Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Financial Products and Services In Australia

Investor Protection in Managed Investor Schemes – Strengthening the Independence and Potency of the Responsible Entity

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A Introduction

1 Perpetual Corporate Trust is a division of Perpetual Limited and acts as trustee, responsible entity and/or custodian for a wide range of financial services and products across both the retail and the wholesale market.

2 Our business is based around investor protection and we have extensive experience in ensuring proper compliance during the life of a scheme and enforcing and ensuring investors' interests are protected upon the insolvency of the scheme operator.

3 The financial crisis has tested the legislative and regulatory regime in Australia and it is both timely and appropriate to review the regime to assess any areas for improvement. We welcome the establishment of the Inquiry and the opportunity to provide a submission to it.

4 This submission contends that investors have a right to expect that:

(a) Responsible Entities will always act independently and in their best interests over those of the scheme sponsor;

(b) There will always be a Responsible Entity unambiguously representing their interests particularly at the time when they need it most – in the event of insolvency or stress of the scheme sponsor;

(c) Scheme assets will always be kept separate and protected from the affairs and assets of the scheme sponsor and be clearly separable in the event of the failure of the scheme sponsor.

5 The submission suggests that recent failures have highlighted weaknesses in all the above areas and makes a series of recommendations aimed at addressing these weaknesses and restoring investor confidence. In brief, these are:

(a) A series of recommendations aimed at strengthening the independence of all Responsible Entities to give investors confidence that a minimum standard will apply in all circumstances;

(b) A series of recommendations aimed at ensuring that investors can be confident that there will always be a party representing their interests particularly in times of insolvency;

(c) A series of recommendations to ensure that scheme assets will always be separate from those of the scheme sponsor.

6 The submission is focused primarily on the following Terms Of Reference:

"2. the general regulatory environment for these products and services;

9. the need for any legislative or regulatory change."

7 With regard to terminology we use the following terms and their associated meanings throughout the submission.

(a) "Compliance Committee" - means a Compliance Committee established under Section 601JA of the Corporations Act.

(b) "Framework/MIA" - these terms are used interchangeably to refer to the overall legislative and regulatory framework introduced as a result of the Managed Investments Act.

(c) "Independent Institutional RE" – an entity whose core business is the provision of independent Responsible Entity services to third parties.

(d) "Scheme" - we use the term scheme to generally represent what may be called in practice schemes, funds or trusts.

(e) "Scheme Sponsor" - this is the entity or institution that has established the scheme and promotes it.

B Regulatory Context

8 The Managed Investments Act had its genesis in the late 1980's and early 1990's following a number of high profile scheme failures most notably the Estate Mortgage group of companies. In 1991 an enquiry commenced into Collective Investments which resulted in the delivery of report in 1993 "Collective Investments: Other People's Money". The recommendations with some amendment were enacted into the Managed Investments Act in 1998.

9 The initial report identified three areas of risk that were relevant for investors and our submission follows this framework. These areas of risk were:

Investment Risk

10 Investment risk is the risk that investments may not perform as expected. There are two elements to Investment Risk:

(a) Performance risk - the risk that the investment doesn't perform as expected. The approach taken by the Managed Investments Act is that

investments will always carry risk associated with the investment judgments of the scheme sponsors and that this should not be regulated.

(b) Disclosure risk - the risk that all the risks of the investment are not adequately disclosed and understood by the investor. The emphasis under the MIA is on providing investors full information to assess the risks of the investment.

Compliance Risk

11 Compliance Risk is the risk that scheme parties may not do what they promised to do. Following the collapses of the early 1990s there was concern that there existed a lack of clarity as to which party was accountable to investors and primarily responsible for compliance with the law and that the responsibility for compliance was "displaced" from the sponsoring entity and so no culture of compliance existed within fund managers. The Managed Investments Act sought to address this through the following measures:

(a) Accountability - the MIA proscribed a Single Responsible Entity that was solely responsible and accountable to investors.

