CHAPTER 2

INQUIRY BACKGROUND AND OBJECTIVES

Introduction

2.1 The *Managed Investments Act 1998* (MIA) introduced a new structure for managed investment schemes so that a single responsible entity (RE) would carry full responsibility for a scheme and any liability for losses. The Act took over from the prescribed investments system (dual-party system) in which funds management was shared by a fund manager and trustee, with the lines of accountability to investors unclear.[1]

2.2 The chief object of the legislation was to increase investor protection in an era of unprecedented growth in managed investment schemes. The trend overall was buoyed by the deregulation of financial markets in the 1980s, which saw a proliferation of collective investment vehicles—from the largest commercial property and management trusts to small one-off schemes such as pine forests, ostrich and yabby farms. The Government's support for self-funded retirement, following the introduction of compulsory superannuation in 1992, further stimulated growth in this sector during the 1990s.

2.3 However, the commercial property crash at the end of the 1980s drew attention to the regulation of managed investments. In particular, the collapse of Estate Mortgage in 1989 highlighted the deficiencies of the dual-party structure, with fund managers and trustees in dispute about their liability for fund failure. Shortly after, another investment scheme, Aust-Wide, also collapsed. The resulting loss of investor confidence, with requests for redemption continuing to outstrip applications for unit trusts, suggested that a comprehensive review of the regulation of collective investment schemes was required.[2]

2.4 Responding to the situation, the then Attorney-General, the Hon. Michael Duffy MP, commissioned the Australian Law Reform Commission (ALRC) and the Companies and Securities Advisory Committee (now the Corporations and Markets Advisory Committee) to inquire into the regulation of managed investments.

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1 The information in this section is drawn from various sources, including the report of the Australian Law Reform Commission and Companies and Securities Advisory Committee, *Collective Investments: Other People's Money, Report No. 65*, 1993; Second Reading Speeches for the Managed Investments Bill 1997 in March, May and June 1998; the Turnbull Review and, as otherwise indicated, in text notation.

2 *Collective Investments: Other People's Money, Report No. 65,* 1993, vol. 1, pp. 1–3.

2.5 The report, *Collective Investments*: *Other People's Money, Report No. 65* (ALRC/CASAC report), was presented in 1993. It found that the dual-party structure of managed investment schemes was fundamentally flawed. The report recommended that, for every scheme, there should be a single RE in which the functions of both the trustee and the fund manger would be vested.

2.6 In 1995, the Labor government released draft legislation for discussion. Its proposal to reform managed investments regulation also provided for single RE arrangements but included a mandated requirement for a separate custodian to hold scheme funds.

2.7 In March 1997, the single RE proposal was endorsed by the Financial System Inquiry (FSI). Recommendation 89 of the *Financial System Inquiry Final Report* (Wallis Report) advised that regulation of managed investment schemes and superannuation should be harmonised 'to the greatest possible extent by bringing the structure of collective investments into line with that for superannuation funds, by introducing a requirement for a single responsible entity'.[3] The Wallis Report did not comment on custodianship of scheme assets, however.

2.8 Following these findings, the Liberal government, in consultation with key industry participants, drafted new legislation to reform the regulation of managed investments.

The Managed Investments Bill 1997

2.9 The Managed Investments Bill 1997 was introduced into the House of Representatives on 3 December 1997 and the Senate on 5 March 1998. The recommendations in the ALRC/CASAC and Wallis reports, as well as the draft legislation put forward in 1995, influenced the form and content of the Bill.

2.10 In his second reading speech on the Bill, the Parliamentary Secretary to the Treasurer, Senator the Hon. Ian Campbell, explained that the new Bill dispensed with the requirement for a mandatory custodian by imposing statutory duties on the RE with respect to the property of any schemes managed. These duties would ensure that:

- scheme property was clearly identified as such; and
- scheme property was held separately from the property of the responsible entity or of any other scheme.

2.11 The RE of a managed investment scheme would have the choice of determining how these requirements would be met. Senator Campbell noted, however, that the Government expected many REs would find it more convenient to appoint a custodian to hold scheme assets. The Australian Securities and Investments

3 Wallis Report, pp. 490-1.

Commission (ASIC—then the Australian Securities Commission) would be given powers to require the appointment of a custodian on a case-by-case basis.[4]

2.12 Under the regime, REs would be subject to a comprehensive and rigorous compliance regime, overseen by ASIC. The Bill contained provisions requiring that:

- a managed investments scheme had to be registered with ASIC if a scheme had, among other things, more than 20 members;
- an RE had to be a public company and was to meet stringent compliance requirements to be licensed by ASIC;
- as part of the licensing requirements, the RE had to lodge with ASIC a compliance plan detailing the measures the RE had in place to operate the scheme to ensure compliance with the law and the scheme's constitution (these measures would include arrangements for the custody and protection of scheme property);
- an RE had to satisfy compliance requirements by having a board of directors, half of whom were independent, or by setting up a compliance committee, with half the membership being independent; and
- a member of a registered scheme who suffered loss or damage because of the RE's contravention of legal requirements could seek damages in a civil action against the RE.

