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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

Wednesday, 7 August 2002

Members: Senator Chapman *(Chair)*, 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 Brandis, Chapman, Conroy and Wong and Mr Ciobo 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 9.07 a.m.

CHAIRMAN—This morning, the committee will be holding its third full public hearing into the findings of the review by Mr Malcolm Turnbull into the Managed Investments Act 1998. This afternoon, the committee will hold its public hearings on the regulations and the ASIC policy statements made under the Financial Services Reform Act.

Before we commence taking evidence, may 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 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 that 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. May I 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, therefore, members of the public are welcome to attend. Finally, if any people in the room have mobile phones, may I request that they turn them off or put them on silent operation.

[9.08 a.m.]

MAHER, Mr Dave, Analyst, Financial System Division, Department of the Treasury

RAY, Mr Nigel, Acting Executive Director, Department of the Treasury

ROSSER, Mr Michael John, Manager, Consumer Protection Unit, Financial System Division, Department of the Treasury

WILESMITH, Mr Brett Anthony, Analyst, Financial System Division, Department of the Treasury

CHAIRMAN—Welcome. As I mentioned, this is a public hearing and so the committee prefers that all evidence be given in public but, if at any time you wish to give part of your evidence in private, you may ask the committee and we will consider that request. An officer of a department of the Commonwealth shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions asked to superior officers or to a minister.

At the end of our session with you, would you please remain behind briefly in case the Hansard officer wishes to check with you any details or spelling in relation to your evidence. Having said that, I invite you to make an opening statement, at the conclusion of which we will proceed to questions.

Mr Ray—We do not have an opening statement, Senator.

Senator CONROY—I am not sure which of you have been assigned to read *Hansard* and keep yourselves entertained, but on 11 July and 12 July it was noted that, in Standard and Poor's view:

> 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.

Do you think a requirement for an independent custodian would provide a genuine improvement in vested protection or would it result in, for example, independent monitoring of fund manager activities? Would it protect client assets in the event of the collapse of a responsible entity?

Mr Ray—In his report, Mr Turnbull considered this question in some detail and received a range of submissions on the question of independent custodians. His conclusion is that the existing arrangements, which provide some flexibility for ASIC to put conditions on licences which could include the appointment of a third-party custodian, provide sufficient protection. As he pointed out, a third-party custodian would sit at odds with the underlying rationale for the Managed Investments Act, which was to replace the old dual structure with a trustee and a fund manager with a single responsible entity. As you would recall, the principal motivation for that

was to increase the protection for investors in the event of a failure. His report found no support for suggestions that that fundamental building block for the act is wrong.

Senator CONROY—So Standard and Poor's are wrong?

Mr Ray—The joint ALRC-CASAC report in, I think, 1993 and Mr Turnbull's review would both suggest that the balance of the argument is that the single responsible entity approach has merit. Standard and Poor's are not wrong in the sense that the approach that we have in Australia differs from that in many other jurisdictions, but there are good reasons for that.

Senator CONROY—It seems to say that 'in all other jurisdictions'. It seems like we are the only one—

Mr Ray—I have not looked at the 180 jurisdictions, so it is hard for me to say.

Senator CONROY—But you are not aware of any others who have got this system? No-one has drawn it to your attention?

Mr Ray—No, not off the top of my head.

Senator CONROY—It just seems at odds with the rest of our philosophy, that we want to try and align ourselves in regulations and standards with the rest of the world. This seems to be a minimum standard in the rest of the world.

Mr Ray—The government's position is that it would prefer Australia to be leading the world and have best practice in regulation.

Senator CONROY—Except in corporate governance.

Mr Ray—Just because we do something that is different does not mean that it is wrong or weaker.

Senator CONROY—I think I may draw those words to your attention many times in the future, Mr Ray. Do you think a requirement for an independent custodian would result in increasing costs to investors?

Mr Ray—That is a very complicated question.

Senator CONROY—It was argued at earlier hearings that it would not. The fees paid for custody services would simply be paid to the custodian rather than to the responsible entity, so there should not be an increase by definition; they are getting paid a fee for doing that job in-house.

Mr Ray—In all these things it would be difficult to separate out what the effects of a particular change are on fees.

Senator CONROY—Did Treasury speak with Mr Turnbull about the committee's request for Mr Turnbull to appear before the committee?

Mr Ray—No.

Senator CONROY—It did not encourage him to think, as part of writing the review, that he may actually be subject to some form of parliamentary scrutiny? He is a bit of a fan of parliament, I understand. It seems unusually bashful for Mr Turnbull. I would like to ask about the duties and liabilities of custodians. Minter Ellison argue that there is a need to clarify that a custodian owes a duty of care to the responsible entity and no-one else, otherwise the custodian could find itself responsible for the actions of the RE.

Mr Maher—This is a fundamental issue; how much responsibility and power you give to the custodian. There was some argument that you would have what you call a 'bare custodian' who would be subject to direction by the RE and who could never disagree or fail to follow an RE's instructions. The issue there was: does that put anyone in a better situation if the RE can still tell the custodian what to do with the assets and where to place them. I think the more responsibility or discretion you give to the custodian—if they can exercise it—the more important the liability issue becomes. I do not know if I could express an opinion on Minter Ellison's position. It is a continuum sort of thing. We have to decide, if we were to have custodians as a compulsory requirement, what sorts of powers and discretions to give them. Depending on how you answer that question, you then have to ask who they should be responsible to. But I have to say that I have not looked at it in detail.

Senator CONROY—IFSA argues that REs should not be liable for the actions of the custodian if it can be shown that the RE took reasonable care and diligence in their selection and monitored their performance. Do you agree with that?

Mr Maher—Again, it is a tough question. I know where IFSA are coming from. I think they were particularly concerned about where assets were put with a custodian overseas, and that they might not have any ability to seek recompense from those custodians if members sued them. But, again, I think the major concern of the report was that, as soon as you move away from the RE being the responsible entity, you have the hallmarks of the system that we tried to address in the first place: there would be different people to sue and they might counterclaim amongst themselves and hold up any sort of speedy compensation for investors.

Mr Rosser—The central idea underlying that is to ensure that the RE puts in place the necessary mechanisms to ensure that the custodian is acting appropriately rather than, as Mr Maher says, to separate the entitlement?

Senator CONROY—Can you sign away your rights? I presume you are implying in the contract.

Mr Rosser—Yes.

Senator CONROY—One of the arguments in relation to public liability at the moment is whether you can sign away your rights. There is a strong view that you cannot; that it will require specific legislation to do that and involve trade practices matters and all those sorts of

things. Do you think you could set up an agreement whereby an IFSA member could set up a contract and the custodian could sign away their rights to be sued by the other people?

Mr Rosser—I am not sure that I was saying that per se. I think what I was saying was rather that it is important for the responsible entity to ensure that, in the selection and operation of the other support arrangements, those are operated and conducted in a way which it feels comfortable with, given its full responsibility in the event of some event. So I am not sure that the legislation goes to the way that that is achieved. But the central tenet is that the responsible entity must remain responsible.

