SUPPLEMENTARY SUBMISSION

an investor in the City Pacific First Mortgage Fund and the City Pacific Income Fund

Inquiry into Financial Products and Services in Australia

Parliamentary Joint Committee on Corporations & Financial Services Department of the Senate Parliament House - Room SG - 64

"I BLAME THE MANAGER, I DO NOT BLAME THE MARKET"

"Bloody Stupid Me"

http://www.news.com.au/heraldsun/story/0,21985,22030091-664,00.html

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SUPPLEMENTARY SUBMISSION – 2009 REVIEW OF MANAGED FUNDS

Introduction

I have made a previous submission to which this submission is supplementary.

I am an investor in the First Mortgage Fund ("FMF") and Income Fund ("CPIF"). Previously both of these funds were managed by City Pacific Limited ("CPL"). Subsequent to a meeting held on 25 June 2009 Balmain/Trilogy ("Balmain") took over the management of the FMF. Leaving the CPIF managed by CPL.

I initially invested in both of these funds for different reasons: I invested in the FMF to achieve a regular higher rate of income secured by 'first mortgages on real property' in Australia and I invested in the CPIF to achieve a slightly higher rate of interest than normally available form a bank or building society and was comforted that my money could be returned to me on an overnight basis. I realised that with regard to my investments in the FMF that I would have to bind my money with the fund for a longer period than other investments, but I thought that was reasonable in the circumstances.

In this supplementary submission I wish to generally cover the issues confronting investors in the FMF now managed by Balmain. I wish to do so because, while the majority of investors in the FMF might feel that they have escaped from CPL, they now face the potential problems of (1) the prospect of new investment into the FMF and the effects thereof, (2) gaining the return of what is left of their investments, and (3) Whether the value of a unit in the FMF remains at $1 or the fund's constitution(as amended) is amended to reflect the 'true value' of a unit. These issues have been raised in at least one user group forum, the 'CPFMF Unit Holders Action Group' ("CPFMFUHAG").

I also wish to discuss the difficulties arising out of the CPIF since the FMF has been frozen and revisit some issue raised in my original submission together with some other issues that have come to mind.

The FMF has a new Manager

At come time prior to September 2008 there has been a steady stream of discontent arising out of discontent related to what many regarded as the manager's self-interest and the FMF's poor performance. The CPFMFUHAG was the first centralised group/forum to crystalise a view that the manager should be replaced. Although this view had cycled from the fore to the background several times, the efforts of the so called 'steering group' and 'Sydney group' worked to attract Trilogy (Brisbane) and Balmain (Sydney) to take an interest in managing the FMF in lieu of CPL.

While there are a lot of side-issues that arise in relation to the foregoing paragraph, I will not enter into those issues in this submission. Suffice to say that at a meeting on 25 June 2009, about 55% members of the FMF voted to replace CPL with Balmain.

Now, to be fair to Balmain, they have only received custody of loan documents in this past week, but given that submissions for this enquiry close on 31 July 2009, I believe it is reasonable to raise the issues I raise here now, rather than risk not being able to raise them at all.

The Struggle for a Better Future

I believe that investors were not attracted to Balmain, but rather repelled by CPL. Balmain's proposal ("the Proposal") for the meeting of 25 June 2009 is located here:
http://www.balmaintrilogy.com.au/proposal.aspx

Under the heading "Strategy" the Proposal:
"... Upon completion of the Asset Assessment and the Legal Review BalmainTRILOGY will advise Investors of the intended future direction of the Fund. This advice will include definitive policies for future distributions and future redemptions. ..."

It was with respect to Balmain's 'strategy' and its clear lack of disclosure as to the path on which it intends to take the FMF that I originally decided to make this supplementary submission.

Fees

Under the heading "Management Fees" the Proposal discloses:

"... The historical management fees charged by the existing responsible entity are a matter for personal opinion as to their appropriateness. BalmainTRILOGY's assessment is that the present fees are approximately double what would be an appropriate level at this time given the current state of the Fund.

Following detailed consultation with unit holders (and some criticism of our original proposal) BalmainTRILOGY has decided to amend its proposed fee structure.

The proposed fee structure is now limited to 1.50% per annum of funds under management. In the event that funds under management reduces through either asset revaluations or redemptions to unit holders the management fee will consequently reduce.

The estimated cost of Custody, Registry and Fund Auditing will remain as a cost to the Fund in accordance with standard industry practice. This cost remains estimated to be 0.12% per annum. It should be noted that BalmainTRILOGY will receive no other income in respect of the Fund other than the above mentioned 1.50% per annum of funds under management. ..."

However, Trilogy's very own First Income Income Mortgage Trust PDS ("the Trilogy PDS"), page 15, discloses:-

Table 2: Fees and Costs that are payable by the Borrower
Trilogy Funds Management or a related party to it is entitled to receive from the borrower, and retain, management fees and costs on each Mortgage Investment made by the Trilogy **first** Mortgage Income Trust. The table below shows the types of fees and costs that the Manager may charge to the borrower.

TYPE OF FEE OR COST	AMOUNT (+GST)	HOW AND WHEN
Loan application fee This is a fee paid by a borrower whether or not the loan proceeds.	Between 0.5% and 3% of the loan.	This fee is paid by a borrower (and not from the assets of the Trust) when an application is withdrawn or at settlement of the loan.
Loan administration fee. This is a loan monitoring and administration fee that the borrower pays.	Between 0.5% and 3% of the loan amount per annum.	This fee is paid on a recurring basis during the term of the loan.
Early repayment fee This is a fee the borrower may have to pay if the borrower repays the loan before the maturity date.	Between 1 to 6 months' interest.	This fee is paid on the early repayment of the loan.
Performance based fee This is a fee that may be payable by the borrower from the profit derived from the project the subject of the loan.	Calculated either: [1] as a percentage of the profit; or as a percentage of the loan amount.	This fee is paid at the maturity of the loan or at such other date as is agreed between Trilogy Funds Management and the borrower.
Loan extension fee This is a fee payable by the borrower where Trilogy Funds Management agrees to the borrower's application to extend the loan repayment date.	Between 0.5% and 3% of the loan.	This fee is paid on or before the date of the commencement of the extended term.
Security release fee This is a fee payable by the borrower where Trilogy Funds Management releases any security held either in full or in part over any lot or unit of the borrower.	$300.00	This fee is paid at the date of the release of the security.

Notes:
[1] Not all Mortgage Investments include this fee.

I shall refer to the fees in Table 2 as 'direct' fees because these fees are paid directly to the manager by the lender.

The fees are also listed on page 12 of the Adviser Edge Report on the Trilogy First Income Mortgage Trust ("the Trilogy Trust").

