CHAPTER 9

PROPOSALS FOR CHANGE

Introduction

9.1 Commenting on the findings of the Turnbull Review and the single RE structure, the Department of the Treasury, said:

> [The Turnbull Review's] conclusion is that the existing arrangements, which provide some flexibility for ASIC to put conditions on licenses which could include the appointment of a third-party custodian, provide sufficient protection [for investors]…[A] third-party custodian would sit at odds with the underlying rationale for the Managed Investments Act, which was to replace the old dual structure with a trustee and a fund manager with a single responsible entity.[1]

9.2 In earlier chapters, the Committee reviewed the extensive compliance framework which is the principal mechanism under which the MIA seeks to protect investors' interests. The checks and balances within this framework are intended to detect non-compliance before it affects the viability of a scheme.

9.3 These checks and balances consist of up-front registration and licensing requirements to ensure every scheme has the proper investor-protection measures in place, and the RE has adequate financial and other resources to run the scheme. Besides registration and licensing, the RE's compliance with requirements is regularly monitored by in-house compliance monitors and by an independent compliance plan auditor on an annual basis. Additional controls are exerted by ASIC's ongoing surveillance and enforcement activities.

9.4 In this chapter, the Committee will examine claims that two interwoven aspects of the former dual-party regime not adopted by the MIA, namely, real-time monitoring of the scheme manager's activities and mandatory third-party custodianship of scheme property, offered investors a level of protection that the MIA has failed to provide. The Committee will consider proposals for change as part of its examination.

9.5 Those in favour of preserving the basic framework of the single RE model have argued that it offers the following advantages:

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1 Mr Nigel Ray, *Committee Hansard,* 7 August 2002, p. 78.

- a 'structurally flexible and very robust regulatory regime' comprising a single RE—'a "trustee" in the true sense of that word', in place of a structure having 'fundamental legal and commercial contradictions';[2]
- five lines of defence which work well to protect investors, and 'to revert to the position where a trustee and manager were both involved (at least theoretically) in investment decisions' would not be in the interests of investors;[3] and
- 'a system which provides a high degree of investor protection.'[4]

9.6 Disadvantages cited by those critical of the model were that:

- the abolition of the independent trustee/custodian meant that:
  - the scheme manager was no longer subject to real-time monitoring by an independent trustee; [5]
  - there was insufficient protection for scheme property;[6]
- investors were less likely to receive fair compensation in the event of a fund's collapse;[7] and
- a detached trustee would be better placed to monitor and report on an RE's activities.[8]

9.7 Critics also claimed that the MIA diverges from global best practice in not requiring mandatory third-party custodianship and point to this as further evidence of the MIA's inferiority.

9.8 The Committee will now consider arguments for and against the single RE model.

The single RE model—supporters and detractors

The protection offered by independent trustees

9.9 The Investment and Financial Services Association Ltd (IFSA) argued in its submission to the Turnbull Review that the single RE model was a substantial improvement on the dual-party structure. IFSA claimed that the protection offered to

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2 Submission no. 2 (Investment & Financial Services Association Ltd), p. 2 of letter attached to main submission.

3 Supplementary submission no. 6A (Mr Russell Stewart), p. 2.

4 Submission no. 12 (Professor Paul von Nessen), p. 1.

5 Submission no. 3 (Trustee Corporations Association of Australia) and submission no. 7 (Trust Company of Australia Limited).

6 Submission no. 9 (Dr Shann Turnbull); submission no. 3 (Trustee Corporations Association of Australia) and submission no. 7 (Trust Company of Australia Limited).

