Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

31 May – 2 June 2011

Question No: BET 8

Topic: LKM Capital

Hansard Page: Written

Senator Cameron asked:

1. Did LKM Capital or the trustee, Sandhurst Trustees, have any obligation to advise debenture holders promptly of the Continuous Disclosure notice of 29th February 2008 lodged by LKM Capital?

Answer:

We have obtained copies of correspondence that supports the representation that LKM wrote to investors to inform them that they had completed a continuous disclosure notice that was available on their website and could be obtained free of charge by calling LKM.

We also note that the 28 February 2008 Notice, was published on ASIC's website with the release of Report 127 in April 2008. This was part of the process by which ASIC intended to make the information generally available. Report 127 also provided a summary of all unlisted, unrated debenture issuer's disclosure, including commentary on LKM's disclosure confirming the reasons it failed to meet certain benchmarks.

On 25 March 2008, ASIC's former Chairman, Mr Tony D'Aloisio, wrote to each unlisted, unrated debenture issuer, including LKM seeking information on how the new benchmark disclosure had been brought to the attention of investors. On 3 April 2008, Mr Rolf Koops, a director of LKM, responded stating:

"I confirm that LKM Capital has communicated its benchmark disclosres [sic] to its investors by way of a letter informing of the benchmarks and directing them to the LKM Capital website to access a copy of the Continuous Disclosure Notice lodged with ASIC."

This information is also consistent with the representation in LKM's Continuous Disclosure Notice dated 30 June 2008.

2. For the purposes of paragraph 69.110 of Regulatory Guide 69, what is the period of time within which a trustee would be considered by ASIC to have advised investors "promptly"?

Answer:

We note Paragraph RG69.110 states:

"RG 69.110 If a trustee forms the view that an issuer is failing to meet the promises made in its disclosure documents, or that there have been material adverse changes in the financial position or performance of the issuer, the trustee should notify both ASIC and the investors promptly. For serious matters, we would expect the trustee to seek appropriate court orders or call a meeting of investors and seek their instructions about what action to take."

The minimum period of time that a trustee should notify ASIC and investor is not specified but will depend on what is reasonable in the circumstances. Once a trustee has made appropriate inquiries and satisfied itself that there is a material adverse change to the financial position or performance of the issuer, the trustee should notify ASIC.

In these circumstances, ASIC will consider stopping any current prospectuses and require disclosure to be made by way of supplementary or replacement prospectuses, or if there is not a current disclosure document in the market, ASIC will also require an issuer to inform investors under its continuous disclosure obligations. In some matters, ASIC will consider seeking orders in the Court.

If an issuer is failing to meet promises made to investors under a prospectus, the promptness of any notification may also be determined by the terms of the trust deed (the usual notice periods for addressing or remedying defaults vary depending on the trust deed) that may provide notice periods for trustee to remedy any breaches of the trust deed. In these cases, the promptness of notifications will be determined by whether the breach will materially prejudice debenture holders.

We also note that if the trustee is aware that investors are rolling-over their investments and not being provided disclosure due to an exception in section 708(14) of the Corporations Act that provides that disclosure need not be provided to existing investors, or even offers to new investors, the promptness of any trustee actions will be assessed with regard to the risk that new money has been received or rolled-over.

3. What are the parameters in the Corporations Act against which ASIC will judge whether or not an issuer or trustee has notified investors and ASIC "promptly" of any material adverse change in the financial position or performance of a debenture issuer.

Answer:

As discussed, there is no specified minimum in which to notify investors. However, in many instances a materially adverse change in the financial position of the issuer may give rise to a breach of the trust deed (for example, a breach of a covenant or ratio). The parameters in the Corporations Act include the Trustee's powers to call meetings of debenture holders in section 283EB of the Corporations Act. It provides that a Trustee may call a meeting in the event of an issuer failing to remedy any breach of the terms of the debentures or provisions of the trust deed or Chapter 2L of the Act, when required by the Trustee.