Balmain Trilogy also stated on 28 May 2009 **"... "Our proposal is for one fee only" ..."**

Now, if one refers to the Trilogy PDS, it clearly discloses (on page 13) that an investor in the fund is not liable for the fees disclosed in Table 2 (above). Table 2 (above) discloses the fees which the manager will take from the lender directly, such monies will not form part of a direct investor cost. However, such fees impact on the lenders and on the lenders' capacity to repay their loans to the fund.

I believe that a good example of the effect of these 'direct' fees is that Trilogy itself has waived its MER on the Trilogy Trust and as noted in the Aegis Report under "Threats" on page 13 (in part): **"... Removal of the manager's waver of its MER would reduce investor returns ..."** (MER - Management Expense Ratio. The total of annual management fees and ongoing expenses of the fund, expressed as a percentage of the total funds under management.)

When one takes into account (in these difficult times) the capacity of a lender to pay a certain amount of money to the fund (interest), then pay another amount of money directly to the manager (the direct fees), and the funds ability to pay the manager its MER and then for the fund to account to investors, an old adage comes to mind "you can't get blood out of a stone'. Sensibly, Trilogy waived its MER to accomplish full distributions, but would it do the same for the FMF? I think not.

There was a lot of silence from Balmain with respect to these 'direct' fees. In fact the 'direct' fees haven't rated a mention. It seems normal within the industry to speak to management fees and 'direct' fees as not being the same, so when Balmain stated that its proposal was 'one fee only', what did it mean?

Did Balmain mean that there would be no 'direct' fees, and that such fees would be paid to the FMF? Or, did Balmain mean that it just hasn't spoken to those fees yet and that it expects to be able to charge those fees as CPL did? (such fees are allowed to be charged pursuant to the FMF's constitution).

I get the impression that investors regard the 1.5% as the sole fee – many investors might not even be aware that other 'direct' fees were charged by CPL directly to the lenders from the FMF.

As most lenders of the FMF are in default at this time and are unlikely to make full repayment in the future, then ensuring that Balmain does comply with its 'one fee only' and does not charge 'direct' fees is extremely important to investors in the FMF. Further, it very well might be that an impost of such 'direct' fees would impact negatively on lenders already neck deep in the mire of uncertainty.

On Page 4 of the Aegis Research Report ("Aegis") on the Trilogy Trust, under "Weaknesses", states (in part): **"... The investor has no opportunity to share in the significant fees charged to borrowers by the manager, including loan application, administration and extension fees, and performance fees ..."**

The mere fact that these fees seem indistinguishable one from the other leaves investors confused about what will be paid into the fund, and what the manager might legally be entitled to pocket for itself on top of the MER. It is my view that such 'direct' costs should be paid directly into the managed fund at all times because such charges do impact on the lender's capacity to repaid its loan. Alternatively, a manager should be required to speak to ALL fees when referring to any fee and thereby set aside any ambiguity in relation to fees.

I believe it is important to ensure that investors are not misled when a manager, or prospective manager, makes a statement with respect to fees: such statements should be all embracing with nothing left to speculate about.

Plight of the 'Frozen Few'

I would like to say that one feels trapped when one's investment is tied up in a frozen (illiquid) managed fund. It seems to me that we (the investors in the fund) are all neatly bundled up, and even after we voted to change the manager, we still feel as if we've been picked up in one bundle and taken from one place to another – there is no 'ray of sunshine', just a feeling of despair.

What surprises me is that Balmain didn't really present a plan, rather it stated ".. **Upon completion of the Asset Assessment and the Legal Review BalmainTRILOGY will advise Investors of the intended future direction of the Fund. ..."**

Now, this statement might sound logical but, it's not: it completely avoids dealing with the most important issue that unit holders should be concerned about: The future direction of the fund. This is part of the problem, the law (and ASIC) expects investors trapped in a frozen (illiquid) fund to accept a proposition from a prospective manager which does not include a clearly defined statement about its intentions as to the fund – the law requires no more from the incumbent manager either.

What is the mystery? Why isn't a manger compelled to make a clear and precise statement about the future direction of a frozen fund? In my opinion, the future of a frozen (illiquid) managed fund comes down to two quite distinct choices – (1) wind up the fund, or (2) manage the fund as ongoing business. There is no doubt that such an entity would give members of that fund a substantial degree of comfort in the circumstances: i**nvestors often speak of being 'forgotten'.**

I'm surprised that the law does not account for an entity as proposed in my first submission: an entity created to take over a supervisory role (in the manner of an administrator) when a fund becomes illiquid. Perhaps such an entity would be able to determine the proper and most realistic path for the manager to take because this entity would be able to form an objective opinion as to the best interests of the members of the fund.

It is clear that winding the fund up would depend on the market, the fund's debt, and future prospects for the fund's assets. However, when it comes to attempting to manage the fund as an ongoing proposition, then other issues arise that are, in my opinion, greater threats to the interests of investors than those which might arise out of slowly winding down the FMF. If a variable unit price ("VUP") is applied there are negatives for the needier investor, and if new investment enters the fund, then any increase in pre-existing asset value must be shared with those new investors: an impost on all pre-existing investors regardless of the value put on a unit.

In circumstances such as for the FMF, the manager (or prospective manager) of the illiquid FMF should be compelled to clearly state whether they intend to run the fund as an ongoing business. They should be compelled to speak particularly to new investment and debt.

Personally, I felt that CPL was so bad a manager that I was prepared to accept Balmain on good faith – but why should I have had to do that? After giving some thought to it, I feel like I'm waiting to read Balmain's PDS for the FMF some time AFTER I've voted to accept them.

I would have preferred to just wind the fund up, but I knew that the market was not conducive to such a move – what were my options? (1) to stay with a manager I had absolutely no confidence in, or (2) take a chance with a prospective manager which told me nothing about my investment's future – I chose the latter – such a decision clearly discloses the terrible position the law had put me in.

A act done subject to duress is an act one is not generally accountable for: As far as I'm concerned, my act in voting for Balmain was made under duress. I believe that many members of the FMF would say likewise. I've seen it, and I've felt it – I know what its like to be a member of a frozen (illiquid) fund managed by a manager in which I have absolutely no confidence in. The whole show was administered by ASIC – what chance did we have?

I now turn to the issues I suspect Balmain will be required to deal with over the coming months and the difficulties that arise for pre-existing members of the FMF.