Senator CONROY—The MIA prohibits an RE or related body from paying insurance premiums for compliance committee members. However, the committee has heard evidence that most compliance committee members rely solely on the insurance cover provided by the RE. Are you aware of this and the implication for the independence of compliance committee members? Do you have any thoughts on that?

Mr Maher—I only became aware of it as we were doing the review and I was not aware of how widespread it was. As you would know from the report, that was one of the issues put forward by the Independent Compliance Committee Members Forum because they were very strongly of the opinion that they should be included in the officers' and directors' policy of the RE. They argued that it would not impinge on their independence. It is something that we agreed to look into more closely rather than come up with a definitive view at the time of the report, mainly due to time constraints. All the anecdotal evidence that I have seen is that it would be prohibitively expensive for Independent Compliance Committee Members Forum members to seek their own insurance. If the result would be that you would have no Independent Compliance Committee members, then you would have to look at some other mechanism. Again, I have not looked at this.

Senator CONROY—Do you think there is an independence issue?

Mr Maher—There certainly is. The legislation would not have made that distinction otherwise. Again, it might have to be a trade-off between independence and practicality. If we are going to have a compliance committee system but, in practice, no-one is prepared to be an independent compliance committee member, then we have got to consider options.

Senator CONROY—On the compliance committee, a number of submissions to the review argue that an external corporate entity should be mandated to sit on a compliance committee or to assume the full compliance monitoring function. What is Treasury's view?

Mr Maher—For me, that was the most difficult issue of the whole report. Again, we looked first of all at the statistics that ASIC had come up with from their surveillance visits. On the face of it, they looked quite poor. There was a quite high percentage where they had to take some sort of remedial action. But we came to the view that we had probably not had enough experience with the new regime to say that it had failed or that there was some sort of major flaw in the independent compliance committee concept sufficient to warrant a major overhaul of it at this stage. The reasons were that ASIC had only collected statistics since the MIA had been in place, so it is difficult to know whether there were major compliance failures prior to the MIA. Again, we thought that, with a bit more experience, the statistics would hopefully

improve. In the report, I think we have said that, if those statistics do not show an improvement in the coming year, there would be a very strong case for maybe adding another string to the bow of independent compliance committees by having a corporate there. The other reason that was canvassed in the report was that we found, over the period of preparing the report, that a lot of the smaller schemes, the ones that were not based in city areas, were finding it difficult to find independent compliance committee members and that perhaps, if we opened it up a little more broadly to, say, an accounting firm or even a trustee company, it could fulfil that function for them. As I say, ultimately it was a lineball decision. We thought it would be a bit hasty to change the arrangements without a bit more experience to see how it was performing.

Senator CONROY—Are you confident that the individual members of the compliance committees will have adequate access to training under the new regime?

Mr Maher—Again, that is one of the recommendations. There should be some standards set down so that the independent compliance committee members get sufficient training. I have attended one or two of the lunchtime gatherings of the Independent Compliance Committee Members Forum and it seems to be quite a good forum for swapping ideas, at least at a very informal level. I am aware that the University of New England—from memory—in conjunction with ASIC ran a short training school for compliance committee members. We are envisaging something a bit more formal, where ASIC might be able to lay down some guidelines saying: 'If you are a compliance committee member of a scheme with these sorts of assets or the nature of scheme is this, then you should perhaps have this sort of training. But if it is something different you should have some other sort of training.' Again, we have not been too prescriptive in the report. Basically, we thought it was something ASIC could develop in consultation with bodies like the Independent Compliance Committee Members Forum. To answer your question briefly, I am hopeful that they would have better access to training and that the general standard of competence and skill of compliance committee members would be increased.

Senator CONROY—Are directors as individual members of the board responsible for directing breaches to ASIC if they are not satisfied that such breaches have been adequately addressed by the RE?

Mr Maher—I would have to consult the legislation about that one.

Mr Ray—We could check. We do not have a directors' duties expert with us, but under normal directors' duties that would follow.

Senator CONROY—Do you have any concerns regarding the fact that the RE is responsible for the selection and removal of compliance committee members and audit staff?

Mr Maher—Again, that is dealt with in the report. I am not so sure that we are concerned with them having the right to do it, but we think that ASIC should be able to remove an underperforming member or someone they think is not suitable. At the moment they do not have that power. In fact, at the moment ASIC is not even informed of who compliance committee members are, which seems a bit of a gap in the legislation. The recommendation in the report is that members and ASIC should be informed when compliance committee members are appointed, are removed or retire. Hopefully, that will promote more transparency so that

members themselves might want to have a bigger say about who is on the compliance committee.

Senator CONROY—I appreciate your concern about underperforming compliance committee members. I was probably looking at it from a slightly different perspective—where they are doing their job and whether the RE is happy that they are doing the job. That leads to my next question: are you concerned that no grounds need to be given for the removal of staff members?

Mr Maher—I had not thought about it in those terms. Getting back to the requirement to notify ASIC when members were removed or appointed, I would think that, if there was a RE that was constantly removing people or there was a great turnover in a compliance committee of a particular RE, it might send a signal to ASIC that perhaps there was something untoward going on at the RE and it might be grounds for them to conduct further inquiries. I am not sure that we went as far as suggesting that there should be specified criteria for removal.

Senator CONROY—In your view, should the protection of qualified privilege enjoyed by compliance committee members regarding their communications with ASIC also be extended to ex-members?

Mr Maher—Again, from memory, I think that the recommendation in the report is that it should be. As I recall, this was largely a request from ASIC. They felt that the protection—

Senator CONROY—Once someone has been removed they have no protection to be able to go to ASIC, because it is not covered.

Mr Maher—Yes, that is a recommendation of the report for that very reason—someone might be removed in circumstances where they feel that they have been unjustly removed, perhaps, and there might be something untoward going on in the RE. You are right, they should have the same protection. It could be an avenue for disgruntled compliance committee members, but ASIC can make that call at the time.

Senator CONROY—Has Treasury undertaken any independent analysis of fees and charges for investors?

Mr Ray—We have considered some of the evidence that has been presented to this committee and to other committees. We have not undertaken independent analysis in the sense of collecting new data.

Senator CONROY—So what evidence did the review or Treasury consider?

Mr Ray—Mr Maher might help me—it is in chapter 4 of the review. They considered some data that had been provided to them in submissions.

Mr Maher—There was not a great deal provided. I think that the Consumers Association made reference to a few studies. IFSA, on the other hand, had their own study commissioned by KPMG, which, not surprisingly, came to different conclusions about whether fees and charges

had risen or fallen. In terms of us doing some independent analysis for this review, it was really just a question of time.

Mr Ray—Also, it would be a question of data. The review makes some recommendations to improve the data.

