

CHAPTER 6:

FUND MANAGERS AND CUSTODIANS

Introduction

6.1 This chapter addresses the impact of the SIS legislation on both fund managers and custodians, and makes observations and recommendations on the following issues:

- borrowing;
- definition of custodian and investment manager;
- capital adequacy requirements;
- removal of investment manager;
- dismissal of custodians for breach of eligibility requirements; and
- 'soft dollar' or undisclosed commissions in funds management.

Borrowing - clause 65

6.2 Prior to amendments introduced into the House of Representatives on 27 September 1993, the SIS legislation allowed superannuation funds to borrow in exceptionally limited circumstances only. More specifically the clause allowed superannuation funds to borrow up to ten percent of fund assets for up to 90 days for the purposes of paying a benefit where there was a cash flow problem. However, the amendments now allow superannuation funds to borrow on a temporary basis to cover the settlement of securities transactions and provide that borrowing can take place where it does not exceed seven days and the amount borrowed does

not exceed ten per cent of the value of the assets of the fund. The borrowing is further limited to circumstances where the need 'was not reasonably foreseeable'.

6.3 The Law Council of Australia submitted that, due to the mechanics of international financing systems, in many cases it was likely that short term financing to settle transactions would be necessary.³⁶ This view was also expressed by witnesses from the National Australia Bank, who submitted that, due to the nature of international trading activities, it is highly probable that a funding mismatch could occur.³⁷

6.4 Accordingly, the Committee believes that the words 'not intended' should replace 'not reasonably foreseeable'. This would clarify the intent of the legislation and take into account the realities of international financing.

Recommendation 6.1:

The Committee recommends that short term borrowing be allowed where it was 'not intended' that the borrowing would be needed, rather than if the need for the borrowing 'was not reasonably foreseeable'. Accordingly, clause 65 should be amended to substitute the words 'not intended' for 'not reasonably foreseeable'.

Definition of custodians and investment managers

6.5 The custodian's role is to hold the legal title of the assets whilst the investment managers invest the assets of the fund to obtain the maximum benefit for the fund members. Several submissions to the Committee raised the concern that the definition afforded to both a custodian and an investment manager were not clear and in practice could lead to a conflict of duties.^{38 39}

³⁶ Evidence p 153

³⁷ National Australia Bank, SIS Sub No 26

³⁸ *ibid*

³⁹ Bankers Trust SIS Sub No 28

6.6 The Government addressed this matter by introducing an amendment in the House of Representatives defining a custodian as 'a person performing custodial duties in relation to the assets of the entity, and is designed to have the normally accepted meaning as given within the superannuation industry'.⁴⁰

6.7 The Committee believes that, whilst this change is in the right direction, it still leaves in doubt the respective roles of fund managers and custodians. For example, the current definition afforded to an investment manager under clause 10 allows for no discretion to be made by the investment manager between different investments. Therefore, this definition may also cover some of the functions that are performed by custodians.⁴¹

6.8 Given the key roles that both investment managers and custodians play in the superannuation industry, investing and holding assets for superannuation fund members, it is vital that their roles be clearly defined.⁴²

Recommendation 6.2:

The Committee recommends that, following the implementation of the SIS legislation, consideration be given to spelling out in regulations the duties of custodians.

Capital adequacy requirements - clause 120

6.9 Clause 120 provides that custodians must have a prescribed value of net tangible assets, otherwise known as a capital adequacy requirement. The Treasurer's press release of 27 May 1993, indicated that \$5 million would be the minimum prescribed value.

⁴⁰ Superannuation Industry (Supervision) Bill 1993, Clause 10

⁴¹ National Australia Bank, SIS Sub No 26

⁴² K Richards, SIS Sub No 52, alerted the Committee to the need under SIS for the trustee of a small employer sponsored fund to obtain a dealer's licence when dealing in securities, further advising that the ASC requirements made this difficult.