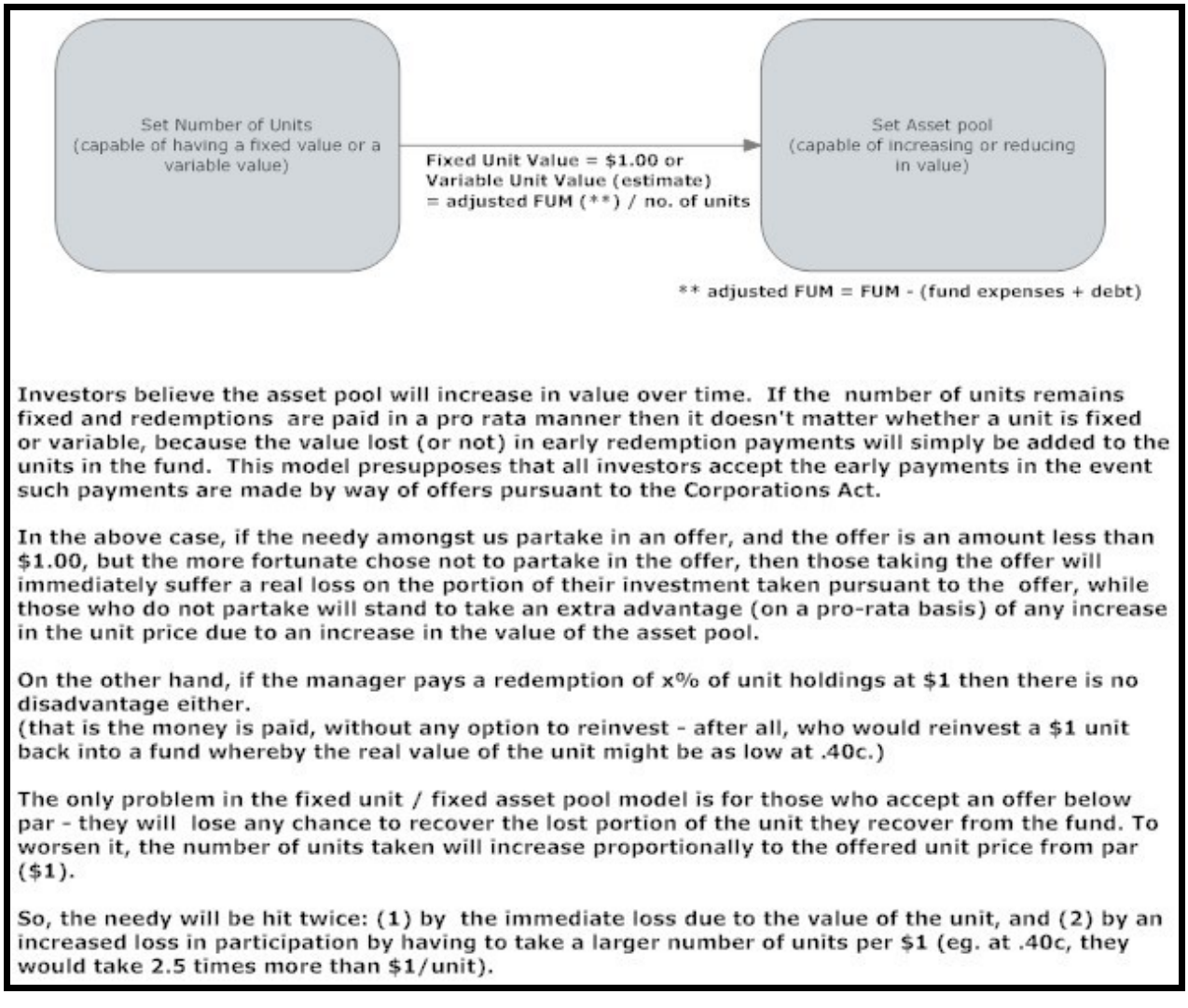
How Is a Unit Valued?

The constitution of the FMF (as amended) sets out that one unit = $1.00. However, in an impaired fund, a unit's 'true' value is more properly calculated by reference to a formula approximating:-

(asset value – (fund debt + fund expenses)) / Total number of members).

In its last report the previous manager (CPL) has declared that a unit is worth about .61c. While I believe that most investors would be more sceptical and believe a value somewhere between .40c and .60c. Regardless of what investors generally think about the value of the unit, most have a optimistic view that the value will increase over time. Balmain has given assurances to members that they will apply their best endeavours to recover as much of the fund's value as is practically possible. Many FMF investors have found comfort in Balmain's assurances.

Some members would see the fund as an ongoing business and would believe that such a proposition is in their own best interests. The manager has not disclosed whether that is the model it will pursue. In fact, the manager has not disclosed any model for the future of the fund: the very reason I say that we have chosen a manager without the manager having to disclose a PDS – I understand it is not necessary for a PDS (as such), but I say this merely to disclose the difficulties we face in this frozen (illiquid) fund.