Senator CONROY—Some of the proponents of MIA argued at the time that there would be substantial cost savings.

Mr Ray—Others argued that there would be substantial cost increases. Mr Turnbull's conclusion was that both sides to that debate probably overplayed it.

Senator CONROY—In Treasury's view, have there been substantial cost savings?

Mr Ray—That is one of those questions which are very difficult for us to answer, because you do not know what—

Senator CONROY—Especially if you have not done any work.

Mr Ray—No, it is not a question about whether we have done any work or not. It is a question about whether or not it is possible to answer in any meaningful way, because we do not know what the counterfactual is. The evidence that this committee has received is that since I think about 1996 there have been some declines in fees and charges—

Senator CONROY—Which have not got anything to do with MIA.

Mr Ray—The point I was making is that that trend has been there for some time. That might be more to do with the maturity structure of the industry—

Senator CONROY—Which altered a lot in the last couple of years, did it?

Mr Ray—It is a relatively new industry.

Senator CONROY—This comes to some of the evidence and discussion we had with some of the previous witnesses. You have probably seen some media coverage of it as well as possibly read the transcript. Are you aware of a December 2000 survey from the US SEC entitled *Report on mutual fund fees and expenses*?

Mr Ray—We are aware of that report.

Senator CONROY—Why, in Treasury's view, are managed fund fees in Australia up to double the level charged to US investors?

Mr Ray—The data are a little more complicated than that. The SEC report is looking at 1999 data, so it is talking about assets under management of just under $US7 trillion. You are comparing that with an Australian asset base of about $A500 billion.

Senator CONROY—They do make the point that scale seems to make no difference.

Mr Ray—They do not quite make that point. They say that, at the fund level, scale may not make much difference, but at the fund family level it does seem to make a difference.

Senator CONROY—That is probably because it is a bit more competitive in the US.

Mr Ray—The weighted average expense ratio across all classes in that study is just under one per cent, which is remarkably similar to the sorts of numbers that you see for Australian superannuation assets, which are at about that mark. It is not clear from the data that you are using that the Australian costs are double. The other thing is that the evidence that is around suggests that there are economies of scale in the industry. For example, I think that Dr Bateman in her study of costs—not charges—found that for a one per cent increase in asset size the cost increase was about half of one per cent. That tends to suggest that there are economies of scale. The other difference that you need to consider is the maturity of the funds, which is the point that I was alluding to before. It is the case in the United States that the weighted expense ratio falls as funds get older. The industry in Australia generally is much younger in maturity structure.

Senator CONROY—What sort of maturity do you think we need then to reach reasonably comparable figures, even taking into account your belief that the figures are not directly comparable? How long do some investors have to wait until our market matures in age?

Mr Ray—The US data shows a difference between funds that are one to five years old and funds that are six to 10 years old.

Senator CONROY—How long has the managed fund industry been going?

Mr Ray—I do not think we have data on what the maturity structure is of the Australian funds. That is the relevant question; not how long the industry has been going.

Mr CIOBO—I have a couple of questions with regard to differential fees. What is Treasury's view of the treatment of differential fees as at present?

Mr Ray—The review has recommended that differential fees be permitted. That recommendation is currently before government, effectively.

Mr CIOBO—But in terms of your consultation, you formed a view on it as to what needs to happen?

Mr Maher—I would probably say 'not finally'.

Mr CIOBO—What are some of the observations Treasury has made, then?

Mr Maher—The legislation at the moment talks about treating members 'equally', and that has been interpreted quite strictly.

Mr CIOBO—Rather than 'fairly'. Sure.

Mr Maher—We would envisage moving away from 'equally' and replacing it with 'fairly', but then are there some sorts of extra conditions that have to be applied? Again, ASIC suggested that there has to be some sort of economic nexus between the different fees offered, not just a special deal because someone is a related company or something along those lines. I guess it would be a question of where you draw the boundary between an economic linkage and an economic requirement. If you drew it too strictly, there would not be any benefit; they would not be able to offer differential fees, except in very limited circumstances. It is one of those competing claims where I think ASIC would like to have it quite tight and the industry is obviously keener to be able to offer differential fees. The short answer is that we are still considering it, I suppose, but we have not come to any pre-emptive decision.

Mr CIOBO—Thank you.

CHAIRMAN—The new arrangements in some respects did not come into full operation until 2000. I note that the review said that the investment climate in Australia, since the introduction of the act, had been relatively favourable, so the new arrangements have not been subject to any significant stress. So you have that situation and you have a relatively short time frame. The Investment and Financial Services Association in their evidence indicated their view that the September 11 market shock had been a significant test for the MIA in terms of efficiency and investor protection, whereas the Trustee Corporations Association of Australia said that September 11 was not a genuine stress test for the MIA, as this would occur only when a large scale redemption occurred and investors sought to claim assets. I am wondering what Treasury's view is of the extent to which the new regime has really been tested in terms of investor protection.

Mr Ray—I think that we would concur with Mr Turnbull's findings that it is quite early days, that a lot funds did not transition to the new regime until the latter half of 1999 to early 2000 and that in some ways we need to allow some time to pass to be able to form any considered views. It is certainly the case that the sorts of stresses that led to the policy change have not occurred.

CHAIRMAN—Does that indicate that it might be desirable to have a further review somewhat down the track?

Mr Ray—The timing of this review was determined by parliament. We keep things under review from time to time anyway.

CHAIRMAN—Dr Alan Greenspan, the Chairman of the US Federal Reserve board, recently said that the avenues and incentives for corporate crime have greatly increased. He emphasised the importance of having independent board members to balance the power of chief executive officers, given what he sees as opportunities for corporate crime and consequent financial failure. Again, the trustee organisations have argued that the MIA's self-regulatory compliance arrangements do not provide sufficient checks and balances on the responsible entities' activities. Does Treasury have a view on the strengths of the act in terms of investor protection compared with the previous dual responsibility regime?

Mr Ray—The government's position is that the current system is an improvement on the previous system and, in particular, that investors have more protection in the event of a failure. That is because the dual system was found wanting in the event of failure.

CHAIRMAN—The issue of net tangible assets has also been raised in the inquiry. Again, the trustee corporation called the capped NTA and insurance requirements a wasting figure and suggested that there should be provision for the NTA to respond to inflation or for some form of indexation. Why has that system not been implemented?

Mr Ray—Generally, these sorts of requirements are not indexed in the act, so it is consistent with other requirements in the act that it is not indexed. There is some inflation. There is a scaling effect, effectively, because of the 0.1 per cent up to $5 million. So, as I say, it tends to scale with the asset base to a point. The NTA are there to ensure that the RE has sufficient resources to enable it to operate the fund. That is what that requirement is about. It is not there to provide a pool that is available in the event of a lot of redemptions, for example. That is not the purpose of the NTA requirement.

