CHAPTER 3

HAS THE MIA REGIME PROVED ITSELF?

Introduction

3.1 The Committee notes that the objective of the *Managed Investments Act 1998* (MIA) is to protect investors' interests through the effective management of institution and compliance risk. As the introduction to the Department of the Treasury's consultation paper explained:

> …the *Managed Investments Act 1998*…was not designed to safeguard investors against the risk that their investments might decline in value because of relatively poor investment strategies or downturns in the market more generally. Rather the MIA sought to address the shortcomings evident under the dual trustee/fund manager structure of the former regime and minimise institutional and compliance risk.[1]

3.2 *Collective Investments: Other People's Money, Report No. 65*, prepared by the Australian Law Reform Commission and the then Companies and Securities Advisory Committee (ALRC/CASAC report), described these types of risk thus:

- institution risk—the risk that the operator or scheme would collapse and scheme assets would not be adequately protected; and
- compliance risk—the risk that the scheme operator would not adhere to the scheme's rules or to laws governing the conduct of the scheme or otherwise would act fraudulently or dishonestly.[2]

3.3 As previously discussed, the ALRC/CASAC report recommended a single RE structure in which third-party custodianship of assets was not mandatory. The report proposed measures to promote a strong compliance culture within the single RE framework. Among the measures proposed were:

- the requirement for licensing of REs to ensure that sufficient compliance arrangements were in place;
- the requirement that directors would owe clear duties directly to investors and that at least half of the RE's board would comprise non-executive directors; and
- increased surveillance and auditing of the scheme's activities by ASIC and external auditors, the latter having specific reporting obligations to ASIC.[3]

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1 *Managed Investments Act Consultation Paper*, 29 May 2002, p. 2, referred to throughout as the Treasury consultation.

2 Vol. 1, pp. 8-10.

3 ALRC/CASAC report, vol. 1, Chapter 10 (regarding the RE) and Chapter 14 (regarding ASIC).

Key elements of the MIA's regulatory framework

3.4 Under the previous arrangements, the trustee of a scheme was intended to act as the investors' representative and to oversee the day-to-day activities of the scheme manager. The trustee owed fiduciary obligations to investors and was the custodian of scheme assets.

3.5 The ALRC/CASAC report concluded that, within the dual-party structure, the fees payable to trustees often did not generate sufficient revenue to enable them to conduct their supervisory activities effectively. The arrangements were also thought to be inflexible and sometimes in conflict with commercial realities. The ALRC/CASAC report expressed serious concerns that the arrangements encouraged the displacement of responsibility by the scheme manager to the trustee. This, the report said, had caused confusion regarding the accountability of the manager and trustee and so jeopardised the interests of investors.[4]

3.6 Under the MIA, there is no mandatory custodianship of scheme property by an independent trustee. Instead, the MIA vests sole responsibility for the operation of a scheme, including the custody of scheme property, in the single RE. The MIA does not look to a trustee to act as the investors' champion. Rather, it seeks to maximise investor protection through existing corporate governance requirements buttressed by an extensive compliance framework and additional measures to minimise the potential for conflicts of interest. In addition, ASIC has much broader powers and responsibilities under the MIA.

3.7 Apart from the single RE, the MIA framework includes requirements for the registration of certain schemes by ASIC.[5] Each scheme must have a constitution and compliance plan, the latter setting out how the RE will discharge its statutory obligations to comply with the Act and the scheme's constitution. Specific arrangements must be made for the management and holding of scheme property, internal and external compliance monitoring, and the maintenance of adequate records.

3.8 In addition, an RE must be a public company and hold a financial services licence to operate a scheme.[6] The RE must hold scheme property on trust for scheme members and ensure it is clearly identified and held separately from other property. ASIC may require scheme property to be held by an agent appointed by the RE.[7]

3.9 The RE may appoint agents and is responsible for the acts of its agents even if those agents act fraudulently or outside their authority or engagement.[8] The activities

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4 ALRC/CASAC report, vol. 1, Chapter 12, pp. 132-3.

5 Sections 601EA (regarding documents to be lodged for registration) and 601ED (regarding ASIC's consideration of the registration application).