7 Submission nos. 3 and 7.

8 Submission no. 1 (Mr J McAuley).

investors by the independent trustee had been 'largely illusory' and referred to the 'fiction that trustees were able to supervise the activities of the managers who had appointed them in the first place.' In this regard, IFSA concluded that the MIA created a regime with 'clear statutory duties and clear lines of responsibility for entities managing other peoples' money' and added that:

> …IFSA would strongly oppose any suggestion that might compromise this most important aspect of MIA. The imposition of external compliance entities, in the form of 'supervisory' boards or custodians, for example, would achieve little or nothing in terms of boosting compliance while undermining the integrity of the MIA regime.[9]

9.10 Mr Michael Shreeve, National Director of the Trustee Corporations Association of Australia (TCAA) rejected IFSA's characterisation of the protection offered by the independent trustee as 'largely illusory'.[10] He countered that the protection afforded by the independent trustee was not illusory but 'real and tangible', manifesting as a dollar for dollar reduction in investor risk. He elaborated:

> The facts are these. The former system was reviewed as a result of a 1991 collapse of property prices and criminal fraud by some fund managers which led to the failure of the Aust-Wide and Estate Mortgage funds. In these cases, investors would have recovered nothing if they had only the fund manager to pursue—or what is now the single responsible entity. It was the trustee corporations and their insurers that provided investors a return of 100 cents in the dollar for Aust-Wide and between 60 and 80 cents in the dollar for Estate Mortgage. The total outlay was many hundreds of millions of dollars.[11]

9.11 Mr Shreeve concluded that while the MIA regime had introduced efficiencies for big business, which wanted to make quick investment decisions without the interference of the trustee, it did so at the expense of having appropriate checks and balances.[12]

Commercial Nominees of Australia—a case study

9.12 In its submission to the current review, IFSA again expressed support for the single RE model and commented that it had produced 'spillover' benefits for the superannuation industry as a result of the 'more focused and compliance-centred operations of MIA regulated schemes'. Elaborating on this point, IFSA commented that:

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9 IFSA's submission to the Turnbull Review, p. 3.

10 IFSA submission no. 2, p. 2.

11 *Committee Hansard*, 12 July 2002, pp. 47–8.

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

> Superannuation has been a major beneficiary of this development, meaning as it does that superannuation fund members have the trustee benefits of SIS and MIA operating in concert to protect their moneys.
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> In this regard, the comments of the Senate Select Committee on Superannuation and Financial Services, in its second Report on Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services, are highly relevant.
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> The Committee examined a number of case studies, including one on the activities of Commercial Nominees of Australia Ltd, in relation to which it concluded:
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> 'In the view of the Committee, one of the main problems associated with CNA and its trusteeship of the ECMT was the investment approach undertaken by the trustees. The Committee considers that the underlying problem of CNA's investments is that they were operating under the old trustee manager regime. Had the investments been made under the MIA, the problems may not have occurred, because of the controls that exist under that Act.'[13]

9.13 The views expressed about CNA's collapse by the Senate Select Committee on Superannuation and Financial Services (Senate Select Committee) which IFSA cited in its submission, attracted criticism from the Trust Company of Australia Ltd (TCAL) and the Trustee Corporations Association of Australia (TCAA).

9.14 The TCAL commented that, contrary to the Senate Select Committee's conclusions, there would have been nothing under the MIA regime to prevent CNA's investment in the mushroom farm had it been a registered scheme and, if it had not been registered, '[t]he investment could nonetheless be executed as there would be no third-party scrutiny of the purchase process.'[14]

9.15 Mr Shreeve, TCAA, claimed at the hearing that the Senate Select Committee's conclusions were 'misleading' in suggesting that the investments associated with CNA's collapse were made under the 'old trustee-manager regime'.

9.16 Mr Shreeve said that CNA's investments had not operated under the old dual-party structure. He suggested that, if the enhanced cash management trust in which CNA had invested, had operated under the old regime, there would have been real-time monitoring under which the failed investment in the mushroom farm could have been prevented. If this had not been the case, he said, investors would at least have had recourse to compensation through the trustee's insurers.[15]

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13 Submission no. 2, p. 4.