Mr Maher—It is interesting that in the initial Law Reform Commission report they were not in favour of any NTA requirement. Their submission said, 'Perhaps we should have something there,' and they made the very point that you would have to have a huge percentage if you wanted it to act as some sort of compensation fund for investors. It really was just a day-to-day operational fund.

CHAIRMAN—The MIA specifies that a responsible entity must not pay an insurance premium on behalf of compliance committee members where insurance covers the committee member for breaches of their duties. We had evidence from Mr Dortkamp of the Independent Compliance Committee Members Forum that responsible entities by and large hold insurance for the compliance committee members under insurance packages offered for the MIA. Are you aware of this development?

Mr Maher—As I said in response to Senator Conroy's question, I became more aware of it as the review went on. Mr Dortkamp says it is widespread; I thought it was a not very widespread practice, but they were keen for it to become widespread because they thought it was just too expensive for individual members to go and get their own insurance. That is something we have in our pile of things to be considered further; the trade-off between independence on the one hand and the practicalities of not having anyone to sit on compliance committees if you do not allow this, which would defeat the purpose of having them in the first place.

CHAIRMAN—Are there any grounds for concern about that development in terms of the respective liabilities of the players?

Mr Maher—Again, I am not 100 per cent sure how widespread it is, but it would be something that ASIC might have to look at, I suppose, if it is contrary to the actual letter of the law. It may be that they could exercise some latitude until the government settles on a position about whether it is prepared to accept some fall back from the notion of compliance committee members having to get their own insurance.

CHAIRMAN—Regarding the power of responsible entities to remove compliance committee members and the lack of whistleblower provisions to protect committee members dismissed by a responsible entity, what protections are currently set out in the act in the event of a disagreement between the responsible entity and the compliance committee member which might lead to the dismissal of a member?

Mr Maher—Mr Ray was just saying that the RE is ultimately responsible for the running of the fund. I would probably have to refresh my memory by looking at the legislation, but, as I understand it, this is the issue of qualified privilege—that is, if a compliance committee member initially goes to the RE or the board of the RE and still has concerns, they can raise them with ASIC—but I would have to double check that. This leads on to the issue of how that privilege should extend to a compliance committee member who has been removed from a compliance committee, because these may be the very circumstances in which a compliance committee member may want to go to ASIC. Without qualified privilege they may be constrained because they would be fearful of being sued. That is one of the recommendations of the report—that that privilege should be extended to people who have been removed from the compliance committee.

CHAIRMAN—It has been suggested in evidence that ASIC should have to approve the removal of compliance committee members by the responsible entity, which is similar to the process for the removal of auditors. Does Treasury have a view on that?

Mr Maher—I think the report did not quite go that far. We suggested that ASIC should be informed when a committee member is removed. I guess if there was a pattern of lots of removals or unexplained removals, perhaps, then that might prompt ASIC to make further inquiries. We did not feel that there was sufficient evidence to suggest that ASIC should actually have the right of veto, if you like, to prevent removal. Another recommendation of the report was that ASIC should itself be able to remove someone if it felt that that person was not performing.

CHAIRMAN—Do you consider that the arrangements under the new regime have enhanced auditors' powers to expose mismanagement or maladministration in a timely manner? What protections are there under the new act to ensure that auditors will not be unfairly or unduly influenced by the responsible entity?

Mr Maher—I am not aware that the new regime has put any more pressures on auditors or has diminished their independence, if you like. There are various issues kicking around about auditors and about whether the auditor of the responsible entity as a company should be different from the auditor who does the audit of the compliance plan for the various schemes. In the report there were some people who said that they should be separate firms—that you should never let the same firm do the two audits. At the other extreme there were people who said that the same person in the same firm should be able to do both audits. The legislation now has what everyone acknowledges to be a compromise—it can be the same firm, but different people within the firm should do the two audits. It was one of those fairly line-ball decisions but we did not think there was enough justification to change that at the moment.

CHAIRMAN—We had evidence from Mr Russell Stewart that ASIC allows 10 per cent investment in unregistered schemes under the MIA, that further protection from the requirement

is, to use his word, 'illusory' and that that restriction on 10 per cent should be removed. He also considered adequate up-front disclosure on scheme registration would be a more appropriate way of dealing with investment in unregistered schemes. What is Treasury's response to that proposal?

Mr Maher—I am not aware of the 10 per cent requirement. It must be an ASIC administrative—

Mr Rosser—I am not aware of it, Senator.

CHAIRMAN—Perhaps that is a question we should direct to ASIC rather than to Treasury.

Mr Maher—The concept of only investing in other registered schemes was so there would not be a huge loophole where someone could invest in a registered scheme that can then go and invest in something that was not regulated. That was the theory behind the requirement, but I am aware that there are criticisms of that requirement.

CHAIRMAN—Thank you for appearing before the committee this morning, the evidence that you have given us and for answering our questions.

[9.53 a.m.]

HUGHES, Mr Sean, Director, Financial Services Regulatory Operations, Australian Securities and Investments Commission

JOHNSTON, Mr Ian, Executive Director, Financial Services Regulation, Australian Securities and Investments Commission

VAMOS, Ms Pauline, Director, Licensing and Business Operations, Australian Securities and Investments Commission

WALL, Mr Michael, Assistant Director, Legal and Technical Operations, Financial Services, Australian Securities and Investments Commission

CHAIRMAN—Welcome. 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 your request. I invite you to make an opening statement if you wish to do so, following which we will proceed to questions.

Mr Johnston—We will not make an opening statement. ASIC, as you would be aware, made a submission to the review of the managed investments regime, and ASIC's basic position was covered in that submission. We are happy to take questions today. I should mention up front that I believe I have appeared before this or a similar committee in years gone by in another capacity, representing the Trustee Corporations Association. At that time I was a member of the national council of the Trustee Corporations Association and the chief executive of a trustee company.

Senator WONG—I want to ask some questions about net tangible assets. At previous hearings it has been argued that the present arrangements mandating a maximum of $5 million of net tangible assets irrespective of funds under management provide inadequate protection for investors. Could you comment on that?

Mr Johnston—I think the point was made in earlier evidence that the $5 million is not there primarily as a buffer for failure of any fund. It is there for three reasons: it is there to make sure that the party operating the scheme has enough backing, enough capital to do its job and to operate the scheme; it is there to give some notion of backing in terms of an orderly wind-up; and it is there basically as what you might define as hurt money—to make sure that the organisation has some substance and has some money invested when undertaking the role that it performs. But it is not actually there as a buffer in the event of failure. Any capital that was there in the event of failure would have to be substantially greater than $5 million in many cases, and it would always be an arbitrary amount.

Senator WONG—So what is the benefit of mandating the maximum?

Mr Johnston—Mandating a maximum would always be arbitrary; we would concede that. If you take into account the reason why it is there, I do not think there would be any benefit in

having it go higher than that. If it was there as some sort of fund in the event of failure then you would apply different reasons to it, but this is not essentially a prudential regime, and it is not a prudential amount of capital that is being applied to it.

