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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Managed Investments Act review

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SYDNEY

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Friday, 12 July 2002

Members: Senator Chapman *(Chairman)*, Mr Griffin *(Deputy Chair)*, Senators Brandis, Conroy, Murray and Wong and Mr Byrne, Mr Ciobo, Mr Hunt and Mr McArthur

Senators and members in attendance: Senators Chapman, Conroy and Murray and Mr Byrne and Mr Griffin

Terms of reference for the inquiry:

To assess the findings of the review by Mr Malcolm Turnbull of the Managed Investments Act 1998, with particular regard to:

a) the risks to investors in the current arrangements, taking into account the extent to which any lack of independent checks and balances may have contributed to recent financial failures in Australia and overseas;

b) global best practice in investor protection of managed funds;

c) the acknowledgment by the review that , under s.1325 of the Corporations Act 2001, a number of parties may be held accountable for member losses;

d) the rejection by the review of proposals which might conflict with the concept of having only a single entity responsible in the event of member losses;

e) the review conclusion that scheme operators not have the option of appointing an external corporate entity for compliance purposes, pending ASIC monitoring of compliance performance;

f) the reasons why the strong growth in managed funds has not resulted in a significant reduction in fees; and

g) any other relevant matters.

WITNESSES

Committee met at 9.36 a.m.

FRENCH, Mr Philip, Senior Policy Manager, Investment and Financial Services Association

LLOYD, Mr Geoffrey, Member, Regulatory Affairs Committee, Investment and Financial Services Association

RALPH, Miss Lynn, Chief Executive Officer, Investment and Financial Services Association

CHAIRMAN—I declare open this public meeting of the parliamentary Joint Statutory Committee on Corporations and Financial Services. Today the committee will hold its second public hearing into the findings of the review by Mr Malcolm Turnbull into the Managed Investments Act 1998. After lunch, the committee will resume its public hearings on the regulations and the ASIC policy statements made under the Financial Services Reform Act.

Before we commence taking evidence, I reinforce for the record that all witnesses appearing before the committee are protected by parliamentary privilege with respect to evidence provided. Parliamentary privilege refers to special rights and immunities attached to the parliament, its members and others, necessary for the discharge of parliamentary functions without obstruction or fear of prosecution. Any act by any person that operates to the disadvantage of a witness on account of evidence given by the witness before this committee is treated as a breach of privilege. These privileges are intended to protect witnesses. I must also remind you, however, that the giving of false or misleading evidence to the committee may constitute a contempt of the Senate. Unless the committee should decide otherwise this is a public hearing, and the public are welcome to attend. I welcome to this hearing Miss Lynn Ralph, Mr Philip French and Mr Geoff Lloyd, representing the Investment and Financial Services Association. Do any of you have any further information that you wish to provide to the committee in relation to your capacity as witnesses here today?

Mr French—No.

Miss Ralph—No.

Mr Lloyd—Yes. I am head of business services at the BT Financial Group but I appear here today on behalf of the Regulatory Affairs Committee of IFSA.

CHAIRMAN—The committee prefers all evidence to be given in public, but should you at any stage wish to give any of your evidence in private you may ask to do so and the committee will consider a request for an in camera hearing. The committee has before it a written submission from IFSA, which we have numbered 2. Are there any alterations, amendments, or additions that need to be made to that submission?

Miss Ralph—No.

CHAIRMAN—I now ask you to make a brief opening statement if you wish to do so, following which we will proceed to questions.

Miss Ralph—Thank you very much. It is a pleasure to appear before you today and to report on the health of the Managed Investments Act regime. I have to say that I also feel personally very pleased. Like many of you, I seem to have had a long history with this piece of legislation. In fact, it was only a few weeks into my previous role as the Deputy Chairman of the Australian Securities Commission, now ASIC, back in 1993, when the Law Reform Commission launched its report *Investments: other people's money*. Only a few months later, I also had the privilege of introducing the then Attorney-General, Michael Lavarch, at an ASC workshop where he publicly announced for the first time his government's intention to adopt the recommendations in that report.

Sadly, and possibly indicative of the reasons for the instigation of the ALRC review in the first place, the ASC was still involved in prosecuting those involved in at least one of the major failures of the previous regime well after I left the ASC in 1996. I appeared before this committee again in March 1998, only three days into my role as Chief Executive Officer of IFSA. I have to say that, at that time, I had the pleasure of watching the Liberal Party, under the hardworking hands and guidance of Senator Ian Campbell, acknowledge and support the principles within the bill and manage its adoption through parliament later that year. The two-year transition period from 1 July 1998 brought its own challenges, and IFSA was pleased to work on behalf of its members and investors to resolve various taxation issues which could have impeded adoption of the new regime.

Some of you may know that I have about 3½ weeks left as CEO of IFSA, and here we are talking about the act again. I am very pleased to be able to say that I think the act is working as originally intended. A strong culture of compliance has developed in those organisations that are responsible for other people's money, and that was the goal of this piece of legislation. I have to say that it is with some sadness, although with some satisfaction, that I can also report that the regime has demonstrated its robustness by withstanding one of the greatest shocks the industry has ever experienced. I refer to the awful events of September 11 and the impact that those events had on the financial markets at the time. I would like to ask Geoff Lloyd to explain to you a little about his experience with the regime—Geoff worked under both regimes at BT—and about his experience as a practitioner and perhaps elaborate a little more on the events of September 11.

Mr Lloyd—I will give you some background to put some of my statements in context. I was a regulator with the ASC at that time and ASIC so I have had experience on both sides, both in the regulatory environment as general counsel at BT for six or seven years and, most recently, as the head of Business Services Area BT for the last two years, looking at those areas that comply with the requirements of the new act outside the asset management obligations. So hopefully I can bring a flavour of the old act and the new act and of the experience of a regulator and a practitioner.

To explain the new regime I thought I might discuss what we have undertaken—these comments are very consistent across the industry under the new MIA regime—and the compliance plan environment and the other matrix obligations have brought to the breadth, the depth and the robustness of the compliance environment of a single responsible entity. That starts under the act with the compliance plan and its obligations, which, since and prior to enactment, has had business lines within asset managers and fund managers as well as directors themselves fully understanding their obligation as the single responsible entity. There is no

other party—those directors and business lines do have weekly, monthly, quarterly and annual obligations, and their depth is right to the bottom of the organisation. Different organisations approach that in different ways—from self-assessment to quarterly sign-offs or monthly sign-offs—but there is ongoing training, an ongoing checklist environment and an ongoing direction that the manager is the single responsible entity and therefore has those responsibilities under the act.

Primarily, that act also brought about the obligation to notify of any breach—I think it is within two business days. That obligation required people not only to understand their obligations and carry them out but also to focus on any issue, be it a breach or a potential breach, in a timely way. So the compliance environment required that to be identified, flushed up and dealt with in a senior way across the organisation in as timely a manner as possible, which is the key. It also required that the regulator and the auditor be notified at the same time. There is the annual review by the auditor of the entire compliance plan and the ongoing obligation of directors to understand its adequacy. That is reviewed at least on a quarterly basis. Under the law it is required on an annual basis.

Importantly, you hear directors using terminology like 'we are the fiduciary'. That is an enormous change. Directors always understood their obligations but at the same time I think they were confused as to where the line was drawn between the trustee and themselves as managers. In my experience that confusion has been removed entirely. Directors know that it is their obligation; they take it seriously and they talk about their fiduciary obligation to investors—their obligation to have single-minded loyalty to those investors. In addition, many managers have compliance committees which bring an external impetus to the adequacy of that structure. I summarise by saying that the depth, breadth and robustness of the compliance environment has seen significant change from what, under the old law, was an environment that allowed dissociation in some instances because of confusion as to where the obligation started and stopped with trustees.

That probably brings me to the September 11 environment. For the industry, those circumstances evidence the way in which managers, as the REs, even with the benefit of hindsight, are unable to be criticised for the way in which they timely and appropriately dealt with a significant obligation that they had about pricing funds. If you go back to the prior law, that was not as clear. In a moment I will give you some examples from my personal experience that evidenced that. But, using my experience, at 1 a.m. on September 11 I had a call from the CEO saying that the crisis had occurred. It woke me up. I got up and we pulled together a team by 6 a.m. By 8 a.m. we had reviewed all our obligations, obtained our own external legal opinions and made a decision on what we would do. Then we spoke to the industry body. All managers had been doing the same. By 10 or 10.30 a.m. at the worst case, the industry had a uniform position. I think it was still appropriate for investors, and investors' protections were maintained. Then the managers, depending upon their individual circumstances, the asset classes and their exposures to different markets, wound out those positions over the next three, four or five days, as appropriate. That was done in a timely way. As I said, by 10 or 10.30 a.m., the answer was there, investors were communicated with and it was in the market.

I wonder what would have happened in the old environment to get out an answer as fast as that which served the same purpose. You had two parties trying to understand what their obligations were and where the deeds started and stopped. Many deeds are old and they are still

ambiguous in these sorts of pricing situations. During the Asian crisis and even the Russian bond crisis—so from mid-1997 to the start of 1998—experience showed that it was very difficult. You had the same situation but on a smaller scale. You ultimately had to identify with the trustee the underlying obligation and agree on what that clause said. At the same time, both parties were seeking their own external legal advice and were in a position where they were looking for expert advice outside of just legal advice—that is, advice on markets. That is never forthcoming; it is very difficult. Ultimately, in both situations, in a general way I can say that managers were left in the position of having to give indemnities to the trustees to move on. It was very difficult to get a timely answer. It was because not one party but two parties had to make that decision. They had their own internal questions to be asked and they obtained their own external opinions. That made it very difficult. With September 11 we saw a timely, appropriate response from the market that, even with the benefit of hindsight, cannot be second-guessed.

Miss Ralph—That is an excellent example of the change in the culture and environment that is going on inside responsible entities under the act in an incredibly short period. Whilst many companies like Geoff's transited quite early in the regime, some companies did not transit until quite late during the two-year transition period. In some cases we are talking about people having about two years in this new regime. There has been an enormous cultural change in that period. The processes that have been put in place in that period are substantive, and the September 11 shock to the marketplaces demonstrated that those processes are now working. The regime has withstood quite a major shock and it has come out with a pretty good report card. Paragraph (f) in the inquiry's terms of reference states:

the reasons why the strong growth in managed funds has not resulted in a significant reduction in fees ...

I would be grateful if the committee could provide the information upon which the conclusion of that statement is drawn, because it is not particularly consistent with the evidence that we have seen or that we have submitted to the committee with our initial submission. As you are aware, our initial submission had an independent survey done by KPMG in relation to actual fee levels being charged by managed investment schemes which are managed by our member companies. We have taken the opportunity to request KPMG to update that survey for the 2001 data. Today I would like to table those results, which update the report we gave in the submission for the latest 12 months of data that is available in the market. The conclusions drawn in the KPMG report are:

For the period 1996 to 2001 we found there has been an overall reduction in the weighted average MER—

that is, the management expense ratio—

of 4.6% (or seven basis points). This seven basis point decrease in MER translates to a cost saving for investors of approximately $71.7m in 2001.

During the period of our study there were two significant regulatory developments impacting retail schemes. These developments were the implementation of the Managed Investments Act (MIA) from 1 July 1998 and the introduction of Goods and Services Tax on 1 July 2000.

Our analysis found that in the period following the implementation of the Managed Investments Act there has been a four basis point reduction in MERs. This reduction can be represented as producing a saving in fees for investors in 2000 and 2001 respectively of $35.7m and $41.0m ...

We believe that this reduction in fees is significant, that it is growing and that it is consistent with the estimates which were made by our association prior to the enactment of the legislation. Having highlighted the positive results in relation to fees, we strongly reiterate our belief that the overhaul of the regulation of collective investment schemes was never driven by a desire to reduce fees; it was driven by a desire to improve the integrity of the industry and increase consumer confidence. I believe that the Managed Investments Act is now producing those results.

CHAIRMAN—Opening with the issue of fees, we heard evidence yesterday from the Trust Company quoting comments you made on 5 September last year. They quoted you as saying that competition had initially driven fees—MERs—down but the introduction of the MIA and the GST had driven them back up. They put the argument that there had been no reduction of fees and asked why you would expect a reduction of fees when a single responsible entity is basically doing the same job that the trustee and the manager did previously. They argued that now that it is in the one entity—and they argued that the cost would be similar—why would the single responsible entity give away revenue when it had a justifiable case to retain it in the sense that it was fulfilling the duties the trustee previously did? You have just given information indicating that fees have in fact gone down. How do you gel your comments last year with the comments you have just made and the points raised by the representative of the Trust Company?

Miss Ralph—I can start by saying two things. My memory of some of their submissions back in 1998 may be a bit hazy, given that we are four years down the track, but I recall that at the time the trustees were saying that fees would go up. Now they seem to be saying that you would expect fees to stay flat. We have always said we thought there would be some reduction in fees. It is also not fair to say that people are doing the same job that used to be done by the two entities. I do not think that is necessarily a correct portrayal of what is actually going on in the marketplace. The requirements under this act are different. You say 'the same job' but we are all trying to achieve the same outcome at the end of the day. I think we would agree that we are trying to have an industry with integrity that consumers have confidence in. But the actual jobs that are being done today are quite different from the jobs that were done in the past. So I do not think it is fair to say that it is the same old two jobs whacked together. I do not think that is an accurate portrayal of what is going on. Geoff, do you want to add something to that point?

Mr Lloyd—I agree. At the same time, in relation to managers, net, net you cannot say it is the same job; they are different. But net, net, dependent on the level of where an organisation was with its own internal compliance methodology prior to the new law, if there was an increase I think that managers have generally borne that as a cost of doing their business. I am not aware of any evidence that suggests that that has gone up for any reason other than, particularly, the GST.

Senator MURRAY—What do you mean by 'net, net'?

Mr Lloyd—Because the roles are different in some organisations, dependent upon where they were, there may have been no change at all. Other organisations may have had to employ different personnel, for instance, to carry out an activity they were not undertaking, and that may have increased their cost.

Senator MURRAY—So it is net of what?

Mr Lloyd—Netting off the changes between the new and old roles; it is just netting those two roles off.

Senator MURRAY—That is what you mean by 'net, net'?

Mr Lloyd—That is correct.

Miss Ralph—Hopefully everyone now has a copy of the latest KPMG result in front of them. The key table is probably on page 9 of that report, and that shows all of the MERs from the 1996 period for various asset classes, because obviously they are different. I think it is fair to say, and it is consistent with my previous comments, that, prior to the introduction of this act, we were already seeing MERs coming down as a result of increasing competition in the marketplace and that that trend was probably in place to a certain extent. We should have expected to see a bit of a blip with the GST. It is possible that competition forced managers to absorb most of that blip.

As Geoff pointed out, across the industry it is difficult to get a real handle on what increased costs MIA might have had for managers, or whether they had any increased costs at all. We do know that we have not seen any increases in MERs as a result of that. So our suspicion is that, as a result of no increased costs, some savings or the preparedness of the manager to wear some increased costs in a competitive environment, at the bottom line the MERs have not ratcheted up in any way. So, yes, it is difficult to unpick where the change in the basis points has actually arisen, unless you were to unpick each manager's pricing, which is obviously a major task. But these are MERs of what is actually being charged in the marketplace today on a very large chunk of the retail funds that are out there.