14 Submission no. 7, p. 7.

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

9.17 Mr Shreeve argued that, contrary to the Senate Select Committee's conclusions, had CNA been regulated under the MIA, the outcome would have been no different for the following reasons:

- CNA, as the RE, would not have prevented the related party transaction because it was the related party;
- hindsight monitoring by the MIA's board, compliance committee, auditors or the regulator would not have picked up the wrongdoing in time;
- based on the history of the case, it is unlikely that the board or compliance committee would have been sufficiently independent to have acted in the interests of investors.[16]

Real-time monitoring

9.18 One of the principal shortcomings of the single RE model, according to the TCAL and the TCAA, is that it does not provide for real-time monitoring of the RE's activities.

9.19 In this regard, Mr Jonathan Sweeney, Managing Director of the TCAL, said that the previous dual-party structure had provided 'an effective layer of independent supervision' with 'real-time prior approval of fund transactions by an independent third-party trustee'. This was contrasted with the single RE model which comprised:

- self-regulation by the RE;
- after-the-event semi-annual financial auditing; and
- periodic compliance plan review and annual compliance plan review typically conducted by a partner of the financial auditor's firm. [17]

9.20 Mr Donald Christie, Managing Director of Equity Trustees Ltd, and appearing with the TCAL at the hearing on 12 July 2002, referred to the Tricontinental Royal Commission and said 'the real issue coming out of that is the power than an executive has in dealing with a board'. Commenting that the trustee or custodian-trustee provided an extra layer of protection for investors, he said that:

> …[trustees] had the reins over the assets; we had the cash. When somebody came along to us to say, 'Send out a cheque for a mushroom farm,' we had the power and the ability to ask the real-time question: 'Why? It's not an appropriate investment for the fund. It's not in the terms of the investments that can be undertaken under the deed.' The process that is now being undertaken—and in the case of Commercial Nominees perhaps not at all—is, at best, retrospective.[18]

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

17 Submission no. 7, p. 1.

18 *Committee Hansard,* 12 July 2002, p. 51.

9.21 The TCAA argued that the absence of an independent body charged with real-time monitoring of the RE's activities was 'a fundamental structural flaw' that would allow the exploitation of conflicts of interest and disadvantage investors. Although it agreed there were benefits in increased compliance awareness in the industry, it considered that 'awareness alone [did] not provide adequate protection, even when coupled with after-the-event surveillance by regulators and auditors'.[19]

9.22 Mr J McAuley, an independent licensed investment adviser, characterised the managed investment market as lacking in transparency and ill-informed, and thought there was a need for an independent body to oversee the RE's activities. He said:

> [In the current market environment] it seems irrational to deprive the market of the services of some specialised agency such as detached trustees, who could be better placed to criticise, observe and publicise inappropriate behaviour in the handling of managed funds. The SRE concept is one which therefore leaves investors even more exposed than ever.[20]

9.23 Not all submitters thought that the trustee's real-time, independent monitoring of the scheme manager's activities under the old regime provided better investor protection than the arrangements under the MIA regime.

9.24 IFSA argued at the hearing that real-time monitoring had been cumbersome and suggested that it militated against effective funds management in times of market stress. IFSA considered that the MIA's credibility had been established by the effective and timely action taken by funds in response to the September 11 crisis. The MIA had facilitated this, IFSA said, by allowing for more streamlined and responsive decision-making than had existed under the old regime.[21] Evidence on this point is discussed in more detail in Chapter 3.

Mandatory third-party custodianship

9.25 The Turnbull Review had received submissions about the relative advantages or otherwise of mandatory third-party custodianship of a scheme's assets.[22] On evaluation of the evidence, the review determined:

> While arguments favouring the appointment of mandatory third-party custodians may carry some merit, such a requirement would not sit easily with the rationale for replacing the dual trustees/fund manger structure with a single RE. This is particularly so as the introduction of mandatory third-party custodians could potentially compromise and confuse the special position of the RE with respect to scheme members.[23]

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19 Submission no. 3, p. 1.

