The Parliament of the Commonwealth of Australia

REPORT ON THE REVIEW OF THE *MANAGED INVESTMENTS ACT 1998*

PARLIAMENTARY JOINT
COMMITTEE ON CORPORATIONS
AND FINANCIAL SERVICES

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Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the duties of the Committee as follows:

The Parliamentary Committee's duties are:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

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Acronyms and Abbreviations

ALRC	Australian Law Reform Commission
ALRC/CASAC report	*Collective Investments: Other People's Money, Report no. 65*, 1993, vol. 1, Australian Law Reform Commission and Companies and Securities Advisory Committee
ASIC	Australian Securities and Investments Commission
ICCM Forum	Independent Compliance Committee Members Forum
IFSA	Investment & Financial Services Association Ltd
JCPAA	Joint Committee of Public Accounts and Audit
MIA	*Managed Investments Act 1998*
PTAL	Perpetual Trustees Australia Limited
RE	Responsible entity
SRE	Single responsible entity
TCAA	Trustee Corporations Association of Australia
TCAL	Trust Company of Australia Limited

List of Recommendations

Chapter 4—The compliance committee

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;[1]
  - 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)[2]; and
- the meaning of 'material' be clarified.

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.

Recommendation 4

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

2 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.

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.

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.

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.

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 lodgment 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.

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.

Chapter 5—Compliance plan auditing

Recommendation 9

The Committee recommends that the *Corporations Act 2001* should be amended to strengthen the independence of compliance plan auditors to include:

- a general statement of principle requiring the independence of compliance plan auditors;
- a requirement for compliance plan auditors to report to ASIC annually about their management of independence issues according to benchmarks developed by ASIC; and
- a requirement for compliance plan auditors to report to ASIC any attempts to corrupt the integrity of the audit.

Recommendation 10

The Committee recommends the application of qualified privilege and whistleblower protection to employees of the RE and, if not already covered by subsection 601HG(8) of the *Corporations Act 2001*, to employees of, and the compliance plan auditor reporting any suspected breaches of the law to ASIC in good faith and with reasonable cause.

Recommendation 11

The Committee recommends that the Department of the Treasury, in consultation with ASIC and relevant industry stakeholders, look into the feasibility of opening up the field for compliance plan auditors where it is considered that persons other than registered company auditors as defined under the *Corporations Act 2001* could effectively carry out the requirements of a compliance plan auditor.

Recommendation 12

The Committee recommends that the Corporations Act 2001 be amended to accommodate ASIC's proposals to:

- require the compliance plan auditor to report to scheme members;
- clarify that the auditor's opinion relates to a scheme's performance for the entire year being audited;
- require a compliance plan audit of a newly registered scheme within the first year of its registration;
- require an auditor's opinion on the adequacy of the compliance plan to be included with a scheme's application for registration; and
- clarify that the compliance plan audit need only focus on material issues.

The Committee further recommends that the Department of the Treasury and ASIC should develop a test of materiality.

Chapter 6—Other checks and balances

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.

Chapter 8—Costs and fees

Recommendation 14

The Committee recommends that the Government commission an independent cost/benefit analysis with a view to determining the impact of the *Managed Investments Act 1998* and other relevant legislation. This will then establish a useful benchmark for future studies. The analysis should specifically look at:

- Australia's performance on costs and fees compared with major overseas financial centres;
- whether and to what extent the MIA has limited or stimulated competition within the industry; and
- whether understanding, transparency and disclosure for consumers has improved and/or is sufficient with regard to managed investments costs and fees.

Recommendation 15

The Committee recommends that the *Corporations Act 2001* be amended to provide for a 'fair' treatment criterion in lieu of 'equal' treatment but only to provide for differential fees.

The Committee further recommends that what constitutes 'fair' treatment should be developed through consultation between the Department of the Treasury, ASIC and industry groups. The Committee notes that the Department is presently consulting with regard to this issue.

Chapter 9—Proposals for change

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.

CHAPTER 1

THE COMMITTEE'S INQUIRY

Review of the Managed Investments Act

1.1 On 6 August 2001 the then Minister for Financial Services and Regulation, the Hon. Joe Hockey MP, announced that Mr Malcolm Turnbull would conduct a review of the *Managed Investments Act 1998*. The review was to report to the Minister by 3 December 2001, within the six months mandated for the report following the triennial anniversary of the Act.

1.2 The terms of reference for the review determined it should evaluate key elements and objectives of the Act, principally to assess whether it had secured better investor protection, a stronger compliance regime and was more cost effective. The terms of reference required that:

The review would evaluate the effectiveness of the arrangements for the regulation of managed investments introduced, contained in Chapter 5C of the *Corporations Act 2001*, to determine whether:

- the arrangements have delivered benefits in terms of:
  - better protection of investors' investments;
  - greater certainty as to the responsibilities, obligations and liability of scheme operators (known as 'responsible entities' under the legislation);
  - the rights of investors in managed investment schemes; and
  - reducing the costs of investing in managed investment schemes.
- the arrangements have strengthened compliance practices, procedures and awareness amongst responsible entities and others involved in the managed investments industry;
- the arrangements cater for the diversity of managed investments, including consideration of the way in which the legislation is administered by the Australian Securities and Investments Commission; and
- refinements could be made (whether requiring legislative amendment or not) to enable the arrangements to operate more efficiently and effectively, while not unnecessarily detracting from the protection afforded to investors.

1.3 The Parliamentary Secretary to the Treasurer, Senator the Hon. Ian Campbell, released the *Review of the Managed Investments Act 1998* (Turnbull Review) on 19 December 2001. Announcing the release, Senator Campbell stated that the findings of the Turnbull Review indicated that, overall, the regulatory arrangements for the managed investments industry were working effectively.[1]

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1 Review of the *Managed Investments Act 1998, Press Release,* 19 December 2001.

1.4 While the scope of the terms of reference were broad, the Turnbull Review nevertheless focussed on operational and technical implications of provisions enshrined in the Act. As the Executive Summary explained, the review did not set out to re-examine the case for the single responsible entity (RE) arrangements in comparison to the previous dual-party structure for managed investments. Instead, it sought to evaluate whether the new arrangements had proved to be efficient, cost-effective and accountable.[2]

1.5 The review also acknowledged its findings were constrained because a large part of the industry was still in transition to the new regime until well into 2000. This made it difficult to determine with any degree of certainty whether or not the new arrangements had reduced risk or decreased costs compared with the former dual-party structure.

1.6 Some issues addressed in the review were subsequently referred for clarification to the Department of the Treasury for public consultation. The Department released the *Managed Investments Act 1998* Consultation Paper on 29 May 2002, and invited responses by the extended date of 17 June 2002. The results of the consultation have not yet been published.

