

City Pacific

Background

The City Pacific First Mortgage Fund (Fund) was previously operated by City Pacific Limited (City Pacific). Trilogy Funds Management Limited (Trilogy) was appointed as responsible entity of the Fund as a result of a meeting of members on 25 June 2009.

The Fund is a registered managed investment scheme which invests primarily in mortgages over real property, including property under construction. The Fund is managed by a responsible entity that acts as both the manager and trustee of the Fund. The Fund has a fixed application and redemption price of \$1 with the promise that redemptions would be paid within short periods of time depending on the class of units held by the member. The Fund has been closed to new investors since March 2008.

A responsible entity is required to be a public company and hold an Australian financial services licence (AFS license) authorising it to operate managed investment schemes. The responsible entity of a scheme is empowered under the *Corporations Act 2001* (Corporations Act) and the constitution of the scheme to make decisions in respect of the management of the scheme. Members also have rights under the Corporations Act and the constitution of a scheme to among other things call and hold meetings to consider resolutions in respect of the scheme including the replacement of the responsible entity of the scheme.

In March 2008, City Pacific announced it was deferring the payment of redemptions from the Fund for an initial period of up to 180 days because of liquidity issues. Essentially the Fund was unable to realise sufficient cash to pay redemptions within the period set out in the constitution. There was a maturity mismatch.

That initial period was extended for a further 180 days bringing the final date for deferment of redemptions to 26 February 2009. The constitution for the Fund provides redemption rights for various classes of units in the Fund. Generally the redemption payment period is 180 days where the Fund is liquid. In certain circumstances it specifies that the redemption payment period may be up to 360 days.

We are aware that City Pacific wrote to members on 13 October 2008 to inform them it had determined that the Fund was 'non-liquid' because it was unlikely to be in a position to commence the payment of redemptions on 26 February 2009. The payment of future distributions was at that time dependent upon the level and timing of loan repayments by borrowers to the Fund. The result is that members are only able to withdraw their investment in the Fund if the responsible entity (now Trilogy) makes a withdrawal offer in accordance with the provisions of the Corporations Act.

Part of the regulatory framework under the Corporations Act for registered managed investment schemes, including the Fund, allows or requires the responsible entity to freeze redemptions where the underlying investments are or become illiquid. A freeze means that for a period, the responsible entity delays or halts redemptions until liquidity improves. The period itself is indefinite and at the discretion of the responsible entity. This is done to protect all of the investors in the scheme.

We recognise that this can create significant hardship for individual investors who need to access their investments while the scheme is 'frozen'. However, without the protection, responsible entities would be forced to liquidate scheme assets to meet investor redemptions. Selling illiquid assets in such a forced or 'fire sale' manner runs the risk of significantly diminishing the value of both the assets of the scheme and therefore members' investments.

Once a determination has been made that a scheme is non-liquid, the responsible entity must follow the procedures set out in the Corporations Act for any future withdrawals. Withdrawals from non-liquid schemes can only occur on the basis that members must be treated equally and the non-liquid withdrawal process (as set out in the Corporations Act) must be followed. This means the responsible entity may provide periodic offers to members to withdraw when money becomes available. The offers need to be made to all members, be open for at least 21 days and if there are insufficient funds to satisfy all members who want to withdraw, members' requests should be satisfied proportionately.

As previously stated no distributions have been made to members of the Fund since July 2008 and City Pacific in its role as responsible entity determined in October 2008 that the Fund was illiquid. The result was that members have not been receiving any distributions and are only able to withdraw their investment in the Fund if Trilogy, as the responsible entity, makes a withdrawal offer in accordance with the provisions of the Corporations Act.

Trilogy held a meeting of members on 1 September 2010 to consider resolutions proposing changes to the constitution of the Fund to, among other things, enable the development of a number of assets in the Fund, amend the \$1 redemption price specified in the constitution to a current unit value, and agree the implementation of a hardship redemption policy, an amended fee structure and a proposed capital repayment strategy.

Members did not pass the resolutions put to the meeting. Trilogy then commenced a capital repayment strategy aimed at returning capital to members of the Fund on a quarterly basis. Since July 2008 Trilogy has paid capital distributions from the Fund to an amount of around \$0.1125 per unit or around \$99.3 million.

Status of investment in the Fund

The Annual Financial Report for the Fund for the year ended 30 June 2014 (2014 Financial Report) and Half Year Financial Report for the period ended 31 December 2014 (Half Year Financial Report) and other information for members, including newsletters, is posted on Trilogy's website at www.balmaintrilogy.com.au.

