

INQUIRY INTO THE COLLAPSE OF TRIO CAPITAL AND OTHER RELATED MATTERS

A statement of the matters expected to be dealt with during the appearance of NAB at the hearing on September 23, 2011, 1.15pm to 2.00pm into the collapse of Trio Capital

Opening Statement

National Australia Bank Limited (NAB) welcomes the opportunity to assist the Committee with its review of aspects of the collapse of Astarra/Trio (Trio).

NAB acknowledges that the financial collapse of Trio has caused significant emotional and financial distress to many Australians. It is deeply regrettable that investors were defrauded by Shawn Richards, who pleaded guilty to dishonesty charges and who is now in prison.

NAB also acknowledges that the Government's \$55M financial assistance and compensation scheme (funded by members of all APRA regulated superannuation funds, including members of the APRA regulated superannuation funds operated within the NAB Group¹) is limited to those who invested through APRA regulated super funds and does not cover self managed super funds.

This background helps to better understand the comments of Chairman Ripoll² that, for the future regulatory environment, "[we] need to make sure that do-it-yourself investors who are doing the right thing but fall victim to fraudulent financial advisers are supported by the regulatory environment".

NAB is aware that the Committee has received submissions and heard evidence from many parties including impacted investors, the Liquidators of Trio, regulators, industry bodies and industry participants.

These submissions and evidence contain scattered references to the role of custodians generally³, and specifically in relation to Trio, the role of ANZ Custodian Services and National Australia Trustees Limited (NAT), a member of the NAB Group. NAT was

¹ For the superannuation funds operated within the MLC & NAB Wealth part of the NAB Group, members contributed a total of \$3.7M, with individual member contributions ranging from \$0.15 to \$35.72

² Media Release dated 01 July 2011

³ See the Australian Custodial Services Association (ACSA) submission dated 19 August 2011

appointed by Trio as custodian on 06 February 2009. The submissions lodged by the Australian Investment & Securities Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and by the Australian Custodial Services Association (ACSA) provide good insights into the role of custodians and the roles of ASIC regulated managers of registered managed investments schemes, known as Responsible Entities (RE) and APRA regulated trustees, known as Registrable Superannuation Entities (RSE).

At the Committee's request, NAB aims through its evidence to provide the Committee with greater insight into two key issues, namely:

- 1) The role of third party custodians; and
- 2) The options for improvements to the current regulatory regime to better protect all investors.

NAB's evidence about the role of third party custodians will cover what custodians are responsible for and what they are not responsible for. NAB will also address the possible "expectation gap" that may exist between what is legally required of custodians and what investors may expect of custodians⁴. This expectation gap seems to arise from a misunderstanding about the respective roles of the RE & RSE on the one hand and the third party custodian on the other. The RE & RSE are singularly responsible for holding scheme or fund property on trust for members. They may appoint agents, including a custodian, to hold this property on behalf of the RE & RSE. The role of custodian is limited to holding assets as agent only for the RE & RSE (as the custodian's direct and only client). The custodian has no discretion as to how custodial assets are invested or managed. The custodian only acts on properly authorised instructions from the RE & RSE.

NAB's evidence will also cover:

- the role of Trio and ANZ/NAT in relation to the Trio funds;
- the roles of ASIC and APRA, and the application of the AML regime, to custodian activities.

⁴ See page 9 and Section F of the Australian Securities and Investments Commission submission dated September 2011

Our second key issue is the options for improvements to the current regulatory regime to better protect all investors. ASIC's and APRA's "banning orders" against the former directors of Trio was based on a clear failure by these directors to do their job. NAB believes there is a critical need for education of RE & RSE directors and officers to ensure they properly understand their duties and obligations. Additionally, there is the issue of adequate capital requirements for an RE and RSE. NAB believes that capital held by an RE and RSE must be sufficient to provide investors with better protection against loss arising from operational risk, including fraud.

Trust and confidence in a fair and effective financial services system is vital. NAB believes that it has an obligation to play an active role in building trust and transparency in the system. NAB will continue to work with Government and regulators to enhance the regulatory environment to ensure that all Australians can invest for their futures with confidence.

