



**ASIC**

Australian Securities & Investments Commission

# **PJC Inquiry into the collapse of Trio Capital Limited**

## **Submission by the Australian Securities and Investments Commission**

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## Executive summary

- 1 The Australian Securities and Investments Commission (ASIC) makes this submission to assist the Parliamentary Joint Committee on Corporations and Financial Services (PJC) with its Inquiry into the collapse of Trio Capital Limited (Trio) and other related matters (the Inquiry). The executive summary provides a snapshot of the report.

### ASIC's submission

- 2 This submission sets out:
- (a) the policy underpinnings of the Australian financial services regulatory (FSR) regime following the Financial System Inquiry in 1997 (the Wallis Inquiry) and a summary of the key legal provisions (see Section A and Appendices 1–3);
  - (b) the key issues raised by the Inquiry's terms of reference (TOR) (see Sections B–I);
  - (c) ASIC's forward program to improve performance of its oversight role (see Sections B–I); and
  - (d) an outline of areas for possible reform to address the issues raised by the Inquiry (see Sections B–I).

### Overview of ASIC's position

#### FSR regime

- 3 As set out in ASIC's submission to the PJC Inquiry into Financial Products and Services (FPS Inquiry) in 2009, key to understanding ASIC's role and responsibility in regard to any corporate collapse is to understand Australia's FSR regime.
- 4 The fundamental policy settings of the FSR regime were developed following the principles set out in the Financial System Inquiry Report 1997 (the Wallis Report). These principles are based on 'efficient markets theory', a belief that markets drive efficiency and that regulatory intervention should be kept to a minimum to allow markets to achieve maximum efficiency. The 'efficient markets theory' has shaped both the FSR regime and ASIC's role and powers.

- 5 The FSR regime seeks to balance investor protection with market efficiency. As such, the regime regulates markets through conduct and disclosure regulation as follows:
- (a) *conduct regulation* includes rules designed to ensure industry participants behave with honesty, fairness, integrity and competence, as well as rules relating to the settlement of disputes between market participants and investors; and
  - (b) *disclosure regulation* includes rules designed to:
    - (i) overcome the information asymmetry between industry participants and investors by requiring disclosure of information required to facilitate informed decisions by investors; and
    - (ii) promote transparency in financial markets.
- 6 The FSR regime is designed to be largely self-executing and, as such, relies on market participants (gatekeepers) to comply with the requirements of the law.<sup>1</sup> In this context ASIC's role is to oversee and enforce compliance, for example by holding gatekeepers to account. Given ASIC has finite resources, it does this through a risk-based approach.
- 7 Recent events in the Australian and global financial system have led to a number of parliamentary inquiries, and with that the possible reassessment of the policy settings of the FSR regime and the economic philosophy that supports it. Most recently, ASIC made a number of recommendations to the FPS Inquiry suggesting areas for possible reform.
- 8 This particular Inquiry provides the opportunity not only to again reflect on some of these broader themes, but also to focus on a discrete set of issues unique to the collapse of Trio.

### **ASIC's oversight activities**

- 9 In performing its role as an oversight body, ASIC uses a number of regulatory tools. These are:
- (a) *Engagement with industry and stakeholders*: ASIC has stakeholder teams that are aligned to the various sectors of the financial economy. These teams are close to their stakeholders and have regular contact with them.
  - (b) *Surveillance*: ASIC conducts reactive surveillances when an issue arises. ASIC also conducts risk-based, proactive surveillance to check compliance and mitigate possible issues.

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<sup>1</sup> Key gatekeepers relevant to the Trio matter include Australian financial services (AFS) licensees generally (and managed investment scheme responsible entities in particular); compliance committees and compliance plan auditors for managed investment schemes; financial advisers; custodians and research houses.

- (c) *Guidance*: ASIC issues guidance in the form of regulatory guides, information sheets and reports. ASIC also supports industry associations to provide guidance on how to comply with the law.
- (d) *Education*: ASIC has a strong focus on investor and financial consumer education. ASIC also educates market participants and companies on how to comply with their legal obligations.
- (e) *Deterrence*: ASIC deters through enforcement action.
- (f) *Policy advice*: Where there is a gap in the law or it needs strengthening, ASIC will provide policy advice about that issue.

### **ASIC's forward program and options for reform**

- 10 While ASIC has fulfilled its role as required in the current FSR regime, ASIC is committed to continually improving its performance.
- 11 ASIC has developed a forward program that will further reduce risks for retail investors. This is in addition to ASIC's ongoing surveillance and deterrence program, which notably includes ongoing surveillance of hedge funds.
- 12 The aspects of this forward program (as they relate to the issues raised by the collapse of Trio) are summarised in Table 1. ASIC's forward program will assist in minimising further retail investor losses. However, ASIC and industry action may not always adequately protect retail investors.
- 13 To that end, we have identified a number of possible options for reform that might be considered, which are summarised in the final column of Table 1 and are detailed in subsequent sections of this submission. In particular, we have focused on possible options to strengthen the regulatory regime relating to various key gatekeepers such as responsible entities, financial advisers, custodians and research houses.

**Table 1: ASIC's forward program and options for reform**

Terms of reference (TOR)	Key issues	ASIC's forward program	Regulatory change options for consideration by Government
Adequacy of licensing arrangements (TOR 11): see Section B	<p>Licensing sets a low barrier to entry and this is not understood by investors.</p> <p>Licensing focuses on the entity and not representatives, limiting ASIC's ability to control entry or ban individuals.</p> <p>Licensing regime might result in a gap between investor expectations and the requirements of the licensing regime.</p>	<p>To raise the entry standards and close the expectation gap between investor expectations and licensing requirements, ASIC:</p> <ul style="list-style-type: none"> <li>proposes to strengthen the financial resource requirements for AFS licensees, commencing with responsible entities for managed investment schemes (other than any bodies regulated by the Australian Prudential Regulation Authority (APRA) that are excluded from the licensee obligation to have adequate financial resources); and</li> <li>will implement the recommendation of the PJC in its August 2011 ASIC oversight report that ASIC amend its website to include an explanation of the meaning and significance of holding an AFS licence.</li> </ul>	<p>To further strengthen the licensing regime, the Government might consider:</p> <ul style="list-style-type: none"> <li>enhancing ASIC's discretion to refuse an AFS licence application—or suspend/remove an existing licence;</li> <li>expanding ASIC's current authorised representative register to cover all representatives who give financial advice on Tier 1 products; and</li> <li>enhancing the remedies available to ASIC under Ch 7 of the Corporations Act.</li> </ul> <p>Note: Work is already being undertaken in this area as part of the Government's proposed Future of Financial Advice (FoFA) reforms.</p>
Role of managed investment scheme compliance plans, auditors and committees (TOR 11): see Section C	<p>For compliance plans and audits, the existing regime might not be as effective as intended because it:</p> <ul style="list-style-type: none"> <li>sets very high-level compliance plan requirements;</li> <li>does not prescribe qualitative standards for compliance plan audits; and</li> <li>does not focus on material contraventions when imposing liabilities on responsible entities and directors of responsible entities.</li> </ul> <p>Compliance committee oversight might not be as effective as</p>	<p>To identify regulatory options to improve the quality of compliance plan audits and to provide better guidance to industry on current requirements for compliance plans, ASIC has:</p> <ul style="list-style-type: none"> <li>committed to conducting another five compliance plan audit inspections for the 2011–12 financial year. ASIC will also review what other regulatory options might be available to improve the quality of compliance plan audits, including consideration of whether the requirements in s601HG(3) and (4) of the Corporations Act need to be strengthened; and</li> <li>formed a project team to review relevant ASIC policy in: <ul style="list-style-type: none"> <li>Regulatory Guide 116 <i>Commentary on compliance plans: Agricultural industry schemes</i> (RG 116);</li> <li>Regulatory Guide 117 <i>Commentary on compliance plans: Financial asset schemes</i> (RG 117);</li> </ul> </li> </ul>	<p>To increase the effectiveness of compliance plans, auditors and committees, the Government might consider the following.</p> <p>For compliance plans:</p> <ul style="list-style-type: none"> <li>reviewing the effectiveness of the role of the compliance plan in the compliance framework;</li> <li>setting more detailed requirements for compliance plans; and</li> <li>introducing an approval process for compliance plan auditors and civil liability provision for compliance plan audits.</li> </ul> <p>For compliance committees, consider minimum requirements for compliance committees and the membership of those committees.</p>

Terms of reference (TOR)	Key issues	ASIC's forward program	Regulatory change options for consideration by Government
	<p>intended because there are either no, or limited, legislative requirements as to:</p> <ul style="list-style-type: none"> <li>• the experience, competence or qualifications for compliance committee members;</li> <li>• the oversight of the appointment of compliance committee members; and</li> <li>• the proceedings of compliance meetings.</li> </ul>	<ul style="list-style-type: none"> <li>– Regulatory Guide 118 <i>Commentary on compliance plans: Contributory mortgage schemes</i> (RG 118);</li> <li>– Regulatory Guide 119 <i>Commentary on compliance plans: Pooled mortgage schemes</i> (RG 119);</li> <li>– Regulatory Guide 120 <i>Commentary on compliance plans: Property schemes</i> (RG 120); and</li> <li>– Regulatory Guide 132 <i>Managed investments: Compliance plans</i> (RG 132).</li> </ul> <p>The project team proposes to amend these regulatory guides to provide better guidance as to what is required in a compliance plan, including material compliance risks for different registered managed investment schemes, and examples of measures to address those risks.</p>	
<p>Access to compensation and insurance (TOR 6): see Section D</p>	<p>Having efficient and effective dispute resolution and compensation mechanisms is integral to promoting the confident and informed participation of consumers in the Australian financial services system.</p>	<p>In administering the dispute resolution framework and compensation system, ASIC will continue to monitor and review whether the dispute resolution and compensation requirements are adequate.</p> <p>This may lead to consultation on proposals to update the requirements in:</p> <ul style="list-style-type: none"> <li>• Regulatory Guide 165 <i>Licensing: Internal and external dispute resolution</i> (RG 165);</li> <li>• Regulatory Guide 139 <i>Approval and oversight of external dispute resolution schemes</i> (RG 139); and</li> <li>• Regulatory Guide 126 <i>Compensation and insurance arrangements for AFS licensees</i> (RG 126).</li> </ul>	<p>Mr Richard St John is currently conducting a review into the need for and costs/benefits of a possible last resort statutory compensation scheme.</p> <p>Note: This work is being undertaken as part of the Government's proposed FoFA reforms.</p>



Terms of reference (TOR)	Key issues	ASIC's forward program	Regulatory change options for consideration by Government
Appropriateness of information and advice provided to investors (TOR 9): see Section E	Managed investment schemes can be complex products, which should be as transparent to the investor as possible.	<p>To help ensure confident and informed investors and financial consumers, and improve transparency, ASIC:</p> <ul style="list-style-type: none"> <li>• is focused on improving disclosure for retail investors and has recently consulted with industry on issues particular to investors in hedge funds;</li> <li>• has an ongoing program of work designed to improve access to financial advice and ensure a high standard of competency of financial advisers; and</li> <li>• has ongoing surveillance and monitoring activities for financial advisers and hedge funds.</li> </ul>	<p>To increase the transparency of registered managed investment schemes, the Government might consider:</p> <ul style="list-style-type: none"> <li>• requiring asset level disclosure for registered managed investment schemes consistent with the 'Stronger Super' reforms;<sup>2</sup> and</li> <li>• excluding certain complex schemes from the shorter Product Disclosure Statement (PDS) regime.</li> </ul>
Role of custodians (TOR 11): see Section F	There may be an expectation gap between what is legally required of custodians and what investors expect the custodian to be doing to safeguard their investment.	<p>In 2011–12, ASIC will review custodian businesses with the objective of issuing a public report about this sector and identifying any issues that might need to be addressed by regulatory reform.</p> <p>ASIC will consider the extent to which custodians are required to identify and report suspicious behaviour and activity of their clients.</p>	Following the outcome and findings of ASIC's 2011–12 review of the sector, the Government might consider whether custodians would be more effective gatekeepers if they were required to identify and report suspicious behaviour and activity of their clients. However, no change is recommended at this time.

<sup>2</sup> See [http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government\\_response/default.htm](http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/default.htm).

Terms of reference (TOR)	Key issues	ASIC's forward program	Regulatory change options for consideration by Government
Role of research houses in product promotion and confidence (TOR 10): see Section G	The global financial crisis and recent publicised corporate collapses have highlighted issues around the appropriate use of research as part of the investment and advice process.	To ensure research houses fulfil their role as effective gatekeepers, ASIC plans to publish a consultation paper later this year with proposals on strengthening regulatory policy to address current issues in the sector.	<p>The Government might consider:</p> <ul style="list-style-type: none"> <li>• requiring research houses to have a reasonable basis for their advice;</li> <li>• banning payments by issuers for research;</li> <li>• requiring research houses to publish all research they prepare (including adverse findings); and</li> <li>• stronger disclosure requirements for research houses and rating agencies by: <ul style="list-style-type: none"> <li>– making the methodology used by these entities more transparent; and</li> <li>– enabling users of research to assess the performance of the research house and the quality of that research.</li> </ul> </li> </ul>
Suitability of managed investment scheme investments for retail investors (TOR 11): see Section H	Neither the Corporations Act nor ASIC policies impose any restrictions on the investment strategy of registered managed investment schemes.	To help investors understand investment strategies and how risky they might be, ASIC has an ongoing program of work to improve the financial literacy of consumers and investors in addition to its work on improving disclosure for retail investors (detailed in Section E).	In its submission to the FPS Inquiry, ASIC suggested a number of reforms to shift the balance between market efficiency and investor protection struck by the FSR regime more in favour of retail investors.
Dual regulated entities (TOR 11): see Section I	Whether there is appropriate regulation of dual regulated entities by ASIC and APRA.	To minimise the risks of regulatory arbitrage, and to promote an efficient regulatory system, ASIC works closely with APRA to ensure a coordinated approach to the regulation of dual regulated entities.	Given the strong and established working relationship between ASIC and APRA, ASIC makes no recommendations for policy change.

## ASIC's involvement with Trio

- 14 ASIC has reviewed its interactions with Trio and its associated entities both before the time when it initiated a formal investigation, and over the course of the (ongoing) investigation itself, to ensure it has discharged, and continues to discharge, its regulatory responsibilities appropriately.
- 15 This review has confirmed that ASIC has performed its role under the current FSR regime in relation to these events.
- 16 Confidential Appendix 4 sets out ASIC's interactions with Trio over the relevant period and the status of its ongoing investigations. Appendix 4 is provided to the PJC on a *confidential* basis because disclosure of the information set out in this appendix may prejudice our ongoing investigations in relation to Trio. When our inquiries and investigations are complete, we will review the appendix to assess the extent to which it can be made public.

DRAFT

## A The financial services regime in Australia and ASIC's role

### Key points

The underlying economic philosophy of the FSR regime is the 'efficient markets theory'.

As a result of this underlying economic philosophy, the FSR regime administered by ASIC is designed to promote market integrity and consumer protection through conduct and disclosure regulation.

In the FSR conduct and disclosure regime, ASIC is an oversight and enforcement body. ASIC conducts a number of activities when fulfilling this role.

### What is the economic philosophy underlying the regulatory regime?

- 17 The economic philosophy underlying the Australian FSR regime<sup>3</sup> is that markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention. This philosophy can be loosely called 'efficient markets theory'.
- 18 Efficient markets theory has been the foundation of Australian financial services regulatory policy since, at least, the Australian Financial System Inquiry of 1981 (the Campbell Inquiry). Its influence continued through to the Wallis Inquiry in 1997.
- 19 The basic features of the current FSR regime were developed following the principles set out in the Wallis Report. The Wallis Report, in accordance with efficient markets theory, states that '[i]n designing regulatory arrangements, it is important to ensure minimum distortion of the vital roles of markets themselves in providing competitive, efficient and innovative means of meeting customers' needs'.<sup>4</sup>
- 20 The Wallis Report recognised that, given the complexity of financial products and the adverse consequences of breaching financial promises, there must be some regulatory intervention in the market to ensure that market participants act with integrity and that consumers are protected. That is, the underlying philosophy accepts that regulation is necessary to deal with factors that prevent the market operating efficiently (e.g. fraudulent

<sup>3</sup> 'Australian financial services regulatory regime' or 'Australian FSR regime' refers primarily to Ch 7 of the Corporations Act. It also includes Chs 5C and 6D, as well as the financial services provisions of the ASIC Act.

<sup>4</sup> Wallis Report, p. 15.

conduct by market participants, information asymmetries and anti-competitive conduct). However, that regulation should be the minimum necessary to respond to market failures.

## How does this economic philosophy shape the regulatory regime?

### Conduct and disclosure regulation

- 21 As a result of this underlying economic philosophy, the FSR regime administered by ASIC seeks to balance investor protection with market efficiency. As such, the regime is designed to promote market integrity and consumer protection through conduct and disclosure regulation as follows:
- (a) *conduct regulation* includes rules designed to ensure industry participants behave with honesty, fairness, integrity and competence, as well as rules relating to the settlement of disputes between market participants and investors; and
  - (b) *disclosure regulation* includes rules designed to:
    - (i) overcome the information asymmetry between industry participants and investors by requiring disclosure of information required to facilitate informed decisions by investors; and
    - (ii) promote transparency in financial markets.
- Efficiency, flexibility and innovation in the financial services industry are promoted by ensuring that these rules are at the bare minimum.
- 22 Conduct and disclosure regulation does not involve any guarantee that regulated products and institutions will not fail. Under a conduct and disclosure regime, retail investors are still subject to risks but should be well informed about those risks before making investment decisions.
- 23 The outcome of this regulatory setting is:
- (a) efficient and flexible allocation of risk and resources and a low cost of capital;
  - (b) promotion of competition, innovation and flexibility; and
  - (c) retail investors having access to a wide range of products.
- 24 On the other hand, under this regulatory setting retail investors may suffer loss because:
- (a) they have access to all financial products (including high-risk products) offered in the market irrespective of their level of understanding of those products or the suitability of those products;

- (b) they can choose the extent of diversification for their investments (including an inappropriately undiversified set of investments); and
- (c) the regulation does not aim to prevent failure of financial products. Indeed, failure of certain products because of, for example, high-risk business strategies, is an essential part of an efficient market.

### **Prudential regulation**

- 25 The Wallis Report accepted that some areas of the financial system require more regulatory intervention than conduct and disclosure regulation. They require financial safety regulation in the form of prudential regulation. Unlike conduct and disclosure regulation, prudential regulation *is* designed to ensure (or increase the likelihood) that financial products and institutions do not fail and that promises by financial services or product providers to investors are met. In this way, prudential regulation may reduce systemic risk (by minimising the risk that key institutions will fail) and promote investor protection (by minimising the risk that promises made to investors are not met).
- 26 The intensity of that prudential regulation should be greatest when the systemic risks and the intensity of the financial promises, and hence the risk of market failure, are greatest. However, as regulation imposes costs both directly and on the wider economy, this more intense form of regulation should not be extended to all participants in the financial markets or to all financial products.
- 27 The Wallis Report recommended, and the Government agreed, that authorised deposit-taking institutions (ADIs) and general and life insurers and large superannuation funds should be subject to prudential supervision by APRA, but not other financial institutions or products.
- 28 For example, securitisation, which was a significant problem in the global financial crisis, is not subject to prudential regulation. Similarly, market-linked investments (debentures, mortgage trusts and unlisted trusts) are not subject to prudential regulation. Also, self-managed superannuation funds (SMSFs) are not subject to prudential regulation.

Note: More details about APRA and ASIC's respective responsibilities are set out in Section I.

## How does this economic philosophy shape ASIC's role?<sup>5</sup>

- 29 In the FSR regime, ASIC is an oversight and enforcement body. The FSR regime is largely self-executing: AFS licensees and other participants are expected to comply with the conduct and disclosure obligations in the law. ASIC oversees compliance with these obligations and then takes appropriate enforcement action when there is non-compliance. ASIC's power to take action ahead of non-compliance is limited.
- 30 Consistent with the economic philosophy underlying the FSR regime, ASIC does not take action on the basis of commercially flawed business models. A significant feature of a number of collapses leading to investor losses is flawed business models—that is, models that could only prosper if asset prices continually rose and debt markets remained open and liquid. Responsibility for flawed business models lies with management and the board.

### ASIC's activities

- 31 The activities ASIC performs when fulfilling its statutory role in the FSR regime are set out below and in Table 2.
- 32 In performing its role as an oversight body, ASIC uses a number of regulatory tools. These are:
- (a) *Engagement with industry and stakeholders*: ASIC has stakeholder teams that are aligned to the various sectors of the financial economy. These teams are close to their stakeholders and have regular contact with them.
  - (b) *Surveillance*: ASIC conducts reactive surveillances when an issue arises. ASIC also conducts highly focused on risk-based, proactive surveillance to check compliance and mitigate possible issues.
  - (c) *Guidance*: ASIC issues guidance in the form of regulatory guides, information sheets and reports. ASIC also supports industry associations to provide guidance on how to comply with the law.
  - (d) *Education*: ASIC has a strong focus on investor and financial consumer education. ASIC also educates market participants and companies on how to comply with their legal obligations.
  - (e) *Deterrence*: ASIC deters through enforcement action.
  - (f) *Policy advice*: Where there is a gap in the law or it needs strengthening, ASIC will provide policy advice about that issue.

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<sup>5</sup> This report focuses on ASIC's role in the FSR regime. ASIC has responsibilities outside financial products and services regulation. ASIC is the corporate regulator, overseeing approximately 1.85 million Australian companies and their directors and officers. ASIC also regulates auditors, registered liquidators and credit providers. In the financial industry, ASIC regulates financial markets and clearing and settlement facilities.

**Table 2: Outline of statutory activities ASIC performs in the FSR regime**

Role	What ASIC does
Administering the AFS licensing regime	ASIC assesses applications for an AFS licence and applications to vary an existing licence. ASIC also has power to impose additional conditions on AFS licences, to cancel AFS licences and to ban a person from participating in the financial services industry.
Registering managed investment schemes	ASIC registers managed investment schemes that meet the requirements in s601EB of the Corporations Act.
Risk-based monitoring of compliance with: <ul style="list-style-type: none"> <li>• the AFS licensing requirements;</li> <li>• the conduct obligations in the Corporations Act;</li> <li>• the general consumer protection provisions for financial services and products in the ASIC Act; and</li> <li>• disclosure obligations</li> </ul>	ASIC monitors and may act on complaints and breach reports. ASIC considers a range of factors when deciding whether to investigate.  In addition to monitoring and acting on complaints and breach reports, ASIC also directly monitors entities, documents and transactions for compliance with the FSR obligations of its own initiative using a risk-based approach. ASIC has certain powers that facilitate its monitoring activities. These include various information-gathering powers.
Taking enforcement action against breaches of the law	ASIC's deterrence and enforcement activities consist of: <ul style="list-style-type: none"> <li>• formal investigations or surveillances of suspected misconduct; and</li> <li>• enforcement actions—that is:               <ul style="list-style-type: none"> <li>– civil proceedings to protect consumers, impose a civil penalty or recover funds for consumers;</li> <li>– criminal proceedings (usually via the Commonwealth Director of Public Prosecutions (CDPP)) to impose a criminal penalty and actively deter misconduct in the market place;</li> <li>– administrative proceedings by ASIC (or via a referral to another decision maker) to remove licence authorisation, disqualify or ban persons; or</li> <li>– setting conditions on future conduct by the party (e.g. via an enforceable undertaking).</li> </ul> </li> </ul> ASIC has a range of compulsory information-gathering, inspection and formal interview powers to facilitate its formal investigations.
Modifying and exempting from the law when appropriate	ASIC has powers to exempt individual entities or products or classes of entities or products from aspects of the FSR regime. ASIC can also modify aspects of the FSR regime.  ASIC exercises these powers on application and on its own motion.  ASIC issues regulatory guidance that explains how and when it will exercise its powers to exempt from or modify the law.



## ASIC's approach to enforcement

- 33 In cases of serious corporate misconduct, ASIC must decide what, if any, enforcement action to pursue to achieve its objectives, which include promotion of fair and efficient financial markets and confident and informed investors.
- 34 Enforcement action can help ASIC achieve its regulatory objectives by, for example, deterring others from misconduct by demonstrating the potential negative consequences of similar misconduct, holding those responsible to account and, where appropriate, pursuing compensation for investors who have suffered loss.
- 35 In making the decision to pursue enforcement action, ASIC necessarily considers a variety of factors. These factors can include:
- (a) the level of harm or loss incurred by investors;
  - (b) the cost of pursuing enforcement action versus the regulatory benefit to be obtained; and
  - (c) the availability of evidence to help secure a successful outcome.
- 36 ASIC cannot state unequivocally the circumstances in which it will pursue enforcement action because the circumstances can vary widely with each case.
- 37 However, ASIC understands that guidance on its enforcement approach is appropriate for reasons of greater clarity and transparency. Guidance can also give market participants and the general public a greater level of understanding about ASIC's enforcement powers and how it uses them. To that end, ASIC is currently drafting guidance on its enforcement approach, which is intended to:
- (a) help the public understand that ASIC follows certain processes before commencing deterrence action, which involves establishing a formal investigation and using its compulsory information-gathering powers;
  - (b) give the public a better understanding of how ASIC approaches its enforcement responsibilities, including how and why it responds to particular types of breaches of the law in different ways;
  - (c) encourage individuals and entities to cooperate with ASIC during an investigation by highlighting the benefits of such cooperation.
- 38 It is anticipated that this guidance will be released towards the end of 2011.

