McMahon Clarke Legal

Submission to Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into agribusiness managed investment schemes

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EXECUTIVE SUMMARY

McMahon Clarke Legal provides the following comments on the inquiry into agribusiness managed investment schemes (MIS) by the Parliamentary Joint Committee on Corporations and Financial Services (Parliamentary Joint Committee):

1. Agribusiness MIS remain one of the most highly regulated sectors in the Australian managed fund market.

2. Whilst the collapses of Timbercorp and Great Southern have been profound and far reaching, we do not advocate significant regulatory or legislative reform. Two areas however worthy of consideration are protection of investors' land use tenure and the ability of an administrator to act in that role for multiple companies, including a responsible entity, within a corporate group.

3. Market forces are likely to dictate and force upon agribusiness scheme promoters structural change and the means by which schemes are promoted and operated.

4. The Australian Securities and Investments Commission (ASIC) has a great opportunity to issue commentary and guidance for enhancing the regulatory framework and the establishment, promotion and operation of agribusiness MIS. ASIC has done this effectively in numerous other sectors.

1. Introduction

1.1 About McMahon Clarke Legal

McMahon Clarke Legal was established in 1994 and has been active in the agribusiness investment sector all that time. Our clients include managers and trustees under the former prescribed interest regime (the predecessor to the managed investment laws now in place) and we now act for responsible entities, custodians and other stakeholders operating in the agribusiness managed investment sector.

We have been very focused on legislative reform, particularly in the area of managed investment schemes. One of our partners, Langton Clarke, wrote the book *Everything you need to know about agricultural investment prospectuses: establishing a project under the Managed Investments Act 1998*. He was also president of the *Managed Investments Industry Association*, a company established to facilitate the development of Australian primary and developing industries through ethical and innovative managed investment products.

1.2 Regulation of agribusiness MIS

Agribusiness MIS are one of the most highly regulated sectors in the Australian managed fund market. MIS, and more importantly their promoters and operators, are governed by the *Corporations Act 2001* and its regulations (Corporations Act), the *Australian Securities and Investments Commission Act 2001*, the *Trade Practices Act 1974*, the *Horticultural Code of Conduct 2007*, the *Income Tax Assessment Acts 1936 and 1997*, *the Anti-Money Laundering and Counter Terrorism Financing Act 2006* plus all other regulatory requirements which traditional farming entities must meet.

The government agencies which have regulatory oversight of agribusiness MIS include ASIC, the Australian Competition and Consumer Commission and the Australian Taxation Office.

Against that highly regulated background, it is our submission that the collapses of Timbercorp and Great Southern are partly attributable to a lack of compliance with, or enforcement of, laws and regulations rather than an inherently flawed business model. Those laws and regulations are adequate and no one specific sector should be subjected to a substantively amended version of them.

Furthermore, the environment in which the collapses have occurred cannot be discounted—significant drought, high debt levels, tightening credit, declining asset values and commodity price falls at a time when companies were

endeavouring to restructure their businesses and reduce debt had an undoubted impact on their financial deterioration.

2. Terms of reference

In this submission, we have not commented on each term of reference. We have used the Parliamentary Joint Committee's numbering and headings for convenience.

2.1 Business models and scheme structures of MIS (term of reference one)

There has been significant media commentary and speculation about reportedly flawed business models and the schemes structures of MIS in light of the collapses of Timbercorp and Great Southern. Our comments on MIS models and structures are as follows:

(a) Lack of funds

One criticism aimed at the MIS sector has been the lack of funds available to a responsible entity to perform their contractual obligations under the individual management agreements entered with investors. Ordinarily, fees are collected in advance (e.g., the application money paid by subscribers to a scheme equates to the first 12 months' fees and rent respectively payable under the management agreement and land use agreement). Timbercorp had a slight variation with some of its schemes with fees paid in October of each financial year so a component represented payment in arrears and the balance was payment in advance.