20 Submission no. 1, p. 1.

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

22 Turnbull Review, pp. 28–9.

23 Turnbull Review, p. 30.

9.26 Contrary to these findings, a number of witnesses to the current inquiry considered that mandatory third-party custodianship of scheme property was essential to protect investors' interests.

9.27 Dr Shann Turnbull, Principal of MAI Services Pty Limited, was critical of the Turnbull Review's failure 'to even consider that the [MIA] was fundamentally flawed' in not requiring mandatory third-party custodianship. He commented that, in doing so, the review:

> …perpetuated the myth of non-executive directors (NEDs) and compliance committees providing safeguards.

and added that:

> …this myth has been exposed by empirical research into UK companies by leading international corporate governance researchers…
>
> [and that] One-Tel, FAI and HIH, etc, provide local examples…[24]

9.28 The TCAL proposed the mandatory use of an 'adequately capitalised and insured external, third-party custodian' and asked:

> Why should we wait for a substantial failure before implementing a sensible reform that involves no additional cost or inconvenience?[25]

9.29 At the hearing on 12 July 2002, Mr Shreeve, TCAA, was critical that third-party custodianship of scheme property was not mandatory under the MIA even though it was 'a fundamental requirement for sound investor protection overseas'.[26]

9.30 The TCAA's submission referred to comments made by Standard and Poor's in this regard that:

> The failure to mandate that fund assets must be held in safekeeping by an independent custodian is of concern and is in contrast to all other major financial centres in the world, where an independent custodian is a minimum standard.[27]

9.31 The TCAA also referred to a survey cited during the gestation of the MIA regime which showed that, out of 43 countries, only two jurisdictions—British Virgin Islands and the Nederland Antilles—did not require an independent trustee or equivalent. The submission reported that the British Virgin Islands had subsequently moved to require an independent custodian.[28]

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24 Submission no. 9, pp. 1-2.

25 Submission no. 7, pp. 4-5.

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

27 Submission no. 3, p. 4.

28 The survey referred to was conducted by KPMG in 1995. See submission no. 3, p. 4.

9.32 The TCAA and the TCAL both argued that the MIA did not comply in practice or theory with core global standards, referring in particular to the International Organisation of Securities Commission's (IOSCO's) standards on regulation of collective investments. The TCAA stated that:

> It might be noted that the core principles issued by the International Organisation of Securities Commission (IOSCO) for the regulation of collective investment schemes require that the assets of a scheme be clearly separated from other assets. IOSCO points out that this is usually achieved by appointing an independent trustee, custodian or depositary.
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> IOSCO further notes that in the unusual situation where assets are held in the name of the scheme operator, additional protective conditions are required. For example, in the US the scheme assets are to be deposited in the safekeeping of a bank or other company whose functions and facilities are supervised by federal or state authorities; further, these arrangements must be independently examined three times a year.[29]

9.33 Of those in favour of the single RE model, Mr Russell Stewart, Partner, Minter Ellison Lawyers, thought the MIA had lifted standards. At the hearing, he discussed what he considered were the five lines of defence provided by the MIA to protect investors. These were:

- the promises made by the responsible entity in the constitution and prospectuses;
- having assets held by a custodian;
- the compliance plan and the compliance committee;
- the restriction on the ability to invest in unregistered schemes; and
- ASIC's supervision of registered schemes and the licensing requirement for REs.[30]

9.34 With regard to his comment concerning custodianship of scheme assets, Mr Stewart added:

> …I think the fact that the assets are held by an independent entity does operate as a practical protection in a lot of cases, because if you do have a total failure of the responsible entity at least there is somebody there who still has the assets. But I do not agree that it is necessary to make that mandatory for all responsible entities, because ASIC has very strict requirements for those who self-custody and in effect they have to have a virtual independent custody operation within their own organisation.[31]

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29 Submission no. 3, p. 4.

30 *Committee Hansard,* 11 July 2002, pp. 18-19. (Mr Stewart's evidence was given in a private capacity and not as a representative of Minter Ellison Lawyers.)

