CHAPTER 4

THE COMPLIANCE COMMITTEE

Introduction—the compliance plan

4.1 Under the MIA, every registered scheme must have a compliance plan which sets out adequate measures that the RE is to apply to ensure compliance with the Act and the scheme's constitution. The plan must include arrangements for:

- the identification of scheme property and its segregation from other property;
- the scheme's compliance committee where one is required—its membership, frequency of meetings, reporting, access to relevant information and access to the auditor of the scheme's financial statements;
- the regular evaluation of scheme property;
- the auditing of the scheme's compliance plan; and
- ensuring adequate record keeping of the scheme's operations.[1]

4.2 The scheme's compliance plan is the 'hub' of the MIA's compliance framework and, together with additional requirements specified in the legislation, provides the model for implementation of in-house and external monitoring of the RE's activities.

4.3 While the Committee heard encouraging evidence about the growth of a strong compliance culture within the managed investments industry, a number of witnesses alleged there were technical and systemic shortcomings in the MIA that seriously diminished the effectiveness of in-house and external compliance monitoring. The most serious allegations questioned the independence and qualifications of those performing the monitoring role.

4.4 In its *Review of Independent Auditing by Registered Company Auditors*, *Report 391*, August 2002, the Joint Committee of Public Accounts and Audit (JCPAA) examined the meaning of independence in a corporate governance context. The Committee believes the following excerpt from the JCPAA report provides a useful definition:

> The concept of independence is open to various definitions depending on the context in which it is used. In a very general sense, being 'independent' refers to a person or group being self-governing and unwilling to be under obligation to others. More specifically, independence can be seen to have two complementary characteristics:

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1 Subsection 601HA(1).

- a state of mind that allows for opinions to be arrived at without being affected by external influences; and

- a matter of appearance in that facts and circumstances are avoided that would lead a third party to conclude that a person's ability to arrive at an independent opinion has been compromised.[2]

4.5 The Committee will now consider the evidence on in-house monitoring. In the following chapter, the Committee will review external monitoring—the compliance plan audit.

In-house compliance monitors

Eligibility-the meaning of 'external'

4.6 The RE's board or a separate in-house compliance committee is required to monitor the RE's activities to ensure there has been compliance with the scheme's compliance plan. Where less than half of the directors on the RE's board are 'external', a separate compliance committee having a majority of 'external' members must be established.[3] Clearly the meaning of the term 'external' is central in assessing the independence of those involved in monitoring the compliance plan of an RE.

4.7 Under subsection 601JA(2) of the Act, a person qualifies as an external director of the RE's board if the person:

a) is not employed or has not been employed in the previous two years by the RE or a related body corporate;

b) is not or, in the previous two years has not been, an executive officer of a related body corporate;

c) is not or in the previous two years has not been, substantially involved in business dealings or in a professional capacity with the RE or a related body corporate;

d) does not have a material interest in the RE or a related body corporate; and

e) is not a relative or de facto spouse of a person having a material interest in the RE or related body corporate.

4.8 With the compliance committee, the concept of an external committee member is similar to that of an external director and is defined in similar terms.[4]

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2 Joint Committee of Public Accounts and Audit, *Review of Independent Auditing by Registered Company Auditors, Report 391,* August 2002, p. 6.

3 Sections 601JA and 601JB.

4 Section 601JB.

4.9 Generally, the criteria specified in the definition are to ensure that a person will only qualify as an 'external member' if the person is likely to be sufficiently removed from the management of, or interests in, the RE or a related body corporate so the person can undertake compliance monitoring with the requisite impartiality.

4.10 Evidence to this inquiry reflected mixed views about the effectiveness of the definition in guaranteeing the independence of compliance committee members or of the board when acting as a compliance monitor.[5]

4.11 Some witnesses identified what they considered were shortcomings with the definition. They said the definition needed to be tightened to close loopholes which would otherwise enable non-independent individuals to serve as compliance monitors.

4.12 In their joint submission, CPA Australia and the Institute of Chartered Accountants in Australia thought that the definition of 'external director' should provide that the relatives of a person ineligible to be an external director should also be ineligible. They also considered that the reference to 'material interest' should be defined by way of a benchmark which could be adjusted, as required, in the regulations or otherwise set at a percentage of the market value of a scheme.[6]

4.13 Mr Paul Dortkamp, Independent Compliance Committee Members Forum (ICCM Forum), supported the exclusion of relatives and the two-year restriction in the eligibility criteria for compliance monitors and commented:

> The key characteristic of an external is independence. While it would be unfortunate if an appropriately qualified person was excluded because of family ties, this would be a more desirable outcome than an uncritical member of a compliance committee.
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> …There is no doubt that a retired member of a legal or accounting firm has much to contribute as an external compliance committee member. Again while the retired partner may be external, my view is that they seek out compliance committees unrelated to their former firms and the 2-year period be maintained.[7]

4.14 The evidence heard by the Committee regarding the definition of 'external' was consistent with the arguments raised by ASIC to the Turnbull Review that:

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5 In the interests of brevity, references to the compliance committee or the compliance monitor should be taken to include the RE's board when it is performing the compliance monitoring function.