At the meeting, the trustee may inform the debenture holders of the failure; submit proposals for protection of the debenture holders' interest to the meeting; and ask for directions from the debenture holders in relation to the matter. Therefore, the trustee must act promptly after the expiry of the notice period the trustee has given for the breach to be remedied. The trustee would also have the option of applying to the Court, under Part 2L.8 of the Act, for directions or to determine questions in relation to the interests of debenture holders.

4. Is it ASIC's position that it only "recommends" but does not require trustees having knowledge of material adverse changes to the financial position of an issuer to promptly notify ASIC and retail investors of that information?

Answer:

In some situations there is a statutory obligation to notify ASIC (see s283DA(e)) of non-compliance with reporting obligations. Strictly, this does not require notification of material adverse change in all circumstances, but ASIC's policy in RG69 is that a trustee should notify ASIC promptly of any materially adverse change. We consider that if the information was not public, then both the issuer and the trustees should take steps to ensure that the market and investors are informed. Paragraph RG69.120 states that:

"The trustee has the power to call meetings of the investors and provide information to and make recommendations to the investors: s283EB. This is an important protective measure, as the trustee has greater resources and experience than retail investors, and is therefore more likely to identify issues with the financial position and performance of the issuer."

5. If ASIC only "recommends", does ASIC believe that retail investors in debentures should be made aware of this, so that they may be aware that the obligations placed on trustees and issuers under Regulatory guides 69 and 198 aren't really obligations at all.

Answer:

ASIC's regulatory guides explain how ASIC interprets and administers the law, describe the principles underlying our approach and gives practical guidance. Therefore, RG69 sets out what trustees and issuers should do in complying with their obligations.

RG198 specifies that a prospectus for an unlisted disclosing entity must identify how it intends to comply with its disclosure obligations.

When RG69 was implemented, the intent was to make sure that investors obtained relevant information. This approach was the basis for: our guidance in paragraph 110; seeking confirmation from issuers that they had brought the new benchmark information to the attention of investors; and also making information available to investors on our website (including posting entity specific benchmark disclosure on ASIC's website and also in the release of ASIC Report 127.

In RG 198, we also outlined how information was to be posted on an issuer's website and that investors were told how information would be available on an on-going basis. This was a further attempt to ensure that continuous disclosure could work effectively in the context of unlisted

disclosing entities without the benefit of a readily accessible and free of charge announcements platform.

ASIC and Treasury are having discussions about the issues raised in RG198 and consideration is being given to the need to amend the law." Apologies if it has already gone to the Chairman, but this amendment highlights we have been on the front foot in raising and dealing with the issues Senator Cameron is concerned about, in particular our letter to Treasury acknowledges that certain investors (including the elderly) may need special consideration. I confirm that Treasury are comfortable with this approach.

6. Does ASIC believe that there is sufficient protection in expecting often elderly retail investors to conduct their own searches on the ASIC website and subsequently purchase the necessary documents to carry out their own due diligence? Wouldn't investors be better served by trustees and/or unlisted issuers being required to disclose lodgement of continuous disclosure notices directly to retail investors.

Answer:

Further to our comments on question 5 above, we have recognised that the regime may not be effectively serving the needs of all investors and reform may be appropriate. ASIC would be supportive of any proposal that assisted all investors to access information and make timely and informed investment decisions. In RG69, we expect to update benchmarks updated at least twice yearly when they provide quarterly reports to the trustee. As part of another project, we took steps around February 2010, to ensure that anyone accessing a quarterly report containing benchmark disclosure from ASIC would be able to do so free of charge.

7. In its letter to Mr. di Suvero of 9th May 2011, ASIC does not say that it is satisfied that there have been no breaches of the Corporations Act by LKM or the Sandhurst. ASIC merely says that it does not intend to take further action.

a. Does this mean that LKM Capital or the trustee may have breached the Act but ASIC will take no further action?