2.13 The new arrangements were commended to the Senate as containing measures to ensure a 'high level of compliance' and being a significant improvement on the previous system. A two-year transitional period would apply for existing schemes to comply with the proposed new regime.[5]

The Committee's report on the Bill

2.14 During debate on the Bill, concerns were raised about:

- ASIC's significantly increased responsibilities under the new regime and the difficulty—without knowing what would be in the relevant policy statements and regulations—in assessing how ASIC would implement the legislation and whether it would have the resources to do so effectively; and
- the lack of a mandatory requirement for a custodian.[6]

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4 Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, p. 447.

5 Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, pp. 445-8.

6 See, for example, Mr Kelvin Thomson MP, Second Reading Speech, *House Hansard*, 3 March 1998, pp. 237-9, Mr Stephen Martin MP, Second Reading Speech, *House Hansard*, 4 March 1998, p. 364 and Senator the Hon. Peter Cook, Second Reading Speech, *Senate Hansard*, 28 May 1998, pp. 3345-6.

2.15 This Committee, then known as the Parliamentary Joint Committee on Corporations and Securities, initiated an inquiry into the Bill and produced its report in March 1998. With only a short time to inquire into and report on the matter, the Committee concentrated on the key issues of investor protection, the use of custodians, management and administration costs, increased flexibility, and ASIC issues relating to resources and policy.

2.16 The majority report of the Committee found that:

- the single RE arrangements were an improvement on the previous system;
- it was reasonable to assume that the streamlined arrangements introduced by the Bill would result in savings for investors; and
- the single RE arrangements would encourage innovation in the managed investments industry.

2.17 The report noted that the Government had made commitments to adequately fund ASIC to carry out its new responsibilities but that it would draw Parliament's attention to any shortfall, as part of its ongoing scrutiny of ASIC. The Committee also suggested that ASIC's policy on capital adequacy and the use of separate custodians should be considered in the review to be conducted by the Department of the Treasury at the end of the two-year transitional period.

2.18 With these factors considered, the Committee majority recommended that the Bill should be passed in its current form. The Australian Democrats, however, submitted a minority report on the Bill. In the minority report, Senator Andrew Murray emphasised that an independent custodian was a minimum international requirement for investor protection. He recommended that, if a trustee was not to be part of a scheme, an independent custodian should be required, unless exempted by ASIC. He argued that small business would be disadvantaged under the new arrangements and proposed that investors have a choice about what system they operated under. The Australian Democrats also requested that capital adequacy amounts be provided in the Bill and that the Bill be reviewed five years after assent.

Commencement of the *Managed Investments Act 1998*

2.19 The Managed Investments Bill 1997, with amendments, received assent on 29 June 1998. The amendments, moved by Labor and Democrat Senators with the support of the Greens, included provisions for capital adequacy amounts to be specified in the legislation. The other principal amendment, at section 3 of the Act, called for a review of its operation. It provided that the Minister must cause a review to take place as soon as possible after the third anniversary of the Act's commencement. The review was to be tabled in Parliament within six months of that anniversary.[7]

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7 Managed Investments Bill 1997, *Schedule of Amendments made by the Senate to which the House of Representatives has agreed*, 25 June 1998.

2.20 The *Managed Investments Act 1998* commenced on 1 July 1998. It inserted Chapter 5C into the Corporations Law[8], replacing the dual-party provisions with the new regulatory arrangements. Other amendments to the Corporations Law effected changes relating to the licensing of scheme operators and the appointment and removal of auditors of managed investment schemes. The *Company Law Review Act 1998* commenced at the same time as the MIA. It inserted companion provisions into the Corporations Law, which revamped company law and included provisions relating to the meetings of scheme members.[9]

2.21 The following table shows the scope of regulatory and operational changes for managed investment schemes under the new legislation.

Table 1: Changes to the operations of managed investment schemes[10]

Old law	**New law**
Manager—public company, usually with securities licence **Trustee** approved by the ASC	**Single responsible entity**—public company with securities dealer's licence; financial and capacity requirements are more stringent than for a general dealer's licence. Prescribed minimum capital requirements.
Scheme assets held by the **trustee** or **sub-custodian** appointed by the trustee	Scheme property may be held by the **responsible entity** or another entity as **custodian,** depending on the adequacy of arrangements for holding scheme property and the amount of net tangible assets. In either case, the **single responsible entity** is ultimately accountable for safeguarding scheme assets.
Scheme **registration not required**	Scheme **must be registered by ASIC**
Approved deed with statutory covenants placing obligations on the manager and trustee	**Constitution** with no implied covenants, but the law requires it address certain matters and imposes responsibilities on the responsible entity
No specified compliance arrangements	**Mandatory compliance arrangements,** including an audited compliance plan and a board or compliance committee with external members
No compliance with related party provisions of Corporations Law (prior July 1998) but some restrictions on related party transactions	**Compliance with provisions for related party transactions** under Chapter 2E of the *Corporations Act 2001*

8 This has been replaced by the *Corporations Act 2001*.

9 Turnbull Review, p. 1 and see the Hon. Peter Costello MP, Treasurer, *Embargo: Treasurer Heralds New Era for Financial System*, Press Release, 1 July 1998.