Initiation and conduct of the Committee's inquiry

1.7 On 20 March 2002, the Committee decided to inquire into the Turnbull Review and adopted the following terms of reference for its inquiry:

To assess the findings of the review by Mr Malcolm Turnbull of the *Managed Investments Act 1998*, with particular regard to:

a) the risks to investors in the current arrangements, taking into account the extent to which any lack of independent checks and balances may have contributed to recent financial failures in Australia and overseas;

b) global best practice in investor protection of managed funds;

c) the acknowledgment by the review that, under section 1325 of the *Corporations Act 2001*, a number of parties may be held accountable for member losses;

d) the rejection by the review of proposals which might conflict with the concept of having only a single entity responsible in the event of member losses;

e) the review conclusion that scheme operators not have the option of appointing an external corporate entity for compliance purposes, pending ASIC monitoring of compliance performance;

f) the reasons why the strong growth in managed funds has not resulted in a significant reduction in fees, and

g) any other relevant matters.

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2 Turnbull Review, pp. 14–15.

1.8 This inquiry follows that into the Managed Investments Bill 1997, which was conducted by this Committee as the Joint Statutory Committee on Corporations and Securities in early 1998.

1.9 The Committee's inquiry into the Turnbull Review was advertised in two national newspapers, the *Australian* and the *Australian Financial Review,* on 6 April 2002. Details were also placed on the Committee's web site and included the terms of reference for the inquiry.

1.10 Written submissions were invited from interested parties to be lodged by 3 May 2002. In addition, the Committee contacted those organisations responding to the Turnbull Review to ascertain their views on the effectiveness of the review and the appropriateness of its findings. A total of 12 submissions, plus two supplementary submissions, was received. A list of submissions is at **Appendix 1.**

1.11 The Committee held public hearings for industry representatives on 11 and 12 July 2002 in Sydney. The Committee also heard from representatives from the Department of the Treasury and from the Australian Securities and Investments Commission (ASIC) in Sydney on 7 August 2002. A list of witnesses who appeared before the Committee is at **Appendix 2**.

1.12 The Committee acknowledges the assistance of those who made submissions or who appeared as witnesses.

CHAPTER 2

INQUIRY BACKGROUND AND OBJECTIVES

Introduction

2.1 The *Managed Investments Act 1998* (MIA) introduced a new structure for managed investment schemes so that a single responsible entity (RE) would carry full responsibility for a scheme and any liability for losses. The Act took over from the prescribed investments system (dual-party system) in which funds management was shared by a fund manager and trustee, with the lines of accountability to investors unclear.[1]

2.2 The chief object of the legislation was to increase investor protection in an era of unprecedented growth in managed investment schemes. The trend overall was buoyed by the deregulation of financial markets in the 1980s, which saw a proliferation of collective investment vehicles—from the largest commercial property and management trusts to small one-off schemes such as pine forests, ostrich and yabby farms. The Government's support for self-funded retirement, following the introduction of compulsory superannuation in 1992, further stimulated growth in this sector during the 1990s.

2.3 However, the commercial property crash at the end of the 1980s drew attention to the regulation of managed investments. In particular, the collapse of Estate Mortgage in 1989 highlighted the deficiencies of the dual-party structure, with fund managers and trustees in dispute about their liability for fund failure. Shortly after, another investment scheme, Aust-Wide, also collapsed. The resulting loss of investor confidence, with requests for redemption continuing to outstrip applications for unit trusts, suggested that a comprehensive review of the regulation of collective investment schemes was required.[2]

2.4 Responding to the situation, the then Attorney-General, the Hon. Michael Duffy MP, commissioned the Australian Law Reform Commission (ALRC) and the Companies and Securities Advisory Committee (now the Corporations and Markets Advisory Committee) to inquire into the regulation of managed investments.

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1 The information in this section is drawn from various sources, including the report of the Australian Law Reform Commission and Companies and Securities Advisory Committee, *Collective Investments: Other People's Money, Report No. 65*, 1993; Second Reading Speeches for the Managed Investments Bill 1997 in March, May and June 1998; the Turnbull Review and, as otherwise indicated, in text notation.

2 *Collective Investments: Other People's Money, Report No. 65,* 1993, vol. 1, pp. 1–3.

2.5 The report, *Collective Investments*: *Other People's Money, Report No. 65* (ALRC/CASAC report), was presented in 1993. It found that the dual-party structure of managed investment schemes was fundamentally flawed. The report recommended that, for every scheme, there should be a single RE in which the functions of both the trustee and the fund manger would be vested.

2.6 In 1995, the Labor government released draft legislation for discussion. Its proposal to reform managed investments regulation also provided for single RE arrangements but included a mandated requirement for a separate custodian to hold scheme funds.

2.7 In March 1997, the single RE proposal was endorsed by the Financial System Inquiry (FSI). Recommendation 89 of the *Financial System Inquiry Final Report* (Wallis Report) advised that regulation of managed investment schemes and superannuation should be harmonised 'to the greatest possible extent by bringing the structure of collective investments into line with that for superannuation funds, by introducing a requirement for a single responsible entity'.[3] The Wallis Report did not comment on custodianship of scheme assets, however.

2.8 Following these findings, the Liberal government, in consultation with key industry participants, drafted new legislation to reform the regulation of managed investments.

The Managed Investments Bill 1997

2.9 The Managed Investments Bill 1997 was introduced into the House of Representatives on 3 December 1997 and the Senate on 5 March 1998. The recommendations in the ALRC/CASAC and Wallis reports, as well as the draft legislation put forward in 1995, influenced the form and content of the Bill.

2.10 In his second reading speech on the Bill, the Parliamentary Secretary to the Treasurer, Senator the Hon. Ian Campbell, explained that the new Bill dispensed with the requirement for a mandatory custodian by imposing statutory duties on the RE with respect to the property of any schemes managed. These duties would ensure that:

- scheme property was clearly identified as such; and
- scheme property was held separately from the property of the responsible entity or of any other scheme.

2.11 The RE of a managed investment scheme would have the choice of determining how these requirements would be met. Senator Campbell noted, however, that the Government expected many REs would find it more convenient to appoint a custodian to hold scheme assets. The Australian Securities and Investments

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3 Wallis Report, pp. 490-1.

Commission (ASIC—then the Australian Securities Commission) would be given powers to require the appointment of a custodian on a case-by-case basis.[4]

2.12 Under the regime, REs would be subject to a comprehensive and rigorous compliance regime, overseen by ASIC. The Bill contained provisions requiring that:

- a managed investments scheme had to be registered with ASIC if a scheme had, among other things, more than 20 members;
- an RE had to be a public company and was to meet stringent compliance requirements to be licensed by ASIC;
- as part of the licensing requirements, the RE had to lodge with ASIC a compliance plan detailing the measures the RE had in place to operate the scheme to ensure compliance with the law and the scheme's constitution (these measures would include arrangements for the custody and protection of scheme property);
- an RE had to satisfy compliance requirements by having a board of directors, half of whom were independent, or by setting up a compliance committee, with half the membership being independent; and
- a member of a registered scheme who suffered loss or damage because of the RE's contravention of legal requirements could seek damages in a civil action against the RE.