Answer:

When advising an individual that ASIC is not taking further action with respect to his/her complaint, this does not necessarily mean that there has not been a breach of the legislation we administer. It may be that there is a breach, however having weighed up all the relevant factors, ASIC has made the decision not to conduct further enquiries or investigations. However, there will be circumstances where due to resourcing restrictions ASIC does not take further action, having prioritized other matters instead.

The "How to complain about companies or people" webpage on the ASIC website clearly states:

We weigh every complaint we receive against four basic questions:

- *What legal action can we take?*
- *Is the evidence likely to be sufficient?*

- *Which complaint is the most urgent and serious?*
- *If we succeed, will people behave better in the future?*

We often receive complaints from consumers who want help getting their money back. Even if we believe there has been misconduct, we generally won't be able to recover money for you. Often you will need to get your own professional advice.

In relation to Mr di Suvero's complaint, ASIC's letter dated 9 May 2011 was merely confirmation of ASIC's position as outlined in an earlier, more extensive, letter dated 29 March 2011. The letter dated 29 March 2011 addressed each of Mr di Suvero's concerns and explained why ASIC had formed the view at that time that it would take no further action in specific detail.

It is also relevant to note, in corresponding with the general public, ASIC is limited in what information it can disclose. *Regulatory Guide 47 – Public comment* outlines ASIC's position in relation to making public comments. ASIC is restricted from releasing information on a number of grounds, including: legal restrictions; policy reasons; pragmatic restrictions and also resourcing restrictions.

b. What are the criteria on which ASIC decides to investigate and/or prosecute trustees or issuers of debentures for possible breaches of the Corporations Act?

Answer:

There are no set criteria which ASIC uses to decide whether to investigate a matter. Each case will be judged on its own merits and the factors that ASIC may take into account will include the seriousness or any potential breach, the antecedents of possible wrongdoers and the losses which have been incurred by investors and the risk of similar wrongdoing.

In relation to any prosecution, ASIC may provide a brief of evidence to the CDPP which will then take the decision as to whether or not criminal proceedings should be commenced.

8. Does ASIC have any concerns about the lengthy, open-ended periods in which entities like LKM can be under administration, particularly given that some investors just don't have an open-ended period of time to wait for recovery of whatever capital is left?

Answer:

ASIC is aware that the administration period for some debenture issuers who have carried on mortgage financing and investment business can be longer than other external administrations. The borrowing 'short' and lending/investing 'long' nature of the business model will sometimes mean that assets cannot be realised in a short period of time unless sold at a considerable discount.

This means that delays are inevitable in realising some assets, though should only takes as long as is reasonably required to provide the best outcome for debenture holders. We understand that retirees are in an extremely difficult position.

When ASIC released RG69, we introduced an investor guide and it discusses concepts particular to debenture issuers and the benchmarks, but also discusses matters around diversification.

9. Does ASIC have any concerns about the possibility that receivers can effectively be "feeding off the carcass" in administrations such as that of LKM Capital?

Answer:

ASIC is aware from the LKM Receivers reports to debenture holders that;

- the Receivers fees total $2.3m (for the period from 1 August 2008 to 31 January 2011),
- total actual and estimated asset recoveries amount to between $32m and $40m on assets with a book value of $61m and
- an estimated distribution to debenture investors within the range of 45 to 55 cents in the dollar (a dividend has already been paid of 20 cents in the dollar).

Receivers remuneration is generally approved by their appointor and paid from the funds realised by them depending upon the terms of the mortgage debenture. The LKM R&M's remuneration would be expected to be approved by the LKM Trustee of the Debenture holders pursuant a Debenture agreement and /or a deed of indemnity and/or deed of appointment. The Corporations Act also empowers the Court to fix remuneration (under s425(1)) and the Court may also vary or amend a remuneration order (under s425(5)) on application of the company liquidator, Administrator, administrator of a deed of company arrangement or ASIC.