Senator MURRAY—Because the GST dealt differently with the financial services industry, it is difficult to assess whether its effects would have been positive or negative. The general principle behind the application of the GST in the new tax system, including the business tax reform, was that greater efficiencies would be delivered and would flow through the business sector. Against that, you would have to net off in the short to medium term—and there is a great debate between us as to when the flow-through effects would occur—the transitional effects and compliance effects of introducing the GST and putting in new systems. In my view it would be very difficult to say that it did not assist in delivering a lower return or that it did. As an observer I would find it very difficult to work out for the financial services industry.

Miss Ralph—KPMG have made some small comments about that on page 11 of this report. They basically say that, because of the ability of the schemes to claim the 75 per cent input tax credits, in theory you should have seen a 2½ per cent increase in fees as a result of the GST; notwithstanding that, there still appears to have been a decline in MERs through that period.

Senator MURRAY—I am very grateful that you have delivered—I have not read it—what looks like a very thorough appraisal which will help us. It was commented yesterday that it was not just the class of assets but the size and scale of the fund manager which affected the cost structure and whether you could deliver economies of scale or such like. I cannot see at a glance that you have segmented this in that sense.

Miss Ralph—No, we have not. This has been an exercise to look at, in toto, the dollar weighted MERs that have been paid in the marketplace, not to do an analysis of economies of scale per se, which is quite a complicated exercise because it is not necessarily the size of the fund that you would need to look at but, for example, the make-up of the investor groups within the funds—that is, whether they are a large number of small accounts or a small number of large accounts, or whether there is a high rate of turnover of accounts or quite stable accounts. All those things could ultimately impact on costs. To determine whether there is a direct correlation involving the size of fund is a difficult and extensive exercise and we have not tried to do that.

Senator MURRAY—But intuitively would you concede their point that it is possible for there to be fund managers whose fees and charges have dropped considerably and might show a better picture than others who might indeed have stayed stable or risen? That is possible, depending on the mix of factors you have just outlined.

Miss Ralph—At page 14 of the report, the table in appendix 2 shows the spread of MERs and the averages. It shows the highs and the lows. You can see that there is a diversity of pricing in the marketplace, as you would expect.

Senator MURRAY—But we do not know whether that is relative to size.

Miss Ralph—We do not know for sure, no.

Senator MURRAY—That is the point they make; that is, that size does influence these matters.

Miss Ralph—But it is also fair to say that investment performance influences these matters. Managers with outstanding performance often take the opportunity to charge a slightly higher price, as you would for a premium product in the marketplace in any other industry. Again, a lot of factors contribute to the price being charged. I would not say that it is a single-factor model that we are looking at. Interestingly enough, the only work on economies of scales and fees that I have seen has been done by the Investment Company Institute in the United States. Again, they have done that exercise in aggregate on their members' funds, which are obviously incredibly larger than the funds here. Even in their report, whilst they say that there appears to be some connection between size and economies of scales and prices, they say that you can only draw that conclusion in an aggregate; you cannot even draw that conclusion for a particular single manager.

Senator MURRAY—As you know, I was a sceptic in this area. From what I have seen, bearing in mind that I have not yet had the opportunity to read your report, I draw this conclusion: for those who feared that fees and charges would go up, that case has not been made; for those who have stated that they would go down, that case might have been made but there are other influences that you have to take into account.

Miss Ralph—We admit that. We say that it is difficult, without doing enormous amounts of work, to understand exactly why. We say that on average across the industry consumers are better off than they were, and we anticipate that that trend is not necessarily about to turn around. I concur with what you say: the evidence that somehow costs would increase under this regime has not been borne out. It is also fair to say that we presume that the benchmark

comparison for this regime is the old regime, but my suspicion is that, had we not moved to a single responsible entity in 1998, in light of the problems that we had experienced with that regime, in your wisdom you would have put a whole range of new requirements on the old regime. That in itself could have led to increased costs. In a funny sort of way, we have been comparing the MIA regime results with the old regime but not perhaps with what would have happened had we not moved to this regime. I suspect that we would not have sat unchanged with the old regime.

Senator MURRAY—You are indulging in a leap of faith!

Miss Ralph—It is also fair to say that even if the old regime had remained unchanged the costs of the two party system in some way, shape or form would not have increased. I guess all of those things make it a difficult conclusion to draw. All we can show are the numbers that are actually out there right now. We may not know exactly why each of these basis point drops occurred, but we do know what the figures are.

CHAIRMAN—We heard earlier from Mr Lloyd about how the new regime has dealt effectively with a major external shock. One of the arguments put to us yesterday was that the new regime makes it easier to cover up internal mistakes or failings and to spread the effect of those mistakes across the entity. Would you comment on that?

Mr Lloyd—There is a combination of things that would otherwise prevail—and do prevail—to prevent that. Importantly, the nature of the obligations is clear across the organisation. There is the quality of the directors at the time of registration and licensing, and their responsibilities are vetted by ASIC up front, so they have to be of quality and of experience. I am sure that no organisation of size would not have a significantly experienced internal compliance department. Compliance has become a profession over the past four-plus years; hence the parties that undertake that profession are professionals.

CHAIRMAN—Even the consultants!

Mr Lloyd—And then there are the external interests. At the same time, auditors have a far greater role than they ever have and they visit us more regularly. Most importantly, ASIC has a greater role. ASIC does conduct regular visits for different things at different times. It is a matrix environment. I do not remember a circumstance in my time in my current organisation when a trustee visited us.

Senator CONROY—In your submission you argue that the MIA should be amended to make it absolutely clear that the custodian is not liable to investors when acting on the instructions of the RE. Can you elaborate on why you believe that amendment is desirable?

Mr French—We think it is basically clear that that is what the legislation strongly implies. We are suggesting that it could be stated more explicitly in the legislation to make it absolutely unequivocal that the agent will only be liable as the agent of the responsible entity.

Senator CONROY—Would the impact of an amendment in the form you suggest be that custodians would be liable if they were not acting on the instructions of the RE? You have

argued that 'when acting on the instructions of the RE' would hopefully clear it up, but would it mean that if the custodians did not act under those instructions they would be liable?

Mr French—If they acted outside their instructions?

Senator CONROY—Yes. The review seemed to argue or reach the conclusion that an amendment in the form that you are talking about might confuse accountability. I was just looking for your response to that.

Mr French—By implying the opposite, do you mean?

Senator CONROY—Yes.

Mr Lloyd—That component of the submission dealt with talk in the market from other bodies. I was surprised to hear that there was uncertainty. I think there is clarity in the current law. The submission was saying, 'If it is not absolute liability and someone has another argument, let's clarify that, because that was the intention.' As you have said before, Senator, 'single responsible entity' means single responsible entity, so absolute liability was not meant to be impaired by this component of the submission. It was just addressing another concern that had been raised by one legal body—I think it may have been a law council.

Senator CONROY—Do you think that, by specifying when acting on the instructions, that could leave open a legal issue if they did not act on the instructions? I am being pedantic. I am not a lawyer and you know that I have strong views on this. I am trying to get a legal view in that regard.

Mr Lloyd—I walked away from the law in the past two years.

Senator CONROY—Congratulations!

Mr Lloyd—If there were a principal-agent argument here that the agent was acting outside of authority and had no ostensible authority to act, I think that the principal would not be liable but the agent could be sued. If a custodian acted and that was not within their authority, if you made such an amendment, in most circumstances the RE would not be liable. However, my view is that that was not the intention of the act so it should not change.

Mr French—And the member would have recourse via section 1325 anyway directly in that situation. That is already covered in the legislation.

Senator CONROY—I was going to move on to the question of liability for acts by the agents. You argue that the RE should not be responsible for the fraudulent activities of agents. Can you elaborate on why you think there is confusion and how this solves it?

Mr French—Are you talking about our second—

Senator CONROY—I am talking about liability for agents in general, and you argue that the RE should not be responsible for the fraudulent activity of agents.

Mr French—And that is the way that trustee law has always operated, and the RE is a trustee in the true sense of the word.

Senator CONROY—You seem to be saying that we have to make it absolutely clear because that section applies, but in this case you want further clarification.

Miss Ralph—They are not related issues.

Senator CONROY—No; I am talking about the principle rather than a related issue.

Mr French—We are saying that it goes a lot further than trustee law has always gone in saying that there is no limit whatsoever. No matter how diligent you have been and regardless of what precautions you have taken, you are held liable and where there is no fault on your part—

Senator CONROY—I presume the RE would be suing the agent at this point anyway if there was fraudulent activity. Members might also get in on it with you, but I presume the RE would jump on them as well.

Mr French—Yes.

Senator CONROY—I want to refer to compliance now. In your submission you recommend an amendment to the effect that a person only fails to qualify as an external compliance committee member if they had substantial business dealings which a reasonable person would expect would influence the member in the performance of their duties. Can you elaborate on that? We received evidence from Mr Stewart yesterday who expressed some frustration in respect of trying to round people up to be on compliance committees. He felt that it was difficult to find sufficiently qualified people.

Senator MURRAY—The quality was patchy.

Senator CONROY—Perhaps you could take us through your thinking on that one.

Miss Ralph—I guess I am not surprised to hear that he thinks that it is a difficult role to fill; we would hope that was the case in that it is similar in many cases to the role of a company director. We do not want every Tom, Dick or Harry walking down the street to put up their hands to be in these sorts of roles.

Senator CONROY—We would not want one person to be on 12 compliance committees either.

Senator MURRAY—And we would like a few Janes and Marys in there as well as Toms, Dicks and Harrys.

Miss Ralph—That is true.

Senator CONROY—Or Lynns.

Miss Ralph—On the one hand we are saying that it should be considered a role that people take on incredibly carefully and thoughtfully. If a previous witness discovered that some of the people he has approached chose not to take that role, I suspect that is a similar position to what you might find in the area of company directors where you will find that similar people for various personal reasons choose not to take on that function.

Perhaps Geoff can talk about what goes on in the industry. I think you have a representative from the Independent Compliance Committee Members Forum appearing before you later today. That group did not exist two years ago. I think it is fair to say that the roles, nature and capacity of independent compliance committee members have really been evolving over the past two years and that group has obviously been contributing to that process in terms of clarifying the roles, responsibilities and the sorts of qualifications, behaviour and conduct that are expected. I think you will continue to see that grow and evolve. A lot of progress has been made. It is fair to say that on day one, two years ago, they probably were not quite there. It is also possible that we still have to see further improvements in the understanding of those roles and the sorts of qualities of the people that are going into those roles, but I think we have gone a long way to achieving what was envisaged for that role. No doubt the ICCMF will talk about those sorts of things. It will be very important for a body like that to bring standards to that role.

Mr Lloyd—From an industry perspective, not from a personal one as we do not have a compliance committee, I reaffirm Lynn's earlier comments. I think that on enactment and certainly in the first year people were concerned about that, but, as I said earlier, compliance is truly labelled a profession in the market now. I have not heard talk that it is difficult to find suitably qualified people. From my perspective, in the last 12 months it has really become a non-issue.

Senator CONROY—Is there a need for the amendment, then, if it is a non-issue?

Mr Lloyd—I think the amendment was trying to address not so much the fact that there was a dearth of individuals, but that the substantial business connection element that excluded someone might for instance mean that a director of your custodian who has left that custodian, cannot now be on your compliance committee. Yet one would assume that that person does their significant business dealing as your custodian and that that, if anything, should more suitably qualify them in their background and experience to be on your compliance committee. They are a custodian; it is a commodity aspect of the market component. So that component was about how they could get on the compliance committee and why they should be on the committee. It was broadening that definition.

Mr French—It was just that the absence of some kind of materiality test rules out people who would otherwise be very useful in that role, that is all.

Senator CONROY—I want to come back to the cost issue and your updated information—and thank you for that. I note that you commissioned the KPMG report and I think you now have an updated one. Your report notes that IFSA's brief to KPMG asks for a:

... report on levels of fees in Australia relative to fees and charges in other overseas markets for comparable products over a 1, 3, and 5 year period ...

I briefly flipped through this one, but I could not find that in the KPMG report. Is it available?

Miss Ralph—We have only presented domestic information here. We have found the international comparisons to be rather problematic because of the nature of the products. Whilst the end goal of the products are quite similar—they are pooled investment vehicles for investors—the style and nature of the products in a lot of countries are not strictly comparable to those in Australia. It has made the international comparisons to try to get to the apples and apples position quite a difficult exercise. We are still not quite satisfied that we have actually got apples and apples yet, which we think are numbers that have some integrity to them and, therefore, some usefulness.

Senator CONROY—Did KPMG produce something that you then looked at and said, 'That is just not apples and apples.' Or did they not—

Miss Ralph—We just looked at it and said, 'That is not the same product.' They had a go at looking at some comparisons, but you could look at it and say, 'It doesn't make sense. It's not useful data. It is not strictly comparable. What conclusions can you draw from it?' We had a go at a couple of countries and tried another one and still had that problem. So we have not quite worked out how to effectively make those comparisons so that you can draw useful valid conclusions about where Australia stands to be able to say, 'These are the marketplaces.' We hate presenting data for which we cannot put our hands on our hearts and say, 'We think that is a correct picture of things.'

Senator CONROY—The SEC issued a report on mutual fund fees and expenses in December 2000. Are you familiar with that? I understand it does actually compare apples with apples—weighted MERs, no entry and exit fees, no load.

Miss Ralph—For American products?

Senator CONROY—Yes.

Miss Ralph—There are different classes of mutual fund products within a single mutual fund.

Senator CONROY—I understand that, but if you do a comparison as to whether it is apples with apples, from my inexperienced knowledge of it, it is apples and apples within a reasonable context. I would like to run you through what the SEC report showed. Incidentally, I was surprised that, between your first and second KPMG reports, there seems to have been a revision of the figures. I am picking on the year 1999, but the figures actually changed between the two reports.

The weighted average management expense ratio on bond funds in the US was 0.8 per cent in 1999 compared to 1.46 per cent in Australia—around 75 to 80 per cent higher. The weighted average management expense ratio on international funds was 1.18 per cent in the US compared to 2.1 per cent in Australia—that is approximately 70 per cent higher. The weighted average management expense ratio on domestic equity funds was 0.9 per cent compared to 1.81 per cent in Australia—about double the rate in the US. As I said, you probably have not seen those

figures, but I was just wondering if there was any reason why there was such a dramatic difference between what US and Australian investors pay.

Miss Ralph—As you say, I have not seen those figures per se and I am not sure which class within each mutual fund those figures are working off, but I can make some assumptions about why this market would be different from that market. That market is 60 years old and quite mature. There are penetration rates into the American community of about 50 per cent—that is, 50 per cent of Americans own a mutual fund. The size of the market is probably 10 times that of the Australian market. The Australian market for retail unit trusts is about 20 years old and the first unit trusts were probably the cash trusts that went on for a number of years. So many of these funds and businesses are, in fact, less than 20 years old. We are not talking about a mature industry here in Australia. We are talking about a significantly smaller industry than in the United States. We are talking about penetration rates into the community of about perhaps 19 or 20 per cent, not 50 per cent. There is a substantially different style of marketplace.

We also know that there is a difficulty in extracting the differences between their products and ours about where advice is charged in the value chain. In Australia, much of the cost of advice for retail products is often embedded in the MER of the product and that is not necessarily always the case in the United States. So, again, you may be trying to compare product and product, but here we have product plus advice and there they are charging in the MER for the product. That may be another distinction leading to those differences in ratios. We could go on and on and I guess one of the problems we found—particularly in trying to make a comparison with the US market—was that the size in itself made it a substantially difficult marketplace to compete with.

