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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Managed Investments Act review

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Thursday, 11 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, Murray and Wong 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.

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Committee met at 4.19 p.m.

CHAIRMAN—I declare open this inquiry of the Joint Committee on Corporations and Financial Services. This afternoon the committee is holding its first public hearing into the findings of the review conducted by Mr Malcolm Turnbull of the Managed Investments Act 1998. It will also hold a further public hearing tomorrow morning on this matter. On 20 March this year, the committee agreed to inquire into the review of the Managed Investments Act 1998 conducted by Mr Malcolm Turnbull which was presented to the Treasurer on 3 December 2001. The act specified that a review should take place three years after the commencement of the new regulatory regime on 1 July 1998. The committee decided that there would be merit in evaluating the findings of the review and advertised its inquiry on 6 April 2002.

The inquiry is to give particular attention 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 section 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 of managed funds has not resulted in a significant reduction in fees; and (g) any other relevant matters. To date the committee has received 10 submissions. The committee wishes to thank the organisations and individuals who have assisted the committee with its inquiry so far.

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 any evidence provided. Parliamentary privilege refers to the 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, which operates to the disadvantage of a witness on account of evidence given by that 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 as such all members of the public are welcome to attend.

[4.22 p.m.]

BRITTON, Mr Michael John, National Manager, Fiduciary Services, Trust Company of Australia

SWEENEY, Mr Jonathan Westaby, Managing Director, Trust Company of Australia

CHAIRMAN—I welcome our first witnesses, the representatives of the Trust Company of Australia. We have your submission before us, which we have numbered 7. Are there any alterations or amendments that you would like to make to your submission?

Mr Sweeney—No, thanks.

CHAIRMAN—You might like to make an opening statement, following which we will proceed to questions.

Mr Sweeney—Thank you for the opportunity to address the committee; we really do appreciate it. I would like to make four points. I will elaborate on each of them briefly and then, obviously, throw to you for questions. Trust Company is in a fairly unique situation in that we operate across the whole financial services spectrum. We are a funds manager, a trustee under the superannuation legislation, a trustee under the Corporations Law for note issues et cetera, and we also have a financial planning arm. So we see the whole industry in all its different aspects, roles and obligations. We can bring a reasonably wide view rather than a narrow view of the industry.

We believe quite strongly that the MIA regime stripped away a very effective layer of independent supervision from the regulation of the managed funds industry. The previous trustee model resulted in real-time prior approval of fund transactions by an independent third party which was subject to after-the-event, semiannual financial audit by its own auditors. ASIC licensed the manager and the trustee, with surveillance programs for both. So you actually had two entities doing a job that necessarily—I believe very strongly—added value in that each entity had different objectives and ASIC regulated and licensed both of them. Under the Managed Investments Act, basically, we now have self-regulation by a single responsible entity subject to after-the-event, semiannual financial audit, a compliance plan operation, a periodic review and an annual compliance plan audit. That is typically conducted by a partner of the auditor of that entity's finances. So you have the auditor of the company on the finance side with another partner auditing on the compliance side. Again, with the spotlight put on the role of auditors and the expansion of those roles, you can see there could be some issues there.

The operational nature of the compliance plan audit and the potential for consulting work further adds to the potential for conflict as highlighted in the recent Ramsay report, as well as by what we have seen happening in the US. Mandating appropriately qualified, capitalised and insured corporate entities to discharge the role on the compliance committee or as an external member of the compliance committee would, we believe, enhance investor protection. One of the things that the legislation does not give is whistleblower protection. We think that could enhance the legislation quite significantly. The compliance committee, at the moment, is under a

lot of indirect pressure to behave. If they do not, the RE can remove them. There are no real sanctions to stop the RE removing anyone on the compliance committee. Another protection we think would enhance independence is a three-year minimum tenure of all members on the compliance committee—again, obviously, provided performance is satisfactory. So there is an opportunity to improve the independence of that compliance committee through either a corporate role and/or by improving the ability of the members to really have independence.

The MIA review concluded that scheme operators should not have the option of appointing an external corporate entity for compliance purposes, pending ASIC monitoring of compliance performance. The non sequitur I felt there was that you are saying, ‘Let’s wait for a disaster,’ and then ASIC can say, ‘This is important. We should have done this.’ It is a sensible reform that would offer no additional cost or inconvenience to the existing structure. There are also quite strong insurance reasons why a corporate member could add a lot of value, and I will get to that later in my preamble.

The second point I would like to make is that global best practice in funds management regulation dictates separation of ownership of fund assets by the use of a contracted third party, either an independent trustee or a custodian. I will not bore you with the myriad examples there, but this is a unique system we have in Australia; no-one overseas has used it. Every major jurisdiction we have looked at has some compulsory separation of ownership through either a trustee or a custodian.

The third point is that litigation will inevitably arise under the MIA or any other regulatory system. It is a fact of life. However, designating a single entity as responsible will not necessarily reduce the number of parties to an action or in any way contain the number of cross-claims to be issued. We think that is a bit of a myth that has been put around—that because there is one entity responsible, only one entity is going to be sued. Section 1325 of the Corporations Act 2001 specifically recognises that the court can make compensation orders against any party accountable for scheme member losses. So it is not confined to the responsible entity. Clearly, the blame game and finger pointing as regards managed investment scheme losses will be as fertile and protracted as ever they were under the former manager-trustee regime. You will have parties being enjoined left, right and centre, all arguing diminished responsibility or that it is the role of the responsible entity. Therefore, I would put quite strongly that section 1325 of the Corporations Law specifically recognise that there is not a single responsibility as far as litigation or loss are concerned.

Dealing with insurance: we understand it is not uncommon to see responsible entities with a $5 million professional indemnity policy—however, coupled with restrictive fidelity extensions—still get approved by ASIC. That can be quite dangerous. This will prove, I think, inadequate in most instances, should a scheme fail. One thing we have seen in the most recent collapses is that underinsurance is a very common issue. Adequate insurances of the RE, auditors and agents of the RE including custodians, registry service providers and legal advisers should also be part of the overall package underpinning the MIA. It is something that ASIC really have to get hold of.

