SMSFs come with attendant responsibilities, one of which is to be alert to the risk or fraud and theft. Unlike APRA-regulated investors, SMSF investors do not have a professional management team to exercise this caution. It is clear to the committee that many of those who gave evidence unquestioningly accepted advice from a financial advisor and were completely unaware of how exposed their life savings were to theft and fraud. On balance, however, the committee does not support the introduction of a compensation scheme that places a levy on SMSF investors as it would expose all SMSF investors to the bad decisions and lack of appropriate caution and prudence of other SMSF investors.

The committee notes that the recently released government-commissioned review by Mr Richard St. John into a statutory compensation scheme for investors in financial services also recommended against establishing such a scheme. Among other things, the review argued that such a scheme would impose upon well managed product providers the obligation to bear losses incurred by badly managed or negligent providers.

Chapter 6 of the St. John report sets out some elements of how a statutory compensation scheme could work if government were to decide to proceed. The St. John report states that SMSFs would not be included in the scheme.

The committee considers that if such a scheme were to be introduced, it could possibly have assisted SMSF investors in the Trio Capital case. These investors lost their money because their SMSF invested in a managed investment scheme of which

Trio was the responsible entity. Under the scheme described in Chapter 6 of the St. John Review, it is in the committee's view likely that Trio would have been found to have failed to meet the relevant standard; Trio would have been liable to pay compensation to its investors; but being insolvent and unable to pay the compensation, the last resort scheme would have come into operation. SMSF investors (as well as direct investors) would have received compensation.

If the policy objections raised by Mr St. John to the operation of such a scheme can be overcome, the committee considers that it has merit and would have assisted to reduce the detriment suffered by innocent Australian investors in the Trio case.

The committee also considers that there is merit in establishing an insurance scheme into which SMSFs could 'opt-in', enabling them to have protection against loss by reason of fraud or theft.

The Trio Capital fraud

The committee's investigation revealed that a number of investment vehicles operated by Trio Capital appear not to have been legitimate investments but merely conduits through which investors' money was stolen. In November 2003, a reputable funds manager, Tolhurst, was acquired by new owners; it now appears that they made this acquisition with a view to defrauding Australian investors (particularly superannuation investors) of substantial sums of money.

The Trio fraud appears to have been designed to take advantage of vulnerabilities in the superannuation system. A key element of the scheme was to move the funds of Australian investors overseas. This had made it much harder for Australian auditors and others to verify the existence of the funds; for Australian liquidators to recover any remaining funds; and for Australian authorities to investigate and to pursue those who have carried out criminal conduct.

The key figures responsible for the Trio collapse appear to have escaped any criminal or other sanctions. The evidence suggests that the 'mastermind' was Mr Jack Flader, an American citizen, at one stage resident in Hong Kong and believed to live in Thailand. The committee heard evidence that he has a history of involvement with securities fraud. While ASIC and APRA accepted enforceable undertakings from a number of former Trio directors, only one former director—Mr Shawn Richard—has been jailed. There is no current investigation relating to Trio by the Australian Federal Police (AFP) or the Australian Crime Commission.

Missed signals

A key finding of this report is that key checks and balances in the Australian financial and superannuation system did not work to identify the existence of fraudulent conduct and to shut it down rapidly. It was left to an alert industry participant to uncover the Trio fraud.

In September 2009, Mr John Hempton, Chief Executive Officer at Bronte Capital Management and a former Treasury official, wrote a letter to ASIC Chairman, Mr Tony D'Aloisio. The letter alerted ASIC to the suspiciously smooth returns achieved by the Astarra Strategic Fund in the context of a turbulent financial environment. Mr Hempton's letter resulted in ASIC launching an investigation into the activities of certain Trio funds.

The regulators—APRA and ASIC—must take their share of the blame for the slow response to the Trio fraud. APRA conducted five prudential reviews between 2004 and 2009. It took no enforcement action as a consequence of any of these reviews. ASIC only began its investigation in October 2009 after Mr Hempton's tip-off.