Regardless, the criticism of advanced fee payments has been their use and application by responsible entities prior to the complete performance of all duties and obligations under the individual management agreements. There are claims subscription money for new schemes partly funded costs of previous schemes, although we are unsure whether there is concrete evidence of that.

In the case of group companies, funds paid as application money or ongoing fees may have been released into the consolidated revenue of the corporate group and then 'drip fed' back to the responsible entity and its related parties (which were often subcontractors for a scheme) as and when required. From a legal perspective, it is our view a responsible entity is perfectly entitled to use fees paid to it as it sees fit—once fees are paid and properly applied under the management agreements, the fees become the

responsible entity's asset. This is not to say the responsible entity's contractual and fiduciary obligations are limited in any way whatsoever.

Nevertheless, in light of the collapses, there is merit in considering whether fees should be retained in a custodial trust account pending performance. It is our view however that legislative or regulatory change to give effect to this is not required for the following reasons:

(i) Responsible entities already have extensive statutory and common law duties which are fiduciary in nature and so a responsible entity is a trustee at law. Breach of those duties is fundamental and serious.

(ii) Any throw back to the prescribed interest days of a dual manager/trustee structure should be avoided. The managed investments regime was introduced in 1998 given the problems the dual structure threw up. If, for example, grower funds were to be held in an account maintained by a third party, such as a custodian, then this is tantamount to the dual structure.

(iii) Conversely, responsible entities are aware of their fiduciary duties and obligations and should, of their own volition, initiate amendments to their own structures. We consider that market forces will dictate a change in the way responsible entities operate schemes, including the means by, and period for which, fees paid in advance are held and then released.

(b) Deferred fee vs recurrent fee model

Following on from the previous point is the differing models which have been utilised by responsible entities in agribusiness MIS. It is commonplace for forestry schemes in particular to have a deferred fee model so after paying an initial application amount, investors are only obliged to pay a fee at the end of the project which is a percentage of harvest sale proceeds. This has been criticised by research houses, for example, because it means investors are reliant on the responsible entity funding the maintenance and management obligations pending harvest from its own assets. Horticultural schemes on the other hand invariably use a recurring annual fee model given the required maintenance and management duties to be performed from season to season.

The deferred fee model was highly attractive to, if not driven by, the financial planning sector because they could legitimately advise their clients that it was effectively a 'set and forget' investment.

It is our view that, again, market forces will dictate structural form regardless and we expect to see more recurring fee model schemes established in the future in preference to deferred fee structures.

(c) Land ownership

The recent collapses have made more acute the complex interrelationships between various stakeholders in an agribusiness MIS. In many cases, the land on which the scheme is operated is either owned by a related party of the responsible entity or an external third party (although there have been numerous schemes which have also offered equity in a land ownership vehicle to investor growers or their associates). Irrespective of who owns land, there are issues to be dealt with in respect of that ownership and particularly the decoupling of water rights from the land under the various State systems in Australia and the separate encroaching of these rights to financiers.

However, subject to one rider below, we are not convinced further regulation in relation to land and water ownership is required. Instead, it is our view greater disclosure on land and water rights is required, including details about ownership, whether those assets are encumbered, the risks associated with the form of ownership and the encumbrances and other related matters. Furthermore, the protection of underlying land in agribusiness has been at the forefront of both ASIC's and the industry's mind for many years. Under the prescribed interest regime, project land was required to be leased to the third party trustee in such a way that it could not be adversely affected by any mortgage or subsequent transfer. That requirement was carried across to (and is in fact more prescribed under) the managed investments regime in the form of the condition of a responsible entity's Australian financial services licence (see conditions 44–46 of ASIC pro forma 209).

If properly enforced, the potential civil and criminal liability imposed on responsible entities and their directors acts as a more than adequate fetter against adversely affecting scheme land.

There has been one issue which has manifested itself in light of the administrations of Timbercorp and Great Southern. The Timbercorp administrator particularly has been very vocal about the fact significant

amounts of rent fall due at the end of the current financial year. If that rent is not paid, then the land owner would be entitled to enforce and potentially terminate the lease. In the event of a subsequent liquidation of the land owning entity, the land could be sold free from the lease encumbrance which was introduced in the first place to protect the interests of growers. There is no doubt this is an unacceptable situation and one which should be addressed.