NAB is today represented by:

- Dick Morath, Chairman of NAT. NAT holds an ASIC issued Australian Financial Services Licence authorising it to, amongst other things, operate custodial or depository services⁵;
- Leigh Watson⁶, Executive General Manager of NAB's Asset Servicing (Custodian) business. NAB is an Authorised Deposit-taking Institution regulated by APRA. NAB also holds an ASIC - issued Australian Financial Services Licence authorising it to, amongst other things, operate a custodial or depository service⁷. Mr Watson is the Responsible Manager for these custodial or depository services;
- Stephen Tadjman, General Counsel, MLC & NAB Wealth.

Set out below, is NAB's response to the statement of matters provided to NAB by the Committee on 15 September 2011.

⁵ other than investor directed portfolio services

⁶ Mr Watson is also a member of the Australian Custodial Services Association Executive Committee

⁷ other than investor directed portfolio services

1. In general terms, what is the role of a custodian?

- a. In general terms, the role of a custodian is to:
 - i. Hold⁸ and administer custodial assets (and any documents evidencing title to the assets) as the agent of the RE/RSE, the RE/RSE being the custodian's direct client;
 - ii. Collect income and other payments attributable to the custodial assets;
 - iii. Act on proper instructions received from the RE/RSE (or its agents) as to the acquisition or disposal of custodial assets;
 - iv. Keep records of the custodial assets held;
 - v. Provide reports to the RE/RSE on the custodial assets held.
- b. As noted by ASIC in its submission to this Commission⁹:
 - i. The custodian has no discretion as to how the assets are invested or managed¹⁰;
 - ii. The custodian only acts on properly authorized instructions from the RE/RSE (as its direct client);
 - iii. Management powers and responsibilities in respect of the trust property are undertaken by a separate manager, rather than the custodian;
 - iv. A custodian must not mingle custodial assets with the custodian's own assets. If a custodian becomes insolvent, the custodial assets are "ring-fenced" so as to be returned to the RE/RSE;
 - v. The duties of a custodian are expressly determined by contract (custody agreement) between the custodian and the RE/RSE;

⁸ As bare trustee

⁹ See paras 278 to 279 & para 283 (pages 72 & 73) of the Australian Securities and Investments Commission submission dated September 2011

¹⁰ See also the evidence of APRA on 31 August 2011 (Keith Chapman) at page 41 of the transcript

- vi. The agreement may prescribe additional administrative (non-custodial) services to be provided by the custodian.
- c. Before appointing a custodian, the RE/RSE is required to undertake proper “due diligence” to ensure that the custodian can effectively and efficiently perform the required custodial services as agent of the RE/RSE.¹¹ The RE/RSE are singularly responsible for holding scheme property on trust for members, either directly or indirectly by a custodian.

¹¹ See ASIC Regulatory Guide 133 (Part B) and APRA Cross Industry Circular No 1: Custodian Requirements for APRA Supervised Entities

2. More specifically, can you explain the role of custodian in relation to the Trio/Astarra funds?

- For Trio, there were 2 custodians in the NAB Group involved, namely National Australia Trustees Limited (NAT) and NAB Asset Servicing (NAS), a division of National Australia Bank Limited (NAB). In this document, unless specified otherwise a reference to 'NAB' includes a reference to 'NAS'.
- NAT acted as custodian to the Trio funds under a custody agreement. Under a separate agreement between NAT and NAB, NAB acted as the sub-custodian to provide services to NAT relating to the Trio funds.
- All assets which NAB held as sub-custodian were registered in the name of National Nominees Limited (NNL), a wholly owned subsidiary of NAB.
- NAT primarily held the cash assets, whilst NAB held all the securities assets.
- Trio was the client of NAT and NAT in turn was the client of NAB.

Role of NAT as a primary custodian:

- NAT took over custodianship of Trio's assets from ANZ Nominees in February 2009.
- NAT's role (either directly or indirectly through NAB) was to:
 - a. take custody of the assets and any documents evidencing title to the assets and hold them for the client;
 - b. act on Trio's proper instructions with respect to assets under custody;
 - c. credit all income and other payments due in respect of assets to the relevant bank account;
 - d. keep records in respect of the assets held under custody;
 - e. provide reports to Trio on the assets under custody. This reporting was provided to Trio via a web-based online reporting system.