The last point I would like to make—something we did not bring out particularly strongly in our submission, but time is bearing out that it is actually a big issue—is that the MIA raises significant barriers to new entrants into the funds management industry. We are seeing any new

boutique manager moving into the wholesale market rather than the retail market. The reason they go into the wholesale or the institutional market is that the MIA does not regulate them. That means the large fund managers, who can afford the expensive set-up costs of the MIA and the expensive ongoing compliance costs, are safe from new and more nimble managers entering the retail market. At the end of the day, the consumer is definitely worse off in that respect.

Fees for setting up a fully compliant, single responsible entity and fund structure, I believe, are in the order of $200,000 as a one-off cost, and at least $70,000 per annum on top of that. So you can see, for a smaller boutique manager, that is a major impost for them to cover those costs. Under the previous structure, trustees acted for between three and seven basis points—that is, three to seven per cent of one per cent of gross assets and then there was usually a minimum fee of between $20,000 and $50,000. So you can see, it was much easier for a group to start up, because those set-up costs were not there. What they could do, effectively, was tap into the trustee companies' economies of scale. What we could do was leverage our economies of scale across all the start-ups. Now, it is the economies of scale of the large fund managers that are determining the future shape of the funds management industry. Is that a good thing? I leave it up to you.

I think competition is very healthy. I know one of the issues that the committee is particularly interested in is the fee levels of the retail products. Obviously, one thing to keep fees very competitive is competition. By stopping or making it very difficult for new entrants into the market, you are going to see further consolidation of the funds management industry which in the long term is not good. But more particularly, a lot of the larger fund managers are overseas owned, so it is not good for Australia. That is my quick precis of what we submitted.

Senator CONROY—I just wanted to talk about the checks and balances that I think you stated 'stripped away an effective layer of independent supervision'. You talk about 'real-time prior approval of fund transactions previously undertaken by trustees'. I want to explore that. When you say 'real-time prior approval of fund transactions', do you mean that before a fund manager executed any transaction on behalf of a managed fund under the old regime, they first needed to obtain the approval of the trustee?

Mr Sweeney—Technically, that is exactly right. What happened in practice in a lot of cases was that there would be—let us use equity funds as an example because that is really what we are talking about—an agreed list or a mandate so that the trustee would say, 'Within this mandate, you can operate.' That would be decided with the trustee and the fund manager. Some trustee companies went to the extent of every single trade having to go through them. We, in our operations and in our opinion, felt that that was quite laborious and, at the end of the day, I am not sure it achieved a good protection role. It really just slowed everything down. So a lot of the newer thinking, the trustee near the end of the reign, was that you had a selected stock list. Anything on that list was fine, so there was a vetting.

Senator CONROY—You have partially answered my next question. On what basis would the approval be given? Was it subject to investment guidelines of the individual fund?

Mr Sweeney—Absolutely.

Senator CONROY—That would cover things like restrictions on the fund manager for, say, the maximum percentage exposure to a company or an issuer—those sorts of things.

Mr Sweeney—The other thing too is we put a lot of self-dealing restrictions in there. We had one client who traded very heavily in over the counter options. A counterparty in a lot of those transactions was a subsidiary of the fund manager. We had to preapprove those ones and we had to get them to provide independent confirmation that the prices struck were market. Under the basis now, there is no requirement for that.

Senator CONROY—You are not confident that Chinese walls exist? This was an argument four years ago—and I know Senator Murray will remember when we were having discussions about it—and we were assured that Chinese walls would exist and there would be separate parts of the organisation.

Mr Sweeney—Chinese walls exist, but do they work?

Senator CONROY—This is obviously a hard one for you to answer, but are you aware of or do you have evidence of the failure of the Chinese walls? I know there were examples given to us four years ago regarding a number of transactions. We had an in camera hearing to discuss some of these issues. Obviously, it is much harder four years down the track, because you and others are no longer there.

Mr Sweeney—It is not really a Chinese wall issue but there was an instance where a fund manager took up a rights issue which proved to be unsuccessful in that there was a shortfall. The funds got the shortfall but they did not get the underwriting commission and we found that out. That is a strange mixture of revenue—as in you get paid to take that risk—and then the risk comes off and you actually have to take the shares at the price. They got the shares at the price but they did not get the commission for the risk. Where that went, I do not know, but we eventually got it into the fund. I do not know whether that was an oversight, but that is not really a Chinese wall; that was more a matter of not matching revenue with risk—and we found there were other instances of that type of behaviour. I cannot comment on whether that was intentional or an oversight mistake. Mike, are you aware of any Chinese wall type issues?

Mr Britton—No.

Senator CONROY—You are out of the loop so it is a bit hard.

Mr Britton—That is correct.

Senator CONROY—In terms of the real-time prior approval issue, how did you obtain the information? Were there direct links to the fund manager's portfolio management systems? Would you have access to real-time pricing?

Mr Sweeney—We have access to the settlements and we get copies of the trades.

Mr Britton—That is right; it was basically funnelled through the fund manager, as I recall. Trust Company's practical experience though was primarily in infrastructure and property custodianships. The fixed interest and equity custodianships, while we are familiar with the

processes, were not our strong suit. The incident Jonathan was explaining a while ago did, in fact, occur in a property fund that was dealing property securities on the exchange.

Mr Sweeney—Although the OTC one was a global equities one.

Mr Britton—True.

Senator CONROY—I would like to move on to third party custodians. There is no compulsory separation between management and control at the moment and you talk about that resulting in unnecessary risks for members. Could you explain what unnecessary risks emerge for members as a consequence of the absence of an independent custodian?

Mr Sweeney—In the absolute disaster scenario, you have a fund manager who has fraudulently disposed of assets. You track that down, find it out, rightly sue them and win. Their PI is $5 million, their capitalisation might be $5 million, if you are lucky, and they might have done $20 or $30 million of fraudulent disposal, and they happen to self-custody. You have got no chance of getting anything more than a maximum of $10 million out of the $20 million.