We have had the benefit of the view of one of our colleagues who, among other things, has promoted amendment to the Corporations Act requiring that any lease instrument cannot be terminated or removed before the end of the term of the scheme except pursuant to a court order where it is just and equitable to do so[1]. We consider this recommendation has merit and is one area where we would not caution against regulatory or legislative reform.

(d) Responsible entities in administration

Industry commentary about Timbercorp and Great Southern has also highlighted the conflict of interest of the administrators. In our view, that conflict is inherent and is twofold:

(i) The administrator must administer a company's affairs that results in a better return for the company's creditors than would result from immediate winding-up. At the same time, the administrator, while ever filling the shoes of the responsible entity, must continue to act in the best interests of scheme investors.

(ii) In the case of group companies the administrator must act in the best interests of creditors of companies related to the responsible entity on the one hand and in the interests of investors in the responsible entity's schemes on the other. It is inevitable that what is in the best interest of creditors of a related party will not be in the interests of investors in a scheme. An obvious example is a related party land owner in administration leasing land to the responsible entity also in administration.

[1] Alan Jessup, Piper Alderman Lawyers, submission to the Parliamentary Joint Committee dated 15 June 2009.

We understand the Timbercorp administrator acted on advice and in fact received the sanction of the court to continue to be able to act as administrator of the responsible entity and the other Timbercorp companies. Nevertheless, this is an issue to which either Parliament or ASIC should give consideration. At a threshold level, we consider an administrator of a responsible entity should not act as administrator of certain related parties within the group, including a parent company or other entity with whom the responsible entity has contracted.

Furthermore, the role of responsible entity is complex and requires a specific competency and capability skill set. We consider it must be a difficult task for an administrator to be in a position to properly understand the operation of agribusiness MIS generally without extensive review and engagement in the operation of the schemes in question. Unfortunately, the nature of many agribusiness MIS is such that this is a luxury the schemes cannot afford and any delay in assessing the ongoing viability of schemes may impair the value of investors' interests (we hasten to add the Timbercorp and Great Southern administrators have pronounced they are making such assessments as quickly as practicable). However, we consider the interests of investors are best preserved and enhanced by having a temporary responsible entity with experience and expertise in running agribusiness MIS being appointed as soon as possible. The temporary responsible entity can then avail itself of the three month statutory period afforded it under 601FG of the Corporations Act to properly assess the viability of the scheme to which it is appointed.

In this regard, we note a recommended reform proposed by our colleagues that ASIC apply to the court as soon as a responsible entity goes into administration for the purpose of appointing a temporary company to fulfil the role[2]. We endorse that recommendation.

2.2 Conflicts of interest for board members (term of reference three)

It is common within group companies for the board of directors of a responsible entity and its parent or related parties to share common directors. There are potential conflicts of interest which arise as a result. However, it is generally the case that responsible entities within group companies have at least one director who does not sit on other boards within the group.

[2] Alan Jessup, Piper Alderman Lawyers, submission to the Parliamentary Joint Committee dated 15 June 2009.

We consider the mechanism of independent directorships can adequately deal with any perceived or actual conflict of interest provided the director is robust enough to act in the interest of his or her company in accordance with statutory and common law duties and obligations.

2.3 Commissions, fees and other remuneration (term of reference four)

We do not wish to make significant comment on this topic particularly as it is included in the terms of reference of the broader inquiry into financial products and services being conducted by the Parliamentary Joint Committee. It is also significant the commission versus fee for service debate has been ongoing and robust and in light of recent announcements by the Investment and Financial Services Association, the Federal Government and ASIC we consider that debate will be concluded in the fullness of time.

Nevertheless, we make the following comments:

(a) There is a perception the level of commissions in the agribusiness MIS sector have been high relative to other investment products. That being said, it has been postulated that a one off up front commission amount will be less than trailing commission paid over the term of a managed fund of comparable length to an agribusiness MIS.