## Enforcement action pursued by ASIC in relation to Trio

39 Since commencing its investigation of Trio in 2009, ASIC has achieved the following outcomes:

- (a) On 7 December 2010, Mr Shawn Richard pleaded guilty to two charges of dishonest conduct in the course of carrying on a financial services business and admitted a third charge of making false statements in relation to financial products. The charges were laid following an investigation by ASIC.
- (b) On 24 June 2011, ASIC accepted an enforceable undertaking from Kilara Financial Solutions Pty Ltd (Kilara) to modify aspects of its compliance culture and to remedy past compliance concerns in the provision of financial advice to retail clients. Kilara recommended retail clients switch their superannuation holding into another fund, My Retirement Plan, which invested in either My Income Pool or My Growth Pool. Trio was the responsible entity for My Retirement Plan.
- (c) On 4 July 2011, ASIC entered into enforceable undertakings with former directors of Trio, Mr Rex Phillipott and Ms Natasha Beck, preventing them from working in the financial services industry for 15 years and two years respectively.
- (d) On 5 July 2011, ASIC announced that it suspended the AFS licence held by Seagrims Pty Ltd (Seagrims) until 27 November 2011. Mr Peter Seagrim and Ms Anne-Marie Seagrim both of Port Augusta, who are the directors and responsible managers of Seagrims, were also both banned by ASIC from providing financial services for three years.<sup>6</sup>
- (e) On 11 August 2011, ASIC entered into an enforceable undertaking with former chairman and director of Trio, Mr David Andrews, preventing him acting in any role within the financial services industry for nine years. With the exception of a small private company in which Mr Andrews is sole director, Mr Andrews also agreed not to act as a director of any corporation for nine years.
- (f) On 12 August 2011, Mr Shawn Richard was sentenced to a total of three years and nine months imprisonment with a minimum term of two years and six months following an investigation by ASIC into the collapse of the Astarra Strategic Fund (ASF) and its responsible entity, Trio, in 2009. This followed Mr Richard's guilty plea in December 2010 (see above).
- (g) On 24 August 2011, ASIC entered into enforceable undertakings with former Trio directors, Mr Keith Finkelde and Mr David O'Bryen, preventing them from taking part in the management of companies and providing financial services for four years each.

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<sup>6</sup> Subject to appeal.

40 ASIC is continuing its investigations.

### **ASIC's structure**

41 In 2008 ASIC completed a strategic review of its operations. The aim of the strategic review was to create an organisation that:

- (a) better understands the markets it regulates;
- (b) is more forward-looking in examining issues and systemic risks;
- (c) is much clearer in outlining to the market why it has chosen to intervene and the behavioural changes it is seeking; and
- (d) has a clearer set of priorities.

42 One of the major outcomes of the strategic review was that ASIC restructured to better fulfil its role as a conduct and disclosure regulator. The four previous ASIC directorates (Enforcement, Compliance, Regulation and Consumer Protection) were replaced with outwardly focused stakeholder teams and deterrence teams. There are currently 11 stakeholder teams and seven deterrence teams.

43 The stakeholder and deterrence teams are located in the Financial Economy part of ASIC's structure. The aim of the Financial Economy teams is to increase confidence and integrity in Australia's capital and financial markets and better protect investors and consumers. The Financial Economy teams are outwardly focused—that is, their work focuses on ASIC's stakeholders. This focus means that ASIC is better placed to drive behavioural change and to better understand the external stakeholders it regulates.

44 Each stakeholder team operates under a national structure and undertakes a variety of activities to influence behaviour of participants in the financial economy and bring about positive changes for consumers and investors. The focus of the stakeholder teams is determined by ASIC's current strategic framework, which is based on three priorities:

- (a) First, ASIC is focused on ensuring investors and financial consumers are informed and confident. Education is key to this and we want to ensure people understand investing—before they part with their money. ASIC will keep working to better understand how and why consumers make decisions. ASIC will also hold gatekeepers to account and these include auditors, directors, advisers, custodians, product manufacturers and distributors, market operators and participants.
- (b) ASIC's second priority is fair and efficient markets. We now have responsibility for supervising the ASX and are working on the regulatory framework for competition in equity markets.
- (c) Our third priority is efficient registration and licensing, with a particular focus on reducing red tape for small business.

45 The Financial Economy stakeholder teams most relevant to the Inquiry's terms of reference are:

- (a) Consumers, Advisers and Retail Investors;
- (b) Investment Banks;
- (c) Investment Managers and Superannuation; and
- (d) Licensing and Registry Services.

There are also specialised Financial Services deterrence teams that take enforcement action in relation to financial services.

## B Adequacy of licensing arrangements (TOR 11)

### Key points

ASIC's ability to protect investors by restricting entry into, or removing participants from, the financial services industry who might cause or contribute to investor loss is limited under the current FSR regime. This is because the current FSR regime:

- sets the threshold for obtaining an AFS licence relatively low and the threshold for cancelling an AFS licence relatively high; and
- focuses on the licensed entity rather than the directors, employees or other representatives.

The Government has supported, as part of the FoFA reforms, the following modifications to ASIC's licensing power to enhance ASIC's ability to protect investors:

- changes to the licensing threshold so that ASIC can refuse or cancel an AFS licence where a licensee may breach (rather than will breach) its obligations;
- clarification that ASIC can ban individuals who are involved in a breach of obligations by another person; and
- 'negative licensing' of individuals so that ASIC can ban individuals who are not fit and proper and may not comply with the law.

ASIC is also proposing to raise the standard for obtaining an AFS licence to operate a registered managed investment scheme by reviewing and strengthening the minimum financial resource requirements expected of a licensee.

Further possible options for reform include granting ASIC a broader discretion to refuse an applicant an AFS licence than is currently the case, or the power to assess the business model of applicants.

### Key issues

- 46 This section discusses the adequacy of the current licensing regime given concerns about the granting of an AFS licence to Trio and its associated entities.
- 47 The key issues in relation to the licensing regime are:
- (a) whether the licensing regime's predominant focus on the AFS licensee is appropriate, rather than providing more focus on the directors, employees, agents and other persons engaged to perform functions in relation to a registered managed investment scheme or other representatives of that entity. This focus means ASIC generally:

- (i) cannot prevent persons from entering the financial services industry; and
- (ii) can have difficulty removing individuals.

These factors limit ASIC's ability to protect investors by restricting or removing from the industry participants who might cause or contribute to investor loss;

- (b) whether the licensing regime, which sets the threshold for obtaining an AFS licence relatively low and the threshold for cancelling an AFS licence relatively high, currently establishes appropriate entry criteria for AFS licensees; and
- (c) whether the licensing regime results in a gap between investor expectations and the requirements of the licensing regime.

### Focus on the entity

- 48 Under the Corporations Act, a person or entity that carries on a financial services business in Australia must obtain an AFS licence from ASIC covering the provision of the relevant financial services, unless an exemption applies. A key exemption is for those who provide services as a representative of a licensee. Essentially, representatives are employees, directors, authorised representatives (including corporate authorised representatives) of the licensee. ASIC *does not* approve representatives. In addition, a person acting as an employee or agent is not themselves treated as providing the financial service of operating a registered management investment scheme.
- 49 This means that the AFS licensing regime generally focuses on the AFS licensee, rather than the directors, employees or agents in relation to operating a registered management investment scheme or other representatives of that entity. However, officers involved in the decision making of a licensee are subject to tests of good fame and character (e.g. police checks) when a licence is granted. Also on grant of a licence, and at other times in surveillance, there is assessment of key persons nominated by the licensee for the relevant financial service business.
- 50 In addition, conduct and disclosure obligations of the FSR regime are largely imposed on the AFS licensee (i.e. the entity), not the representatives who work for that entity: see Appendix 2 for more detail.<sup>7</sup>
- 51 This focus on the entity limits ASIC's ability to restrict individual participants in the financial services industry where, for example, they might

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<sup>7</sup> There are some specific conduct and disclosure obligations that are imposed directly on authorised representatives, as well as AFS licensees.

have worked for another entity that, in turn, is suspected of engaging in questionable conduct.

52 While authorised representatives must be registered with ASIC, ASIC has little information about employee representatives. On the whole, ASIC must rely on licensees to ensure the competence and integrity of their representatives in the financial services industry.

53 ASIC can experience difficulties in locating (and taking action against) so-called ‘bad apples’ in the financial services industry. For example, there is no register that records representatives in the financial services industry, which might assist in identifying individuals of concern.

### Licensing threshold

54 Consistent with the economic philosophy underlying the FSR regime, the legislative framework is designed to let entities enter the market. ASIC must grant an AFS licence if:

- (a) the application is made properly;
- (b) ASIC has no reason to believe that the applicant will not comply with the licensee obligations;
- (c) ASIC is satisfied that there is no reason to believe that the applicant or the applicant’s responsible officers are not of good fame or character; and
- (d) the applicant has provided ASIC with any additional information requested for the purposes of assessing the application.

55 ASIC *cannot* refuse an application for an AFS licence for reasons beyond the relevant criteria (e.g. ASIC cannot refuse to grant a licence on the basis of the licensee’s proposed business model). At most, the licensing process seeks to ensure that an entity is confined to providing financial services that it is competent to provide and has adequate resources to provide at the time of application. It does not involve an endorsement of business models adopted by the applicant.

56 A key issue concerning the licensing regime is to what extent it should operate as a ‘gate-keeping’ mechanism to maintain market integrity and protect investors by keeping out participants who may otherwise lack the competence, integrity or resources (i.e. adequate financial resources, systems and processes) to provide the relevant financial services.

57 After a licence is granted, ASIC only has the power to suspend or cancel a licence in limited circumstances.

58 ASIC can only immediately suspend or cancel a licence on application by the licensee or where the licensee is insolvent, ceases to carry on the

business, is convicted of serious fraud, or is incapacitated. ASIC can suspend or cancel a licence after a hearing when:

- (a) the *licensee* has not complied with its obligations;
- (b) ASIC has reason to believe the *licensee* will not comply with its obligations in the future;
- (c) ASIC is no longer satisfied that the *licensee* is of good fame or character;
- (d) a banning order is made against the *licensee* or a key representative of the licensee; or
- (e) the application was materially false or misleading or omitted a material matter.

59 ASIC's decision to suspend or cancel a licence can be appealed to the Administrative Appeals Tribunal (AAT). In practice, ASIC has found it very difficult to establish before the AAT that a licensee will not comply with obligations in the future. This makes it difficult to remove licensees who may potentially cause investor losses in advance of an actual breach.

### **Gap between expectations, and requirements, of licensing regime**

60 The FSR regime requires granting of an AFS licence where an application has been made properly and ASIC has *no reason to believe* the applicant will not comply with its licensee obligations and is satisfied that there is no reason to believe that the applicant and its responsible officer are not of good fame and character. Importantly, the 'no reason to believe' test requires actual evidence the applicant has been involved in illegal activity and not just mere suspicion.

61 Licensing may create a gap between investor expectations, and the requirements of the licensing regime with a relatively low threshold for obtaining an AFS licence, the relatively high threshold for removing a licence and the focus on the licensed entity, rather than the directors, employees or other representatives of that entity. Licensing does not mean that the licensee has been approved by ASIC or indicate some level of the quality of financial services provided by the licensee.

### **Adequate remedies**

62 The current remedies for AFS licensees and their representatives could be more proportionate. The way key provisions are framed, and the remedies attaching to those provisions, do not always properly respond to the range of misconduct in the market place.



- 63 We see a range of misconduct in the financial services sector, in terms of the actors, products and behaviour involved. We also see a wide range in terms of severity and impact on consumers and the market as a whole. It is an important principle of regulatory practice that the regulator can and does respond proportionately to conduct in the market.

## ASIC activities

### Licensing process

- 64 ASIC has a dedicated team that assesses AFS licence applications. ASIC uses a risk-based approach in its assessment of licence applications. This helps ASIC determine the level of scrutiny it gives an application. In general, the factors that ASIC takes into account in its risk assessment are the complexity of the licence authorisations being applied for, as well as ASIC's analysis of the kind of business the applicant is undertaking (e.g. financial planning business or issuing financial products) and the market in which the applicant proposes to operate.

### Strengthening the licensing regime: Financial resource requirements

- 65 Investor protection could be improved by increasing the licensing threshold. As indicated above, the threshold of the AFS licensing regime is consistent with the economic philosophy underpinning the FSR regime, and so there are limits to the changes ASIC can make.
- 66 Nevertheless, ASIC has explored enhancing the criteria for licensing within the limits of the existing conduct and disclosure regime. ASIC has initially focused on increasing the financial resource requirements that must be met by the responsible entities of registered management investment schemes. Other categories of AFS licensees, which are also subject to financial resource requirements, may be examined in future.
- 67 ASIC imposes financial resource requirements<sup>8</sup> on AFS licensees to help ensure that:
- (a) a licensee has sufficient financial resources to conduct its business in compliance with the Corporations Act (including carrying out supervisory arrangements);
  - (b) there is a financial buffer to decrease the risk of a disorderly or non-compliant wind-up if the licensee's business fails; and

<sup>8</sup> The financial resource requirements imposed by ASIC are explained in Regulatory Guide 166 *Licensing: Financial requirements* (RG 166).

- (c) there are incentives for the licensee to comply with the law (i.e. through the risk of financial loss).
- 68 The financial resource requirements do not presently apply to entities regulated by APRA because these entities are subject to prudential requirements.
- 69 ASIC's work has investigated how a responsible entity's resources (e.g. adequate financial resources, systems and processes) may be bolstered:
- (a) to improve compliance with the law by responsible entities and supervision of their representatives; and
- (b) if failure does occur, to mitigate the consequences for the responsible entity's investors and the markets in which it participates.
- 70 In developing the proposals to amend the financial resource requirements for MIS in ASIC's Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140) released in September 2010, ASIC has been mindful of the fundamental purposes of the financial resource requirements for AFS licensees and focused on the most suitable mechanisms for achieving those purposes in the context of the managed investment industry. Specifically, the proposals seek to:
- (a) ensure responsible entities will have adequate financial resource requirements to meet their operating costs (e.g. the costs of ensuring compliance with the Corporations Act) throughout the life of their registered management investment schemes;
- (b) align the interests of responsible entities and management investment scheme investors by ensuring that responsible entities are entities of substance and that owners of responsible entities have sufficient equity in the business to have a real incentive to ensure its success;
- (c) ensure Australia provides comparable investor protection to other leading financial services centres and comparable regulatory regimes to enhance Australia's reputation as an attractive financial services centre;
- (d) provide some level of assurance that, if a responsible entity does fail, there is sufficient money available for the orderly transition to a new responsible entity or to wind up the registered management investment schemes; and
- (e) secure accurate and efficient data on the industry for reporting and analytical purposes and the representation of the industry.
- 71 The proposed new financial resource requirements would, in summary, require responsible entities to:
- (a) maintain a 12-month cash flow forecast, aimed at increasing the early detection of cash flow issues in a 'business as usual' situation;

- (b) change the method of calculating net tangible assets (NTA) by removing the existing \$5 million cap on the NTA requirement so that NTA better reflects the operating risk of the responsible entity;
- (c) assess the maximum liability under any personal guarantees provided by the responsible entity and exclude from the NTA calculation that potential liability (except in certain limited circumstances);
- (d) exclude from the calculation the NTA requirement undertakings provided by certain listed parents (to provide some protection for the responsible entity against collapse of the parent);
- (e) introduce an NTA liquidity requirement, which would require responsible entities to have cash or cash equivalents of at least 50% of their NTA requirement, and to have assets equivalent to the NTA requirement in liquid assets or cash or cash equivalent; and
- (f) report to ASIC their NTA requirement, actual NTA, average value of scheme property, average gross revenue and cash or cash equivalents at the end of each financial year.

72 The above proposals do not seek to:

- (a) prevent responsible entities from becoming insolvent due to poor business models or cash flow problems;
- (b) prevent registered management investment schemes from failing due to poor business models or cash flow problems; or
- (c) provide compensation to scheme members who suffer a loss, for whatever reason.

73 The proposals are designed to benefit investors, responsible entities, and the managed investment sector by improving investor protection and enhancing the confidence in the managed investment industry. They seek to ensure that responsible entities have adequate financial resources and liquidity management practices to support the management of other people's money responsibly, without being unreasonably burdensome or creating significant barriers to entry.

74 ASIC is currently consulting with the Office of Best Practice Regulation (OBPR) on a Regulatory Impact Statement (RIS) for these policy proposals.

### **Helping investors better understand the licensing regime**

75 The PJC on Corporations and Financial Services recommended in its August 2011 report on *Statutory oversight of the Australian Securities and Investments Commission* that:

ASIC amend its website to include an explanation of the meaning and significance of holding an Australian financial services licence. The information could also be usefully included on the MoneySmart website.

- 76 This recommendation arose because the PJC was concerned to address any investor confusion regarding the significance of AFS licences. ASIC will implement the PJC's recommendation.

## Changes to policy settings

### Government action to enhance ASIC's licensing powers

- 77 The Government has accepted recommendations of the FPS Inquiry to ensure ASIC can take into account a broader range of matters when determining whether to issue an AFS licence, or whether to cancel or suspend a licence. ASIC's powers to remove persons from the industry will also be enhanced because ASIC can take into account a wider range of matters at the banning stage.
- 78 In its submission to the FPS Inquiry, ASIC recommended the Government consider the merits of modifying the requirements for granting and removing AFS licences in order to enhance ASIC's ability to protect investors. ASIC suggested this could be achieved by replacing the current licensing 'entry' requirement (that ASIC has no reason to believe the licensee 'will not comply' with its obligations under s912A in the future) with the slightly lower standard of 'may not comply' or 'is not likely to comply' with its obligations in the future.
- 79 This change would overcome some of the difficulty ASIC currently experiences when trying to assess whether an applicant *will* comply with its obligations and meet its licence conditions before it has commenced business. The proposed slightly lower standard (i.e. 'may not comply' or 'is not likely to comply') would enable ASIC to consider a wider range of matters than currently permitted and minimise this difficulty.
- 80 This requirement (i.e. 'may not comply' or 'is not likely to comply' with its obligations) could also be introduced as a basis for cancelling or suspending AFS licences after a hearing. As stated above, ASIC has found it very difficult to establish before the AAT that a licensee will not comply with its obligations in the future. This limits ASIC's ability to act before a breach.
- 81 The PJC agreed with ASIC and made the following recommendations in its final report:
- Recommendation 6
- The committee recommends that section 920A of the Corporations Act be amended to provide extended powers for ASIC to ban individuals from the financial services industry.

### Recommendation 8

The committee recommends that sections 913B and 915C of the Corporations Act be amended to allow ASIC to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee ‘may not comply’ with their obligations under the licence.

- 82 The Government supported these recommendations as part of its FoFA reforms. Legislation to broaden ASIC’s licensing powers has been released for consultation and is expected to be introduced to Parliament later this year.

## Other options to strengthen the licensing regime

### Broad discretion to refuse an applicant a licence

- 83 Currently, s913B of the Corporations Act states that ‘ASIC must grant an applicant an Australian financial services licence’ if particular requirements are satisfied. This means ASIC has very little basis on which to refuse an applicant a licence.
- 84 Even if ASIC’s licensing power is expanded in line with the FoFA reforms outlined above, ASIC will still be mandated to grant a licence when the applicant ostensibly satisfies the relevant criteria.
- 85 If it were considered desirable to give ASIC a greater discretion in the licensing process, ASIC suggests the Government might consider amending the primary licensing provision in s913B to ‘ASIC may grant a licence’ (rather than ‘ASIC must’) if certain criteria are met. This would mean that, for the applicant, the award of a licence is more akin to a privilege rather than a right.<sup>9</sup>
- 86 Alternatively, the Government could consider providing a residual ‘catch-all’ discretion to broaden the circumstances in which ASIC may refuse a licence (i.e. ‘ASIC must grant a licence if the following conditions are met ... unless there is any other reason which in ASIC’s reasonable opinion justifies the refusal of the application’.)
- 87 Similar amendments could be made to the provisions in the Corporations Act dealing with when ASIC can suspend or remove a licence.

### Power to assess the business model of applicants

- 88 In its submission to the FPS Inquiry, ASIC noted that other options to improve investor protection by increasing the licensing threshold include:

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<sup>9</sup> In the United Kingdom, the Financial Services Authority (FSA) has the discretion to grant a Part IV Permission under the *Financial Services and Markets Act 2000*, subject to appropriate avenues of challenge and review. Similarly, in Hong Kong the Securities and Futures Commission (SFC) has the discretion to grant a licence to carry on regulated activities under the Securities and Futures Ordinance, subject to appropriate avenues of challenge and review.

- (a) placing the onus on applicants to prove that they meet the threshold requirements; or
- (b) requiring ASIC to assess the business models of applicants.

89 ASIC continues to consider that increased investor protection created by these options is likely to be outweighed by the costs of these reforms. Increasing the licensing threshold in this way, especially by requiring a review of business models of licence applicants, would:

- (a) increase barriers to entry, which will raise costs, reduce competition and stifle innovation;
- (b) impede individuals' rights to conduct businesses of their choice;
- (c) possibly increase attempts to conduct illegal activity in the unregulated sphere; and
- (d) increase regulatory costs.

#### **Focusing on representatives**

90 In other jurisdictions, there is more focus on the individual during the licensing process—that is, the regulator must approve individuals at the entry stage: see Table 3.

**Table 3: Regulation of individuals**

Hong Kong	Individuals who carry on regulated activities for a licensed corporation must be licensed and are subject to a 'fit and proper' test.
Singapore	Individuals who perform any of the functions of a financial adviser must be licensed and are subject to a 'fit and proper' test.
United Kingdom	Individuals who perform a 'customer function', including advising on investments, dealing and arranging, must be approved by the Financial Services Authority.

91 While requiring ASIC to approve individuals involved in the financial services industry might improve ASIC's ability to ensure those who may engage in unacceptable conduct cannot enter the financial services industry, ASIC believes that the costs of such a reform would outweigh this benefit. Such a reform would dilute the key responsibility of the licensee and significantly increase regulatory costs.

92 However, a further option that might be considered is extending ASIC's current authorised representatives register to cover all individuals who offer

financial advice (or, at the least, personal financial advice) on certain investment products.

- 93 A more complete register of advisers providing personal advice to consumers and investors on Tier 1 financial products<sup>10</sup> would enhance ASIC's regulatory efficiency in identifying and targeting poor advice, support licensees' efforts to conduct proper due diligence on prospective employees and facilitate investor checks on a prospective adviser.
- 94 Related Government initiatives such as the proposal to create a register of individuals permitted to perform certain functions such as auditors of SMSFs and financial planners providing tax advice suggest that accountability and transparency measures such as public registers are important elements to the broader objective of lifting professional standards. Registers of authorised individuals are also a feature of comparable international jurisdictions such as the United Kingdom, United States, Singapore and Hong Kong.

### **Adequate remedies**

#### *Infringement notices*

- 95 The Committee may wish to consider the possibility of including an infringement notice provision in the licensing regime. The general rationale for using an infringement notice regime is that infringement notices:
- (a) are justified by the efficiency and cost savings they provide for enforcement agencies and as a low-key means for a potential defendant to 'atone' for wrongdoing;
  - (b) are particularly useful for more minor offences, where a high volume of contraventions is expected, where a penalty must be imposed immediately to be effective and where the assessment turns on straightforward and objective criteria;
  - (c) provide a less harsh and discriminatory way of dealing with minor offences, speed and reduced expense, elimination of delay in the courts, and proportionality between the seriousness of the offence, the enforcement procedure and the penalty, and the offences to be dealt with by way of infringement notice are those in which a high proportion of defendants plead guilty;
  - (d) supplement existing criminal and civil court procedures; and
  - (e) remedy a significant gap in the current enforcement framework by allowing the imposition of a financial penalty for minor contraventions which would otherwise not be pursued.

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<sup>10</sup> This is all financial products excluding most general insurance products, basic deposit products, consumer credit insurance, non-cash payment products and First Home Saver Account (FHSA) deposit accounts: see ASIC Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146).

96 An infringement notice provision is a useful tool for compliance breaches dealing most effectively with breaches such as poor documentation or for breaches where no major evidence of significant consumer harm exists. Infringement notices provide a low–moderate level sanction for more straightforward breaches. They allow the individual or firm to accept a modest sanction for minor breaches and continue in business, without fear of drawn-out and costly litigation, and the damaging impact this can have on reputations and livelihood.

*Disgorgement of profits*

97 Disgorgement orders allow a regulator to deprive an entity of any financial benefit derived directly from a breach (which may include the profit made or loss avoided) where quantifiable. This is an important tool to remove any economic incentive to breach the law (i.e. because it could result in increased profit or cost savings to the breaching party).