6 Section 601FA.

7 Subsection 601QA(1).

8 Section 601FB.

of the RE are monitored by an in-house compliance committee which is either the RE's board or a separate in-house compliance committee.[9] A registered auditor who is separate from the auditor who audits the scheme's financial statements must be appointed by the RE to conduct an annual audit of the scheme's compliance plan to determine, among other things, that the RE has complied with the plan.[10]

3.10 The MIA imposes obligations on the RE to report to ASIC as soon as practicable, any breach of the law that relates to the scheme and has had or is likely to have a materially adverse effect on scheme members.[11] Compliance committee members and the compliance plan auditor are also required to report matters to ASIC in certain circumstances where there has been or is a suspicion of a contravention of the law.[12]

3.11 ASIC's role under the MIA is extensive. It is responsible for assessing applications for scheme registrations and REs' licences. It is empowered to conduct surveillance checks of schemes and must be notified by the compliance auditor in certain instances where contraventions of the Act have occurred or are reasonably suspected. It is required to take the appropriate enforcement action in relation to breaches by the RE or others involved in its operation.

The MIA's performance to date: an overview

3.12 The Turnbull Review did not draw any firm conclusions about the effectiveness of the MIA's compliance arrangements.

3.13 This was partly because ASIC had not conducted compliance surveillance under the previous regime. There were consequently no data on which comparisons could be based. Furthermore, the review noted that ASIC's surveillance outcomes for 2000/2001, although pointing to compliance breaches in 69 of the 83 schemes surveyed, were not necessarily a reliable indicator of compliance across the industry. The review attributed this to two factors. First, ASIC's surveillance had targeted expected problem areas and, second, the survey had been conducted during the first year of the regime's operation—a period when a higher non-compliance rate would not be unusual.[13]

3.14 At the Committee's statutory oversight hearing with ASIC in June 2002, Mr Ian Johnston, Executive Director, Financial Services Regulation, confirmed that

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9 Sections 601HA (compliance plan), 601JA (when a compliance committee is required) and 601JC (functions of the compliance committee).

10 Section 601HG.

11 Paragraph 601FC(1)(l).

12 Compliance plan auditor's reporting obligations are in subsection 601HG(4). Compliance committee members' reporting obligations are in subsection 601JC(1).

13 Turnbull Review, p. 58.

ASIC's surveillance results should not be taken as representative of the industry as a whole. In this regard, he stated that:

> In respect of managed investments, we conduct a targeted surveillance program, whereby we look on a risk basis at the sort of activity that is taking place in the sector…there is always a fairly high proportion of corrective action that has to be taken by the people on whom we carry out surveillance. But that can create a misleading impression. Over the past couple of years in respect of our targeted surveillance program, 80 per cent of the participants on whom we have carried out surveillance have been required to take some form of corrective action. That seems very high, but that is because it is a targeted, risk-based program. It is not a random going around the industry completely every year, but it is actually looking at where we think the risks are high and at the participants whom we think are more risky than others. You would expect to see and hope to see a high proportion of corrective action taken. That goes from everything from collecting disclosure to us taking away someone's licence to issuing or launching a prosecution.[14]

3.15 The Investment & Financial Services Association Ltd (IFSA) offered positive feedback about the MIA. At the hearing on 12 July 2002, Ms Lynn Ralph, IFSA's then Chief Executive Officer, commented that:

> …the act is working as originally intended. A strong culture of compliance has developed in those organisations that are responsible for other people's money, and that was the goal of this piece of legislation.[15]

3.16 Mr Geoffrey Lloyd, Member, Regulatory Affairs Committee, IFSA, added that the MIA had prompted an 'enormous change' among directors of REs who characterised their obligations to investors as 'fiduciary'. He concluded that:

> …the depth, breadth and robustness of the compliance environment has seen significant change from what, under the old law, was an environment that allowed dissociation in some instances because of confusion as to where the obligation started and stopped with trustees.[16]

3.17 Mr Lloyd also considered that reporting obligations under the MIA had triggered a more active approach among REs towards identifying and acting on breaches or potential breaches. He commented that:

> [The MIA's reporting] obligation required people not only to understand their obligations and carry them out but also to focus on any issue, be it a breach or a potential breach, in a timely way. So the compliance environment required that to be identified, flushed up and dealt with in a

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14 *Committee Hansard,* 17 June 2002, pp. 17–18.