2.13 The new arrangements were commended to the Senate as containing measures to ensure a 'high level of compliance' and being a significant improvement on the previous system. A two-year transitional period would apply for existing schemes to comply with the proposed new regime.[5]

The Committee's report on the Bill

2.14 During debate on the Bill, concerns were raised about:

- ASIC's significantly increased responsibilities under the new regime and the difficulty—without knowing what would be in the relevant policy statements and regulations—in assessing how ASIC would implement the legislation and whether it would have the resources to do so effectively; and
- the lack of a mandatory requirement for a custodian.[6]

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4 Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, p. 447.

5 Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, pp. 445-8.

6 See, for example, Mr Kelvin Thomson MP, Second Reading Speech, *House Hansard*, 3 March 1998, pp. 237-9, Mr Stephen Martin MP, Second Reading Speech, *House Hansard*, 4 March 1998, p. 364 and Senator the Hon. Peter Cook, Second Reading Speech, *Senate Hansard*, 28 May 1998, pp. 3345-6.

2.15 This Committee, then known as the Parliamentary Joint Committee on Corporations and Securities, initiated an inquiry into the Bill and produced its report in March 1998. With only a short time to inquire into and report on the matter, the Committee concentrated on the key issues of investor protection, the use of custodians, management and administration costs, increased flexibility, and ASIC issues relating to resources and policy.

2.16 The majority report of the Committee found that:

- the single RE arrangements were an improvement on the previous system;
- it was reasonable to assume that the streamlined arrangements introduced by the Bill would result in savings for investors; and
- the single RE arrangements would encourage innovation in the managed investments industry.

2.17 The report noted that the Government had made commitments to adequately fund ASIC to carry out its new responsibilities but that it would draw Parliament's attention to any shortfall, as part of its ongoing scrutiny of ASIC. The Committee also suggested that ASIC's policy on capital adequacy and the use of separate custodians should be considered in the review to be conducted by the Department of the Treasury at the end of the two-year transitional period.

2.18 With these factors considered, the Committee majority recommended that the Bill should be passed in its current form. The Australian Democrats, however, submitted a minority report on the Bill. In the minority report, Senator Andrew Murray emphasised that an independent custodian was a minimum international requirement for investor protection. He recommended that, if a trustee was not to be part of a scheme, an independent custodian should be required, unless exempted by ASIC. He argued that small business would be disadvantaged under the new arrangements and proposed that investors have a choice about what system they operated under. The Australian Democrats also requested that capital adequacy amounts be provided in the Bill and that the Bill be reviewed five years after assent.

Commencement of the *Managed Investments Act 1998*

2.19 The Managed Investments Bill 1997, with amendments, received assent on 29 June 1998. The amendments, moved by Labor and Democrat Senators with the support of the Greens, included provisions for capital adequacy amounts to be specified in the legislation. The other principal amendment, at section 3 of the Act, called for a review of its operation. It provided that the Minister must cause a review to take place as soon as possible after the third anniversary of the Act's commencement. The review was to be tabled in Parliament within six months of that anniversary.[7]

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7 Managed Investments Bill 1997, *Schedule of Amendments made by the Senate to which the House of Representatives has agreed*, 25 June 1998.

2.20 The *Managed Investments Act 1998* commenced on 1 July 1998. It inserted Chapter 5C into the Corporations Law[8], replacing the dual-party provisions with the new regulatory arrangements. Other amendments to the Corporations Law effected changes relating to the licensing of scheme operators and the appointment and removal of auditors of managed investment schemes. The *Company Law Review Act 1998* commenced at the same time as the MIA. It inserted companion provisions into the Corporations Law, which revamped company law and included provisions relating to the meetings of scheme members.[9]

2.21 The following table shows the scope of regulatory and operational changes for managed investment schemes under the new legislation.

Table 1: Changes to the operations of managed investment schemes[10]

Old law	New law
Manager—public company, usually with securities licence **Trustee** approved by the ASC	**Single responsible entity**—public company with securities dealer's licence; financial and capacity requirements are more stringent than for a general dealer's licence. Prescribed minimum capital requirements.
Scheme assets held by the **trustee** or **sub-custodian** appointed by the trustee	Scheme property may be held by the **responsible entity** or another entity as **custodian,** depending on the adequacy of arrangements for holding scheme property and the amount of net tangible assets. In either case, the **single responsible entity** is ultimately accountable for safeguarding scheme assets.
Scheme **registration not required**	Scheme **must be registered by ASIC**
Approved deed with statutory covenants placing obligations on the manager and trustee	**Constitution** with no implied covenants, but the law requires it address certain matters and imposes responsibilities on the responsible entity
No specified compliance arrangements	**Mandatory compliance arrangements,** including an audited compliance plan and a board or compliance committee with external members
No compliance with related party provisions of Corporations Law (prior July 1998) but some restrictions on related party transactions	**Compliance with provisions for related party transactions** under Chapter 2E of the *Corporations Act 2001*

8 This has been replaced by the *Corporations Act 2001*.

9 Turnbull Review, p. 1 and see the Hon. Peter Costello MP, Treasurer, *Embargo: Treasurer Heralds New Era for Financial System*, Press Release, 1 July 1998.

10 Drawn from a table provided in ASIC's submission to the Turnbull Review, Part 1, pp. 9–10.

2.22 The commencement of these arrangements coincided with the launching of the new regulatory framework for the Australian financial sector. The Australian Securities Commission became the Australian Securities and Investments Commission (ASIC). ASIC took on responsibility for market regulation and consumer protection across the financial system, including for investment and superannuation products.[11]

2.23 ASIC's regulatory responsibilities increased significantly under the new regulatory regime. More particularly, changes to the Corporations Law conferred specific discretionary powers on ASIC to allow the flexibility necessary to cater for scheme diversity.[12]

2.24 The emphasis on ASIC's supervision of the single RE arrangements under the MIA was the main catalyst for Opposition amendments requiring a review of the MIA after its third year of operation. Senator the Hon. Peter Cook, in his second reading speech in May 1998, stated that the review was intended to determine whether the new regime was in fact delivering increased investor protection, and whether ASIC had the capacity to fulfil its mandate as regulator of managed investment schemes.[13]

Review of the Managed Investments Act

2.25 The review undertaken by Mr Malcolm Turnbull commenced its work in August 2001. The results of the review were presented to the Treasurer on 3 December 2001.[14] The review inquiry attracted 31 submissions from industry participants, professional advisers, consumer and investor representatives and members of the public.

2.26 Senator Campbell, when releasing the Turnbull Review on 19 December 2001, announced that the findings of the review indicated that, overall, the regulatory arrangements for managed investments were working effectively. However, the Senator also announced that some matters would be the subject of further consultation between ASIC, the Department of the Treasury and industry participants and stakeholders.[15]

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11 The Hon. Peter Costello MP, Treasurer, *Embargo: Treasurer Heralds New Era for Financial System*, Press Release, 1 July 1998.