(b) It is unclear whether the level of commissions has been promoted by the companies offering MIS or by the financial planning sector who have argued higher levels of commission are warranted given the complexity of agribusiness MIS and the role required to property explain them to financial planning clients.

(c) The introduction of Division 394 into the *Income Tax Assessment Act* (for forestry MIS) providing for a minimum amount of investors' application funds to go into forestry expenditure has limited, among other things, the amount of commission that can be paid.

(d) The current disclosure regime surrounding commissions is very robust.

(e) One criticism aimed at the agribusiness sector is so called advisors are in fact just selling agents, appointed to do no more than sell a particular product or a particular promoter's products. There have been recent calls for renaming product-selling, commission-driven advisors as 'selling

agents' or something similar and only those who provide a full financial planning package to be called advisors[3].

At the end of the day we consider market forces will dictate the preferred remuneration structure and the level and quality of disclosure about remuneration. Therefore, we caution against further regulation in this area. For example, the Corporations Act already provides that a financial services guide (FSG) provided by an authorised representative of an Australian financial services licensee must set out information about the kinds of financial services and the products to which those services relate. Currently that requires an authorised representative to disclose in the FSG that it is authorised to provide, for example, "general advice on Project ABC". Critics of the marketing conduct surrounding agribusiness MIS suggest that additional disclosure should be made so the FSG provides the representative can provide "general advice on Project ABC only and on no other products". It seems to us inappropriate that a FSG must disclose what an authorised representative *cannot* do, as that is potentially endless.

Furthermore, there are already adequate laws prohibiting misleading and deceptive conduct by licensees and their representatives.

2.4 Projected returns and supporting information (term of reference 10)

The advent of regulatory guide 170 (introduced as policy statement 170) *Prospective Financial Information* in 2000 effectively brought an end to any forecasting in offer documents for agribusiness MIS. As the Corporations Act has always required, statements about future events (including representations about financial returns, specific growth rates, yields and prices) must be based on reasonable grounds. ASIC's view has long been there are too many combinations and permutations of events that could impact on a set of forecasts in an agribusiness MIS that it is not credible for a responsible entity to claim they have a reasonable basis for making those forecasts. Furthermore, ASIC extended this view to that of an industry expert who certified certain variables and then prepared an expert report which, in turn, formed the basis for a responsible entity to conclude its forecasts were reasonable.

Whether ASIC's view is correct has become academic because that view forced an end to forecasting.

[3] Dominic Alafaci, MD of Collins House Financial Services, quote in *Money Management* magazine, Vol. 23 No. 19 4 June 2009.

There may be many other sources of information which lead a responsible entity to conclude it can provide forecasts on reasonable grounds. Based on our experience in assisting clients to verify statements and compile due diligence, there is a wealth of credible supporting information.

It is our view a better approach would be for ASIC to allow forecasts in other documents with full disclosure of the grounds on which those forecasts are reasonably based including, in accordance with ASIC's published view in RG 170, an industry expert report). However, the disclosure must also include a sensitivity analysis showing the impact on forecasts if price, yield, cost and any other relevant factors change. This was a previous requirement of ASIC which provided for far more effective disclosure.

3. Conclusion

The complexities of agribusiness MIS cannot be understated. This may in part have led to the adverse financial outcome for certain companies operating within the sector.

Whilst the collapses of Timbercorp and Great Southern have been profound and far reaching, this submission cautions against reactive regulation and law reform. It is our view the laws governing agribusiness MIS are already robust enough. It is compliance with, or enforcement of, those laws which needs to be the focus of attention.

There is an opportunity for ASIC to revisit its regulatory guides, or issue new guidance, on minimum requirements it expects to be observed by responsible entities in scheme establishment, promotion and operation in order to comply with those laws. There is also no doubt it is also incumbent on the industry to ensure and promote the highest level of compliance with the laws as they stand.