(b) Independence - the introduction of the Single Responsible Entity, in most cases owned and resourced by the scheme sponsor rather than an institutional trustee, introduced a potential weakness into the framework, namely a lack of independent decision making (ie: independent of the interests of the scheme sponsor) for decisions affecting the interests of investors. The MIAs approach in addressing this was, in certain circumstances, to require a majority of independent directors on the board of the Responsible Entity. An alternative utilised by many Responsible Entities was to instead have a Compliance Committee with a majority of independent members.

(c) Compliance culture - The MIA introduced a series of measures aimed at improving the compliance culture generally of the industry including:

(i) Licensing - the introduction of the licensing of Responsible Entities was aimed at increasing the standard of compliance. A key basis for having the license approved is demonstrating to ASIC a commitment to compliance.

(ii) Compliance plans - directors of Responsible Entities are explicitly responsible for ensuring that compliance measures are in place and for the development of a compliance plan which is lodged with ASIC.

(iii) Increased powers of ASIC - ASIC performs surveillance on REs to ensure that they are performing their role effectively.

(iv) Increased responsibilities of auditor - Auditors are explicitly responsible for reporting to ASIC any non-compliance with the constitution or compliance plan that they become aware of in the course of their audit.

Institutional Risk

12 Institutional Risk is the risk that investors will lose money due to the failure of the scheme sponsor. The MIA addressed this risk in two ways:

(a) Minimum capital requirements - proscribing a minimum amount of base capital for Responsible Entities to maintain; and

(b) Option of independent custodian - providing for the option of the appointment of an independent custodian and allowing ASIC to require it in certain circumstances.

Regulatory Philosophy

13 The philosophy behind regulation is based on an efficient markets approach and leads to ASIC taking a philosophy to promote market integrity and consumer protection through conduct and disclosure regulation. The history and reasoning behind this philosophy to the regulation of financial markets is well summarised in ASIC's submission to the Inquiry into Agribusiness Managed Investment Schemes (see paragraphs 43-52 of that submission).

14 We believe ASIC has done an excellent job within the bounds of that philosophy. We make no general comment on this philosophy of regulation other than where it impacts on our specific areas of comment below. Some of our recommendations may require ASIC to take a role slightly outside the bounds of their current philosophy (see paragraphs 44, 45 and 48).

C The Problems

15 The collapses and failures of various schemes over the past few years as the result of the financial and economic conditions have "stress tested" the MIA framework for the first time since its introduction. This has highlighted numerous weaknesses in the robustness of the regime that are worth analysing for improvement.

16 In our assessment below we have not mentioned specific cases. Rather, we have described in a generic sense what we understand to have been key weaknesses. In describing the areas of weakness we have followed the framework of risks set out in the previous section.

Investment Risk

17 (a) Investment performance - many of the failures of recent times have been simply the result of bad business decisions which cannot and should not be regulated against.

(b) Disclosure - as noted in the previous section, the emphasis of the MIA has been weighted toward full disclosure of all risks associated with an investment leading to quantity over quality in terms of information supplied to prospective investors. The test of whether investors truly comprehend the risks of what they are investing in has not been met in many circumstances and the emphasis should now move toward simplicity and clarity as well as measures to improve point of sale advice. We know that these points are already well understood by government and are being well argued by others. We make no detailed recommendations beyond these comments.

18 Notwithstanding our comments above we do believe that bad business models can be regulated against and that some investment products are inappropriate to be offered to retail investors regardless of the extent or manner of disclosure of risks.

Compliance Risk

19 With regard to the objectives of ensuring a single point of accountability and improving the compliance culture across the industry we believe that the MIA has been successful. However, we believe that many of the recent failures have raised the question of whether the independence of decision making of some Responsible Entities was adequate.

20 Examples of the types of decisions that are questionable and their consequences are:

(a) Allowing interdependency between scheme activities and scheme sponsor activities.