15 *Committee Hansard*, 12 July 2002, p. 24.

16 *Committee Hansard*, 12 July 2002, p. 25.

> senior way across the organisation in as timely a manner as possible, which is the key.[17]

3.18 At the hearing on 12 July 2002, Mr Paul Dortkamp advised the Committee that the growing demands of compliance across the industry had prompted the establishment of the Independent Compliance Committee Members Forum (ICCM Forum) in 1999. As a co-founder, he had felt there had been a need to set up a venue 'for the externals or independents' to swap ideas and so encourage the growth of a better educated and professional compliance sector.[18]

3.19 Mr Dortkamp said the MIA had generated 'a very large shift' in awareness of compliance and risk management among large fund managers that had filtered down to the small end of the market. He also noted that the requirement for REs to be licensed had forced them 'to really go through and lay out chapter and verse what their compliance regime will be' when otherwise they would not have done this.[19]

3.20 Mr Dortkamp thought the compliance committee's obligation to report breaches or potential breaches to ASIC was a highly effective compliance tool which kept REs in line. In this regard, he said:

> It is a great weapon to have on a compliance committee—the fact that we have the obligation to take things through to ASIC if we do not feel they are being dealt with adequately by the RE is a phenomenal threat. In any time of difficulty, you only have to breathe the word and people become very efficient at providing material that was slow coming, if I can put it that way.[20]

3.21 In a similar vein, Mr Russell Stewart, Partner, Minter Ellison Lawyers (MEL), considered the need for REs to maintain their licences to be a very effective regulatory tool as it provided a real incentive for REs to comply with requirements and report breaches in a timely way. He said that:

> In practice, what I am seeing quite frequently is that the fund managers take very seriously the obligation to report immediately to ASIC any breach. The reason they take that seriously is because, if they fail to do that and they are caught, that could prejudice their licence. I have come to the view that that has been the most powerful mechanism within many of the fund managers for identifying and promptly reporting compliance breaches.[21]

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17 *Committee Hansard*, 12 July 2002, p. 25.

18 *Committee Hansard*, 12 July 2002, p. 59.

19 *Committee Hansard*, 12 July 2002, p. 59.

20 *Committee Hansard* , 12 July 2002, p. 62.

21 *Committee Hansard,* 11 July 2002, p. 17. (Mr Stewart's evidence was given in a personal capacity and not as a representative of Minter Ellison Lawyers.)

3.22 ASIC was more reserved about the effectiveness of the RE's reporting obligations and advised the Committee that while some REs were diligent about reporting breaches to ASIC, 'others [were] less forthright'.[22]

3.23 In relation to the effectiveness of the MIA regime overall, Mr Johnston, ASIC, was somewhat equivocal. While he thought the MIA had secured a higher awareness of compliance than was formerly the case and pointed to the protection offered by in-house compliance monitoring, he opined that it was perhaps too early to give a 'strong opinion' that the new framework was working completely. He said that:

> We have not seen…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.[23]

3.24 Before considering submitters' comments on MIA regulation in the context of this inquiry's terms of reference, a logical first step is to consider whether the MIA has been sufficiently tested by market stresses to have proved its efficacy.

Stress-testing by the market

3.25 The Turnbull Review adverted to the difficulties in assessing the effectiveness of regulation under the MIA in a time of relative buoyancy in financial markets. It did not refer to the events of 11 September 2001, possibly because these were not regarded as exerting sufficient stresses on the market to constitute a credible test.

3.26 The Department of the Treasury, when asked at hearings about whether the September 11 market shock had been a significant test for the MIA, appeared to think not and responded that:

> …we would concur with Mr Turnbull's findings that it is quite early days, that a lot of 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.[24]

3.27 Contrary to the Department's conclusions, IFSA referred to the events of September 11 as 'quite a major shock' from which the MIA had emerged with 'a pretty good report card'.[25]

3.28 Mr Lloyd, IFSA, commented that, in contrast to what the situation would have been with the former dual-party structure, the MIA had enabled REs to respond to the

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22 Mr Sean Hughes, *Committee Hansard*, 7 August 2002, p. 101.

