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Dr Shona Batge
Committee Secretary
Parliamentary Joint Committee
on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600

Email: corporations.joint@aph.gov.au

Dear Dr Batge

RE: Parliamentary Joint Committee on Corporations and Financial Services (Committee)
Inquiry into Financial Products and Services in Australia (Inquiry)

As a member of the Trustee Corporations Association (**TCA**) Trust Company Limited (**Trust**) has participated in, and supports the submission made by the TCA to the Inquiry. As noted in the TCA's submission, challenging economic conditions at present have provided the first substantive test of the single responsible entity regime introduced with the *Managed Investments Act*.

Trust is an ASX listed financial services company with operations spanning trustee and custodianship, financial planning and superannuation. Trust is a specialist property and infrastructure custodian and is also a licensed responsible entity. Trust welcomes the Inquiry and has prepared the following submission.

Background to the introduction of the Managed Investments Act

The collapse of Estate Mortgage in 1989 was regarded by some as demonstrating the deficiencies of the dual-party investment structure, with fund managers and trustees in dispute about their liability for fund failure. Shortly after, another investment scheme, Aust-Wide, also collapsed.

In response to these collapses the then Attorney-General, the Hon. Michael Duffy MP, commissioned the Australian Law Reform Commission and the Companies and Securities Advisory Committee to inquire into the regulation of managed investments. This inquiry produced the 1993 report, *Collective Investments*: *Other People's Money,* (**ALRC/CASAC report**). The report recommended that, for every scheme, there should be a single RE in which the functions of both the trustee and the fund manager would be vested.

The ALRC/CASAC report concluded that the dual-party structure had caused confusion regarding the accountability of the manager and trustee and so jeopardised the interests of investors. The ALRC/CASAC report also expressed concerns that the fees payable to trustees often did not generate sufficient revenue to enable them to conduct their supervisory activities and that the arrangements encouraged the displacement of responsibility by the scheme manager to the trustee.

The *Managed Investments Act 1998* (**MIA**) introduced a new structure for managed investment schemes so that a single responsible entity (**RE**) would carry full responsibility for a management investment scheme and any liability for losses. The MIA took over from the prescribed investments system (dual-party system) in which funds management was shared by a fund manager and trustee.

Under the current regime managed investment schemes must be registered with ASIC and operated by a licensed public company acting as a single "responsible entity". The RE acts as trustee for the scheme members and is responsible for the conduct of the scheme. The scheme must be constituted under a constitution that complies with chapter 5C of the *Corporations Act* and be operated in accordance with a "compliance plan" which must be audited annually and, ordinarily, monitored by a compliance committee. REs, their officers, employees and compliance committee members are subject to certain duties in relation to the conduct of the scheme.

Turnbull review

In August 2001 the then Minister for Financial Services and Regulation, the Hon. Joe Hockey MP, announced that Mr Malcolm Turnbull would conduct a review of the MIA. The review report was released in December 2001.

The review recognised the need to strengthen some areas of compliance in managed funds under the MIA and recommended enhanced powers for ASIC. However, the review did not categorically conclude whether compliance overall in the managed fund industry has been strengthened or weakened with the advent of the MIA. Nor did it confirm any cost savings for the industry as a result of the legislation, a much anticipated benefit of the new regime when it was first introduced. The review also did not re-examine the validity of the single responsible entity arrangements in comparison to the previous dual party structure.

The TCA's submission to the Turnbull review suggested that in the interests of investor protection, property of a managed investment scheme should always be held by an independent custodian, as this would be more effective in preventing fraud and self-dealing by the RE than the current MIA requirements, which allow for self-custody or custody by a party related to the RE. The TCA's submission also proposed that custodians should owe limited duties to scheme members, including to:

- identify and hold scheme assets separately from other assets they hold;
- refer to the compliance committee cases of suspected self-dealing; and
- reject instructions from the RE if the custodian had knowledge of fraud.

It should be noted that in the case of Estate Mortgage and Aust-Wide, investors would have recovered nothing if they had only the fund manager to pursue - or what is now the single responsible entity. It was the trustee corporations and their insurers that provided investors a return of 100 cents in the dollar for Aust-Wide and between 60 and 80 cents in the dollar for Estate Mortgage.

Key issues with the current regulatory system

Trust recommends that the Committee seriously reconsider the single responsible entity regime. Current economic circumstances, as highlighted by the specific examples in this submission, have exposed the weaknesses of the single responsible entity system and have served to demonstrate that the promised benefits of the regime have not been delivered to investors. Should the current system be retained,

then Trust suggests that the Committee give regard to the following key issues. These issues do not appear to have been specifically addressed in the hearings held by the Committee inquiry into agribusiness managed investment schemes.

Capital requirements for the RE

Under ASIC's Regulatory Guide 166 Licensing: Financial requirements, REs of managed investment schemes must:

- hold sufficient financial resources to meet their liabilities over at least a 3-month term; and
- hold net tangible assets (**NTA**) of 0.5 per cent of the value of the assets and other scheme property of the registered schemes operated with a minimum requirement of $50,000 and a maximum of $5 million; or
- hold NTA of $5 million if a separate custodian has not been appointed.

In addition, REs must maintain professional indemnity insurance and insurance against fraud at a minimum of $5 million or the value of scheme assets, whichever is less. This is set out in ASIC's Regulatory Guide 131 Managed investments: Financial requirements.