Mr Wall—The $5 million figure was mandated under the licensing legislation before the FSR reforms, so we have reflected it in our policy and licence conditions going forward. Ian is right; it was a figure I think which was originally derived from SIS to make sure there was some comparability with the superannuation regime.

Senator WONG—One of the comments made in the review was that it would be unrealistic for investors to expect a full recovery of their losses in the event of a collapse. This is in this context. I wonder what your view is on that.

Mr Johnston—If you are talking about making some sort of recovery from the capital of the operator, that would be right, depending on the loss and depending on the cause of the loss.

Senator CONROY—Do you think there is a misperception among potential investors that that is what it is for? Do you think they believe that it is backed: 'There is money behind it therefore I can fully recover'? Do investors understand that it is really not for that?

Mr Johnston—I am not aware that there would be many operators promoting the capital as some means of investor protection. If it was being promoted in that way, there would certainly be a risk of that. I am not aware of many examples of that happening.

Senator WONG—Examples of that being promoted?

Mr Johnston—Of that sort of representation being made.

Senator WONG—I turn now to the issue of compliance committees. We have had a number of submissions arguing that an external corporate entity should be mandated to sit on a compliance committee or to effectively assume the full compliance monitoring function. What is your view about that?

Mr Johnston—I do not think we have a strong view on that. At this stage it is too early to tell whether there is any major problem with the way the compliance committees are operating. We have conducted a number of surveillances—Mr Hughes might talk about those a bit later—that have thrown up some issues that we have had to deal with in terms of compliance committees, but I am not sure that any of those issues would be any different if there was a corporate member of a compliance committee.

Senator WONG—Why do you say that?

Mr Johnston—If you look at the sorts of issues that we have found—and I might ask Mr Hughes to mention those—I do not think that any of them would have been any different had a corporate member been there rather than an individual member.

Mr Hughes—The preponderance of issues that we have identified in the course of those surveillances have related to what I would call administrative breaches. The top five issues that we have identified are late lodgment of returns, a breach of NTA requirements, ineffectiveness of the compliance plan per se—in terms of complying with the provisions in their compliance plan—poor monitoring and reporting processes.

Senator WONG—In terms of your analysis of problems with compliance committees thus far?

Mr Hughes—That is right. The presence, or otherwise, of a corporate member of that compliance committee, in our view, would not have affected those breaches or those deficiencies.

Senator WONG—The only thing that concerns me a little is that we seem to be saying, 'We do not think it is a bad thing, unless it is demonstrated to be a bad thing.' I am more interested in which model we think is going to provide better investor protection and better compliance monitoring.

Mr Johnston—We would need to be satisfied that there was reason why it would provide a better model of compliance monitoring. At this stage, I do not think that case has been made out.

Senator WONG—You referred to a survey you conducted in relation to breaches.

Mr Hughes—That is right. The survey was in relation to a review of those compliance plans which have been lodged with ASIC where there was a qualification by the auditors. We have gone behind those to identify what some of those deficiencies might be.

Senator WONG—Was that done randomly or was it targeted?

Mr Hughes—We reviewed all of the compliance plan reports which had been qualified.

Senator WONG—What sort of percentage of compliance failure was identified?

Mr Hughes—In the last year, that ended 30 June 2001, 12.9 per cent were qualified out of a total of just over 2,000. The top five deficiencies were those which I identified.

Senator WONG—One of the issues that was discussed earlier was training for members of compliance committees. What sort of training do they have available to them?

Mr Johnston—Some have undertaken training. We assisted in the formulation of a course provided by the University of New England specifically for members of compliance committees. We would certainly like to see members of compliance committees have a good understanding and be adequately trained. We would probably encourage bodies such as the forum to develop standards and apply those standards to members of compliance committees. If it was able to be done that way first then we would be happy to see that develop.

Senator WONG—Who would develop that?

Mr Johnston—The forum itself. That is a quasi industry body, if you like.

Senator WONG—I am aware of that. You do not see a role for ASIC in developing such standards?

Mr Johnston—Not at this stage. I think that our preference would be to allow them to develop some standards first. If that did not work then we might have something else to say on the matter. But I think that is a better starting point.

Ms Vamos—We have had a focus on ensuring in compliance plans that REs go through a process to appoint a compliance committee member. Part of that process is to ensure that there are no potential conflicts and also to ensure that they do have the required knowledge and training and that there is a balance across the compliance committee that covers not only technical expertise but some industry knowledge as well. So it is a bit of a balancing act.

Senator WONG—I understand the RE is responsible for the selection and removal of compliance committee members and audit staff. Do you have a view about that? Similarly, do you have a view about whether or not it would be appropriate for grounds to be provided for you to remove these persons?

Mr Johnston—Again that is something that we have dealt with to some extent in the compliance plan that Ms Vamos can speak to.

Ms Vamos—Again, the primary responsibility there is for the RE to ensure that it appoints a compliance committee that can discharge its duties and that has been our focus. If the RE does not appoint an appropriate compliance committee then we take action against the RE.

Mr Johnston—We have suggested that we should have the power to remove compliance committee members who are not doing their job.

Senator CONROY—What sort of criteria would you envisage would lead to the removal under the powers you are talking about?

Ms Vamos—Non-attendance at meetings would be one. There are usually minimum quorum requirements for compliance committee meetings. If compliance committee members do not attend meetings and do not take part in the decision making then I would suggest ASIC would be concerned.

Mr Johnston—One of the other things we would look at—and I would say up-front that we have not become aware of an instance such as this—is that, if there was a major failure of compliance in an entity and the grounds giving rise to that failure had been given to the compliance committee members and yet they had not discharged their obligations by coming to us to report breaches, that would be another ground that we would use.

Ms Vamos—And, of course, any major conflicts that the compliance committee members may have. That is an issue that we take quite seriously.

Senator WONG—If ASIC were given that power, how would that operate in practice? How would you become aware of the sorts of breaches that you are talking about that might lead to removal?

Mr Johnston—By undertaking compliance audits as we do at the moment. We conduct audits on a targeted basis generally, although in each of the past two years we have conducted surveillances that have meant that we have got around to visit some 20 per cent of the industry.

Mr Hughes—It is a combination also of reviewing and acting on complaints that we might receive from investors or others in the industry, as well as targeting, as Mr Johnston says, segments of the industry where we think there to be high risk. So it would be a combination.

Senator WONG—This is probably a question about directors' duties. I think Senator Conroy asked Treasury whether or not directors as individual members of the board are responsible for directing breaches to ASIC if they are not satisfied that such breaches have been adequately addressed by the RE.

Mr Johnston—We have said—I think it was in our submission—that where there is a board rather than a compliance committee we would like to see the same sorts of duties that are applied to compliance committee members applied to directors of the entity. That would, of course, mean that they would have that obligation.

Senator WONG—But they currently do not.

Mr Johnston—Was that in our submission?