Senator CONROY—On the scale and size issue in particular, the SEC also thought that the size of the funds would influence the level of fees. However, their analysis showed that:

> ... the management expense ratios of large funds declined as individual fund assets grew, but the decline was not statistically significant.

So they dismiss the scale argument completely.

Miss Ralph—Yes. The piece done by the Investment Company Institute, which is effectively our equivalent in the US, on economies of scale also does not make a strong argument that there is somehow a connection—except at the very top end. Within those averages in the US, there is a handful of incredibly big and very popular funds produced by a handful of the very popular managers—the Vanguards and the Fidelities. The ICI report implies that, whilst all the way up the scale it is difficult to see a straight line relationship between economies produced by scale, at the very top end there does appear to be some evidence for that in these very large funds. Those funds are the size of our entire industry! That is a reason why we found it difficult. Just to use averages to compare the two countries is a bit vexed because of the differences in the pools of funds that you are looking at and their nature. I would be interested to see whether the SEC did a spread around those averages because I think you would find that some very large funds exist in the US with quite low rates but also that there are some quite small funds in the retail sector with rates that would be comparable to ours.

Senator CONROY—Notwithstanding some of the differences you have outlined—and we have agreed that the scale issue is not necessarily a factor—do you think Australian investors are entitled to pay the same comparable fees as American investors?

Miss Ralph—I would like that for every single product that exists in the marketplace and not just for financial services. I think it is probably fair to say that consumers in Australia do not pay the same prices that consumers in America pay for everything they might buy.

Senator MURRAY—You are not going to talk to us about steel and agriculture in America, are you?

Miss Ralph—Or sheets and towels or mobile phones.

Senator CONROY—I have to agree with Senator Murray that trying to draw a comparison between steel or towels and investment products, which transfer a little easier, is not practical. It is probably because there are no transportation costs, if you want to get down to very silly arguments. You seem to agree that it is reasonable for Australian investors to expect, over time—I am not saying tomorrow—

Miss Ralph—I have not drawn that conclusion at all, I am sorry.

Senator CONROY—I thought you said you would like to see—

Miss Ralph—No, I said I would like to see Australian consumers being able to access all products and services possibly over time. But I guess I was being slightly facetious in that being a realistic proposition to illustrate my view.

Senator CONROY—Do you think it is realistic for Australian investors to expect to pay the same level of fees as American investors for similar products?

Miss Ralph—Probably not until we are a 60-year-old and mature industry with a 50 per cent penetration rate into the community as well.

Senator CONROY—The Turnbull review noted that:

Proponents of the new arrangements claimed that substantial cost savings could be achieved by the replacement of the dual trustee/fund manager structure with a single RE, and that this would translate into lower fees and charges for investors.

Your submission notes that there have been some savings. Putting aside the drop between 1996 and 1998, which was pre-MIA, and probably 1999 when people were just changing their constitutions, from 1999 to the present day, do you think there has been a substantial fall? I am quoting from Turnbull rather than from anything you have necessarily said directly.

Miss Ralph—We are saying that we think the falls and the quantums that we have seen are consistent with what our expectations were when we originally talked about the act. I think it is fair to say that if we were sitting here today and there had been no falls in fees at all, we would still say this act has been a success. We still think the raison d'etre for this act was not about

cost savings and efficiencies but about improved investor protection and about not going through the sorts of horrors we went through in the late 1980s and early 1990s with the previous regime.

Senator CONROY—I appreciate that point. It is just that, at the time, the proponents—and like you, I have lived through, though probably not quite as long—

Senator MURRAY—Careful, Stephen.

Senator CONROY—This is my fourth or fifth year of MIA, or MIB as it used to be known, and like you, Miss Ralph, and Mr Turnbull and Senator Murray, I do remember people sitting in front of parliamentary committees arguing that there would be substantial savings. Looking at three of the classes that you talked about—domestic, equity and active—in 1999 the MER figure was 1.81 and in 2001 it was 1.81. That does not sound like a substantial fall in terms of the claims being made back then. The figures for international equity were 2.01 and 1.91 and for domestic bonds they were 1.46 and 1.44. They just do not sound like the substantial amounts talked about back then.

Miss Ralph—I would just say two things: first, a basis point on a big pool of money is a substantial amount of money, even though it might look like a very small thing; second, and I reiterate what we said earlier, we gave evidence in relation to what we thought would happen to costs under the new regime. We are not overly bullish. We gave some figures that I think are consistent with the sorts of numbers being produced here. We did that only because others were saying that there would have been substantive increases in the cost of the new regime.

Senator CONROY—So it was bullish to match bullish.

Miss Ralph—No, I do not think we were overly bullish. I think the numbers now being produced are consistent with the sorts of savings we had anticipated and the figures that were quoted in our submissions back then. I still have to say that $40 million a year and growing is pretty substantive—it is to me, anyway.

Mr BYRNE—I may have missed this because I had to step out earlier when Senator Chapman was asking questions, but what are your perspectives on using an external company as the compliance entity rather than an individual? That has been put forward by a number of people.

Miss Ralph—We can understand where those suggestions are coming from, but we have some difficulty with that model. The concern is that, to a certain extent, the concept of the single responsible entity and the people sitting either on the board or on the compliance committee of that entity would take on some of the attitudes that Geoff has described. When we heard about this proposal, we asked ourselves whether you would apply a similar sort of model to, say, a listed company entity—that is, would you allow a director of a listed company entity to be another corporate? We were not quite sure that you would come up with the same sort of answer or recommendation. The other point is that, if responsible entities want to avail themselves of the skills and experience of individuals, say, in an accounting firm, a custodian or whatever, there is nothing stopping them from accessing the skills and experiences of those individuals by appointing them as individuals either to the compliance committee or to the

board. That individuals could get some indemnity from their employer—that is, the accounting firm, the custodian or whatever—if they so choose, but there did not seem to us to be cause for concern that responsible entities could not access exactly the same skills and experience by having the individual sitting there as they could by putting that same person there with a corporate hat on. So I have to say that we are not necessarily big supporters of this notion. We would rather see individuals there wearing the heat. We think that is the way the act should work and the way it was envisaged to work. We do not necessarily see enormous advantage in having the option of placing a corporate entity on either the compliance committee or the board, but we do see some potential downsides.

Mr BYRNE—The downside being what?

Miss Ralph—When you put an individual in a position of responsibility, that is when the heat really gets applied and the regime becomes effective.

Mr Lloyd—You certainly get focus if you look at the list of compliance committee members and your name is there—

Mr BYRNE—Yes.

Mr Lloyd—as against a company name. That is what the act was trying to achieve.

Miss Ralph—We would also have a concern if a responsible entity said, 'I can now just outsource my entire compliance regime to someone else.' I do not think that is what we originally envisaged that this regime would result in. If that is the case, then you should not be a responsible entity. Get someone else to take that role on in toto.

Mr French—The downside is the same as dual responsibility. Once again, it starts to muddy the waters of who is accountable.

Mr BYRNE—So in a sense what you are saying is that it would be going back to the old system in terms of the trust and effectiveness.

Mr French—It is the thin end of the wedge in that regard.

Mr BYRNE—My understanding is that the responsible entity can remove a person from the compliance committee. Is that correct? Can they just remove them?

Mr Lloyd—Yes

Mr BYRNE—Do you know what the grounds for removal would be?

Miss Ralph—Do you mean under the law?

Mr BYRNE—Yes.

Miss Ralph—We might have to take that on notice.

Mr French—Yes, they are appointed by the responsible entity.

Mr BYRNE—Yes.

Mr French—They are able to remove a compliance committee member but they do not—

Mr Lloyd—I am not sure the law is specific, to be honest.

Mr French—No, that is right.

Miss Ralph—I am not sure either.

Mr Lloyd—There is a right to appoint. My recollection is that there is a right to remove but there are no conditions imposed under law in exercising that power.

Mr BYRNE—What if members of the compliance committee had some difficulties with the responsible entity and they were removed? What protections are there for those people who are discharging their duties on the compliance committee?

Miss Ralph—Protection once they are removed, do you mean, or before they get removed?

Mr BYRNE—Before. For example, on a theoretical basis say there was information the compliance committee was causing responsible entity some difficulty over a particular issue. The responsible entity has the power to remove them. What is to offer them protection if they were discharging their duties?

Miss Ralph—They can go to the regulator, for a start.

Mr Lloyd—The law requires them to go to the regulator if they feel—

Mr BYRNE—Who goes to the regulator? The compliance committee?

Mr Lloyd—My recollection is that if any member of the compliance committee feels that a matter is not being dealt with adequately by the RE they have an obligation that has criminal responsibility if they do not carry it out to report that to the regulator. I think the purpose of that provision was to head that situation off, actually. But they still have that obligation, and that is a personal obligation, to notify the regulator. That is my recollection.

Miss Ralph—We can certainly go back and check that specific provision for you.

Mr BYRNE—All right. It would be interesting to get that information.

Mr French—In the case you were talking about where somebody who may be troublesome was removed and it was because of a genuine problem, their duties require them to report to the management of the responsible entity and then to the regulator. Any responsible entity that did that in order to get rid of somebody like that would have the regulator sniffing around pretty fast.

Mr BYRNE—But in terms of a broad understanding of grounds for removal or terms, are there stipulated terms in relation to the compliance entity in terms of a person—

Miss Ralph—I think we will have to take that on notice to check the act for you.

Mr BYRNE—Sorry. I am just asking for my information, not to try and prove a point.

Miss Ralph—No.

Mr BYRNE—I guess I would like to know the length of term a person would serve on the compliance committee, the basis for removal and that sort of stuff. I want to know the protections that are offered to these people who have taken, as you were saying before, a fairly onerous position.

Mr Lloyd—I think we should give you the accurate answer. What was embedded in the act was the obligation to appoint and have an adequate representation of independence with the right skill set. Inherent in that was a right to remove. I do not think the act is specific. However, importantly, the obligation to notify any act that has not been undertaken to the board and the regulator immediately—with criminal penalty—is where we ended up for that specific reason. That was to embed that obligation both with the RE and then at the regulator so all parties would be aware and one would be exposed.

Mr BYRNE—I appreciate your point. Senator Conroy also mentioned points, somewhat facetiously, about people being on 12 committees. Are you aware of people on compliance committees representing—

Senator CONROY—Tragically, it is true.

Mr BYRNE—It is true, is it? No suggestion about it? Are you aware of a number of people who are sitting on two, three or four compliance committees or more?

Miss Ralph—I guess I have to look at those particular situations because what you might find, for example, is within an organisation, like Geoff's—I am not saying it is specifically like his—there might be more than one responsible entity. A corporate entity that is a responsible entity may be managing a range of different products in different funds.

It may be the case, for example, that a single independent compliance committee member could be sitting on a couple of responsible entities within a single group. I think that if you went to any of the major banks you would find that they are holding more than one responsible entity and that that person may in fact be sitting on a range of committees within a single organisation. I would have to check.

Mr BYRNE—Would you be able to check them? I know that it is a difficult question for you to answer, but is there a possibility of doing that? If there is no way it is not a problem.

Mr Lloyd—I think there is a representative later from the body that represents those members. I would suggest that it might be more appropriate to ask that person.

Miss Ralph—I think it is fair to say that within a large financial institution you would find more than one responsible entity, albeit you would find that the compliance procedures, plans and processes for those responsible entities and for the products sitting under those could be very similar. Unlike a company director—where, if you sit on 12 boards, you are talking about substantially different sorts of entities, potentially—it could be the case that a person is sitting on bodies for a range of funds at a particular bank or large investment house where the procedures and compliance plans are all quite similar. Again, as Geoff says, I think that you should ask the representative from the ICCMF, if that is the case. It could be causing that.

Senator CONROY—Do you think that there is a maximum number of compliance committees that one individual should sit on?

Miss Ralph—Again, I think that is a hard question. It depends on whether we are talking about substantially different sorts of responsible entities, with substantially different products et cetera. I think that is a hard question to answer. It is one that we have not had to look at because it has not been raised with us yet.

Mr French—I think that would be a very simplistic approach. MIA is based on the number of registered schemes and each registered scheme must have a compliance plan and so on. So in a large organisation you could have a responsible entity with integrated pricing et cetera for a whole lot of registered schemes and to say that you can only be on six would not recognise the commonality.

Mr BYRNE—After the crash of the State Bank of South Australia it was a concern that the same people had appeared on a number of boards of related companies arising out of the State Bank technology companies et cetera. It was a view then that there should be some limitation, given the sorts of potential conflicts that existed, of the number of boards that people were on. Just from a layperson's perspective, I would see some potential difficulties arising out of one person being on 12 boards. We would accept that there would be corporate entities or compliance entities within a particular organisation, but what about different organisations?

Miss Ralph—I think you are raising two different issues through the example that you are using. One is the whole issue of conflicts of interest that can arise. That seems to be potentially a different issue to this notion of numbers of boards. Certainly, if you look at the corporate governance arena, where the issue about numbers of boards has arisen, it has not arisen because of concerns about conflicts of interest that may arise from those but rather from sheer workload and the ability to handle the workload involved. I guess, to a certain extent, that is why we are saying we are not quite sure about this issue being similar in the managed investments area. The nature of funds can be quite similar—the pricing structures, the compliance plans and those sorts of things—and therefore your ability to sit across a number of registered schemes and be quite competent doing that job would be very different to sitting across a number of quite varied corporate entities, with different businesses and those sorts of things. So I think there are two issues that we are potentially talking about here.

Mr BYRNE—The other thing is the liability insurance for those people who are on compliance entities. Would you like to comment on that.

Senator CONROY—Help!

Miss Ralph—I think that is not an area we are really across. We would defer it to Mr Dortkamp, who I think you are hearing from later in the day. He would have a broader experience of what his members are actually experiencing out there. His membership covers the full range of managed investment schemes that exist out there.

Senator MURRAY—In economic terms, where markets have different profit levels—and, in this case, fees and charges may or may not be higher than in other markets—you might say that markets which have a higher return are exhibiting oligopolistic tendencies. There is rent seeking and profit taking occurring. Such markets will typically have a somewhat cosy cartel-like arrangement in terms of administrative practices or habits or, even more typically, there will be barriers to entry. Neither this committee nor you have been able to make an authoritative evaluation of our market performance versus others—this is not a case I am making; it is just an introduction—but the barriers to entry issue was raised with us yesterday. One of the witnesses said to us that under the MIA this market was now less competitive, with fewer competitors, and had characteristics that made it harder for new entrants to come in and compete. Do you have any feelings as to whether this is a more or less competitive market and whether or not it is harder for new entrants to participate in the market?

Miss Ralph—Are you asking that specifically in relation to MIA and its impact or just generally?

Senator MURRAY—No. As I understood it, the witness was saying that the switch to the new regime had introduced a market situation where it was harder for new entrants to get in and perform. I am asking because it is relevant to Senator Conroy's line of questioning. If the outline proposition he put is that our market is performing less efficiently in terms of costing—that may be the broad base of it—you have to then look for what the reasons are. The reasons could simply be that people are getting together and having little cosy arrangements as to what they are doing or it could be that you just do not have enough aggressive competition in the marketplace.

Miss Ralph—First of all, I would like to ask the witness from yesterday to give us the actual statistical evidence that shows there are fewer competitors in the marketplace. What I am about to say is my opinion because I have not done the numbers, but I do know how my membership numbers go. I would like to take a step back and say again that I think we can also paint a picture of an industry that is still young and growing. It is an industry where significant investment is still required. Therefore significant capital is still being injected into new services, technology and that sort of stuff. That is compared to an American marketplace which is quite mature and commoditised and not growing in the same sort of percentage leaps and bounds that this marketplace is as a young industry.