6 Supplementary submission no. 4A, p. 2 of attachment. Another witness, Mr Russell Stewart, Partner, Minter Ellison Lawyers (but appearing in a personal capacity) also commented on the need to clarify 'material interest' so that otherwise well qualified people would not be excluded from a compliance monitoring role. See reference below.

7 Submission no. 10, p. 1.

- the definition of 'external' should prohibit relatives of ineligible individuals acting as compliance monitors; and
- the meaning of 'material' in the definition should be clarified.[8]

4.15 Another criticism of the definition was that the meaning of being 'substantially involved in business dealings or in a professional capacity' was too vague. This, it was alleged, had the effect of excluding otherwise well-qualified people from membership of compliance committees.

4.16 In this regard, Mr Russell Stewart, Partner, Minter Ellison Lawyers (MEL), commented that:

> I think a lot of people have had trouble working out how those rules actually work. I have been involved in discussions about what 'substantially involved in business dealings' means. It sounds straightforward, but in reality the way that you end up having to interpret that is if there has been almost any kind of business dealing then it means that a particular person is not suitable as an independent compliance committee member. I do not think that most organisations find it all that easy to get suitable people…
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> Similarly, with respect to 'having a material interest', maybe that is in some ways easier to apply. The committee may have heard from others about those things but in practice people find them vague and difficult to interpret. Take, for instance, an independent director of a company; a lot of people would think that if you had an independent director that would be an eminently suitable person to have on a compliance committee but under these rules it seems as if that sort of person might be ruled out.[9]

4.17 Similarly, Mr Geoffrey Lloyd, Member, Regulatory Affairs Committee, Investment & Financial Services Association Ltd (IFSA), was concerned that the prohibitions on substantial business dealings would exclude an ex-director of an RE's custodian. He said:

> …one would assume that that person does their significant business dealing as your custodian and that that, if anything, should more suitably qualify them in their background and experience to be on your compliance committee.[10]

4.18 To address the possibility that suitable candidates might be ruled out, IFSA had proposed to the Turnbull Review that the 'substantial business dealings' criterion be qualified by 'which a reasonable person would expect to influence the member in performance of their duties'.[11]

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8 ASIC's submission to the Turnbull Review, Part 2.

9 Submission no. 6, p. 3; *Committee Hansard*, 11 July 2002, p. 21. (Mr Stewart's evidence was given in a personal capacity and not as a representative of Minter Ellison Lawyers.)

10 *Committee Hansard*, 12 July 2002, p. 33.

11 Submission no. 2, Attachment 1, p. 19.

4.19 When asked at this Committee's hearing on 7 August 2002 if ASIC supported IFSA's proposal, Mr Michael Wall, Assistant Director, Legal and Technical Operations, ASIC, commented that:

> 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.[12]

4.20 In its submission to the Turnbull Review, ASIC advised that it had given relief so that a person would not be taken to have been substantially involved in business dealings, or in a professional capacity, with a responsible entity because they are or, in the previous 2 years were, an external director of a related body corporate or a member of a compliance committee of a registered scheme operated by a related body corporate. ASIC suggested that the legislation be amended to provide for such persons to qualify as members of compliance committees.[13]

4.21 ASIC's proposal would seem to be at odds with the concerns raised by Mr Michael Shreeve, National Director of the Trustee Corporations Association of Australia (TCAA), who cited the following as illustrative of problems regarding independence:

> …the entity that owns the RE could have a director and that director could be considered an external member of the compliance committee.[14]

The Committee's views

4.22 The Committee notes the evidence that the definition of 'external' needs to be tightened to ensure, as far as possible, that individuals serving in the compliance monitoring role will be independent. It agrees that the sole qualification for appointment as a compliance monitor, namely, that the person is an 'external' director or member, does not guarantee that that person will be 'independent'.

4.23 The Committee notes ASIC's comments that the references to a 'material interest' in the definitions of an 'external' director and member need clarification.

4.24 However, the Committee is not satisfied, on the evidence, that a clear case has been established to make recommendations regarding clarification of the term

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12 *Committee Hansard*, 7 August 2002, p. 96.

13 ASIC's submission to the Turnbull Review, Part 2.

14 *Committee Hansard*, 12 July 2002, p. 53.

'substantially involved' or to extend eligibility in terms of the relief presently granted by ASIC (and referred to above).

Recommendation 1

The Committee recommends that:

- **the definition of 'external director' and 'external member' in sections 601JA and 601JB respectively of the *Corporations Act 2001* should be amended to ensure that:**
  - **they are independent;[15]**
  - **relatives and de facto spouses of ineligible individuals are ineligible to act on the compliance committee (whether as the board or an external compliance committee)[16]; and**
- **the meaning of 'material' be clarified.**

Criticisms of the in-house compliance monitoring model

4.25 Apart from the doubts expressed about whether the definition of external was consistent with the concept of independence, a number of witnesses also identified a number of problems with the reliability of in-house monitoring as a check on the RE's activities.