12 Senator the Hon. Ian Campbell, Second Reading Speech, *Senate Hansard*, 5 March 1998, pp. 445-8. See also the Turnbull Review, pp. 18–19.

13 Senator the Hon. Peter Cook, Second Reading Speech, *Senate Hansard*, 28 May 1998, pp. 3342-6.

14 Turnbull Review, p. 1.

15 *Review of the Managed Investments Act 1998,* Press Release, 19 December 2001.

2.27 The review commented that time constraints had limited the review's capacity to make definitive statements about the regime's effectiveness in certain areas, for example, those relating to costs.[16]

2.28 Nonetheless, the Turnbull Review expressed an overall confidence in the integrity of current arrangements. It made a number of recommendations designed to clarify the legislation but rejected proposals for the appointment of corporate compliance committee members and for legislative clarification of the roles and duties of agents appointed by the RE. As indicated previously, it did not examine whether there was a need for mandatory custodianship of fund assets.

Committee' s inquiry into the review

2.29 When the Committee reported on the Managed Investments Bill 1997 in March 1998, it recommended that the Bill be passed. Even so, it expressed one overriding concern—that the Government take care to ensure that the concurrent restructuring of ASIC and the introduction of the new regulatory arrangements for managed investments would not weaken 'actual investor protection and perceived investor protection'.[17]

2.30 The Turnbull Review did not examine in any depth the fundamental elements of the new arrangements. Rather it focused on the effectiveness of the implementation of the new regime. As noted earlier, the timing of the review inquiry process was also tight—only four months—as against the six months allowed under the legislation.

2.31 The Committee considers that the significant changes introduced by the MIA should be closely examined, especially given the continued and growing economic importance of the managed investment sector.

2.32 Since the introduction of the MIA, the assets held in managed investment schemes has almost doubled to $175 billion. Three million Australians have now invested in managed funds.[18]

2.33 Large-scale corporate failures in the past two years have destabilised domestic and overseas financial markets and prompted widespread initiatives for reform. In particular, they have raised questions about the independence of company directors and auditors and how conflicts of interest might be most effectively addressed.

2.34 Given these factors, the Committee believes there is a need for further consideration of the regulatory arrangements for managed investments to ensure they are able to meet the consumer-protection objectives of the MIA.

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16 See in particular, Turnbull Review, p. 58.

17 *Report on the Managed Investments Bill 1997*, p. 9.

18 Figure at March Quarter 2002, Australian Bureau of Statistics, *5655.0 Managed Funds, Australia.*

2.35 An analysis of the issues raised in the inquiry follows in the body of this report.

CHAPTER 3

HAS THE MIA REGIME PROVED ITSELF?

Introduction

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

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

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

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

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

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

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

2 Vol. 1, pp. 8-10.

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

Key elements of the MIA's regulatory framework

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

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

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

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

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

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

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

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

6 Section 601FA.

7 Subsection 601QA(1).

8 Section 601FB.

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

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

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

The MIA's performance to date: an overview

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

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

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

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

10 Section 601HG.

11 Paragraph 601FC(1)(l).

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

13 Turnbull Review, p. 58.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> We have not seen…examples of gross misconduct that we thought could not have arisen under the earlier model. So as far as we can tell just now it is working well but we think it is too early to say.[23]

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

Stress-testing by the market

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

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

> …we would concur with Mr Turnbull's findings that it is quite early days, that a lot of funds did not transition to the new regime until the latter half of 1999 to early 2000 and that in some ways we need to allow some time to pass to be able to form any considered views. It is certainly the case that the sorts of stresses that led to the policy change have not occurred.[24]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

3.32 Continuing on this theme, he added:

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

The Committee's views

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

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

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

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

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

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.
>
> …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…
>
> 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]

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

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]
>
> 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

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.
>
> When you put an individual in a position of responsibility, that is when the heat really gets applied and the regime becomes effective…
>
> 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

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

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]

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.

CHAPTER 5

COMPLIANCE PLAN AUDITING

External compliance monitoring

5.1 When applying for registration, a scheme must lodge a copy of the scheme's compliance plan with ASIC.[1] The compliance plan must set out adequate measures which the RE is to apply to ensure compliance with the Act and the scheme's constitution when operating the scheme. The plan must specify arrangements for the holding and valuation of scheme property, the proper constitution and functioning of the compliance committee, the auditing of compliance with the plan and the maintenance of adequate records.[2]

5.2 In addition to the requirements already mentioned, all the directors of the RE must sign the copy of the compliance plan (or the amended or new compliance plan) lodged with ASIC.[3] ASIC is empowered to require additional information about a compliance plan and may direct the RE to modify the compliance plan to ensure consistency with legislative requirements.[4]

5.3 These provisions all highlight the importance of the compliance plan in the MIA framework.

The compliance plan audit

5.4 Under the MIA, a registered company auditor must conduct an annual audit of compliance with the scheme's compliance plan.[5]

5.5 The compliance plan audit is intended to provide an independent check on the in-house monitoring of a scheme's compliance plan. This explains why the compliance plan auditor must be independent of the RE's scheme and also why the same auditor cannot be the auditor of the RE's financial statements (although both auditors may work for the same firm of auditors).[6]

5.6 The spate of high-profile corporate collapses overseas and in Australia over the past two years has highlighted the importance of good corporate governance and the need for reporting to be transparent and reliable. As mentioned earlier, the United

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1 Section 601EA.

2 Section 601HA.

3 Sections 601HC and 601HE.

4 Sections 601HD and 601HE.

5 Subsection 601HG(1).

6 Subsection 601HG(2).

States has recently introduced the *Sarbanes-Oxley Act of 2002*, which aims to increase the accountability of directors, ensure the independence and quality of financial auditing, and improve disclosure so it is more reliable.

5.7 Closer to home, the Government recently released its CLERP 9 issues paper. This presages legislative amendments to strengthen auditor independence, enhance the transparency of on-going disclosure and encourage shareholder participation.

5.8 Although the discussion in this report concerns performance-based, qualitative auditing as opposed to financial auditing, the principles regarding independence are considered to be the same. The Committee has consequently been able to draw on overseas legislative initiatives and numerous commentaries and reports dealing with governance issues.[7]

5.9 The Committee did not hear a great deal of evidence on the independence of external compliance monitoring per se. Of the evidence presented, however, the major issue was whether merely prohibiting the same auditor from auditing both the scheme's financial statements and the compliance plan was a sufficient guarantee of independence.

5.10 The possibility of allowing professionals other than accountants to undertake compliance plan auditing was also raised.