Mr Wall—That is right, it was. Currently the law does not make express provision for the duties that apply to members of the compliance committee to apply to members of an external board now.

Senator WONG—Would there be any arguable duty arising as a general function of one's duties as a director in the absence of an express provision?

Mr Johnston—There would be a requirement on the RE to notify us of any breach in any event. There is always a requirement on the responsible entity—

Senator WONG—I appreciate that. I am talking about directors specifically though.

Mr Wall—Sorry. The argument would be, of course, that the general fiduciary duties which apply under the act to directors on one reading would cover the specific duties which are imposed on compliance committee members. So to that extent there is that duty. That would certainly be our submission—to make it beyond doubt and make it abundantly clear so that where there is an external board each board member is cognisant of what those duties are in the

context of a managed investment scheme but the express duties which presently apply to compliance committees would apply to the board.

Senator WONG—There would even be a legal argument, wouldn't there, that the absence of specifying that in relation to external board members when it had been specified in relation to the compliance committee would mean that it actually had been excluded?

Mr Johnston—That could be argued, although as I say it is required of the RE to notify us of breaches in any event.

Senator WONG—I understand that.

Mr Wall—Whilst anything is arguable as a matter of law, I would be absolutely astounded if that were ever successful because the compliance committee notion is based on the model that it is an extension of, and is accountable to, the board and that the board is responsible for the conduct ultimately of everybody.

Senator WONG—I do not advocate it as a policy position; I am just suggesting that there might be some drafting issues.

Mr Wall—That is right.

Senator WONG—Should the protection of qualified privilege enjoyed by compliance committee members regarding their communications with ASIC also be extended to ex-members?

Mr Johnston—Yes, we think it should.

Senator WONG—We have had some discussion about REs paying insurance premiums for compliance committee members. Some of the evidence before this committee has been that most compliance committee members rely solely on the insurance cover provided by the RE. I assume you are aware of this.

Mr Johnston—Yes.

Senator WONG—Could you give us a view about what implications you think this has for the independence of such members?

Mr Johnston—It is a practice that does not overly concern us. I think it is better that there be insurance made available to members of compliance committees. My understanding is that the law does not prohibit the payment of the premium by the RE; it only prohibits it in the case of wilful neglect of duty or wilful breach of duty. There may have been a misunderstanding earlier in other evidence. The law does not restrict the payment of the premium by the RE; it in fact contemplates that that can happen. It is only in the case of wilful breach that the RE cannot pay the premium, and that would not be permitted in any event.

CHAIRMAN—You would not be able to get insurance for wilful breach, would you?

Mr Johnston—It would be great if you could.

Senator WONG—On the issue of the ineligibility of compliance committee members, IFSA argued in their submission that a person would only fail to qualify as an external compliance committee member if they had substantial business dealings which a reasonable person would expect to influence the member in the performance of their duties. Do you support that position?

Mr Johnston—It is a difficult balance to strike. Mr Wall basically drafted our submission and we dealt with this in our submission so I will ask him to address that.

Mr Wall—Mr Johnston is right, it is a delicate issue. We are talking about the question of what a substantial involvement in some other capacity actually is. I know that there are divided views about what 'substantial' means. There have certainly been some submissions from some of the law firms, accountants and so on which have said, 'We have provided some services in the past and that should not disqualify us from being a member of the compliance committee.' While we understand that it is finely balanced, our view is that, unless the law was changed, we would probably err on the side of caution and say that the test as it presently exists would probably prohibit people who have been involved in some substantial capacity.

Senator WONG—Material interest.

Mr Wall—Yes. I know I am talking in legal terms again; it is very difficult without actually translating it to a specific example.

Ms Vamos—It is to do with ex-auditors and lawyers—that is, people who have been providing professional advice to responsible entities. Sometimes the RE would like to appoint their lawyer as a compliance committee member, and they are often excluded.

Mr Wall—That is under the current regime, and it might also, for example, involve a partner of a law firm. For example, the partner might have had no direct involvement with the responsible entity but one of the fellow partners of the law firm will be precluded under the current test from taking up that role.

Senator WONG—I would like to turn now to the audit of compliance plans. I understand that you made a submission to Mr Turnbull's review for reform relating to the auditing of compliance plans and that the review has recommended further consultation. I would like to ask some questions about the recommendations you put forward. Are you able to outline briefly the main thrust of those recommendations in relation to the audit of compliance plans?

Mr Wall—One of the most important things is that, at the moment, the audit of the compliance plan is undertaken and it is presented to the responsible entity. We think that the audit plan itself must take into account the interests of the members and that members should be provided with a copy of the audit report in respect of the compliance plan. That is one of the most important issues that we raised in our recommendations. At the moment the compliance plan itself and the audit of the compliance plan are provided to the responsible entity, so we have suggested that that should be extended.

There are also some uncertainties which we have addressed in our report and which we think are technical anomalies. These are to do with the timing of the compliance plan, and we have recommended that it should be brought forward within a specified period, rather than the rather complicated technical procedure which is set out under the law at the moment. So we say that from the time of registration a plan should be audited every nine or 12 months so it is abundantly clear. At the moment there are different practices or interpretations of what that means.

There is also some uncertainty, it appears, as to whether the auditor's opinion itself should cover the entire period—that is, the whole nine- or 12-month period. There are some auditors who have taken the view, applying a very technical interpretation of the law at the moment, that it only requires them to sign off that everything seems to be in order at the date of the report. So it does not really have any retrospectivity, which then defeats the purpose of the audit.

The other issue is, of course, materiality. At the moment, the law does not refer to any materiality in relation to an audit. On a strict reading you could qualify it because there has been a very technical breach which was a one-off, did not cause any loss or harm and was not reflective or suggestive of any systemic compliance failures. That one level could require the auditor to qualify the report. There is a question about whether we should introduce materiality tests into the legislation, which of course gives rise to some problems in the auditing framework because we are talking about qualitative rather than quantitative factors.

Senator WONG—Do you mean by 'materiality test' that one would only qualify the audit report in circumstances where you thought it was important enough to report?

Mr Wall—That is right.

Senator WONG—What did you actually say should happen on that?

Mr Wall—We have said that we should develop a materiality test, but that it will require further consultation with industry about what that is. Our discussions with auditing bodies to date have certainly revealed that there is no consistency. It is a qualitative factor, so it becomes much more difficult to try to quantify.

Mr Johnston—Materiality tests work far better in financial audits where you can apply a quantum to the percentage of assets, or whatever the quantum might be, whereas materiality in the qualitative sense, where you are looking at a breach of an obligation, is more difficult. But we would submit that there should be materiality tests to avoid audits being qualified in the event of trivial, immaterial matters.

Senator WONG—It might be difficult to clarify how you draw that line. Did you have a further comment to make?

Mr Johnston—No, they are the main thrusts.

Senator WONG—None of those were picked up by the review?

Mr Wall—I think all of them basically were picked up by the review.