98 Currently, under s1101B of the Corporations Act, ASIC can seek a wide range of orders and there is nothing that would preclude a court from making disgorgement orders. Section 1101B(4) lists some examples of orders a court may make under this provision; however, there is no specific provision for disgorgement orders.

99 Among the list of orders a court may make under s1101B(4), there is an example of orders requiring a person to publish advertisements in relation to contraventions of the market integrity rules.

100 It is not clear that a court may order disgorgement of profits relating to misconduct under the current wording of s1101B. Greater clarity may be warranted.

## Summary

101 Table 4 summarises the key issues raised by this term of reference, ASIC’s forward program and possible changes to the policy settings that the Government might consider to deal with the issues.



**Table 4: Adequacy of licensing arrangements (TOR 11)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
<p>Licensing sets a low barrier to entry and this is not understood by investors.</p> <p>Licensing focuses on the entity and not representatives, limiting ASIC's ability to control entry or ban individuals.</p> <p>Licensing regime might result in a gap between investor expectations and the requirements of the licensing regime.</p>	<p>To raise the entry standards and close the expectation gap between investor expectations and licensing requirements, ASIC:</p> <ul style="list-style-type: none"> <li>• proposes to strengthen the financial resource requirements for AFS licensees, commencing with responsible entities for managed investment schemes (other than any bodies regulated by the APRA that are excluded from the licensee obligation to have adequate financial resources); and</li> <li>• will implement the recommendation of the PJC in its August 2011 ASIC oversight report that ASIC amend its website to include an explanation of the meaning and significance of holding an AFS licence.</li> </ul>	<p>To further strengthen the licensing regime, the Government might consider:</p> <ul style="list-style-type: none"> <li>• enhancing ASIC's discretion to refuse an AFS licence application—or suspend/remove an existing licence;</li> <li>• expanding ASIC's current authorised representative register to cover all representatives who give financial advice on Tier 1 products; and</li> <li>• enhancing the remedies available to ASIC under Ch 7 of the Corporations Act.</li> </ul> <p>Note: Work is already being undertaken in this area as part of the Government's proposed FoFA reforms.</p>

## C Role of management investment scheme compliance plans, auditors and committees (TOR 11)

### Key points

The key issues in relation to managed investment scheme compliance plans, auditors and committees are:

- the content requirements for management investment scheme compliance plans are at a very high level, resulting in difficulties in taking regulatory action for failing to have a compliance plan in place that meets legal requirements;
- liability for the responsible entity and its directors attaches to any contravention of the compliance plan, rather than just material contraventions. This encourages generic compliance plans with low standards that nonetheless still satisfy the legal content requirements for compliance plans;
- the Corporations Act merely requires a compliance plan audit to be done, but does not impose any qualitative standards by which a compliance plan auditor must conduct their audits; and
- compliance committee oversight is not as effective as it could be because there are no requirements as to the experience, competence or qualifications for compliance committee members.

ASIC is currently reviewing its own guidance to industry on these issues within the existing law.

However, ASIC believes that the Government might also consider:

- examining the effectiveness of the role of the compliance plan in the compliance framework;
- setting more detailed requirements for compliance plans;
- introducing an approval process for compliance plan auditors and civil liability provision for compliance plan audits; and
- introducing requirements for compliance committees and their members.

### Key issues

102

This section discusses the adequacy of the current regulatory regime for compliance plans, auditors and committees given that these checks and balances did not appear to fulfil their intended function in helping prevent the collapse of Trio.

- 103 The key issues in relation to registered managed investment scheme compliance plans and auditors are:
- (a) the content requirements in s601HA of the Corporations Act for compliance plans are at a very high level, resulting in the compliance plans not being as effective as may have been intended and difficulties in taking regulatory action for failing to have a compliance plan in place that meets s601HA requirements;
  - (b) liability for the responsible entity and its directors attaches to any contravention of the compliance plan, rather than just material contraventions. This can result in generic compliance plans that contain low standards. These low standards are still able to satisfy the content requirements for compliance plans; and
  - (c) the Corporations Act merely requires a compliance plan audit to be done, but does not impose any qualitative standards by which a compliance plan auditor must conduct their audits.
- 104 The key issues in relation to registered managed investment scheme compliance committees are:
- (a) there are no current legislative requirements as to experience, competence or qualifications for compliance committee members;
  - (b) there is also no regulatory or member oversight of the appointment of compliance committee members; and
  - (c) the Corporations Act does not specify many governance requirements in relation to the proceedings of the compliance committee.

### **The rationale for compliance plans, auditors and committees**

- 105 Chapter 5C of the Corporations Act was designed to address the fundamental risk of the responsible entity of a registered managed investment scheme not following the rules set out in the managed investment scheme's constitution or the laws governing registered managed investment schemes.
- 106 There are three mechanisms in Ch 5C to deal with the perceived compliance risk in a cost effective way. These are the requirements for:
- (a) each registered managed investment scheme to have a compliance plan setting out adequate measures for the responsible entity to apply to ensure the managed investment scheme complies with its legal obligations (s601HA);
  - (b) the compliance plan to be audited annually by a registered company auditor or audit firm (s601HG); and
  - (c) a compliance committee to be established where less than half of the directors of the responsible entity are external directors (s601JA).

## Requirements of compliance plans

107 A compliance plan is a document designed to set out the various checks and balances to be established to ensure that a registered managed investment scheme operates in accordance with the requirements of its constitution and the Corporations Act.<sup>11</sup> The Corporations Act does not specify what constitutes adequate checks and balances, with the intention being that the responsible entity develop and implement an appropriate set of compliance measures to address a minimum number of mandatory risks. The approach was intended to provide flexibility for responsible entities to create compliance measures that were tailored for the particular registered managed investment scheme.<sup>12</sup>

108 The relevant legislative provisions for compliance plans include the following sections of the Corporations Act.

### **Content: s601HA**

109 The compliance plan of a registered managed investment scheme must set out adequate measures that the responsible entity is to apply in operating the managed investment scheme to ensure compliance with the Corporations Act and the managed investment scheme constitution. This includes, but is not limited to, the arrangements for ensuring that all scheme property is clearly identifiable as scheme property and held separately from the property of the responsible entity and any other managed investment scheme, the compliance committee (if any) functions properly, scheme property is valued at regular intervals, the compliance plan is audited as required by s601HG and adequate records are kept.

### **Incorporation by reference: s601HB**

110 A compliance plan for a registered managed investment scheme may incorporate specified provisions, as in force at a specified time, of another registered managed investment scheme for which it is a responsible entity.

### **Ability to change compliance plan: s601HE**

111 The responsible entity has the ability to modify or repeal the managed investment scheme's compliance plan and replace it with a new compliance plan. The responsible entity can do this unilaterally. The responsible entity must lodge a copy of the modified or new compliance plan with ASIC within 14 days after the modification is made or the compliance plan is repealed.

<sup>11</sup> See Explanatory Memorandum to the Managed Investments Bill 1997.

<sup>12</sup> See Corporations and Markets Advisory Committee, *Collective investments: Other people's money*, September 1993.

**Duties of the responsible entity: s601FC(1)(g) and (h)**

112 The responsible entity has duties to ensure the compliance plan meets the requirements of s601HA and to ensure that it complies with the managed investment scheme's compliance plan. Failure to comply with these duties by the responsible entity attracts civil penalties. It is also an offence for any persons who are intentionally or recklessly involved in a responsible entity's contravention of s601HA.

**Duty of the officers of the responsible entity: s601FD(1)(f)**

113 The officers of the responsible entity have a duty to take all reasonable steps to ensure that the responsible entity complies with the managed investment scheme's compliance plan. Failure to comply with this duty by an officer attracts civil penalties. It is also an offence for any person who intentionally or recklessly contravenes or is involved in the contravention of this section of the Corporations Act.

**ASIC guidance**

114 ASIC provides guidance on how a responsible entity might prepare a compliance plan for a registered managed investment scheme and includes illustrative guidance on what might be included in a compliance plan in the following regulatory guides: RG 116, RG 117, RG 118, RG 119, RG 120 and RG 132.

115 In ASIC's view, on the basis of the current legislative settings, a responsible entity preparing a compliance plan should:

- (a) undertake a structured and systematic process that considers its obligations under the Corporations Act and the managed investment scheme's constitution;
- (b) identify the risks of non-compliance; and
- (c) establish measures designed to meet these risks (see RG 132).

116 The compliance plan should describe the compliance activities with enough detail and certainty for the auditor and ASIC to assess, at a later time, whether or not the plan has been complied with: see RG 132.17.

**Compliance committees**

117 The compliance committee is intended to act as an intermediary between the operational compliance unit and board of directors in relation to compliance monitoring, assessment and reporting. Given ASIC's finite resources, the compliance committee also plays an important role as 'gatekeeper'.

118 The current relevant legislative provisions for compliance committees include the following sections of the Corporations Act.

**Need for compliance committee: s601JA**

- 119 Where the board of directors does not have a majority of external directors, the responsible entity must establish a compliance committee within 14 days.

**Membership of compliance committee: s601JB**

- 120 A registered managed investment scheme's compliance committee must have at least three members, the majority of whom must be external members.

**Duties of compliance committee members: s601JD**

- 121 Compliance committee members are subject to duties to act honestly, to exercise the degree of care and diligence that a reasonable person would exercise if they were in the member's position and are prohibited from making improper use of information acquired through their position as a member of the committee or making improper use of their position (whether directly or indirectly) to gain an advantage for themselves or any other person or to cause detriment to the members of the managed investment scheme.

**Inclusion in compliance plan: s601HA(1)(b)**

- 122 The manner in which the compliance committee performs its functions will be set out in the managed investment scheme's compliance plan. The compliance plan must include provisions ensuring that the compliance committee functions properly, including adequate arrangements relating to the membership of the committee, how often committee meetings are to be held, its reports and recommendations to the responsible entity and its access to information relevant to the responsible entity's compliance with the Corporations Act.

**Audit of the compliance plan**

- 123 The requirement to appoint a compliance plan auditor who audits the compliance plan annually operates as an independent external oversight of the responsible entity's compliance arrangements. The purpose of requiring an audit of the compliance plan is to ensure the compliance plan is current at all times.
- 124 The current relevant legislative provisions for compliance plan audits and auditors include the following sections of the Corporations Act.

**Audit of compliance plan: s601HG(1)**

125 The responsible entity must ensure at all times a registered company auditor, an audit firm or an authorised audit company is engaged to audit compliance with the managed investment scheme's compliance plan.

**Restriction on acting as a compliance plan auditor: s601HG(2)**

126 A person is not eligible to act as a compliance plan individual auditor, lead auditor or review auditor if the person is an associate of the responsible entity, an agent holding scheme property on behalf of the responsible entity or an associate of an agent of that kind or the auditor of the responsible entity's financial statements (although they may work for the same firm).

**Role of compliance plan auditor: s601HG(3), (4), (4A) and (4B)**

127 A compliance plan auditor must, within three months after the end of the financial year of the managed investment scheme:

- (a) examine the managed investment scheme's compliance plan;
- (b) carry out an audit of the responsible entity's compliance with the compliance plan during the financial year; and
- (c) give to the responsible entity a report that states whether, in the auditor's opinion:
  - (i) the responsible entity complied with the managed investment scheme's compliance plan during the financial year; and
  - (ii) the plan continues to meet the requirements of Pt 5C.4 of the Corporations Act.

128 If the compliance plan auditor discovers, or has reasonable grounds to suspect there has been, a breach of the compliance plan or certain other contraventions or misconduct, the auditor must report it to ASIC if it is a significant breach or the auditor believes it will not be adequately dealt with by including it in the audit report or bringing it to the attention of directors.

**Right to access books and records: s601HG(6)**

129 In conducting the audit, the compliance auditor has a right of access at all reasonable times to the books of the managed investment scheme and may require an officer of the responsible entity to give the auditor information and explanations for the purposes of the audit.

130 In auditing a compliance plan, a compliance plan auditor must comply with the legislative requirements in s601HG, and is expected to take into account any relevant ASIC policy and adhere to the requirements contained in the Standards on Assurance Engagements. Currently, compliance plans are generally audited taking into account the following:

- (a) ASAE 3100 *Compliance engagements* (ASAE 3100);
- (b) GS 013 *Special considerations in the audit of compliance plans of registered managed investment schemes* (GS 013);
- (c) GS 007 *Audit implications of the use of service organisations for investment management services* (GS 007);
- (d) RG 132; and
- (e) Regulatory Guide 34 *Auditor's obligations: Reporting to ASIC* (RG 34).

## ASIC activities

### ASIC's activities involving compliance plans

#### Submission to Productivity Commission

131 ASIC made a submission to the Productivity Commission's Annual Review of Regulatory Burdens on Business and Consumer Services on 26 February 2010 identifying concerns with the nature of the content requirements in s601HA for compliance plans and noting that the overreaching of liability settings for responsible entities and directors was resulting in generic compliance plans that were not meeting their intended legislative purpose.

132 ASIC recommended, among other things, that:

- (a) the content requirements for compliance plans in s601HA be amended to be more focused on systemic and material risk; and
- (b) the liability provisions in s601FC(1)(g), (h) and 601FD(1)(f) be amended to focus on liability for material contraventions.

133 The Productivity Commission declined to accept the recommendations.

#### Development of amended regulatory guidance on compliance plans

134 During 2009 and 2010, ASIC surveyed four compliance plan auditing firms and 15 high-volume lodgers of applications to registered managed investment schemes in order to obtain their views about ASIC's current guidance in RG 132.

135 Several key themes emerged from our interviews with compliance plan audit firms. These included:

- (a) the Corporations Act does not provide specific enough guidance about what a compliance plan should include, and as a result a practice has developed of generic template compliance plans;
- (b) a 'best practice' compliance plan should include a detailed description of the registered managed investment scheme, identify relevant risks of



non-compliance with the law (including specifically the AFS licensee obligations in s912A) for that managed investment scheme and have detailed enough compliance measures so that the auditor understands what is to be done and who is responsible for doing it;

- (c) compliance plans are a small part of the overall compliance and risk framework; and
- (d) in addition to compliance plans, properly structured and functional compliance committees are crucial to effective compliance.

136 The survey results for the 15 high-volume lodgers illustrated that:

- (a) they had developed compliance plan ‘templates’ for efficiency purposes;
- (b) they were happy with the ASIC guidance in RG 132 on the basis of the current legislative settings in relation to what a compliance plan should contain, but wanted flexibility to craft their own compliance measures;
- (c) they did not necessarily consider that the ASIC guidance in RG 132 would lead to the compliance plan doing what it is intended to do—namely, to minimise the risk of non-compliance with the Corporations Act and the constitution; and
- (d) there was a need for ASIC to update RG 132.

137 Taking into account ASIC’s experience and these survey results, ASIC has formed a project team to review its policy in RG 116, RG 117, RG 118, RG 119, RG 120 and RG 132. The project team proposes to amend these regulatory guides to provide better guidance as to what is required in a compliance plan, including material compliance risks for different registered managed investment schemes, and examples of measures to address those risks. ASIC will also seek to encourage responsible entities to draft each compliance plan to contain a detailed description of the registered managed investment scheme and its investment strategy.

## **ASIC’s activities involving compliance plan audits**

### **Compliance plan audit inspections**

138 ASIC recently undertook a project to inspect compliance plan audits. The project conducted on-site inspections for five compliance plan audit files during the 2010–11 financial year. The inspections included compliance plan audits carried out by both ‘Big Four’ accounting firms and smaller accounting firms.

139 The objectives of the project were to:

- (a) use the inspection findings to assist in a review of RG 132;

- (b) raise the importance of compliance plan audits with compliance plan auditors; and
  - (c) improve the quality of compliance plan audits.
- 140 The project allowed ASIC to develop a better understanding of the work done by compliance plan auditors and to examine whether there might be any areas of regulatory concern that ASIC might seek to influence compliance plan auditor behaviour or practice.
- 141 ASIC identified the following areas of concern for future regulatory consideration:
- (a) the obligation of auditors to report on the adequacy of compliance plans;
  - (b) whether a particular compliance plan measure achieves its objectives;
  - (c) reliance on other auditors;
  - (d) audit independence and competence declarations;
  - (e) how the auditor satisfies themselves that the responsible entity has complied with its obligations in all material respects as required under ASAE 3100; and
  - (f) audit approach and testing methodology.
- 142 The project team communicated their findings individually to the compliance plan auditors, who were then given an opportunity to respond. Many of the compliance plan auditors acknowledged that the project team's findings were cause to improve their compliance plan audit behaviours and practices.
- 143 In order to ascertain whether the areas of concern ASIC identified were systemic issues across the industry, ASIC has committed to conducting another five compliance plan audit inspections for the 2011–12 financial year and ASIC will review what regulatory options might be available to improve the quality of compliance plan audits, including consideration of whether the requirements in s601HG(3) and (4) of the Corporations Act need to be strengthened.

## Changes to policy settings

### Compliance plans

- 144 Over the years, ASIC has observed a practice of responsible entities still meeting legislative requirements for compliance plans but:
- (a) producing a 'one size fits all' or 'template' compliance plan which is routinely applied and lodged for all registered managed investment schemes operated by the same responsible entity; and

- (b) commonly supplementing compliance measures in the compliance plan with detailed compliance procedures and processes that sit outside the compliance plan in separate manuals. For example, a compliance plan may identify a risk of failing to calculate a unit price correctly and include a compliance measure that this risk is mitigated by the procedures that sit outside the compliance plan.

145 Reasons for these practices include operational efficiency, cost effectiveness and in order to assist the responsible entity in mitigating its compliance risk without unnecessarily exposing its officers to a breach of their duty in s601FD(1)(f) of the Corporations Act.

146 The effect of the existing law is any failure by the responsible entity or officers in relation to compliance with the compliance plan exposes them to civil liability. A less detailed compliance plan lessens the risk of contravening the Corporations Act.

147 A lack of detail in the law about what is needed in compliance plans means they may not be as effective as intended and it creates difficulties in taking regulatory action for failing to have a compliance plan in place that meets s601HA requirements.

148 ASIC believes that the Government might consider the merits of:

- (a) reviewing whether the compliance plan is an effective component of the compliance framework or, alternatively, amending the compliance plan content requirements in s601HA to:
  - (i) introduce a 'significance threshold' for the risks the compliance plan ought to contain and better focus on systemic and material risks;
  - (ii) include specific requirements (e.g. valuation frequency and compliance committee processes); and
  - (iii) require that the compliance plan contain a detailed description of the registered managed investment scheme and its investment strategy;
- (b) amending the responsible entity duty and liability provisions in s601FC to remove the liability for a non-material breach of the compliance plan; and
- (c) amending the officer duty and liability provisions in s601FD to remove the liability for a non-material breach of the compliance plan.

### **Compliance committees**

149 There are no current legislative requirements as to experience, competence or qualifications for compliance committee members. Prospective or current

compliance committee members are not required to undergo any type of training.

150 The lack of any competency requirements was recognised by the Review of the Managed Investments Act 1988 (Turnbull Report) in 2001 and the PJC Review of the Turnbull Report in 2002. The Turnbull Report subsequently made recommendations that compliance committee members be subject to qualification and experience requirements. However, these recommendations have not as yet been implemented.

151 There is also no regulatory or member oversight of the appointment of compliance committee members. The terms of appointment of compliance committee members are determined solely by the responsible entity. Neither ASIC nor members have any power to approve or remove compliance committee members.

152 The Corporations Act does not specify many governance requirements for the proceedings of compliance committees. Subject to requirements about minimum numbers of members, keeping minutes of meetings and records of recommendations and reports, compliance committees may regulate themselves and their proceedings as they consider appropriate (as long as they do so consistently with the compliance plan and the requirements of the responsible entity).

153 ASIC believes the Government might consider imposing minimum requirements for compliance committees and the membership of those committees.

### **Compliance plan audits**

154 Under s601HG(3) of the Corporations Act, the compliance plan auditor must examine the compliance plan, carry out an audit and report their findings to the responsible entity. Non-compliance with s601HG(3) is a strict liability offence: see s601HG(7A). This means that under the current legislative regime a compliance plan auditor will contravene s601HG(3) only if they do not do the three tasks mandated by this subsection.

155 The current regime does not make it an offence to conduct a poor quality compliance plan audit. Under the current regime, the relevant question in terms of liability is whether or not the compliance plan audit was actually done. Part 5C.4 of the Corporations Act does not impose any qualitative standards by which a compliance plan auditor must conduct their audit. This lack of qualitative standards contributes to compliance plan audits not providing the regulatory oversight which might be expected from the audit of compliance plans.

156 Furthermore, the auditor's responsibilities under s601HG(3) are fairly limited. The auditor is only required to examine, audit and report on the

responsible entity's compliance with the compliance plan and is not required to examine and report on the responsible entity's compliance with the Corporations Act or the scheme's constitution.

- 157 Under s1292 of the Corporations Act, the Companies Auditors and Liquidators Disciplinary Board (CALDB) may, on ASIC's application, suspend or cancel the registration of an auditor where the auditor has failed to perform adequately or properly the duties of an auditor or any duties or functions required by an Australian law.
- 158 The assurance standards relevant to compliance plan audits are ASAE 3100 *Compliance engagements* (ASAE 3100) and ASAE 3000 *Assurance engagements other than audits or reviews of historical financial information* (ASAE 3000). There is also a guidance statement GS 013 *Special considerations in the audit of compliance plans of managed investment schemes* (GS 013).
- 159 If an auditor failed to conduct a compliance plan audit in accordance with the assurance standards, there would appear to be a prima facie case for ASIC to pursue the auditor in the CALDB. However, these assurance standards, which are specifically relevant to a compliance plan audit, are different from auditing standards applying to the auditing of financial reports because they do not have the force of law.
- 160 There is consequently no precedent for a successful action against a compliance plan auditor.
- 161 The limited legal obligations of a compliance plan auditor under s601HG(3) make disciplinary action an untested option until such time as the obligations of the auditor are better articulated by the courts or by changes to the legislation.
- 162 ASIC believes that the Government might consider the merit of introducing:
- (a) an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval;<sup>13</sup> and
  - (b) civil liability provisions for compliance plan audits. We note that such measures may increase compliance plan costs (e.g. through an increase in insurance costs).

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<sup>13</sup> A similar approval process has been proposed for auditors of SMSFs as part of the Government's Stronger Super reforms.

## Summary

163

Table 5 summarises the key issues raised by this term of reference, ASIC's forward program and possible changes to the policy settings that the Government should consider to deal with the issues.

**Table 5: Role of managed investment scheme compliance plans, auditors and committees (TOR 11)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
<p>For compliance plans and audits, the existing regime might not be as effective as intended because it:</p> <ul style="list-style-type: none"> <li>sets very high-level compliance plan requirements;</li> <li>does not prescribe qualitative standards for compliance plan audits; and</li> <li>does not focus on material contraventions when imposing liabilities on responsible entities and directors of responsible entities.</li> </ul> <p>Compliance committee oversight might not be as effective as intended because there are either no, or limited, legislative requirements as to:</p> <ul style="list-style-type: none"> <li>the experience, competence or qualifications for compliance committee members;</li> <li>the oversight of the appointment of compliance committee members; and</li> <li>the proceedings of compliance meetings.</li> </ul>	<p>To identify regulatory options to improve the quality of compliance plan audits and to provide better guidance to industry on current requirements for compliance plans, ASIC has:</p> <ul style="list-style-type: none"> <li>committed to conducting another five compliance plan audit inspections for the 2011–12 financial year. ASIC will also review what other regulatory options might be available to improve the quality of compliance plan audits, including consideration of whether the requirements in s601HG(3) and (4) of the Corporations Act need to be strengthened; and</li> <li>formed a project team to review relevant ASIC policy in: <ul style="list-style-type: none"> <li>Regulatory Guide 116 <i>Commentary on compliance plans: Agricultural industry schemes</i> (RG 116);</li> <li>Regulatory Guide 117 <i>Commentary on compliance plans: Financial asset schemes</i> (RG 117);</li> <li>Regulatory Guide 118 <i>Commentary on compliance plans: Contributory mortgage schemes</i> (RG 118);</li> <li>Regulatory Guide 119 <i>Commentary on compliance plans: Pooled mortgage schemes</i> (RG 119);</li> <li>Regulatory Guide 120 <i>Commentary on compliance plans: Property schemes</i> (RG 120); and</li> <li>Regulatory Guide 132 <i>Managed investments: Compliance plans</i> (RG 132).</li> </ul> </li> </ul> <p>The project team proposes to amend these regulatory guides to provide better guidance as to what is required in a compliance plan, including material compliance risks for different registered managed investment schemes, and examples of measures to address those risks.</p>	<p>To increase the effectiveness of compliance plans, auditors and committees, the Government might consider the following.</p> <p>For compliance plans:</p> <ul style="list-style-type: none"> <li>reviewing the effectiveness of the role of the compliance plan in the compliance framework;</li> <li>setting more detailed requirements for compliance plans; and</li> <li>introducing an approval process for compliance plan auditors and civil liability provision for compliance plan audits.</li> </ul> <p>For compliance committees, consider minimum requirements for compliance committees and the membership of those committees.</p>

## D Access to compensation and insurance (TOR 6)

### Key points

Having efficient and effective dispute resolution and compensation mechanisms is integral to promoting the confident and informed participation of consumers in the Australian financial services system.