5.11 The MIA requires the compliance plan auditor to report to the RE on whether the scheme complied with its compliance plan during the year under examination and whether the plan meets the requirements of the Act.[8] If there are deficiencies, then the audit must be qualified, and contraventions of the Act reported as soon as possible to ASIC.[9]

5.12 At the Committee's hearing on 7 August 2002, ASIC provided the Committee with results of a survey it had conducted on qualified audits for the year ended 30 June 2001. It advised that, of just over 2,000 compliance plan audits lodged for the year, 12.9 per cent had been qualified. Of these qualifications, ASIC reported that the top five deficiencies were more administrative in nature and included late lodgement of returns, breaches of net tangible asset (NTA) requirements, ineffectiveness of the

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7 For commentaries and studies, see for example: Professor Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, October 2001; Joint Committee of Public Accounts and Audit, *Review of Independent Auditing by Registered Company Auditors, Report 391*, August 2002; Ernst & Young, *Survey of Top 200 Companies' Compliance with NYSE Listing Rules, Corporate Governance Series*, September 2002. See also ASIC's survey of auditor independence concluded in December 2001 (ASIC Media and information release 02/13 *ASIC announces findings of auditor independence survey*, 16 January 2002.

8 Subsection 601HG(3).

9 Subsection 601HG(4): ASIC must be notified if the auditor has reasonable grounds to suspect that a contravention of the Act has occurred and believes that the contravention has not or will not be adequately dealt with by commenting on it in the auditor's report.

compliance plan (i.e. failure to comply with the provisions of the plan), poor monitoring and reporting processes.[10]

5.13 ASIC proposed several legislative amendments to upgrade the integrity of compliance plan audits and said they would be best introduced as a package.[11] These had been submitted to the Turnbull Review which suggested development through industry consultation.[12] These were that:

- the auditor of the compliance plan should be required to report to scheme members and not just to the RE;
- the auditor's opinion should relate to the performance of the scheme throughout the whole year, and not just at certain times or at the end of the financial year (section 601HG is unclear, and a majority of auditors reported only that the plan was adequate as at the end of the financial year);
- the first compliance plan audit for a new scheme should be completed and lodged within nine months of the scheme's registration (and not up to 21 months later);
- an auditor's opinion on the adequacy of a new scheme's compliance plan should be lodged with other documents when the scheme applies for registration; and
- the legislation should specify that the compliance plan audit should focus on 'material' issues.[13]

5.14 In relation to the last point about materiality, Mr Johnston, Executive Director, Financial Services Regulation, ASIC, suggested that the development of a 'materiality' test would promote efficiencies by avoiding qualification of audits for trivial, immaterial matters.[14]

5.15 The Trustee Corporations Association of Australia (TCAA) shared ASIC's view that compliance plan auditors should not only report to ASIC but also to scheme members. In addition it proposed a more extensive role for the compliance plan auditor which would include:

- more frequent and timely monitoring of scheme operations;
- monitoring of related party dealings;
- acting as the 'investor champion' if action against the RE was required; and

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10 Mr Sean Hughes, *Committee Hansard*, 7 August 2002, p. 92.

11 *Committee Hansard*, 7 August 2002, p. 99.

12 Turnbull Review, p. 71; Treasury consultation pp. 29–31.

13 See ASIC's submission to the Turnbull Review, Part 2, pp. 12–15; Turnbull Review p. 71.

14 *Committee Hansard*, 7 August 2002, p. 97.

- more frequent reporting—say, quarterly—to ASIC and, as referred to before, to scheme members. [15]

5.16 In a joint submission, CPA Australia and the Institute of Chartered Accountants in Australia thought compliance plan audits should be more frequent.[16]

5.17 The TCAL asserted in its submission that potential conflicts of interest arising with the compliance plan audit had not been properly dealt with by the MIA.

5.18 On this point, Mr Jonathan Sweeney, Managing Director, TCAL, commented at the hearing on 11 July 2002 that:

> Under the Managed Investments Act, basically, we now have self-regulation by a single responsible entity subject to after-the-event, semiannual financial audit, a compliance plan operation, a periodic review and an annual compliance plan audit. That is typically conducted by a partner of the auditor of that entity's finances. So you have the auditor of the company on the finance side with another partner auditing on the compliance side. Again, with the spotlight put on the role of auditors and the expansion of these roles, you can see there could be some issues there.
>
> The operational nature of the compliance plan audit and the potential for consulting work further adds to the potential for conflict…[17]

5.19 The TCAA envisaged other ways in which the independence of compliance monitors could be safeguarded. In evidence to the Committee, Mr Michael Shreeve, National Director, suggested opening up the field:

> We believe access to this compliance monitoring role should be widened. Allowing qualified professionals other than accountants to take on this work would introduce more competition into the area. It would also improve options to avoid conflicts of interest between financial audit and other work. We understand that this is being considered for superannuation. It is also relevant that the compliance monitoring role involves operational and other risk management issues that a financial auditor is not necessarily equipped to review.We see positive influences from this arrangement in placing downward pressure on costs. Increased competition in the compliance monitoring role and the monitoring of related party dealings should better ensure arms-length pricing. We see a stronger compliance monitor reducing the need for compliance committees and external board members.[18]

5.20 Asked whether the MIA had sufficient protections to ensure that compliance plan auditors would not be unfairly or unduly influenced by the RE, the Department of the Treasury responded that the Department:

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15 Mr Michael Shreeve, *Committee Hansard*, 12 July 2002, p. 49.

16 Supplementary submission no. 4A, p. 2.

17 *Committee Hansard*, 11 July 2002, p. 2.

18 *Committee Hansard*, 12 July 2002, pp. 49–50.

> …[was] not aware that the new regime [had] put any more pressures on auditors or…diminished their independence…There are various issues…about whether the auditor of the responsible entity as a company should be different from the auditor who does the audit of the compliance plan for the various schemes. In the [Turnbull Review] there were some people who said that they should be separate firms—that you should never let the same firm do the two audits. At the other extreme there were people who said that the same person in the same firm should be able to do both audits. The legislation now has what everyone acknowledges to be a compromise—it can be the same firm, but different people within the firm should do the two audits. …we did not think there was enough justification to change that…[19]

The Committee's views

5.21 The Committee notes the findings of several reports and surveys on auditor independence which indicate unequivocally that there is a need for reform to strengthen auditor independence in Australia.

5.22 Professor Ian Ramsay's report, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, commissioned by the Government and released in October 2001, commented that the growth of large accounting firms and an increase in non-audit services provided by these firms increased scope for conflicts of interest. The report also noted that Australia lagged behind other parts of the world, particularly the United States and Europe, in the development of measures to improve audit independence.[20]

5.23 The findings of an auditor independence survey conducted by ASIC and concluded in December 2001, were consistent with those of Professor Ramsay's report. ASIC's survey indicated practices in the use of audit services that would appear to militate against auditor independence. The respondents' use of non-audit services was widespread and accounted for about 50 per cent of the total fees paid to auditing firms. Although most respondents had audit committees, it was found that better mechanisms to deal with potential conflicts of interest were needed. Partner rotation was inconsistent and rotation of firms was almost non-existent.[21]

5.24 An Ernst & Young study into Australia's top 200 companies, indicated that more than 25 per cent would not meet the basic requirements for audit committees

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19 Mr Dave Maher, *Committee Hansard*, 7 August 2002, p. 88.