To draw comparisons between the economic forces going on in those two marketplaces and somehow say that we can therefore draw conclusions about what is going on, raises some questions. That might be the case if these were two mature marketplaces but I just do not think that they are. They are not the same; they are not at the same stage of development. As people have tried to gain increased competitive advantage in this marketplace we have seen some consolidation of players. You would see regularly in the newspapers the mergers coming about between significant players in this marketplace, who may perhaps believe that economies of scale do matter, but that is their opinion and they may or may not be able to demonstrate that.

Senator CONROY—Mention Time Warner and AOL to them.

Miss Ralph—If it is their desire to compete upon such a basis then good luck to them. But, at the same time, we are seeing a whole raft of new players coming into the marketplace and a whole range of new boutiques. I have a continuous stream of new members applying for IFSA on a regular basis. They are quite small and they are boutique fund managers.

One of the reasons why they can come into the marketplace, which has nothing to with MIA or anything like that, is that there are now providers—similar, for example, to Geoff's organisation and others—who provide platforms from which those wholesale boutique investment managers can get access to the marketplace. That has been a real change in the last five to 10 years. So we are now seeing more of those small managers pop up because they have the capacity to distribute their product in a way that did not exist 10 years ago. It is fair to say that if you talk to them they will say, 'Gosh, this MIA is bloody onerous!' At IFSA, when they ring up and say that to us, we say, 'Yes, that's correct, and so it should be.' Any piece of regulation provides barriers to entry—we all acknowledge that at the end of the day.

Senator MURRAY—As do capital adequacy requirements.

Miss Ralph—All of those sorts of things create barriers. It is for you to make the judgment about where the appropriate barrier for entry into this marketplace should be. Having said that, it is also fair to say that under the old regime certain players found it difficult to find a trustee to act on behalf of their funds. Even now, some small groups choose appropriately, as envisaged by this regime, not to be the responsible entity. For example, some small investment managers—and in fact some large investment managers—say, 'We don't want to be a responsible entity; we want to be an investment manager and we will submit ourselves to the scrutiny of a responsible entity.' Some groups choose that model and, similarly to the old regime, have a hard time finding a responsible entity. But you have to ask yourself whether that is perhaps the price of barriers to entry.

There will always be some barriers but they have not stopped a lot of new boutiques from entering this marketplace and offering investment management services—any more, perhaps, than the old regime did. I would have to do a headcount but that is my sense of and my experience in the marketplace. Some managers come to us saying, 'Can you help? It is so hard to get a responsible entity.' And we say, 'That's right. You have to do your homework. You have to know what you are doing. You have to have a compliance culture and a compliance plan. You can't just come into this marketplace.' When we supported this act, that is what we wanted to see. So we are not convinced. It would be interesting for someone to do the actual numbers in the marketplace, but I think at the top end we are seeing a maturation of the industry as it grows and at the bottom end we are seeing new players come in.

Senator MURRAY—If you are so inclined, I am sure the committee would love to have further information.

Miss Ralph—If you find an academic who could do this for us!

Senator MURRAY—I also want to touch on independence and integrity, an area Mr Byrne was addressing. I have found, over a series of committees that I have been involved in on a

series of issues—as probably have other members of the committee—that the word 'independence' is used very lightly and that people seldom look behind it and see that true independence does not apply. I will give you an example. A typical board of directors has a dominant financial interest and/or a dominant management interest which control that board, sometimes in concert. The appointment of those directors, even though they are in theory elected, is either as a result of the direct influence of those who have an economic interest or as a result of indirect patronage. So true independence of directors and audit committees is just notional. All those with positional power, such as management, are either directly or indirectly linked to dominant economic interests. In the case of boards of directors there have been no best practice guidelines or criteria yet developed by the regulators, such as ASIC and ASX, to ensure that the system guarantees as much independence as possible.

With that introduction I ask you—and this relates to Mr Byrne's line of thinking—whether, with what you describe as a young industry, there is a need for the development of criteria and guidelines to ensure the best practice process of achieving compliance committees, responsible entity structures and custodians who are of the optimum quality, independence and integrity. You cannot do that legislatively; you would have to do that with a practice note or a guidance note from, say, ASIC developed in conjunction with institutions such as yours. I am talking about a kind of prudential mechanism. Could I have your reaction?

Mr French—The Managed Investments Act sets out the statutory duties of the directors and explicitly requires them, for example, to prefer the interests of the scheme over the interests of the manager.

Senator MURRAY—It is like a corporations act for shareholders. You know that that has not occurred in a number of companies.

Mr French—The MIA is very specific in a way that the Corporations Act is not with regard to company directors. It is very onerous. When it comes to resolving conflicts of interest, obviously you are dependent to some extent on the integrity and intelligence of human beings, but the act sets out a very strict regime. Geoff might have something to say with regard to the directors he works with.

Senator MURRAY—If I could help you a little—

Miss Ralph—Are you suggesting something similar to IFSA's blue book for compliance committee members? We define incumbents and what we expect their qualities to be.

Senator MURRAY—I have not gone through that. If the committee do not have a copy, we should have one. Politicians, when they are dealing with markets, environments and so on, look for hand-washing—that is, people within organisations, entities or structures who wash each other's hands to maximise returns. It is an alertness that politicians develop. To get over that problem, people with integrity and who operate best practice in a market or industry should be encouraged as much as possible across the market and the industry. That is why you develop guidance notes, practice guidelines and your blue book, if it is in that area. Is there enough out and about which ensures the principal mechanisms for ensuring the integrity and independence of the system and minimising failure which results from a version of the system? Is enough

being done to develop optimal criteria for custodians, responsible entity management, compliance committees and so on?

Miss Ralph—As you are aware, the blue book that I am referring to is designed in a corporate governance sense for listed company entities. It goes into details about both the quality and quantity of independent directors that we think appropriate for boards. It is an interesting issue that you raise about whether a similar guideline should be produced for boards and compliance committees of responsible entities and whether that is most appropriately done by IFSA, the regulator or the Independent Compliance Committee Members Forum where those people should generate the standards for their profession, or a combination thereof.

Senator MURRAY—Let me summarise it. You probably have not given thought to it, so let us leave it here because we will run out of time. Do you think it would be of assistance to the integrity and operation of the MIA system if best practice guidance notes in the key areas of independence and quality were developed by the regulator in conjunction with the industry?

Miss Ralph—I have to say that I do not have a strong opinion about who should necessarily develop them. Inevitably, with our IFSA standards and guidance notes that are applied to a range of other issues—for example, the calculation of MERs et cetera—we would always consult the regulator in the development of those standards and guidelines. Whilst I am not sure that we have a strong opinion about who should develop these—because inevitably you will find that people work together on them anyway—we have found that the changes of conduct and behaviour as a result of something like our blue book, which does not even have the power of the regulator behind it, has had an impact on the compositions of boards over the last few years.

The sorts of standards that you are talking about would have the same impact over time on responsible entity boards and compliance committees and would probably be a useful tool. When people come to a board or directorship, there is an enormous amount of material out there that they can draw upon to help them understand their obligations and responsibilities and the standards of conduct that are expected of them. There is probably not quite as much in this area, because we are only a couple of years down the track. We could probably usefully benefit from something in that area; albeit, I am not sure exactly who that should originate from. It could be from a variety of places and probably still have a similar effect.

Senator MURRAY—Thank you.

CHAIRMAN—Are there any further questions?

Senator CONROY—If we have finished I would like to say—and I am sure Grant would want to say the same—thank you, Lynn, for the many times you have been generous with your time. I think if we were to check the record we would probably find that Lynn has appeared before this committee more than anybody else in the last five years; at times I have thought you were stalking us. But I would like to put my appreciation on the record for the help and assistance you have given me and the committee. I also want to give you the chance to deny that you have signed a three-year contract to coach the Swans from next year.

Miss Ralph—No. I will still be in the stands, waving my scarf.

Senator CONROY—It just seems very coincidental—moving on, having more time on your hands.

Miss Ralph—Thank you very much for the opportunities over the last few years to appear. I think there have been some really useful and productive debates with this committee. I would also like to say that I am leaving IFSA in the incredibly capable hands of Richard Gilbert—whom I am sure you are all familiar with—Philip and the rest of the team, and fantastic members like Geoff Lloyd who are always more than happy to come and talk about these things at any time, either in official hearings such as these or one-on-one.

CHAIRMAN—Stephen stole my thunder. Thank you for your cooperation with the committee over your years as the chief executive of IFSA. I wish you all the best in your new consulting role.

Miss Ralph—Thank you. May I just add one more thing about MIA. We did not get to it and it was not raised. It would be our opinion that ASIC have done a very good job in this area, both through the transition period and subsequently through being quite active out in the marketplace. That has been an important part of the regime. People may come before you and say, 'ASIC doesn't do a good enough job in this area; they don't have good people.' Part of the reason is that my industry keeps nicking them. If they were not any good at ASIC, the industry would not keep stealing them. They stole Geoff; we stole Philip—there is a whole range of ex-ASIC people working in our industry and that, to me , is an indication that they have done a good job. People respect the people who are working there. Their role has been important in making this whole thing work. We have not actually talked much about that but I think it is important to acknowledge. From our side we think they did quite a good job in bringing this regime in place.

Mr Lloyd—I would reaffirm that, particularly the focus around openness and being prepared to come and discuss an issue without necessarily presenting a position. Both the industry and ASIC feel that the relationship is strong enough to be able to do that. Consequently, issues are brought up sooner and dealt with in a more open way. That is rare in a regulator but it is always apparent at ASIC.

CHAIRMAN—Thank you very much, each of you, for appearing before the committee and answering our questions.

[11.12 a.m.]

CHRISTIE, Mr Donald James, Managing Director, Equity Trustees Ltd

McGRATH, Ms Gai Marie, General Counsel and Company Secretary, Perpetual Trustees Australia Ltd

SHREEVE, Mr Michael George, National Director, Trustee Corporations Association of Australia

CHAIRMAN—I now welcome to this hearing Mr Michael Shreeve, Mr Don Christie and Ms Gai McGrath, representing trustee organisations. The committee prefers all evidence be given in public, but if at any time you wish to give any of your evidence in private you may request the committee to do so and we will consider that request. We have before us your written submission, which we have numbered three. Are there any alterations or additions that you need to make to that submission before proceeding?

Mr Shreeve—No.

CHAIRMAN—I invite you to make some opening remarks, following which we will proceed to questions.

Mr Shreeve—I would like to make a brief opening statement about some general issues. Then I think Gai will say a few words on some technical issues about the Corporations Law that arose in the previous remarks to you. Don will make some brief comments about the business side of matters.

The first thing I would like to do is to comment on some incorrect and misleading statements that we feel have been made in other submissions to this committee about the MIA and then briefly outline our concerns with the regulatory framework and some suggested improvements. First, in talking about the events of September 11 it is not fair to represent that as a stress test of the MIA. What essentially happened was that redemptions were suspended, and a genuine stress test to us is when large scale redemptions actually occur—only then do you see if the purported assets are really there and have the values claimed. The second misleading statement is a quote from one of the submissions. It says:

> ...the former dual party system, while appearing to offer investors additional security through the presence of an independent supervising trustee, was subject to fundamental legal and commercial contradictions which rendered such protection largely illusory.

The protection was not illusory—the additional security was real and tangible. The facts are these. The former system was reviewed as a result of a 1991 collapse of property prices and criminal fraud by some fund managers which led to the failure of the Aust-Wide and Estate Mortgage funds. In these cases, investors would have recovered nothing if they had only the fund manager to pursue—or what is now the single responsible entity. It was the trustee corporations and their insurers that provided investors a return of 100 cents in the dollar for

Aust-Wide and between 60 and 80 cents in the dollar for Estate Mortgage. The total outlay was many hundreds of millions of dollars.

Importantly, funds were not required from the government and therefore this system did not increase moral hazard in the way that the bail-out of HIH, Pyramid or Commercial Nominees does. In contrast, the current system requires no managed fund, no matter how large, to hold more than $5 million in net tangible assets and $5 million of insurance. The third misleading statement presented to this committee is a quote about Commercial Nominees. It states:

> The ... underlying problem of CNA's investments is that they were operating under the old trustee manager regime. Had the investments been made under the MIA, the problems may not have occurred, because of the controls that exist under that Act.

CNA's investments did not operate under the old trustee manager structure. CNA was a superannuation trustee, approved by APRA, which invested superannuants' money in a scheme that they called an enhanced cash management trust, which in turn lent to a mushroom farm. If that cash management trust had operated under the old trustee manager regime, the trustee would have refused to sign a cheque paying funds to a mushroom farm run by a party related to the scheme manager. If it did sign the cheque, then the trustee and its insurers would have been required to compensate investors. In addition, the cash management trust was not registered under the MIA. This is because an exemption applies to schemes that take funds only from wholesale clients like CNA or that have fewer than 20 members.

However, it is interesting to consider what might have occurred if schemes were subject to responsible entity requirements, given the weaknesses we see in the MIA investor protection framework. Firstly, as a superannuation trustee approved by APRA, CNA would have appointed itself as the responsible entity. We have every reason to believe that ASIC would have approved that, given that APRA had approved them as a superannuation trustee. Then, as scheme manager, CNA would not have prevented the related party transaction, because they were the related party.

Secondly, any external members of the board or compliance committee—and it is worth in this context realising that a compliance committee is an option; you do not need to have a compliance committee if half of your board members are what they called 'external', which has a different definition to 'independent'—would not have been aware of the transaction until, at best, after the event. Indeed, if CNA withheld details from them they may not have found out until the scheme collapsed. If they did become aware, it is likely that no action would have been taken, because, based on other CNA actions, CNA would presumably have appointed external parties that were either tame or happy to share the proceeds of fraud. Investors would thus be left relying on hindsight monitoring by auditors or the regulator to pick up the problem. We have seen that this does not work in a timely fashion.

In other words, the MIA, in our judgment, lacks adequate controls to prevent fraudulent activity. There is speculation as to what might have happened, but if CNA can do it in the superannuation field we see no reason why you cannot construct a similar arrangement for managed funds. We correct these misleading statements not because we want to revisit history but because myths can be dangerous and they need to be exposed. If the parliament is given false information that stands uncorrected, then understandably there is a risk that it will make poor policy.

We would now like to move onto the current regime and its weaknesses. The key shortcomings of the MIA framework for us are as follows. Compliance monitoring lacks genuine independence. The REs, external directors and all compliance committee members are appointed by, paid by and may be removed by the RE. Scheme property need not be held by an independent custodian—this is a fundamental requirement for sound investor protection overseas.

The lack of genuine independence means that you are left with self-monitoring, which we believe is ineffective. There is inherent conflict of interest in self-monitoring. ASIC found breaches and compliance failures in 83 per cent of REs inspected in 2000-01. Hindsight monitoring by auditors and regulators is also ineffective—we point to HIH and Commercial Nominees. Every week we hear new revelations of areas where this system is not working.

There is no investor champion. The RE is entrenched. It can be sacked only if individual investors overcome the complex logistics of calling a member meeting and then achieve a vote of 50 per cent of all members. An RE can change a scheme's constitution if, in its own view, it reasonably considers that the change will not adversely affect members' rights. As we saw in relation to September 11, correctly in those circumstances, it can unilaterally suspend investors' right to exit the fund via buybacks.

