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

Dear Ms Batge

New inquiry into agribusiness managed investment schemes

We enclose a submission we wish to submit to the Parliamentary Joint Committee on Corporations and Financial Services for the Committee's consideration.

We are happy to discuss the matter.

Yours faithfully
Piper Alderman

Per:

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Submission to New Inquiry into Agribusiness Managed Investment Schemes

It is important for the Committee to understand that the failures of Timbercorp and Great Southern Plantations do not mean that the business model for investment in agricultural managed investment schemes from a macro point of view is flawed or that this method of funding agricultural enterprises in Australia ought to be abandoned.

There are a number of reasons for these failures and in this submission I make suggestions for changes that would overcome some of the problems that the above failures highlighted.

I have had many years experience in this field including under the former prescribed interest schemes. In my view a number of problems that have arisen are due to the merging of the functions of trustee and manager that existed under the former prescribed interest provisions.

The duties which are imposed on responsible entities and directors of responsible entities of registered schemes under sections 601FC(1) and 601FD(1) respectively of the Corporations Act, 2001 are fiduciary in nature so essentially the role of the responsible entity is that of a trustee rather than a manager. There is an inherent conflict between the role of a trustee and a manager and the previous checks and balances that existed under the former legislation are now gone. Nevertheless there is now a new regime that we have to live with. There are matters that in my view changes that can be made within the existing system to protect investors in these schemes.

One of the benefits of these types of schemes, contrary to the rhetoric of local Farmers who have a vested interest in keeping such schemes out of their area (their complaint being that it forces up land prices so keeping down prices enables them to purchase land at a cheaper cost), is that funds that would not otherwise be available for agricultural production in this country are made available. This creates infrastructure and jobs. A sheep farm over many hectares that may not employ many people can suddenly become labour intensive e.g. vineyards and orchards.

An example of the benefit of these arrangements is the Calypso Mango seen during season in our major supermarkets and Woolworths in particular. This product is an Australian product and is available due to the same being grown under a registered managed investment scheme structure. It could not have been developed without the monies put into its development from the registered schemes.

For ease we will follow the headings referred to in the announcement.

1. **Business models and scheme structures of MIS**

   The major weaknesses with the structures and my comment on how these weaknesses can be rectified are as follows:

1.1 **the land ownership**

Currently there is no provision in the Corporations Act, 2001 which requires the underlying land to be held for the benefit of the investors in the Project. ASIC have imposed a licence condition on responsible entities purportedly to deal with this problem which is ambiguous. The ambiguity has permitted Timbercorp in particular to enter into land ownership arrangements pursuant to which the head lease is stated to be personal to the Timbercorp entity and is not scheme property. The effect of this is that upon the liquidation of the Timbercorp entity, the Growers have no registered interest in the land held for their benefit. The liquidator can therefore sell the land free of the interests of the Growers.

My recommendation to deal with this weakness would be to insert into the Corporations Act, 2001 or the regulations a provision along the following lines:

"(1) The responsible entity of a registered scheme which is a primary production scheme must hold all application monies in a separate trust account which must not be released until such time as an instrument that confers the right, for the purpose of the scheme, to use the land on which any primary production will occur in the operation of the scheme, is registered under State or Territory land titles law, in the name of the custodian unless subsection (4) applies.

(2) The custodian will hold the interest in the land created by the instrument referred to in sub-section (1) on trust for the members.

(3) The interest in the land held by the custodian pursuant to sub-section (2) shall be deemed to be scheme property for the purposes of this Act.

(4) Subsection (1) shall not apply if an instrument that confers the right, for the purpose of the scheme, to use the land on which any primary production will occur in the operation of the scheme, is registered under State or Territory land titles law, in the name of either:

(a) the members collectively; or

(b) each member separately in relation to that portion of the land on which the primary production business in which the member has an interest is being conducted (an example is a forestry right).

(5) Any instrument registered pursuant to this provision may not be terminated or removed before the end of term of the scheme except pursuant to an order made by the Court where it is just and equitable to do so."

Such a provision would prevent the loss of an investor's investment through the failure of the responsible entity or the land owner. To prevent the removal of the instrument being manufactured e.g. by non-payment of rent the Court would have ultimate control over whether the instrument was removed from the land.

1.2 **lack of funds to operate the scheme**

Management fees tend to be collected by responsible entities of these schemes annually in advance. This creates the problem that if the responsible entity were to fail or change during that 12 month period, there may be insufficient funds available to carry out the work during that 12 month period. This ability to collect fees in advance also encourages a type of Ponzi scheme where this years fees are being used to pay last year's expenses.

In my view this problem can be removed by a simple change to the rules under which these schemes operate as follows:

"(1) The responsible entity of a registered scheme which is a primary production scheme that has any fees that are for the performance of services by the responsible entity under an agreement with the member or members for an eligible service period in excess of three months must place the proportion of those fees that are for the performance of services by the responsible entity in excess of that three month period in a trust account held by the custodian.