20 The *Sarbanes-Oxley Act of 2002* passed by the United States Congress on 30 July 2002 requires all members of the audit committee to be fully independent and at least one to be appropriately qualified. The committee is responsible for the appointment and supervision of the independent auditor.

21 See ASIC Media and information release 02/12 *ASIC announces findings of auditor independence survey*, 16 January 2002 with attachment. The findings were based on answers to questionnaires sent to 100 of Australia's largest companies, of which 67 provided comprehensive replies.

under United States law, namely, that all members must be fully independent and at least one a 'financial expert'.[22]

5.25 The Committee is satisfied on the basis of evidence presented to it during the inquiry and also taking into account the numerous studies on the subject, that additional measures are needed to ensure the independence of external auditing.

5.26 The Committee notes that the Joint Committee of Public Accounts and Audit (JCPAA) proposed several measures to enhance auditor independence. These included:

- the establishment of an independent audit committee in all publicly listed companies with the statutory prescription of minimum requirements for the role, responsibilities and composition of the committee;
- a clear statement in the *Corporations Act 2001* requiring an auditor to be independent when undertaking his or her functions (which can be assessed by reference to a Code of Professional Conduct of the professional accounting bodies);
- requirements for auditors of publicly listed companies to report annually to ASIC regarding the management of independence issues according to benchmarks developed by ASIC, with ASIC having the relevant investigatory and enforcement powers;
- the imposition of greater accountability on directors of companies being audited;
- to cater for an expansion in the role of auditors, the principle of joint and several liability should be replaced with proportional liability, and audit firms should be permitted to operate within limited liability structures and a cap should apply to professional liability claims; and
- the provision in the *Corporations Act 2001* of 'whistleblower' protection for those raising concerns about corporate fraud and other irregularities.

5.27 The Government's CLERP 9 paper, in common with the JCPAA's recommendations, proposed the inclusion in the *Corporations Act 2001* of a general statement of principle requiring the independence of auditors. It also proposed the establishment of an audit committee but, diverging from the JCPAA's recommendation, for the top 500 listed companies only.

5.28 Some of the other proposals in CLERP 9 which are relevant to the Committee's inquiry included the amendment of the *Corporations Act 2001* to require:

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22 Ernst & Young News Release, *Ernst & Young study reveals Australian corporate lag behind in board independence* and *Survey of Top 200 Companies' Compliance with new NYSE Listing Rules, Corporate Governance Series*, 24 September 2002. (See Chapter 4 for commentary on the *Sarbanes-Oxley Act of 2002*, regarding 'financial experts'.)

- auditors to make an annual declaration to the company's board that they have maintained their independence according to the Act and the rules of their professional accounting bodies;
- the application of the Joint Code of Professional Conduct of the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia dealing with professional independence;
- the rotation of audit partners every five years;
- auditors to attend AGMs of listed companies to answer reasonable questions about the audit;
- auditors to report to ASIC any attempts to influence, coerce, manipulate or mislead the auditor; and
- the application of qualified privilege and 'whistleblower' protection to company employees reporting to ASIC in good faith and with reasonable cause, any suspected breach of the law.

5.29 The Committee further notes the ICAA and CPA Australia's new Australian standard for audit independence which bans the provision of non-audit services such as material asset valuations where, in also conducting the audit, a firm could be required to check their own work.[23]

5.30 The Committee believes there is substantial merit in the proposals made in the JCPAA report, CLERP 9's issues paper, and the ICAA and CPA Australia's new audit standard outlined above. The Committee's recommendations consequently draw on several of these proposals.

Recommendation 9

The Committee recommends that the *Corporations Act 2001* should be amended to strengthen the independence of compliance plan auditors to include:

- **a general statement of principle requiring the independence of compliance plan auditors;**
- **a requirement for compliance plan auditors to report to ASIC annually about their management of independence issues according to benchmarks developed by ASIC; and**
- **a requirement for compliance plan auditors to report to ASIC any attempts to corrupt the integrity of the audit.**

5.31 The Committee considers that the overall integrity of compliance monitoring would benefit from the extension of qualified privilege and whistleblower protection to employees of REs and, where the application of the legislation may be uncertain, to employees of compliance plan auditors.

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23 ICAA and CPA Australia Media release, *New Australian standard for audit independence,* 23 May 2002.

Recommendation 10

The Committee recommends the application of qualified privilege and whistleblower protection to employees of the RE and, if not already covered by subsection 601HG(8) of the *Corporations Act 2001* to employees of, and, the compliance plan auditor reporting any suspected breaches of the law to ASIC in good faith and with reasonable cause.

5.32 The Committee considers the suggestion that eligibility to conduct a compliance plan audit be opened up to persons other than registered company auditors has sufficient merit to justify further investigation. It is possible that persons with other qualifications and experience could be eminently suitable to conduct compliance plan audits for certain schemes. There would be the added benefit of increasing the pool from which compliance plan auditors could be drawn. This could play a part in reducing scope for conflicts of interest.

Recommendation 11

The Committee recommends that the Department of the Treasury, in consultation with ASIC and relevant industry stakeholders, look into the feasibility of opening up the field for compliance plan auditors where it is considered that persons other than registered company auditors as defined under the *Corporations Act 2001* could effectively carry out the requirements of a compliance plan auditor.

5.33 In making the above recommendations, the Committee assumes that legislative amendments will be made under CLERP 9 resulting in better governance of managed investment schemes by making directors more accountable, strengthening the independence of financial auditors and improving the continuous disclosure regime, largely through more extensive enforcement.

5.34 The Committee has not made recommendations regarding audit partner or audit firm rotation but awaits with interest CLERP 9's conclusions in this regard. In the meantime, the Committee would encourage initiatives in the private sector to develop best practice audit standards for performance audits.

5.35 The Committee notes that the proposals submitted by ASIC to improve the integrity of the compliance plan audit have been included in the Department of the Treasury's consultation regarding issues raised in the Turnbull Review. Of these proposals, the Department has commented in its consultation paper that:

> While they may impact on the costs faced by a RE, [the proposals] have the potential to substantially enhance investor protection. However, they also affect the liability and duties of auditors of compliance plans, and it is important that auditors be given adequate opportunity to comment on the proposals. It is therefore suggested that these matters be progressed through

consultation involving the Treasury, ASIC, the auditing profession and other interested parties.[24]

5.36 The Committee notes the proposals in the JCPAA report and CLERP 9's paper to limit the liability of auditors in response to increases in their exposure entailed in other proposed reforms. Assuming these proposals are adopted, the Committee believes that ASIC's proposals will improve regulation under the MIA by:

- clarifying the legislation;
- providing for more timely lodgments of audits for newly registered schemes;
- bringing additional expertise to the formulation of a scheme's compliance plan;
- imposing greater accountability on the compliance plan auditor and increasing transparency.