ASIC continues to monitor and review whether the dispute resolution and compensation requirements are adequate.

The Australian Government, as part of the FoFA reforms, has appointed Mr Richard St John to conduct a review into the need for and costs/benefits of a possible last resort statutory compensation scheme.

### Key issues

- 164 This section discusses the adequacy of the current regulatory regime around access to compensation and insurance given the losses sustained by investors as a result of the collapse of Trio.
- 165 Having efficient and effective dispute resolution and compensation mechanisms is integral to promoting the confident and informed participation of consumers in the Australian financial services system (one of ASIC's key objectives in s1 of the ASIC Act).
- 166 Recent consumer research commissioned by ASIC's Consumer Advisory Panel (CAP) and published in ASIC report *Compensation for retail investors: The social impact of monetary loss* (REP 240) highlights the social impacts when consumers are not fully compensated for monetary loss suffered as a result of their licensee's misconduct.
- 167 The key findings of the research were that:
- (a) investors who suffered the most had invested all their money, had not diversified or went into debt as part of their investment strategy;
  - (b) most investors' losses were associated with an underlying product that was either frozen or collapsed;
  - (c) the impact of the monetary loss was immediate on investors without a financial buffer, while for others the first six months from when they discovered their loss were critical. Most investors received none or only a few cents in the dollar back;
  - (d) investors had little knowledge of existing avenues of redress, such as their financial service provider's internal dispute resolution system or the external dispute resolution scheme they belonged to;

- (e) investors were reluctant to commence legal action to recover their monetary loss, particularly when they blamed themselves;
- (f) some investors suffered ‘catastrophic loss’ as their loss was ‘so significant their life will never be the same’. Some felt prolonged anger, uncertainty, worry and depression; and
- (g) investors who suffered monetary loss lacked confidence in the Australian financial system, financial advisers, the Government and regulators.

### Possible avenues for obtaining compensation

168 ASIC REP 240 recently identified at least six possible avenues investors can access to seek compensation when they suffer monetary loss as a result of the misconduct of their financial services provider: see Table 6.

**Table 6: Avenues for obtaining compensation**

Avenue	Process
Internal dispute resolution (IDR)	Approach the financial services provider directly to seek a resolution.
The Superannuation Complaints Tribunal (SCT) and ASIC-approved external dispute resolution (EDR) schemes	<p><b>The SCT</b></p> <p>Investors can complain to the SCT<sup>14</sup>—a statutory body established under the <i>Superannuation (Resolution of Complaints) Act 1993</i>.</p> <p>The SCT can review decisions and the conduct of superannuation providers, including trustees of regulated superannuation funds and approved deposit funds, retirement savings account providers and life companies providing annuity policies.</p> <p><b>ASIC-approved EDR schemes</b></p> <p>There are currently two ASIC-approved EDR schemes—the Financial Ombudsman Service (FOS)<sup>15</sup> and the Credit Ombudsman Service Limited (COSL)<sup>16</sup> that investors can complain to for free.</p> <p>Whether an investor can complain to either FOS or COSL depends on which scheme the financial services provider has joined.</p> <p>Where complaints are about:</p> <ul style="list-style-type: none"> <li>• <i>financial advisers</i>—an investor may complain to either FOS or COSL (as both schemes have financial adviser members); and</li> <li>• <i>fund managers</i>—an investor can only complain to FOS. We are not aware of any fund managers having joined COSL.</li> </ul>
Self-initiated private action	The investor sues the financial services provider in court or attempts to obtain an outcome through private negotiation, mediation or arbitration.

<sup>14</sup> For more information about the SCT, see [www.sct.gov.au](http://www.sct.gov.au).

<sup>15</sup> For more information about FOS, see [www.fos.org.au](http://www.fos.org.au).

<sup>16</sup> For more information about COSL, see [www.cosl.com.au](http://www.cosl.com.au).



Avenue	Process
Join a private class action	<p>The investor chooses to start or join a class action where investors who have suffered loss from the same type of misconduct bring a group action.</p> <p>Such an action may be on a 'no-win, no-fee' basis.</p>
Through the winding-up process of a financial services provider (administrator/ liquidator)	<p>Where a company may no longer be a viable business, an administrator or liquidator may be appointed to wind up the company.</p> <p>In doing so, the administrator or liquidator will generally assess the liabilities/debt, assets and income of the company to work out whether the company can recover, be sold or needs to be wound down.</p> <p>If the company is wound down, the administrator/liquidator will decide which creditors are paid out of the remaining assets or funds. Creditors with secured interests (such as banks) will usually have first priority in being paid out.</p>
ASIC action	<p>Through:</p> <ul style="list-style-type: none"> <li>• negotiations with the AFS licensee;</li> <li>• legal action or other enforcement action; or</li> <li>• a s50 ASIC Act class action—where ASIC runs a group action to obtain compensation for investors who suffered loss from the same type of misconduct. ASIC has to consider whether it is in the 'public interest' to do so.</li> </ul>

### Special compensation arrangements for fraud under the SIS Act

- 169 The Australian Government's retirement income system is based on a 'three-pillars' policy, with the 'three-pillars' consisting of:
- (a) the publicly funded Age Pension;
  - (b) compulsory private superannuation saving through the 'superannuation guarantee'; and
  - (c) voluntary private saving through superannuation and other savings vehicles.
- 170 The concessional tax treatment afforded to private savings in superannuation is designed to encourage Australians to set aside income over the course of their working lives to help fund their retirement and to also reduce reliance on the publicly funded Age Pension.
- 171 These features form the core retirement income framework in Australia.
- 172 Part 23 of the SIS Act allows the trustee of an APRA-regulated fund (which does not include SMSFs) to apply to the Minister for Financial Services and Superannuation for a grant of financial assistance where the fund has suffered 'a loss' as a result of fraudulent conduct or theft.

- 173 The ‘loss’ must be a *substantial diminution of the fund*: see s229(1) of the SIS Act. That is, the loss must not be ‘negligible’ or ‘trivial’.<sup>17</sup>
- 174 It is up to the Minister’s discretion whether or not to grant financial assistance and the amount of that assistance. This means that a court, tribunal or other dispute resolution body does not have to find that there was fraud or theft; rather, the Minister must be convinced in their own mind that fraud or theft did in fact occur.<sup>18</sup>
- 175 When considering whether to grant financial assistance, the Minister must have regard to whether the ‘public interest’ requires that financial assistance should be provided and the Minister must also consult with APRA: see s230A and 231(1) of the SIS Act.
- 176 If the Minister considers that financial assistance should be provided, it will be paid out of the Consolidated Revenue Fund and recouped by way of a levy on all regulated superannuation funds under the *Superannuation (Financial Assistance Funding) Levy Act 1993* (i.e. the cost of compensating is spread across all regulated superannuation funds and possibly their members).
- 177 The rationale underpinning Pt 23 is to protect against the risk of a fund failing as a result of fraud or theft, given the key role that superannuation plays in the retirement income system.
- 178 SMSFs (a legal vehicle to facilitate ‘do it yourself’ (DIY) superannuation and enhance choice in retirement investments) were not included in the Pt 23 compensation regime:
- As the SMS trustees are also members, it is assumed that the trustee(s) will act in their own best interests, and that members do not need the full range of statutory measures to protect them in relation to the conduct of the trustee. Accordingly, SMSFs are exempted from some of the provisions of the SIS Act, including the financial assistance provisions of Part 23 of the SIS Act. This is in accordance with a recommendation of the Financial Sector (Wallis) Inquiry.<sup>19</sup>
- 179 On 13 April 2011, the Australian Government announced that it would grant approximately \$55 million in financial assistance to benefit over 5000 members of four superannuation funds that were formerly under the trusteeship of Trio.<sup>20</sup>
- 180 As part of the Australian Government’s announcement to grant financial assistance to Trio investors, the Government stated that the reason for

<sup>17</sup> See Treasury, *Review into Part 23 of the Superannuation Industry (Supervision) Act 1993*, Review Paper, 3 June 2003, p. 2, at [www.treasury.gov.au/contentitem.asp?NavId=021&ContentID=654](http://www.treasury.gov.au/contentitem.asp?NavId=021&ContentID=654).

<sup>18</sup> *Ibid.*, p. 5.

<sup>19</sup> *Ibid.*, p. 4.

<sup>20</sup> See The Hon Bill Shorten MP, *Financial Assistance to Trio’s Super fund investors*, Press Release No. 0.51, 13 April 2011, at [www.dpm.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/051.htm&pageID=003&min=brs&Year=&DocType=](http://www.dpm.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/051.htm&pageID=003&min=brs&Year=&DocType=).

providing full compensation to Trio investors was to ensure consistency with other compensation arrangements under the Financial Claims Scheme for ADIs (i.e. banks or insurers) in the event of a collapse.

### **The requirement to have a compliant dispute resolution system**

- 181 All AFS licensees (including fund managers and financial advisers) must have a compliant dispute resolution system as a general obligation of their AFS licence: see s912A of the Corporations Act. This dispute resolution system must be able to cover complaints about the licensee's authorised representatives.
- 182 Unlicensed product issuers and product providers must also have a compliant dispute resolution system: see s1017G of the Corporations Act.
- 183 The dispute resolution system must consist of both:
- (a) an IDR procedure that meets ASIC's approved standards and requirements; and
  - (b) membership of an ASIC-approved EDR scheme (unless the SCT can handle all 'retail investor' complaints about the licensee's business).
- 184 The Corporations Act and Corporations Regulations 2001 (Corporations Regulations) set out the matters that ASIC may consider when making or approving IDR procedures and approving EDR schemes. These matters are summarised in Table 7.
- 185 ASIC provides detailed guidance on the dispute resolution requirements in:
- (a) Regulatory Guide 165 *Licensing: Internal and external dispute resolution* (RG 165); and
  - (b) ASIC Regulatory Guide 139 *Approval and oversight of external dispute resolution schemes* (RG 139).
- 186 The key dispute resolution standards and requirements in RG 165 and RG 139 that currently apply to financial services providers are summarised in Table 8.

**Table 7: Dispute resolution requirements under the Corporations Act and Corporations Regulations**

Requirements	Details	Reference
General	<p>Financial services providers must have a dispute resolution system that covers complaints by retail clients.</p> <p>The dispute resolution system must consist of:</p> <ul style="list-style-type: none"> <li>• an IDR procedure that complies with standards and requirements made or approved by ASIC; and</li> <li>• membership of one or more EDR schemes approved by ASIC, where the SCT does not cover complaints about the products/services provided.</li> </ul>	See s912A(1)(g), 912A(2) and 1017G of the Corporations Act.
IDR procedures	<p>When considering whether to make or approve standards or requirements relating to IDR procedures, ASIC must take into account:</p> <ul style="list-style-type: none"> <li>• Australian Standard AS ISO 10006–2006 <i>Customer satisfaction—Guidelines for complaints handling in organizations</i> (AS ISO 10006–2006); and</li> <li>• any other matter ASIC considers relevant.</li> </ul>	See regs 7.6.02(1) and 7.9.77(1)(a) of the Corporations Regulations.
EDR schemes	<p>When deciding whether to approve an EDR scheme, ASIC must take into account the following matters:</p> <ul style="list-style-type: none"> <li>• the accessibility of the scheme;</li> <li>• the independence of the scheme;</li> <li>• the fairness of the scheme;</li> <li>• the accountability of the scheme;</li> <li>• the efficiency of the scheme;</li> <li>• the effectiveness of the scheme; and</li> <li>• any other matter ASIC considers relevant.</li> </ul>	See regs 7.6.02(3) and 7.9.77(3) of the Corporations Regulations.

**Table 8: Summary of ASIC's current policy on dispute resolution**

Requirements	Details	Reference
IDR procedures	<p>From 1 January 2010, financial services providers must have IDR procedures that:</p> <ul style="list-style-type: none"> <li>• cover the majority of complaints retail clients make;</li> <li>• adopt the definition of 'complaint' in AS ISO 10002–2006;</li> <li>• satisfy the Guiding Principles of Section 4 of AS ISO 10002–2006 and the following sections of AS ISO 10002–2006: <ul style="list-style-type: none"> <li>– Section 5.1—Commitment;</li> <li>– Section 6.4—Resources;</li> <li>– Section 8.1—Collection of information; and</li> <li>– Section 8.2—Analysis and evaluation of complaints;</li> </ul> </li> <li>• provide a 'final response' within 45 days (or give reasons for the delay); and</li> <li>• appropriately document IDR procedures.</li> </ul> <p>Note: A 'final response' is a written response setting out: the final outcome offered at IDR; the right to complain to EDR; and the name and contact details of the relevant EDR scheme.</p> <p>A final response is not required in limited circumstances where complaints are resolved to the customer's complete satisfaction by the <i>end of the fifth business day</i> after the complaint is received and the customer has not requested a response in writing.</p>	RG 165
EDR schemes	<p>Financial services providers must:</p> <ul style="list-style-type: none"> <li>• belong to one or more EDR schemes; and</li> <li>• have appropriate links between their IDR procedures and EDR scheme (including a system for informing complainants about the availability of EDR and how to access it).</li> </ul> <p>An EDR scheme must satisfy us that it meets the initial and ongoing requirements that ASIC must take into account when approving a scheme.</p> <p>These requirements include:</p> <ul style="list-style-type: none"> <li>• that the scheme maintains its independence by having certain governance structures (including an equal representation of industry and consumer representatives on its Board);</li> <li>• complainants are able to access the scheme for free;</li> <li>• that the EDR scheme reports: <ul style="list-style-type: none"> <li>– systemic issues and serious misconduct;</li> <li>– general complaints information; and</li> <li>– information about complaints received and closed with an indication of the outcome against each scheme member in their annual report;</li> </ul> </li> <li>• that the scheme has adequate coverage in terms of: <ul style="list-style-type: none"> <li>– the types of complainants who can complain to the scheme (at a minimum the scheme should cover 'retail clients' within the meaning of the Corporations Act);</li> <li>– the vast majority of types of complaints in the relevant industry (or industries) the scheme members belong to; and</li> <li>– the amount of monetary compensation the scheme can award; and</li> </ul> </li> </ul>	<p>RG 165</p> <p>RG 139</p>

Requirements	Details	Reference
	<ul style="list-style-type: none"> <li>that the scheme operates a compensation cap that is consistent with the nature, extent and value of consumer transactions in the relevant industry or industries (from 1 January 2012, a minimum compensation cap of at least \$280,000 for complaints (or \$150,000 for general insurance complaints) involving monetary values of up to \$500,000 will apply); and</li> <li>that scheme awards are binding on members when complainants accept the scheme outcome in full and final settlement of their claim and that the scheme has processes in place to ensure compliance with their determinations.</li> </ul>	

### ASIC-approved EDR schemes

- 187 EDR is intended to be a cheaper, quicker, easier to access and more consumer friendly alternative to going to court.
- 188 Under regs 7.6.02 and 7.9.77 of the Corporations Regulations, ASIC has the power to approve financial industry EDR schemes (subject to conditions), having regard to the matters summarised in Table 8.
- 189 To date ASIC has approved eight EDR schemes,<sup>21</sup> although only two currently remain in existence (the FOS and COSL) due to the merger or consolidation of predecessor schemes.

### FOS and its jurisdiction for financial adviser and fund manager complaints

- 190 On 16 May 2008, ASIC approved FOS as an EDR scheme under the Corporations Act. FOS is also approved under the *National Consumer Credit Protection Act 2009* as a scheme for consumer credit.
- 191 FOS was formed by the merger of five pre-existing ASIC-approved schemes:
- the Insurance Ombudsman Service (IOS);
  - the Banking and Financial Services Ombudsman (BFSO);
  - the Financial Industry Complaints Services Limited (FICS);
  - the Insurance Brokers Disputes Limited (IBDL); and
  - the Credit Union Dispute Resolution Centre (CUDRC).
- Together, these schemes covered banks, credit unions, general and life insurers, stockbrokers, financial advisers, fund managers and insurance brokers.

<sup>21</sup> See [www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+approved+external+complaints+resolution+schemes?opendocument](http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+approved+external+complaints+resolution+schemes?opendocument).

- 192 Around this time, another scheme, the Financial Co-operative Dispute Resolution Scheme (FCDRS), wound down its operations and its members joined either FOS or COSL.
- 193 In December 2009, ASIC approved FOS's single TOR,<sup>22</sup> which consolidated the five separate TORs or Rules of its predecessor schemes. The new TOR commenced operation on 1 January 2010.
- 194 The FOS TOR forms part of the special contract between FOS and its members (and also sets out how complainants will be treated as part of FOS complaints handling processes):<sup>23</sup> see Table 9. FOS also explains in more detail how it will interpret its TOR in its Operational Guidelines.<sup>24</sup>

**Table 9: The key provisions in the FOS TOR**

No.	FOS jurisdiction	Description	Paragraph reference in the FOS TOR
1	What type of complaints can FOS handle?	FOS can handle complaints between a financial services provider and a complainant that arise from a contract or obligation arising under Australian law.	Paragraph 4.2(a)
2	Jurisdictional exclusions	Except complaints: <ul style="list-style-type: none"> <li>• made by persons who are not 'retail clients' under the Corporations Act;</li> <li>• that have already been dealt with by a court, tribunal or other ASIC-approved EDR scheme, or where there is another more appropriate forum for handling the complaint (i.e. a court);</li> <li>• about the decisions of trustees (in their capacity as trustees) of approved deposit funds and of regulated superannuation funds;</li> <li>• about the investment performance of a financial investment, except a complaint concerning non-disclosure or misrepresentation; and</li> <li>• relating to the management of a fund or scheme as a whole.</li> </ul>	Paragraphs 4 and 5

<sup>22</sup> See ASIC Advisory (09-263AD) *ASIC grants approval to the Financial Ombudsman Service Limited for its new single terms of reference* and ASIC report *Feedback from submissions to the Financial Ombudsman Service Limited's new Terms of Reference* (REP 182).

<sup>23</sup> See *FICS Ltd v Deakin Financial Services Ltd* [2006] FCA 1805 and *Mickovski v Financial Ombudsman Service* [2011] VSC 257.

<sup>24</sup> See [www.fos.org.au/centric/home\\_page/about\\_us/terms\\_of\\_reference\\_b/operational\\_guidelines.jsp](http://www.fos.org.au/centric/home_page/about_us/terms_of_reference_b/operational_guidelines.jsp).

No.	FOS jurisdiction	Description	Paragraph reference in the FOS TOR
3	What does FOS consider when handling complaints?	FOS will determine complaints according to what is fair in all the circumstances, having regard to: <ul style="list-style-type: none"> <li>• legal principles;</li> <li>• applicable industry codes or guidance as to practice;</li> <li>• good industry practice; and</li> <li>• previous relevant decisions of FOS or a predecessor scheme (although FOS will not be bound by them).</li> </ul>	Paragraph 8.2
4	The types of outcomes FOS can provide	Award monetary compensation for: <ul style="list-style-type: none"> <li>• direct loss—where the claim is \$500,000 or less, for financial adviser or fund manager related complaints—award compensation of up to \$150,000 for direct loss per claim (and from 1 January 2012, award up to \$280,000 for direct loss per claim);</li> <li>• the complainant's costs (capped at \$3000); and</li> <li>• interest.</li> </ul>	Paragraph 9 and Schedules 1 and 2
5	Fraudulent conduct	FOS can handle complaints involving fraud. FOS must report all fraudulent, grossly negligent or wilful breaches of the laws or obligations under the TOR to ASIC as 'serious misconduct'	Paragraph 11.3

### Financial adviser complaints and proportionate liability

- 195 For investors who invest in funds on the advice of a licensed financial adviser, access to FOS depends on the complainant showing that the financial adviser engaged in some misconduct (e.g. they provided unsuitable or inappropriate financial advice).
- 196 Should FOS find in favour of the investor, and hand down an award for compensation, such an award may not cover the full amount of monetary loss suffered. This is because FOS, under its current TOR, is only able to award compensation of up to \$150,000 for direct loss (or \$280,000 if the complainant brings their complaint to FOS on or after 1 January 2012).
- 197 However, even if other parties who are not FOS members (e.g. directors, auditors, research houses) may have contributed to the investor's loss, unlike a court, FOS will not be required to:
- reduce the sum awarded to reflect the proportion or amount that may be owed by the financial adviser licensee to take into account the other amounts proportionately owed by non-scheme members; nor
  - join all other non-scheme persons to the complaint in order to continue to reasonably handle the complaint.



- 198 This is because ASIC-approved EDR schemes have been recognised as being different from courts, and do not need to abide by strict ‘proportionate liability’ requirements applicable to courts.
- 199 Instead, an EDR scheme (i.e. FOS), due to its special contractual agreement with members (its Constitution and TOR), can award full compensation in favour of the complainant (within the limits of the scheme’s compensation cap amount). The scheme member may then separately pursue other non-scheme persons who may have contributed to the investor’s loss: see *Wealthcare Financial Planning Pty Ltd v Financial Industry Complaints Service Ltd & Ors* [2009] VSC 7.
- 200 This enables complainants to access compensation more quickly and has some implications for the financial adviser licensee’s compensation arrangements.
- 201 It is also important to note that there are real limitations relating to EDR if a fund manager or financial adviser becomes insolvent. In many cases, schemes such as FOS may continue to handle the complaint and award compensation in favour of the complainant; however, the extent to which compensation will be available to ensure a member’s compliance with a scheme award may be limited.

### **The requirement to have adequate compensation arrangements**

- 202 Trustees of APRA-regulated superannuation funds must have a professional indemnity (PI) insurance policy that covers fraud.
- 203 Trustees of APRA-regulated superannuation funds must meet certain financial adequacy requirements as part of the superannuation guarantee. These financial adequacy requirements have not been reviewed since 1993 and are under review as part of the Government’s Stronger Super reforms.
- 204 Under s912B of the Corporations Act, licensees (including financial advisers and fund managers) must have adequate compensation arrangements for compensating retail clients for loss or damage due to breaches of the ‘financial services laws’.
- Note: Section 761 of the Corporations Act defines ‘financial services laws’ as including other chapters of the Corporations Act, the consumer protection provisions of the ASIC Act and other Commonwealth, state or territory laws relevant to the provision of financial services.
- 205 Regulation 7.6.02AA of the Corporations Regulations mandates that the key form of compensation a licensee must have is an acceptable contract of PI insurance.

- 206 ASIC Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126) discusses the key features a PI insurance policy must have for it to be ‘adequate’ (and that ASIC may approve other alternative compensation arrangements and how the licensee may approach ASIC to do so).
- 207 RG 126 states that to be adequate, the PI cover must:
- (a) be adequate having regard to the licensee’s financial services business (the volume of business, the number and kind of clients, the kind of business and the number of representatives), and the maximum liability to compensation claims that realistically might arise;
  - (b) cover EDR scheme awards;
  - (c) cover fraud or dishonesty by directors, employees and other representatives of the licensee (although fraud cover is not required for sole traders); and
  - (d) have a limit of at least \$2 million for any one claim and in the aggregate for licensees with total revenue from financial services provided to retail clients of \$2 million or less. (For licensees with total revenue from financial services provided to retail clients greater than \$2 million, minimum cover should be approximately equal to actual or expected revenue from financial services provided to retail clients (up to a maximum limit of \$20 million).)
- 208 RG 126.22 also states that we do not consider PI insurance to be a mechanism for providing compensation directly to consumers. Rather, it is a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources.
- 209 PI insurance is also not intended to cover product failure or general investment losses, claims for loss solely as a result of the failure (e.g. insolvency) of a product issuer or where a return on a financial product has not met expectations. Nor is it intended to underwrite the products of a product issuer: see RG 126.9 and RG 126.23.

#### **The compensation arrangements of other financial adviser licensees**

- 210 For investors who invest on the advice of a financial adviser, their ability to access compensation, even if an FOS award is made in their favour, will likely depend on the particular terms of each financial adviser licensee’s PI policy.
- 211 Such policies may be limited in policy coverage—for example, the policy might have a limit of only \$2 million for each and every claim and claims in the aggregate.
- 212 If this is the case, it is likely that these limits may be quickly exhausted.

## Liability for representatives who engage in fraud

213 Sections 917A(1) and 917E of the Corporations Act state that licensees are responsible for the conduct of their representatives (employees, directors and authorised representatives) where their conduct causes loss or damage to an investor (whether or not they are acting within the AFS licensee's authority), if:

- (a) the representative's conduct relates to the provision of a financial service;
- (b) the client could be reasonably expected to rely on the conduct; and
- (c) the client in fact relied in good faith.

Note: See Div 76, Pt 7.6 of the Corporations Act (s917A, 917B–917F).

214 The licensee and representative would be jointly and severally liable to the investor for their loss: see s917F of the Corporations Act. However, as previously mentioned, the obligation to have compensation arrangements rests with the AFS licensee and not the representative.

215 Under s912A(ca), AFS licensees must also take reasonable steps to ensure that their representatives comply with 'financial services laws'.