3. It has been put to the committee (submission 25, p10) that the ARP Growth Fund, managed by Trio Capital, was under the custodianship of National Australian Trustees Ltd, a subsidiary of NAB. What was the custodian's role in authorising transfer of funds overseas?

In relation to the ARP Growth Fund MIS, a major asset of that fund was units in Professional Pensions ARP a Hong Kong based managed fund. NAT became and remains, through NAB its subcustodian, the custodian of 4,065 units in the Professional Pensions ARP.

On transition to NAT the value of the units in the Professional Pensions ARP was recorded as being \$50.3m. In September 2009, we received from the administrator of Professional Pensions ARP a valuation statement for this asset of \$52.3m. On 2 December 2009, we were notified by the administrator that the director of the Professional Pensions ARP suspended determination of the net asset valuations.

Since we became custodian of the units in the Professional Pensions ARP, we have not received any authorised instructions to deal with those units. Our role has been to hold a record of the asset - that is, the unitholding.

In relation to the authorisation of overseas funds transfers, the only funds transferred overseas under authorised instructions were:

- 13 payments for A\$14.3m in total to a Standard Chartered Bank account located in Hong Kong on account of EMA International in relation to Deferred Purchase Agreements (DPAs), and
- 16 Euro payments for equivalent A\$0.8m in total to German entities for loan instalments and legal fees.

We do not believe any of these payments related to the ARP Growth Fund.

**4. Can you explain the process for transferring monies to overseas hedge funds?
What checks and balances are in place as part of that process?**

- The process for transferring funds to overseas hedge funds is essentially no different to any other transfer of funds overseas.
- As contractually agreed, in respect of any money transfers, NAT and NAB will only act on authorised instructions of their clients.
- NAT and NAB will not act on any client instructions which:
 - are incomplete, ambiguous or unclear; or
 - are contrary to law or would conflict with other rules, operating procedures or market practice of any relevant market, clearance system or securities system (e.g. CHESSE, Austraclear).
- As a custodian we may delay, block or refuse to make any payment if we consider such action (or refusal to act) is required for the purpose of our compliance with our obligations under any laws pertaining to anti-money laundering or counter terrorism financing. Alternatively, we may process the transaction and then immediately report it to AUSTRAC if it suspicious in nature.
- Upon receipt of an instruction, the transaction is authorised and processed in terms of our standard operating procedures.
- Funds are remitted to the foreign beneficiaries using NAB's established network of correspondent banks.
- This involves:
 - Entering payment details into NAB's international trade finance system; and
 - Transaction details are independently verified and approved prior to release.
- Arrangements for authorised instructions are stipulated in the custody agreement.

5. At what level in the organisation does authorisation of the transfer take place?

- As outlined in Question 1, the custodian must act on properly authorised instructions from the RE/RSE.
- Once validated, the process to action a payment is as follows:
 - Within NAB we have tiered delegated authority limits covering domestic and foreign payments. These limits are risk-based and reflect the quantum of the payment as well as the seniority of the approving officer.
 - For example, a foreign cash payment up to \$15m requires 2 officers to authenticate and release the funds. For larger payments these require 3 officers to be involved to authenticate and release the payment.

6. Does NAB have a role in detecting fraud or reporting suspicious behaviour as part of that overseas transfer?

- In addition to contractual obligations with the client outlined in question 4, NAB as a Reporting Entity under the AML/CTF Act is obligated to report to AUSTRAC any activity that it identifies as being suspicious in nature.
- For our staff, this means where they identify any activity that is unusual (be it either customer related or transactional) and it cannot be explained either logically or rationally, then details of the activity must be submitted internally to a NAB central investigations unit for further investigation. Should this investigation confirm that the activity is suspicious, a Suspicious Matter Report (SMR) will be lodged with AUSTRAC.
- RE/RSE have a responsibility to ensure that their own internal control framework is robust to properly manage fraud risk. RE/RSE also have a responsibility to ensure that their appointed agents, including their fund managers and third party custodians, have robust controls in place.