4.26 These concerned:

- the appointment and removal of committee members;
- insurance cover for Committee members;
- duties and functions of members of the RE's board when acting as the compliance monitor;
- the role of an external corporate entity; and
- the qualifications and experience of compliance monitors.

The Committee examines each of these concerns in order.

Appointment and removal of committee members

4.27 Under the MIA, the RE has power to appoint and remove compliance committee members but is not required to notify ASIC of appointments or removals.

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15 A definition of 'independent' should be developed that reflects the qualities referred to in the introduction to this chapter.

16 The terminology used in the Act is 'relative or de facto spouse'. 'Relative' and 'de facto spouse' are defined in section 9 of the Act.

4.28 The Turnbull Review thought this omission left the way open for conflicts of interest. The review consequently recommended legislative amendments to correct this by:

- requiring the RE to inform ASIC and scheme members of the identity of compliance committee members and when they are appointed, removed or retire; and
- conferring powers on ASIC to remove a compliance committee member for inadequate performance or otherwise where it would be inappropriate for the member to continue to serve on the committee.[17]

4.29 However, the Turnbull Review stopped short of recommending that ASIC be given the power to approve the appointment of members.

4.30 Evidence heard by the Committee about the RE's powers of appointment and removal was largely consistent with the findings of the Turnbull Review.[18] Witnesses were concerned that the RE's powers seriously threatened the independence and thus the integrity of compliance monitoring.

4.31 Mr Shreeve, TCAA, commented that compliance monitoring lacked 'genuine independence' and pointed out that:

> …REs, external directors and all compliance committee members are appointed by, paid by and may be removed by the RE.[19]

4.32 The Trust Company of Australia Limited (TCAL) echoed these sentiments. It stated that the tenure of compliance members was insecure because '[t]here are no real sanctions to stop the RE removing anyone in the compliance committee.'[20] The TCAL proposed amendments to enhance the independence of the corporate compliance entity by ensuring that 'compliance committee members could operate without fear of summary removal if they [did] not toe the line.' It wanted to see:

- guaranteed tenure for the independent compliance entity (recommended that all compliance committee members should have a minimum three-year tenure, provided their performance was satisfactory)[21]; or
- mandatory disclosable reasons for dismissal.[22]

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17 Turnbull Review, pp. 62–3.

18 This could be because a number of witnesses made submissions on these issues to the Turnbull Review and the Committee's inquiry.

19 *Committee Hansard*, 12 July 2002, p. 49.

20 *Committee Hansard*, 11 July 2002, p. 3.

21 *Committee Hansard*, 11 July 2002, p. 3.

22 Submission no. 7, p. 2.

4.33 Ms Gai McGrath, General Counsel & Company Secretary, Perpetual Trustees Australia Limited (PTAL), and appearing with the Trustee Corporations Association of Australia, agreed that there were no checks on the RE's powers to dismiss committee members, and proposed ways in which the RE might be made more accountable when exercising these powers. She commented that:

> REs have the capacity to remove compliance committee members, and no grounds need to be given to any person for that removal. In a case of the removal of an auditor of a public company, the auditor has to get ASIC permission to retire from that position, and an explanation has to be given to ASIC as to why that auditor is being changed. In the case of compliance committee members, I do not see any reason why the same regime should not operate, which would give them some protection and ASIC would know what is behind the removal of the member.[23]

4.34 Mr Paul Dortkamp, ICCM Forum, saw similar problems with the current arrangements and outlined possibilities for improvement:

> There are some smart things you could do there. I think the way to guarantee your independence would be to make it hard to get rid of you, to add the bureaucratic overlay, such as requiring approval by ASIC. ASIC would then send you a letter…asking, 'Are there any circumstances you would like to bring to our attention before we consent to your removal?' That would be a very simple mechanism.[24]

4.35 The Department of the Treasury was concerned about the lack of transparency regarding the membership of compliance committees. This, the Department considered, provided scope for REs to exercise their powers of appointment and removal arbitrarily. As well as removing diligent members, REs might find it in their interests to retain under-performing members. The Department proposed amendments to correct these shortcomings:

> …we think that ASIC should be able to remove an under-performing 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.[25]

4.36 These amendments, the Department opined, would have the added benefit of bringing potential problems to ASIC's attention:

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23 *Committee Hansard*, 12 July 2002, pp. 50–1.

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

25 Mr Dave Maher, *Committee Hansard*, 7 August 2002, pp. 82–3.

> …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.[26]

The Committee's views

4.37 The Committee accepts that, if the RE is to have powers to appoint and remove compliance monitors, the legislation should ensure that these powers cannot be exercised arbitrarily.