5.37 The Committee supports ASIC's proposals for the improvement of compliance plan audits and notes that the Department of the Treasury has sought the views of the public on these.

The Committee strongly believes that greater transparency in reporting should be encouraged and therefore makes the following recommendation:

Recommendation 12

The Committee recommends that the Corporations Act 2001 be amended to accommodate ASIC's proposals to:

- **require the compliance plan auditor to report to scheme members;**
- **clarify that the auditor's opinion relates to a scheme's performance for the entire year being audited;**
- **require a compliance plan audit of a newly registered scheme within the first year of its registration;**
- **require an auditor's opinion on the adequacy of the compliance plan to be included with a scheme's application for registration; and**
- **clarify that the compliance plan audit need only focus on material issues.**

The Committee further recommends that the Department of the Treasury and ASIC should develop a test of materiality.

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24 *Review of the Managed Investments Act 1998 Report*, Department of the Treasury Discussion Paper, Chapter 3.

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.

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.

CHAPTER 8

COSTS AND FEES

Introduction

8.1 In this chapter, the Committee considers whether the MIA has helped to reduce costs and fees in the managed investments industry. The Committee will then review the evidence on differential fees to decide whether legislative amendment would be desirable.

How has the MIA affected costs and fees?

8.2 In its chapter on costs, the Turnbull Review commented that:

> It is likely that both sides of the debate over-played the impact on costs, particularly given the difficulty in obtaining consistent and comparable quantitative evidence. This is due to a number of factors—most importantly, the lack of a single parameter that serves as a reliable indicator of the cost of investment. Although management expense ratios (MERs) are often taken as a proxy of the cost of investing, they rarely encompass the full range of fee and charge structures in a managed scheme. This leads to difficulties in making comparisons between schemes, and even within the same scheme over time.
>
> A related difficulty is attempting to disentangle the 'true' cost of investing from other factors that impact upon managed schemes…[W]hile conditions have been buoyant, the competition within the industry has acted to ensure that the effect of extraneous factors…has been relatively muted. However, such factors add to the difficulty in making a definitive statement on whether costs have risen or fallen as a result of the implementation of the MIA.[1]

8.3 In its current inquiry, the Committee sought to clarify the impact of the MIA on fees and to determine whether the strong growth in the managed funds industry in recent years, has been matched by an acceptable decrease in fees.

8.4 The importance of this issue is highlighted by the findings in the United States Securities and Exchange Commission's *Report on Mutual Fund Fees and Expenses*, released in December 2000 (SEC report) that apparently small increases in fees were shown to have quite significant and negative long-term ramifications for investors.

1 Turnbull Review, pp. 75-6.

The study found that a 1 per cent increase in a fund's annual expenses could reduce an investor's end account balance in a fund by 18 per cent after 20 years.[2]

8.5 The Committee heard a range of views about costs and fees in funds regulated by the MIA. Some witnesses claimed that fees had trended downwards since the MIA's introduction, whereas others claimed fees had stayed the same or increased.

8.6 Most of the evidence was anecdotal with the exception of a statistical analysis of fees and charges across the Australian managed funds industry for the period 1996 to 2001 provided by the Investment & Financial Services Association Ltd (IFSA).[3]

8.7 The Trust Company of Australia Limited (TCAL) thought the MIA's impact on costs and fees varied according to fund size—for small funds, costs had increased while for large funds, there would be cost savings. Mr Jonathan Sweeney, Managing Director, TCAL, commented that:

> …our own internal experience on the funds management side is that it is costing us more, but we are managing only half a billion dollars. We are a smaller fund manager. It is most likely costing the big guys, who are managing $10 billion or $30 billion, less. But are they passing it on in fees?[4]

8.8 The Trustee Corporations Association of Australia (TCAA) claimed that, while proponents of the MIA had predicted the new regime would lead to cost reductions, there appeared to be no evidence that reductions attributable to the MIA had resulted in lower fees for investors. One reason for this, the TCAA suggested, was that REs were keeping the fees that, under the old regime, would have been paid to trustees. In addition, the TCAA questioned whether outsourcing by REs was negotiated on commercially acceptable, arm's-length terms. In this regard, the TCAA claimed that:

> …the absence of substantially lower fees reflects the fact that under the RE structure many activities of a scheme often are sub-contracted to related entities at prices that are higher than would apply through arm's length negotiations, and certainly higher than would be permitted if an independent entity acted as the investors' representative.[5]

8.9 According to Ms Lynn Ralph, IFSA's then Chief Executive Officer, costs had reduced since the introduction of the MIA. Ms Ralph cited the following passage from IFSA's report in support of this:

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2 The United States Securities and Exchange Commission, *Division of Investment Management: Report on Mutual Fund Fees and Expenses*, December 2000: www.sec.gov/news/studies/feestudy.htm (October 2002), p. 4.

3 *Retail Registered Schemes Fees and Charges: Second Release*, July 2002. (IFSA commissioned KPMG to prepare this report.)

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

5 Submission no. 3, p. 7.

> [KPMG's] analysis found that in the period following the implementation of the Managed Investments Act there has been a four basis point reduction in MERs. This reduction can be represented as producing a saving in fees for investors in 2000 and 2001 respectively of $35.7 m and $41.0 m…[6]

8.10 Referring to these figures, Ms Ralph commented that:

> We believe that this reduction in fees is significant, that it is growing and that it is consistent with the estimates which were made by our association prior to the enactment of the legislation.[7]

8.11 In response to the Committee's suggestion that fees had been falling since 1996, in other words, before the introduction of the MIA in 1998, Ms Ralph conceded this was so but argued that, as a general rule, managed investment ratios (MERs) had not risen since the MIA. In this regard, it said that:

> …across the industry it is difficult to get a real handle on what increased costs MIA might have had for managers, or whether they had any increased costs at all. We do know that we have not seen any increases in MERs as a result of that. So our suspicion is that, as a result of no increased costs, some savings or the preparedness of the manager to wear some increased costs in a competitive environment, at the bottom line the MERs have not ratcheted up in any way. So, yes, it is difficult to unpick where the change in the basis points has actually arisen, unless you were to unpick each manager's pricing, which is obviously a major task. But these are MERs of what is actually being charged in the marketplace today on a very large chunk of the retail funds that are out there.[8]

Start-up costs as a barrier to competition

8.12 Some of the evidence heard by the Committee suggested that the cost of meeting requirements under the MIA had discouraged smaller enterprises offering boutique services to enter the industry. It was argued that this would reduce competition in the industry and remove downward pressure on charges.[9]

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6 Committee Hansard, 12 July 2002, p. 26. Quoted from *Retail Registered Schemes Fees and Charges: Second Release*, July 2002, p. 1. (MERs generally measure the ongoing management costs of funds but do not factor in the full range of fees applying across managed funds, for example, entry and exit fees. However, in a recent report on disclosure of fees and charges in managed investments commissioned by ASIC, Professor Ian Ramsay commented that the MER 'provides useful information relating to relative costs across similar funds and can identify trends in relation to ongoing management charges and expenses over time. It is to be noted that similar operating expense ratios are used in other countries such as Canada, New Zealand and the United States…' (See Professor Ian Ramsay, *Disclosure of Fees and Charges in Managed Investments, Review of current Australian Requirements and Options for Reform,* 25 September 2002, p. 205.)