10 Drawn from a table provided in ASIC's submission to the Turnbull Review, Part 1, pp. 9–10.

2.22 The commencement of these arrangements coincided with the launching of the new regulatory framework for the Australian financial sector. The Australian Securities Commission became the Australian Securities and Investments Commission (ASIC). ASIC took on responsibility for market regulation and consumer protection across the financial system, including for investment and superannuation products.[11]

2.23 ASIC's regulatory responsibilities increased significantly under the new regulatory regime. More particularly, changes to the Corporations Law conferred specific discretionary powers on ASIC to allow the flexibility necessary to cater for scheme diversity.[12]

2.24 The emphasis on ASIC's supervision of the single RE arrangements under the MIA was the main catalyst for Opposition amendments requiring a review of the MIA after its third year of operation. Senator the Hon. Peter Cook, in his second reading speech in May 1998, stated that the review was intended to determine whether the new regime was in fact delivering increased investor protection, and whether ASIC had the capacity to fulfil its mandate as regulator of managed investment schemes.[13]

Review of the Managed Investments Act

2.25 The review undertaken by Mr Malcolm Turnbull commenced its work in August 2001. The results of the review were presented to the Treasurer on 3 December 2001.[14] The review inquiry attracted 31 submissions from industry participants, professional advisers, consumer and investor representatives and members of the public.

2.26 Senator Campbell, when releasing the Turnbull Review on 19 December 2001, announced that the findings of the review indicated that, overall, the regulatory arrangements for managed investments were working effectively. However, the Senator also announced that some matters would be the subject of further consultation between ASIC, the Department of the Treasury and industry participants and stakeholders.[15]

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11 The Hon. Peter Costello MP, Treasurer, *Embargo: Treasurer Heralds New Era for Financial System*, Press Release, 1 July 1998.

12 Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, pp. 445-8. See also the Turnbull Review, pp. 18–19.

13 Senator the Hon. Peter Cook, Second Reading Speech, *Senate Hansard*, 28 May 1998, pp. 3342-6.

14 Turnbull Review, p. 1.

15 *Review of the Managed Investments Act 1998,* Press Release*,* 19 December 2001.

2.27 The review commented that time constraints had limited the review's capacity to make definitive statements about the regime's effectiveness in certain areas, for example, those relating to costs.[16]

2.28 Nonetheless, the Turnbull Review expressed an overall confidence in the integrity of current arrangements. It made a number of recommendations designed to clarify the legislation but rejected proposals for the appointment of corporate compliance committee members and for legislative clarification of the roles and duties of agents appointed by the RE. As indicated previously, it did not examine whether there was a need for mandatory custodianship of fund assets.

Committee' s inquiry into the review

2.29 When the Committee reported on the Managed Investments Bill 1997 in March 1998, it recommended that the Bill be passed. Even so, it expressed one overriding concern—that the Government take care to ensure that the concurrent restructuring of ASIC and the introduction of the new regulatory arrangements for managed investments would not weaken 'actual investor protection and perceived investor protection'.[17]

2.30 The Turnbull Review did not examine in any depth the fundamental elements of the new arrangements. Rather it focused on the effectiveness of the implementation of the new regime. As noted earlier, the timing of the review inquiry process was also tight—only four months—as against the six months allowed under the legislation.

2.31 The Committee considers that the significant changes introduced by the MIA should be closely examined, especially given the continued and growing economic importance of the managed investment sector.

2.32 Since the introduction of the MIA, the assets held in managed investment schemes has almost doubled to $175 billion. Three million Australians have now invested in managed funds.[18]

2.33 Large-scale corporate failures in the past two years have destabilised domestic and overseas financial markets and prompted widespread initiatives for reform. In particular, they have raised questions about the independence of company directors and auditors and how conflicts of interest might be most effectively addressed.

2.34 Given these factors, the Committee believes there is a need for further consideration of the regulatory arrangements for managed investments to ensure they are able to meet the consumer-protection objectives of the MIA.

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16 See in particular, Turnbull Review, p. 58.

17 *Report on the Managed Investments Bill 1997*, p. 9.

18 Figure at March Quarter 2002, Australian Bureau of Statistics, *5655.0 Managed Funds, Australia.*

2.35 An analysis of the issues raised in the inquiry follows in the body of this report.