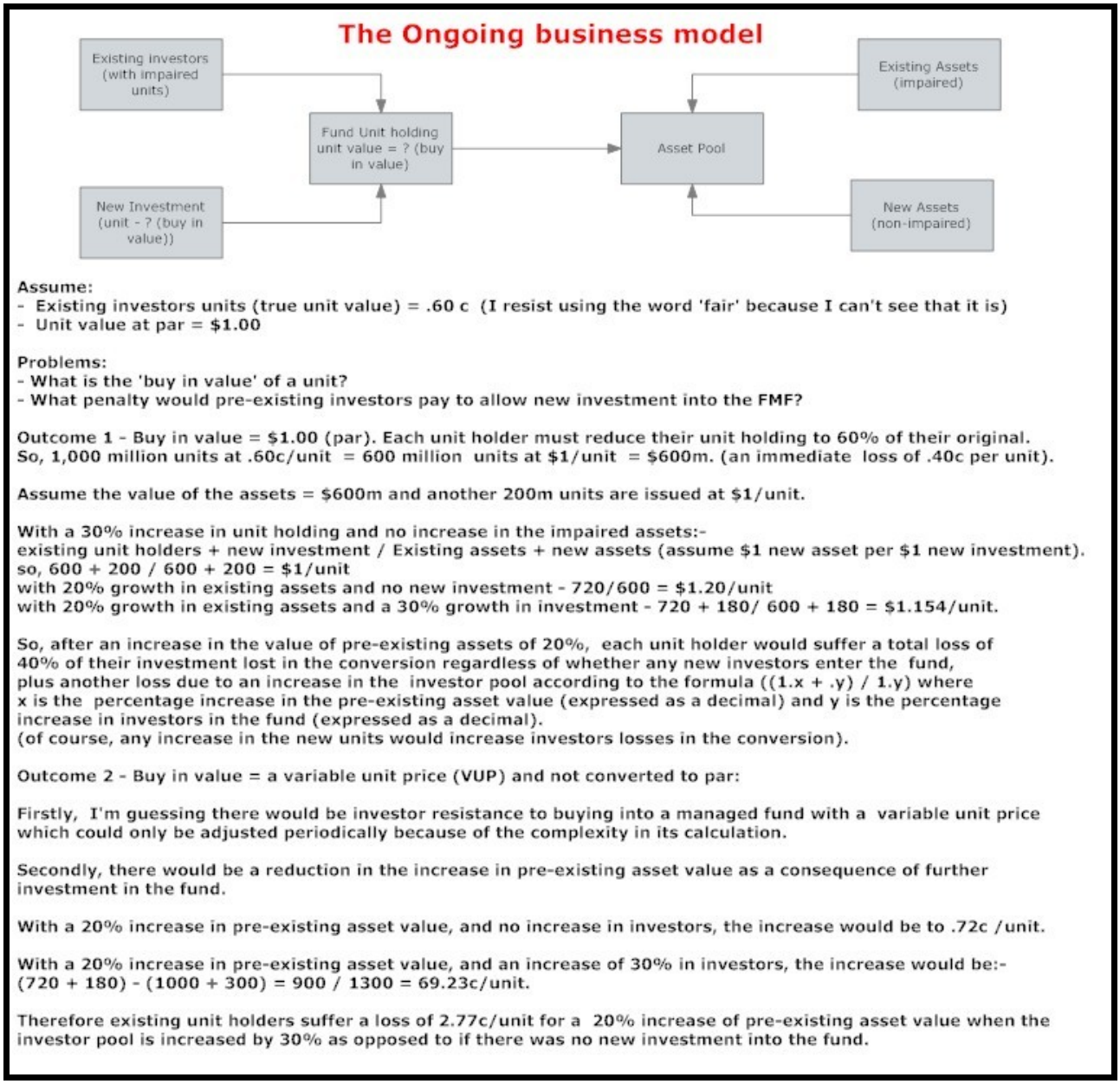
It is my view that manager's offers (pursuant to the Corporations Act) based on a value less than $1.00 disadvantage the needy in cases where there is an optimistic view about the future of a frozen (illiquid) fund. In fact, offers tend to force every one to lose in circumstances whereby new investment is allowed into the fund, because as members take up an offer at a reduced unit price, their remaining interest in proportionally reduced by an disproportionate amount.

I believe that, in cases where the unit price prior to the freezing of a managed fund is fixed, then the unit price should remain fixed until such time as the fund is no longer capable of paying that fixed price (that is, when the dregs of the fund are to be paid out). In this way, there is no discrimination between those who leave, and those who chose to stay. Of course, this is a moot point when offers are made at the fixed unit price (as disclosed in the fund's constitution (as amended))

The Future of the FMF

In this fund, unit holders might see the ongoing business model as a way to get their money back, whereas the manager sees that same model as a way to securing itself a bright future full of wonderful income from a great big fat lazy cash cow ripe for continuous milking –a trap easily set by everyone's innate need and greed: it just might be that only one of the parties is satisfied once the trap has sprung.

The Ongoing Business Model



Assume:
- Existing investors units (true unit value) = .60 c (I resist using the word 'fair' because I can't see that it is)
- Unit value at par = $1.00

Problems:
- What is the 'buy in value' of a unit?
- What penalty would pre-existing investors pay to allow new investment into the FMF?

Outcome 1 - Buy in value = $1.00 (par). Each unit holder must reduce their unit holding to 60% of their original.
So, 1,000 million units at .60c/unit = 600 million units at $1/unit = $600m. (an immediate loss of .40c per unit).

Assume the value of the assets = $600m and another 200m units are issued at $1/unit.

With a 30% increase in unit holding and no increase in the impaired assets:-
existing unit holders + new investment / Existing assets + new assets (assume $1 new asset per $1 new investment).
so, 600 + 200 / 600 + 200 = $1/unit
with 20% growth in existing assets and no new investment - 720/600 = $1.20/unit
with 20% growth in existing assets and a 30% growth in investment - 720 + 180/ 600 + 180 = $1.154/unit.

So, after an increase in the value of pre-existing assets of 20%, each unit holder would suffer a total loss of 40% of their investment lost in the conversion regardless of whether any new investors enter the fund, plus another loss due to an increase in the investor pool according to the formula ((1.x + .y) / 1.y) where x is the percentage increase in the pre-existing asset value (expressed as a decimal) and y is the percentage increase in investors in the fund (expressed as a decimal).
(of course, any increase in the new units would increase investors losses in the conversion).

Outcome 2 - Buy in value = a variable unit price (VUP) and not converted to par:

Firstly, I'm guessing there would be investor resistance to buying into a managed fund with a variable unit price which could only be adjusted periodically because of the complexity in its calculation.

Secondly, there would be a reduction in the increase in pre-existing asset value as a consequence of further investment in the fund.

With a 20% increase in pre-existing asset value, and no increase in investors, the increase would be to .72c /unit.

With a 20% increase in pre-existing asset value, and an increase of 30% in investors, the increase would be:-
(720 + 180) - (1000 + 300) = 900 / 1300 = 69.23c/unit.

Therefore existing unit holders suffer a loss of 2.77c/unit for a 20% increase of pre-existing asset value when the investor pool is increased by 30% as opposed to if there was no new investment into the fund.

It seems, in the absence of new investment, that pre-existing investors would be required to retain their investments in the FMF: a condition with which investors should not be encumbered. A manager, or prospective manager, should be compelled to explain the advantages and disadvantages (in full) when there is an intention to attempt to continue and illiquid fund as a going concern.

Slowly Winding Up The FMF

The trouble with the ongoing business model is that it must naturally include new investment, and to my mind, new investment simply detracts in a substantial way from the aspirations of the pre-existing investors in the FMF. I constructed the following table to determine the effects of new investment into the fund on pre-existing investors' share of that increase. To attract new investment, pre-existing members must accept the losses as the fund stands at the time of the new investment - a condition that I would think is unacceptable to most pre-existing investors.

Loss of percentage increase on pre-existing asset pool to pre-existing investors due to new investment in the fund

(rounded to 1/10 of 1%) Formula = 1.x + .y/ 1.y
where x = % increase in pre-existing asset value (expressed as a decimal)
and y = % increase in new investment (expressed as a decimal)

% increase in (X)	10% increase in (Y)	20% increase in (Y)	30% increase in (Y)	40% increase in (Y)	50% increase in (Y)
10.00%	9.10%	8.30%	7.70%	7.10%	6.70%
20.00%	18.20%	16.70%	15.40%	14.30%	13.30%
30.00%	27.30%	25.00%	23.10%	21.40%	20.00%
40.00%	36.40%	33.30%	30.80%	28.60%	26.70%
50.00%	45.50%	41.70%	38.50%	35.70%	33.30%

For example, an expected increase in pre-existing assets by 40% (in yellow) would result in an increase of only 30.8% (green) to pre-existing investors if investor participation is increased by 30% (blue).

