CHAPTER 6

OTHER CHECKS AND BALANCES

Introduction

6.1 In this chapter, the Committee will review the evidence on two other checks and balances in the MIA's regulatory framework:

- ASIC's licensing, surveillance and enforcement activities; and
- licensing of REs, particularly with regard to net tangible asset and insurance requirements.

ASIC's capacity to discharge its responsibilities under the MIA

6.2 As mentioned earlier, ASIC is one of the important 'checks and balances' in the MIA regime. Among other things, ASIC is required to:

- assess applications for registration of a scheme which involves a review of the scheme's constitution and compliance plan;
- assess applications for licensing of REs which includes a review of applicants' financial resources and compliance arrangements; and
- carry out surveillance checks of schemes to ensure there is compliance with the scheme's constitution, compliance plan and the Act.

6.3 In addition, the MIA confers extensive discretionary powers on ASIC under which it may modify or vary the Act's provisions for all schemes or on a case-by-case basis. For example, ASIC may require a scheme or class of scheme to engage a third-party custodian of scheme property. ASIC has powers to determine how certain legislative criteria for registration and licensing can be met and has issued comprehensive policy statements in this regard.

6.4 It is clear that, given the self-regulatory nature of the MIA regime, ASIC's ability to properly discharge its responsibilities under the MIA is crucial to the regime's effectiveness.

6.5 During debate on the Managed Investments Bill 1977, members of the Opposition, the Australian Democrats and Independents argued that ASIC might not have sufficient funding to enable it to fulfil its role. They commented on the difficulties of arriving at any informed conclusion on this point because the regulations and policy statements relevant to ASIC's role had not been formulated.[1]

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1 See, for example, Senator the Hon. Peter Cook, Second Reading Speech, *Senate Hansard*, 28 May 1998, pp. 3345-6; Senator Dee Margetts, Second Reading Speech, *Senate Hansard,*

This concern about funding was the principal catalyst for amendments to the Bill which required a review of the Act after its third year of operation.

6.6 ASIC advised the Turnbull Review that the introduction of the MIA had required the rapid development of new administrative systems and intensive staff training, as well as restructuring of existing resources, and the completion of a high volume of operational work.[2] ASIC observed that:

> Because so much of ASIC's work is responsive and driven by scheme applications, any stress on resources impacts directly and disproportionately on our ability to supervise the industry in a proactive way—by undertaking surveillance; providing guidance or by adjusting policy setting.[3]

6.7 On 14 May 2002, the Government announced a boost to ASIC's funding 'to enable it to maintain its enforcement capability and for ongoing work in implementing and administering the *Financial Services Reform Act 2001*'.

6.8 ASIC's response to the increased funding was that it would 'substantially improve ASIC's capacity to respond to current market circumstances and to plan for the next four years'.[4]

6.9 In evidence to the Committee, Mr Ian Johnston, Executive Director, Financial Services Regulation, ASIC, commented that:

> We are pleased to have received substantially increased funding from government to meet our obligations under the Financial Services Reform Act and, indeed, for the wider sphere of ASIC activity.[5]

and further that:

> [ASIC's] application for funding we made was as part of the output pricing review process and in our funding bid we identified what resources we thought we needed to implement FSRA…We added to that a shortfall that we thought we had in terms of enforcement resources generally, going wider than FSRA. The money that we received was largely in line with the bid that we had made.[6]

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22 June 1998, p. 3562; Senator Brian Harradine, Second Reading Speech, *Senate Hansard*, 22 June, 1988, pp. 3569-70.

2 ASIC's submission to the Turnbull Review, Part 1, p. 48.

3 ASIC's submission to the Turnbull Review, Part 1, p. 48.

4 ASIC Media and information release 02/168 *ASIC welcomes additional funding*, 15 May 2002.

5 *Committee Hansard*, 23 May 2002, p. 68. (The hearing was for the Committee's inquiry into the regulations and ASIC's policy statements made under the *Financial Services Reform Act 2001*.)

6 *Committee Hansard*, 23 May 2002, p. 70. (The hearing was for the Committee's inquiry into the regulations and ASIC's policy statements made under the *Financial Services Reform Act 2001*.)

6.10 While ASIC has indicated that its funding is sufficient to support its activities, evidence to the Committee on this issue was mixed.

6.11 The Investment & Financial Services Association Ltd and Mr Paul Dortkamp, Independent Compliance Committee Members Forum (ICCM Forum), thought ASIC had been very effective in fulfilling requirements under the MIA, and in working to consolidate awareness of the requirements in the industry.[7]

6.12 On the other hand and notwithstanding ASIC's increased funding, some submissions questioned whether ASIC had the resources to discharge its responsibilities. The Trust Company of Australia Limited (TCAL), for instance, commented that:

> An enhanced role and powers of the ASIC are seen to supplement the self-regulatory nature of the MIA regime. Transition to the new FSR regime would seem to be a large distraction for the ASIC over the next two years. Additional four-year Federal funding recently announced is likely to be swallowed up by prominent lawsuits rather than discharging any enhanced role or exercising additional powers.[8]

6.13 In his submission, Mr J P Macauley, an independent licensed investment adviser, remarked on the increased vulnerability of investors under the MIA and contended that this was not mitigated by the existence of industry regulators 'because the magnitude of the task precludes sufficient resources ever being available via regulatory effort'.[9]

6.14 Mr Roger Valentine, Consultant Legal to National Council, Association of Independent Retirees, Inc, expressed concerns about ASIC's capacity to conduct adequate surveillance to prevent fraudulent activity under current compliance arrangements, given the larger number of risky investment vehicles available to retirees.[10]

6.15 The Committee notes the concerns raised about ASIC's funding, particularly in view of ASIC's increased workload flowing from the implementation of the reforms introduced by the *Financial Services Reform Act 2001* and regulations.