Senator WONG—Were they included in the recommendations?

Mr Johnston—You have me at a loss. I cannot recall whether or not those were picked up in the recommendations.

Mr Wall—The review said that the matter really should be discussed further between ASIC, the auditing bodies and Treasury, so I do not think that Mr Turnbull made a recommendation one way or the other, apart from noting that it was an issue that was worthy of further—

Senator WONG—Why was there a view that some of them—for example, the provision of the compliance plan to members—needed to be further discussed?

Mr Johnston—I might just correct that for the record—that was the 'provision of compliance audits'.

Senator WONG—I am sorry; I mean 'compliance audits'. That was my mistake.

Mr Johnston—I do not think there was further discussion.

Senator WONG—Is there a view that there is an unnecessary cost implication from that? Was that put to you?

Mr Johnston—Nothing was put to us. This was material that we put to the review, so it is not a discussion that we have had with industry.

Senator WONG—Mr Wall, is there a significant increased cost resulting from those sorts of proposals that you have raised?

Mr Wall—I would argue that it would probably be the reverse. The materiality test, once we have actually agreed on what is an acceptable test, will have a benefit which will flow on to investors generally because, if a report has been qualified in respect of, as Mr Johnston said, a trivial, insignificant or isolated event, it may send out a wrong message.

Mr Johnston—I imagine, though, that the audit industry might well argue that, if you report to members on compliance breaches, that is widening the net of people who can rely on the report. At the moment, if they report only to the responsible entity, that is a very limited group obviously who can rely on the report. There might be an argument that it would increase costs because of the increased responsibility that might flow from having to report more widely than to the RE.

Ms Vamos—It is a liability issue. They become liable to the members if they have a duty directly to the members. I believe that is something that the accountancy body—

Senator WONG—This is the auditing body?

Ms Vamos—Yes.

Mr Hughes—Arguably, though, that liability exists—

Senator WONG—I was just going to say that. I fail to see—

Ms Vamos—That is certainly an argument that has been put to me.

Senator WONG—Would that liability not exist in any event?

Mr Hughes—We think it probably would but, as Ms Vamos says, it is the argument from the auditing profession.

Senator WONG—In terms of these recommendations that you have discussed in relation to auditing compliance plans, in your submission to the review did you have a position on whether they needed to be implemented together?

Mr Johnston—My recollection is that we thought that they should be treated as a package.

Senator WONG—Why is that?

Mr Johnston—Because we were looking at the integrity of the audit. It seemed that, if you were going to deal with audit of compliance plans, you should deal on both sides. As we pointed out, there is perhaps an overburdensome obligation to report on breaches that are immaterial and, at the same time, we think that it should be made clear to whom the report is made that it is far better to treat all of those things together rather than deal with only one side of the issue.

Senator WONG—What has happened as a result of the recommendations that these be discussed further—I think you said that was Mr Turnbull's recommendation?

Ms Vamos—We issued something quite some time ago about materiality. In practice, a lot of the audit breaches that are reported are material. A lot of the words that we have framed around that information release we issued are about the size of breaches' impact on individual investors, as well as the repeated noncompliance of the same type of issue. We have gone as far as we can as far as producing material for the industry is concerned, and it has been about how that has impacted on practice. I think that has been a little bit early as well.

Mr Johnston—I remind you that a consultation period has opened just now where Treasury is consulting with industry.

Senator WONG—I am not actually having a go at ASIC on that. I have some questions on differential fees. I understand the review recommends that the current requirement that investors in the same class be treated 'equally' be replaced with a requirement to treat them 'fairly'.

Mr Johnston—We have supported that.

Senator WONG—Why have you supported that?

Mr Johnston—For the sorts of reasons that were discussed in earlier evidence. We think that the way the law is currently framed would mean that differential fees would not be able to be applied equally. ASIC had issued some class audit relief to enable this to occur. So we think that it would be clearer if a fairness amendment was made. That would then remove the need for ASIC to deal with it by way of class audit and allow the industry to proceed on a more secure basis.

Senator WONG—You are concerned that the equal test is extra work for you because you have to identify the class. Is that what you are saying?

Mr Johnston—Not quite in that way.

Mr Wall—The test as it is presently posited says that you must treat members of the same class equally or different classes fairly. At general law, 'equally' may mean, for example, 'fairly' because it recognises that you cannot treat everybody equally in every circumstance according to their interest. But the way the act is structured, it seems to us that we have limited, if any, discretion. It seems to replace the common law position such that you have to treat everybody absolutely equally, and that is impracticable. We have acknowledged that the commercial realities are that there are circumstances where 'fairly', which reflects the common law of what 'equal' means, could apply here, but perhaps as modified to ensure that the integrity of managed investments and the interests of investors across the scale from the retail to the institutional are fair and that the retail interests are not completely diluted, disadvantaged or disenfranchised.

Senator WONG—Do you think 'fairly' gives them adequate protection?

Mr Wall—We think it does, as modified in a way by some of the submissions we have made to the commission—that is, there needs to be transparency in disclosure about it and there needs to be an economic justification test such that we are not having a group of investors subsidising or cross-subsidising somebody else or that it will not result in a net detriment for the scheme as a whole or members.

Senator WONG—Thank you.

CHAIRMAN—Recently, at the inaugural lecture of the Monash Governance Research Unit, your chairman, David Knott, asked whether the traditional approach of leaving the responsibility for corporate governance and compliance with boards, shareholders and auditors was still valid given the increase in avenues and incentives for corporate crime. Given the number and scale of corporate collapses in recent history—internationally as well as the couple in Australia—do you consider the self-regulatory arrangements under the Managed Investments Act as sufficient to guard against the potential increase in corporate fraud and corporate crime?

Mr Johnston—The overall framework here provides for a model of self-regulation and also provides for a model of compulsory reporting to the regulator. There has been a mandated requirement that there be either a majority of independent directors or an independent compliance committee. I guess that differentiates the managed investments regime from the rest of the corporate model that applies to companies. So there have been some additional protections put around managed investments that are not there for the wider corporate sphere. In

our submission we said that it is perhaps too early for ASIC to give a strong opinion about whether that was working completely. We have not seen—and we identified this in our submission—examples of gross misconduct that we thought could not have arisen under the earlier model. So as far as we can tell just now it is working well but we think it is too early to say. There are additional independent protections for managed investments that are not there in the company structure.

CHAIRMAN—Have you had sufficient experience to make some judgment about the effectiveness of the obligation to report breaches to ASIC?

Mr Johnston—I will ask Mr Hughes to address that.

Mr Hughes—I endorse what Mr Johnston says. We find across the industry that at times there is variance in terms of reporting obligations. Some responsible entities are very good—they come forward very quickly. To an extent, there is an issue about materiality: some feel the need to tell us about absolutely everything that has gone wrong; others are less forthright. To endorse what Mr Johnston says, I am not sure that we have identified any enhanced reporting as a result of MIA at this stage. It is probably a bit early to say.