It seems to me that once a Fund has become impaired to a certain extent (as in the case of the FMF), then such a fund should be compelled to wind up in the best interests of the fund's members. There is no good reason why member's investments should be trapped with a frozen (illiquid) frozen fund merely to satisfy the aspirations of its manager. I am not suggesting that it is Balmain's view that the fund be run as an ongoing business, rather I refer to the fact that members and managers generally do not see eye to eye of this matter.

Generally, it seems that the wind up option is normally regarded as a sudden death option whereby the recovery of monies is determined by the price of assets in the immediate to near future – there seems to be no way to take advantage of future market improvement, consequently investors are reluctant to consider this option seriously.

I believe that the applicable law should include (if it doesn't already) the capacity for a manager to wind down the fund in such a way that it might take advantage of future (up to 2 years or more) potential market improvement in cases where a fund is illiquid and the fund has foreclosed on loans and held assets as a consequence of those foreclosures. The applicable law should require managers of affected funds to disclose to members a full list of the properties held, the addresses, a description of the properties, loan value outstanding (including all outstanding interest), the expected value at the then present time, and values expected at future intervals.

Capitalisation of Loans

It seems in the FMF that the manager capitalised loans by moving the loan from one entity to another. Eg. MP Pacific Investments Pty. Ltd. to MP Pacific Investments Unit Trust (CP1 owned 50% of each of these entities), and then to Marina Cove Pty. Ltd. (please see my original submission). Investors have no knowledge as to the loan arrangements made to non-related party lenders.

This loan commenced with a $15m loan to MP Pacific Investments Pty. Ltd in or about September 2007 and in March 2009, the loan was transferred eventually to Marina Cove Pty. Ltd. For $17.8m (Marina Cove Pty. Ltd. Is 100% by CP1 – CP1 is owned 30% by CPL) with dubious security.

Only $600k was ever paid back over the entire period of the loan between about September 2007 until March 2009.

I believe that such loans should be prohibited because they give the impression that there is movement in the loan book, but in many cases such loans are merely 'rolled over' to other 'hand puppets' animated by the same 'hands'. Also, it is important to note that such loans were 'rolled over' when the FMF was illiquid.

I believe such 'rolling over' should be regarded as creating new loans, and should be prohibited when funds are illiquid.

However, with regard to such activity within a liquid fund, I believe the loans should be **marked clearly as due by the original lender** because there is no real 'pay out' of the original loan. It seems that both interest and capital are simply moved a 'new loan' to a new 'hand puppet'.

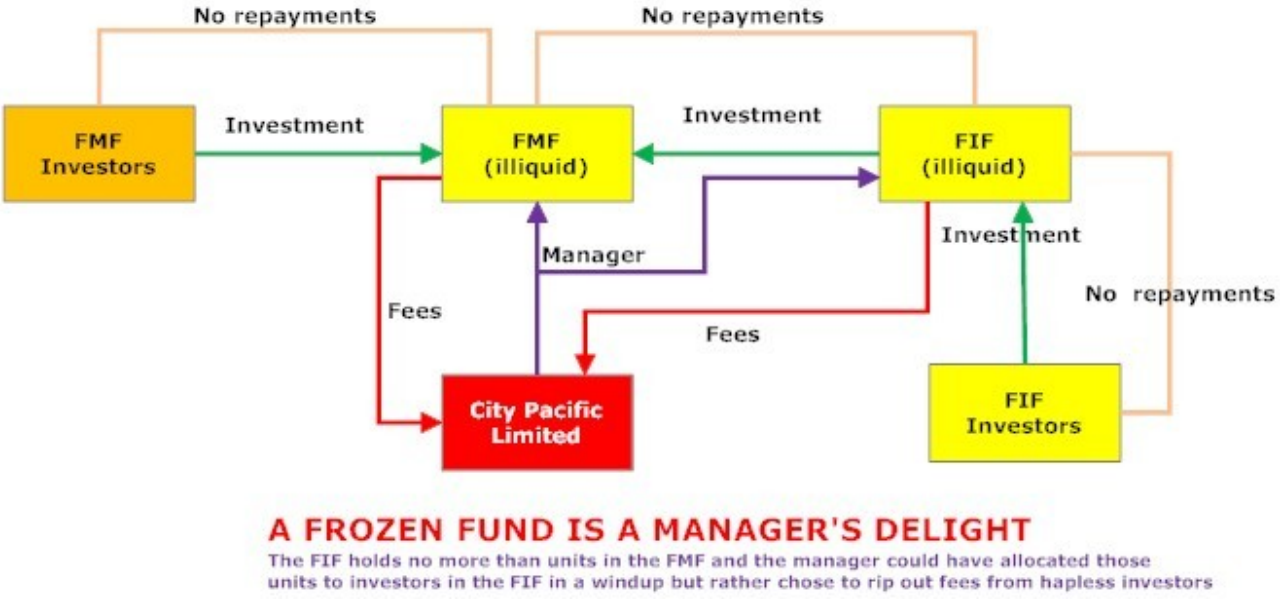
It may seem that I'm contradicting myself, but in the case of a liquid fund, the manager gives the impression the loan book is turning over while referring to such loan, but in reality, it is not. In the case of the illiquid fund, any change in entity must be regarded as a new loan – since the illiquid fund requires a return of capital, such return of capital should be a much higher priority than 'rolling over' a loan to a new entity, even in the case where the same 'hands' animate the new 'hand puppet'. In fact, the return of capital to an illiquid fund must be made the manager's overriding priority.

I would like to restate (from my original submission) that non-disclosure of the separate amounts of interest paid/payable have aided in allowing managers not to disclose rolled over loans by disguising exactly how much interest has been paid (cash) versus how much is payable. All this is obfuscated (from an investor's perspective) by the accruals accounting system which seems to present a fantasy world of accounts to ordinary investors as a cash-driven real-world accounting system. Accruals accounting really makes it difficult for investors to know the true state of affairs about a company – Accruals accounting should be put to death for managed funds.

This section applies to all loans – However, in relation to managed funds, if related party transactions are prohibited as a consequence of future improvements in the applicable law, then clearly this section no longer applies to such loans.

The City Pacific Income Fund

As an investor in the CPIF, I am concerned that the manager continues to charge extraordinary fees on a fund that is frozen (illiquid) due to the manager's own actions. The manager has continued to charge a substantial management fee even though any value that the CPIF might have is subject to its investment in the FMF (in units).