Senator CONROY—You describe that as a worst case scenario but fraud is always the hard one because fraud is not the same as mismanagement or some of the other Chinese wall style issues that arise.

Mr Sweeney—Let us say that there is a valuation mistake in a price. That is the custodian’s fault but because it is a self-custody there is obviously very strong commercial pressure for that never to percolate up to the compliance committee or the RE, and therefore nothing is done about it. When there is an external custodian, obviously, there is no commercial impediment.

Senator CONROY—I was going to come to that. Could you explain how you thought the appointment of an independent custodian would militate against that.

Mr Sweeney—It certainly creates friction, in that if there is a mistake the RE has got a strong interest to pursue it, whereas with self-custody you could argue commercially—ethically there is a very strong commitment to pursue it—it is less strong. The thrust of it is that you bring in two parties that have a duty and also have separate ownership, so they are both looking at each other.

Senator CONROY—In terms of bringing in an independent custodian, there will be additional costs and that would be a strong argument, I would have thought.

Mr Sweeney—I do not think there will be any additional cost because if you self-custody at the moment, you charge a custodian fee. It is at a market rate. I could stand corrected but I do not see any additional costs at all.

Senator CONROY—Aren’t these custodianships wafer-thin now under this new Managed Investments Act? Weren’t we promised that these sorts of costs were going to be driven down and there would not be much fat left any more?

Mr Sweeney—I do not think custody costs have come down at all, other than from competition. I think the argument was that the saving from the trustee fee that was between three and seven per cent of one per cent was going to come down and the so-called compliance costs were going to be a lot less than that, and that would be passed on, but it is arguable whether that has happened. I think, to be fair, we have not had long enough to see if that is going to occur. The conversion costs of the Managed Investments Act run into tens of millions of dollars across the industry. They are certainly more than two years of trustee fees; there is no doubt about that.

Senator CONROY—Your submission seems to suggest that you believe that net tangible asset requirements are inadequate as they currently stand. Could you clarify that?

Mr Britton—If you are running at one billion plus, your net tangible assets are capped at $5 million; that is the maximum. If you make a mistake of 'only' one per cent on $2 billion or $3 billion, that is already over your NTA—and mistakes of one per cent can and do occur. If you only have recourse to $5 million and the PI falls over with an insurer not being there, that is it; that is all you have. Also, that NTA can be dissipated very quickly through other mechanisms. That is our problem. We are saying that, if you have self-custody as well, suddenly you have both liabilities in one NTA. If you had NTA requirements on the trustee in superannuation—even if they had an external custodian, which is not the case—you would have $5 million in each point of NTA, and you would have two separate bits of PI insurance. Again, it further protects people.

Senator CONROY—As I understand it, most compliance committee members rely solely on the insurance cover provided by the responsible entity. In your view, could this reliance on the RE for insurance undermine the independence of the committee members?

Mr Sweeney—Worse than that, it might actually stop the total recovery of it. As I pointed out in my preamble, we have found cases where there were quite big carve-outs on the PI that the compliance committee members got. Suddenly you are suing that person as an individual who does not have PI cover. I do not know how wealthy they are, but my experience suggests that they are being paid $25,000 or $30,000 a year; that is a lot of risk to take on for $25,000 or $30,000 a year. The other point is that the act precludes the RE from giving them full insurance, from memory.

Mr Britton—Yes, there is a restriction on the level of insurance that the RE can provide to the compliance committee member. I think that is a topic under the Treasury's consultative paper; it is one thing that Mr Turnbull wanted looked at.

Mr Sweeney—If you put a corporate member—say an employee of Trust Company—in there, the Trust Company PI insurance, which is much broader, will cover that individual. To be honest, it is a lot more than $5 million, so you have a much bigger insurance load.

Senator CONROY—I understand that you believe that an external corporate entity should sit on a compliance committee or assume the full responsibility of a monitoring function—this came up while you were talking just now. Can you elaborate a little more on that?

Mr Sweeney—At the moment, you have a compliance committee that might meet—in your experience, Mike, how often? Six or seven times a year?

Mr Britton—Bimonthly is the most frequent that I have experienced.

Mr Sweeney—So it is a maximum of six times a year; in some cases, maybe it is only once or twice a year. A compliance auditor goes in there only twice a year; again, that is the maximum.

Mr Britton—Usually, that is it; yes. It is a cost basis.

Mr Sweeney—So this compliance committee meets three or four times a year and is audited twice a year. It is comprised of individuals who might have other roles and obligations in other jobs and who are being paid between $20,000 and $30,000 for this role. They are appointed by the responsible entity, they can be removed by the responsible entity at any time and their insurance is given to them by the responsible entity—there is a lot of pressure there not to rock the boat. If they resign or are removed, my understanding is that there is no need to give a reason for that resignation or removal to ASIC. So you never find out why people go; they just go. It makes much more sense to me to put in an independent corporate body which will not have all those sorts of pressures. Do not get me wrong: I am sure there are some very good, independent compliance committee members. I am not suggesting the reverse for a second. But, on the other hand, there is potential for pressure to be put on.

Senator CONROY—I understand that the review does not see this as a pressing issue, but agrees that concern may be warranted if compliance performance—as judged by ASIC's performance measures—does not show any improvement in the next few years, I think it says.

Mr Sweeney—Shutting the gate after the horse has bolted?

Senator CONROY—Yes. Do you see that the sort of change you are talking about would actually keep the gate locked?

Mr Sweeney—It would make it much easier to get a truly independent review.

Senator CONROY—I just note for the record that the latest ASIC surveillance statistics revealed breaches or compliance failures in 69 of the 83 responsible entities inspected, or 83 per cent. However, ASIC did acknowledge that the surveillance was targeted rather than random. What does that say to you? 'I told you so,' maybe?

Mr Sweeney—Talking a little against that line, a good compliance system should throw up breaches. If it is not throwing up breaches, that, to us, raises every single warning sign because it means that it is not being done properly. You are right: there are definitely problems. But a good system should throw up breaches. It is really the magnitude and the type of the breach.