23 *Committee Hansard*, 7 August 2002, pp. 100–1.

24 Mr Nigel Ray, *Committee Hansard*, 7 August 2002, p. 86.

25 Ms Lynn Ralph, *Committee Hansard,* 12 July 2002, p. 26.

September 11 crisis in an effective and timely way. As a result, investors' funds could be protected. In this regard, he said:

> I wonder what would have happened in the old environment to get out an answer as fast as that (for September 11)…[Under the old regime] you had two parties trying to understand what their obligations were and where the deeds started and stopped…It was very difficult to get a timely answer. It was because not one party but two parties had to make that decision. They had their own internal questions…and they obtained their own external opinions. With September 11 we saw a timely, appropriate response from the market that, even with the benefit of hindsight, cannot be second-guessed.[26]

3.29 Mr Michael Shreeve, National Director of the Trustee Corporations Association of Australia (TCAA), asserted that the events of September 11 did not test MIA arrangements, because:

> What essentially happened was that redemptions were suspended, and a genuine stress test to us is when large scale redemptions actually occur—only then do you see if purported assets are really there and the values claimed.[27]

3.30 Mr Jonathan Sweeney, Managing Director, the Trust Company of Australia Limited (TCAL), agreed with the TCAA that the response of the managed funds sector to September 11 was not a sufficient test to prove the MIA's effectiveness. In this regard, he commented that:

> …the system has to be put under stress to find out. When the going is good, there are no problems, because markets are rising. Rising markets hide problems; falling markets do not. You need a real stress, a real shock to the system, to test it. The effects of September 11, when you look at them, lasted for only a couple of weeks and then the markets came back. Sure they have drifted off recently, but a lot of the funds froze, so we do not really see that as a stress either.[28]

3.31 Mr Sweeney referred to an aspect of the MIA which he considered encouraged systemic weaknesses in the industry. He commented on the falling numbers of smaller funds entering the market which he attributed to raised barriers to entry brought about by the MIA. This, he said, had promoted the growth of large funds and correspondingly greater opportunities for abuse because:

> …scale enables you to hide mistakes more easily…you have a wider pool of assets to amortise them across, and they are less material.' [29]

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26 *Committee Hansard*, 12 July 2002, p. 26.

27 *Committee Hansard*, 12 July 2002, p. 47.

28 *Committee Hansard*, 11 July 2002, pp. 10-11.

29 *Committee Hansard,* 11 July 2002, p. 11.

3.32 Continuing on this theme, he added:

> …the whole point of funds management is that you are going to get some things wrong and…some things right…The consumer protection element of the Managed Investments Act…was to stop malfeasance and to stop other people's money being taken illegally, inappropriately, unethically…A shock can cause commercial pressure to make that decision harder and harder to avoid in some organisations that are stressed…To me, the market move stresses are secondary. Really, once you get to a size and a position of control, it increases the opportunity for someone to work the system harder for their benefit.[30]

The Committee's views

3.33 The Committee notes ASIC's evidence that it is too early to draw any definite conclusions that the MIA regime is working well. Certainly, on the basis of evidence provided during the inquiry, the Committee is not persuaded that market conditions, including the September 11 crisis, have exerted sufficient stresses on the managed investments industry to test the MIA's effectiveness.

3.34 The TCAL's suggestion that the MIA has favoured large fund managers, is of some concern to the Committee because of the potential impact this could have on fund diversity, fees paid by investors and protection of investors. These issues are touched on in Chapter 8, Costs and Fees.

3.35 Nonetheless, the Committee notes the evidence that the MIA has prompted the growth of a vigorous compliance culture and is encouraged by the contribution in this area made by the ICCM Forum.

3.36 The following chapter looks closely at compliance requirements under the MIA.

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30 *Committee Hansard*, 11 July 2002, pp. 11-12.