The Half Year Financial Report indicates units in the Fund still maintain some value, approximately 7 cents per unit. The annual financial report for the Fund for the year ended 30 June 2010 recorded the value of a unit in the Fund to be approximately 43 cents per unit. We understand from the financial reports prepared by City Pacific and Trilogy that the reduction in the value of the assets of the Fund has arisen due to a range of factors including impairments to the value of assets, expenses involved in the operation of the Fund, the sale of assets and capital distributions paid to members of the Fund.

In a letter dated 26 March 2015 Trilogy has notified members that they have achieved further asset sales, and that the remaining assets are now subject to contract. We are not in a position to comment on possible reasons for the financial position of the Fund, or the time taken to sell the assets of the Fund beyond noting the reasons set out in the correspondence to members and the annual and half year financial reports issued by City Pacific and Trilogy.

Trilogy is also pursuing actions against previous directors, legal advisors and auditors of the Fund and City Pacific about transactions entered into while City Pacific was the responsible entity of the Fund. Trilogy commenced an action against the directors of City Pacific on 27 April 2012 in the NSW Federal Court with the judgement currently reserved. On 2 April 2014 Trilogy commenced an action against the law firm Minter Ellison about a co-lending arrangement entered into by City Pacific and also filed a statement of claim on 25 September 2014 against KPMG in relation to their role as compliance plan auditor for the Fund. Trilogy has also had to respond to claims from various borrowers.

We note that Trilogy has repaid the finance facilities of the Fund. The constitution of the Fund provides the power to the responsible entity to borrow money for the purposes of the Fund and allows for the use of financial accommodation to fund redemptions. In the financial year ending 30 June 2005 City Pacific established a financing arrangement for the Fund with the Commonwealth Bank of Australia (CBA). The finance facility was for a total amount of \$200m. The financial report for the year ended 30 June 2005 stated that the finance facility was established for the purposes of meeting unexpected withdrawal requests and that as at 30 June 2005 the facility was drawn to \$117m. As security for the finance facility the CBA was provided with a fixed charge over all of the assets of the Fund.

We note concerns raised that the finance facility arranged by City Pacific on behalf of the Fund exceeded the levels outlined in the Product Disclosure Statements (PDS) for the Fund. The constitution does not limit the level of borrowing that may be undertaken by the Fund.

We have reviewed a number of PDS for the Fund within our possession and found that a PDS dated 1 February 2005 did contain a statement to the effect that for the life of the PDS borrowings were not expected to exceed 10% of the gross assets of the Fund. It appears from our records that City Pacific may have amended this statement through a supplementary PDS issued on or about 21 June 2005 to reflect that the level of borrowing had increased to \$200m and was not expected to exceed 20%. City Pacific subsequently issued new PDSs for the Fund on 23 November 2005, 18 May 2006 and 1 December 2007. We have been able to review the disclosure in the PDSs dated 18 May 2006 and 1 December 2007. While both of these PDSs disclose the ability of the Fund to borrow and in the case of the 18 May 2006 PDS the amount of borrowing as at the date of the PDS, neither document contains a statement that indicates the facility would be limited to 10% of the assets of the Fund.

We note that member approval was not required prior to entering into or amending the terms including any limits of the finance facility.

ASIC Actions

ASIC has engaged with both responsible entities about the Fund. Details of the significant engagements relevant to the Fund are outlined below.

Imposition of additional license conditions on City Pacific

In June 2005 ASIC imposed additional licensing conditions on City Pacific with their consent. ASIC imposed the conditions on City Pacific's AFS license following concerns relating to City Pacific's compliance, as the responsible entity of the Fund, with the provisions of the Corporations Act.

The provisions related to members' rights to withdraw from the Fund. ASIC was concerned that amendments to the constitution of the Fund in 2001 and 2005, regarding the specified period for members to withdraw from the Fund, may have been invalid. This meant that City Pacific had 90 business days to meet a members' request for a withdrawal from the 'On Call' investments in the Fund, not five business days, as promoted by City Pacific.

ASIC was also concerned that:

- the changes to the period specified in the constitution of the Fund may have adversely affected the rights of members of the Fund and therefore should have been made by way of a special resolution of members; and

- an 'On Call' class within the Fund marketed by City Pacific was not in fact an on call product.

City Pacific agreed under the additional conditions to notify members of the Fund:

- that the amendments to the Fund's constitution relating to withdrawal periods were invalid, meaning that members never had a right to a five-day withdrawal period;
- that 'On Call' investments were not actually on call but could be paid within 90 business days by City Pacific; and
- how CPL could have funded withdrawals from 'On Call' investments.

The additional AFS license conditions required City Pacific to engage external experts, acceptable to ASIC, to review the loan book and underlying mortgages in the Fund and the liquidity of the Fund pursuant to the Corporations Act. City Pacific was required to report their conclusions to ASIC by September 2005. This date was extended on request from City Pacific as a result of the expert's review taking longer than expected. ASIC received the expert's report on or about 28 September 2005 (Expert's Report). The additional AFS License condition was removed in February 2007 as it had been complied with and was no longer relevant at that time.