Mr GRIFFIN—So you are saying that it is a great system, by the sound of it.

Mr Sweeney—In those cases, that could be good compliance, yes—as long as they do not do the same thing twice. That is what this is all about: improving the way we do everything. I would suggest that in some of those cases that is good compliance.

Senator CONROY—I want to talk about costs. We briefly touched on that before. Turnbull dismissed costs from day 1. That is probably unusual. Have we invited Mr Turnbull to appear before us? I hope we have.

CHAIRMAN—We have not as yet.

Senator CONROY—I think it would probably be appropriate for him to come along to have a chat so that we can ask him about those issues. The review did not conduct any analysis of fees and it dismissed other research commissioned by IFSA from KPMG. You have argued that the persistently high MERs are indicative of the RE absorbing the old trustee fee in addition to the managers' fee. Can you provide the committee with any empirical data on why we still have these persistently high MERs?

Mr Sweeney—I cannot give you hard survey data, because we obviously have not done it. I suppose there are two observations to make. One is that fund managers' REs run at a profit and a lot of the remuneration to individuals is determined by the level of profit. So if you can absorb something and make money out of it then it is in your commercial interest to do so. Secondly, if you increase consumer protection, most of the time the consumer pays for it. That is, again, just a fact of life. The real question, I suppose, that we debate internally in Trust Company is: is the cost of this consumer protection that the consumer is effectively paying for delivering a better system than previously?

Personally, I do not think it costs any less to do the MIA than it did to have a trustee. I have no evidence of that. I know that our own internal experience on the funds management side is that it is costing us more, but we are managing only half a billion dollars. We are a smaller fund manager. It is most likely costing the big guys, who are managing $10 billion or $30 billion, less. But are they passing it on in fees? Again, it would have been interesting in that IFSA survey to survey the big end of town and then the little end of town, because that is where there are big cost differences. The little end would be bleeding, it would definitely be costing them more, whereas it would be a saving to the big end. One of the reasons I think the big fund managers wanted this legislation is that it let them implement the investment decisions a lot quicker. You did not have a nosey trustee in there getting in the way of quick execution. I agree that that is what you want, that you want efficiencies in the system, but there have to be checks and balances. I am not sure that a six-month review six months later by the compliance committee is really helping a lot.

CHAIRMAN—Your role as a trust company under the old regime, under the dual system, was obviously to fulfil the trustee role. How has your role changed under the MIA?

Mr Sweeney—We are now a custodian for most of our clients that we were a trustee for. We are very active in the superannuation market as a trustee, which is quite similar to the old Prescribed Interest role. That business is growing very strongly. We have some compliance relationships with some clients in different areas. We were lucky in a lot of senses. As a

proportion of our revenue, it was not anything like what it was to a Permanent or Perpetual Trustees. To us, it was less of a whack around the head.

CHAIRMAN—But you have not actually moved into funds management?

Mr Sweeney—We were already there. Trust Company is unique. We do funds management, superannuation trusteeship, financial planning, trusteeship and custody. So we actually do the whole spectrum.

CHAIRMAN—You were not limited to being trustees.

Mr Sweeney—Not at all.

CHAIRMAN—Did Malcolm Turnbull consult with you in the course of his review?

Mr Britton—We put a submission in.

CHAIRMAN—Was there no face-to-face contact, though?

Mr Britton—He did fire back an email asking our opinion in relation to whether we thought annual meetings were a good idea.

Mr Sweeney—Yes, for funds. But that was not covered in our submission.

Senator CONROY—But you are not on a first-name basis?

Mr Sweeney—No.

Senator CONROY—Did you meet him in the process?

Mr Sweeney—I have met him in other forums.

CHAIRMAN—Are there any more questions?

Senator MURRAY—As Senator Conroy has alluded to, I was very nervous that all the checks and balances were being removed. I wanted a few more added which were not. I am still a bit nervous, I must say. Jan Wade, the former Victorian Attorney-General, was also pretty nervous. My first question to you relates to time lines. I gather from what you have said that your view is that if there are problems, in terms of prudential behaviour, as a result of the changed investment regime, it will take some time for those to emerge. In other words, they have to build up. I gather that you have said that three years is too short a time for those who felt nervous to have seen the effects of the act in full. Do you have a time frame over which you would expect the full wash-through of the effects of the new regime to have emerged?

Mr Sweeney—The real answer is that the system has to be put under stress to find out. When the going is good, there are no problems, because markets are rising. Rising markets hide problems; falling markets do not. You need a real stress, a real shock to the system, to test it.

The effects of September 11, when you look at them, lasted for only a couple of weeks and then the markets came back. Sure, they have drifted off recently, but a lot of the funds froze, so we do not really see that as a stress either. They said, 'We're closed for three days until we reprice.'

Senator MURRAY—Are you talking years or decades or do you not know?

Mr Sweeney—We honestly do not know. The unlisted property trusts calamity in 1991 was one of the big driving forces behind the Managed Investments Act, because of AustWide and Estate Mortgage. That was a massive calamity that exposed problems in the system. There is no doubt about that. It is interesting to point out that even under that massive problem most investors got back 100c in the dollar. They did not get it back from the fund manager, the RE; they got it back from the trustee and the trustee's insurance policy.

Senator MURRAY—Yes. We had all that evidence at the time. The next question is obvious, of course: do you see any signs of stress, apart from the normal stresses and strains that you expect in a marketplace and in the economy?

Mr Sweeney—One of the signs I see of stress is that limited competition. Before, when we were a trustee, we had a lot of smaller fund managers coming to us who were starting up. We were looking at evaluating seven or eight a year, at least. We have had maybe two approaches since the MIA came in.

Senator MURRAY—Let us take that proposition of yours. Less competition means fewer competitors. Fewer competitors, given the size of the market, mean greater scale. By the way, you must not nod because Hansard will not pick it up. If you want to agree, you can say yes. If you do not agree, do not say anything!

Senator CONROY—You should take the hint there, Senator Murray!

Senator MURRAY—I nearly got away with it. It is my assessment that the greater problem in markets and economies worldwide, not just here, is scale and that the market shocks now from failure are much greater than they might have been in previous decades. Would you agree with that?