6.10 It was submitted that, whilst being a means of ensuring that a custodian is an organisation of substance, a blanket capital adequacy requirement of \$5 million dollars provides little assistance to fund members should the custodian become insolvent, and is an altogether inadequate form of prudential supervision as compared to other capital requirements such as the risk weighting of assets⁴³. Unfortunately, time limitations prevented the Committee from exploring a viable system of asset risk weighting. This, along with the option of having a simple scale of net tangible assets relative to funds managed, could be considered by the Government when it is preparing regulations to implement capital adequacy requirements.⁴⁴

6.11 The Committee noted that small funds, in cases where an investment manager wishes also to act as a custodian, should they be unable to meet the \$5 million capital adequacy requirement, they can appoint an outside entity to act as custodian provided that entity satisfies the capital adequacy requirement.

Recommendation 6.3:

The Committee recognises the need for a capital adequacy requirement to establish the substance of custodians and, to a lesser extent, provide a financial buffer in the case of insolvency. The Committee recommends that in drafting regulations the ISC continue to consider a more comprehensive and flexible approach to the capital adequacy requirements for fund managers and custodians.

Removal of investment manager - clause 118

6.12 Subclauses (1) and (2) of clause 118 set out when a person and an individual or a body corporate becomes a disqualified person. A 'disqualified person' is prohibited from being a fund manager or custodian. County NatWest submitted that under clause 118, a body corporate is a 'disqualified person' if any 'responsible officer', that is a director, secretary or executive

⁴³ County Nat West SIS Sub No 65

⁴⁴ AAPBS, SIS Sub No 76, submitted that the definition of an approved guarantee be broadened to include an approved building society.

officer, has been convicted of an offence involving dishonesty or has been the subject of a civil penalty under the SIS provisions. County Natwest further advised that this 'strict liability' provision does not allow any flexibility to take account of particular circumstances to allow the manager to remedy the situation.⁴⁵

6.13 This provision, therefore, has the potential to result in an investment manager losing its entire superannuation funds as a result of a single breach by an individual employee. The Committee believes that this consequence appears to be unduly harsh. However, it is not unreasonable to expect that any responsible officer who commits an act of dishonesty should not be in a position of authority and that the ISC and the fund should be in a position to remove such persons.

Recommendation 6.4:

The Committee recommends that provisions relating to the removal of fund managers consequent to a responsible officer becoming a disqualified person be amended to ensure that there is not an automatic termination of the manager.

The Committee further recommends that in these cases it is the duty of the fund manager to remove the disqualified person from any financial dealings with the fund.

Dismissal of custodians for breach of eligibility requirements - clause 120

6.14 The Committee also received submissions claiming that the provisions involving the dismissal of custodians under clause 120 are too harsh.⁴⁶ For example, National Australia Bank submitted that where the custodian ceases to comply with the eligibility requirements under clause 120, the trustee must automatically dismiss the custodian.

⁴⁵ *ibid*, p 20

⁴⁶ National Australia Bank, SIS Sub No 26

6.15 In addition, clause 120 allows no time for the custodian to endeavour to correct its position. This could result in harsh and unintended consequences if the custodian only breaches the eligibility requirements temporarily.

Recommendation 6.5:

The Committee recommends that the Government monitor the operation of SIS legislation to ensure that it does not result in any harsh or unintended consequences for custodians who temporarily fail to satisfy eligibility requirements.

'Soft commissions'

6.16 The term 'soft commission' refers to undisclosed commissions, reimbursement for expenses incurred or non-monetary forms of payment. The Investment Funds Association advised the Committee that, for example, under this method of remuneration a funds manager may enter into an arrangement with a stockbroker to provide a certain amount of business to the stockbroker and that the funds manager may provide services in lieu of the normal stockbroking fee.⁴⁷ Such practices may also provide scope for tax minimisation, as undisclosed commissions may not be included in the broker's taxable income. Bankers Trust also advised the Committee on soft commissions and following their appearance provided a copy of the AIMG draft Practice Note of 23 September (see Appendix G).

6.17 On a number of occasions during its two year inquiry into superannuation the Committee has stated that there should be openness and transparency in the setting of fees, charges and commissions throughout the superannuation industry in order that consumers of services are able to compare relative prices and services. Unless sound reasons can be posited in favour of the practice of charging soft commissions, the Committee is of the view that the industry work on a 'commission only' basis. Failing this, the Commonwealth, through its corporations powers, should legislate against soft commissions.

⁴⁷ Evidence p 133

Recommendation 6.6:

The Committee recommends that the Joint Committee on Corporations and Securities investigate 'soft commissions' as part of its inquiry into institutional investment.