216 Commonwealth, state and territory criminal laws generally treat fraud as an indictable offence, and depending on the type of representative of the licensee, other duties or obligations may apply, for instance:

- (a) employees of responsible entities must not use their position to gain an improper advantage (s601FE); and
- (b) directors are under certain duties (e.g. to not be intentionally dishonest: s184).

217 A consumer will generally be unable to obtain compensation through the licensee or representative where fraud has been perpetrated against the fund as a whole unless the client can show they have a personal action against the licensee or representative.

## ASIC activities

218 In administering the dispute resolution framework and compensation system, ASIC continues to monitor and review whether the dispute resolution and compensation requirements are adequate.

219 Our monitoring involves assessing intelligence received through consumer complaints, and our regular liaison meetings with:

- (a) consumer representatives at our CAP meetings; and
- (b) the SCT and ASIC-approved EDR schemes (FOS and COSL).

- 220 This may lead to consultation on proposals to update the requirements in:
- (a) Regulatory Guide 165 *Licensing: Internal and external dispute resolution* (RG 165);
  - (b) Regulatory Guide 139 *Approval and oversight of external dispute resolution schemes* (RG 139); and
  - (c) Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG 126).

### **Why ASIC did not pursue compensation for Trio investors**

221 ASIC has a number of avenues for pursuing civil recovery to compensate aggrieved investors. For example, s50 of the ASIC Act enables ASIC to carry on a proceeding for recovery of damages for fraud, negligence and other specified types of misconduct committed in connection with a matter to which an investigation relates.

- 222 ASIC has discretion to commence civil recovery action on behalf of an aggrieved investor (whether under s50 of the ASIC Act or civil penalty proceedings or otherwise) if it is in the public interest to do so. In considering whether it is in the public interest to take civil recovery action on behalf of an aggrieved investor ASIC can take into account a range of considerations that may include the following:
- (a) a viable cause of action being identified (i.e. establishing misconduct by the defendant that gives rise to the basis for a compensation action);
  - (b) the availability of evidence (admissible in court) to prove the cause of action;
  - (c) the regulatory effect of bringing the action;
  - (d) the extent of impact or quantum of loss arising from the alleged misconduct;
  - (e) the costs of bringing any action and the potential liability for costs if not successful;
  - (f) the existence of other parties able to commence and fund proceedings seeking compensation for aggrieved investors (such as an external administrator or the investors themselves);
  - (g) the prospects of the action being successfully litigated by ASIC;
  - (h) the availability of funds to satisfy a judgement against a defendant to the proceedings;
  - (i) the availability of funds to satisfy any costs orders made by the court should ASIC be successful;
  - (j) the ability to readily quantify and prove losses incurred by aggrieved parties as a consequence of any contraventions;

- (k) ASIC's regulatory priorities at the time; and
- (l) the availability of alternative forms of dispute resolution.

223 All of these factors were relevantly considered by ASIC when deciding not to pursue compensation action arising from its investigation into Trio.

224 In certain circumstances, ASIC may choose to enter into an enforceable undertaking instead of commencing civil proceedings or taking administrative action. ASIC has publicly released a regulatory guide that discusses when ASIC might enter an enforceable undertaking: see Regulatory Guide 100 *Enforceable undertakings* (RG 100). In summary, this will only occur when ASIC considers that it will provide an effective regulatory outcome, where ASIC believes that a contravention of the law has occurred and that it is in the public interest to do so. ASIC will not accept an enforceable undertaking when it is clear that the relevant misconduct constitutes criminal conduct.

225 In relation to ASIC's investigation into the conduct of the directors and officers of Trio, ASIC formed the view that the enforceable undertakings entered into by the relevant directors and officers were a swifter, more regulatory effective and more certain outcome than court proceedings.

## Changes to policy settings

226 The Australian Government, as part of the FoFA reforms, has appointed Mr Richard St John to conduct a review into the need for and costs/benefits of a possible last resort statutory compensation scheme.

227 The review of compensation arrangements is directed at exploring ways to improve compensation arrangements in the financial services industry, relevant to a retail client who incurs loss or damage as a result of a breach of an obligation by a licensee or its representative.

228 The terms of reference of Mr Richard St John's review notes that such loss or damage could be incurred, for example, when a licensee makes fraudulent use of a client's investment funds.

229 The terms of reference of the review also makes clear that it is not concerned with compensation for investors who suffer loss in the value of their investment in the absence of any misconduct by a licensee or their representatives. This may arise as a result of:

- (a) product failure or investment losses;
- (b) the financial failure of a financial product issuer; or
- (c) poor performance by an investment (e.g. shares depreciate because of an economic downturn).

## Summary

230 Table 10 summarises the key issues raised by this term of reference, ASIC's forward program and possible changes to the policy settings that the Government should consider to deal with the issues.

**Table 10: Access to compensation and insurance (TOR 6)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
<p>Having efficient and effective dispute resolution and compensation mechanisms is integral to promoting the confident and informed participation of consumers in the Australian financial services system.</p>	<p>In administering the dispute resolution framework and compensation system, ASIC will continue to monitor and review whether the dispute resolution and compensation requirements are adequate. This may lead to consultation on proposals to update the requirements in:</p> <ul style="list-style-type: none"> <li>• Regulatory Guide 165 <i>Licensing: Internal and external dispute resolution</i> (RG 165);</li> <li>• Regulatory Guide 139 <i>Approval and oversight of external dispute resolution schemes</i> (RG 139); and</li> <li>• Regulatory Guide 126 <i>Compensation and insurance arrangements for AFS licensees</i> (RG 126).</li> </ul>	<p>Mr Richard St John is currently conducting a review into the need for and costs/benefits of a possible last resort statutory compensation scheme.</p> <p>Note: This work is being undertaken as part of the Government's proposed FoFA reforms.</p>

## E Appropriateness of information and advice provided to investors (TOR 9)

### Key points

Managed investment schemes can be complex products, which should be as transparent to the investor as possible. Yet there is no current specific statutory requirement for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level.

ASIC is focused on improving disclosure for retail investors and has recently consulted with industry on issues particular to investors in hedge funds.

ASIC has ongoing surveillance and monitoring activities for financial advisers. This includes both proactive risk-based activities and some ongoing reactive surveillance work (e.g. based on complaints). ASIC also monitors the quality of advice through periodic 'shadow shopping' surveys.

ASIC believes the Government might consider whether disclosure at asset level for registered managed investment schemes might assist investors assess both the type of financial products they are exposed to and the extent of that exposure.

### Key issues

- 231 This section discusses the adequacy of the current regulatory regime around information and advice provided to investors given that the disclosure regime underpinning the FSR regime may be viewed as not having met community expectations given the losses sustained by some Trio investors.
- 232 There is no current statutory requirement for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. Therefore, there is no means by which scheme members can legally require specific information on the portfolio holdings of the registered managed investment schemes in which they have invested.
- 233 Absent the responsible entity providing this information on request of the scheme member voluntarily, investors cannot assess their exposure to particular assets associated with particular registered managed investment schemes and take this into account when considering whether or not they should continue to hold those investments.

## Current disclosure requirements for managed investment scheme

- 234 Currently, s1013D of the Corporations Act prescribes the statements and information required to be included in a Product Disclosure Statement (PDS). Section 1013E further provides for a general obligation to include other information that might influence a decision of a reasonable person, as a retail client, to acquire a financial product.
- 235 Section 1013(C)(2) provides that the information required by s1013D and 1013E need only be included in the PDS to the extent it is actually known—for example, to the responsible person named in the PDS as a licensee providing services in relation to the issue or sale of the financial product.
- 236 Neither s1013D, 1017D nor the Corporations Regulations specifically require disclosure of scheme assets in point-of-sale or ongoing disclosure. Nor does the current legislation specifically require the disclosure of the underlying fund manager in the PDS. Consequently, at no stage during an investment in a registered managed investment scheme is there any specific requirement to disclose scheme assets, or the underlying fund manager, to the scheme member under the current legislation.
- 237 In the absence of a specific legal requirement to disclose details of assets, a relevant question is whether this information would be information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, as to whether or not to acquire a product for the purposes of s1013E of the Corporations Act.
- 238 The question must involve consideration of the factors listed in s1013F(2). Among other things, the factors to be taken into account include, but are not limited to:
- (a) the nature of the product (including its risk profile); and
  - (b) the extent to which the product is well understood by the kinds of people who commonly acquire products of that kind as retail clients.
- 239 However, it is common industry practice not to disclose investments at the asset level for managed investment schemes, even for simpler, less complex products.
- 240 In the Morningstar Global Fund Investor Experience Report for 2011, Australia rated a ‘D–’ in the section on ‘disclosure’. Part of the reason for that grading was that the vast majority of the countries included in the Morningstar study require full and complete disclosure of portfolio holdings. Only Australia and New Zealand do not require disclosure of portfolio holdings.



- 241 In the superannuation context, trustees for regulated superannuation funds and approved deposit funds are required to include, as a part of ongoing reporting requirements:
- (a) a statement of assets in respect of the relevant subplan, or, if none, the fund; and
  - (b) each combination of investments that the trustee knows or ought reasonably to have known are invested in, directly or indirectly, a single enterprise or single group of associated enterprises and have a combined value in excess of 5% of the total assets of the relevant subplan, or, if none, the fund (s1017DA(1) of the Corporations Act and reg 7.9.37(1)(g) of the Corporations Regulations).
- 242 A current member or beneficiary of a superannuation product may also request at any time the issuer of a superannuation product to provide specific information which the member reasonably requires for the purposes of, among other things, understanding the particular investments of the superannuation entity or relevant subplan. This right is extended to include persons who were, within the preceding 12 months, a member of the superannuation entity: see s1017C(9) of the Corporations Act.
- 243 Trustees are not required to make any other public disclosure about the underlying portfolio investments of the fund.
- 244 To that end, the Government has given in principle support to recommendation 4.16 of the Super System review, which recommended that trustees of large APRA funds be required to disclose their complete portfolio holdings on a six-monthly basis in accordance with an outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry. This would require disclosure to APRA within 60 days after the end of each six-month period, corresponding with normal financial years and half-years, and then public disclosure of the same information, on the fund's website, three months later.
- 245 An announcement from the Minister on these and other Stronger Super reforms is anticipated later in 2011.

## ASIC activities

### ASIC activities on hedge fund disclosure

- 246 As part of a broader project on improving disclosure for retail investors, ASIC has considered the particular issues posed for investors in hedge funds (such as many of the Trio funds).

- 247 Inadequate disclosure occurs when the information required to be disclosed under the Corporations Act:
- (a) is not included in the PDS; or
  - (b) is included in the PDS, but it is not clear, concise and effective (e.g. the information is presented in such a dense and complex way that investors are unable to understand the true nature of the investment). This problem can be exacerbated if advertising and other sales practices do not highlight risks and thus give a misleading impression of the product.
- 248 Hedge funds, because of their diverse investment strategies and use of leverage and offshore investments, can pose more diverse and complex risks for investors than traditional managed investment schemes. Given the risks for retail investors associated with investing in hedge funds, and that many rely on disclosure material to inform their decisions to invest, disclosure needs to provide retail investors with all the information they require to make an informed investment decision. In some cases, this may include a decision not to invest in these products.
- 249 ASIC released a consultation paper on 24 February 2011 proposing the introduction of disclosure principles and benchmarks for hedge funds which set out the specific characteristics of the fund that we think ought to be addressed in the PDS: see Consultation Paper 147 *Hedge funds: Improving disclosure for retail investors* (CP 147).
- 250 The disclosure principles and benchmarks are designed to improve disclosure for retail investors to enable more informed decisions about investing in products of this kind, and to make comparisons between the products and business models of different issuers more straightforward. In seeking to improve disclosure, we are aiming to ensure that retail investors have all the information they need to make an informed investment decision. However, this should not be regarded as an indication that we consider these products to be suitable for all or most retail investors.
- 251 We propose that all issuers of hedge funds should disclose information in the PDS about the following key features and risks of the fund:
- (a) investment strategy;
  - (b) investment manager;
  - (c) fund structure;
  - (d) assets—valuation, location, custody;
  - (e) liquidity;
  - (f) leverage;
  - (g) derivatives;
  - (h) short selling;

- (i) periodic reporting; and
- (j) withdrawals.

252 We are currently working through submissions in response to our consultation paper. We intend to publish a draft regulatory guide for further consultation in late 2011.

### **Financial Services Working Group shorter PDS proposals**

253 The shorter PDS regime established by the Corporations Amendment Regulations 2010 (No. 5) is intended to simplify disclosure requirements for certain products to benefit both investors and product issuers alike.

254 In developing the shorter PDS regime, ASIC understands the intention was to exclude schemes that invest in complex financial products, such as structured products, or are hedge funds (complex schemes) from the shorter PDS regime.

255 However, ASIC notes that some hedge funds and complex schemes—despite their complexity—may satisfy the definition of a ‘simple managed investment scheme’ and so meet the criteria for the shorter PDS regime.

### **ASIC’s advice work to improve quality and access to advice**

256 Substantial reform relevant to the advice industry is ongoing as part of the Government’s FoFA reforms. A number of these reforms will necessarily impact on ASIC and the manner in which it regulates the advice industry.

257 ASIC nonetheless has an independent and ongoing program of work designed to improve access to financial advice and ensure a high standard of competency of financial advisers.

### **ASIC’s work on a new training and assessment framework for financial advisers**

258 In April 2011, ASIC released Consultation Paper 153 *Licensing: Training and assessment framework for financial advisers* (CP 153) which proposed amending the assessment and professional development framework for financial advisers by requiring:

- (a) all new and existing financial advisers who provide Tier 1 financial advice to pass a Financial Services Competency Certification exam to ensure they have the requisite competencies to perform their role (Entry Stage);

- (b) all new financial advisers following the Entry Stage to be supervised by a supervisor (who has at least five years experience in the industry) for a minimum period of one year full time or equivalent;
- (c) all financial advisers to undertake a Knowledge Update Review every three years on changes to laws, market issues and new products; and
- (d) ongoing continuing professional development requirements.

259 We are in the process of reviewing the submissions we received to CP 153 and developing our guidance and revised assessment and professional development framework.

260 Our work in this area is intended to enhance and maintain the competence of financial advisers, lead to improvements in the quality of advice and increase consumer confidence.

### **Surveillance of financial advisers and hedge funds**

261 ASIC takes a proactive risk-based approach to its surveillance activities regarding financial advisers and hedge funds. This involves identifying, analysing and evaluating the key risks in our regulated population and focusing our surveillance activities on those areas we consider to be of the highest risk. This program sits alongside our ongoing reactive surveillance work, which is sourced from complaints or breach reports.

262 For risk-based surveillances to be carried out effectively it is essential that ASIC understands and identifies both the key risks in the industry and has up-to-date information on AFS licensees so that it can assess the level of risk and its relative impact at an entity level.

263 ASIC receives information at the point in time when a licence application is made but this is not regularly updated and there are many crucial aspects of a licensed advice business about which ASIC has no current information. Accordingly, for those areas identified as gaps, ASIC requests information to enable it to have a greater understanding of the types of advice provided and strategies and compliance procedures utilised.

264 ASIC has developed a number of risk indicators that use the information received from licensees. These indicators build a picture of each licensee based on the categories of risk identified. Using this information, along with other more reactive inputs, ASIC is able to determine the types of risks that it should focus its resources on and licensees that should be part of its risk-based surveillance program.

265 ASIC is also carrying out 'shadow shopping' research this year. It will be examining the quality of financial advice provided to people at retirement. The definition and gradations of 'quality' retirement financial advice will be

established by ASIC in consultation with an expert reference group that includes both industry and consumer group representation.

266 In the media release when this research was announced, ASIC Chairman Greg Medcraft said:

ASIC is focusing on retirement advice because the numbers of people getting ready to retire is growing, particularly baby boomers. Around 20% of the current super pool is in retirement products, such as de-accumulation products, and this is likely to double over the next decade. It's critical people make good decisions about their retirement and get quality retirement advice to make the most of their retirement savings.

Given the current Future of Financial Advice Reforms, our shadow shopping will not be focused on 'naming and shaming' financial advisers. The objective of the shadow shopping exercise is to define good quality advice to give industry guidance and help consumers maximise their retirement savings.

267 In addition, the retirement shadow shopping research aims to:

- (a) improve ASIC's understanding of how consumers and investors view and experience the retirement financial advice process;
- (b) provide general feedback to the financial advice industry, in particular identifying areas where conduct needs to be improved, and identify areas of suspected misconduct for further action;
- (c) encourage continued professionalisation of retirement advisers; and
- (d) encourage people to seek financial advice when planning for retirement.

### **Financial literacy initiatives**

268 ASIC is responsible for promoting the confident and informed participation of consumers and investors in the financial system: see s1(2) of the ASIC Act. In carrying out this responsibility, ASIC's aim is to foster a financially literate community where Australian consumers can make informed decisions about financial products and services, understand their rights and responsibilities, and be in a position to identify and avoid bad investment choices.

269 For a discussion of ASIC initiatives around financial literacy, see paragraphs 364–384.

## Changes to policy settings

### Improved disclosure at asset level for managed investment schemes

- 270 ASIC believes the Government might consider more stringent disclosure requirements at the asset level of registered managed investment schemes. This could place retail investors and their advisers in a better position to assess the exposure of registered managed investment schemes to particular assets and whether or not an investment should be made in them.
- 271 Importantly, expert commentators on investment matters can use this information to inform the public about the performance of different fund managers and hold managers more accountable for the services they provide. For example, even if individual consumers do not—or cannot—read each of these reports, consumers will find analysis provided by the likes of research houses and comparison sites very useful in assessing and deciding between managed funds.
- 272 These requirements would also be consistent with the Government’s views on the Stronger Super reforms, specifically its support in principle for recommendation 4.16 of the Super System review, which recommended that trustees of large APRA funds be required to disclose their complete portfolio holdings on a six-monthly basis in accordance with an outcomes reporting standard to be developed by APRA in consultation with ASIC and the industry. An announcement from the Minister on these and other Stronger Super reforms is anticipated later in 2011.

### Clarification around the shorter PDS regime

- 273 Consideration might also be given to excluding certain complex schemes from the shorter PDS regime. The inclusion of those schemes as ‘simple managed investment scheme’ products may not promote confident and informed decision making by investors and consistent disclosure standards for complex products. To sufficiently disclose information about these complex schemes, we consider a full PDS is required.

## Summary

- 274 Table 11 summarises the key issues raised by this term of reference, ASIC’s forward program and possible changes to the policy settings that the Government should consider to deal with the issues.

**Table 11: Appropriateness of information and advice provided to investors (TOR 9)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
<p>Managed investment schemes can be complex products, which should be as transparent to the investor as possible.</p>	<p>To help ensure confident and informed investors and financial consumers, and improve transparency, ASIC:</p> <ul style="list-style-type: none"> <li>• is focused on improving disclosure for retail investors and has recently consulted with industry on issues particular to investors in hedge funds;</li> <li>• has an ongoing program of work designed to improve access to financial advice and ensure a high standard of competency of financial advisers; and</li> <li>• has ongoing surveillance and monitoring activities for financial advisers and hedge funds.</li> </ul>	<p>To increase the transparency of registered managed investment schemes, the Government might consider:</p> <ul style="list-style-type: none"> <li>• requiring asset level disclosure for registered managed investment schemes consistent with the 'Stronger Super' reforms; and</li> <li>• excluding certain complex schemes from the shorter Product Disclosure Statement (PDS) regime.</li> </ul>

## F Role of custodians (TOR 11)

### Key points

Custodians are important gatekeepers. However, there may be an expectation gap between what is legally required of custodians and what investors expect the custodian to be doing to safeguard their investment.

ASIC will be commencing a review of custodians with the objective of issuing a public report about this sector and identifying any issues that might need to be addressed by regulatory reform. We will consider how custodians could be more proactive in identifying and reporting suspicious matters involving their clients. We will liaise with AUSTRAC in this regard.

ASIC does not recommend changes at this time pending the outcome of ASIC's 2011–12 review of the sector.

### Key issues

- 275 This section discusses the obligations of custodians given that assets in Trio funds were held by external custodians.
- 276 There may be an expectation gap between what is legally required of custodians, and what investors expect the custodian to be doing in relation to their investments.
- 277 Custodians are important gatekeepers in that they have access to information, including real-time data on the flow of money through investment products, unavailable to ordinary investors.

### What is a custodian?

- 278 A custodian is generally a person who is responsible for safekeeping the assets of a third party client (e.g. a managed investment scheme). The custodian holds legal title to the assets of the client (e.g. property of the managed investment scheme). Typically, management powers and responsibilities in respect of the trust property are undertaken by a separate manager, rather than the custodian. Importantly, the custodian only acts on properly authorised instructions from its direct client or authorised agent.
- 279 The role of a custodian is referred to as a 'bare trustee' because its primary function is to hold legal title of the assets without any discretion as to how the assets are invested or managed. However, unless specifically determined by statute, the duties of a custodian are expressly determined by contract (custody agreement) between the custodian and the client. This agreement may prescribe additional administrative (non-custodial) services to be



provided by the custodian such as fund accounting/reporting, stock lending, facilitating corporate actions and foreign exchange.

280 Most custody providers in Australia are major domestic and international banks or specialised trustee companies.

281 The term ‘custodial services’ is given specific statutory definition in s766E of the Corporations Act. In summary, it is ‘an arrangement ... where the beneficial interest in a financial product ... is held ... by the provider on trust for, or on behalf of, a client, but does not include a managed investment scheme or trustee of a superannuation fund’.

### **How does ASIC authorise and regulate custodians?**

282 ASIC issues AFS licences to authorise entities to provide custodial or depository services for financial products. All AFS licensees must comply with the general obligations under Pt 7.6, Div 3, including s912A of the Corporations Act, such as:

- (a) ensuring the financial services are provided efficiently, honestly and fairly; and
- (b) unless the body is regulated by APRA,<sup>25</sup> having adequate resources (including financial, technological and human resources) to provide the financial services.

283 Additionally, the custodian must comply with Ch 7.8, Div 3 for holding the clients’ property (essentially to segregate the property of different clients and from its own assets). Critically, a custodian is not permitted to mingle custodial-held property with its own assets or otherwise claim proprietary rights to it (e.g. using it as collateral for loans taken out in its own name). Hence, if a custodian should become insolvent, the custodial assets are ‘ring-fenced’ and should typically be returned to the client in the normal course.

284 The Corporations Act does not otherwise prescribe any specific requirements for custodians (in addition to those that apply to all AFS licensees).

### **Regulatory Guide 133**

285 ASIC has issued Regulatory Guide 133 *Managed investments: Scheme property arrangements* (RG 133) which governs the requirements under which registered managed investment scheme property must be held (therefore, it applies to custodians of registered schemes), and more broadly to provision of a custodial or depository service for financial products—for example, as a custodian (other than the trustee) of a superannuation fund. These requirements address:

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<sup>25</sup> APRA will regulate custodians if they are ‘authorised deposit-taking institutions’ within the meaning of the *Banking Act 1959*.

- (a) organisational structure;
- (b) staffing capabilities;
- (c) administrative resources, such as having arrangements in place for holding assets, monitoring internal controls and organised reporting lines; and
- (d) how assets must be held.

### **Regulatory Guide 166**

286 Licensed custody service operators are required by s989B of the Corporations Act to demonstrate compliance with the financial requirements of their AFS licensees. In this regard, ASIC RG 166 stipulates the minimum financial requirements that a custodian should satisfy. In summary, a custodian should at all times have NTA of \$5 million.<sup>26</sup> In some limited circumstances, custodians should meet Adjusted Surplus Liquid Fund requirements up to a maximum of \$100 million.

287 Each financial year, AFS licensees must prepare a true and fair profit and loss statement and balance sheet, and lodge these with ASIC on the prescribed FS70 form. AFS licensees are also required to lodge an Audit Report in the prescribed FS71 form. Both forms must be lodged with ASIC within three months of the end of the financial year.

288 The FS71 Audit Report must address the following:

- (a) the effectiveness of a licensee's internal controls in giving assurance about the conduct of the custodian other than financial product disclosure dealing with client money and other property of clients;
- (b) whether each account required by s981B and 982B has been operated and controlled in accordance with those sections; and
- (c) whether all necessary records, information and explanations have been received from the licensee.

### **APRA's role in regulation**

289 Where a custodian is also an ADI it is subject to APRA's supervision in its capacity as an ADI (including, for example, with regard to capital adequacy). For these reasons, APRA has a role in the supervision of custodians.

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<sup>26</sup> Applicants whose custodial or depository service is incidental to their financial services business or that of a related body corporate usually need only meet base level financial requirements and a requirement of Surplus Liquid Funds of \$50,000. Also, custodians who are ADIs are not required to comply with the \$5 million NTA requirement as they are subject to APRA's own financial requirements.

## AUSTRAC's role in regulation

- 290 The Australian Transaction Reports and Analysis Centre (AUSTRAC) is responsible for the administration of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* and the *Anti-Money Laundering and Counter-Terrorism Financing Rules 2007 (No. 1)* (together, the 'AML/CTF Act'). Relevantly, this requires custodians to make extensive due diligence inquiries when taking on (on-boarding) prospective clients, as well as carrying out suspicious matter reporting thereafter.
- 291 Since 2009, all custodians must conduct due diligence inquiries on clients. The due diligence inquiries entail collecting and verifying the identity of clients for the purposes of reducing the risks of the relevant business being used for money laundering or terrorism financing purposes.