<u>Consequence:</u> *Prevents a clear separation of assets or leads to an impairment of value of the assets of the scheme due to the insolvency of the scheme sponsor.*

(b) Allowing interdependency between the solvency of the Responsible Entity and the scheme sponsor.

<u>Consequence:</u> *Compromises the Responsible Entity's ability to remain solvent independently of the scheme sponsor.*

(c) Not actively monitoring the solvency of the scheme sponsor or ensuring that contingency plans exist in the event that the scheme sponsor becomes insolvent.

<u>Consequence:</u> *Leads to requirement to find a willing replacement Responsible Entity and the associated complications.*

(d) Allowing financing to be provided to investors by scheme sponsors.

<u>Consequence:</u> *Has "muddied the waters" of the relationship between investors and the sponsor group ie: between obligations to investors as beneficiaries versus seeing them as obligors in respect of a significant asset.*

21 Unlike the directors of a listed company, independent directors of a Responsible Entity are pitted against the resources of an institution over which they do not have the power to hire or fire. Whilst a majority of independent directors is required, that requirement falls away if a properly constituted Compliance Committee is formed. Even where there are a majority of independent directors in place, the majority is generally slight (as opposed to a clear majority in the case of a listed company). This "horizontal" dynamic (where the independents are effectively "visitors" to an organization) as opposed to a "vertical" dynamic (where the independents clearly feel "top of the tree") cannot be over-emphasised. The additional responsibility to ensure the separation of the activities to those of the sponsoring entity also requires close attention. These factors heighten the required qualities of the individual to ensure robust questioning and scrutiny.

22 The option of having a majority of independent members on a Compliance Committee to satisfy the test of independence is a weakness in the framework since a Compliance Committee has a far more limited role to that of a Responsible Entity. Many decisions that can cause prejudice to investors can be made without Compliance Committee involvement.

Institutional Risk

23 We believe the main area of weakness in the MIA framework is with regard the protections afforded to investors when the sponsoring institution becomes insolvent. These protections fall into the following two areas:

(a) RE solvency - ensuring that the party that is looking after investors interests ie: the Responsible Entity is in a position to remain solvent and independent through times of stress.

Recent failures have resulted in the following problems for investors:

(i) the Responsible Entity becoming insolvent as a result of the insolvency of the scheme sponsor;

(ii) the receiver or administrator of the Responsible Entity being the same as that for the scheme sponsor leaving investors with a lack of clarity as to where their interests lie versus the interests of other creditors of the group in the eyes of the administrator/receiver;

(iii) the difficulty in finding a replacement Responsible Entity because of concerns of incoming REs surrounding:

- the adoption of liabilities for past actions;
- the potential for future liabilities in litigious situations with insufficient protections and insufficient indemnities;
- the adoption of financial obligations on behalf of the scheme;
- the lack of commercial incentive.

(iv) the threat of wind up of the scheme as a result of not being able to find a replacement Responsible Entity when this may not be in the best interests of the investors.

(v) directors of Responsible Entities resigning at the time of stress for fear of personal liability.

The Managed Investments Act aimed to achieve RE solvency through mandating a minimum level of capitalisation capped at $5m. This is a flawed approach for the following reasons:

(vi) Capitalisation by itself does not prevent insolvency. It is relevant only to the extent that it represents working capital and has some relationship to debts incurred, contractual obligations to meet or resources required to properly undertake its role.

(vii) If the $5m is not "free cash" (ie: if it has somehow been financed through intercompany support such as guarantees or loans) then it defeats the purpose and makes the RE's solvency interdependent on that of the scheme sponsor.

(viii) Having the capitalisation capped is meaningless. If it was intended to prevent insolvency then it should bear some relationship to obligations incurred. Even if it was meant only as a "buffer against loss" (and the Managed Investments Act explicitly did not intend it to be) then it should also bear some relationship to the size of the assets under management.

What is most important is that an RE should have effective arrangements in place to ensure that it can continue to operate in the event of insolvency of the scheme sponsor. Factors relevant are access to the management fee from the scheme and access to resources ie: an effective assignment of contracts etc.