From late 2008 to mid 2009, APRA was unable to obtain from Trio a valuation of certain Trio funds' assets. The committee questions how a trustee can be subject to what APRA describes as 'active supervision' over a period of six years and yet, when essential information was not forthcoming at the end of this period, APRA did not act quickly. For a risk based supervisor, as APRA is, the inability of a trustee to provide basic valuation information should have raised strong concerns.

The committee also has concerns at the length of time it took for ASIC to detect the fraudulent activity. It is particularly concerned that communication between ASIC and APRA was lacking in the months from late 2008 to mid-2009. It seems that APRA had not communicated to ASIC its requests for Trio to provide information. As a result, when ASIC commenced its active surveillance of hedge funds in June 2009, it did not seem aware that Trio was not providing the prudential regulator with basic facts about the existence of assets and their value. This information should have been communicated.

The committee also believes that the regulators missed key events that laid the platform for the Trio fraud. The first was the purchase of Tolhurst from its previous owners in late 2003 by interests associated with Mr Flader. The second event related to investments in Trio products via a pooled superannuation trust called Professional Pensions PST (PPPST). In 2004, the trustee of PPPST, the Trust Company, was replaced after expressing concerns at the new investment approach of the interests associated with Trio. These concerns were either not relayed to APRA or did not lead APRA to take action.

ARP Growth Fund

As late as 2008, audits of the ARP Growth Fund, as well as other managed investment schemes that were part of Trio's range of products, continued to certify the accounts as giving a true and correct report of the financial position of the Fund. This occurred even though the principal asset of the Fund was a contract held by a company in the British Virgin Islands, and the auditor did not independently verify the existence of the company or the value of the contract.

A key factual question is whether the principal underlying asset of the ARP Growth Fund ever existed and had value. ASIC and APRA gave evidence to the committee that they believed the contract did exist but its value fell to zero as a result of Bear Stearns' liquidation in the global financial crisis of 2008. The committee heard other evidence that if the contract did exist, then it would have retained value as a result of Bear Stearns' liabilities being assumed by JP Morgan.

The committee is not satisfied that ASIC and APRA are correct in their belief that the contract fell to zero, or that this is founded on a reasonable investigation. The committee is concerned that ASIC and APRA hold this view because they have failed to fully investigate the alternative possibility: there may have never been a contract and the ARP Growth Fund was a fraudulent venture.

The need for further investigation

The committee is surprised that there appears to have been very little follow up activity by APRA, ASIC and other authorities such as the AFP, to seek to recover outstanding moneys or to bring to justice those who have committed crimes which have led to great suffering on the part of Australian investors.

As best the committee can ascertain, there are no ongoing criminal investigations into the conduct of Mr Flader or others involved in developing and implementing this scheme. Mr Richard has been charged and convicted, but he appears only to be the local foot soldier of the scheme.

The committee has been unable to obtain clear answers or evidence from ASIC, APRA or the AFP as to whether any attempts have been made to bring charges against Flader and others, to have them extradited to Australia, or even as to whether their names are on a watch list for people passing through Australian airports. There have been no examinations on oath of Mr Flader or any person other than Mr Richard and Mr Eugene Liu.

ASIC has provided some limited funding to the liquidator PPB Advisory to allow it to investigate the status of the various offshore companies into which moneys were invested by ARP Growth Fund and other Trio entities. The committee strongly believes there needs to be a renewed focus and energy on the part of ASIC, APRA and the AFP into pursuing every avenue to seek redress for Trio investors and to bring to justice all involved in this scheme.

The committee wishes to see these agencies pursue criminal investigations into the key figures responsible for this scheme as a matter of high priority. ASIC must provide all necessary funding for PPB Advisory to pursue its investigation to a full conclusion, including where necessary conducting examinations on oath of figures such as Mr Flader and others it considers necessary as part of the investigation.

Financial advisers

Another issue which the Trio collapse raises—an issue also raised in the case of Storm—is the role of financial advisers. Many investors put money into Trio vehicles based on advice from financial advisers.