Mr Sweeney—Scale involves two things. You are right; if an Enron or a company like that goes, it has got a massive problem. Also, scale enables you to hide mistakes more easily, because you have a wider pool of assets to amortise them across, and they are less material. So, the bigger you are—

Senator MURRAY—The reason I want to pursue that line of argument is this: traditional economic theory—and a number of us have economics in our background—says that you let the market have its failures because that is, in fact, the market working well. Things move on, and you resolve issues. However, market shock theory now says that, if you get shocks that are too great, the consequence is not a healthy market restored in the vacuum but structural fractures and so on. That means to me that you have got to, as far as possible, apply the precautionary principle. You put in changes expecting problems rather than waiting for the problems to emerge and then putting in changes thereafter. It seems to me that your submission goes some way in that direction. It seems to me that you are saying to us, 'Here are a few prudential things

which will improve the system and make the chances of failure less likely and the chances of better management more likely.' But, in the sense of big market shocks—and I think it almost reverts to a point that Senator Conroy was making from a different direction—there is really almost nothing anyone can do, is there? If there is huge fraud or huge areas of misjudgment or huge mistakes in market understanding, of which we have numbers of examples, there is not that much you can do.

Mr Sweeney—The MIA is designed to protect for fraud or negligence, basically; it is not designed to protect for bad judgment. We all agree on that, and the whole point of funds management is that you are going to get some things wrong and you are going to get some things right. That is what they are paid to do. The consumer protection element of the Managed Investments Act, as in the old structure as well, was to stop malfeasance and to stop other people's money being taken illegally, inappropriately, unethically or whatever. A shock can cause commercial pressure to make that decision harder and harder to avoid in some organisations that are stressed. If you have a look at a lot of the corporate fraud, sure, it happened in companies that were going very well but it also happened in companies—certain retailers in South Australia—where you had a lot of pressure to either perform or manage or whatever, and they took that opportunity. To me, the market move stresses are secondary. Really, once you get to a size and a position of control, it increases the opportunity for someone to work the system harder for their benefit.

Senator MURRAY—Would you rank the prudential precautionary mechanisms that you include in your recommendations, which you believe will improve the integrity and durability of the system? What is the most important to you?

Mr Sweeney—If you are looking at disaster scenarios, then to me the independent custodian—and, Mike, I would appreciate your view—is the most important because, at the end of the day, you are not going to have a fund manager standing. Aust-wide is a classic case of that—the fund manager was not even there—it blew up; bang, nothing. If you have an independent custodian, you have someone holding the assets, which means at least that unit holders can get hold of the assets and, if there have been any mistakes or whatever by the custodian, you have got someone to sue. You obviously cannot sue the responsible entity because they are gone. They are not around, but at least the clients still have the assets which, at the end of the day, is very important. That would be the majority of the potential loss.

Senator MURRAY—And the reason your focus is there is that, if you have independent appointment, tenure and oversight, you believe the prudential mechanism is improved.

Mr Sweeney—It is much more difficult to cooperate with an external party, to be brutal, than with an internal party in pushing the envelope.

Senator MURRAY—How would you respond to the kind of view that you would say that, anyway, because you are talking up your book? You will make more money out of that happening.

Mr Sweeney—Yes, that is fine. That is a fair comment: we will make more money if you have compulsory external custodians. But we have a good custody business at the moment, without there being that compulsory nature. A lot of our clients believe that an external

custodian is vital from a marketing point of view, for exactly the reasons I have spoken about. An added benefit is that our assets are held independently by an independent group, so that if something does happen to us, you still have all your assets under someone else's control.

Senator MURRAY—Is your motive in making this kind of recommendation self-interest or is it based on the knowledge that this actually does improve the marketplace operation?

Mr Sweeney—I think it is both, to be honest. I think it will improve the system. We are not a large player. We do not have any equity custody business at all, and that is the largest custodian equity market, and fixed interest and global; we do none of that. As a proportion of our revenue, what we get from this area is about 10 per cent. What would it mean to us in profit terms? A bit, but not a lot. So this is not something—

Senator MURRAY—It is not a big earner?

Mr Sweeney—It is not a big earner for us. Maybe you can put a discount on it for that, because, if you turn around and say, 'You don't need an independent custodian,' and ask whether life will cease for us, the answer is: absolutely not.

Senator MURRAY—Did I hear you say you had put these propositions to the Turnbull review?

Mr Sweeney—Yes.

Senator MURRAY—Why do you think he did not even address them in passing?

Mr Sweeney—You would have to ask him.

Senator MURRAY—You would assume a review of the act, from whatever direction, must pay attention to risk. Essentially, the parliament's interest in this matter is in minimising unacceptable risk.

Mr Sweeney—Absolutely. We strongly believe that. The other thing we put when the bill was being debated was to let the trustee system operate for the small and medium sized person, having regard to a cost-benefit analysis, because that makes a lot more sense to them. But for the big end of town, if they want to convert to an MIA regulated entity, by all means let them do so. So you had two parallel structures: a structure that worked very well for the smaller to medium sized end of town, because they could not afford the full MIA regime; and for the big end of town, you had the opportunity to convert.

Senator MURRAY—What happens to your recommendation—and I will paraphrase it—that there should be a mandatory requirement for appointment to an adequately capitalised and insured external third party if the insurers will not insure you? That is happening quite a lot in the marketplace.

Mr Sweeney—In our circumstances, we are lucky in that we have had no claim on our PI in our 115-year history.

Senator MURRAY—Do you know that there are little old ladies' sewing groups who have not ever had a claim, and suddenly they are being refused insurance?

Mr Sweeney—Yes.

Senator MURRAY—In the climate we are in right now, all sorts of credible people with good claims history are either being priced out of insurance or being refused insurance. What happens if insurers will not insure you?

Mr Sweeney—It is compounded because it means the responsible entity will not be able to get insurance, either.

Senator MURRAY—Does your recommendation fall down then, or would you self-insure between trustees?