6.16 However, without evidence to the contrary, the Committee is in no position to contest ASIC's view that it has sufficient funding to properly discharge its obligations. ASIC's evidence is that its current funding is largely in line with its projected requirements.

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7 *Committee Hansard* pp. 46 and 62.

8 Submission no. 7, p. 1.

9 Submission no. 1, p. 1.

10 *Committee Hansard*, pp. 72–4.

Licensing requirements for REs—NTAs and insurance

6.17 Under section 912A of the *Corporations Act 2001,* financial services licensees must ensure that they have available adequate financial resources to provide the licensed services, carry out supervisory arrangements and provide for an adequate risk-management system. Under ASIC's Policy Statement 166 *Licensing: Financial requirements*, REs of managed investment schemes must:

- hold sufficient financial resources to meet their liabilities over at least a 3-month term; and
- hold net tangible assets (NTA) of 0.5 per cent of the value of the assets and other scheme property of the registered schemes operated with a minimum requirement of $50,000 and a maximum of $5 million; or
- hold NTA of $5 million if a separate custodian has not been appointed.[11]

6.18 In addition, REs must maintain professional indemnity insurance and insurance against fraud at a minimum of $5 million or the value of scheme assets, whichever is less. This is set out in ASIC's Policy Statement 131 *Managed investments: Financial requirements*.[12]

6.19 The Turnbull Review considered NTA requirements as setting a level at which a scheme would be regarded as having sufficient financial resources to properly conduct its operations. The review did not regard an RE's NTA as providing a potential source of funds against which investors could draw compensation for losses caused by an RE's malfeasance or negligence.[13]

6.20 The Committee considers this approach is correct and notes ASIC's comments in this regard that:

> …the $5 million [NTA] requirement is not there primarily as a buffer for failure of any fund. It is there…to make sure that the party operating the scheme has enough backing, enough capital to do its job and to operate the scheme; it is there to give some notion of backing in terms of an orderly wind-up; and it is there basically…to make sure that the organisation has some substance…But it is not actually there as a buffer in the event of failure.[14]

6.21 The Turnbull Review did not come to any definite conclusion regarding NTA requirements and proposed that the matter should be revisited when the findings of the Superannuation Working Group (SWG) on NTA levels for superannuation trustees

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11 This is only a very brief summary of the basic requirements. These requirements vary according to the type of managed investment scheme involved.

12 Paragraphs 131.16 to 131.19.

13 Turnbull Review, p. 27. See also ASIC Policy Statement 131 *Managed investments: Financial requirements*, para. 131.10.

14 Mr Ian Johnston, *Committee Hansard*, 12 July 2002, p. 90.

were known.[15] This was consistent with the recommendations of the Financial System Inquiry Final Report released in March 1997 (the Wallis Report) that the regulatory framework for managed investments and superannuation should be harmonised to the greatest possible extent.[16]

6.22 In its draft report, *Options for Improving the Safety of Superannuation*, the SWG recommended that:

- trustees be required to have minimum of $100 000 NTA, or where the value of the assets under management was greater than $10 million, NTA must be equal to 0.5 per cent of the assets under management to a maximum of $5 million.[17]

6.23 The report also recommended that other measures should be implemented if insurance could not be arranged.

6.24 On 24 October 2002, *Options for Improving the Safety of Superannuation—Report of the Superannuation Working Group*, was released. In this report, the SWG reviewed its draft recommendation for capital adequacy requirements. The SWG decided to follow the legislative capital adequacy requirements for responsible entities of managed investment schemes which are expressed at a high level of generality, i.e. 'adequate resources'. It was proposed that the Australian Prudential Regulation Authority (APRA) would be responsible for developing revised capital adequacy requirements in consultation with relevant stakeholders. However, the SWG proposed that the legislation should set out factors APRA should consider when determining these requirements. These would include:

- the trustee's composition, skill, knowledge and experience;
- independence of the trustee;
- the composition and quality of management;
- independence of management;
- the quality of internal risk management systems;
- administrative issues such as the level of back-office activity and the soundness and efficiency of administrative and computer systems;
- custodial arrangements and the degree to which they reduce overall risk;
- issues relating to investments such as investment experience; and
- the type and level of insurance cover.[18]

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15 Turnbull Review, p. 28.