ASIC has not undertaken a review of the LKM R & M's remuneration as it is a matter between the R&M and the Trustee and makes no comment as to the reasonableness of the remuneration.

Background; On 1 August 2008, Sandhurst Trustees Limited, as Trustee of the Debenture holders ("the Trustee") appointed Brian Silvia and Andrew Cummins of Ferrier Green Krejci Silvia as Receivers and Managers ("R&Ms") over the assets of LKM; the assets being subject to the Trustee's security.

It is expected that the R&M's remuneration would be approved by the Trustee pursuant to a deed of indemnity and/or deed of appointment.

In the most recent (tenth) report to debenture holders dated 21 April 2011, the R&Ms report that a dividend to debenture holders of 20 cents in the dollar has been paid with a total estimated return after realisation and receivership costs will be within the range of 45 to 55 cents in the dollar.

The R&Ms ninth report to debenture holders dated 29 November 2010 reports total remuneration paid of $2,012,019 and shows tasks performed include asset realisations, investigation into the affairs of the company, and conduct of a public examination with a breakdown of $300k relating to the legal proceedings / public examinations, $1M to asset realisations, $400k to the management and sale of the retirement villages, $200k to report to debenture holders and attending to their queries, and $100k to general administration matters.

R&Ms reported, in the most recent Form 524receipts and payments (from 1 August 2008 to 31 January 2011)lodged with ASIC, fees totalling $2.318m.

The ninth report to debenture holders dated 29 November 2010 provides a breakdown of the estimated realisations as follows;

Asset Class	Book value 31 July 2008 ($m)	Recoveries to 31 October 2010 ($m)	Forecast High Range ($m)	Forecast Low Range ($m)
Loan Portfolio	32.5	20.3	26.7	23.4
Property Portfolio	10.0	2.6	4.2	3.6
Retirement Villages	9.6	-	4.2	4.2
Private Equity	9.2	-	5.0	1.0
	$61.3	$22.9	$40.1	$32.2

10. Does ASIC have any concerns about the general level of receivers' fees and professional costs in administrations where the value of the assets under administration is relatively low and can have a significant negative impact on the final return to investors?

Answer:

Remuneration of Receivers and Managers is generally approved by *their appointor or by the Court.*

Remuneration of Liquidators and Voluntary Administrators must be approved by the approving party [Committee of inspection, creditors or the Court]. The Corporations Act empowers the Court to review remuneration claims and confirm, increase or decrease that remuneration.

ASIC does not have statistical data to allow an assessment of the relationship between assets recoveries, remuneration charged and returns to creditors.

When ASIC undertakes a review of practitioner remuneration it will assess the compliance by insolvency practitioners with procedural requirements as set out in the Corporations Act and based on the facts of the specific matter.

Value for money from insolvency services

ASIC had noted in its submission to the Senate Inquiry that as part of its forward program, it aims to obtain statistical data from practitioners to allow an assessment of the relationship between asset recoveries, remuneration charged and returns to creditors.

On 2 June 2011 Parliamentary Secretary Bradbury and Attorney General McClelland released an options paper titled "A Modernisation and Harmonisation of the Regulatory Framework Applying to Insolvency Practitioners in Australia" as the Government's response to the Senate Committee Inquiry Report into the regulation, registration and remuneration of insolvency practitioners in Australia and ASIC's involvement and activities. The Options Paper seeks submissions to improve value for money for recipients of insolvency services. ASIC is following this matter closely.

Receivers remuneration

It is standard practice that mortgage debentures provide that receivers and managers appointed shall be agents of the company. In general, the company is the appointees' principal and is liable for their remuneration if the appointment is made under a mortgage debenture. The receivers are generally entitled to recover from the funds realised by them, their costs, expenses and remuneration attributable to the realisation.

The quantum of remuneration of Receivers and Managers and the basis of approval will depend on the wording of the mortgage debenture, although the IPA code provides some guidance.