Another point that is important to highlight is that there is often confusion between scheme solvency and RE solvency. The confusion arises because the RE incurs the debts of the scheme personally and is indemnified from its assets to meet them. The solvency of the RE should be maintained as a separate issue to the question of solvency of the scheme.

(b) Separation of assets - ensuring that investors' assets are clearly separate and protected from the assets and affairs of the insolvent sponsoring institution.

Recent failures suggest that in some cases only nominal compliance is being paid to this requirement (eg: you cannot separate trees from land). Assets may be legally separate but, in practice, become impossible to separate from the insolvency of the scheme sponsor or their value becomes impaired due to the interdependencies.

D The Options

24 The following are the various options that we see are available to respond to the current situation and we offer comments in respect of each.

Option 1 Status Quo – "schemes should be allowed to fail"

25 There is an argument that scheme failures are a natural consequence of a free market. Thus, an option is to manage the failures but leave the regulatory framework untouched.

26 The benefits of this option are:

(a) No additional cost of regulation.
(b) Maintains innovation and competition.

27 The arguments against this response are:

(a) The potential loss of confidence in Australia's savings system.
(b) The immediate cost to the retirement savings of many people.
(c) The flow on impact to the economy.

Option 2 Independent Institutional RE For All Managed Investment Schemes

28 The weaknesses highlighted in this paper exist across all managed investment schemes however the weaknesses only get tested in times of stress and "at the fringe". There is an argument that it is precisely protection in times of stress from the activities of the "fringe" that the regime should offer and to differentiate between players will always allow some to "slip through the net". Without a minimum standard of protection that is effective in all circumstances investors will not have confidence in the system as a whole.

29 Advantages:

(a) A "one size fits all" approach to industry regulation
(b) Combines advantages of MIA (increased ASIC oversight, licensing, and compliance plan regime) with the advantages of an assured independent and capitalised representative of investors.
(c) Provides a manageable number of Responsible Entities for ASIC to oversee

30 Disadvantages:

(a) Compliant majority are penalised for actions of the minority
(b) Costs of transition from the existing framework could be significant

Option 3 Create a "Two Tier" Approach To Regulation

31 An alternative approach to Option 2 above is a "two tier" approach. Under this option there would be one approach for scheme operators that meet minimum standards of compliance, solvency and independence, and an alternative approach for firms that fail to meet those standards.

32 This approach has the advantage of not overly penalising the vast majority of firms that do comply. It provides for innovation but places a price on lower standards and provides an incentive to improve.

33 A system such as this would require criteria to be developed around the boundaries between the "tiers" and would require an element of judgment by ASIC (see paragraphs 44, 45 and 48).

34 Advantages:

(a) Ensures a minimum standard across the entire industry that investors can be confident in
(b) Allows innovation and competition to continue
(c) Provides a manageable number of Responsible Entities for ASIC to monitor

35 Disadvantages:

(a) Requires judgment to be applied leading to potential subjectivity
(b) Additional cost at the lower tier

E The Solutions

36 Perpetual Corporate Trust makes the following recommendations to strengthen investor protection for investors in Managed Investment Schemes. Our recommended approach follows that of Option 3 in the previous section. We suggest some measures of improvement that should apply to all Managed Investment Schemes as well as some higher standards that should apply to scheme sponsors that fail to meet minimum criteria.

All Managed Investment Schemes

Strengthen Independence

All Managed Investment Schemes to have a majority of independent directors - Compliance Committees as a means of meeting the independence test should be abolished

37 Investors in all Managed Investment Schemes should have confidence that the board of the Responsible Entity is solely focused on their interests over the interests of the scheme sponsor. Whilst Compliance Committees perform a valuable function in respect of the Compliance Plan, they do not oversee all the activities and decisions of the Responsible Entity. The concept allows scheme sponsors to pass the independence test (through an independent Compliance Committee) whilst leaving critical decisions affecting the interests of investors outside of their grasp.