7. The submission from the Australian Custodial Services Association (submission 43) notes that "The financial services industry is particularly vulnerable to the risk of international fraud." What processes does NAB have in place, as a custodian, to mitigate the risk?

Across the NAB Group, the key controls in fraud mitigation are:

- All new staff must successfully pass stringent probity checks prior to being offered employment with NAB. Probity checks are also undertaken for part-time employees, contractors and outsourced arrangements.
- NAB has organisational structures that clearly segregate processing staff from client facing staff.
- We only act on the authorised instructions of our clients.
- We have a centralised Fraud team that works closely with the police to mitigate fraud.
- Whistleblower, Concern Online, policies and frameworks.
- Yearly mandatory compliance training for all staff (e.g. Code of Conduct).
- Unusual activity reporting to central NAB AML Monitoring unit.
- Annual internal audits which are undertaken on a risk based approach.
- Ernst & Young, NAB's independent auditor, undertakes audits of the internal controls of NAB each half-year. Results of their testing are included in its GS 007 report.
- In support of this, as part of our anti-money laundering (AML) obligations, NAB undertakes extensive Know Your Client (KYC) analysis prior to onboarding new clients and on-going due diligence of those clients. This requires both domestic and global searches of names.

8. It has been suggested (ASIC submission p72) that "there may be an expectation gap between what is legally required of custodians and what investors expect the custodian to be doing to safeguard their investment." Do you believe there is an 'expectation gap'?

- It is possible that an expectation gap may exist between what is legally required of custodians and what investors believe the role of a custodian to be.
- As a member of a large professional financial services group, NAT and NAB clearly understand their role as custodians. An end investor may not comprehend the roles and responsibilities of a custodian given the many distinct and separate roles in the investment and superannuation value chain.
- Further education at the RE/RSE level and investor level may be required so that all parties in the investment and superannuation value chain understand their relevant role and responsibilities.
- NAB would be willing to assist in any industry education initiatives.
- Custodians use the Product Disclosure Statement / Information Memorandum process as the means to articulate the boundaries of their roles and responsibilities as a custodian.

9. Custodians are generally regulated by ASIC. Where a custodian is also an Authorised Deposit-taking Institution (ADI), it is regulated by APRA. To which regulator do you report? Does this regulatory split lead to any confusion? Do you think it is clear to the regulators where the boundary lies in relation to responsibility for regulation of custodians?

- NAB is regulated by APRA as an ADI and also by ASIC as a holder of an Australian Financial Services license in its capacity as a custodian. NAT also holds an Australian Financial Services License to provide custodial and trustee services and is regulated by ASIC.
- Both NAT and NAS are members of the NAB Designated Business Group which is a reporting entity subject to AUSTRAC oversight for the purposes of Anti-Money Laundering/Counter-Terrorism Financing compliance.
- In our experience having multiple regulators does not provide any operational challenges for NAB either as a bank or in its capacity as a custodian as responsibilities are clearly delineated among ASIC, APRA and AUSTRAC, and these roles are understood internally within NAB.
- Our assessment from the interactions of ASIC, APRA and AUSTRAC in respect of our authorised banking and custodian activities is that each of the regulators understand and execute their roles and responsibilities in accordance with the boundaries set by their relevant regulatory frameworks.

10. The *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* and the *Anti-Money Laundering and Counter-Terrorism Financing Rules 2007 (No. 1)* require custodians to make extensive due diligence inquiries when taking on prospective clients, as well as carrying out suspicious matter reporting thereafter. Could you provide more detail about those due diligence inquiries and, broadly, the sort of things that trigger 'suspicious matter reporting?'