16 Recommendation 89, pp. 490-1.

17 *Options for Improving the Safety of Superannuation—Draft Recommendations of the Superannuation Working Group*, 4 March 2002, p. 27. (This recommendation applied to trustees approved under the *Superannuation Industry (Supervision) Act 1993*. Another recommendation applied to superannuation funds without a trustee. The SWG did not consider capital was necessary for these funds but proposed alternative measures such as insurance.)

6.25 The Trustee Corporations Association of Australia (TCAA) and the TCAL raised concerns that the NTA and insurance requirements of REs under the MIA did not provide the same protection to scheme members as the previous arrangements under the dual-party system.

6.26 In this regard, Mr Michael Shreeve, National Director, TCAA, commented at the hearing on 12 July 2002 that:

> We believe the schemes have inadequate financial underpinnings compared to the previous regime. REs with net tangible assets and insurance each of no more than $5 million can and do hold at risk many billions of dollars of investors' funds.[19]

6.27 He argued that capping insurance cover at $5 million 'no matter how many billions of dollars [an RE is] managing' militated against investors' interests. He contrasted the situation with the previous regime where, he said, insurance cover could be augmented with the capital of the trustee companies.

6.28 In response to questioning about what the capital adequacy requirements of REs should be, Mr Shreeve opined that 'if $5 million was considered appropriate several years ago, with inflation a larger number is probably appropriate now' and, later, that:

> The maximum figure is very difficult. There is no right figure…The point of capital…is to make sure you have adequate resources to get up and running. The minimum capital you need is $50,000. Arguably, that might be a bit on the low side. In the event of something going wrong, your financial underpinnings are provided in insurance and capital. They both provide value to you. It is probably less expensive to allow the insurance to keep going up rather than to require the inputting of capital. We do not have a firm view on what the maximum should be. We think that, as a matter of principle, the insurance should go up with the size of funds under management. If $5 million was appropriate before, keep pace with inflation. It is very hard to argue why a $5 million cap is too high or too low. Different people would have different views.[20]

6.29 Mr Donald Christie, Managing Director, Equity Trustees Ltd (appearing with the TCAA), suggested that 'perhaps the CPI or something like that' might be an appropriate basis for ongoing adjustment of the NTA.[21]

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18 *Options for Improving the Safety of Superannuation—Report of the Superannuation Working Group*, 24 October 2002, Recommendation 16, p. 51.

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

20 *Committee Hansard,* 12 July 2002, pp. 54 and 56.

21 *Committee Hansard*, 12 July 2002, p. 54.

6.30 Like the TCAA, the TCAL was critical of ASIC's insurance and NTA requirements. At the hearing, Mr Jonathan Sweeney, Managing Director, commented with regard to insurance levels that:

> …we understand it is not uncommon to see responsible entities with a $5 million professional indemnity policy—however, coupled with restrictive fidelity extensions—still get approved by ASIC. That can be quite dangerous. One thing we have seen in the most recent collapses is that under-insurance is a very common issue…Adequate insurances of the RE, auditors and agents of the RE including custodians, registry service providers and legal advisers should also be part of the overall package underpinning the MIA.[22]

6.31 When asked for clarification of the TCAL's objections to what it considered were inadequate NTA requirements for REs, Mr Michael Britton, National Manager, Fiduciary Services, TCAL, said:

> If you are running at one billion plus, your net tangible assets are capped at $5 million; that is the maximum. If you make a mistake of 'only' one per cent on $2 billion or $3 billion, that is already over your NTA—and mistakes of one per cent can and do occur. If you only have recourse to $5 million and the PI falls over with an insurer not being there, that is it; that is all you have. Also, that NTA can be dissipated very quickly through other mechanisms…We are saying that, if you have self-custody as well, suddenly you have both liabilities in one NTA. If you had NTA requirements on the trustee in superannuation—even if they had an external custodian, which is not the case—you would have $5 million in each point of NTA, and you would have two separate bits of PI insurance. Again, it further protects people.[23]

6.32 The Committee asked the Department of the Treasury why no provision had been made to for NTA levels to respond to inflation or some other form of indexation. The Department responded that:

> Generally, these sorts of requirements are not indexed in the Act, so it is consistent with other requirements in the Act that it is not indexed. There is some inflation. There is a scaling effect, effectively, because of the 0.1 per cent up to $5 million. So, as I say, it tends to scale with the asset base to a point. The NTA are there to ensure that the RE has sufficient resources to enable it to operate the fund. That is what that requirement is about. It is not there to provide a pool that is available in the event of a lot of redemptions, for example. That is not the purpose of the NTA requirement.[24]

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

23 *Committee Hansard*, 11 July 2002, p. 7.

24 Mr Nigel Ray, *Committee Hansard*, 7 August 2002, p. 87.

The Committee's views

6.33 The Committee appreciates that an RE's NTA are not intended to provide a pool of funds upon which investors can draw in the event of fund losses.

6.34 However, it notes the comments made by Mr Britton from the TCAL of the importance of having sufficient NTA and insurance cover merely to provide an adequate financial buffer against investment miscalculations, particularly where the funds under management are quite extensive.

Recommendation 13

The Committee recommends that ASIC review its NTA and insurance requirements for REs to determine whether they should be subject to periodic adjustment to take into account, for example, CPI rises or the quantum of funds under management.