There are clear 'regional clusters' of victims of Trio based on the locality of operations of particular financial advisers, including Tarrants in Wollongong, Seagrims in regional South Australia and Mr Paul Gresham on Sydney's North Shore. The committee does not know with certainty why these advisers recommended their clients use Trio products, but the evidence suggests that their recommendations were influenced by the high commissions paid by Trio.

The committee notes that an enforceable undertaking has been obtained from Mr Gresham, who advised a large number of his clients to put money into the ARP Growth Fund. Mr Gresham appears to have known and dealt with the principals of the fraud since at least 2003. If this is the only action which ASIC intends to take against Mr Gresham, the committee would be surprised and disappointed.

The conduct and involvement of the Wollongong-based Mr Ross Tarrant in advising 220 of his clients to invest in the ASF appears to have been in a different category to that of Mr Gresham. Nonetheless, Mr Tarrant was paid hefty commissions by recommending Trio to his clients. The committee recommends that ASIC investigate financial planners' and accountants' advice to SMSF investors in Trio Capital.

The committee notes the imminent reform of the financial advice sector through the implementation of the Future of Financial Advice (FOFA) legislation. Some of the financial advice given to Trio clients may have been in contravention of the 'best interests' test and conflicted remuneration provisions of the FOFA legislation.

However, these provisions would not protect against a circumstance where an adviser 'turns bad' and sets out to either defraud his clients or at the very least to concentrate on enriching himself while wilfully disregarding the evidence that the investment scheme into which he is putting his clients' money was fraudulent. In the committee's view, this is an accurate description of what occurred with Mr Gresham. In these cases, what is required is more effective enforcement of existing laws.

Auditors, custodians and research houses

From the evidence to this inquiry, the committee has identified 'expectation gaps' between what is expected of auditors, custodians and research houses and what they are actually responsible for doing.

It is of concern to the committee that auditors' approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist. Further, an auditor's assessment of a compliance plan and the work of the compliance committee as 'effective' essentially only means that they exist. Clearly in the case of

Trio, the requirement for the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.

The committee also notes that an enforceable undertaking was obtained from Mr Timothy Frazer, an auditor from the firm WHK. This is evidently an alternative to referring the matter to the Companies, Auditors and Liquidators Disciplinary Board for other disciplinary action. The committee questions whether this is an appropriate end to the matter. It agrees that a separate tribunal function is important but questions whether ASIC is making the best use of the Board and its role in maintaining professional standards.

The committee endorses ASIC's suggestion of an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval. The committee also supports ASIC's proposal to review the effectiveness of compliance plans and if necessary, require more detail to be provided in these plans.

Custodians appear to have a limited role in managed investment schemes of the kind conducted by Trio, and by many legitimate financial services providers. The custodian (in Trio's case, the National Australia Bank) does very little to protect the funds of investors. It makes no independent checks before transferring money offshore. Instead, the custodian simply acts on the instructions of the responsible entity.

The committee strongly supports ASIC's program to review custodian businesses and identify those issues requiring regulatory reform. In particular, the committee urges ASIC to consider the safeguards that a custodian could put in place to ensure it is able to identify and report suspicious transfers that do not trigger the anti-money laundering provisions.

The committee considers that the word 'custodian', particularly in product disclosure statements, is inappropriate. ASIC should find another term, such as a 'Manager's Payment Agent', which does not give unwarranted reassurance to investors.

Trio has also exposed misconceptions about the role of research houses. There appears to be a perception among some investors that research reports and ratings are a comment on future performance of a fund. This is not the case—the reports are solely an analysis of the past performance of the investment. There is a reasonable expectation among investors that research houses will verify the data upon which their reports and ratings are based. Again, this is not the case.

As was the case with the auditors, the custodians and to a lesser extent APRA, the research house Morningstar relied on the information provided by Trio without verifying whether the data was accurate. This is not to suggest that Morningstar acted improperly. Rather, it reflects the structure of the system, built as it is on the responsible entity providing information and acting honestly.