4.38 Issues relating to the independence of in-house compliance monitoring which are of particular concern to the Committee are that:

- there is no oversight of the RE's appointment or removal of compliance monitors; and
- the RE might fail to remove under-performing or partial compliance monitors.

Recommendation 2

The Committee recommends that the RE be required to:

- **report all appointments, retirements, resignations or removals of compliance monitors (whether as members of the board or of a separate compliance committee) to ASIC within a specified period (e.g. 5 business days);**
- **disclose annually to scheme investors the names of all current compliance monitors; and**
- **disclose annually to scheme investors the names of compliance monitors who have retired, resigned or been removed in the previous year and the reasons for all resignations and removals.**

Recommendation 3

The Committee recommends that ASIC be empowered to remove a member of a compliance committee where ASIC forms the view that the member is not performing adequately or otherwise should not be on the committee. The removal would be subject to reasonable notice requirements and rights to administrative review of ASIC's decision.

Insurance cover for members of compliance committees

4.39 There was some discussion during the inquiry about whether compliance committee members should have to pay for their own insurance cover, the rationale being that this would bolster the members' independence.

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26 Mr Dave Maher, *Committee Hansard*, 7 August 2002, p. 83.

4.40 Subsection 601JG(1) prohibits an RE or a related body corporate from paying the insurance premium of a compliance committee member in respect of a liability the member has incurred for a wilful breach of the member's duties in section 601JD. The prohibition does not extend beyond this.

4.41 For Mr Dortkamp, ICCM Forum, the fact that compliance committee members were included in the RE's insurance cover was irrelevant to their independence. He did not consider insurance prohibitions were an effective tool for maintaining independence and commented that:

> The prospect of different types of cover through different insurers seems…to go against the core principle of MIA being the concept of a single responsible entity.[27]
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> As an individual I would rather have us all in the same bucket; I would not like to see my insurance company fighting the RE's insurance company.[28]

4.42 Mr Dortkamp advised that most compliance committee members relied on insurance cover provided by the RE. He said the most commonly used policy was designed specifically for the MIA regime and was expressly intended to include compliance committee members. When commenting on the availability of insurance cover for members individually, he said:

> I am not aware of any compliance committee members who continue to have [their own] cover for their compliance committee roles. One external compliance committee member who did have cover last year, has been unable to renew. The reason given by the insurers was that cover is evaluated on a responsible entity basis and not an individual [basis].[29]

4.43 ASIC's advice in relation to the RE's payment of committee members' insurance premiums was that:

> 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.[30]

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27 Submission no. 10, p. 1.

28 *Committee Hansard*, 12 July 2002, p. 60.

29 Submission no. 10, p. 2.

30 Mr Ian Johnston, *Committee Hansard*, 7 August 2002, p. 97.

The Committee's views

4.44 Although the Committee heard evidence that it is accepted practice for REs to pay the professional indemnity insurance premiums for compliance monitors, the Committee does not consider that this constitutes a threat to the independence of those members. In this regard, the Committee defers to the evidence of Mr Dortkamp and ASIC.

Duties of members of compliance board

4.45 As noted earlier, an RE is not required to have a compliance committee if half of its board members are external. The Committee will now look specifically at the functions and duties of an RE board when acting in the compliance monitoring role (the compliance board).

4.46 ASIC expressed concerns in its submission to the Turnbull Review, about the failure of the MIA to spell out compliance monitoring functions and duties for the compliance board. ASIC said it had seen instances where:

> …board members did not consider that they had any obligation to monitor compliance with, or adequacy of, the compliance plan.[31]

4.47 ASIC argued that the legislation should be amended to apply the same duties and functions to the compliance board that applied expressly to compliance committee members, which are:

- to monitor the RE's compliance with the compliance plan and report its findings to the RE;
- to report to the RE actual or suspected breaches of the Corporations Act or the scheme's constitution;
- to report to ASIC if the RE does not address reported breaches appropriately; and
- to regularly assess the compliance plan and to make recommendations to the RE about any changes that it considers should be made.[32]

4.48 Furthermore, ASIC referred to legislative requirements that compliance plans contain adequate arrangements relating to compliance committee membership, meetings, reporting and so on. It was concerned that some boards were not giving compliance monitoring issues sufficient prominence at general board meetings. To remedy this, it proposed legislative amendments to the contents of the compliance plan to cater for compliance boards, in particular:

- to require separate compliance meetings;
- to stipulate frequency of compliance meetings; and

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31 ASIC's submission to the Turnbull Review, Part 2, p. 17.

32 Subsection 601JC(1).

- to set out reporting arrangements.[33]

The Turnbull Review endorsed ASIC's proposals.