I do not believe the manager has acted in investors' best interests by continuing to take this fee in circumstances whereby the manager should have wound up the fund and distributed the units to investors. This is clearly a case where a manager is really ripping off investors. There is no chance of any near term capacity for the FMF to pay redemptions, and therefore, as a consequence, the CPIF is unable to do so.

The manager has sat on this fund and have not taken the interests of the CPIF's investors into consideration: the manager has been merely content to rip out over $70k per annum to manage a few accounts and a frozen investment in the FMF.

I believe CPL should have wound up this fund over one year ago. I make this complaint in addition to my view (as expressed in my original submission) that CPL should have withdrawn the CPIF's investment in the FMF quite some time before the FMF was frozen (3 March 2008).

This is yet another example of how a manager finds a frozen (illiquid) fund a true 'delight' – the manager has total use of the money without any distribution or redemption to pay and takes a commission on top. The manager further capitalises on the fact that investors in any managed fund are generally incapable to coming together to decide their respective fund's future.

It is also another clear example (relating to my suggestion in my previous submission) of why the law should create an 'entity' capable of overseeing frozen (illiquid) funds. Had such an entity been able to oversee the CPIF, I'm confident that it would have compelled the manager to wind the fund up. The CPIF has received little press and is in a worse position that the FMF because its members face a double penalty – one from the FMF (severely impaired units) and the other within the CPIF itself (charging on the full value of the investment).

First Income Investment Practices

By way of example, on page 11 of the CPIF PDS dated 2 January 2008 (now withdrawn), CPL discloses (in part) under the heading '"3.1 Our Investment Approach

City Pacific's objective is to to maximise returns for you. Investments of the Fund will be in Stable Interest Investments and high yielding ***Loans secured by registered First Mortgages over real property*** and in some circumstances, Collateral Security. … " {emphasis mine}

The PDS went on to state (under the heading "**3.3 Mortgage Investments**" the following sub-headings:-

Acceptable Security Properties
Loan to Valuation Ratio
Borrower's Capacity to Service and Repay
Pricing
Loan Administration System
Loan Approval

followed by the following headings:-

3.4 Loan Assessment Criteria
3.5 Valuation Practices of City Pacific
3.6 Loan Management
3.7 Security
3.8 Borrower Fees
3.9 Borrowings
3.10 City Pacific Income Fund Portfolio

followed by the following heading/subheadings:-

4.1 Factors influencing success and risk
4.2 Specific Business Risk
Loan Defaults
Loan Performance Risk
Construction and Development Loans
Interest Rate Risk
Distribution Risk
Liquidity Risk
Capitalisation of Interest Payments
Gearing Risk
Lending Risk

and then the PDS went on to **4.3 General Investment Risks**

and then, after the whole PDS made the CPIF look like a developer, where did the manager put our money?

The Board of CPL (as manager for the CPIF) put most of our investments straight into the FMF – just straight to the other fund, just a change of hat for the Board of CPL – Did they really believe they could create a 'Chinese Wall' inside their own heads? Did they really believe that it would be possible to switch between the sides of the walls merely by way of thought control?

Now, is the CPIF's investment into the FMF is in compliance with the PDS? I say that it's not – because there is not ONE single issue explained in the PDS that applies to an investment in the FMF [see the list of headings above].

Why hasn't ASIC acted on the massive and substantial breach of CPIF's PDS?

Just what is the purpose of a PDS if the manager is simply going to disregard it?

Just what is the purpose of a PDS if ASIC is not going to enforce its compliance?

I will restate here that the Board of CPL (as manager for the CPIF) knew or ought to have known (as manager for the FMF) that the CPIF's investment in the FMF was at risk and failed to withdraw that investment in order to protect the interests of the members of the CPIF. The Board kept the money to feed its own developers, many being in default while they continued to collect fees from both funds which had been depleted by their own hands.

CPL failed investors in the CPIF on two grounds (1) the Board failed to comply with the fund's PDS by investing outside of the guidelines of the PDS, and (2) in the circumstances, the Board failed to withdraw the CPIF's investment in the FMF in a timely manner.

Fiduciary Standards

The Manager's Executive

As stated before, I believe we voted for Balmain under duress (at least a duress felt subjectively) with many of us having the knowledge one of the members of Balmain's senior management has been found guilty of breaching his client's trust. In an article published on news.com.au on 17 June 2009, Mr. Bacon stated (in part):

"... Mr Ryan said yesterday he did not believe the matter should concern any of the more than 11,000 investors in the fund, who have been unable to access their money or receive distribution since mid-2008.

Mr Ryan stressed that he and his fellow directors had to bear personal liability for the actions of a rogue employee, who made the loan back in 1999. "There are completely different regulations today. Our compliance is totally different to what it was then," he said.

Mr Ryan also noted that ASIC had not banned him as a company director, while the Law Society had taken no action to have him struck off.

Trilogy chairman Rodger Bacon defended Mr Ryan. "He's a fine guy with great skills and abilities and has never been restricted by any legal body," Mr Bacon said. ..."

Now, I'm sure Mr. Ryan is a 'fine guy with great skills' and I'm also confident that he has never been restricted in any legal body either, but really, both of those issues are not the point – we're not interested in Mr. Ryan's legal standard, investors concerns are about the fiduciary standard that Balmain brought to the table.

Mr. Bacon only made comment to Mr. Ryan's involvement in an ASIC case – However, he did not make reference to a Supreme Court case where **Mr. Ryan was personally (with others) found to have breached a client's trust.** Mr. Bacon did not disclose this more important matter and chose to hide it from public scrutiny, including the report in respect to the above quoted article. **Original case** – *Jessup v. Lawyers Private Mortgage Fund and others*
Appeal – *Jessup v. Lawyers Private Mortgage Fund and others*

However, in the same article: **"... City Pacific managing director John Ellis was reluctant to be drawn on the case yesterday. "I would let the matter speak for itself," Mr Ellis said. ..."**

I don't blame Mr. Ellis for not being drawn, after all, it wasn't the time to bring Mr. Sullivan (the Ex-CEO of CPL) discharged bankruptcy into the glare of the media. There wasn't a mention from Mr. Ellis, Mr. Ryan, Mr. Bacon (Chairman Trilogy), or Balmain – it was hush-hush.

The 'ASIC matter' brought a substantial fraud to the fore – ASIC (on behalf of a handful of investors) sued MDRN Lawyers, and yes, it wasn't Mr. Ryan who committed the fraud, nevertheless Mr. Ryan was largely responsible for the supervision of the fraudster – and the strangest thing was that the fraud benefited the lawyers, not the fraudster.