## ASIC activities

### ASIC's forward program

- 292 In 2010–11, ASIC completed a substantial review of the custodian industry, primarily as an information-gathering exercise and to inform ASIC about individual or systemic weaknesses that might warrant regulatory intervention and reform. ASIC reviewed over 20 custodians and made inquiries regarding, in particular, the custodians' operational and compliance processes and systems. This included a review of the detection and reporting by licensed custodians of breaches to ASIC in a previous 12-month period.<sup>27</sup>
- 293 The review of the breaches reported to ASIC under s912D found that they related to contraventions of s912A of the Corporations Act (general obligations of AFS licence holders) as well as breaches of the client property provisions. In some cases it appeared that the level of breach reporting was less than might have been expected.
- 294 In 2011–12, ASIC will be commencing a further review of custodians and their business with the objective of issuing a public report about this sector. The issue of the level of reporting by custodians (identified in the 2010–11 review) will be further explored.

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<sup>27</sup> AFS licensees are required under s912D of the Corporations Act to report to ASIC breaches or likely breaches of the obligations imposed on them under the Corporations Act if the breaches or likely breaches are significant as defined in the Corporations Act.

## Changes to policy settings

- 295 ASIC makes the following observations as they affect adequacy of the current regulatory arrangements:
- (a) APRA plays a role in the regulation of custodians, thereby supporting ASIC's function;
  - (b) the introduction of the AML/CTF Act and the requirement to 'Know Your Client' in 2009 should further strengthen the regulatory regime; and
  - (c) there are other means by which regulation occurs—for example, a custodian will typically provide an external audit report (GS 007) to the investment management service organisations to which it provides custodial services.
- 296 ASIC will be conducting a further review of the custodian industry in 2011–12 and will have an opportunity to identify systemic weaknesses (and ultimately recommendations to rectify these). Critically, ASIC will consider how to ensure that custodians fulfil a genuine gatekeeper function.
- 297 For example, ASIC is proposing to liaise with AUSTRAC and industry regarding the 'suspicious matter reporting' obligations of custodians under the AML/CTF Act. ASIC proposes to ascertain the extent to which custodians are currently required to identify and report suspicious behaviour of their clients and those that are authorised to act on the client's accounts, including assessing the veracity of authorised instructions (e.g. where the fund manager provides an instruction to the custodian to direct payment to a third party account).
- 298 ASIC will consider whether further obligations are necessary, in addition to those in the anti-money laundering regime and will liaise with the Government as to our findings. The advantages of any additional regulation to custodians (and the ultimate cost passed on to the managed fund and superannuation industry) should be measured against any possible mischief that increased regulation is likely to identify.

## Summary

- 299 Table 12 summarises the key issues raised by this term of reference, ASIC's forward program and possible changes to the policy settings that the Government should consider to deal with the issues.

**Table 12: Role of custodians (TOR 11)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
<p>There may be an expectation gap between what is legally required of custodians and what investors expect the custodian to be doing to safeguard their investment.</p>	<p>In 2011–12, ASIC will review custodian businesses with the objective of issuing a public report about this sector and identifying any issues that might need to be addressed by regulatory reform.</p> <p>ASIC will consider the extent to which custodians are required to identify and report suspicious behaviour and activity of their clients.</p>	<p>Following the outcome and findings of ASIC's 2011–12 review of the sector, the Government might consider whether custodians would be more effective gatekeepers if they were required to identify and report suspicious behaviour and activity of their clients. However, no change is recommended at this time.</p>

## G Role of research houses in product promotion and confidence (TOR 10)

### Key points

The global financial crisis and recent publicised corporate collapses have highlighted issues around the appropriate use of research as part of the investment and advice process.

ASIC plans to publish a consultation paper later this year with proposals on strengthening regulatory policy to address current issues in the sector.

The Government might consider:

- requiring research houses to have a reasonable basis for their advice;
- banning payments by issuers for research;
- requiring research houses to publish all research they prepare (including adverse findings); and
- stronger disclosure requirements for research houses and rating agencies to make the methodology used by these entities transparent, and enable users of research to assess the performance of the research house and the quality of that research.

### Key issues

- 300 This section discusses the role and regulation of research houses given that some of the investment products that failed in Trio were covered by research houses.
- 301 The global financial crisis and recent publicised corporate collapses have highlighted issues around the appropriate use of research as part of the advice process. Some of the investment products that failed in these instances were covered by research houses and were highly rated or had positive recommendations published about them at, or close to the time, they failed.
- 302 Consequently, there is concern both in Australia and overseas about:
- (a) potential conflicts of interest in the production of research;
  - (b) whether research houses are managing these conflicts adequately; and
  - (c) whether research houses are otherwise providing high quality, appropriate and compliant services.
- 303 Many users of research are financial advisory firms, which typically use research houses as a risk screening mechanism to identify products for inclusion on their approved product lists (APLs). Many retail clients and

their advisers rely, at least in part, on expert research in making investment decisions and formulating financial advice.

304 It is clear that research houses have a ‘gatekeeper’ function in the market place. In particular, research can influence, including through the process of constructing APLs, which products individual advisers recommend to their clients. On that basis, research quality and transparency is important in ensuring that clients receive appropriate advice.

### What is a research house?

305 The Corporations Act does not define research as a particular product distinct from ‘general advice’. Therefore, no specific licence authorisations are required to operate a research business.

306 Although there is no established definition of a research house, research houses can be broadly defined as:

... firms that provide objective, independent ratings (except credit ratings), recommendations or opinions on financial products (e.g. managed funds, structured products, superannuation funds and insurance products). They may rate quoted or unquoted products.<sup>28</sup>

307 In 2004 ASIC published Regulatory Guide 79 *Managing conflicts of interest: An ASIC guide for research report providers* (RG 79). RG 79 is specifically targeted at licensees who are traditional providers of research on investment products—known variously as research analysts, securities analysts or research houses.

308 RG 79 defines a research report as general advice that:

- (a) is in writing;
- (b) includes an express or implicit opinion or recommendation about a named or readily identifiable investment product; and
- (c) is intended to be, or could reasonably be regarded as being intended to be, broadly distributed (whether directly or indirectly) to clients (whether wholesale or retail) in Australia.

309 ASIC recently reviewed the research house industry to identify current regulatory issues within the research house sector and to determine whether further regulatory action or guidance was warranted. This review identified the following key issues:

- (a) conflicts of interest;
- (b) research quality;
- (c) transparency; and

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<sup>28</sup> Joint ASIC/Treasury report, *Review of credit rating agencies and research houses*, October 2008, p. 23.

- (d) reliance by users of research.

### Conflicts of interest

- 310 Research houses' businesses can present a number of conflicts of interest. These can broadly be categorised as:
- (a) revenue model conflicts, arising from the fact that product issuers often pay research houses to produce product ratings;
  - (b) ancillary business conflicts, which arise when a research house (or an associated company) operates a business that complements, but could also make preferential use of, the research house's research (e.g. associated companies that operate a managed fund); and
  - (c) analyst conflicts, which may arise between individual research staff and the research house, its commissioning clients or end-users.
- 311 All research houses that provide general advice are required to be licensed. Under the Corporations Act, licensees are obliged (among other things) to have adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to the provision of financial services by the licensee, or a representative of the licensee, as part of the financial services business of the licensee or the representative (the 'conflicts management obligation'): see s912A(1)(aa).
- 312 Other licensee obligations that will apply to research houses include:
- (a) the obligation to do all things necessary to ensure that their financial services are provided efficiently, honestly and fairly (s912A(1)(a));
  - (b) the obligation to comply with financial services laws and to take reasonable steps to ensure their representatives do likewise (s912A(1)(c) and (ca));
  - (c) the obligation to have adequate compliance arrangements (reg 7.6.03(g) and Pro Forma 209 *AFS licence conditions* (PF 209));
  - (d) where general advice is given—the obligation to warn a client that advice does not take into account the client's objectives, financial situation or needs (s 949A); and
  - (e) a range of prohibitions, including those for misleading or deceptive conduct in the provision of financial services, dishonest conduct, unconscionable conduct and insider trading: see Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181) at RG 181.17.
- 313 ASIC has provided detailed guidance on the management of conflicts of interest generally. RG 181 sets out:



- (a) our general approach to compliance with the statutory obligation to manage conflicts of interest in s912A(1)(aa) (the conflicts management obligation);
- (b) guidance for licensees generally on controlling and avoiding conflicts of interest; and
- (c) guidance for licensees generally on disclosing conflicts of interest.

314 It also includes some issues for licensees to consider in complying with their obligations: see the Schedule to RG 181.

315 ASIC has also provided specific guidance to the research industry on compliance with the law and good practice. RG 79 is specifically targeted at licensees who are research report providers.

### **Research quality**

316 In ASIC's experience, most research houses appear to have research processes in place that include ratings committee sign-off or peer review. Senior research staff members are also usually qualified and experienced. However, there are some concerns among users of research about whether the skill and experience of, especially more junior, research analysts is sufficient to conduct effective analysis of relevant products.

317 Other possible issues relating to issues of research quality include:

- (a) whether research houses devote sufficient resources to individual reviews or review an appropriately wide range of products (some users thought the range was too narrow, others too wide);
- (b) the depth of 'due diligence' conducted by research houses;
- (c) the fact some investment products that have collapsed in recent years were the subject of positive research at, or close to, the time of their collapse. This may also indicate a wider issue with the expectations of some users that research houses have the ability to accurately forecast or predict product collapses; and
- (d) whether research houses' internal systemic reviews of ratings by sector, and updates to product issuers in the event of any material changes to ratings, do not occur in a sufficiently timely manner.

### **Transparency**

318 There is often a lack of transparency about the methodology used to arrive at product recommendations, opinions and ratings. At present, there are no industry-wide standards for the disclosure of research methodology or, indeed, of the meaning of particular ratings. For example, it is not always made clear whether ratings are opinions about the absolute quality of a product or its quality relative to peers in a particular category.

319 In addition, there is a lack of consistency in the presentation of research ratings, which makes meaningful comparison difficult.

### **Reliance and users**

320 While research provides relevant facts about a product, not all research reports are comprehensive or exhaustive. Advisers are generally expected to conduct further research into a product before recommending it to clients. For example, many licensees have a product or investment committee which engages with the research houses about issues they need to clarify.

321 Currently, there appears to be different degrees of reliance on research houses. Some financial advisers utilise research houses as their main source of investigation into products. ASIC believes that a high rating alone from a research house or a rating agency is not sufficient basis for an investment decision.

322 There appears to be a level of ‘mismatch’ between what is expected of research houses and what research houses offer or produce. It is this ‘mismatch in expectations’ that has fed criticisms in the ability of research houses to promote product confidence in the market place.

## **ASIC’s activities**

323 As a result of ASIC’s research house review, ASIC plans to publish a consultation paper later this year with proposals on strengthening our current regulatory policy to ensure the current issues in the research industry are addressed. Based on ASIC’s findings, there are:

- (a) some new issues ASIC believes it is appropriate to give guidance and express expectations on; and
- (b) some issues ASIC previously expressed views on that need to be refined and updated.

324 At the same time, we will also be raising awareness of our expectations, through targeted education and surveillance activities.

325 Following the consultation process, ASIC will publish an updated regulatory guide for research providers (including research houses). We will monitor compliance with the guidance and expectations in the final guide. We expect this will include a specific surveillance project about 12–24 months after publication of the final guide.

326 If it appears necessary and appropriate, we will consider periodic review of compliance with the guidance and expectations. This could take a variety of forms, including:

- (a) a periodic survey or questionnaire;
- (b) a periodic notice to licensees to provide information and documents to ASIC; or
- (c) a periodic (e.g. annual) compliance report lodged with ASIC (either on a best practice or mandatory basis).

327 ASIC may recommend further law reform in this area if needed following this project.

328 A mandatory annual compliance report was proposed by Senator Sherry in 2008 and a similar approach is being currently developed for credit rating agencies: see Consultation Paper 160 *Credit rating agencies: IOSCO Code Annual Compliance Report* (CP 160). We are considering similar requirements for some or all research report providers.

## Changes to the policy settings

329 In the event that the Government considers further action is warranted, ASIC believes the Government might consider:

- (a) requiring research houses to have a reasonable basis for their advice;
- (b) requiring research houses not to accept payment from product issuers for research (i.e. avoid this conflict of interest);
- (c) requiring research houses to publish all research they prepare (including adverse findings); and
- (d) stronger disclosure requirements for research houses and rating agencies to:
  - (i) make the methodology used by these entities transparent; and
  - (ii) enable users of research to assess the performance of the research house and the quality of that research.

330 Financial advisers are specifically obliged to have a reasonable basis for any personal advice: s945A of the Corporations Act. Research reports, while general advice, are extensively relied on by wholesale and retail investors. As such, the providers should arguably be obliged to have a reasonable basis for any research they provide.

331 Overseas, particularly in the US,<sup>29</sup> there are new precedents being set with court cases against rating agencies and asset consultants. Research houses and rating agencies have been asked to verify and show evidence for their research.

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<sup>29</sup> Alison Bevege, 'Legal threats loom over research-based advice', *Financial Standard*, vol. 9(13), 2011, p. 1.

- 332 In ASIC's submission to the FPS Inquiry, ASIC stated:
- Remuneration of research houses is commonly paid by the product issuer, which creates an obvious conflict of interest and has the potential to distort the quality of research reports often used by advisers in making product recommendations to clients. A user-pays model for research house remuneration might help improve the quality of the research used by advisers.
- 333 ASIC is aware of views that the revenue model based conflict of interest of greatest industry concern is that of issuers commissioning and paying for research reports. The Committee could consider whether such payments are conflicts that should be avoided completely.
- 334 A related issue is ensuring that all research is published, including unfavourable research. We understand that some research houses do not consistently publish negative research, or only make it available very briefly on their subscription service or website. Whether this is 'self-censorship' or at the request of product issuers, we suggest that this is an issue that the Committee may wish to consider.
- 335 Stronger disclosure requirements for general advice could also be introduced for research houses and rating agencies. Users of research would also benefit from greater transparency about the methodology involved and the performance of the research provider.
- 336 Research houses should publish sufficient information to allow users to form a view about the research house's own performance and therefore the quality of their research. A user of a research report will benefit from having access to a comparison between the performances of products at each rating level against a relevant benchmark.
- Note: For example, they could publish the average performance of all equity funds given the highest rating against the ASX 200 benchmark, the average performance of all equity funds given the next highest rating against the benchmark, and so on. We expect that for robust research houses, higher rated products would, over the longer term, outperform lower rated products.

## Summary

- 337 Table 13 summarises the key issues raised by this term of reference, ASIC's forward program and possible changes to the policy settings that the Government might consider to deal with the issues.

**Table 13: Role of research houses in product promotion and confidence (TOR 10)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
<p>The global financial crisis and recent publicised corporate collapses have highlighted issues around the appropriate use of research as part of the investment and advice process.</p>	<p>To ensure research houses fulfil their role as effective gatekeepers, ASIC plans to publish a consultation paper later this year with proposals on strengthening regulatory policy to address current issues in the sector.</p>	<p>The Government might also consider:</p> <ul style="list-style-type: none"> <li>• requiring research houses to have a reasonable basis for their advice;</li> <li>• banning payments by issuers for research;</li> <li>• requiring research houses to publish all research they prepare (including adverse findings); and</li> <li>• stronger disclosure requirements for research houses and rating agencies by: <ul style="list-style-type: none"> <li>– making the methodology used by these entities more transparent; and</li> <li>– enabling users of research to assess the performance of the research house and the quality of that research.</li> </ul> </li> </ul>

## H Suitability of managed investment scheme investments for retail investors (TOR 11)

### Key points

Neither the Corporations Act nor ASIC policies impose any restrictions on the investment strategy of registered managed investment schemes.

To help investors understand investment strategies and how risky they might be, ASIC has an ongoing program of work to improve the financial literacy of consumers and investors in addition to its work on improving disclosure for retail investors.

In its submission to the FPS Inquiry, ASIC suggested a number of reforms to shift the balance between market efficiency and investor protection under the FSR regime more in favour of retail investors.

### Key issues

338 This section discusses the suitability of some registered managed investment scheme investments for retail investors. The issue is raised because of the complex products in which Trio investors were able to invest.

#### **No restrictions on investments by registered managed investment scheme**

339 Neither the Corporations Act nor ASIC policies impose any restrictions on what a registered managed investment scheme may invest in. Before June 2007,<sup>30</sup> registered managed investment schemes were prohibited from investing in managed investment schemes that were not registered under Ch 5C of the Corporations Act. The restrictions were intended to prevent a responsible entity from establishing or investing in unregistered managed investment schemes, including foreign collective investment structures, to avoid the protections for scheme assets that normally apply to registered managed investment schemes. ASIC provided limited exemptions to allow certain investments in managed investment schemes to be held, even though the managed investment scheme receiving the investment was not a registered managed investment scheme in a number of circumstances.

340 The restrictions were removed by legislative amendment in recognition of registered managed investment schemes increasingly seeking to diversify their investments and that such investments are not generally made for the purpose of avoiding regulation. The restriction on what a registered managed

<sup>30</sup> Section 601FC(4) was repealed with effect from 28 June 2007.

investment scheme may invest in proved difficult to maintain in light of commercial pressures to allow many legitimate foreign investments.

### **Purpose and framework of registering managed investment schemes**

341 The purpose behind the regime requiring registration of managed investment schemes is to ensure that all collective investments that receive investments from retail investors are clearly identifiable for regulatory and general information purposes.<sup>31</sup>

342 There is a prescribed principles-based statutory framework in the Corporations Act for the registration of a managed investment scheme. Section 601EB sets out the requirements that must be met before ASIC can register a managed investment scheme. These requirements include that there must be:

- (a) an application that sets out the name and address of the registered office of the proposed responsible entity and the name and address of the person who has consented to be the auditor of the compliance plan;
- (b) a responsible entity that is a public company that holds an AFS licence authorising it to operate a managed investment scheme;
- (c) a constitution that meets s601GA and 601GB of the Corporations Act;
- (d) a compliance plan that meets s601HA of the Corporations Act;
- (e) arrangements in place for the annual audit of the compliance plan; and
- (f) a statement by the directors of the proposed responsible entity that the managed investment scheme's constitution complies with s601GA and 601GB of the Corporations Act and the managed investment scheme's compliance plan complies with s601HA of the Corporations Act.

343 ASIC *cannot* refuse to register the managed investment scheme if it meets the requirements in s601EB of the Corporations Act.

344 A constitution of a registered managed investment scheme is a legally enforceable document that sets out the rights, duties and liabilities of the responsible entity in its operation of the managed investment scheme. The constitution is required by s601GA of the Corporations Act to contain, as a minimum, information about the issue and redemption price of interests in the managed investment scheme, the investment powers of the responsible entity, the complaints process for investors, how the managed investment scheme will be wound up, the fees and expenses investors can be charged, the borrowing powers of the responsible entity and how investors can

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<sup>31</sup> Corporations and Markets Advisory Committee, *Collective investments: Other people's money*, September 1993.

withdraw their investment. ASIC is not required to register a managed investment scheme unless this information is included in the constitution.

345 We have detailed previously the requirements for a compliance plan of a registered managed investment scheme.

346 The principles-based statutory framework is supplemented by policy published by ASIC that seeks to provide further guidance for responsible entities about how they can meet the statutory framework. Regulatory Guide 134 *Managed investments: Constitutions* (RG 134) provides guidance for responsible entities on how ASIC believes they might meet the minimum content requirements for a constitution as required in s601GA and 601GB of the Corporations Act.

347 Regulatory Guide 132 *Managed investments: Compliance plans* (RG 132) provides guidance for responsible entities on how ASIC believes they might meet s601HA of the Corporations Act. RG 132 does not include a checklist of what must be built into a compliance plan, but it does list examples of scenarios that should be assessed in the compliance plan. In addition, there are ‘compliance plan commentaries’ that list ASIC’s view of what compliance plans for certain types of registered managed investment schemes should include.<sup>32</sup>

### **The process undertaken to register managed investment schemes**

348 A responsible entity that wishes to request ASIC register a managed investment scheme must prepare and lodge an application that is in the prescribed form or contains the prescribed information. If an application is not in the prescribed form or does not contain the prescribed information, ASIC can refuse to accept it or can refuse to register the managed investment scheme. The application comprises:

- (a) Form 5100 *Application for registration of a managed investment scheme* (Form 5100) that is signed and dated. This form sets out the basic details about the managed investment scheme, including the name of the managed investment scheme, the name of the responsible entity, the name and licence number of the auditor and asset type of the managed investment scheme;
- (b) Annexure to Form 5100, which cross-references the contents of a constitution required by s601GA and 601GB of the Corporations Act to the equivalent provisions in the managed investment scheme’s constitution;

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<sup>32</sup> See RG 116, RG 117, RG 118, RG 119 and RG 120.



- (c) the constitution of the managed investment scheme (this is not a prescribed form), which must be executed and dated;
- (d) the compliance plan of the managed investment scheme (this has no prescribed form), which must be signed by all directors; and
- (e) Form 5103 *Director's statement relating to an application for registration of a managed investment scheme* (Form 5103) that is signed and dated by all directors. This form requires the directors of a responsible entity to certify that the application to register the managed investment scheme meets the prescribed requirements for applications to register managed investment schemes.

349 ASIC is not required by statute to obtain information about, or assess, the business model or underlying assets of the managed investment scheme. Rather, ASIC's function in registering managed investment schemes is to ensure that each managed investment scheme meets the minimum statutory requirements as set out in s601EB of the Corporations Act and ensure that all managed investment schemes are clearly identifiable in its register.

350 After ASIC receives an application to register a managed investment scheme, the assessment of it is conducted according to a set process.

### **Suitability of complex assets for retail investors**

351 The suitability of an investment to an investor depends on the personal circumstances of the investor, including, for example, the risk appetite of the investor, the risk profile of the investor's investment portfolio, the investor's investment horizon, the investor's ability to understand the risk characteristics of the product taking into account any advice the investor receives, and the investor's capacity to track the performance of the financial product, personally or through an adviser.

352 In a direct investment situation, it is important that an investor makes an assessment of the product in light of these risk factors before investing, and then throughout the life of the investment.

353 However, when an investor invests in a registered managed investment scheme managed by a responsible entity, or a professional investment manager acting on the responsible entity's behalf, the investor relies on the responsible entity to assess the risks of the particular financial products that the managed investment scheme invests in (the underlying assets) and implement strategies to manage such risks, consistent with any disclosures to the investor (e.g. by diversification). The investor still needs to assess the suitability of an investment in the registered managed investment scheme and, for this purpose, will generally be given a PDS.

- 354 A PDS provides information about the responsible entity, the professional investment manager, the managed investment scheme's investment strategy, the kinds of investments that are to be held as scheme assets and the risks of investment.
- 355 Investment in some assets through a registered managed investment scheme may be suitable for a retail investor even in cases where direct investment by the retail investor would not be suitable. To the extent that a retail investor can be confident of the performance of the responsible entity, the complexity of a product may be of lesser importance, as may the difficulty in the retail investor monitoring the investment. In some cases, the managed investment scheme may create diversification in the underlying assets, reducing the need for diversification in the investment portfolio of the investor.
- 356 However, where the responsible entity fails to assess, monitor or manage the risks in investing in the underlying assets, or if the responsible entity fails to implement the strategies disclosed in the PDS, even in the absence of fraud, the investors will be exposed to risks they are unlikely to be prepared or equipped to take.
- 357 Accordingly, the question as to which investments may be regarded as suitable for retail investors indirectly through a registered managed investment scheme is therefore related to the adequacy of regulation of the responsible entity of the managed investment scheme.
- 358 To make it reasonable for a retail investor to rely on the responsible entity performing its duties, there needs to be robust and effective regulation and compliance arrangements. This might entail:
- (a) sufficient arrangements to ensure that all investments were made in accordance with the responsible entity's duties;
  - (b) that the investments were regularly and appropriately valued;
  - (c) that there were appropriate custodial arrangements; and
  - (d) that any material related party transactions were independently assessed.
- 359 Our recommendations on compliance plans are relevant in this regard.
- 360 Other than the failure of the responsible entity, another factor that can heighten the risk for a retail investor is gaining exposure to a financial product through a 'multiple layer' structure in that a registered managed investment scheme invests in one investment vehicle (e.g. company, managed investment scheme or derivative), which in turn may invest in another investment vehicle.
- 361 It is not an uncommon practice in the industry that a registered managed investment scheme invests in another managed investment scheme to gain

particular exposure to underlying assets in a cost effective way (e.g. a retail feeder fund investing in wholesale funds that has greater economies of scale). It is therefore not necessarily unsuitable for retail investors to be indirectly invested in intermediary investment vehicles.

362 However, the multiple layer structure may create difficulties in identifying an investor's ultimate exposure through an investment and the extent of exposure to a particular financial product or type of financial product that may arise indirectly through multiple investment vehicles. The risks associated with multiple layer investment can be exacerbated where multiple layer investment occurs in foreign jurisdictions where regulatory oversight is not as thorough.