4.49 At the hearing on 12 July 2002, Ms McGrath, PTAL, supported ASIC's proposal to clarify compliance boards' responsibilities. She commented that:

> There is a question mark over what those external members [on the RE's board] are supposed to be doing in this compliance area. There was a suggestion in the Turnbull review that some of the functions of the compliance committee should be imposed on the board of REs where the choice has been made not to have a compliance committee. I commend that suggestion. [34]

4.50 Ms McGrath pointed to another factor which she thought militated against the compliance board's independence, namely that, while the balance of power for compliance committees favoured external members, this was not the case for compliance boards which only required half their members to be external.[35]

4.51 As noted previously, a separate compliance committee is not required unless fewer than half of the RE's directors are external.[36] On the other hand, a compliance committee must comprise at least three members, a majority of whom must be external members.[37]

4.52 The TCAA did not think the Turnbull Review's recommendations got to 'the heart of the problem' and argued that 'reliance on "self-compliance" (whether by the board or compliance committee) [was] unacceptable, particularly when many billions of dollars of investors' funds are at risk'.[38]

4.53 In evidence to the Committee, Mr Shreeve, TCAA, was critical that a compliance committee separate from the RE's board was not mandatory and argued that independence of external board members was not guaranteed:

> …a compliance committee is an option; you do not need to have a compliance committee if half of your board members are what they called 'external', which has a different definition to 'independent'…[39]

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33 ASIC's submission to the Turnbull Review, Part 2, p. 15.

34 *Committee Hansard*, 12 July 2002, p. 50.

35 *Committee Hansard*, 12 July 2002, p. 50.

36 Subsection 601JA(1).

37 Subsection 601JB(1).

38 Submission no. 3, p. 2.

39 *Committee Hansard*, 12 July 2002, p. 48.

The Committee's views

4.54 The Committee notes ASIC's observations that some boards undertaking the compliance monitoring role appear not to have a good grasp of their responsibilities or do not give these the necessary prominence at board meetings. The Committee believes that the failure of the legislation to spell out the procedural requirements and the responsibilities to be observed by the board should not go uncorrected.

Recommendation 4

The Committee recommends that the *Corporations Act 2001* be amended to ensure that:

- **the requirements in the compliance plan dealing with the arrangements which a compliance committee must make regarding membership, holding of meetings and so on, as far as appropriate, be expressly applied to the board when acting in the compliance monitoring role; and**
- **the functions and duties applicable to the compliance committee, as far as appropriate, be expressly applied to the board when acting in the compliance monitoring role.**

4.55 The Committee is concerned that the RE's board can conduct compliance monitoring if only half of its directors are external and notes that a separately constituted compliance committee requires a majority of external members.

4.56 In the interests of ensuring the independence of compliance monitoring, the Committee believes that, unless the RE's board has a majority of external directors, a separate compliance committee should be established.

Recommendation 5

The Committee recommends that the *Corporations Act 2001* be amended so that the RE of a registered scheme must establish a compliance committee if a majority of its directors are not external directors.

Appointment of an external corporate compliance entity

4.57 The Committee heard proposals for the appointment of an external corporate compliance entity either to conduct the compliance monitoring itself or to act as an external member on a compliance committee. This proposal was advanced for two reasons:

- to ensure compliance monitors had the necessary expertise to discharge their functions properly; and
- to ensure independence in the compliance monitoring function.

4.58 The Turnbull Review considered the problems which schemes based in rural or regional areas might have in accessing suitably qualified and experienced people to conduct compliance monitoring. The review saw some appeal in allowing an external

corporate entity to act as a compliance monitor to remedy this problem but decided against the proposal on the grounds that:

- smaller, less sophisticated REs would be more likely to outsource the compliance monitoring role to an external compliance entity and this could lead to the abrogation of their compliance responsibilities by those REs;
- a large compliance entity might come to dominate a smaller RE;
- the provision for an additional form of compliance monitor would add to the complexity of the legislation;
- certification of compliance entities would be necessary and any tendency by the entity to delegate its responsibilities to staff lacking the requisite skills would have to be guarded against; and
- ASIC's surveillance statistics had identified the use of external service providers as a source of non-compliance. The outsourcing of the compliance monitoring role to an external corporate entity could add to non-compliance.

4.59 The review suggested that the proposal might warrant further consideration if ASIC's surveillance figures for the next few years indicated there was a need to review compliance mechanisms.[40]

4.60 When invited to comment on this proposal at the hearing on 7 August 2002, ASIC advised that it had not yet identified major problems in the operation of compliance committees. In addition, it was not sure that the problems identified during its surveillance activities would be remedied by the substitution of a corporate compliance entity in place of the existing arrangements.[41]

4.61 IFSA could not see any advantage in the proposal. Ms Ralph commented that, if an RE needed specific skills and experience, there was nothing to stop the RE from appointing the individuals having the appropriate background to the RE's board or compliance committee. She commented further that:

> We do not necessarily see enormous advantage in having the option of placing a corporate entity on either the compliance committee or the board, but we do see some potential downsides.
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> When you put an individual in a position of responsibility, that is when the heat really gets applied and the regime becomes effective…
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> We would also have a concern if a responsible entity said, 'I can now just outsource my entire compliance regime to someone else'.[42]

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40 Turnbull Review, pp. 64–5.