Surely it is a matter that should be disclosed, after all, Mr. Ryan now holds an important position in the new manager of the FMF and it is very much a supervisory role. It was fortunate for investors that MDRN were well insured.

It wasn't so long ago that many investors were complaining about the fact that if 'they only knew' about Mr. Sullivan being a discharged bankrupt that they wouldn't have invested in the FMF – well, we were running from the aftermath of Mr. Sullivan's leadership of the FMF, and we run straight towards an entity engaging a senior executive who had a fraud committed on his watch, and was found by the Supreme Court of Queensland to have committed a breach of trust.

If one reads the decision, one will see that Mr. Ryan strenuously argued that he didn't owe the plaintiff any duty of trust – in fact, several arguments were put up to distance himself from any obligations to the plaintiff (once called 'client').

Might we see ourselves in the future lamenting "I knew, but why didn't I act"? I have no doubt he's a 'fine guy with great skills', but I would think there's a lot of folk out there who think very much the same of Mr. Sullivan.

Case in point:. Investors concern themselves about an executive's fiduciary standing, executive's friends, Mr. Bacon (as Chairman of Trilogy, a man we now entrust our $600m fund to) thinks otherwise, he says Mr. Ryan 'a fine guy with great skills'. In fact, Trilogy were good to CPL too – no mention of Mr. Sullivan's past bankruptcy – was it just a 'Mexican stand-off'?

I couldn't imagine it possible to have a more diverse set of concerns about the issue: fiduciary standing R.I.P.?

The Manager's fiduciary behaviour

CPL, as manager of the FMF, issued PDS No. 4 for the FMF on 8 August 2001. On page 11 under the heading '5.6 Risk Management Generally', it stated (in part):

"... In order to manage risks associated with loans, City Pacific ensures that it complies with its lending manual, which requires it to conduct a range of searches which are appropriate to a particular property or borrower, normally these include:
Credit Reference Reports
Bankruptcy Searches
...
Searches to ensure borrowers have suitable insurance policies in place ..." {emphasis mine}

This statement was following in PDS No. 5 dated 27 August 2002 , and in PDS No. 6 dated 29 September 2003, all in identical places – ***However, in PDS 7 dated 1 February 2005, under the heading '5.7 Risk Management Generally' on page 14, the PDS discloses identical words with the exception of 'bankruptcy searches'.*** {emphasis mine}

Was this by design or by error? A PDS is an important document which must be highly scrutinised before being placed before the public. One can only assure that the intention of the institution was to allow discharged bankrupts to loan from the FMF within having their histories disclosed – I guess CPL would not consider that a problem especially given that the CEO was a discharged bankrupt and he didn't have to declare that to investors.

The FMF has lent to the Atkinson/Gore group and one its senior management is Mr. Gore who is a discharged bankrupt. As I understand it, the loan totals about $175m or more. The Atkinson/Gore loans had been foreclosed on by CPL as manager for the FMF and the extent of the fund's losses to this loan are not yet determined.

Had CPL amended its lending manual? Or had CPL decided not to comply with its so called 'lending manual'? – did they amend it to do business with Mr. Gore's company? Or perhaps to do business with other companies whereby a senior manager is a bankrupt?

Broadbeach Land - "Pacific Beach" Revisited

In my previous submission I stated that I believed that the 'development' at Pacific Beach should have been declared a related party transaction. CPL's 'Company Profile 2006', disclosed on page 25, under the table titled 'Property', line 9, :-

Current Major Projects	Value	Owner	Expected Completion Date
Pacific Beach	$960m	CPL 33.3%	August 2010

The identical table was used on page 24 of CPL's 'Capital Raising and Company Update February 2007'.

I again ask, why was this project not declared as a related party transaction in the financial statements of the FMF? And, why didn't ASIC look into this matter?

Breaches

I believe that it's necessary for members of a managed fund to be informed of breaches of either the fund's constitution and the PDS as well as in the event the manager fails to comply with applicable laws. It would be worthwhile to add breaches of the fund's facility covenants.

Impairments – Real or Fantasy?

In an attachment headed 'Questions and Answers' to a letter dated 19 August 2008 and headed 'IMPORTANT NOTICE – PLEASE READ CAREFULLY', CPL stated (in part):-

"... Question **7. Will the July and August distributions be paid to me at any stage in the future?**

- -***Unfortunately no, the amount is required to off-set the provision as outlined in 1 above is therefore not able to be paid at a later date***."

"... Question 1. Is the Fund in trouble? ...

- in respect to the current market conditions a 5% provision against the total value of the loans made by the Fund is considered reasonable by management. ***A provision is an accounting entry that establishes an allowance for a potential loss.*** Given the current market volatility it is considered prudent to make a provision in the event that any losses occur...." {emphases are mine}

I have always found these two statements troubling because, on the one hand Mr. Sullivan makes the statement that the accounting entry is a 'provision', yet uses that mere accounting provision as the very reason the Board of CPL ("Board") withholds two consecutive distributions from investors. Now, I don't argue the right of a manager to pay distributions to capital, but in this case, there was no impairment of capital, it was a mere 'accounting provision'.

After the changing of the guard, Mr. Ellis makes the following statement in a letter to unit holders asking for their support in the upcoming vote on 25 June 2009:-

"... The Truth About ***Recent*** Impairments

The Fund's half year accounts to 31 December 2008 show that we have made provision for impairments in the Fund's underlying security assets of $339 million – about 35% of the Fund's underlying value. ***Let me stress that impairments are a provision – not a loss.*** They reflect the estimate of losses that might be made should assets be sold or realised in the currently distressed property market. I have repeatedly stated that it is not City Pacific's intention to "fire sale" the Fund's assets. We will, wherever possible, facilitate an orderly repatriation of the Fund's assets over time. This is only sensible and will give the Fund the best chance of achieving maximum value for its assets in this extraordinarily difficult economic climate. ..." {emphases mine}

I believe this later document is carefully crafted because the heading includes the word 'recent' so as to distinguish these later impairments which are 'not a loss' from the 'accounting provision' made by Sullivan which consumed two months of our distributions which, according to Mr. Sullivan, will not be repaid at any time in the future.

In the first instance they wanted our money, so even accounting provisions were losses, while in the second instance they wanted our vote and suddenly real impairments were not losses. Horses for courses?

What is our protection in a case like this? Is this a consequence of our prudential choice? Or is there really something very, very wrong?

It might be a good question for the regulator – Which of Ellis or Sullivan are right? Or, are both of them right?

Read all about it – black is white – believe me, I'm a manger!

Conclusions

The choices for investors locked away in frozen (illiquid) funds are few, and the difficulties of getting investors to make choices about the future of their respective managed funds are many.