Mr Sweeney—I would not do the business if I could not get PI. I would get out of it, because if you make one mistake in this business, you wipe out your market.

Senator MURRAY—So your recommendation would be dependent on either the market providing insurance or the government, as last-resort insurer, providing it?

Mr Sweeney—I think it is important. Our market capitalisation is $100 million. Our professional indemnity insurance as a percentage of our market cap is very high. You do not deal with a $50,000 error; you can wear that. Insurance is to cover you for that big mistake.

Senator MURRAY—Can you let us know what the insurance premiums are in this area, typically, unless you have got it in your head? I do not necessarily need to know them for your business, but I would like to have an understanding of what the cost and the terms of insurance are in summary.

Mr Sweeney—I would find that difficult to answer because we all sign, with our insurance policies, confidentiality agreements that we cannot reveal details.

Senator MURRAY—That is why I suggest to you that you could give it to us as a generalisation. You have told us you have half a billion dollars under managed funds. I do not know what the actuaries have said but they would have computed a risk, which I presume would be an industry standard, and they derive premiums for that risk. That is really what I want to know, so that we can go away, as a committee, and say, 'For every $1 billion of managed funds the standard actuarial risk is such and such and the standard premium will be that.' Then, of course, individuals would be able to negotiate better or worse terms, depending on their claims history and their negotiating abilities. I am really not asking for your particulars, I just need some guidance, if the chair is happy for that as a question on notice.

Mr Sweeney—To be honest, that would be difficult for us to do or find. To ask someone like AIG or one of the PI insurers would be a much better place to go because there are only three or four groups who insure financial services companies' PI.

Senator MURRAY—Yes, but we are not going to ask them to appear before the committee for that purpose.

Mr Sweeney—Okay, because I do not think they will tell us; that is what I am saying.

Senator MURRAY—But you must know what your premiums are.

Mr Sweeney—We know what ours are but, as I said, our premium would be a lot lower than the market's because we have had zero claims.

Senator MURRAY—Just double it up and let us know.

Mr Sweeney—All right.

Senator MURRAY—If you can give us some guidance; you can see where we need to go with this. If a central part of your recommendation is for adequate capitalisation and that, generally speaking, is a kind of ratio item—but that is an imposition you can put on anybody—you either have $5 million capitalisation or you haven't, and that is the end of it. With respect to 'adequately capitalised', I presume you mean the 'adequately' as a qualifier to cover insured—adequately insured. If you could not get insurance, what happens? We need to know what that means.

CHAIRMAN—It can be given in confidence to the committee, too.

Mr GRIFFIN—We can say some figures and you could nod.

Mr Sweeney—I can answer it in some ways. It depends on the asset class as well. We tend to operate mainly with what we call bulky assets—infrastructure and property. It is very difficult for someone to steal a property when we are the custodian of it. However, for electronic assets like equities and fixed interest, it is a lot easier for errors, mistakes, whatever, to happen, because there is high volume—a lot of transactions. It is actually quite a complicated question; the answer is not simple. But I would, again, throw to the regulator. They are meant to understand the rest of the industry, they are meant to be guiding this; surely they would be much better suited because they go to every fund manager, they know what every fund manager's PI insurance is. They would be a treasure trove of information. Is that a good handball?

Senator MURRAY—You can sit on this side!

Mr BYRNE—Your submission had the anecdotal evidence regarding responsible entities receiving former trustees' fees in addition to their own management fees. If that is the case, do you believe that they should be paid the former trustees' fees?

Mr Sweeney—If they have taken on the risks and liabilities and responsibilities of it, yes.

Mr BYRNE—So you would be okay with that?

Mr Sweeney—Yes. I have to admit I was never a believer in the reduction of fee argument. We actually put many submissions in that it would not happen because why would a profit organisation—they are not charities—take on huge risks and costs without being paid for it? It does not make sense.

Mr Britton—I think the hurtful point there, raking back over the coals, was that people were promised that it was going to be cheaper and we could see it was not going to be cheaper.

Mr Sweeney—But again, we were accused of self-interest and pushing a line that favoured our position. It is very easy to level, and you cannot defend it because, yes, we have a vested interest in some of these changes; no doubt about it.

CHAIRMAN—There being no further questions, thank you both for appearing before the committee, for your evidence and answers to questions.

[5.15 p.m.]

STEWART, Mr Russell Andrew Forsyth (Private capacity)

CHAIRMAN—Welcome, Mr Stewart. Do you have any comments to make about the capacity in which you appear?

Mr Stewart—I am a partner in Minter Ellison; however, I am appearing in a personal capacity, so the views I present are not necessarily the views of the firm.

CHAIRMAN—We have before us your submission which we have numbered 6. Are there any alterations or amendments that you wish to make to the submission?

Mr Stewart—No further alterations.

CHAIRMAN—In that case, I invite you to make an opening statement, following which we will proceed to questions.

Mr Stewart—My background is that I have worked as a lawyer in the managed investment field for close to 20 years, and I have acted for trustees and for fund managers. With respect to the observations that I have made in a personal capacity, a lot of them are essentially technical in nature, so not all of them necessarily merit discussion by the committee. As a general observation, I would say that the introduction of the Managed Investments Act amendments has lifted standards. I see that just in relation to the clients I deal with. There are numerous issues that I have raised in the submission, but there are several that I could comment on briefly, before inviting you to ask me questions.

I also support the possibility of corporate membership of compliance committees. I think that that would promote professionalism. You would find that trustee companies and others would make personnel available who had the resources, training and background to be able to improve the quality of the work of the compliance committees. In practice, what I am seeing quite frequently is that the fund managers take very seriously the obligation to report immediately to ASIC any breach. The reason they take that seriously is because, if they fail to do that and they are caught, that could prejudice their licence. I have come to the view that that has been the most powerful mechanism within many of the fund managers for identifying and promptly reporting compliance breaches.