## ASIC activities

363 Given the economic philosophy of the FSR regime (i.e. markets operate most efficiently with minimum regulatory intervention), ASIC has two main tools to try and address the issue that complex investments are freely available to retail investors: improved disclosure (discussed in Section E); and financial literacy initiatives.

### **Initiatives to assist Australians to make better financial decisions**

364 One of ASIC's key priorities is to promote the confident and informed participation of consumers and retail investors in the Australian financial and credit systems: see s1(2) of the ASIC Act.

365 In order to deliver on this key priority, ASIC is working to implement the National Financial Literacy Strategy and other initiatives to help investors make better financial decisions.

366 The aim is to foster a more financially literate community where Australian consumers can make better informed decisions about financial products and services, understand their rights and responsibilities, and be in a position to identify and avoid bad investment choices.

### **National Financial Literacy Strategy**

367 From 1 July 2008, ASIC assumed the responsibilities of the former Financial Literacy Foundation and became responsible for leading the Australian Government's financial literacy work in consultation with the Financial Literacy Board.<sup>33</sup>

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<sup>33</sup> See [www.flb.gov.au](http://www.flb.gov.au).

368 This led to the development of the National Financial Literacy Strategy,<sup>34</sup> which was prepared by ASIC in consultation with key financial literacy partners and stakeholders, and after considerable research into what Australians know about, and do with, their money. The National Financial Literacy Strategy builds on existing initiatives in Australia and overseas, and has benefited from the input of the Financial Literacy Board which also endorsed the strategy.

369 In delivering the National Financial Literacy Strategy, ASIC is involved in four key streams of work:

- (a) delivering financial literacy programs;
- (b) ensuring access to independent information and tools;
- (c) looking beyond education to solutions that promote financial wellbeing; and
- (d) developing partnerships with industry and the community.

#### **Delivering financial literacy programs**

370 A core part of the National Financial Literacy Strategy is to foster the skills, knowledge, attitudes and values needed to build financial resilience through ‘education pathways’.

371 This involves embedding financial literacy into the core curriculum of schools and higher education institutions through a National Framework.

372 The National Framework focuses on:

- (a) understanding money—for lower primary students;
- (b) consumer literacy—for upper primary students;
- (c) personal finance—for lower secondary students; and
- (d) money management—for upper secondary students.

373 To further this work, ASIC is in the process of rolling out teacher training to 6000 teachers Australia-wide and is also developing online teacher training modules to link to the National Framework. We are also working to assist businesses with financial literacy programs for their staff.

#### **Ensuring access to independent information and tools**

374 As part of the National Financial Literacy Strategy, ASIC recently launched its new MoneySmart website.<sup>35</sup> New media such as YouTube, Facebook and Twitter are also being used to expand access to MoneySmart.

<sup>34</sup> See ASIC report *National Financial Literacy Strategy* (REP 229).

<sup>35</sup> See [www.moneysmart.gov.au/](http://www.moneysmart.gov.au/).

375 To date the website has received a significant number of visitors and generated many requests for publications. This website replaced the previous FIDO website which delivered consumer information and tips, and aims to give consumers and investors an easy to access, ‘one-stop-shop’ for independent information (including online tools and resources such as budget planners and calculators) so investors can make more informed and therefore better financial decisions.

376 The MoneySmart website contains information on a range of topics, including borrowing and credit, superannuation and retirement, SMSFs and investing in more complex products.<sup>36</sup>

377 The next stage in the development of the MoneySmart website is to look at providing more tools and information so Australians can be taken on a journey, starting from engagement with their financial circumstances and needs, to knowledge about investing and personal goal setting and ultimately being able to receive personal guidance and ongoing support to help them follow through on achieving the goals they have set.

378 We also provide access to information and tools through a range of other mechanisms such as our publications program.

379 A recent education initiative is the ‘Investing between the flags’ initiative, which aims to help investors with basic tips on how to make better investment decisions. The initiative includes the delivery of information through booklets and seminars and grew out of a number of collapses following the global financial crisis where it became apparent that many investors did not understand investing basics (e.g. how to diversify their investments).

#### **Looking beyond education to promoting financial wellbeing**

380 The National Financial Literacy Strategy acknowledges that to complement our financial literacy work, other regulatory responses or ‘nudges’ may be necessary to not only properly protect, but also promote, confident and informed investors.

381 These other regulatory responses may include investor-friendly default options to ‘opt in’ or ‘opt out’, improved disclosure and/or improved product design by way of ‘suitability’ requirements for retail investors. Having good default options in superannuation was recognised by the Cooper-led review into the superannuation system review, whose recommendations are now being implemented as part of the Australian Government’s Stronger Super reforms.

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<sup>36</sup> See [www.moneysmart.gov.au/investing/complex-investments](http://www.moneysmart.gov.au/investing/complex-investments).

### Developing partnerships

- 382 The development of the National Financial Literacy Strategy recognises that partnerships with other cross-sectors are crucial to being able to collaboratively raise financial literacy levels in Australia. To further this, ASIC is continuing to work on developing cross-sectoral partnerships.
- 383 We have formed our first ever national, cross-sectoral Financial Literacy community of practice group which brings together up to 90 people each month, from across Australia and New Zealand and from all of the sectors working in the financial literacy space. The group meets via video conference link up on a monthly basis to share information, build networks and promote best practice on financial literacy.
- 384 We also continue to work with members of our Consumer Advisory Panel and other consumer/community organisation partnerships to help deliver our financial literacy messages and share information and ideas.

### Changes to policy settings

- 385 In ASIC's submission to the FPS Inquiry, ASIC suggested a number of possible reforms that would shift the balance between market efficiency and retail investor protection more in favour of retail investors.
- 386 In particular, ASIC suggested the Government could consider:
- (a) a duty of suitability for product issuers and intermediaries. This would require product manufacturers and/or distributors to take some responsibility for ensuring products are sold to the right investors; and
  - (b) amending the regulatory regime to prohibit the sale of certain products to retail investors or place limitations on the design of products sold to retail investors, in order to safeguard investors from high-risk or unsuitable products.
- 387 These two suggestions may not be aligned with the economic philosophy underlying the FSR regime (i.e. the efficient markets theory: see Section A). As such, the issue of whether there is a need for such a fundamental review of the regime is a policy matter for Government. To that end, we note the final report of the FPS Inquiry which stated:

The committee is of the opinion that it is not for the parliament or the government to determine for whom particular investment products are appropriate. This is a decision for individual investors, in consultation with a financial adviser bound by a fiduciary duty to put their clients' interests ahead of their own.<sup>37</sup>

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<sup>37</sup> Para 6.170 of FPS Inquiry final report.

## Summary

388 Table 14 summarises the key issues raised by this term of reference, ASIC's forward program and possible changes to the policy settings that the Government might consider to deal with the issues.

**Table 14: Suitability of managed investment scheme investments for retail investors (TOR 11)**

Key issues	ASIC's forward program	Regulatory change options for consideration by Government
Neither the Corporations Act nor ASIC policies impose any restrictions on the investment strategy of registered managed investment schemes.	To help investors understand investment strategies and how risky they might be, ASIC has an ongoing program of work to improve the financial literacy of consumers and investors in addition to its work on improving disclosure for retail investors (detailed in Section E).	In its submission to the FPS Inquiry, ASIC suggested a number of reforms to shift the balance between market efficiency and investor protection struck by the FSR regime more in favour of retail investors.

## I Dual regulated entities (TOR 11)

### Key points

Dual regulated entities are subject to oversight by both APRA and ASIC.

To minimise the risks of regulatory arbitrage and to promote an efficient regulatory system, ASIC works closely with APRA to ensure a coordinated approach to the regulation of dual regulated entities.

### Key issues

389 This section discusses issues that arise when an entity is regulated by more than one regulator, as was the case in Trio.

#### Oversight arrangements for dual regulated entities

390 There are approximately 33 entities that hold both:

- (a) an AFS licence to operate as a responsible entity; and
- (b) a registrable superannuation entity (RSE) licence to operate as a registrable superannuation entity. These entities are known as dual regulated entities.

391 A summary of the obligations of RSEs under the *Superannuation Industry (Supervision) (SIS) Act 1993* (SIS Act) and responsible entities is set out below.

#### APRA-regulated superannuation entities

392 A trustee of an RSE (or RSE licensee) must at all times:

- (a) comply with the fund's governing rules and provisions of the SIS Act, including the statutory covenants under s52 of the SIS Act;
- (b) meet the prudential requirements under its RSE licence;
- (c) maintain adequate financial, technical and human resources to operate as a trustee under the SIS Act;
- (d) maintain minimum standards of fitness and propriety for superannuation fund trustees;
- (e) comply with a risk management strategy which is specific to the trustee and specific for any RSE for which the trustee acts in the capacity of trustee; and
- (f) ensure that any outsourcing arrangements are conducted under proper and enforceable agreements.



393 RSEs are generally subject to periodic supervisory reviews of their compliance with RSE licence conditions, which include compliance with the trustee's established risk management strategy and risk management plan.

### **Managed investment schemes**

394 A responsible entity of a registered managed investment scheme must at all times:

- (a) comply with the scheme's constitution and the scheme's compliance plan;
- (b) meet the requirements under its AFS licence;
- (c) if it is not an APRA-regulated entity, have adequate financial, human and technological resources to operate under its AFS licence;
- (d) maintain competence to provide financial services and ensure that its representatives are adequately trained and are competent to provide those financial services;
- (e) if it is not an APRA-regulated entity, have adequate risk management systems;
- (f) ensure the responsible entity, its officers and employees perform specific duties in accordance with Pt 5C.2 of the Corporations Act; and
- (g) as a public constitutional company, ensure the directors comply with their statutory directors' duties obligations under the Corporations Act.

Note: The differences in regulatory oversight are summarised in more detail in Appendix 2.

### **Differences in obligations of RSEs and responsible entities**

395 There are two key differences in the obligations under the Corporations Act for dual regulated entities. Dual regulated entities are excluded by the Corporations Act from the obligations to have:

- (a) adequate resources, including financial, technical and human resources (s912A(1)(d)); and
- (b) adequate risk management systems, including a risk management statement (s912A(1)(h)).

396 This is on the basis that these issues are regulated under the SIS Act by APRA and it would be duplicative for ASIC to also require adequate resources or review risk management arrangements.

397 For example, a risk management strategy for a dual regulated entity would ordinarily be expected to address the risk to the RSE licensee from the responsible entity or other business, and perhaps even the registered managed investment schemes themselves. Further, dual regulated entities have not tended to separate the staffing or management of their

responsibilities under the different lines of business (e.g. responsible entity, RSE and financial planning) and policies such as business strategy, risk management, compliance and investment management usually cover all three areas of the business.

398 The obligations under the Corporations Act for dual regulated entities are otherwise the same as for all other managed investment schemes.

399 ASIC generally does not adopt a significantly different regulatory approach for responsible entities that are dual regulated entities from those that are not, except in relation to adequate resources and adequate risk management systems. ASIC conducts normal proactive and reactive surveillance activities described below in relation to dual regulated entities as for other responsible entities. For example, ASIC conducted a ‘trustee for hire’ proactive surveillance activity in 2010–11, which included dual regulated entities.

#### **Dual-regulated entities: Licensing**

400 When an entity is regulated by both APRA and ASIC, it applies for an AFS licence under the ‘composite’ process. This means the entity does not have to demonstrate to ASIC under s912A that it has available adequate resources (including financial, technological and human resources) to provide the financial services covered by the licence. The rationale is that APRA will consider these issues, thereby making the application process more efficient as each regulator considers the issues most relevant to its areas of responsibility.

#### **Surveillance of financial reporting of superannuation funds**

401 Currently, no Australian regulator undertakes regular surveillance of the financial reports of regulated superannuation funds, approved deposit funds and pooled superannuation trusts (super entities) or related audit firm inspections. These entities exclude SMSFs.

402 The arguments in support of the regulation of super entity financial reporting and audit are:

- (a) significant investor monies are held in super entities and regulation will assist in ensuring accountability of trustees;
- (b) regulation will support confidence and informed decisions by trustees and investors, particularly in the context of superannuation choice;
- (c) investors may not currently be aware that there is no regulation and this information could impact on investor confidence;
- (d) auditors of SMSFs will be subject to registration by ASIC and oversight by the ATO; and

- (e) it would be inconsistent to have greater protection for SMSFs than for super entities.

### Which regulator should assume responsibility?

- 403 Treasury, APRA and ASIC are all aware that there is a regulatory vacuum which might increase the risk of a failure with super entity reporting and all are committed to resolving this issue as a priority.
- 404 Given ASIC's existing financial reporting expertise, ASIC would be willing to have financial reports of the relevant superannuation funds lodged with it for monitoring and surveillance assuming it were given additional resources.

## ASIC activities

- 405 ASIC conducts proactive surveillance of responsible entities on the basis of internally generated measures (such as risk-based surveillances over discrete groups of responsible entities). For example, last year ASIC conducted risk-based surveillance activities over 'responsible entities for hire', responsible entities of aggressive mortgage schemes and responsible entities of unlisted property schemes, and operators of hedge funds.
- 406 ASIC also may conduct surveillance action on a reactive basis to information received regarding an AFS licence holder's compliance with its risk management obligations on the basis of, for example:
- (a) breach reports received from the AFS licensees;
  - (b) breach reports received from the auditor of a registered managed investment scheme's compliance plan;
  - (c) complaints received from members of registered managed investment schemes or the general public; and
  - (d) intelligence reports received from external sources (e.g. other government regulators).
- 407 Entities wanting to operate a managed investment scheme are also required to prepare and provide a risk management system statement (other than where they are regulated by APRA) describing the entity's strategy for managing risk (including the risk of non-compliance with the Corporations Act), the frequency and nature of internal and external review and audit processes.<sup>38</sup>
- 408 The strategy is required to discuss processes the entity has adopted to identify, monitor, mitigate and manage its business risks.<sup>39</sup> The risk

<sup>38</sup> See ASIC Regulatory Guide 3 *AFS licensing Kit: Part 3 Preparing your additional proofs* (RG 3), pp. 14–15.

<sup>39</sup> *Ibid.*

management system statement may be reviewed by ASIC's licensing directorate for appropriateness as part of the decision as to whether to grant the application for an AFS licence.

### **ASIC and APRA inter-agency cooperation**

- 409 There are a number of ways in which ASIC and APRA cooperate, including information exchanges, regular meetings and joint projects. Each of these occurs on both a formal and informal basis.
- 410 The framework for the interaction between the two agencies is set out in:
- (a) the Memorandum of Understanding (MOU); and
  - (b) the Joint Protocol.
- 411 The MOU covers the following key areas:
- (a) *regulatory and policy developments*: each agency will notify the other of any proposed changes to regulatory policy which are likely to affect the other and consult where appropriate;
  - (b) *mutual assistance and coordination*: the agencies agree to establish such arrangements as appropriate to facilitate cooperation in matters such as coordinating information-sharing, joint inspections, referral of cases and enforcement action;
  - (c) *information-sharing*: the agencies agree that, subject to legislative provisions, information that is relevant to the other agency will be shared as requested on a best endeavours basis;
  - (d) *unsolicited assistance*: each agency agrees to notify the other of the existence of any information likely to assist that agency, notwithstanding that it may not have received a request for the information; and
  - (e) *international representation*: when only one agency is represented at international regulatory fora, it will consult the other agency before or after the particular gathering as appropriate.
- 412 The Joint Protocol is intended to be read with the MOU. The protocol sets out an overview of the ASIC–APRA liaison structure, including the seniority of attendees and frequency of the meetings. Both agencies meet regularly for:
- (a) operational liaison meetings; and
  - (b) enforcement liaison meetings (now between ASIC Deterrence and APRA Enforcement).
- These liaison meetings discuss:
- (c) current projects;
  - (d) matters relating to dual regulated entities; and

- (e) requests for information to be shared.
- 413 Each agency has a designated liaison officer. Experience shows that close contact between these officers is essential to the smooth functioning of the inter-agency relationship.
- 414 Informal meetings between these liaison officers help facilitate understanding, shared commitment to proactive coordination and smooth cooperation.
- 415 The global financial crisis necessitated a closer level of contact between ASIC and APRA operational officers. It resulted in ASIC and APRA officers understanding better each other's modus operandi and priorities.
- 416 It led to a habit and practice of:
- (a) engaging with the other regulator before regulatory actions (e.g. compliance inspections) are taken where the other regulator is likely to be interested;
  - (b) notifying, discussing and jointly planning supervisory activities;
  - (c) discussing which regulator is the most appropriate to investigate matters or take particular action—for example, in relation to:
    - (i) shadow banking without a banking licence; or
    - (ii) prudential regulation of the non-banking sector;
  - (d) if necessary, modifying original timetables to accommodate the other regulator; and
  - (e) coordinating day-to-day operations, especially in special circumstances.

## Changes to policy settings

- 417 Given the strong and established working relationship between ASIC and APRA, ASIC makes no recommendations for policy change.

## Key terms

Term	Meaning in this document
AAT	Administrative Appeals Tribunal
ADI	Authorised deposit-taking institution
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
AML/CTF Act	<i>Anti-Money Laundering and Counter-Terrorism Financing Act 2006</i> and the <i>Anti-Money Laundering and Counter-Terrorism Financing Rules 2007 (No. 1)</i>
APL	Approved product list
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
AS ISO 10006–2006	Australian Standard AS ISO 10006–2006 <i>Customer satisfaction—Guidelines for complaints handling in organizations</i>
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
CALDB	Companies Auditors and Liquidators Disciplinary Board—the independent statutory body that considers applications from ASIC and APRA regarding the conduct of registered auditors and liquidators
Campbell Inquiry	Australian Financial System Inquiry of 1981
CAP	Consumer Advisory Panel
Ch 7 (for example)	A chapter of the Corporations Act (in this example numbered 7)
compliance plan	A document designed to set out the various checks and balances to be established to ensure that a registered managed investment scheme operates in accordance with the requirements of its constitution and the Corporations Act Note: See Explanatory memorandum to the Managed Investments Bill 1997.

Term	Meaning in this document
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
COSL	Credit Ombudsman Service Limited
CP 140 (for example)	An ASIC consultation paper (in this example numbered 140)
EDR	External dispute resolution
enforceable undertaking	One of the remedies available for breaches of the legislation as an alternative to civil or administrative action
FHSA deposit account	An FHSA that is a deposit product (as defined in s761A)
FIDO	Financial Information Delivered Online, the former consumer website of ASIC
financial product	Generally a facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> <li>• makes a financial investment (see s763B);</li> <li>• manages financial risk (see s763C);</li> <li>• makes non-cash payments (see s763D)</li> </ul> <p>Note: See Div 3 of Pt 7.1 of the Corporations Act for the exact definition.</p>
financial service	Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act
First Home Saver Account (FHSA)	A financial product that meets the requirements of the <i>First Home Saver Accounts Act 2008</i>
FoFA reforms	Future of Financial Advice reforms
FOS	Financial Ombudsman Service—an ASIC-approved EDR scheme
FPS Inquiry	PJC Inquiry into Financial Products and Services in 2009
FSA	Financial Services Authority (UK)
FSR regime	The Australian financial services regulatory regime, which refers primarily to Ch 7 of the Corporations Act. It also includes Chs 5C and 6D, as well as the financial services provisions of the ASIC Act
GS 007	Guidance Statement 007 <i>Audit implications of the use of service organisations for investment management services</i>
IDR	Internal dispute resolution

Term	Meaning in this document
National Financial Literacy Strategy	The National Financial Literacy Strategy was launched by the Hon. Bill Shorten MP, Minister for Financial Services and Superannuation, and Assistant Treasurer on 15 March 2011. ASIC prepared the strategy in consultation with key financial literacy partners and stakeholders, and after considerable research into what Australians know about, and do with, their money
PJC	Parliamentary Joint Committee on Corporations and Financial Services
Product Disclosure Statement (PDS)	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
reg 7.6.04 (for example)	A regulation of the Corporations Regulations (in this example numbered 7.6.04)
regulatory guide	A document issued by ASIC to explain when and how ASIC will exercise its powers, including how it will interpret the law, also giving practical guidance
RG 194 (for example)	An ASIC regulatory guide (in this example numbered 194)
RSE	Registered superannuation entity
s311 (for example)	A section of the Corporations Act (in this example numbered 766E), unless otherwise specified
SFC	Securities and Futures Commission (Hong Kong)
shorter PDS regime	The requirements set out in Div 3A of Pt 7.9 of the Corporations Act as modified by Subdivs 4.2 to 4.2C and Schs 10B, 10C, 10D and 10E of the Corporations Regulations, which prescribe the content and length of the PDS for first home saver accounts, margin loans, superannuation products and simple managed investment schemes
Short-Form Product Disclosure Statement (Short-Form PDS)	A PDS that complies with the requirements set out in Div 3A of Pt 7.9 of the Corporations Act, which were introduced by the Corporations Amendment Regulations 2005 (No. 5), and which provide issuers with the option of giving retail clients a Short-Form PDS (unless excluded) as long as a full PDS is available on request: see s1017H as inserted by Sch 10BA of the Corporations Regulations
SIS Act	<i>Superannuation Industry (Supervision) (SIS) Act 1993</i>
SMSF	Self-managed superannuation fund
Statement of Advice (SOA)	A document that must be given to a retail client for the provision of personal advice under Subdivs C and D of Div 3 of Pt 7.7 of the Corporations Act Note: See s761A for the exact definition.



Term	Meaning in this document
Stronger Super reforms	The Stronger Super reforms are the Government's response to the review of Australia's superannuation system (Super System Review). The Stronger Super reforms were announced by the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon Bill Shorten MP, on 16 December 2010
Tier 1 products	All financial products except those listed under Tier 2
Tier 2 products	General insurance products, except for personal sickness and accident (as defined in reg 7.1.14); consumer credit insurance (as defined in reg 7.1.15); basic deposit products; non-cash payment products; FHSA deposit accounts
TOR	Terms of reference
Trio	Trio Capital Limited
Turnbull Report	Review of the <i>Managed Investments Act 1988</i>
Wallis Inquiry	Financial System Inquiry in 1997

## List of appendices

The following appendices contain additional information relating to sections of this submission.

**Appendix 1: The type of investment vehicles, funds and other products involved in Trio, and the relevant regulatory regime (TOR 1)**

**Appendix 2: Summary of the differences between the SIS Act regime and the Corporations Act regime**

**Appendix 3: The steps in scheme registration assessment**

**Appendix 4: Related information—confidential**

## Appendix 1: The type of investment vehicles, funds and other products involved in Trio, and the relevant regulatory regime (TOR 1)

### Overview of the specific products in Trio

- 418 Trio held an AFS licence to operate as a responsible entity and an APRA registered superannuation entity (RSE) licence. Its business was based in Albury, NSW, and it employed 30 people.
- 419 At the date of the appointment of voluntary administrators, Trio was:
- (a) the responsible entity of 25 registered managed investment schemes (Trio managed investment schemes) and the operator for three unregistered managed investment schemes; and
  - (b) the trustee of a number of superannuation funds (Trio superannuation funds).
- 420 Table 15 sets out the managed investment schemes and superannuation funds operated by Trio.
- 421 The underlying assets of the various Trio managed investment schemes comprised liquid and illiquid assets, such as:
- (a) contractual rights (i.e. deferred purchase agreements (DPAs));
  - (b) interests in overseas hedge funds or mutual funds; and
  - (c) interests in overseas companies.
- 422 In addition to investing in interests in overseas hedge funds, and mutual funds and securities in overseas companies, Trio managed investment schemes also invested in other investments offered by offshore entities. For example, one of the Trio schemes invested in DPAs with a company registered in the British Virgin Islands and another invested in derivatives contracts involving Bear Stearns.

**Table 15: Managed investment schemes and superannuation funds operated by Trio**

Superannuation funds	Managed investment schemes	
<i>Trustee services</i>	<i>Responsible entity services</i>	<i>Investment services</i>
Astarra Personal Pension Plan	Astarra Australian Equities Pool	Astarra International Covered Call Fund
Astarra Pooled Superannuation Trust	Astarra Conservative Fund ARP Growth Fund	Astarra Overseas Equities Pool
Astarra Superannuation Plan	Astarra Diversified Fixed Interest Pool	Astarra Portfolio Service (formerly Astarra Diversified No. 4 Pool)
Employees Federations of NSW Superannuation Plan	Astarra Cash Pool	Astarra Strategic Fund
My Retirement Plan	Astarra Growth Fund A&T First 200 Fund Advantage Diversified Fund Advantage Fund/Equities/ Emerging Markets Advantage Fund/Fund of Funds Astarra Australian Covered Call Fund Astarra Balanced Fund Astarra Capital Protected Pool Astarra Wholesale Property Fund	Astarra Wholesale Portfolio Service MillhouseIAG Private Equity Fund MARQ Capital Diversified Direct Property Fund My Growth Plan My Income Plan Regional Land Property Fund TIC Currency Fund TIC Diversified Property Fund TIC Currency Wholesale Trust TIC Diversified Wholesale Property Trust

## Legislative framework

- 423 This appendix sets out the key requirements of the legislative framework relevant to the investment vehicles, funds and other products. It covers:
- (a) regulation of superannuation funds;
  - (b) general obligations;
  - (c) licensing the responsible entity;
  - (d) registering the managed investment scheme;
  - (e) disclosure obligations; and
  - (f) supervision of conduct by ASIC.
- 424 This appendix is not a comprehensive description of the regulation of the investment vehicles applicable to Trio.