41 Mr Ian Johnston, *Committee Hansard*, 7 August 2002, pp. 91–2.

42 *Committee Hansard*, 12 July 2002, p. 38.

4.62 Mr Dortkamp, ICCM Forum, shared IFSA's view that appointments to the compliance committee should be on an individual basis. This was because it engendered a sense of personal responsibility. He also considered that appointment of a corporate compliance entity could make the compliance committee 'dysfunctional' because it provided scope for breaks in continuity of those representing the corporate entity. Mr Dortkamp outlined the potential problems thus:

> The risk, as I see it, is that the people will be rotated through the committee. Really, you meet every two or three months; that seems to be about where we have settled. On the basis of the worst case, they are only meeting four times a year. If you were to change the person, the dynamics of the meeting would be changed. If I am on a committee and a new person comes on board there is a learning period, and there almost isn't time for that. You really want people on the committee to be aware of all the issues—and you are sort of kept up to date during the quarter anyway. Having a corporate person—the actual individual in the meeting—changing from meeting to meeting is the worst case and it is unlikely that that would happen. That would be very dysfunctional. My comment on the period is more from the point of view of functionality. I also think that if you are sitting there as the representative of a corporate rather than as an individual, you could believe that to some extent you are shielded by your corporation from the full effects of your decisions. There is nothing like being totally exposed on a personal basis to really focus your brain. We do not trivialise things; we do not gloss things over. It stops here.[43]

4.63 Other respondents strongly supported the proposal for an external corporate entity on the grounds that it would enhance the independence and professionalism of compliance monitoring.

4.64 Mr Jonathan Sweeney, Managing Director, Trust Company of Australia Limited (TCAL), commented that the conclusions of the Turnbull Review not to proceed with a corporate compliance entity were akin to saying, 'Lets wait for disaster' before taking action. He contended that the appointment of an external corporate entity for compliance purposes was a 'sensible reform that would offer no additional cost or inconvenience to the existing structure' but would bring 'quite strong' advantages.[44]

4.65 He argued that an external corporate compliance entity would relieve conflicts of interest and referred to factors within the MIA which, in his view, created such conflicts:

> [The] compliance committee meets three or four times a year and is audited twice a year. It is comprised of individuals who might have other roles and obligations in other jobs and who are being paid between $20,000 and $30,000 for this role. They are appointed by the responsible entity, they can

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43 *Committee Hansard*, 12 July 2002, p. 60.

44 *Committee Hansard*, 11 July 2002, p. 3.

> be removed by the responsible entity at any time and their insurance is given to them by the responsible entity—there is a lot of pressure there not to rock the boat. If they resign or are removed, my understanding is that there is no need to give a reason for that resignation or removal to ASIC. So you never find out why people go; they just go. It makes much more sense to me to put in an independent corporate body which will not have all those sorts of pressures.[45]

4.66 In addition to improving compliance monitoring, Mr Sweeney argued that a corporate compliance entity would provide investors with a vastly larger insurance pool from which to claim compensation in the event of fund losses.[46] Professional indemnity insurance would be more readily available and premium costs would be more reasonable for a corporate member.[47]

4.67 The TCAA supported the concept of a corporate compliance entity and argued that it would complement, rather than diminish, the single RE framework. The TCAA responded to each of the Turnbull Review's objections as follows:

- smaller REs or those likely to focus less on compliance issues were the ones most in need of an independent, external compliance entity;
- there appeared to be no concerns about REs using large audit firms or other service providers so the argument about REs being dominated by a larger corporate compliance entity was questionable. Also the RE had power to dismiss the entity;
- concerns about complexity in the legislation were not relevant and were outweighed by the benefits offered by a more independent structure;
- the need for 'certification' arrangements would merely put the compliance entity on a par with other service providers such as auditors, custodians and IT specialists; and
- outsourcing would improve, rather than impair, compliance. If the RE is unable to manage outsourcing effectively, this should raise questions about the RE's ability to operate a managed fund.[48]

4.68 Mr Stewart, MEL, remarked that, in his experience, the quality of compliance committee members varied enormously in terms of expertise and capability. He considered that companies, such as trustee company subsidiaries, with corporate backup and professionalism, would considerably strengthen the compliance function.[49] He stated:

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45 *Committee Hansard*, 11 July 2002, p. 8.

46 *Committee Hansard*, 11 July 2002, pp. 7 and 14.