I would like to say something briefly about an area in which I am probably a heretic, but it is not the only area in which I am a heretic. I think that it would be in the interests of the community to review the prohibition on registered schemes investing in unregistered schemes. At first blush that sounds like an awful proposition, but the reality is that the technical problems that arise from registered schemes not being able to invest in unregistered schemes occur not infrequently in practice. I believe the protection should arise at the front end through the original registration of a scheme through requirements for adequate disclosure. ASIC already permits funds to invest up to 10 per cent in unregistered schemes. It seems to me that the concept that there is further protection available from this requirement is largely illusory.

The next point that is worth paying some attention to is that, obviously, the managed investments changes were very much designed to try and protect consumers. One example is that, if there is a breach, particularly a breach of disclosure, the investor has virtually an indefinite, unlimited period within which to declare void the investment and recover their money in full. It seems to me that it would be reasonable to have a procedure whereby once a breach is discovered, the fund manager can notify the investor. The investor has a particular time within which to act. If they do not act within that time, then the matter is brought to a conclusion. But as it stands under the act, there is a kind of indefinite awkward situation for fund managers as to how to deal with that.

The final point I thought I should mention relates to ASIC's differential fees policy. I am not sure how familiar the committee is with that. In essence, the differential fees policy is based on a view of the operation of the act, and that view is that fees which a fund manager must charge have to be as provided for in the scheme constitution, and the only exceptions to that are scaled fees or fees that are charged to sophisticated and professional investors. The irony is that the way that operates in practice is that, when they are offering investments directly, fund managers do not have a discretion to offer reduced entry fees or reduced annual management fees to the ordinary investor. They can only offer those to the professional investor or to investors who are, by definition, more wealthy. It is a paradoxical situation because if the investor goes through an investment adviser, the investment adviser can generally rebate an amount which is equivalent to the full entry fee. It seems to me that that is an anomaly which it would be useful to address. Those were the only points I wished to make.

Senator CONROY—In terms of risks to investors, could you outline for the committee the five lines of defence for investors that you talk about and briefly indicate whether you believe these defences are functioning well under the MIA regime?

Mr Stewart—Yes. The first line consists of the promises made by the responsible entity, and those are contained both in the constitution and in the prospectuses. I think in general those are working well because professional fund managers take a lot of care to ensure that what they promise is clear and that they are in a position to deliver. The second line of defence is having assets held by a custodian, and I heard the comments made by previous witnesses in relation to that. There is a slight paradox there because I think one of the things that led some of the industry players to push for the MIA was that they were handling superannuation funds and also they were aware of investment companies which were not required to have an independent trustee. Also, in their life business, they were not required to have an independent custodian, yet in the managed funds area they were. But I have to say that I think that the fact that the assets are held by an independent entity does operate as a practical protection in a lot of cases, because if you do have a total failure of the responsible entity at least there is somebody there who still has the assets. But I do not agree that it is necessary to make that mandatory for all responsible entities, because ASIC has very strict requirements for those who self-custody and in effect they have to have a virtual independent custody operation within their own organisation.

The third line of defence, as I see it, is the compliance plan and the compliance committee. In my view, the compliance plans got off to a bad start because they were often excessively complex. We have done some work on developing more streamlined compliance plans. I think they are in their nature very difficult for ordinary people within funds management organisations to administer. They tend to have about 60 pages of very detailed prescriptive

things, and I can say from observation that I have been aware that many people have found those hard to manage. But I think the concept is good and I think the consciousness of compliance and the fact of compliance have improved enormously in the sorts of people who are our clients.

The fourth line of defence I mentioned is the restriction on the ability to invest in unregistered schemes. Other than that, there is virtually no restriction on the ability of funds to invest, and that is appropriate, because really this is a regime that relies not on a prudential supervisor to judge what investments are appropriate or are not appropriate but on disclosure. So if you want to offer a derivatives fund that invests in gold futures, as long as the investors know what they are investing in, I do not see any reason why that should be restricted. I would also have to differ from the previous witnesses in the sense that I think there was a problem, under the old regime, of having a trustee as a kind of supervisor to the extent that the trustee was involved in actual investment decisions. That created a very difficult situation, because the trustee was always terrified as to what their responsibility might be, and that often created great difficulties in the practicalities of actually getting funds invested. In terms of listed securities, I think they mostly paid very little attention to what was done; the acquisitions were pretty much always done before the trustee got around to the settlements.

The fifth line of defence is ASIC's role in supervising registered schemes. As I mentioned earlier, the licence obligation is really the most powerful tool there. I do not agree with everything ASIC has done, but they deserve a lot of credit for the way they have risen to the task. Most fund managers now are very conscious of what ASIC will accept or will not accept and of the obligation to disclose to ASIC if something goes wrong. Where that happens and you have to go and talk to ASIC, ASIC are generally extremely constructive about it. They have been excellent in that respect.

Senator CONROY—In your submission you argue there is a need to—and I quote:

… clarify that a custodian of scheme property owes duties to the responsible entity and no-one else.

Otherwise, the custodian can find itself liable for actions of the RE. Would you elaborate on the problem or proposition there.

Mr Stewart—The main way in which I am aware that that problem has arisen was in the Robert Maxwell case in England. As you probably know, Robert Maxwell arranged to steal a very large amount of money from a superannuation fund. Although I understand the matter never came to court, there were certainly threats against the custodian for having allowed the money to be paid over in response to a request. Of course, the custodian was in a difficult position, because there were certain protocols that applied, and they followed the protocols.

My concern is that, technically, a custodian is a trustee. They may be the barest of bare trustees but they are nevertheless trustees. It seems to me to be open to argument that in a situation where the custodian handed over assets, if it had studied the constitution of the fund and it had studied the offer documents, it would have been aware that what was happening was a breach, and then the custodian would not have been liable on general trustee principles. If you cut off that obligation by statute, you may remove an area of uncertainty—and, I was going to say, possibly cheapen the insurance for custodians and make it more possible to negotiate lower

fees for custodians, but I hesitate to say that because lower fees are not something that happen very easily.

Senator CONROY—In your submission you also argue:

It seems quite unreasonable that the responsible entity should be liable for the acts or omissions of an agent or other person engaged, acting fraudulently or outside the scope of their authority or engagement.