## Regulation of superannuation funds

- 425 APRA is responsible for prudential supervision of parts of the superannuation industry and administers the SIS Act and relevant regulations. APRA supervises:
- (a) superannuation entities, which include approved deposit funds and pooled superannuation trusts,<sup>40</sup> and
  - (b) retirement savings accounts.
- 426 SMSFs are regulated by the ATO. Further, exempt public sector superannuation managed investment schemes are not regulated by ASIC, APRA or the ATO, although some may have indicated a willingness to comply with some or all of the SIS Act requirements.<sup>41</sup> These funds need to meet the requirements imposed on them by the legislation that established the schemes, instead of the SIS Act or the Corporations Act.
- 427 ASIC's role in superannuation has a conduct and disclosure focus. ASIC has responsibility for some aspects of conduct by superannuation trustees, as well as administering the requirements for trustee disclosure to members. ASIC's responsibilities are primarily included in the Corporations Act, although ASIC does administer parts of the SIS Act as well.<sup>42</sup> These parts of the SIS Act include:
- (a) s68A regarding conduct relating to fund membership (kickback provisions);
  - (b) s101 regarding the trustee's duty to establish arrangements for dealing with inquiries or complaints; and
  - (c) s155 regarding fair dealing on issue or redemption of a superannuation interest.
- 428 Further, ASIC's responsibilities include:
- (a) AFS licensing for those trustees who have public offer superannuation funds, or who offer other financial services (such as advice); and
  - (b) monitoring PDSs and other disclosure obligations, including member and ongoing reporting (relevant provisions in relation to disclosure are included in both the Corporations Act and the SIS Act).
- 429 The SCT is an external dispute resolution body where superannuation fund members may seek resolution of disputes concerning superannuation funds. ASIC provides administrative support to the SCT. The SCT is also required

<sup>40</sup> See definitions in s10 of the SIS Act.

<sup>41</sup> See Sch 1AA of the SIS Regulations.

<sup>42</sup> See s6 of the SIS Act for the general administration, including the division of responsibilities between the regulators.

to report contraventions of laws or governing rules to either ASIC or APRA, as appropriate.<sup>43</sup>

430 In December 2010, the Government gave its response to the Super System Review Report that had been released earlier that year. The Super System Review had looked at the governance, efficiency, structure and operation of the superannuation system in Australia.

431 In its response, Stronger Super, the Government has indicated support for significant reform to the superannuation system in Australia. These reforms may include changes to the back-office systems for superannuation trustees (SuperStream) as well as changes to default fund arrangements (MySuper), trustee obligations (Governance) and changes to the SMSF sector.

### **Definition of managed investment scheme**

432 The term managed investment scheme is defined in s9 of the Corporations Act to include schemes having the following features:<sup>44</sup>

- (a) people contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the managed investment scheme (whether the rights are actual, prospective or contingent, and whether they are enforceable or not);
- (b) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the managed investment scheme (whether as contributors to the managed investment scheme or as people who have acquired interests from holders); and
- (c) the members do not have day-to-day control over the operation of the managed investment scheme (whether or not they have the right to be consulted or to give directions).

### **Registration of managed investment schemes**

433 A managed investment scheme must generally be registered by ASIC under s601EB of the Corporations Act if:

- (a) it has more than 20 members;
- (b) it was promoted by a person or an associate of a person, who was, when the managed investment scheme was promoted, in the business of promoting managed investment schemes; or
- (c) the managed investment scheme:

<sup>43</sup> See s64 and 65 of the *Superannuation (Resolution of Complaints) Act 1993*.

<sup>44</sup> The definition in s9 also specifies exceptions to the definition.

- (i) is related to an ASIC determination under s601ED(3) of the Corporations Act that a number of managed investment schemes are closely related requiring registration when the total number of members of all the managed investment schemes exceeds 20; and
- (ii) the total number of members of all of the managed investment schemes to which the determination applies exceeds 20.

434 An exception to the registration requirements is if all the issues of interests in the managed investment scheme that have been made would not have required the giving of a PDS if the managed investment scheme had been registered when the issues were made.

435 The responsible entity must be a public company, hold an AFS licence and must prepare the following documents governing the operation of the managed investment scheme, before registering the managed investment scheme:

- (a) *a constitution*—setting out the legal relationship between members of the managed investment scheme and the responsible entity;<sup>45</sup>
- (b) *a compliance plan*—setting out a range of measures the responsible entity is to apply in operating the managed investment scheme to ensure compliance with the Corporations Act and the constitution.<sup>46</sup> If the majority of the responsible entity’s directors are not external to the responsible entity, the compliance plan and the responsible entity’s compliance with it must be monitored by a compliance committee. The compliance committee must have at least three members and a majority of them must be external. Compliance with the compliance plan is also subject to an annual external audit.

436 The Corporations Act requires that ASIC must register a managed investment scheme within 14 days of receipt of an application for registration, unless:

- (a) documentary requirements for the application are not satisfied;
- (b) the responsible entity is either not a public company or does not hold an appropriate AFS licence;
- (c) the managed investment scheme’s constitution does not meet statutory content requirements or is not legally enforceable;
- (d) the managed investment scheme’s compliance plan does not meet statutory content requirements (or is unsigned); or

<sup>45</sup> ASIC Regulatory Guide 134 *Managed investments: Constitutions* (RG 134) sets out ASIC’s approach to assessing constitutions of managed investment schemes.

<sup>46</sup> ASIC Regulatory Guide 132 *Managed investments: Compliance plans* (RG 132) sets out ASIC’s approach to assessing compliance plans of managed investment schemes.

- (e) the managed investment scheme has not had an auditor engaged to audit the responsible entity's compliance with the managed investment scheme's compliance plan.

437 ASIC undertakes a limited assessment when registering a managed investment scheme. The steps in that assessment are set out in Appendix 3.

### **General obligations of a responsible entity**

438 As the holder of an AFS licence, the responsible entity is subject to a number of general obligations under s912A of the Corporations Act. Such duties include the obligation to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly, to comply with conditions of the licence and to comply with financial services laws.

439 As AFS licensees, responsible entities must meet base level financial requirements set out in RG 166.<sup>47</sup> These require the responsible entity to have:

- (a) positive net assets and be solvent;
- (b) sufficient cash resources to cover three months expenses with cover for contingencies; and
- (c) maintained audit compliance.

440 Responsible entities must also maintain minimum net tangible assets of \$5 million unless the responsible entity uses a custodian. If a custodian is used, the responsible entity must maintain 0.5% of assets of the registered managed investment schemes it operates, with a minimum requirement of \$50,000 and a maximum requirement of \$5 million.<sup>48</sup>

441 The responsible entity (and its officers) is also subject to a number of specific statutory obligations within Ch 5C of the Corporations Act. Under s601FC, the responsible entity of a registered managed investment scheme must (among other obligations):

- (a) exercise the degree of care and diligence that a reasonable person would exercise if they were in the responsible entity's position;
- (b) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests; and

<sup>47</sup> ASIC Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140) sets out ASIC's proposals on modifications to the financial resource requirements to apply to responsible entities of registered managed investment schemes.

<sup>48</sup> See ASIC Regulatory Guide 166 *Licensing: Financial requirements* (RG 166). See also new proposals in CP 140.



- (c) where a managed investment scheme is to be offered to retail investors, prepare a PDS.

442 The Corporations Act does not prescribe or proscribe particular product features or characteristics, so long as the nature of the investment is disclosed in the PDS.

### **Obtaining an AFS licence**

443 A person who carries on a financial services business in Australia must obtain from ASIC an AFS licence that covers the provision of the relevant financial services (s911A(1)), unless an exemption applies. Responsible entities of registered managed investment schemes must be licensed, as must superannuation trustees who have public offer superannuation funds or who provide additional financial services (such as financial product advice).

444 A key exemption is for those who provide services as a representative of an AFS licensee (i.e. the licensing regime focuses on the licensee rather than the individuals who act on behalf of the licensee). Representatives can be employees, directors or authorised representatives (including corporate authorised representatives) of the licensee. ASIC does not approve individual representatives. However, ASIC does maintain a public register of licensees and authorised representatives (but not other representatives such as employees) of licensees.

445 ASIC cannot refuse an application for an AFS licence for reasons beyond criteria set out in the law. ASIC also cannot refuse to grant a licence without giving the applicant an opportunity to be heard and a refusal to grant a licence can be reviewed by the AAT.

446 ASIC may impose conditions on a licence. ASIC imposes conditions on all licences that support the obligations that apply to AFS licensees. A key condition in any licence is the authorisation which sets out the scope of financial services that a licensee is authorised to conduct. The authorisations may permit the licensee to perform one or more financial services and may be further limited by reference to particular financial products.

### **Conduct obligations**

447 Once licensed, AFS licensees are subject to various conduct obligations under the Corporations Act.<sup>49</sup> For example, AFS licensees must:

- (a) comply with conditions on their licence and the financial services laws;
- (b) provide financial services efficiently, honestly and fairly;
- (c) have adequate arrangements to manage conflicts of interest;

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<sup>49</sup> Sections 912A and 912B and other various obligations in Pts 7.6, 7.8 and 7.10.

- (d) ensure representatives (employees, directors and authorised representatives) are adequately trained and competent, and comply with the law;
- (e) have adequate resources (including financial, technological and human resources) to provide the financial services covered by their licence and to carry out supervisory arrangements (unless they are regulated by APRA);
- (f) maintain the licensee's own competence, skills and experience;
- (g) maintain internal and external dispute resolution systems where clients are retail consumers;<sup>50</sup>
- (h) maintain adequate risk management systems (unless they are regulated by APRA);
- (i) properly handle client money (trust account and audit requirements);
- (j) notify ASIC of significant breaches;
- (k) have adequate arrangements to compensate retail clients for losses; and
- (l) provide key disclosure documents.

448 Superannuation trustees who hold AFS licences are also prudentially regulated by APRA and, as a consequence of this, are not subject to the requirements in paragraphs 447(e) and (h) regarding resources and risk management.

### **Licensing the responsible entity**

449 ASIC *must* grant a licence to anyone who meets the criteria in s913B of the Corporations Act. This provision requires ASIC to grant an AFS licence where:

- (a) all documentary requirements with the application were submitted by the applicant;
- (b) ASIC has no reason to believe that the applicant will not comply with the obligations that will apply under s912A if the licence is granted;
- (c) ASIC is satisfied that there is no reason to believe that the applicant is not of good fame or character;
- (d) the applicant has provided ASIC with any additional information requested by ASIC; and
- (e) the applicant meets any other requirements prescribed by regulations made for the purposes of this paragraph.

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<sup>50</sup> Unlicensed product issuers and secondary sellers must also maintain internal and external dispute resolution procedures: s1017G of the Corporations Act.

450 To enable it to form a view on this, ASIC collects information from the applicant about its responsible officers and about its organisational expertise, compliance arrangements, training supervision and monitoring of representatives, adequacy of financial, human and IT resources, dispute resolution systems, and risk management practices. It imposes conditions on the licence (such as conditions relating to minimum financial resources) to address these matters.

451 In deciding whether to licence a responsible entity, ASIC conducts a review of documents provided in support of the licensing application. These documents set out the responsible entity's proposed compliance arrangements and operating capacity. ASIC also assesses the people involved in operating the responsible entity, known as the 'responsible managers'. This assessment takes into account the responsible managers' knowledge (qualifications) and skills (experience) against the requirements of ASIC Regulatory Guide 105 *Licensing: Organisational competence* (RG 105). The responsible managers (minimum of two) need to have relevant experience and knowledge.

452 ASIC also:

- (a) reviews the proposed responsible entity's financial accounts to ensure the entity meets the financial requirements set out above;
- (b) assesses the adequacy of the responsible entity's professional indemnity and fraud insurance arrangements—by assessing a certificate of currency issued by the insurer. The certificate of currency sets out the limitations of the insurance coverage; and
- (c) assesses whether the responsible entity proposes to use an external custodian to hold scheme assets and then, if a custodian is to be used, ASIC ensures the custodian has a minimum net tangible assets of \$5 million.

## Registering the managed investment scheme

453 In deciding whether to register a managed investment scheme, ASIC conducts the following assessments.

### A general assessment

454 ASIC conducts a general assessment of the application and the responsible entity to ensure:

- (a) the constitution and compliance plan are executed appropriately;
- (b) appropriate ASIC forms are filed (including a Form 5103 which is a statement signed by the directors of the responsible entity stating that the managed investment scheme constitution and compliance plan comply with the Corporations Act); and

- (c) the proposed responsible entity is a public company that holds an AFS licence authorising it to operate the managed investment scheme in accordance with the Corporations Act.

#### **An assessment of the scheme's constitution**

455 ASIC conducts an assessment of the scheme's constitution to ensure it complies with s601GA and 601GB of the Corporations Act. These provisions are supported by ASIC policy and deal with:

- (a) unit pricing;
- (b) powers of the responsible entity to make investments or otherwise deal with scheme property and to borrow or raise monies;
- (c) dealing with complaints;
- (d) winding up the managed investment scheme;
- (e) rights of the responsible entity to fees and indemnities out of scheme property;
- (f) rights of members to withdraw from the managed investment scheme, ensuring the legal enforceability of the constitution; and
- (g) an assessment of the managed investment scheme compliance plan to assess whether the compliance plan meets the content requirements of s601HA of the Corporations Act.

456 This provision requires that the compliance plan includes measures to ensure compliance with the Corporations Act and the managed investment scheme's constitution, including arrangements for:

- (a) identification and segregation of scheme property;
- (b) a compliance committee if less than half of the directors of the responsible entity are external directors;
- (c) valuation of scheme property;
- (d) an annual audit of the compliance plan; and
- (e) keeping adequate records of the managed investment scheme's operations.

#### **Offering financial products: PDSs**

457 Interests in a registered managed investment scheme and superannuation funds must generally be offered to retail investors through a complying PDS: see Pt 7.9 of the Corporations Act.

458 A PDS must include information about:

- (a) the significant benefits of the product;
- (b) the significant risks of the product;

- (c) the costs of the product; and
- (d) other significant features of the product (s1013D).

459 Disclosure is also required of certain other material information: see s1013E. The level of information in the PDS is limited to the amount reasonably required by a retail client who is making a decision whether to acquire that product: see s1013D(1).

460 The PDS is only required to be lodged with ASIC in certain circumstances: see s1013I and 1015B. ASIC does not approve or authorise PDSs.

461 PDSs must be worded and presented in a clear, concise and effective manner: see s715A and 1013C(3).

462 There have been a number of legislative initiatives to deal with lengthy and complex point-of-sale disclosure. For example, Short-Form PDSs were introduced in 2005 to address complex and lengthy disclosure provided in PDSs. A Short-Form PDS summarises the key information in a PDS (e.g. information about the issuer, benefits, risks, costs, return, dispute resolution and cooling off). It should comply with Div 3A of Pt 7.9 of the Corporations Act, as modified by the Corporations Regulations. A Short-Form PDS can be given instead of a PDS for all products except for general insurance products (where different requirements apply). Short-Form PDSs are now offered in the market but not extensively.

463 The Corporations Amendment Regulations 2010 (No. 5), commencing on 15 June 2010, amended the regulations to provide that PDSs for many superannuation products and simple managed investment schemes would need to provide shorter and simpler PDSs.<sup>51</sup> The amending regulations provide:

- (a) a maximum page length of eight pages (for superannuation and managed investment scheme PDSs), together with a prescribed minimum font size;
- (b) prescribed section headings to make it easier for consumers to find important information in the PDS and compare across products;
- (c) key content requirements to ensure that consumers are provided with the key information they need to make an investment decision;
- (d) provision for other material to be located outside the PDS document itself, but form part of the PDS through incorporation by reference; and
- (e) provision for inclusion of additional information within the PDS, provided the prescribed length is not exceeded.

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<sup>51</sup> Note that PDSs for standard margin lending facilities are also included in the shorter PDS regime (the new regime commenced for these products on 1 January 2011).

464 Following an announcement by the Government to delay the mandatory commencement of the shorter PDS regime, ASIC has recently extended the transitional period for the shorter PDS regime until 22 June 2012. This means that issuers of superannuation and simple managed investment scheme PDSs can opt in to the new shorter PDS regime after 22 June this year, but can remain in the current PDS regime if they prefer to.

### **Stop orders**

465 The Corporations Act gives ASIC the powers to issue a stop order in respect of a PDS where the document is defective (because it is misleading or defective, or does not contain material information), or where the PDS is not worded and presented in a clear, concise and effective manner: see s1020E. ASIC can only issue a final stop order following a hearing where interested parties are given the opportunity to make submissions as to whether the stop order should be made.

466 However, ASIC's compliance actions do not always result in stop orders. In cases where ASIC believes a PDS is defective, the issuer may rectify their disclosure document by issuing a supplementary PDS.

467 ASIC's stop order powers also extend to advertisements or other promotional material (s1018A) made by product issuers where the advertisement or promotional material contains misleading or deceptive statements or omits material required under s1018A of the Corporations Act. This stop order power permits ASIC (subject to a hearing where interested parties have the right to make submissions) to order that the advertising be removed from publication.

### **Periodic disclosure**

468 In addition to the primary obligation to provide a PDS, there are a number of further disclosure obligations that apply to financial products. These obligations include providing a periodic statement to retail clients for financial products that have an investment component: see s1017D. These requirements include superannuation and managed investment schemes.

469 A periodic statement must be provided for each reporting period during which a holder holds the product. The statement must contain all information the issuer of the financial product reasonably believes the holder needs to understand the investment in the financial product: see s1017D(4). Among other things, the periodic statement must include:

- (a) opening and closing balances for the reporting period;
- (b) the termination value of the investment at the end of the reporting period;

- (c) any increases in contributions in relation to the financial products by the holder or another person during the reporting period; and
- (d) details of any change in circumstances affecting the investment that has not been notified since the previous periodic statement: see s1017D(5).

## Appendix 2: Summary of the differences between the SIS Act regime and the Corporations Act regime

470 Table 16 lists the differences between the SIS Act regime and the Corporations Act regime, while Table 17 gives the sources of some relevant legal powers available to APRA and ASIC to regulate superannuation entities and managed investment schemes respectively.

**Table 16: The differences between the SIS Act regime and the Corporations Act regime**

Main difference	Superannuation entity	Managed investment scheme
Key legislation	<i>Superannuation Industry (Supervision) (SIS) Act 1993</i> (SIS Act), Corporations Act	<i>Corporations Act 2001</i> (Corporations Act)
Key regulator(s)	Australian Prudential Regulation Authority (APRA)—prudential ASIC—conduct and disclosure	ASIC
Legal entity	Trustee	Responsible entity
Type of entity	Constitutional company, body corporate or group of individual trustees	Public company
Governing document	Trust deed/governing rules	Constitution
Investment vehicle	Registrable superannuation entity (RSE)	Australian registered scheme
Holder of licence	RSE licensee (may also be an AFS licence holder)	AFS licence holder (may also be an RSE licensee)
Main operational risk documents	Risk management strategy/risk management plan	Compliance plan/risk management arrangements
Decision-making body	Trustees (Board of)	Directors (Board of)
Person responsible for licence	Responsible officer	Responsible manager
Type of asset	Assets in trust fund	Scheme assets/property
Withdrawals/transfers	Subject to superannuation preservation/payment restrictions	Subject to managed investment scheme's constitution and Corporations Act

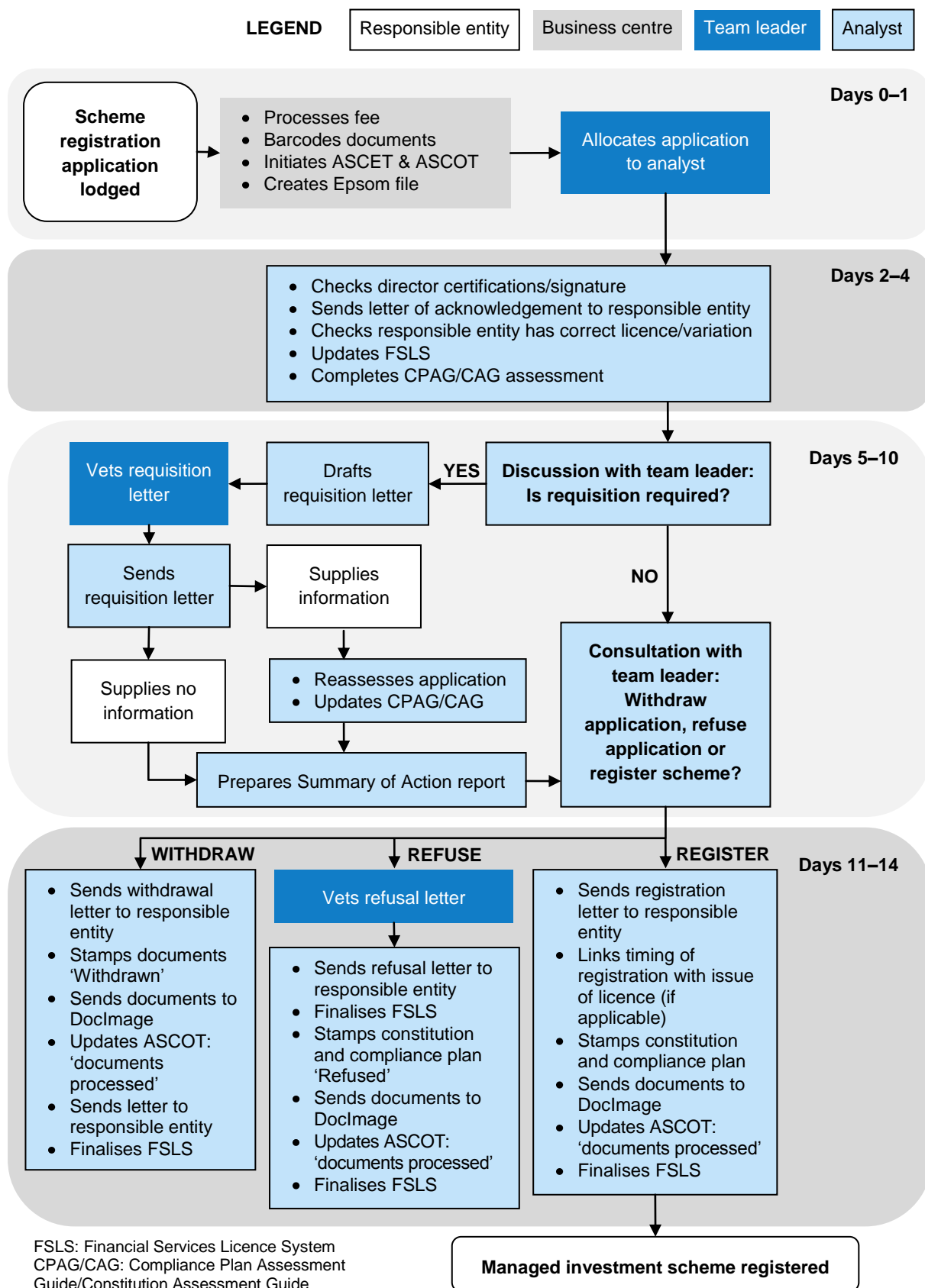


**Table 17: Sources of power**

<b>Legal power</b>	<b>Superannuation entity (references are to the SIS Act unless otherwise stated)</b>	<b>Managed investment scheme (references are to the Corporations Act unless otherwise stated)</b>
Vary, revoke or impose conditions on licence	Pt 2A	Div 4, Pt 7.6
Registration of entity	Pt 2B	Pt 5C.1
Disqualification of individuals	Div 3, Pt 15	Div 8, Pt 7.6
Suspension/appointment/winding up	Pt 17	s464 (responsible entity), Pt 5C.9 (registered scheme)
Financial compensation	Pt 23	s912B
Information gathering	Div 2, Pt 25	s601FF, Divs 2–4, Pt 3 ASIC Act
Protective orders and enforceable undertakings	Div 3A, Pt 25, Pt 27	s1324, s93A ASIC Act
Conduct investigations	Div 4, Pt 25	Div 1, Pt 3 ASIC Act
Conduct examinations/interviews	Div 5, Pt 25	s601FF, s19 ASIC Act
Commence legal proceedings (criminal, civil)	Pt 21	s1315 (criminal) and 1323 (civil), s49 ASIC Act
Derivative action (civil proceedings in the name of company or individual to recover damages or property)	No equivalent	s50 ASIC Act
Appoint auditor	Pt 16, Div 3	s331AAC

## Appendix 3: The steps in scheme registration assessment

Figure 1: Process for applying to register a managed investment scheme



## **Appendix 4: Related information—Confidential**

To assist the Inquiry, ASIC has provided further information in a separate confidential appendix (Appendix 4).

The material in this appendix has been provided to the Inquiry on a confidential basis so as not to prejudice ASIC's ongoing investigations or breach ASIC's legal obligations under s127 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act).