- The obligations under the AML/CTF Act and Rules took effect on 12 December 2007. As of this date, all new customers were required to be identified and verified to (at the very least) the minimum standards required under the Act & Rules.
- To meet the regulatory obligations of the AML/CTF Act & Rules, NAB established an AML Program designed to address both the minimum legislative requirements of the AML/CTF Act and Rules (which are risk-based) and its own ML/TF risk assessment (or posture) with respect to its customers, products & services and distribution channels.
- Under the AML/CTF Act & Rules it is recognised that where a customer who has an existing relationship with a reporting entity that pre-dates the customer identification requirements of the Act (i.e. the relationship existed prior to 12th December 2007) they are considered to be “pre-commencement customers”. These customers were not required to be subject to those customer identification standards (as applied for new customers) that were in force at the time the RFP with NATL was proposed.
- Both NAT and NAS (as a business unit of the NAB Group), are part of the NAB Designated Business Group (DBG) for the purposes of AML/CTF Reporting to AUSTRAC. This means that they would both be subject to the AML program established by NAB.
- Following on from this point, under the DBG structure, members within this Group may also rely on the customer identification process applied to a customer in one business unit when commencing to transact with one another.
- Whilst the AML Program endorses minimum standards that must be complied with, this does not preclude individual business units (within the same DBG) from conducting further due diligence where it is felt necessary to understand further why

a customer would want to transact across a particular product or service, as well as to assist with forming a picture as to how the product or service will be utilised.

- In terms of suspicious matters, any decision that is made to submit such a report will typically be based upon two key and known elements of the customer:
 1. The information that they would have provided at the commencement of the relationship about who they are, what they do and how they will likely utilise products and services being provided to them. This assists with reporting entities such as NAB being able to form a picture of the type of activity that they will undertake and what can be considered to be usual and expected.
 2. The activity that actually takes place once the relationship commences, and the observations that are made in relation as to whether this is what has been advised to be usual and expected activity.
- Obviously where there are issues in observed activity, appropriate inquiries are made to understand what the rationale is of this, and based on responses or findings a decision can be made as to whether this is unusual and therefore requires a further investigation – the result of which may lead to a Suspicious Matter Report being lodged with Austrac.
- Whilst extensive and enhanced due diligence is a component that supports the suspicious matter reporting framework, it is not necessarily the sole basis that would drive a report being made. Observed activity plays an important part in this process as a reporting entity is able to assess what a customer says will take place against what it actually may do in terms of transacting.

IN RELATION TO TRIO

- Trio's relationship with NAB dates back to 2001. As such under the AML/CTF Act Trio is recognised as a pre-commencement customer. This relationship extended to the provision of transactional banking products and services through Business Banking.
- In 2008, as part of the RFP process, NAT undertook its own due diligence that was primarily focused upon understanding the customer from the perspective of the business proposition to commence a custodian arrangement. This included:

- Reviewing Trio's PDS documents to confirm dealings with a licensed custodian (ANZ Custodians);
- Site visit to client's place of business;
- Performing identification and verification of all authorised signatories to the NAT custody accounts;
- Confirming Trio's AFSL and ASIC registration;
- Meeting CEO and CFO on separate occasions to understand their business operations.

11. As an ADI, NAB is one of a series of gatekeepers that offer services within the financial advice value chain. To whom is NAB mainly responsible as custodian?

- NAT and NAB in their capacity as a custodian for a RE/RSE are responsible to the RE/RSE in accordance with their custody agreements (and associated services schedules).
- The custody agreement provisions clearly state that as a custodian we will not act on instructions that are considered to be unclear, ambiguous or unlawful.
- In our interactions with our clients the remit of our role as custodian is regularly discussed.
- It is worthwhile to note that in acting as custodian, both NAT and NAB were not undertaking ADI activities. For example, the taking of deposits and the associated lending activity are not functions of a custodian.
- The role of custodian is disclosed in the relevant Product Disclosure Statements or Information Memorandum.

12. Do custodians have a role in verifying the underlying value of the assets of which they are custodians?

- The RE/RSE are responsible for investment and valuation risks of their assets.
- A custodian's obligations to its client are set out in the Custody Agreement. The custodian sources prices from various providers which can include the fund manager or administrator of the client's assets. Where the custodian cannot source a price it will accept a price upon receipt of a properly authorised instruction from the client.
- NAB does provide its clients with regular, online, on-demand reporting of their assets and publishes monthly information with respect to those assets that have not been repriced for at least 5 days.
- In the case of Trio, we followed our standard practices and operating procedures in relation to asset value reporting.