47 Submission no. 7, p. 5.

48 Submission no. 3, Appendix 2, pp. 1-3.

49 Submission no. 6, p. 3.

> I have been involved in trying to find, for a client, appropriate people to be compliance committee members. I have found it a somewhat disconcerting experience because of the great variety of people who are filling that role—some of them I know; some of them I do not know. But there is certainly an enormous variation in the different types of people, their backgrounds and the quality of them. I cannot help thinking that there would be no loss, and probably a bit to be gained, if you were able to have a corporate member of a compliance committee which would be required then to provide—and in the nature of things, you would expect that they would provide—a particular individual who would attend the meetings. They would also have recourse to training, expertise and backup which a lot of independent individuals do not have. I know that they are trying to develop their training, their professionalism and skills and so on, but I still think that there would be nothing lost by allowing companies to fulfil that role.[50]

The Committee's views

4.69 The Committee is concerned that some schemes may not have reasonable access to sufficiently competent individuals to act as compliance monitors and consequently sees merit in the proposal for the appointment of a corporate compliance monitor. The Committee notes the objections raised by the Turnbull Review to this proposal but is more inclined to accept the arguments raised against these objections by the TCAA.

4.70 Having said this, the Committee has identified two factors of possible concern.

4.71 First, ASIC's surveillance statistics indicate that outsourcing may encourage non-compliance. On the other hand, the TCAA has argued that an RE, if it is supposedly competent to operate a scheme, should have the competency to properly manage its outsourcing. Ideally, this should be the case.

4.72 The Committee considers that possibilities for non-compliance can be overcome if a corporate compliance entity is only allowed to act as a member of a compliance committee and not as the committee itself. Indeed, the Committee considers the advantages of this are that the entity would have the resources and backup to enhance its performance as a compliance monitor. In this regard, the Committee notes Mr Stewart's observations that a representative of a corporate compliance entity acting as a committee member 'would…have recourse to training, expertise and backup which a lot of independent individuals do not have'.[51] There are downsides, however, and this is the second factor which the Committee will now consider.

4.73 Mr Dortkamp commented that, to optimise performance, it was important to have continuity in the membership of the committee. With a corporate compliance

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50 *Committee Hansard*, 11 July 2002, p. 21.

51 *Committee Hansard*, 11 July 2002, p. 21.

entity as a committee member, this continuity is less likely. Furthermore, both Mr Dortkamp and IFSA argued that representatives of a corporate compliance entity were less likely to approach their responsibilities with the same level of personal commitment as individuals. As Mr Dortkamp put it, 'there is nothing like being totally exposed on a personal basis to totally focus your brain'.[52]

4.74 The Committee accepts that lack of continuity could present problems but believes these can be ameliorated by proper record-keeping and—in the case of the entity itself—comprehensive hand-overs upon changes in personnel.

4.75 Furthermore, the Committee believes that the threat of removal for incompetence is likely to provide a sufficient additional incentive for a corporate compliance entity and, indeed, all committee members, to discharge their responsibilities with the necessary diligence. In this regard, the Committee has recommended that ASIC should have powers to remove a member either for inadequate performance or otherwise where ASIC considers it would be inappropriate for the member to continue in the compliance-monitoring role.

Recommendation 6

The Committee recommends that the *Corporations Act 2001* be amended to allow a corporate compliance entity to act as a member of a registered scheme's compliance committee.

Qualifications and experience of compliance monitors

4.76 In its consideration of the adequacy of selection criteria for compliance monitors, the Turnbull Review noted that, as long as a person met the criteria to qualify as 'external', the legislation prescribed no other criteria such as those requiring certain levels of competency or skill to carry out the requisite duties. The review moved to rectify this by recommending that standards should be developed relating to qualifications and experience of compliance committee members.[53]

4.77 During the Committee's inquiry, the evidence indicated that there were limited formal training opportunities to assist compliance monitors to develop or acquire the relevant knowledge to properly discharge their duties. Mr Dortkamp advised that, in contrast to other professional areas, there were no set courses for the purpose. He said that the ICCM Forum had worked with the University of New England to present a course on two occasions at the University. He said this course had been supported more by compliance professionals than by the compliance committee members it had been designed to help.[54]

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52 *Committee Hansard*, 12 July 2002, p. 60.

53 Turnbull Review, pp. 59–60, Recommendation no. 10.

54 *Committee Hansard*, 12 July 2002, pp. 64–5.

4.78 The Committee was also told of the links the ICCM Forum had forged with ASIC which Mr Dortkamp indicated had had a positive influence on the industry. In particular, he said that:

> One of the things we have done with the forum, too, is to get ASIC to come along each month, which has been quite effective. The mainstream fund manager and the independent compliance committee people know the people in ASIC personally. We also go to the IFSA conference and run a separate stream each year—it is in Brisbane again this year—so there is a bit of interaction between the externals and ASIC in an industry sense, and there are some pretty clear channels. Because of my self-appointed position, I also get a few phone calls from people exploring what I call difficult issues. Because we have very clean links through to ASIC, I think people are pretty comfortable about taking their concerns there on an unofficial basis.[55]

4.79 Mr Lloyd, IFSA, agreed with Mr Dortkamp that the ICCM Forum's activities had been beneficial for the compliance industry and had assisted individual compliance monitors to gain a full appreciation of their roles. He observed:

> I think it is fair to say that the roles, nature and capacity of independent compliance committee members have really been evolving over the past two years and that group has obviously been contributing to that process in terms of clarifying the roles, responsibilities and the sorts of qualifications, behaviour and conduct that are expected. I think you will continue to see that grow and evolve. A lot of progress has been made…It is also possible that we still have to see further improvements in the understanding of those roles and the sorts of qualities of the people that are going into those roles, but I think we have gone a long way to achieving what was envisaged for that role.[56]

4.80 At hearings, the Committee raised the possibility that best practice criteria and guidelines could be developed to ensure all those connected with the governance of managed investment schemes, including compliance monitors, were of optimum quality, independence and integrity.