(2) The custodian must not release any monies paid into the trust account referred to in sub-section (1) save for that proportion that relate to fees that are for the performance of services by the responsible entity under an agreement with the member or members for an eligible service period that does not exceed three months."

This will mean that if a responsible entity was to be removed or goes into administration during a 12 month period, the maximum loss to members would be 3 months worth of fees leaving further monies available to the new responsible entity to perform the responsible entity services.

1.3 **lack of clarity of position of a responsible entity that is in administration or liquidation**

There are no current provisions in the Corporations Act, 2001 that deal with what occurs if a responsible entity is placed in administration or liquidation. Clearly a responsible entity should not continue to be a responsible entity if it is externally administered. This is because of the inherent conflict of interest of an administrator or

liquidator which has to act in the interests of creditors when there is an overriding duty to also act in the best interests of members.

It is therefore recommended that a provision by inserted into the Corporations Act, 2001 that provides as follows:

"If a responsible entity of a registered scheme becomes externally administered under Chapter 5.3A or a liquidator is appointed to the responsible entity then ASIC must apply to the Court for the appointment of a temporary responsible entity by the Court pursuant to section 601FP of the Corporations Act, 2001."

1.4 lack of alternative responsible entities

Due to the practice of ASIC in only issuing Australian financial service licence authorisations on a scheme by scheme basis, in the event of a failure of a responsible entity such as has occurred in the Timbercorp or Great Southern Plantation, there is no entity which can step in as a temporary responsible entity to protect investors. Further the regulator ASIC has been particularly uncooperative in assisting existing responsible entities who operate registered primary production schemes to amend their AFSL to add further schemes. In addition ASIC refuses to accept the position at law that an entity cannot be appointed as a responsible entity until it holds an AFSL that authorises it to operate that scheme by refusing to issue the licence authorisation until **after** the appointment when the appointment cannot be made unless it is granted **before** the appointment. Even though this has been pointed out to ASIC they insist on adopting a position that is contrary to the law making the process of protecting investors in a situation such as has now occurred difficult.

Due to the failure of the regulator it is recommended that section 601FA be amended to provide that:

" Notwithstanding the aforesaid provisions, an entity which holds an Australian financial services licence which authorises it to operate a managed investment scheme of any kind may be appointed by the Court pursuant to section 601FP as a temporary responsible entity."

This will make it easier for investors in the current circumstances to have their position protected by the appointment of a temporary responsible entity, This will prevent the process driven regulator delaying the appointment to the detriment of investors.

1.5 failure of the regulator to act to protect investors

The Corporations Regulation 5C.2.02 provides that:

" ASIC, or a member of a registered scheme, may apply to the Court for the appointment of a temporary responsible entity of the scheme if ASIC or member reasonably believes that the appointment is necessary to protect scheme property or the interests of members of the scheme."

In the current circumstances where there are large numbers of investors, the regulator has been particularly inactive in acting to protect investors. Members of these schemes have been nervous about taking the proceedings themselves because of the threat of a costs order against them.

The position could be improved by adding the following provisions:

"The appointment of a temporary responsible entity must be made pursuant to any such application by ASIC or a member if:

(a) the responsible entity is insolvent;

(b) the responsible entity is subject to external administration under Chapter 5.3A;

(c) a liquidator is appointed to the responsible entity.

The costs of any application by a member pursuant to these provisions must be paid out of scheme property unless the Court considers the application was frivolous or vexatious."

2. The impact of past and present taxation treatments and rulings related to MIS

2.1 actions by Commissioner contrary to law

The Commissioner of Taxation issued a public ruling that was clearly contrary to the case law in TR 2007/8 notwithstanding the submissions made to the contrary by established tax practitioners. The Commissioner's position was proved to be contrary to law in the Full Bench of the Federal Court in .

The Commissioner has now accepted the position. However the taking of a position contrary to law had the effect of creating uncertainty leading to a fall off in investment activity. As a result cash flows of existing operators was adversely affected for a period of time which has contributed to the current circumstances.

2.2 lack of symmetry in the tax laws

The mismatch in the timing of deductions of the investors with the return of income by the promoters has lead to a myriad of confusing provisions in the Tax Acts.

Further it has encouraged bad agricultural practice as promoters seek to match the agricultural expenditure with the funding from investors to ensure deductions are obtained in the income year in which the funding paid by investors is provided. For example, most investors provide their funding in June of each income year. In order for this expenditure to be fully deductible in that income year, the manager must expend those funds prior to 30 June. This generally is not the ideal time for planting out trees, vines etc but promoters are forced to do so because of the effect of the income tax laws. This was not always the case but was a consequence of measures introduced by the Liberal Government designed to spread the deduction over two income years.