31 *Committee Hansard*, 11 July 2002, p. 18.

9.35 In contrast to Mr Stewart's view, the TCAL was not satisfied that conferring a discretion on ASIC to require appointment of a custodian was enough. In addition, the TCAL considered this would only open the door for extensive litigation against ASIC for lost investments if a fund did not appoint a custodian as directed and had subsequently failed. The submission asked:

> What do scheme members lose by requiring an independent custodian for all managed investment schemes?[32]

9.36 When asked by the Committee what he considered to be the key investor-protection mechanism missing from the MIA regime, Mr Sweeney, TCAL, nominated the mandatory independent custodian. He explained to the Committee that:

> If you are looking at disaster scenarios, then to me the independent custodian…is the most important because…you are not going to have a fund manager standing…If you have an independent custodian, you have someone holding the assets…and, if there have been any mistakes or whatever by the custodian, you have got someone to sue. You obviously cannot sue the responsible entity because they are gone…

and in relation to the advantages of the custodian's independence from the RE:

> It is much more difficult to cooperate with an external party, to be brutal, than with an internal party in pushing the envelope.[33]

9.37 The TCAA agreed with the TCAL that the MIA's failure to require mandatory third-party custodianship of scheme property had seriously jeopardised investors' interests.

9.38 However, the TCAA proposed a revised, 'fully responsible entity' framework under which the RE would be fully responsible for its own actions and those of agents but not 'solely' responsible. Other parties involved in the running and oversight of the scheme would be expressly accountable to investors.

9.39 In addition, the new framework would involve the elimination of the in-house compliance committee and the expansion of the compliance plan auditor's function:

- to include more frequent and timely monitoring;
- to provide for quarterly reporting to the RE and annual reporting to ASIC and scheme members; and
- to act as the investors' representative in pursuing remedies against the relevant parties for scheme losses due to compliance breaches.

9.40 The TCAA also proposed opening up the compliance auditing role to other qualified and approved professionals. In this regard, the TCAA referred to

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32 Submission no. 7, p. 2.

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

recommendations by the Productivity Commission in its superannuation legislation review that the Australian Prudential Regulation Authority should examine whether there was a need to confine compliance audits to financial auditors. The TCAA believed that widening access to the compliance monitoring function beyond financial auditors would address conflict of interest concerns and ensure more commercially sound pricing.[34]

9.41 In a supplementary submission to the inquiry, the TCAA referred to Canada's recent proposal for mutual funds to establish an independent 'governance agency' to monitor a fund's business practices and compliance with the law. Commenting on this proposal, the TCAA stated that:

> Canada, like all advanced economies except Australia, requires separate custody arrangements for managed funds.
>
> However, the regulators have stated that in addition to this, it is one of the few countries in the world that does not have an independent compliance monitor to address the potential conflicts of interest that are inherent in most mutual fund structures. It is proposing that mutual funds be required to establish a 'governance agency' to oversee the actions of the fund manager.
>
> The governance agency…would…be directly responsible to the investors…and have wide investor protection responsibilities…[35]

9.42 When asked by the Committee whether the MIA would be improved if ASIC were to have a much greater involvement in independence and integrity issues regarding compliance, Mr Shreeve, TCAA, commented that:

> We think that there is a fundamental structural problem in that the idea of self-regulation, even if people are approved by ASIC and even if they have codes of conduct, will be very difficult to make work effectively. We believe there is an inherent conflict of interest that needs an alternative buttressing force—that is, a genuinely independent compliance monitor.[36]

<u>The Committee's views</u>

9.43 Mr David Knott, Chairman, ASIC, when commenting on the spate of recent corporate failures in Australia, suggested that one contributing factor had been a growing complacency towards corporate governance. This, he proposed, had been nurtured by sustained economic growth during the '90s and Australia's 'remarkable'

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34 Submission no. 3, pp. 8-9. *Committee Hansard,* 12 July 2002, pp. 49-50. See also Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation, Report no. 18*, 10 December 2001, pp. 60-7.