In addition City Pacific stopped offering its five-day 'On Call' product after ASIC raised issues with the company earlier in 2005 about the disclosure associated with the product in the PDS. City Pacific issued a subsequent PDS which did not offer the five-day 'On Call' product.

ASIC assessed the Expert's Report and made further inquiries with City Pacific focusing on the liquidity arrangements of the Fund. As a result ASIC reviewed the PDS for the Fund. A new PDS was issued in November 2005, after a notice of hearing was issued. ASIC raised concerns with City Pacific about among other things, disclosure relating to liquidity, valuation, pricing of redemptions, borrower assessment practices, the finance facility, loan book concentration and loan defaults.

In addition the withdrawal provisions of the constitution of the Fund were amended at a meeting of members and the compliance plan for the Fund was revised.

Action in relation to disclosure concerns

ASIC actively monitored the disclosures of the Fund after 2005 as a result of ongoing concerns about the management of liquidity within the Fund and took action in February 2006 to stop City Pacific making certain statements in advertising. At this time City Pacific issued a further Supplementary PDS for the Fund. We note that another supplementary PDS was issued in May 2006 before an updated PDS was issued on 1 December 2007. A supplementary PDS was issued in March 2008 that withdrew the PDS. ASIC continued to engage with City Pacific over this time.

Members meeting to remove City Pacific and appoint Trilogy

A members meeting was held on 25 June 2009 to consider resolutions to remove City Pacific and appoint Trilogy as responsible entity of the Fund. Prior to the meeting ASIC engaged with both City Pacific and Trilogy to ensure as far as possible the disclosures of each party were not misleading.

ASIC's register was amended to record Trilogy as the responsible entity for the Fund on 7 July 2009 after the Federal Court in Brisbane dismissed an application by City Pacific challenging the result of the meeting on a number of grounds. We took steps, including writing to the Federal Court, to ensure arrangements were in place to facilitate the management of the Fund while the Federal Court considered the application made by City Pacific.

Members meeting to restructure the Fund

Trilogy held a meeting of members on 1 September 2010 to consider resolutions proposing changes to the constitution of the Fund to, among other things, enable the development of a number of assets in the Fund, amend the \$1 redemption price specified in the constitution to a current unit value, the implementation of a hardship redemption policy and an amended fee structure and a proposed capital repayment strategy. ASIC reviewed the meeting materials prior to their release to members and provided comment and feedback to Trilogy to ensure members had adequate disclosure.

ASIC investigations into conduct of directors

We have investigated concerns about the conduct of City Pacific and its directors about the operation of the Fund. Our investigations included interviews with directors and officers of City Pacific. We have decided not to pursue any actions against City Pacific or its directors as there was insufficient evidence to support taking regulatory action.

We have however assisted Trilogy in pursuing claims against City Pacific and its directors by authorizing Trilogy as an eligible applicant for the purposes of applying to the Court to require persons to be examined about the affairs of City Pacific.

Cancellation of City Pacific's Australian financial services license

On 15 March 2011 we cancelled the Australian financial services license of City Pacific after external administrators were appointed.

Hardship Payments

We granted relief to Trilogy to enable them to allow capped redemptions for members of the Fund in cases of hardship. As outlined above a responsible entity of a frozen fund cannot

make any exceptions to the blanket freeze on redemptions. However, we have certain powers to modify the Corporations Act and, following the freezes of many funds in October 2008, we made an urgent modification of the Corporations Act to allow responsible entities to return some capital to certain members in exceptional circumstances. This is known as hardship relief. Responsible entities need to apply to us for this relief; members are not able to apply to get money for reasons of hardship if the responsible entity for their scheme does not have the relief.

The terms of the hardship relief modification allow responsible entities to accept partial redemption applications, subject to caps, from members who, for example, were unable to meet reasonable and immediate family living expenses or who were experiencing circumstances warranting compassion, including medical costs for serious illness, funeral expenses or to prevent foreclosure.

Trilogy posted its hardship policy and Financial Hardship Statutory Declaration on its website. The policy provided details of the criteria that must be satisfied to apply for a hardship withdrawal, the amounts a member can receive, which members may be eligible to make a hardship withdrawal application, the withdrawal price and the process for making a hardship withdrawal application.

In a letter dated 20 April 2012 Trilogy notified members that it had paid all outstanding hardship payments for the redemption periods ending 31 March 2011 and 30 September 2011 with a total of \$755,909 being distributed. Trilogy suspended the hardship program until further notice due to liquidity constraints within the Fund. It does not appear that any further distributions have been made under the hardship program.