38 Applying the higher requirement to all Responsible Entities provides investors with greater confidence that a minimum standard applies to all decisions impacting the scheme.

The criteria for independence should be reviewed

39 Because of the dynamics associated with acting as a director of a Responsible Entity, (ie: to ensure independent thinking and separation of assets and activities from a sponsoring entity who otherwise performs many functions for it) the need for independence is high. Directors of Responsible Entities should pass the highest test possible for independence from the scheme sponsor.

Responsible Entity Solvency and Continuity

Capitalisation requirements should be reviewed

40 The logic of requiring an amount of capitalisation of the Responsible Entity to ensure solvency should be reviewed, since having access to a small pool of capital does not ensure solvency. Rather, ensuring that there are no interdependencies between the solvency of the Responsible Entity and that of the scheme sponsor is more critical. It is also important to have a clear idea what the capital is intended to be used for. If it is to provide a pool of working capital to fund resources to support the Responsible Entity in looking after investors' interests in the event of insolvency of the scheme sponsor then some relationship to the size of the scheme is relevant and an arbitrary cap of $5m is inappropriate.

Responsible Entities Should Be Resourced and Prepared For Contingencies

41 Responsible Entities should be structured to ensure that they can meet their obligations to investors in the event of the insolvency of the scheme sponsor. This should require having dedicated resources reporting to and employed by the board of the Responsible Entity, a service agreement with the scheme sponsor that can be terminated both legally and practically in the event of insolvency of the scheme sponsor, and direct access to the management fee revenues of the scheme.

Separation Of Assets

Independent custodian required in all circumstances

42 An independent custodian should be required in all circumstances rather than being subject to a determination by ASIC. Investors should have this as a minimum expectation without having to enquire as to whether it is the case. The requirement of an independent custodian is market practice in most other jurisdictions.

43 One of the weaknesses of the existing regime that has been previously debated at length is the fact that a custodian acts on the direction of the Responsible Entity and thus an independent custodian is no assurance that all assets have been captured and are not caught up in the insolvency of the scheme sponsor. Thus, the effectiveness is as good as the trustworthiness of the Responsible Entity. This ties directly in to the measures recommended above to ensure greater independence of the Responsible Entity. Responsible Entity directors and their dedicated resources should have a direct relationship with the custodian and should have a particular focus on reviewing the controls around cashflows to ensure that all cash and assets are held by the custodian.

Review other factors to ensure proper separation of assets

44 Other factors should be reviewed to ensure that the separation of assets is real and not nominal, and to prevent interdependency on the scheme sponsor (eg: audit tests, greater review by ASIC, review of the custodian requirements).

Independent Institutional RE Required In Certain Circumstances

45 In situations where the scheme sponsor cannot demonstrate a culture of compliance and independence of scheme interests over sponsor interests or cannot demonstrate a clear separation between its activities and those of the Responsible Entity, an Institutional Responsible Entity approved by ASIC should be required.

46 An Institutional Responsible Entity would put beyond doubt any question regarding the independence in decision making of matters affecting investors' interests and would ensure continuity of investor representation in the event of insolvency of the scheme sponsor.

47 Having a limited number of Institutional Responsible Entities acting in respect of many schemes would also be more efficient for ASIC to monitor and enforce a consistency of approach.

48 This recommendation raises the question as to why this wouldn't cause the same issues that existed prior to the introduction of the Managed Investments Act.

The response to this is:

(a) it would still be a Single Responsible Entity but would be independent and institutional;
(b) there is now a national licensing regime of trustees and Responsible Entities and much more oversight by ASIC;
(c) there are now solvency requirements albeit, in our opinion, that are in need of revision as described earlier.

49 Perpetual Corporate Trust would welcome the opportunity to work with ASIC and legislators to ensure ASIC has clear and objective criteria by which to determine the need for an Independent Institutional RE.