35 Submission no. 3A, p. 1.

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

survival of the Asian financial crisis so that corporate governance 'lost momentum as an effective program for corporate risk management'.[37]

9.44 Among the other factors proposed by Mr Knott as contributing to recent corporate failures were:

- the changing market conditions in 2000 which brought 'buried problems to the surface' which could be more easily hidden in more buoyant times with easy access to debt and equity;
- management neglect or misconduct; and
- a failure of accounting and auditing to deliver acceptable outcomes.

9.45 In relation to this last point, Mr Knott referred to:

> …the paradox that auditors are expected to reconcile a commercial service provider/client relationship with a watchdog/whistleblowing responsibility.

and added that:

> All of the commercial incentives support their service provider/client relationship; and there is very little legislative or other incentive to support their public responsibility role.[38]

9.46 There is no doubt that the corporate collapses in the US and Australia have shaken market confidence and focussed attention on corporate governance, particularly with regard to the independence of company directors and auditors.

9.47 The United States has made significant changes to its corporate governance regime in the *Sarbanes-Oxley Act of 2002* which the Committee has already referred to. In Australia, the Government has commenced the process of corporate governance reform, particularly in the area of auditor independence, with its CLERP 9 issues paper released in September 2002.

9.48 Against this background, questions raised about corporate governance and, in particular, the effectiveness of internal and external compliance monitoring and self-regulation under the MIA take on an added resonance.

9.49 The Committee notes that the MIA's regulatory framework was devised following several years of sustained buoyancy and confidence in Australia's financial markets. The framework places considerable confidence in the independence and integrity of its compliance monitors which, in view of HIH, One-Tel, Harris Scarfe and the corporate debacles in the United States, may have been misplaced.

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37 Address by Mr David Knott, Chairman, ASIC, to the CPA Congress 2002 Conference, *Protecting the investor: the regulator and audit,* 15 May 2002.

38 Address by Mr David Knott, Chairman, ASIC, to the CPA Congress 2002 Conference, *Protecting the investor: the regulator and audit,* 15 May 2002.

9.50 Evidence presented to the Committee has raised concerns that the key investor-protection elements under the MIA may not be delivering the level of protection that investors are entitled to expect and, indeed, which is needed to maintain confidence in the managed funds sector among domestic and overseas investors.

9.51 The Committee has made recommendations about licensing requirements for REs, specifically, that ASIC review NTA and insurance requirements for REs. In this regard, the Committee's main objective is to ensure that an RE has a sufficient financial buffer to enable it to ride out the consequences of poor investment decisions or otherwise to guard against the risk of a disorderly wind-up if the business fails.

9.52 The Committee is also concerned about start-up and on-going costs imposed on managed funds by the MIA and whether they have translated into lower fees for investors. Tied in with this is the effect of the MIA on market structure and competition which ultimately has an impact on investor protection.

9.53 Although important, these matters should not divert attention from the fundamental objective of the MIA—to ensure that scheme property will be protected in the event of a scheme's collapse or an RE's malfeasance.

9.54 As a start, it is essential that in-house and external compliance monitors have the requisite degree of independence to enable them to carry out their role so that conflicts of interest are promptly identified and successfully managed before they threaten the viability of a fund.

9.55 On the basis of the evidence heard during its inquiry, the Committee questions whether the Act makes adequate provision for the independence of the key players in the compliance framework—the RE's board, the compliance committee, and the compliance plan auditor.

9.56 Indeed, the Committee's recommendations put forward in earlier chapters of this report reflect the Committee's concern and seek to strengthen the independence of the compliance framework by:

- tightening the definition of 'external' to enhance the independence of the compliance board and compliance committee;
- requiring the RE to advise ASIC of appointments, retirements or dismissals of compliance board or committee members;
- conferring powers on ASIC to remove non-performing compliance monitors;
- placing members of the compliance board under the same duties and obligations as compliance committee members;
- developing guidelines for competency and integrity for in-house compliance monitors;

- requiring the compliance plan to include minimum standards of competency and integrity for compliance monitors;
- allowing a corporate entity to be a member of a compliance committee; and
- imposing additional reporting obligations on the compliance auditor including a requirement that the auditor report to scheme members.