Trust's concern is that some existing managed investment schemes have insufficient financial underpinning. REs with NTA of only $5 million (the maximum required) and $5 million of insurance (the maximum required) can, and do, hold at risk many billions of dollars of investors' funds. Accordingly, there should be amendment to the regulation of managed investment schemes to require a more substantial level of capital and insurance for REs that has regard to the size of funds under management and is not capped at a level as low as $5 million.

No requirement for external custodian

Under the current regulatory regime, scheme property is not required to be held by an independent custodian, provided that the requirements in Regulatory Guide 133 are satisfied, the most notable of these being the obligation to have NTA of $5 million.

The requirement for an external custodian has previously been advocated by the TCA. Opponents of this proposal have suggested that a bare custodian will provide little protection against misuse of scheme property because it will be required to deal with the property as instructed by the scheme operator.

In the United States, the United Kingdom and Canada, scheme property must be held by an independent custodian. In not requiring mandatory third-party custodianship of scheme property, Australia has chosen to deviate from what is considered to be global best practice. A third-party custodian of scheme property is crucial to protect investors' interests. An independent custodian would provide a real-time check on RE compliance and in the event of a failure of a RE, fund assets would be out of the control of the RE and thus would be protected.

Compliance

One of the principal shortcomings of the single RE model is that it does not provide for real-time monitoring of the RE's activities. The previous dual-party structure provided independent supervision with real-time approval of fund transactions by an

independent third-party trustee. This can be contrasted with the current regulatory regime which comprises:

- self-regulation by the RE;
- after-the-event semi-annual financial auditing; and
- periodic compliance plan review and annual compliance plan review typically conducted by a partner of the financial auditor's firm.

There is also a lack of independence due to the fact that an RE's "external" directors or compliance committee members are appointed by, paid by, and may be removed by the RE.

Trust believes that the Inquiry should have regard to the need to clearly define the roles and liabilities of all parties involved in the running and oversight of a scheme, and expanding the present function of the compliance plan auditor to encompass:

- more frequent and timely monitoring of the RE's performance;
- reporting periodically to the RE and, as necessary, to ASIC on the RE's compliance procedures and the conduct of the scheme;
- widening access to the compliance monitoring role by allowing other qualified professionals to take on this work.

Recent examples of failure under the current regime

Allco: Related party transaction and lack of compliance oversight

On 21 January 2008, Record Funds Management Limited, as responsible entity of the Allco Property Fund, paid $18.8 million to a related party at a time when the Allco Group was under significant financial stress. It is difficult to see how this transaction was in the best interests of unitholders.

Furthermore, it was reported in the *Sydney Morning Herald* on 13 March 2009 that the administrator of the Allco Finance Group, McGrathNicol, has recommended ASIC look into several deals conducted by Allco, which included a $50 million loan made to an investment vehicle owed by Allco directors and senior management. The administrator revealed Allco Finance made the loan to Allco Principals Trust (APT) on December 18, 2007, to ensure the investment vehicle's 7 per cent stake in Allco was not margin called. McGrathNicol suggested the loan could be reviewed by ASIC on the grounds it could have breached the requirement to seek shareholder approval for such transactions. Allco never disclosed the loan.

Allco's complex structure rendered it impossible for investors to see a clear line of responsibility. An independent party is in a far better position to appoint an administrator while there are still assets left to be sold and can also bring scrutiny to related party transactions.

Timbercorp and Great Southern: Insolvency and RE not acting in investors interests

Great Southern Managers Australia Ltd (**GSMAL**) is the responsible entity of 43 registered managed investment schemes. On 16 May 2009, the directors of GSMAL and its ASX-listed parent Great Southern Limited (**Great Southern**) appointed Ferrier Hodgson as voluntary administrators of the companies.

As reported in the *Australian Financial Review* on 27 July 2009, investors in certain 2006 and 2007 projects of GSMAL were asked, in January 2009, to swap their ownership in cattle for shares in the listed entity Great Southern. It has also been reported that certain of these investors were offered inducements to secure the resolutions needed to complete "Project Transform". These resolutions were passed by the slimmest of margins and the collapse of Great Southern means that the shares these investors now hold are worthless. These transactions were clearly in the interests of Great Southern, rather than the investors, and should not have been proposed by the RE.

Timbercorp Securities Ltd (**TSL**) is the responsible entity of 33 registered managed investment schemes. On 23 April 2009 the directors of TSL and its ASX-listed parent Timbercorp Limited appointed KordaMentha as voluntary administrators of the companies.

Upon the insolvency of a responsible entity or scheme there will be a number of competing interests:

(a) the RE;
(b) the participants in the scheme (the scheme members);
(c) creditors of the RE whose debt arose in the course of the RE's functions in relation to the scheme (the scheme creditors);
(d) creditors of the RE whose debt was incurred other than in relation to the RE's management of the scheme (the general creditors); and
(e) the external administrator of the RE and/or the scheme.

As noted in Michael West's opinion article in the *Sydney Morning Herald* on 8 July 2009, in both the Great Southern and Timbercorp situations, the *"RE was caught between perpetuating its own existence (and therefore fees for the holding company) and putting investors' interests first, which would in many cases involve winding the scheme down."*

The examples cited in this submission along with many others serve to highlight that the current regulatory regime does not adequately protect investor's interests. The ostensibly very onerous legal obligation placed on an RE and its directors and officers to prefer the interests of members to its own interest is simply not being adhered to

We would be pleased to provide any further information that the Committee might require. If you have any questions regarding this submission, please do not hesitate to call Peter Bryant on (02) 8295 8402.

Yours faithfully,

[Sent by email to corporations.joint@aph.gov.au]

John Atkin
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