We believe the schemes have inadequate financial underpinnings compared to the previous regime. REs with net tangible assets and insurance each of no more than $5 million can and do hold at risk many billions of dollars of investors' funds. The single responsible entity, if it can be legally sustained, seems to imply that a bankrupt RE and the custodian can abscond with scheme assets and the custodian cannot be pursued by investors. If the custodian can be pursued, then the concept of the single RE should be exposed as a myth. We also note that an MIA style regime is rejected in all other financial systems.

Turning to solutions, we believe that with minimal change the sound parts of the MIA can be retained. The compliance culture that people are talking about is good. It is disappointing that that compliance culture did not exist amongst fund managers under the previous regime. But I think that can be retained and the weak parts improved at reasonable cost or possibly a reduction in costs. A more realistic, robust and cost-effective structure would entail clarifying the roles and liabilities of all parties involved.

We believe the REs should retain full responsibility for the operation of a scheme and be solely responsible for the prudence of investments. We think that a fully responsible entity is a better concept than a singularly responsible entity in terms of both policy and legal and commercial reality. We think the role of the compliance plan auditor can be expanded to involve more frequent and timely monitoring of scheme operations to minimise the likelihood of problems arising due to maladministration, negligence or fraud. We think related party dealings should be monitored and we think that role should also include potentially acting as investor champion if action against the RE is required.

We believe access to this compliance monitoring role should be widened. Allowing qualified professionals other than accountants to take on this work would introduce more competition into the area. It would also improve options to avoid conflicts of interest between financial audit and other work. We understand that this is being considered for superannuation. It is also

relevant that the compliance monitoring role involves operational and other risk management issues that a financial auditor is not necessarily equipped to review.

We see positive influences from this arrangement in placing downward pressure on costs. Increased competition in the compliance monitoring role and the monitoring of related party dealings should better ensure arms-length pricing. We see a stronger compliance monitor reducing the need for compliance committees and external board members. That is all I would like to say. Gai may be able to clarify some of the Corporations Law issues.

Ms McGrath—I am speaking to you as Perpetual's general counsel and company secretary but I also act as a director of three responsible entities within our group. One of these runs our funds management business, but the other two are outsourced responsible entities which act as the responsible entity for third-party investment managers—the boutique investment managers that Lynn Ralph was speaking about. We have two companies that play that role. So I have experience with the old regime and with what has happened with the new regime.

The committee is obviously considering a couple of things that have been raised in submissions, the first one being whether some provision should be introduced to limit the exposure of a custodian who acts in accordance with the directions of an RE. It is important that the committee be aware that, if that were introduced, it would take away a legal right that investors currently have to sue that custodian. Under general trust law, a person who knowingly participates in a breach of trust is liable to the beneficiaries of that trust. Knowing participation includes where they shut their eyes to the obvious. For example, if a custodian did receive an instruction from an RE to do something with a fund's assets that was obviously incorrect, inappropriate and not consistent with the constitution or representations that had been made to investors, they would currently be exposed and liable. If that were removed, investor protection in that area would be reduced. So I think it is important that committee members recognise that that would be a consequence of making that change.

The other area relates to the government structures that apply to these schemes and the choice of REs as to whether or not they have a compliance committee, which they are not required to do if 50 per cent of their board is comprised of external members. So, automatically, you do not have a very even balance of power between external members, executives and other people associated with the RE. There is a question mark over what those external members are supposed to be doing in this compliance area. There was a suggestion in the Turnbull review that some of the functions of the compliance committee should be imposed on the board of REs where the choice has been made not to have a compliance committee. I commend that suggestion.

In addition to that, I think it is important that the qualifications and experience of those board members need to be consistent with those of the compliance committee members; otherwise you still have a mismatch. In a compliance committee, you can have an internal member and two externals, so the balance of power is in favour of the external members. That is not the case with the board of the RE; it is an even balance of power. REs have the capacity to remove compliance committee members, and no grounds need to be given to any person for that removal. In a case of the removal of an auditor of a public company, the auditor has to get ASIC permission to retire from that position, and an explanation has to be given to ASIC as to why that auditor is being changed. In the case of compliance committee members, I do not see any

reason why the same regime should not operate, which would give them some protection and ASIC would know what is behind the removal of the member.

The other issue relates to the whistleblowing function that an individual compliance committee member might want to play with the regulator. Interestingly, qualified privilege is given to compliance committee members in their communications with ASIC on the operation of a scheme, which protects them from defamation actions and other things. That does not apply to an ex-compliance committee member—if that person were removed by the RE and went to ASIC as a whistleblower, they would not have the same protection. That is a real issue that needs to be examined here.

Those are the main points I want to make. It needs to be understood that, if someone has made a decision not to have a compliance committee, protection levels and experience and all the other things that go with it are not the same as if they have to have one. So the question is whether or not they should be compulsory in all cases, and I think that is something the committee should consider. I will hand over to Don to raise any industry issues.

Mr Christie—Thank you for the opportunity. Like one of our previous presenters from IFSA, my background was with the securities commission; in fact, I go back to the National Companies and Securities Commission under Henry Bosch. I do recall the stress that was placed on the property trust act in those days. I will talk just briefly about the role I played there as an investigator with the Tricontinental royal commission, which was a fascinating experience. Probably the most entertaining loan I can remember them making was $72 million, with the security of a mortgage over the lease over the air space over the Bondi interchange station to build a hotel without any development approval. It was wonderful!

Senator CONROY—Developments the Krogers have always been into!

Mr Christie—I do not think that party is involved. But the real issue coming out of that is the power that an executive has in dealing with a board. In that case, the board had relied on one member of the board to undertake, effectively, due diligence on the credit approvals. The money had already gone out by the time the board got to see the credit approval process, and the executive was punching through loans very quickly and with a great deal of power over the board members. I think we can see parallels in that today with HIH, OneTel and various others we have seen in the market recently. As Gai said, we should also examine the position of 50 per cent executive and 50 per cent non-executive directors in an RE and the ability of the executive to push through very much the type of business that it wants to.

Secondly, I would like to point out that, with the real-time monitoring that the trustee or custodian-trustee used to provide—trustees who were acting as custodians also used to provide it—we had the reins over the assets; we had the cash. When somebody came along to us to say, 'Send out a cheque for a mushroom farm,' we had the power and the ability to ask the real-time question: 'Why? It's not an appropriate investment for the fund. It's not in the terms of the investments that can be undertaken under the deed.' The process that is now being undertaken—and in the case of Commercial Nominees perhaps not at all—is, at best, retrospective.

Thirdly, one of the points picked up before was the ability of small fund managers to act as an RE and to get themselves qualified under the Managed Investments Act. I think that is a very

important point. We deal still with a number of small fund managers, the boutique fund managers that were mentioned, and they do have that issue. Most of them are operating now in the wholesale area. When I say that, I mean that most of the structures they have put in place are to feed into the master trusts run by the major fund managers and disseminated through financial planners and major fund managers' distribution outlets. So, in a sense, I think the potential is there to decrease competition, because the ability to build the product that can be sold retail is not really there in the smaller end of the market.

Senator MURRAY—I will not repeat the big lead-in I had to give to the previous witness, because I think you would have heard it. I really want to come to the independence and integrity issue. Given that we accept the new system, you have made some suggestions that would improve the independence and the integrity of those structures that are involved in this system. Do you think that ASIC needs to get far more involved in the issue of who is on what body—who are the custodians, what are their qualities, what kind of training are they given, how do they get there, who are the compliance committees, where do they constitute, is there multiple membership, who is on the REs, are they serial members of serial funds et cetera? You know the questions.

Mr Shreeve—We think there is a structural issue, and then there is how you implement within that structure. We think that there is a fundamental structural problem in that the idea of self-regulation, even if people are approved by ASIC and even if they have codes of conduct, will be very difficult to make work effectively. We believe there is an inherent conflict of interest that needs an alternative buttressing force—that is, a genuinely independent compliance monitor. We believe that the various bodies that provide services should all have some sort of approval by ASIC, be they a custodian, a compliance monitor or an RE. I think it is very difficult to expect ASIC to monitor individuals in a wide range of activities and make a ruling.

Senator MURRAY—That is why I explored with the previous witness the issue of guidance notes and guidelines which have to be developed by the regulator, in my view. The witness equivocated on that, but there can be no other person who does it. The regulator must always consult and interact with the industry to get a sensible outcome. That is what I am after. We have the same problem with directors: there is no best practice guidance note, either from the ASX or the ASIC, for directors.

Ms McGrath—Quite a useful precedent exists in relation to financial planning. As you would be aware, policy statement 146, which came into force on 1 July, imposes certain experience and expertise requirements for financial planning activities. So there is a precedent. ASIC put out a policy statement setting out guidelines for people as to what experience they needed in order to fulfil a particular role but that did not extend to individually assessing those people. The obligation is on the licence holder to make sure they have assessed the people in their organisation who provide that service. So there are precedents for these sorts of regimes to be put in place.

The other point I would like to make relates to custodians. It is very interesting that under the Financial Services Reform Act a custodian of MIA assets was exempted from having to have a licence. It was very peculiar that that was introduced but, as I understood it, it was introduced for this reason: it might somehow undermine the concept of a single responsible entity if a licence were required for a custodian of MIA assets. It is not the same for superannuation

custodians; they have to have a licence. It seemed a bit strange that that exemption was introduced in that way—a whole class of people who do this activity will not need to be licensed under the Financial Services Reform Act. I can understand why people thought that way, but I think it is incorrect to say that there is the concept of a single responsible entity. The word 'single' does not appear in the legislation, and I do not think the law operates in a way that makes a single party responsible. A range of parties will be responsible if there is a problem.

Senator MURRAY—My colleagues on this committee have raised issues concerning the removal of compliance committee members by the RE. Independence at its basis means independent appointment, secure tenure, proper remuneration and an independent process for removal. In many sectors the parliament, because of what has happened worldwide and in Australia, is now looking at these issues far more closely and asking, 'What is true independence?' Do you believe that that is an area which needs to be beefed up prudentially?

Mr Shreeve—I call them external members rather than independent members because 'external' is weaker than 'independent'. I stand to be corrected on this, but I believe the entity that owns the RE could have a director and that director could be considered an external member of the compliance committee.

Ms McGrath—That is correct.

Mr Shreeve—They are clearly not independent—they are the owner of the RE—yet they qualify as external. Some work can be done on improving the independence of various people but it is quite easy to set up an RE with people who may meet whatever independent criteria you could choose to put in place. The structure still involves self monitoring, if you like, within the institution.

Senator MURRAY—Yes.

Mr Shreeve—Take the board, for example: yes, they may have a fiduciary responsibility to the investors, but they also have a responsibility to the company they run to make profits for that company. There is a conflict of interest.

Senator MURRAY—If you ask them where their first responsibility is, what do you think they are going to answer—to their employer, perhaps?

Mr Shreeve—It depends. Normally, the employer would appoint people whose interests lie with the employer. That is the problem with the act. There is a conflict that is imposed on those people. There are also people who behave inappropriately. Where is the guardianship against that happening? We believe it is not in the current act.

Senator MURRAY—The other area I want to ask about is insurance. You have made much of the fact that in the old system trustees were up for market failure. They had to cough up for the loss of investors' money—principally, I gather, through the mechanism of insurance. If insurers can withdraw cover or make it uneconomic for minor charitable outfits who have never had a claim and who just run little community affairs, they can certainly do it for areas which are regarded as high-risk investments. What will happen in this structure if insurance cover is

drastically reduced, withdrawn or capped? How would the old structure have been better, in this circumstance, than this new structure?

Mr Shreeve—Insurance is like the cure; prevention is better. You get prevention by having compliance monitoring that is genuinely independent and timely and prevents the problem from arising. The new structure we are proposing will be much better because it will have a much better chance of stopping things happening. At the moment the insurance is not high. The maximum insurance people are required by ASIC to have is $5 million, no matter how many billions of dollars they are managing. So I would say removing insurance is not going to make things much worse than they already are. Under the old scheme, if the insurance was removed, you would rely on the capital of the trustee companies, which differs between companies.

Senator MURRAY—I did not pick up that you had recommended a particular mechanism for the capital adequacy system, in terms of either a ratio or an amount.

Mr Shreeve—No, we did not recommend a particular technique. Our view is that that is something to be discussed with the industry. Our principle is that there is no logic in capping insurance at a certain level. If a scheme keeps doubling in size, we think insurance will probably keep going up.

Senator MURRAY—I was talking about the capital adequacy ratio.

Mr Shreeve—I suppose there is some logic to capping capital. One argument says that the bigger you are the more capital you should put up—that would better encourage integrity. Another argument says that in this area capital is to make sure you have operating skills and activities. I guess that if $5 million was considered appropriate several years ago, with inflation a larger number is probably appropriate now.

Senator MURRAY—My last question relates to that point. Would you agree, firstly, that it needs to be increased to match its real value then; and, secondly, that for future reference it should be indexed so that it does not have to be adjusted?

Mr Christie—Being from the smaller end of the trustee market, I understand that the original amount was there not as an alternative to insurance but basically as a test to see whether you were big enough to own the systems and buy the people who were going to be adequate to monitor the investments. On the issue of insurance being withdrawn, insurance has certainly got more expensive—I have not yet seen it withdrawn—and each year we increase our level of cover, whether by index or by quantum, of assets under management. On the issue of the $5 million, I tend to agree. That was an appropriate number at the time but it is now enshrined in legislation and will not move in 10 years time. It is obviously a wasting amount, and perhaps the CPI or something like that might be appropriate.

Senator CONROY—In your submission you quote Standard and Poor's, who state:

> The failure to mandate that fund assets must be held in safekeeping by an independent custodian is of concern and is in contrast to all other major financial centres of the world, where an independent custodian is a minimum standard.

Can you take us through some of that argument again? We are out there by ourselves; normally we like to be aligned with the world, but in this one we are more adventurous.

Mr Shreeve—That is right. As to why we are there, in our view it does seem inappropriate. When I read through the history of the MIA it was stated that we were doing something very similar to what happens in America. That is quite untrue—that was another piece of misleading evidence. In America the scheme operator's board is appointed by the investors, not by the operator itself. The funds must be held in the name of the investors, not in the name of the scheme operator. There are some exceptions to that, in which case they must be held by an independent custodian which is a bank and which is inspected several times a year by an auditor to make sure that the assets are there.

I have not seen any arguments as to why an independent custodian should not be used, other than that the single responsible entity is singularly responsible and therefore must be entitled to do whatever it wants to do, including holding the assets in its own name or by a related party if it so chooses. To me, the problem in policy making is that people keep focusing on the need for this single responsible entity. If you ask them, 'What happens if other people are involved in losing scheme assets?' they answer, 'It seems as though those other people can be pursued, which means they are also responsible.' You would want them to be responsible. If indeed the single responsible entity is not singularly responsible—if there are others and if it is only fully responsible for what it does and what its agents do—people ought to stop talking about it like that, and they should stop opposing sensible independent investor protection techniques because they conflict with what is a myth.

Senator CONROY—It seems unusual that, at a time when business in particular is calling for accounting standards to be harmonised, for one set of accounting standards around the rules, for regulations to be harmonised, for one set of regulations and similar taxation regimes—

Senator MURRAY—And for antitrust laws—no, we have those!

Senator CONROY—I am with you on that one. It seems that there is this push from the business community—in most cases, with good reason—to try and get that consistency, but we seem to have jumped into an area that is completely inconsistent with the rest of the world. It seems to be an anomaly that does not seem to stand up in the face of all other arguments put in all other sets of circumstances. They are major issues.

