CHAPTER 7

LIABILITY OF THE RESPONSIBLE ENTITY AND SECTION 1325

Introduction

7.1 Section 601MA of the *Corporations Act 2001* expressly provides a member of a registered scheme who suffers loss or damage because of the RE's contravention of Chapter 5C, with a right of action against the RE.

7.2 In his second reading speech for the introduction of the Managed Investments Bill 1997, the Parliamentary Secretary to the Treasurer, Senator the Hon. Ian Campbell, explained the intention behind this provision:

> The single responsible entity concept will clarify and simplify the legal duties and responsibilities of a manager by imposing clear statutory duties in relation to investors and the scheme it operates, and providing a right of civil action against the responsible entity by any member of the scheme who suffers loss or damage because of conduct contravening those duties and responsibilities. From the point of view of investor protection, it will ensure that the liability for any loss of investors' funds, through negligent or illegal activity, rests entirely with the responsible entity.[1]

7.3 Although the RE is responsible for the operation of a scheme, it has power to appoint agents to do anything it is authorised to do in connection with the scheme. The legislation makes it clear, however, that the RE is liable for the actions of its agents even if they act fraudulently or outside the scope of their authority or engagement.[2] Commenting on this, the Explanatory Memorandum to the Managed Investments Bill 1997 explained:

> The effect of this provision is to provide that the responsible entity is liable to members for any act or omission in relation to the affairs of the scheme. This places the onus upon the responsible entity to make good to scheme members any losses suffered by a scheme as a result of the conduct of persons engaged by the responsible entity in relation to the scheme. The responsible entity may in turn seek to recover its costs from the other persons.[3]

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1 See Parliamentary Secretary to the Treasurer, Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, p. 446.

2 Subsection 601FB(2).

3 Managed Investments Bill 1997, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 18.

7.4 One of the key distinctions between the MIA regime and the dual-party structure is the MIA's removal of the mandatory requirement for a trustee/custodian.

7.5 Under the MIA, the appointment of a custodian to hold scheme funds is not mandatory[4] unless ASIC directs third-party custodianship.[5] Even so, the Act does not set out the conditions of appointment, nor the duties of the custodian to perform this task.

7.6 The Turnbull Review considered whether, and to what extent, third-party custodians should be accountable to scheme members.[6] There had been no consensus in the submissions about what the custodian's role should be and where the RE should stand in terms of liability for the custodian's actions.

7.7 Some saw the custodian as merely a bare trustee while others thought the custodian should take a more active role in monitoring the RE and also pursuing remedies against the RE where there was evidence of negligence or wrongdoing.

7.8 The review was reluctant to endorse proposals to expand the role of third-party custodians on the grounds that, to do so, could create the same sort of confusion over accountability that existed under the prescribed interests regime.

7.9 Although rejecting the expansion of the custodian's role, the review nonetheless identified section 1325 as providing members with a civil right of action for recovery of loss or damage against parties other than the RE whose contravention of Chapter 5C had caused the loss or damage.

7.10 It could perhaps be argued that this constituted an implicit acknowledgment by the review of the contradictions contained in the concept of the single RE.

7.11 One of the objectives of the MIA was to simplify and clarify lines of accountability so that scheme members would not have to engage in complex litigation in the event of loss or damage. The excerpt from Senator Campbell's second reading speech featured at the start of this chapter makes this clear.

7.12 When invited to comment on the Turnbull Review's failure to examine proposed alternatives to the single RE concept, the Department of the Treasury stated that:

> …the major concern of the report was that, as soon as you move away from the RE being the responsible entity, you have the hallmarks of the system that we tried to address in the first place: there would be different people to

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4 Paragraph 601FC(i); section 601FB; paragraph 601FC(j).

5 Subsection 601QA(1) confers a discretion on ASIC to require third-party custodianship of scheme property. ASIC's Policy Statement 131 *Managed investments: Financial requirements* provides that ASIC will generally require an RE to appoint a custodian if its net tangible assets are under $5 million.

6 Turnbull Review, p. 30.

> sue and they might counterclaim amongst themselves and hold up any sort of speedy compensation for investors.[7]

7.13 In contrast to the Department's view, the Trust Company of Australia Limited's (TCAL's) submission commented that:

> To suggest that finger pointing and blame shifting will be a thing of the past simply by designating a party as the Responsible Entity is far too simplistic.[8]

7.14 At the hearing on 11 July 2002, Mr Jonathan Sweeney, Managing Director, elaborated on the TCAL's comments and stated that:

> Section 1325 of the Corporations Act 2001 specifically recognises that the court can make compensation orders against any party accountable for scheme member losses. So it is not confined to the responsible entity. Clearly, the blame game and finger pointing as regards managed investment scheme losses will be as fertile and protracted as ever they were under the former manager-trustee regime. You will have parties being enjoined left, right and centre, all arguing diminished responsibility or that it is the role of the responsible entity. Therefore, I would put quite strongly that section 1325 of the Corporations Law specifically recognise that there is not a single responsibility as far as litigation or loss are concerned.[9]

7.15 The Trustee Corporations Association of Australia (TCAA) shared the TCAL's views that section 1325, in contemplating the liability of parties other than the RE, was inconsistent with the single RE concept. The TCAA said in its submission that the question of accountability under the MIA regime needed to be made clear and that:

> …the 'single' RE is a misnomer, because a number of other parties carry unavoidable responsibility in the operation and oversight of managed investment schemes.[10]

7.16 At the hearing on 12 July 2002, Mr Michael Shreeve, National Director, TCAA, said that:

> If indeed the single responsible entity is not singularly responsible—if there are others and if it is only fully responsible for what it does and what its agents do—people ought to stop talking about it like that, and they should stop opposing sensible independent investor protection techniques because they conflict with what is a myth.[11]

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7 Mr Dave Maher, *Committee Hansard*, 7 August 2002, p. 80.

8 Submission no. 7, p. 3.

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

10 Submission no. 3, p. 5.

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

7.17 Although the TCAL and the TCAA saw contradictions between the single RE concept and section 1325, neither they nor any other submitters to the inquiry suggested that the right of action conferred by section 1325 should be abolished.

7.18 The Committee consequently considers that, despite theoretical inconsistencies between the single RE concept and the right of action available under section 1325, these inconsistencies fail to establish a case to alter the status quo.