Further in relation to forestry schemes, the lack of symmetry is particularly obscene. The effect of the income tax provisions in relation to forestry schemes is that a forestry manager must return the income in the income year in which the investor claims the deduction. This means that the receipt of the income by the forestry manager is returned in an income year before the expenditure is incurred which would otherwise be available as a deduction. For example if in the year ended 30 June 2009 a forestry manager receives $5,000 in fees that are for the plantation establishment. The forestry manager will pay income tax on the $5,000 leaving only $3,500 available for the plantation establishment after tax because the plantation establishment occurs in the following income year. On the other hand when the expenditure is made by the forestry manager on the plantation establishment there is no income against which to deduct that expenditure creating a tax loss which may never be used unless there are continuous schemes. Once the continuity of schemes stops the taxation of the income catches up on the forestry manager

The correct position should have been income tax is paid on the difference between the receipt and the expenditure not on the receipt with no deduction for the expenditure.

This lack of symmetry no doubt will have contributed to the cash flow difficulties of operators of forestry schemes particularly in the current economic climate where there is a lack of capital for investment.

It is recommended that the derivation of income be dealt with in accordance with the current law under the *Arthur* Murray principle namely that it is derived when it is earned.

3. **commissions, fees and other remuneration paid to marketers, distributors, related entities and sellers of MIS to investors (including accountants and financial advisers)**

Although the current law provides for proper disclosure of this in the PDS, FSG or SoA, the level of commissions in this area have been high. This no doubt has led to Division 394 providing for a 70% DFE test which will necessarily limit the amount paid out in commissions to advisers.

The ideal circumstance would be to have as much as possible available to put into the ground but with other than forestry schemes working out a direct expenditure test may be difficult where more is involved than planting trees e.g. there are annual harvests of many types of agricultural schemes e.g. vineyards, orchards, olive groves.

Short of the legislature limiting the amount of commissions payable, the present disclosure provisions are probably the best that can be done without a complete revamp of the financial services regime.

In my view there is a problem in licensing advisers to give financial product advice when in reality all they do is sell product. In my view there should be two forms of licensing in this area, one for real financial product advice for which no commission is payable but is done on a fee for service basis and a second for selling financial product for which commission may be payable. If consumers understood that in reality they were not being given financial product advice but being sold product this may have an effect on whether or not they acquired the product.

4. **the accuracy of promotional material for MIS, particularly information relating to claimed benefits and returns (including carbon offsets)**

The current provisions of the Corporations Act are sufficient to deal with this issue. If there is a problem then it is because the provisions are not being complied with or enforced. It is largely left to the individual investors to take action if there is any non-compliance in this area.

In the early days of carbon offset discussions, there was what has turned out to be incorrect information. However this is largely because policy in this area had not been developed. There should now be no difficulties in proper disclosure.

5. **the range of individuals and organisations involved with the schemes, including the holders of the relevant Australian Financial Services Licence**

The only improvement would be a back to the future approach so as to separate the function of agricultural management from the trustee role of the responsible entity with an independent responsible entity to watch over the rights of the Growers. This would have ensured that the

Timbercorp and Great Southern debacle did not happen as there would have been an independent trustee to ensure that:

5.1 monies were retained in trust and expended on the actual agricultural enterprise;

5.2 the lease over the land was held by independent trustee so that if the manager collapsed the Growers still retained an interest in the land.

However this approach is unlikely ever to be re-implemented as it was removed in 1998.

6. **the level of consumer education and understanding of these schemes**

There is now really no excuse for a lack of understanding of these schemes which have been operated for many years. It is a case of too many people listening to advisers whose advise must be tarnished by the commissions they earn.

7. **the performance of the schemes**

As with any business there is no means of legislating good business practice. Our economic system is designed to allow some form of failure. People take risks and sometimes those risks eventuate. This is particularly so with agriculture where there are myriads of agricultural risk beyond the control of any manager. These risks appear to be adequately disclosed. It seems to be more a problem of investors ignoring those risks.

Perhaps again another "back to the future" approach could be taken so that on the front cover of every PDS it is disclosed that the investment is a speculative investment and investors should seek their own independent financial advice.

8. **the factors underlying the recent scheme collapses**

It appears from press reports that the primary reason behind these collapses is not the structure of the schemes but the fact that they were operated almost like a Ponzi scheme, namely this year's management fees were being used to pay last year's expenses. This eventually catches up on you particularly in a circumstance where investments were dried up for a period as a result of the wrongful application of the law by the Commissioner for Taxation.

This problem can be avoided by some of the proposals referred to above such as either an independent responsible entity required to hold the fees paid in trust or requiring the management fees to be released no more than quarterly in advance.

9. **the projected returns and supporting information, including assumptions on product price and demand**

The general practice has not been to make any projected returns because of the effect of the introduction of ASIC Regulatory Guide 170. This regulatory guide has in fact made it impossible to include any forecasts in an agricultural PDS. Therefore there is no disclosure at all. This means there has to be some guessing by investors based on current prices. The former ASIC approach was set out in a Practice Note which required disclosure of assumptions with sensitivity analyses. This was a far better approach that one that has the effect to put a blanket ban on projections.

10. **the need for any legislative or regulatory change**

As discussed above, there is a need for some regulatory change. On approach is to make only minor changes such as those referred to in paragraph 1 above would overcome many of the problems. The other approach is a "back to the future" approach by separating the responsible entity and manager roles so that there is an independent responsible entity protecting the interests of Growers.

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