9.57 However, the Committee is not persuaded that strengthening the integrity of compliance monitoring and ensuring that REs have adequate financial backing—without more—will deliver the optimum protection for scheme property.

9.58 In the United States, the United Kingdom and Canada, scheme property must be held by an independent custodian.

9.59 There is no question that, in not requiring mandatory third-party custodianship of scheme property, Australia has chosen to deviate from what is considered to be global best practice.

9.60 Clearly there are two distinct schools of thought on the new MIA regime. Those belonging to one hold serious doubts about the wisdom of dispensing with a mandatory third-party custodian. They believe that a third-party custodian of scheme property is crucial to protect investors' interests and strongly advocate a return to the dual-party structure. They point to global best practice and suggest that Australia is out of step with the major financial centres of the world where an independent custodian is a minimum standard.

9.61 The other is convinced that the safeguards built into the new regime, such as the statutory duties imposed on the RE, the rigorous compliance obligations and ASIC's surveillance role, offer sound investor protection. They see great strength in having a single responsible entity which is designed to provide clear accountability and cost savings.

9.62 The Committee understands the concerns of those looking to return to the old dual-party structure with a trustee and a fund manager. It appreciates that there is no precedent for the RE system. Further, the Committee acknowledges that the new arrangements for protecting investor interests have yet to be genuinely tested by market conditions—that it is still early days and some sectors of the business community harbour lingering uncertainty about the soundness of the MIA.

9.63 The Committee sought the Department of the Treasury's view on whether a requirement for an independent custodian would provide better protection for investors. Mr Nigel Ray, Executive Director from the Department, commented that the Turnbull Report had found no support for claims that the single RE model was wrong.[39]

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39 *Committee Hansard*, 7 August 2002, p. 79.

9.64 When asked to comment on the view expressed by Standard and Poor's that the MIA's failure to require mandatory third-party custodianship of fund assets was contrary to requirements in all other major financial centres of the world, Mr Ray responded that:

> The government's position is that it would prefer Australia to be leading the world and have best practice in regulation. Just because we do something that is different does not mean that it is wrong or weaker.[40]

9.65 The evidence presented to the Turnbull Review and the Committee's current inquiry, has failed to establish a convincing case that the MIA's regulatory framework would benefit from the imposition of mandatory or optional third-party custodianship or any other major structural changes. The Committee is satisfied that the framework currently in place, together with the measures recommended by the Committee to ensure that conflicts of interest are properly managed, is delivering a high standard of protection to investors in managed funds.

9.66 The Committee consequently does not intend to make any recommendations regarding structural changes to the regulatory framework. Having said this, the Committee stresses that there are areas of concern with the MIA's management of conflicts of interest. The Committee therefore strongly urges the adoption of its recommendations to deal with these.

9.67 However, in acknowledgement of the arguments put in favour of optional third-party custodianship, the Committee believes that the current provisions of the Act in this regard should be monitored by ASIC.

Recommendation 16

The Committee recommends that the current provisions of the *Managed Investments Act 1998* relating to third-party custodianship, should be monitored by ASIC with regular reports being made to the Parliamentary Joint Committee on Corporations and Financial Services with particular regard to:

- **the number of entities opting into third-party custodianship; and**
- **providing some qualitative comparative analysis of the performance of those entities with, and those without, third-party custodians.**

The Committee further recommends that on the basis of these reports, the Committee should regularly review the efficacy of the current opt-in provisions in the Act compared with an alternative opt-out provision regarding optional third-party custodianship.

Senator Grant Chapman
Chairman

40 *Committee Hansard*, 7 August 2002, p. 79.