In the event a managed fund becomes illiquid, then there is a need for the applicable law to balance the interests of needy investors (those needing the return of a substantial part of the remainder of their investments) and those who are prepared to wait for an improved return. There is also clear need for managers to map out the future direction of the fund and communicate same with investors in a timely manager.

The applicable law should no longer allow investors to be trapped within their investment with the only 'escape hatch' out through any particular manager's endeavours.

The applicable law should no longer permit managers to continue on with a 'business as usual' attitude when a fund is illiquid. Under certain conditions funds should be wound up at the earliest opportunity in order to protect the interests of investors, taking into account (1) the behaviour of the manager, (2) the market, and (3) the needs of investors

There is a great need to improve confidence in managed fund by ensuring that senior management of the managers and of the lenders have a strong fiduciary standing and any fiduciary breaches determined by a court (within a set period of time) by a senior manager of a managed fund be disclosed to all investors of that particular fund, as well as to new investors in that fund.

When one looks to see the deliberate act of withdrawing the checking for bankruptcy as part of the CPLS's lending practices from the PDS (in or before PDS 7), one sees how fiduciary standards seem to slip so easily. A discharged bankrupt as CEO of the manager of the FMF was allowed to lend money placed in trust with the FMF to another discharged bankrupt engaged as a senior manager engaged by a lender without any check for bankruptcy. It would be virtually impossible for an investor in the FMF to note the subtle (but serious) change in the FMF's chain of PDS issues.

Lastly, I believe that, with respect to related party transactions, the manager's practice of rolling over loans to different named entities owned substantially by the same parties should be prohibited when a fund is illiquid. Further, such the rolling over of loans in these circumstances give the impression that the fund's loan book has movement when it might not have movement. I believe that in such cases loans should be reported in the name of the original lender until the loan has truly been paid out. [to see the related party transactions of the FMF, please see my original submission under the heading 'Related Parties' – please note how loans were 'paid out' from one entity to another – to me, it looks like a Michael Jackson moon walk rather than a set of business transactions.}

I would hope that in the future, a managed fund would no longer be permitted to engage with it's manager's related companies thereby rendering moot my views on the manager dealing with related companies.

The CPIF is a train wreck because of CPL's mismanagement and self-interest. Investment from the CPIF should not have been made in the FMF in contradiction of the CPIF's PDS. Further, the CPIF investment in the CPIF should have been withdrawn at least at the same time as CPL jumped on its own life raft with the de-consolidation.

Suggestions For Change

That the applicable law is changed with respect to frozen (illiquid) funds **to:**

- **reflect the concerns of the more needy investors so they are not discriminated against, in particular with respect to offers made by the manager [offers should be made at the listed unit price so that 'needy' investors will not be made to lose at the expense of the more 'deep-pocked' investors.**
- **mandate the winding up of managed funds when such funds become impaired to a certain extent and in certain circumstances (such as the City Pacific Income Fund finds itself)**
- **compel managers to give a clear and defined plan as to how the fund will operate in the future (such plan should include debt, new investment (if any)), the value of a unit in the fund, and the respective advantages and disadvantages of either winding up the fund, or continuing as an ongoing business**
- **compel prospective managers to give a clear and defined plan as to how the fund will operate in the future (such plan should include debt, new investment (if any), the value of a unit in the fund, and the respective advantages and disadvantages of either winding up the fund, or continuing as an ongoing business – particular attention should be paid to the effects of new investment on the expectations of pre-existing investors trapped in the fund.**
- **in the absence of an entity constructed by the applicable law to wind up the fund in certain circumstances, then the manager of a managed fund should be compelled to wind up the fund up in those same certain circumstances – eg. In the event that a fund is impaired to such an extent that it is not in investors best interests for the fund to continue as an ongoing business**
- **in any event, ASIC should investigate all transactions of any managed fund that becomes illiquid, and continue to do so while the fund remains illiquid to protect investors' interests.**

That the applicable law should be changed, with respect to managed funds in general, to compel managers and prospective managers to make clear statements as to fees – to compel them to clearly disclose and distinguish between management fees and 'direct' fees (those paid by lenders directly to the manager) so that a representation made to 'fees' should particularise all fees collected by both the manager and the managed fund.

That the applicable law should compel all senior office holders employed/engaged by the manager of a managed trust to declare any breach of fiduciary duty (in particular, but not limited to, breaches of trust and bankruptcy,) committed within 5 years of the date of being found in breach by a court, (or within 5 years from the date of discharge in the case of bankruptcy). to all members and to new members of that managed trust.

That the applicable law should also include the specific minimums of what checks must be made into corporate entities and natural persons with respect to an application to borrow money.

That in the event a manager de-consolidates a managed trust from its accounts, then that manager should be compelled to issue a full set of accounts disclosing the true state of the company's financial position at least some reasonable period before the proposed de-consolidation should be allowed to take effect. The declaration of consolidation and/or de-consolidation must be disclosed in a PDS on which investors may rely.

That the applicable law should compel a manager to disclose a related party transaction in the name of the original related party which originally took the loan regardless of a change in entity/entities continuing to hold the loan if the continuing entity/entities are substantially owned by the same parties owning the original related party.

That the applicable law be amended (if necessary) to broaden the meaning of 'related party transaction' to include cases whereby a manager or a related party to that manager has a real or potential opportunity to acquire a profit/commission from an enterprise which has dealings with the manager's fund. I refer here to CPL and CP1s involvement in the proposal to develop the land at Broadbeach, Gold Coast, known as "Pacific Beach"] whereby CPL has declared in numerous documents that it has a 33.3% ownership but this ownership was not reflected in the FMF related party loans disclosure.

That the manager of a managed fund be compelled to inform member's of any breach in that fund's facility covenants, breach of law (in particular, compliance), breaches of that fund's constitution, and breaches of that fund's PDS. Members should be notified within a reasonable period, say 14 days.

It would seem that ASIC should have a compliance team which 'audits' each managed fund to ensure strict compliance between its PDS and the fund's actual investments.

I would also like to re-iterate that the applicable law should mandate that the disclosure of 'income paid/payable' should be made in separate columns and not a single grouped entry in order that investors are able to determine whether related party loans have actually been paid (or not).

Notes

Please note that the link to CityPac document "Q&A" dated 19 August is now:
http://www.citypac.com.au/citypac/documents/schemes/cpfmf/180day/20080819%20Questions%20and%20Answers%20-%20CPFMF%20and%20Distributions.pdf

I believe CityPac (www.citypac.com.au) may have changed some links on their site, so in the event a link fails then the reader should search for the required document on the site.