Can you run us through that.

Mr Stewart—In practice, it raises great problems for responsible entities because they are often dealing with other parties. They outsource investment management and things of that kind, and it seems to me that requiring a responsible entity to accept liability in circumstances where it does not have control—I realise it is a question of where the risk applies—is just going too far.

Senator CONROY—Turnbull disagreed.

Mr Stewart—He did; yes.

Senator CONROY—He argued that legislative prescription of a custodian’s duties and liabilities is not considered to be desirable, arguing that this runs counter to the intent of MIA to avoid confusion over accountability and to preserve the concept of a single RE responsible to members for the operation of a scheme. How do you respond?

Mr Stewart—It is always a matter of degree and of where risk is carried. One of the practical issues that arises is where a responsible entity is using overseas custody arrangements. Sometimes, in countries where the rules are not as organised and well enforced as they are here, it is a question of whether a responsible entity can legitimately require that the investors—as long as they disclose the risk—accept that risk. My view is that they should be able to do that.

Senator MURRAY—Should it be a percentage or a proportionate liability?

Mr Stewart—No, I suppose it is really a question of where the responsible entity is in a position where it cannot control a particular risk; it should have the right to disclose that to the investors and indicate that the investors have the opportunity of either accepting it or not.

Senator MURRAY—Yes, but my point is this: if the circumstance you mentioned is in Australia, everyone is under the same rules and you know what it is. In the second circumstance you mentioned, if the risk is shared with an overseas jurisdiction, would you apply a percentage or a proportionate liability so the investor knew that the additional risk they were taking in such an activity would be limited? It would not reside, say, 99.9 per cent outside of Australia, where they would be uncertain as to what that meant in terms of the rules of recovery, debt, liquidation, administration or whatever the device is for failure.

Mr Stewart—I think it depends very much on the type of fund. If it is a fund which is investing in, say, Third World debt in relation to particular types of emerging market jurisdictions, then I would have thought that the responsible entity might want to say, ‘Well, if

you invest in these types of things, here are the risks,' and the investor accepts 100 per cent of the risk. It would depend on what particular type of fund you are dealing with.

Senator CONROY—You would have heard some of the earlier discussion about the rules for compliance committees. You support changes to permit the appointment of companies, and I think that we have covered that a little, previously. Do you concur with the discussion earlier?

Mr Stewart—Yes. I should say that I have not been a member of a compliance committee and I have not had direct observation of how they are operating in practice so, as it were, I am commenting from a distance. I have been involved in trying to find, for a client, appropriate people to be compliance committee members. I have found it a somewhat disconcerting experience because of the great variety of people who are filling that role—some of them I know; some of them I do not know. But there is certainly an enormous variation in the different types of people, their backgrounds and the quality of them. I cannot help thinking that there would be no loss, and probably a bit to be gained, if you were able to have a corporate member of a compliance committee which would be required then to provide—and in the nature of things, you would expect that they would provide—a particular individual who would attend the meetings. They would also have recourse to training, expertise and backup which a lot of independent individuals do not have. I know that they are trying to develop their training, their professionalism and skills and so on, but I still think that there would be nothing lost by allowing companies to fulfil that role.

Senator CONROY—You mentioned that you have been hunting for compliance committee members, and you make reference to rules that are unnecessarily cumbersome.

Mr Stewart—This is more about the disqualification rules. I do not think I am the only one; I think a lot of people have had trouble working out how those rules actually work. I have been involved in discussions about what 'substantially involved in business dealings' means. It sounds straightforward, but in reality the way that you end up having to interpret that is if there has been almost any kind of business dealing then it means that a particular person is not suitable as an independent compliance committee member. I do not think that most organisations find it all that easy to get suitable people. I have not given thought to how that restriction could be recouched but it could be less restrictive than it is. Similarly, with respect to 'having a material interest', maybe that is in some ways easier to apply. The committee may have heard from others about those things but in practice people find them vague and difficult to interpret. Take, for instance, an independent director of a company; a lot of people would think that if you had an independent director that would be an eminently suitable person to have on a compliance committee but under these rules it seems as if that sort of person might be ruled out.

Senator CONROY—Recommendation 10 of the Turnbull review is about the development of standards of qualification experience for committee members. Do you think that covers it? It might give some clarity to the issues you have been referring to.

Mr Stewart—I would agree with that.

Senator CONROY—My last question concerns differential fee arrangements. In your submission you note that:

> The anomaly is that the poor pay full fare, whereas the rich can negotiate a reduction.

You take this view:

> ... that fees are sufficiently 'specified' in the constitution if maximum amounts are specified, but the responsible entity is free to reduce fees at its discretion.

Does this provide sufficient protection for 'poor investors', to use your phrase, who may not have the knowledge or size to negotiate a fee reduction?

Mr Stewart—In relation to investors who are neither large nor professional, they normally deal with a funds management organisation en masse, so there is no real question of individual negotiation or anything of that kind. Where this issue comes up is where you have a fund manager who might have a particular product that they sell in part through investment advisers but which they also might want to sell direct. The problem they face is that if they want to sell it direct they might want to do it on the basis of a very much reduced entry fee. Another circumstance where this often arises is when you have mergers of funds or you have a fund that is being wound up and they want to offer the unit holders in that fund an opportunity to go into another fund but to waive the up-front fee.

The difficulty is that, under the current rules, they really cannot do that unless they create a separate class of units. It is relatively easy to create a separate class of units and let them come in on that class, but that is an artificial thing to do and it creates accounting and reporting problems which seem to be unnecessary. I do not want to give the impression that it would strengthen the hand of an ordinary mum and dad investor to negotiate a reduction. That is not how it would work. It would be more that the fund managers would then be able to, and I think competition might then produce an opportunity for people to, compete in lowering fees for ordinary investors. I think that by requiring that they have to charge the fee that is in the constitution it is helping to maintain fees at a higher level than they otherwise would be.

CHAIRMAN—If there are no further questions, thank you very much for appearing before the committee, Mr Stewart.

Committee adjourned at 5.40 p.m.