Mr Shreeve—We can only agree: it is an anomaly. It is hard even to understand why fund managers would not want to have an independent body checking their excellent compliance performance. They ought to welcome it, saying, 'We have done this work, we have a compliance culture and we are doing a fantastic job, so come and have a look at it; we are more than happy to be subject to external scrutiny.' I do not see a problem with using an independent custodian. That would be good. If you use a related party custodian or self custody and you charge for it, the danger is that pricing is higher than it needs to be.

Senator CONROY—Should there be an extra cost from an independent custodian?

Mr Shreeve—I do not think so. It is a very competitive market.

Ms McGrath—In fact, it is a commoditised market now. It has consolidated and become global. The players are very large global custodians and the prices have come right down over recent years.

Mr Christie—The other thing you might find is that, again at the smaller end of the market, that makes it more difficult for players to enter. My experience of the global custodians is that they are not really interested in anything under about $1 billion. But the gap can be filled commercially by smaller custodians.

Senator CONROY—Moving on to capital adequacy, your submission contends that the present arrangements mandating a maximum of $5 million of net tangible assets irrespective of funds under management provide inadequate protection for investors. Can you elaborate on what that is and what you believe the maximum NTA should be?

Mr Shreeve—The maximum figure is very difficult. There is no right figure. Should it have been five before? Should it have been 10? I do not think there is a right figure on that. The point of capital, as Don mentioned, is to make sure you have adequate resources to get up and running. The minimum capital you need is $50,000. Arguably, that might be a bit on the low side. In the event of something going wrong, your financial underpinnings are provided in insurance and capital. They both provide value to you. It is probably less expensive to allow the insurance to keep going up rather than to require the inputting of capital. We do not have a firm view on what the maximum should be. We think that, as a matter of principle, the insurance should go up with the size of funds under management. If $5 million was appropriate before, keep pace with inflation. It is very hard to argue why a $5 million cap is too high or too low. Different people would have different views. We think the main focus of attention ought to be on making sure the problem does not arise in the first place, which is through independent compliance monitoring rather than how much there is to recompense investors if there is a problem.

Senator CONROY—I was going to come to that. The review noted that the rationale for the financial requirements is to ensure that the RE will have the financial stability to operate a scheme on a continuing basis and that it will be unrealistic for investors to expect a full recovery of their losses in the event of a collapse. What is your view on that?

Mr Shreeve—It is a fair enough view that they should not expect a full recovery. But as we have seen with superannuation, for example—or HIH—immense pressure is put on the parliament to make sure people do get their money back if something goes wrong. If there is a regulatory regime in place it is incumbent on the regulators and the people who put the legislation in place to ensure that there are adequate protections to prevent a problem from occurring.

Mr Christie—Perhaps I can assist. The cost of capital to a company, even with the increases in insurance we have seen, is probably a lot higher than the cost of buying insurance. If you are looking to protect a percentage of funds under management or a position of the funds that you are controlling, my suggestion is that you look at a mix of both. Our shareholders take a risk; the investors also take a risk when they put money into a scheme of this type. There are certain risks they should not have to deal with, like people defrauding them. There are market risks that they should have to deal with.

My shareholders put capital into a company and expect a return on it. Currently, if we were to expand capital you would find that the cost of doing that from our point of view would be far higher than to say, 'Instead of raising over $20 million in capital I would rather buy another $20 million layer of insurance even at the higher price.' If the capital has to sit there and virtually do nothing, or be invested in bonds, shares or whatever it might be, the rest of that business has to work very hard to support a commercial return for shareholders.

Senator MURRAY—But you have to avoid thin capitalisation.

Mr Christie—I do not disagree at all. Again, we are looking at a position where there is a minimum at which you can act. In our case, our assets might be $18 million or $20 million. If you started to do that as a percentage of funds under management, you would have to hold that and would probably seek to raise further capital. But I believe $18 million to $20 million is adequate to allow us to have the right systems, the right assets and the right people in place to deal with the requirements of an RE. At the other end of the scale, do we buy enough insurance—I think the term in the act is 'adequate insurance'—to ensure that investors are compensated in the case of frauds and other things that might happen? They are never going to happen with me, but—

Ms McGrath—Insurance does not cover fraud. I think that particular issue needs to be focused on. Under the old regime there was the Estate Mortgage fraud, for example. The trustee's insurers compensated those investors not because the trustee was fraudulent but because the trustee was negligent. So the insurance of the fund manager was avoided because of fraud but another pool of insurance was available where there had been no fraud. Under this regime, if there is fraud there is no insurance and there is no-one else to go to. There is no compensation scheme like the one that exists for superannuation which we have just seen invoked in the case of the Commercial Nominees fraud. That compensation scheme was made available because it applies in the superannuation context; there is no scheme of that nature in place for these types of funds.

Senator CONROY—You have touched on the some of the issues I want to raise in my next question. The review also noted:

If a persuasive case were made for higher NTA requirements, this would still need to be considered against the costs of imposing higher requirements across the entire industry—

and, presumably, higher potential costs for the end investor. We canvassed that issue yesterday with FSR, when Senator Murray raised it. Do you have any views on that? I know you said you did not have the maximum, but is that a tough balance for the parliament or for the regulator to look at?

Mr Shreeve—You have to look at what you get by imposing the cost on the industry. If the capital goes up a bit, it is not going to be of any benefit unless investors can claim on it, as Gai pointed out. And in what circumstances would they claim on that capital? It is usually if there has been fraud, negligence or maladministration. If that is going on, you could imagine a situation where the fraudsters actually take away the capital as well as the scheme assets—they take the lot. Under the previous scheme, the scheme operators would be bankrupt. Whatever capital they may have had would be gone. Insurance is probably better in that regard but, as Gai

also pointed out, in the event of fraudulent activity the insurance of the RE is invalid. This is why we are saying you should have a compliance monitor who is properly capitalised and properly insured so that there is something for the investors.

CHAIRMAN—What does the insurance cover, if it does not cover fraud?

Ms McGrath—Negligence.

CHAIRMAN—Just negligence?

Ms McGrath—Essentially—breach of trust.

Senator CONROY—Moving on to compliance, in your submission you claim:

... the MIA regime exposes scheme members to significant risk of loss ... because of the absence of effective, timely oversight of scheme operators by an independent entity. A system of 'well-after-the-event' surveillance by the regulator and auditor has proven deficient in other sectors of the financial system.

Could you comment on the role of the compliance committee in the context of that?

Mr Shreeve—Some REs do not have compliance committees. They are optional. You can just have even numbers of so-called external and board members—

Senator CONROY—A few Chinese walls?

Mr Shreeve—You can have all those things. You can have all the advice you need and all the guidelines you want, but that will not stop corrupt people doing corrupt things. Essentially, appointing people to a compliance committee is no different from appointing people to a board. You can still get the wrong people. If they want to do inappropriate things or cover up mistakes, pressure can still be brought to bear on them to do that. With regard to fraud, they are likely to be party to the activity.

Mr Christie—Whether or not there is a compliance monitor or compliance officer in the business, the compliance committee is effectively fed by the executive or, at the end of the year, by the compliance audit provider. With regard to the example I referred to before of Trico or HIH, a dominant force within the management structure can push certain views through to the compliance committee.

Mr Shreeve—And how often have we heard directors saying, 'We were profoundly misled; we were unaware of what the company was doing'? We would say that the same thing could happen with a compliance committee, if you have one, or with a board of directors if you do not have one. It is not an effective way of ensuring independent oversight.

Senator CONROY—You have answered my next question with that answer.

CHAIRMAN—As there are no further questions, I thank you for appearing before the committee and for answering our questions.

[12.02 p.m.]

DORTKAMP, Mr Paul, Cofounder, Independent Compliance Committee Members Forum

CHAIRMAN—Welcome. The committee prefers all evidence to be taken in public, but if at any stage you wish to give part of your evidence in private, you may request that of the committee and we will consider such a request. We have before us your written submission which we have numbered 10. Are there any alterations or amendments that you need to make to the submission?

Mr Dortkamp—No.

CHAIRMAN—I invite you to make an opening statement after which we will proceed to questions.

Mr Dortkamp—I have been in the financial services industry since 1971. I left being a mainstream fund manager in 1977 and became a consultant. I thought I would be helping to set up small fund managers. Since then, I have been doing less of that and more compliance. Very early on, in early 1999, I was appointed to a compliance committee for a smaller fund manager. At about that time, a couple of us established the forum for the independent compliance committee members. We felt that there was a need for a venue for the externals or independents—whichever nomenclature you wish to use—to discuss what was happening. It was an ideas swapping venue. We have been meeting in Sydney most months. We have about 260 people on our mailing list and about 80 people turn up each month. We also have versions running in Melbourne and Brisbane. The whole idea is to beef up the role to make it a real role because it was very rubbery early on. Our big thing is to have on compliance committees educated, knowledgeable people who understand the issues. That is our role in the equation. We need a strong regulator, very independent compliance committees and a good compliance culture inside organisations. That is where we are coming from.

I have also seen the change inside large organisations. I am on a couple of investment committees as well. There has been a very large shift, between the mid-1990s and now, in terms of the way compliance and risk management are managed within large fund management organisations, and that has filtered right down to the small end of the market. The licensing is quite rigorous now. It forces people who would not otherwise address licensing—because they are very entrepreneurial—to really go through and lay out chapter and verse what their compliance regime will be. There is a good framework for establishing that and putting it in place. I am very interested in lots of the comments made by the two previous groups of people to do with custody and externality. I am quite looking forward to your questions on how we operate as a group. We are unincorporated: this is purely a gathering of like minds. We do not have any formal structure at all. It is all pretty much done electronically and in person. So I suppose the fierceness of the independence extends that far; that we are really very keen to be seen to be very external.

Mr BYRNE—In terms of your submission, you argued that a two-year restriction before a retired member of a legal or accounting firm can join a compliance committee should be maintained. Do you want to comment on that?

Mr Dortkamp—This is just the issue of externality. It ties in with people, say, being on a fund manager's board or board of management then leaving and then mysteriously turning up as an allegedly independent person. The accounting profession has come in for a bit of criticism. I am on some compliance committees with some very good ex-audit partners of the big legal firms, and they are excellent compliance committee members. I have been on one where 'they knew each other very well' is probably the polite way of putting it—though I do not think that was ever an issue, because it made for some fairly fierce debate. The perception was unfortunate, and I would rather remove the perception. There are some great people out there and it is very easy to cross over.

Mr BYRNE—Do you think it could be an issue? Rather than just in terms of perceptions, do you think it could be an issue?

Mr Dortkamp—It is very unlikely, because of the nature of the people. By the time auditors get to the retired partner level they are pretty seriously fierce.

Mr BYRNE—I understand also that you agree with the review's conclusion that external corporate entities should not be allowed to either sit on a compliance committee or assume the full compliance monitoring function. Why is that your view?

Mr Dortkamp—The corporation will have some very good people they will then put on the committee. The risk, as I see it, is that the people will be rotated through the committee. Really, you meet every two or three months; that seems to be about where we have settled. On the basis of the worst case, they are only meeting four times a year. If you were to change the person, the dynamics of the meeting would be changed. If I am on a committee and a new person comes on board there is a learning period, and there almost isn't time for that. You really want people on the committee to be aware of all the issues—and you are sort of kept up to date during the quarter anyway. Having a corporate person—the actual individual in the meeting—changing from meeting to meeting is the worst case and it is unlikely that that would happen. That would be very dysfunctional. My comment on the period is more from the point of view of functionality. I also think that if you are sitting there as the representative of a corporate rather than as an individual, you could believe that to some extent you are shielded by your corporation from the full effects of your decisions. There is nothing like being totally exposed on a personal basis to really focus your brain. We do not trivialise things; we do not gloss things over. It stops here. It is a concern that that could be in the back of people's minds.

Mr BYRNE—That leads to my last question. In the submission you noted that most compliance committee members rely solely on the insurance cover provided by the RE and that you are not aware of any compliance committee member who continued to have their own independent cover. I guess the question is: could this reliance on the RE for insurance undermine that person's independence?

Mr Dortkamp—I do not think so. As an individual I would rather have us all in the same bucket; I would not like to see my insurance company fighting the RE's insurance company. I

think that is very distracting. I would rather be vulnerable. I would rather be in the same camp as the RE as far as insurance goes, and judging by the comments, it is going to have a fairly limited use anyway. I think that is an unwanted distraction. I would rather feel that we are all in this together and that it is up to me to take a stand on issues early to head things off.

Mr BYRNE—So you do not believe that would compromise that person's independence?

Mr Dortkamp—No. The cost to the RE is infinitesimal. They are paying $120,000 a year, or whatever, for their cover. You cannot take out the cost of adding the compliance committee members to it. We have had a fair bit to do with AIG, which we think covers about 60 per cent of the REs in Australia. Its policy is specifically written for MIA, so it is in there as part of the package. It is not like they are giving us a benefit that is $20,000 or $30,000 worth. The insurance companies are now giving us a benefit that we cannot obtain ourselves at any price. You get paid your compliance committee fees plus the cost of your insurance and, if you can rely on your RE's insurance, then you pocket the $10,000 or $20,000—I think you would have a conflict there. But, in the current circumstances, there can be no conflict. It is not like you can make a saving.

Mr BYRNE—But if you have a company where it is the RE that pays the compliance members, that can remove the compliance members—and we have gone through the potential protections—and that offers insurance to the compliance members, doesn't that provide a framework, if there was some disputation between the compliance committee, or even members of the compliance committee, and the RE, that could provide some general incentive for them to toe the line put forward by the RE?

Mr Dortkamp—My view is that, if it is going to go wrong, it is going to go wrong in a big way.

Mr BYRNE—But doesn't that provide the framework? It is all about things not going wrong until they go wrong, and then you look at it in hindsight, you look at the relationships that have built up and the structure of the organisations and the relationships that allowed things to happen. If you are talking about trying to separate the RE from the compliance committee and guarantee its independence, couldn't there be some modifications? As I said, if they are paying them, they are insuring them and they can remove them, does that not provide a framework where these people's independence could be prejudiced?

Mr Dortkamp—I do not think so, because if it is bundled in they cannot remove your insurance cover.

Mr BYRNE—I am sorry, I meant that in a general sense. I am not talking about just that particular point.

Mr Dortkamp—You have combined the three together.

Mr BYRNE—Yes.

Mr Dortkamp—I think it comes down to the appointment of the right kind of people. In difficult situations I think some people are more easily compromised than others. But the main

thing, and the toughest one, would be when you get your compliance committee charter and/or your contracts—and I have been on five compliance committees. I am currently on four, which I think is fine; that gives me a broad range, which is a good thing. The issue of asymmetric appointment and removal clauses is quite a difficult one. There was some earlier discussion, which I have not really done a lot of thinking about but which makes sense, that when you remove an auditor they cannot go until after the next audit has been completed. There are some smart things you could do there. I think the way to guarantee your independence would be to make it hard to get rid of you, to add the bureaucratic overlay, such as requiring approval by ASIC. ASIC would then send you a letter—in a form 70 whatever it would be this time—asking, 'Are there any circumstances you would like to bring to our attention before we consent to your removal?' That would be a very simple mechanism. That has only come to me today so not a lot of thought has gone into it.

Mr BYRNE—With your permission, Mr Chairman, if Mr Dortkamp has any further thoughts on that subject of guaranteeing the independence of those on the compliance committee he could take it on notice and submit those thoughts to the committee.