4.81 In this regard, Ms Ralph advised the Committee that IFSA had developed a 'blue book' on corporate governance for listed company entities. She said this had produced positive changes in conduct and behaviour which had had an impact on the composition of boards over the previous few years. She thought that a similar set of guidelines for RE boards and compliance committees would be a 'useful tool' and would be best developed through consultation.[57]

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

56 *Committee Hansard*, 12 July 2002, p. 33.

57 *Committee Hansard*, 12 July 2002, pp. 44–5.

4.82 Mr Dortkamp thought the development of guidelines would be worthwhile and suggested this could be achieved through ASIC's 'policy statement methodology'.[58]

4.83 Ms McGrath, PTAL, shared this view and thought the experience and expertise requirements set out in ASIC's Policy Statement 146 *Licensing: Training of financial product advisers* would provide a useful precedent.[59]

4.84 ASIC's view was that it would prefer to see the ICCM Forum develop draft standards as a basis for future discussion.[60]

4.85 The Committee notes recent developments in the United States, the United Kingdom, Canada and Australia to improve corporate governance standards.[61] Of particular interest to the Committee is the emphasis given by the *Sarbanes-Oxley Act of 2002* on the need for a company's auditing compliance monitors to have the necessary expertise to properly perform their role.[62]

The Committee's views

4.86 The Committee is concerned that, other than the 'external' requirement, there is no 'quality control' of compliance monitors. While the Committee applauds the initiatives of the ICCM Forum to provide for the exchange of ideas and improvement of standards within the compliance industry, it believes more should be done to set minimum standards of competency and integrity. This is particularly so given the compliance committee's fundamental position within the MIA framework. However, having said this, the Committee is aware of the need to accommodate segments of the managed investments industry based outside metropolitan centres when formulating its recommendations.

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58 *Committee Hansard*, 12 July 2002, pp. 65-6.

59 *Committee Hansard*, 12 July 2002, p. 52.

60 Mr Ian Johnston, *Committee Hansard*, p. 93.

61 In the United States, the *Sarbanes-Oxley Act of 2002* was introduced into law on 30 July 2002. In the United Kingdom, the Financial Services Authority is reviewing listing rules in several areas including corporate governance and has commissioned an independent review of the role of non-executive directors. In Canada, the Joint Committee on Corporate Governance issued its final report, *Beyond Compliance: Building A Governance Culture*, in November 2001. In Australia, the Government has recently released its CLERP 9 discussion paper.

62 Under this Act, public companies must have independent audit committees which pre-approve independent audit and non-audit services. Disclosure is required in quarterly and annual reports as to whether or not the audit committee has at least one 'financial expert' and, if not, the reasons for this must be stated. A new rule proposed by the Securities Exchange Commission under the Act will also require public companies to disclose the number and names of 'financial experts' on the company's audit committee. See the United States Securities and Exchange Commission Release no. 2002-150, *SEC Proposes Additional Disclosures, Prohibitions to Implement Sarbanes-Oxley Act*, 16 October 2002, www.sec.gov/news/press/2002-150.htm.

Recommendation 7

The Committee recommends that the *Corporations Act 2001* be amended to require:

- **the compliance plan of a registered scheme to set out detailed minimum standards of competency and integrity which each compliance monitor must meet;**
- **any amendments to the compliance plan regarding these minimum standards must be approved by a majority of compliance monitors before lodgement of the amendments with ASIC. The copy lodged with ASIC should also be signed by the compliance monitors; and**
- **the RE to disclose details of the minimum standards annually, preferably at the same time as details of compliance monitors are disclosed.**

4.87 The Committee envisages that standards of competency for compliance monitors could vary depending upon the scheme involved. However, the Committee considers it would assist industry if a body of benchmarks was developed to complement the legislation. In this regard, the Committee notes that ASIC, IFSA, PTAL and Mr Dortkamp, ICCM Forum, were supportive of such a proposal.

4.88 ASIC should develop model minimum standards to be used where a registered scheme compliance committee does not wish to develop its own.

Recommendation 8

The Committee recommends that ASIC, in consultation with industry, develop guidelines and model minimum standards for competency and—if considered necessary—integrity, for in-house compliance monitors.