Mr Johnston—We have observed—and we also mentioned this in our submission—that there is a higher awareness of compliance than there was formerly. Well before the sorts of collapses et cetera that you are talking about compliance was something that people in the managed funds industry were very aware of and talked about—they talked about models of compliance. We think that there has been a positive movement in that sense since MIA came into force.

CHAIRMAN—Is there any validity in criticisms that there are conflicts of interest within the single responsible entity's control of selection and removal of compliance committee members and audit staff which may be detrimental to compliance and investor protection objectives?

Mr Johnston—The model that is there allows the appointment to be made by the responsible entity. Some might say that that inherently gives rise to some sort of potential conflict but I am not sure that it can be any other way, if that is the model that is there.

Ms Vamos—The underlying obligation, again, is on the responsible entity to ensure that the compliance committee can discharge its obligations. The way it appoints compliance committee members is quite transparent and certain procedures must be followed in the compliance plan. So provided that the RE continuously takes responsibility seriously we are safe.

Mr Johnston—One of the things that we look at in our compliance visits is whether there has been any removal—and the grounds for such removal—of someone who has been taken off a compliance committee. We look at that in our visits.

Mr Wall—I will supplement that by reminding the committee that there are other built-in protections such as the review of the compliance plan at the end by the auditors. So, in the absence of conspiracy theories, one would think that these things would certainly be picked up.

CHAIRMAN—Could you elaborate on the concerns that you expressed in your submission to the MIA review regarding contradictory scheme registration requirements?

Mr Wall—Yes. Is that in relation to the registration of multiple schemes? There are a number of submissions in relation to registration.

CHAIRMAN—It could be. It is the issue that Treasury dealt with in its consultation paper, at page 12.

Mr Wall—Yes. I will now refresh my memory. It is about when a scheme is required to be registered and the number of members it has and disclosure issues. There was some technical anomaly—and I am rereading this, so I apologise—in the way that the law had been structured such that there was an avoidance. There was a possibility of not having to register a scheme because of some exception in the disclosure provisions. Again, I am trying to read it as I am addressing this, so I apologise for that.

CHAIRMAN—That is okay.

Mr Wall—But, as I understand it, it was a technical issue which we thought had to be cured.

Mr Johnston—Schemes are required to be registered partly based on the number of members. There is another provision of the law that deals with disclosure where you have fewer than 20 members. One part of the law deals with that being open ended in terms of time and the other part of the law deals with there being a 12-month period, so there is an opening for there to be an avoidance mechanism. I think that is the issue, Michael.

Mr Wall—That was certainly the issue.

CHAIRMAN—Registering multiple schemes of fewer than 20 members—is that the loophole?

Mr Wall—That could certainly be one consequence, in that you would deliberately seek to do that. Alternatively, one of the other key parts of registration was that if you were not required to have a disclosure—under the FSR reforms, of course, that changes—then arguably you were not required to register your scheme. As Mr Johnston has pointed out, there is an anomaly between the fundraising provisions which were enacted after the Managed Investments Act and the structural requirements of the Managed Investments Act. The two sections did not interact all that well and, as a result, there was a clearly unintended consequence in that you could get out of registering your scheme.

Mr Johnston—Chairman, I do not think we are doing very well by elaborating on it.

Mr Hughes—I can add one real life example of what Mr Wall was talking about. I am certainly aware of one instance where we have wound up a scheme in which that avoidance arrangement was attempted. A number of schemes with fewer than 20 members were established, we became aware of that and we wound those schemes up and appointed a liquidator. So, yes, the tension exists but we have identified it in the past.

Mr Johnston—Senators, we might revisit our position and come back to the committee with a written comment.

CHAIRMAN—Okay. Can I raise with you the matter I raised with Treasury about this allowance of a 10 per cent investment in unregistered schemes. Mr Russell Stewart said in his evidence that further protection from that requirement limiting it to 10 per cent is illusory and that 601FC(4) should be removed.

Mr Johnston—What that is dealing with is an anti-avoidance mechanism whereby we would not want to see a registered scheme being used as a front or as a device to invest downstream in unregistered scheme investments and therefore the protections that are made available by having the scheme registered and regulated under the managed investments regime removed by simply taking all of the money and parking it or investing it in non-approved schemes. So it is an anti-avoidance mechanism. We did recognise, though, that there were some circumstances where that was impractical for fund managers and that there was perhaps no real regulatory danger in allowing a small proportion of moneys to be invested downstream in another type of vehicle, but we put a limit of 10 per cent, which I think we did by class order.

Mr Wall—Mr Johnston is right. As well, we have identified particular asset classes into which that 10 per cent can be invested to ensure that they do not end up, for example, in mushroom farms or something.

CHAIRMAN—So your view is that the 10 per cent needs to be retained to prevent avoidance?

Mr Johnston—Yes, otherwise it would be open for a registered scheme to be offered and the money to be simply channelled elsewhere.

Senator WONG—Mr Hughes, you answered a question of mine in relation to your compliance surveillance and a recent survey which I think you said was worth 12.9 per cent of breaches. When was that survey conducted?

Mr Hughes—It was for the plans submitted for the year ended 30 June 2001. We conducted the review between November 2001 and March 2002. Coincidentally, it is of interest to note that 12.9 per cent were qualified for the 2001 year and in 2000, the previous year, 13 per cent were qualified; they are similar numbers.

Senator WONG—Have you undertaken any surveillance as to compliance failures subsequent to that survey you gave me information on?

Mr Hughes—Yes, in relation to those breaches which we identified as being significant there were a number where we have taken follow-up action. Having identified our concerns to both the compliance plan auditor and the responsible entity, we have indicated to them that we will be undertaking follow-up surveillance during the next six months.

Senator WONG—Do you have any statistics regarding your most recent data on such surveillance?

Mr Johnston—I would like to clarify that we are here talking about the annual compliance plan audit. These are the compliance plans that were qualified by the auditor; this is not just our normal surveillance of breaches.

Senator WONG—Can we go to that then? Can you give me some information about your most recent surveillance data?

Mr Hughes—I am quoting from memory here, but in the last year, ended 30 June 2002, we have undertaken surveillances in relation to something in the order of 90 to 100 schemes and about 120 responsible entities. Those have been a combination of what we call reactive or complaints based surveillances, where we act on a complaint, and in addition to those matters we have also undertaken some specific campaigns identifying concerns in the primary production area, which we regard as high risk.

Senator WONG—Are you able to give us any percentages on breaches or compliance failure in relation to those surveys? Did you say the most recent was 90 to 100?

Mr Hughes—I would prefer to give that evidence in private if I may. We are not in a position to release our findings publicly at this stage. I request that we go in camera.

Mr CIOBO—Before we go, are there any further questions to be asked in public?

Senator WONG—No.

Evidence was then taken in camera—

Committee adjourned at 10.49 a.m.