CHAIRMAN—That would be useful for the committee's deliberations. Following on from that, the representatives from IFSA highlighted the fact that, if there are issues of concern, it is your duty to report them to ASIC. Do you think that is sufficient protection for your independence, or do you think there is a need for greater independence for compliance committee members?

Mr Dortkamp—It is a great weapon to have on a compliance committee—the fact that we have the obligation to take things through to ASIC if we do not feel they are being dealt with adequately by the RE is a phenomenal threat. In any time of difficulty, you only have to breathe the word and people become very efficient at providing material that was slow coming, if I can put it that way. One of the things we have done with the forum, too, is to get ASIC to come along each month, which has been quite effective. The mainstream fund manager and the independent compliance committee people know the people in ASIC personally. We also go to the IFSA conference and run a separate stream each year—it is in Brisbane again this year—so there is a bit of interaction between the externals and ASIC in an industry sense, and there are some pretty clear channels. Because of my self-appointed position, I also get a few phone calls from people exploring what I call difficult issues. Because we have very clean links through to ASIC, I think people are pretty comfortable about taking their concerns there on an unofficial basis. I do not think you need to do a lot more there. I do not know whether you had a suggestion or whether it was just a leading question.

CHAIRMAN—Is it your view that the responsible entity structure is working satisfactorily and does provide adequate investor protection? The corollary of that is therefore: do you not accept the criticisms that are being made of it in the evidence we have heard from the trustee representatives?

Mr Dortkamp—I believe it is a significant improvement. I worked as a mainstream fund manager through the 1990s. The difference between then and now is huge. I think I have good privilege here—

CHAIRMAN—Absolute privilege!

Senator MURRAY—You are not about to burst into profanity, are you!

Mr Dortkamp—I get into trouble every time I say this: large global fund managers—for example, Chase or Principal BT—capitalise many billions of dollars in a global sense. I find it hard to believe that an Australian trustee company of $100 million or $50 million can add another layer of protection. I find that very difficult to believe. Having worked for large fund managers, it does not really make sense to me. It is difficult to convey the improvements in the compliance culture in fund management organisations over the last few years, even just the last five years. It is just enormous. I do not know how to describe it. Things were done okay in the 1990s, and now they are being done very well. I think the more prescriptive regime that has come out of MIA has made a huge difference. There are some very strong compliance people inside organisations. In organisations where things have gone wrong, boards of fund managers are quite keen to see that the compliance professionals within the organisation are strong people who can come straight through to them and bypass the Tricontinental style of CEOs around the organisation.

We sometimes run case studies where we create the role of the belligerent CEO who tries to shout everything down. To an extent, we are trying to train compliance committees to overcome those sorts of people inside organisations. If you are stuck there with them, the right thing to do is to stay rather than to go, because that is what investors really want you to do. It is a side question, but in a difficult situation I do not think anybody wants a compliance committee member to quit. I think you have to stay there, take the heat and get sued—do the lot. I do not think there is any choice about that. I think it is a significant improvement, and I would not like to see it changed.

Senator MURRAY—Without revealing your own circumstances, what is the typical remuneration of a compliance committee member?

Mr Dortkamp—We did a survey a year or two ago. We only got about 70 or 80 responses but it gave us a reasonable indication. The full range was $12,000 to $50,000. I thought the $12,000 ones were charitable donations, bearing in mind the risk, and some of them were—there are REs of charitable type things. Obviously the $50,000 is the top end of town. The bulk seemed to be purely determined on funds under management; there did not seem to be any other factor. We tried surveying for other things but they had no statistical significance. The bulk seemed to be between $25,000 and $35,000 a year for most compliance committees—pretty much all those from $100 million up to a couple of billion. It correlated very tightly with funds under management. That was effectively in the set-up phase. Now we are seeing more start-up fund managers and I would say that $25,000 to $35,000 has slipped a bit, because the new REs do not have $100 million under management to start with; they only have a few million. Typically it seems to be between $20 million and $25 million for the newer ones.

Senator MURRAY—What is the typical professional background of those people?

Mr Dortkamp—We seem to be getting the full mix. There are a lot of ex-auditors and a few ex-fund managers. I would tend to describe it as white-collar professional with some involvement in the financial services industry.

Senator MURRAY—Are there many lawyers and accountants?

Mr Dortkamp—There are lots of lawyers and accountants; that is right.

Senator MURRAY—You mentioned that you have been on five compliance committees and are now on four, and you said that was manageable. In your practical experience, is that the kind of limit people should aim for to do the job well? If someone was on 12, would they be doing an incompetent job?

Mr Dortkamp—I do not think so. The professional charge-out rate of $2,000 a day seems to be what lots of people aim for, and it works out mathematically quite nicely to almost $25,000. If you spend a day a month on a compliance committee, I think you are spending enough time on it. You have some preparation time, some meeting time and some follow-up time, and if you stay there a day—and that is being kind—

Senator MURRAY—So what is the answer? How many compliance committees?

Mr Dortkamp—To do it well, I think a dozen is probably pushing it—it would be a planning nightmare more than anything else—but I do not think there is a 'too much'.

Senator MURRAY—You answered that it does not matter if you have multiple responsibilities.

Mr Dortkamp—That is correct.

Senator MURRAY—But I assume there is a competency level beyond which you cannot do the job.

Mr Dortkamp—Yes, because you would not be able to devote enough time to each. In theory you could do 20 if you were prepared to work every day on a compliance committee.

Senator MURRAY—Do you mean if you were a professional full-time compliance committee member?

Mr Dortkamp—You would get conflicted out. The REs are paranoid about professional proprietary information, so if you are on a compliance committee for a property fund manager that is it—the others will not want you. If you are on one for a hedge fund, the other hedge funds will not want you.

Senator MURRAY—You mentioned that you are trying to start training. Is there no ASIC sponsored or industry sponsored training system for compliance committee members?

Mr Dortkamp—No. It seems peculiarly difficult to get some people to go to training. Maybe I am ageist, but by 55 or whatever they feel they know everything, so there is a bunch of people you cannot appeal to in a training sense. They feel that their main virtue is their externality, but there is actually a lot of virtue in having a good working knowledge of some of the more detailed running of the industry. You might have been a fine litigation lawyer but that does not mean you know a lot about managed investments or financial services, apart from your superannuation. So there would be some benefit in having training.

Senator MURRAY—Given the responsibilities, yes. The Institute of Company Directors, for instance, has a full suite of training programs.

Mr Dortkamp—They do great courses.

Senator MURRAY—The trustees association does, and the lawyers and accountants do. It seems an odd gap.

Mr Dortkamp—The University of New England worked with us to get a course together based on the company director type course. They have run it a couple of times. There were more compliance professionals at the course than there were compliance committee members, unfortunately.

Senator MURRAY—Can you explain to me whether you are able to go to ASIC as an individual compliance committee member or does the committee as a whole have to do it?

Mr Dortkamp—I have seen it done both ways.

Senator MURRAY—So you can have a situation where nine out of 10 might not, but one whistleblower has the access?

Mr Dortkamp—Yes. We take the view that, if you feel that strongly and you are in a minority, you should go. I do not know whether it has any legal basis, but my counsel to anybody in a difficult situation is to go to ASIC. In lots of these very difficult situations we have found that it is the lone person who finds they are out of step with everybody else—they are only out of step with the people inside the organisation; they are not out of step with society.

Senator MURRAY—Do you think the act should provide that compliance committee members who are removed should be given a continuity of cover, both in terms of their liability whilst they are there and for any whistleblowing activities they might think necessary after they have been removed?

Mr Dortkamp—It would make a lot of sense.

Senator MURRAY—So a whistleblower provision in the act would be useful?

Mr Dortkamp—I think so, yes.

Senator MURRAY—On the independence issue, I am one of those parliamentarians who have come to the view—probably as a result of my work on this committee and on the Joint Committee of Public Accounts and Audit—that, by and large, the act should say what needs to be done but the regulator should flesh that out and say how it needs to be done. I think the act should require that, for bodies such as compliance committees, the issue of true independence should be established—that they must be independent, not just external—and conflict of interest provisions should be drawn up et cetera. ASIC would then go out and talk to everybody, come up with a guidance note and say, 'This is how we suggest it is—if you want to be flexible with

this you can, but this is the benchmark.' How do you react to an improved set of guidelines, if you like, in this area?

Mr Dortkamp—I think that globally we are seeing the importance of independence. I have started to collect my own little press clipping file on independence, especially of any American information. It seems very timely now to really focus on this. It seems as though the ASIC policy statement methodology works fairly efficiently. Do you legislate to do that or do we lean on them?

Senator MURRAY—You can legislate the basics for it and that allows the flexibility, because circumstances change over time and people get informed. But at present the legislation does not require ASIC to do it, and they have not done it. Incidentally, as I have said earlier today, they have not done it for directors either, which I just find amazing.

Mr Dortkamp—I would support that.

CHAIRMAN—You mentioned difficulties—I think that was the word you used—in some of the compliance experience you have had in terms of when you decide to go to ASIC as a committee or as an individual. Do you have practical examples of situations you have been in—obviously, without identifying any of the parties involved?

Mr Dortkamp—The most practical one is probably trivial in a sense, in that the dealer's licence has a requirement for NTA. Companies are very good at sorting out the $5 million, and we have seen some pretty spectacular accounting failures, in that people have done intergroup transactions which have destroyed the NTA. That is the most common breach and it is quite black and white. It is normally a breach of your compliance plan because you have to cover this. It is definitely a breach of your dealer's licence, which is immediately reportable to ASIC. Most REs go into a sort of dither, saying, 'Do we really have to report this to ASIC, how soon and what sort of trouble are we going to get into?'

So that is an easy context and it is very black and white. What happens in practice is that the RE might be saying, 'We are trying to fix that and we won't report it until it is fixed.' The reality is that the law says that you report straightaway. The threat then is that someone will say, 'If the committee won't do it then I will.' That is probably the best example of a practical thing.

A more fuzzy one would be, say, a unit pricing error. If it has the standard 30 basis points then you should compensate investors. So you can say that 30 basis points in a global share fund might not matter too much but 30 basis points in a cash management trust does matter these days. Therefore, you might have a debate about whether the compliance parameters have been breached in terms of investors' protection—and writing a wrong, effectively—and that to cause these investors to be worse off is purely an error on the RE's part.

That is the more difficult one. Would you go racing off to ASIC if they said that it is only 29 basis points and it is the cash management trust but that they are not going to do anything? That is a tough one because then you are asking the question of whether you believe the RE is taking appropriate action. If you genuinely did not believe that the RE had taken the appropriate action to deal with it then I think it would be your obligation to go to ASIC. They are two fairly bland

ones and they happen all the time. We see lots of audit reports that come up with NTA breaches around the industry.

Senator MURRAY—I have one question which I forgot to ask. With regard to this business of an external entity like a trustee structure, I have always held the perhaps heretical view that investors should be able to decide what kind of structure they want, frankly. But your point is well understood when you say that to impose a trustee kind of device over Chase Manhattan is a bit odd given their global situation. But I would have thought that for small domestic fund managers who might not have the stretch, depth, expertise or experience, perhaps, that a trustee structure would be appropriate in those circumstances. I do not think it is appropriate for the law to say that you cannot revert to the old system if you want to in certain market sectors. I do not think a trustee structure should be mandated over the whole system; I accept that. But I can see a market niche situation at the smaller and more vulnerable end of the domestic market for that kind of structure that is not a single responsible entity.

Mr Dortkamp—To some extent it is catered for. My concern would be regulatory overcharge. Where there is a chance that you have different operating environments with different cost structures, I think that the 'smart operators' would tend to shop for the correct regime. So I am worried about the marginal operators; I am worried about loopholes by having multiple jurisdictions. That is my first concern. There are mechanisms for people who want to have the Big Brother overlay, which is the pre-vetting combination of custodian and trustee that the trustee companies are looking at. Ironically enough, one of the trustee companies does offer that to certain boutiques. If you want to be a start-up fund manager and all you want to do is manage money, look at the Bloomberg screen and buy and sell Australian shares or whatever, you can do that and there are service providers that will give you the wraparound.

Senator MURRAY—Are you saying that the market mechanism exists already?

Mr Dortkamp—Yes, you can do that. You can just sit in your office with two or three people, get a phone call about how much money has come in, invest the money and send off the dealing slips or whatever and they all go through the service provider. It effectively operates in the same way as the old system except that you are just appointed the portfolio manager. So there is a market mechanism to achieve the same objective where you can just blithely sit there and say, 'I am just a portfolio manager and that is all.' There are ways out of that.

CHAIRMAN—There are no further questions. Thank you for providing your evidence before the committee, Mr Dortkamp.

[12.34 p.m.]

GOODACRE, Mr Stanley Alex, Chair, Taxation and Investment Review Group, Association of Independent Retirees Inc.

VALENTINE, Mr Roger Stuart James, Consultant Legal to National Council, Association of Independent Retirees Inc.

CHAIRMAN—I now welcome the representatives of the Association of Independent Retirees. Would you like to say something about the capacity in which you appear?

Mr Valentine—Yes. I am a retired barrister and solicitor. The National Council of the Association of Independent Retirees is currently incorporated but is in the course of becoming a company limited by guarantee. My background is 21 years in private practice as both a barrister and solicitor. I was admitted to the Supreme Court of Tasmania in 1956 and to the High Court of Australia in 1957. I entered an equal partnership with my master within a couple of weeks of my 24th birthday and of being admitted.

I sold my share in private practice to my partners and became the senior solicitor at the public trust office in Tasmania for some seven years. I then was suddenly shot upstairs and became the public service arbitrator for Tasmania. When the Public Service Board was abolished I then became the commissioner for review, which headed up the public service of Tasmania and was responsible not to the government but to parliament. I then was appointed the public trustee of Tasmania and was there for six years before I retired early.

In all my private practice, we had a lot of mortgage clients. We had a contributory mortgage fund. The public trust office dealt a great deal with mortgages and investments. In over 20 years there was not one occasion when there had to be a mortgagee sale of any transaction so far as the firm and the public trust office were concerned.

Mr Goodacre—I have a bachelor of science and a diploma in education and am also a member of the Royal Australian Chemical Institute. In this position I am acting as the chairman of the taxation and investment review group of the Association of Independent Retirees. That is a subcommittee of the NSW division of the association but we work on behalf of the total national membership of the association. I also serve on the Australian Taxation Office's personal tax advisory group on behalf of retirees and investors. The review group that I chair is basically composed of practising or retired taxation accountants and a couple of ex-professors of economics and law from the University of Sydney and Macquarie University. I was an industrial chemist by training and that made me particularly competent in leading a taxation review group!

Senator MURRAY—About as competent as we are!

Mr Goodacre—The taxation review group started off when we were asked to prepare a reform agenda to put before the taxation reform task force in 1998. Out of that, that group was then formed. It languished for a while after we had done all our work and been to the Senate

committee in Brisbane and so on. We were re-formed in November 2000 and our basic work is in fact aimed at preparing logical and well reasoned policy for the association—in the area of taxation primarily. I have had less to do in the investment area because I have been too busy in the taxation area. Each year we prepare a pre-budget submission on the association's policy. I think that is enough about me.

CHAIRMAN—The committee prefers all evidence be given in public but if at any stage you wish to give evidence in private you may request that of the committee and we will consider it. We have your written submission before us, which we have numbered 8. Are there any alterations or omissions to your submission before we proceed?

Mr Valentine—No. As you probably have observed, the submission was prepared by the chairman of the committee, who unfortunately has had a knee replacement. We have stood in for him today and his apology is extended to you.