Better disclosure by managed investment schemes

The committee believes that greater disclosure of portfolio assets would help to improve monitoring of managed investment schemes, which would in turn assist in the earlier detection of fraud. It seems likely that had the regulators and gatekeepers had information about the underlying assets of the Trio Capital funds, the significant delay in APRA's requests for information in 2009 would not have occurred.

The committee therefore recommends that the government release a consultation paper to investigate the options for a statutory requirement for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. This requirement must be developed with a view to enabling scheme members to legally require specific information on the portfolio holdings of the registered managed investment schemes in which they have invested. This type of requirement would provide important information for the gatekeepers, the regulators and investors.

The committee notes the provisions contained in the recent exposure draft of the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012. The bill would provide APRA with an explicit power to require Registrable Superannuation Entity (RSE) licensees to provide investment information on their assets, or assets derived from their assets, that are invested by a managed investment scheme or a custodian of an RSE licensee. Where an RSE of a superannuation fund invests in a managed investment scheme, which in turn invests in another investment scheme, the information about the second scheme's assets must be provided to the RSE.

Self managed superannuation funds

The committee notes that SMSFs are subject to less stringent regulatory requirements under the SIS Act than APRA-regulated funds. The trustees of SMSFs are responsible for all decisions, and must make those decisions for the benefit of members, but SMSFs are not subject to the same prudential requirements as APRA-regulated funds.

Reflecting this more limited regulatory regime, SMSFs are not regulated by APRA. Instead, they are registered with, and overseen by, the ATO. The ATO's focus is on the SMSF's compliance with superannuation and taxation laws, not on prudential safeguards. That is, the ATO focuses on ensuring that SMSFs are not used as vehicles to avoid tax, that the SMSF has an investment strategy and that an independent auditor verifies annually that its investments have been made in accordance with that strategy. Unlike APRA-regulated funds, the ATO's role as regulator is not to ensure that the SMSF has appropriate risk management strategies.

The lack of stringent prudential regulation of SMSFs means that the role of finance professionals is extremely important in both the decision to set up an SMSF, in developing its investment strategy, in implementing that strategy and in complying with taxation laws and managing risk. Accountants' advice about the taxation implications and appropriateness of particular superannuation structures, such as

SMSFs, and financial planners' advice about the investment strategies and risks of such funds will generally be central to people's decisions about the structure of their superannuation affairs. While an SMSF investor and trustee will frequently use other finance professionals, such as auditors and actuaries, in their superannuation dealings, accountants and financial planners are generally people's entry point into the SMSF sector and, as such, occupy a key role in the sector.

The committee is concerned that some SMSF investors in Trio Capital seemed not only unaware that their investment was unprotected from theft and fraud, but unaware they had even established a self-managed fund. The committee considers that this highlights the need to improve financial literacy for those considering SMSFs. Similarly, there is a responsibility for accountants and financial advisers to better educate their SMSF clients and clearly communicate the risks and advantages of investing through these vehicles.

Protecting Australians' superannuation savings

In the committee's opinion, the Trio case exposes the significant vulnerability of the Australian superannuation savings system to targeting by criminals including offshore based criminals. Australia has one of the largest such savings pools in the world. Many Australians are disengaged from their superannuation savings. This is a product of a compulsory superannuation system, of many younger people having low balances, and of investors' inability to access their funds until they retire. The result is that many people will not pay close attention to how their funds are performing. In the case of Trio, Mr Gresham produced fictitious account statements for several years. Account holders had no reason to seek to withdraw the money and as a result, the fraud continued undiscovered for some time.

The committee believes there are significant policy steps required to better protect against the threat to Australia's superannuation system from criminals. These include:

(a) a dedicated focus within the AFP to detecting and combating superannuation fraud;

(b) more detailed scrutiny by APRA of the 'trigger points' at which criminals take control of superannuation vehicles;

(c) a much more vigorous criminal investigation, involving ASIC, APRA and the AFP, into the Trio fraud, with a view to pursuing the maximum available criminal sanctions against those responsible; and

(d) legislation to allow assets to be recovered from those personally involved in fraud and theft, with the proceeds to go towards compensating those who have lost money as a result of the fraud and theft.