The Corporations Act gives power to the Court to fix remuneration under s425(1) and the Court may also vary or amend a remuneration order under s425(5) on application of the company liquidator, Administrator, administrator of a deed of company arrangement or ASIC.

Remuneration for liquidations and voluntary administrations

As per ASIC submission to Senate Inquiry into the Conduct of Insolvency Practitioners and ASIC's Involvement:

- The key elements of the regulatory framework dealing with an insolvency practitioner's remuneration are the requirements that:

  - remuneration must be approved by the approving party [Committee of inspection, creditors or the Court];

  - the insolvency practitioner must provide sufficient information to enable the approving party to assess whether the remuneration is reasonable; and

  - if the remuneration is referred to the court for review, the court must have regard to whether the remuneration is reasonable taking into account any or all of a number of matters prescribed in the Corporations Act.

- ASIC's role in the approval process is limited to monitoring the compliance by insolvency practitioners with procedural requirements. In certain circumstances ASIC has the power to refer a remuneration claim to the court for review.

11. Is one effect of an unlisted disclosing entity being placed under administration to effectively remove it from the normal oversight and regulation that it would otherwise be under in accordance with regulatory guides 69 and 198? What regulatory function or oversight does ASIC have over an unlisted disclosing entity where administrators and/or receivers have been appointed?

Answer:

We note that section 283BG provides that a debenture issuer does not need to provide quarterly report to ASIC or the trustee during an external administration , including where a receiver is appointed. ASIC has also provided relief from reporting obligations, in accordance with our policy in RG174, as we consider that the members have no ongoing economic interest in the company. In

these circumstances, as any cost associated with preparing and lodging financial reports will be borne by creditors (or debenture holders in this case), we consider that relief is appropriate.

a. Is one effect of an unlisted disclosing entity being placed under administration to effectively remove it from the normal oversight and regulation that it would otherwise be under in accordance with regulatory guides 69 and 198?

Answer:

The appointment of an external administrator to any company, including unlisted disclosing entities, has virtually the same effect on all stakeholders: debts due to debenture holders are frozen, assets are realised with the proceeds of sale distributed in accordance with the priorities set down in the Corporations Act, with investors/shareholders being last in priority.

The very nature of insolvency, liabilities exceeding assets, and accordingly, shareholders funds and value, are therefore worthless. Unsecured debenture holders do not fare much better and rarely receive a significant level of return in the dollar.

Continuous disclosure obligations are found in *Regulatory Guide 198: Unlisted disclosing entities: Continuous disclosure obligations,* and *Regulatory Guide 69: Debentures and unsecured notes: Improving disclosure for retail investors.*

These Regulatory Guides are important in the context of solvent entities only.

Insolvent unlisted disclosing entities are dealt with under the terms of *Regulatory Guide 95: Disclosing entity provisions relief.* RG95.49b discusses relief available to: *Unlisted disclosing entities when disclosure of information which is confidential and unreasonably prejudicial* (to those entities).

Such relief may be granted *"if disclosure would expose trade secrets, matters under negotiation [such as the value of assets for sale], or other matters still under negotiation and details of disputes"* (RG95.49b).

Accordingly, if an external administrator is appointed to an unlisted disclosing entity, it would be quite likely that relief would be sought by the external administrator from the relevant disclosure provisions as the disclosure of asset values or important negotiations for sale, would prove prejudicial to the interests of investors and unsecured debenture holders.

The various insolvency provisions of the Act, namely 438D and 533 plus the requirements to lodge regular accounts of receipts and payments, require the preparation of certain reports to the regulator and unsecured creditors in the instance of the appointment of a Voluntary Administrator or Liquidator. A Receiver and Manger is not required to communicate with unsecured creditors.

b. What regulatory function or oversight does ASIC have over an unlisted disclosing entity where administrators and or receivers have been appointed?

Answer:

The fact that an entity is an unlisted disclosing entity does not make detract from the usual requirements placed upon external administrators to report to ASIC, or if required, to account to the Court pursuant to Section 536 of the Act.