CHAIRMAN—I invite you to proceed with an opening statement, and following that we will move to questions.

Mr Valentine—Perhaps, being lawyers, one of the problems is that we like to qualify our witnesses. I think it is appropriate that we qualify what the independent retirees are about. There is a popular misconception that if you are living either fully or partly from your investments you are a silvertail. It has taken some years for people to realise that our members are not silvertails. Many live at a very narrow margin but their assets are sufficient to prevent them from getting a pension. Some do receive one, and that is why we talk about some of our members as being partly self-funded as well as those members who are self-funded. The fact of the matter is that either way their assets are not reasonably realisable. The other aspect is that should they have to call upon their capital to live then they are not self-funded for very long and they fall into calling upon the public purse to help them along. That is the first point we would like to make.

We are a body which has members in every state; we are representative of all states. The division presidents or their nominees are on the national council, the governing body, which meets every two months. We have some 16,000 members throughout Australia, but what probably qualifies us most is the fact that over the last three years retirees have lost in the vicinity of $3 billion—not million but billion—through fraud of investments. It does not stop there. In the last week or so in one particular state another scam has arisen. We find that $50 million is reported to be involved. It is also reported that that involves 2,000 retirees. So we believe that we have an interest in what is happening.

Senator MURRAY—You sure do.

Mr Valentine—As I have said, the paper is very broad. One thing that I would like to preface my remarks with concerns the main criticism that this has come about because of dishonest lawyers, valuers, investors and so forth. To an old chap like me, it is very noticeable that nobody has said anything about the legislators. When I was first practising law the point was that you could never invest trustee funds in an airy-fairy way. To give an example: in my state—and this was probably the universal idea—to invest mortgage moneys you had to receive a valuation by two valuers, the property had to be within the state in which you were lending, and the amount you lent was not to exceed 60 per cent. On top of that, the trustee acts used to

provide that there were certain specified investments that could be made. Some were with trustee companies. Government bonds were included as a trustee investment, and there were other limited situations.

What happened during the greedy eighties and in the following years was that the so-called 'prudent person' concept came in. I do not need to draw attention to what has happened since that occurred. Something that I learned the night before the last might well be of interest to the committee: one of our very senior executive members on the national council drew attention to the fact that he had decided to ask his investment adviser what his background was. It turned out that he had been a bookmaker. So, for a reason that I suppose is reasonable, he went to another investment adviser, but before he started, he asked what the adviser's background was and he was told, ' I was an officer in the Army.' So one wonders.

Mr GRIFFIN—I would go with the bookmaker.

Mr Valentine—Yes, but why did he change his job?

Senator CONROY—The only question you have to ask is: was he a successful bookmaker?

Mr Valentine—So the first thing that struck me, knowing that I was coming here at short notice, was what sort of oversight is there into the qualifications of those who set themselves up to be financial advisers. Having removed those limitations, as they were called, on trustee investments, one now trusts the investment adviser. I was interested in matters that were raised earlier and the comments about the need for some trustee structure. You will note that one of the matters that Mr Beaton has put in the submission is that perhaps too much emphasis is put on the big players and that there needs to be some emphasis on the small players. I thought the comments were extremely relevant to that aspect of our submission, and that is available to the committee.

There are a couple of things that I should specifically draw your attention to. The first statement that I would like to amend, as the chairman asked, is at the third last paragraph on page 4. It says:

Look at 'The Big' Picture ... If the Current Government is serious in its intent to effectively control the finance industry and eliminate risks to investors it must in all conscious—

That should read 'conscience', I am sorry—

look at the macro picture and address not merely the crime of fraud, but also its contributors; its aid and abettors—the professions which wax fat on the service they are seen to provide in a manner that is questionable in the least.

With great respect, I would like to insert after the word 'government', 'and all parliamentarians.' It is so easy to sit back and say, 'It's the government's fault.' But we very often find that the real action, the real transformation that comes about is from ordinary members of parliament who may not be in government. To them, I think, a lot is owed and it is to them that I think this particular statement can be directed.

At the top of page 5 of our submission we say:

A.I.R. supports the institution of a legal overview system that looks beyond the immediate perpetrator and investigates areas of contributory negligence, professional misconduct or collusion. Only when those measures are in place will there be sufficient deterrence and accountability.

It would seem to me, with the greatest respect, that this is an area that the Managed Investments Act could look at very seriously. The paper refers to when those who have perpetrated some particular default are discovered but—surprise, surprise!—their funds are not accessible because there are family trusts and all sorts of other things. It seems to the independent retirees that one of the real deficiencies in the act is that the pursuit of the funds is prevented by the existing law. I understand all of the basic principles—that you cannot get money back from somebody else—but if in fact the money is ill-gotten gains, it would seem to me very good indeed that the legislation was altered to enable the pursuit of those funds in ways that are currently blocked by ordinary common law.

Another aspect that we would like to draw attention to is the introduction of government bonds. We believe that if they are in competitive forms—I am speaking about the last paragraph on page 6—and backed by government regulation and indemnification, it would be irresistible to the majority of investors who invest for income security. The exodus of money from the commercial funds would be significant. We believe that that would be a catalyst that would make the industry itself become more serious about self-regulation and indemnification. These comments, however, are not intended to have application to speculative investors.

Mr Goodacre—It would certainly attract the majority of retirees' investment, and I think that is where we are coming from. If the word 'retiree' was put in there it would add some strength to it, from our point of view.

Mr Valentine—The funds that a very well-known perpetrator of fraud—certainly very well known in Tasmania—had his clients invest in were called MOB1, MOB3, MOB4 and so on. The MOB stood for 'money or bust'. So those who put their money into it knew that it was very definitely speculative. He then disappeared to America, but on the way to the aircraft, before flying overseas, he diverted because a large cheque had been given to him—he cashed it before he went and then caught a later flight. So those folk were aware. But in the general run of things, our members—a very large proportion of whom have suffered very badly at the hands of fraud—would find great attraction in that, as Mr Goodacre has said, which might in itself result in a bit more self-regulation.

As stated in paragraph 1 on page 7 of the paper, under term of reference G, 'Other relevant matters', our view is that there is an indication that there is an urgent need to review the role and responsibility of ASIC, APRA, valuers, auditors, solicitors and law firms, and also government entities providing financial and related services. Notwithstanding the inclusion of the regulatory provisions after the unlisted property crisis in 1990, which were aimed at the provision of strict guidelines for the valuation of property assets, we have seen what has happened since—it just has not worked.

So the Association of Independent Retirees supports the need to review regulatory legislation and to address the current situation which provides what we respectfully submit is deficient, flimsy and inadequate protection to investors and in particular to retiree investors, who can be shown to be the major target group of unscrupulous financial and associated practitioners. I

noticed that the question arose earlier, I think during Mr Byrne's questions and I refer to the page 11 of our submission where we say:

As things stand ... if people are going to have member investment choice they are going to experience difficulty in choosing between funds and in comparing costs and investment returns because there are no ... standards of disclosure that are standard across different funds.

Another role that AIR directs its urgent attention to of course covers the professions. I was amused to read on page 6 of the submission:

One is obliged to query why the regulating body warning against what may at law constitute false misrepresentation has failed to use its regulatory/registration authority to question/expose such improbable schemes?

This is termed 'Caveat Emptier'. As you know, the correct term is 'caveat emptor'. I thought that was very good and I propose to use it in the future, because it is certainly a way to empty out the funds of retirees. I do not need to comment any further except perhaps to say that there must be an internal accountability provision built into finance industry administration, and I repeat that going back to the good old days might not be such a bad idea.

Senator CONROY—So you would argue for a return to the previous regime rather than some of the things you have heard this morning about an independent custodian? You do not think an independent custodian would provide sufficient protection?

Mr Valentine—There would be great support for an ombudsman. As we see it, ASIC does not seem to have the power to pursue funds. It can investigate but it does not have the power to pursue funds.

Senator CONROY—Is it the power or the resources?

Mr Valentine—You will see in our submission that we think there are insufficient resources. We believe that if ASIC and others had more resources that would give them a great deal more scope for action, but I do not think it would give them the power. Similarly the fraud squad—and you have seen the reference to that—can pursue prosecution, but our retirees who suddenly find they are pensioners say, 'We would like to be able to get the money out of the places where the perpetrator of the fraud has squirreled it away.'

Mr Goodacre—It has to be done fairly quickly, too, because we are all approaching a stage in our lives when we do not have time to recover some of those losses.

Senator CONROY—I understand that you are also concerned that ASIC does not vet compliance plans under the MIA.

Mr Valentine—That is as we understand it.

Senator CONROY—ASIC has put forward suggestions for law reform relating to the independent audit compliance plans. Would you support that?

Mr Valentine—Yes, indeed. I should mention that in the submission we have made reference to a contributory scheme on the basis of it being an indemnity. The submission refers to a contributory scheme for all parties which includes those who invest. We are a little bit nervous about too much prominence being given to the investors having to contribute to the scheme

because we feel that the returns are so small. For example, let us consider the situation that has existed in recent years for a mortgage. The average Australian mortgage is close to $100,000. In the last five or six years, interest rates have come down from about 15 per cent to about five per cent. The average family household has found that their interest payment has dropped from $1,250 a month to one-third of that, which is $420 by my calculations—and I repeat, I am only a lawyer not a mathematician. So in the last few years the average family has been saving $830 a month for the same mortgage.

The same applies to businesses. The interest rates that they are paying on money they have borrowed have been slashed. But those who invest and who received their 15 per cent before—for example, if they invested in a solicitors mortgage fund—are losing $830 a month because now they get only $430 instead of the $1,250 they may have received when they invested back in those days. That factor is sometimes overlooked. Everyone seems to benefit from a drop in interest rates except those of us who have invested money to live from.

Mr GRIFFIN—Mr Valentine, I have to say that of all the organisations I have dealt with as a local member of parliament, your organisation has been extremely effective in making sure that members of parliament are aware of that impact.

Mr Valentine—I am delighted to know that. We can chalk that one up.

Senator MURRAY—One of the strong motivations for the Managed Investments Act and the single responsible entity concept was to make sure that those responsible for managing risk were also those on whom liability and responsibility could be placed. As a theoretical concept, that has attractions although, as everyone knows, I was one of the sceptics about the full consequences of that. However, in your submission you quite rightly point to another area of concern, which the committee may want to comment on in passing in its report, and that is the government regulatory and responsibility area. You have identified a number of circumstances. I will just use two examples, from Tasmania and Western Australia, although there are many.

In Tasmania the solicitors mortgage fund scams were effectively regulated and conducted under state law. In Western Australia the mortgage finance scams were, again, effectively—or ineffectively, probably—regulated and managed under state law. In Western Australia, the respective board was incompetent and had too few powers. They were supposed to have oversight. The minister responsible was delinquent and the responsible department was useless. You could run through a pattern of things. I think one of the things we as a committee and you as a national association have to recognise is that if the essence of investment is national and indeed international in concept—I think the chairman will tell you that 40 per cent of investment funds are now invested overseas, never mind in Australia—to have investors fall between the cracks of regulators is wrong. ASIC does not know how far it should have got involved in Western Australia or Tasmania. We have to end that. Either a national body has to be responsible and delegated, such as ASIC and those sorts of things, or there has to be a better system. One of the things I get out of your submission is the observation that risk as a result of a lack of oversight has emerged often because of difficulties of power and responsibility at the state level. Would that be a good summation?

Mr Valentine—I think so, too, and I intended to say that at the beginning when I pointed out how the state legislation had moved away from trustee investments to prudent person. What

happens, especially in a small state like Tasmania, is that there is pressure on parliamentarians to do what is done in other states. In Tasmania, the real case that mattered was the superannuation fund board and Fouche. This was the case in which the state superannuation fund board, which was a government body, invested money in a country club which a very well known wrestler was building. In fact, when it burnt down it was discovered that they had invested in the business. The case—which as a student I was brought up to believe was almighty; you lent only on the bricks and mortar—disappeared about the time I ceased full-time employment—although I do not know that I have really retired.

In fact, of the scams that have occurred, strangely, there is a coincidence with one of those legal firms. They invested in a country club near Launceston and a country club on the north-east coast of Tasmania. In both those cases they lent on the business, which included bricks and mortar, but not only the bricks and mortar. I do not believe that there would have been that enormous scam, and you are obviously very aware of the case so I do not need to mention the firm's name, if there had not been a change to legislation which took away the requirement to invest in trustee investments.

I know that people will say, 'That's very restrictive. It means that shares and things are not available.' But we have superannuation organisations and that sort of thing that may be interested in that. But looking at just the trustee investment and the small investor, the loss of that I believe—as you say—resulted in the scams in Tasmania and I suggest, although I am only talking about what was reported, the scams in Western Australia.

CHAIRMAN—I was a little bit involved in this through another committee. It was suggested in evidence before that committee that, particularly for those mortgage schemes in Tasmania, had those schemes been required to come under the Managed Investments Act the problems would not have arisen because of the requirements of that act. Rather than perhaps going back to your idea of the trustee investments, if it had actually come forward and been part of the national regulatory scheme those problems would have been avoided.

CHAIRMAN—Have any of these things that have happened since been under the Managed Investments Act?

Mr Valentine—Sorry, such as what?

Senator MURRAY—'No' is the answer; not to my knowledge.

Mr Valentine—No. All of those were under the state jurisdiction.

Senator MURRAY—That was where I was going to go with the next point. It is a good interjection from the chairman, because—

Mr Valentine—That may be the answer

Senator MURRAY—it seems to me that it is open to the committee to recommend that in future ASIC or the minister provide an annual appraisal of significant areas of investment where investment funds, whether those of retirees or anybody else, are at risk where the act or federal protective devices—either through the regulator or through the act itself—do not apply. It is my

judgment, based on recent events, that most of the recent losses have been outside the Managed Investments Act and have been within the state regulatory ambit rather than the federal regulatory ambit. I may or may not be right in that, because the committee has not examined that issue specifically, but you have raised the issue of how much money is being lost by retirees. The information I have received—and I have had delegations come to see me in my capacity—has all landed in that area. I am not sure just how much effort has been made by the minister responsible at a federal level to coordinate, with COAG ministers or their counterparts, a review of the areas of investment outside federal acts and regulations and of where the weaknesses are.

Mr Valentine—You have hit the nail on the head. As you have said, our body is a national body. It comprises 82 branches throughout Australia in the states, and it has built up from that. If the bringing of what were formerly state responsibilities under the Managed Investments Act will solve the problems, then we are all for it.

Senator MURRAY—I do not know if it would, but it is an area—

Mr Goodacre—Yes, it is well worth pursuing.

Mr Valentine—It may be worth examining.

Senator MURRAY—which may be worth examining, because it seems to me that many of your perceptions and criticisms have a state emphasis.

Mr Valentine—The author of the submission is South Australian. He is President of our South Australian division, so he has personal knowledge of those things he has mentioned. I have personal knowledge of the Tasmanian situation only as a retired lawyer and therefore have an interest. I have the very firm view that our problems in Tasmania came about because of this introduction of the 'prudent person'. I am afraid that what has happened is that prudent persons have not proved to be prudent. I certainly agree, as Mr Goodacre says, that that may well be an excellent matter to pursue. I would be surprised if states were to oppose that, especially on the recent record.

CHAIRMAN—As there are no further questions, I thank you both for appearing before the committee, for your evidence and for your answers to our questions.

Committee adjourned at 1.14 p.m.