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

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

9 See, for example, submission no. 6A, p. 2.

8.13 In the absence of any statistical breakdown of fund sizes and number of players across the industry, the Committee heard anecdotal evidence only with regard to the effect of the MIA on competition within the industry.

8.14 Mr Sweeney, TCAL, said that the MIA had disadvantaged smaller operators and was creating market forces that would encourage further consolidation in the funds management industry which was not a good thing. In the TCAL's view, the MIA had raised barriers to entry causing new boutique managers to enter the wholesale rather than the retail market to escape regulation under by MIA. The upshot of this development, Mr Sweeney said, was that:

> …the large fund managers, who can afford the expensive set-up costs of the MIA and the expensive ongoing compliance costs, are safe from new and more nimble managers entering the retail market. At the end of the day, the consumer is definitely worse off…[10]

8.15 Mr Sweeney estimated that to set up a fully compliant single RE and fund structure would involve a start-up cost of approximately $200,000 and ongoing costs of at least $70,000 a year. Under the old regime, it was easier for newcomers to join the industry:

> …trustees acted for between three and seven basis points—that is, three to seven per cent of one per cent of gross assets and then there was usually a minimum fee of between $20,000 and $50,000. So you can see, it was much easier for a group to start up, because those set-up costs were not there. What they could do, effectively, was tap into the trustee companies' economies of scale. What we could do was leverage our economies of scale across all the start-ups.[11]

8.16 The TCAA shared the TCAL's view that start-up and ongoing costs imposed by the MIA had disadvantaged smaller players and was driving them into the wholesale sector. At the hearing on 12 July 2002, Mr Donald Christie, Managing Director, Equity Trustees Ltd (appearing with the TCAA), commented that this had the potential to reduce competition and favour major fund managers, 'because the ability to build the product that can be sold retail is not really there in the smaller end of the market'.[12]

8.17 When asked to comment on allegations that the MIA had raised barriers to entry, Ms Ralph, IFSA, queried whether there was actual statistical proof that there were fewer competitors in the industry. While acknowledging that there had been mergers between significant fund managers, Ms Ralph considered that there had been 'a whole raft of new players' entering the marketplace and 'a whole range of new boutiques.' Ms Ralph said that, for various reasons other than the MIA, developments

10 *Committee Hansard*, 11 July 2002, p. 4.

11 *Committee Hansard*, 11 July 2002, p. 4.

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

over the past 5 to 10 years had created new opportunities for wholesale boutique investment managers to enter the industry through platforms set up by large providers:

> [s]o we are now seeing more of those small managers pop up because they have the capacity to distribute their product in a way that did not exist 10 years ago.[13]

8.18 Ms Ralph said that 'any piece of regulation provides barriers to entry' and commented that:

> …under the old regime certain players found it difficult to find a trustee to act on behalf of their funds. Even now, some small groups choose appropriately, as envisaged by [the MIA] regime, not to be the responsible entity…Some groups choose that model and, similarly to the old regime, have a hard time finding a responsible entity.
>
> There will always be some barriers but they have not stopped a lot of new boutiques from entering this marketplace and offering investment management services—any more, perhaps, than the old regime did.[14]

The Committee's views

8.19 Much of the evidence to the inquiry reflected a strong polarisation of views regarding the effect of the new regime on costs and industry structure. However, the Committee was not able to properly test this evidence given the absence of reliable, independent quantitative data.

8.20 While the data presented by IFSA indicated a downward trend in MERs, there was no hard evidence that this had translated into lower fees to investors or whether the downward trend could be attributed either wholly or in part to the changes introduced by the MIA.

8.21 The Financial Impact Statement in the Explanatory Memorandum for the MIA proposed that:

> In general, the anticipated cost to schemes of meeting procedural requirements of [ASIC] (such as licensing of the responsible entity, registration of a scheme, etc) are expected to be no greater than the cost of current analogous requirements.[15]

8.22 Contrary to the predictions of the explanatory memorandum, there appeared to be some consensus during the Committee's inquiry that the MIA had raised barriers

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13 *Committee Hansard*, 12 July 2002, p. 43. (In evidence to the Committee, Mr Paul Dortkamp also touched on the changes mentioned by IFSA. See *Committee Hansard,* 12 July 2002, p. 67.)

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

15 Managed Investments Bill 1997, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 9.

to entry in the funds management industry which had caused smaller players to opt for the wholesale rather than retail market.

8.23 The Committee is concerned that rationalisation in the industry should not reach an unacceptable level because of the effects this could have not only on fees, but also on investor choice and protection.

8.24 Professor Paul Von Nessen, Head of the Department of Business Law and Taxation at Monash University, recommended in his submission that a cost/benefit analysis comparing total economic costs incurred under the new system compared with its benefits should be conducted. He commented further that:

> It appears that analysis so far has concentrated only upon a comparison of the total costs absorbed by investors under the former and current system. I would hope that a more complete economic justification for the Managed Investments Act could be established through your review. A finding that [the Act] results in marginally lower fees than were charged under the prescribed interest system does little to validate the benefits of its enactment.[16]

8.25 The Committee agrees with Professor Von Nessen's assertion that a reduction in fees charged to investors, without additional benefits, is insufficient validation of the MIA. Furthermore, the Committee has serious concerns about the claims raised in evidence to this inquiry, namely, that the MIA has stymied competition within the industry.

8.26 Given the absence of any reliable, independent data on the subject, the Committee felt it was ill-equipped to draw any conclusions. The Committee would be particularly interested in information about the MIA's impact on costs and fees, competition and overseas investment in the industry.

Recommendation 14

The Committee recommends that the Government commission an independent cost/benefit analysis with a view to determining the impact of the *Managed Investments Act 1998* and other relevant legislation. This will then establish a useful benchmark for future studies. The analysis should specifically look at:

- **Australia's performance on costs and fees compared with major overseas financial centres;**
- **whether and to what extent the MIA has limited or stimulated competition within the industry; and**
- **whether understanding, transparency and disclosure for consumers has improved and/or is sufficient with regard to managed investments costs and fees.**

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16 Submission no. 12, p. 2.

8.27 The Committee notes that better disclosure by managed funds to enable an investor to compare fees, will promote competition within the industry. The Committee therefore commends ASIC's recent initiatives to improve disclosure of fees within the managed funds industry.[17]

Reducing costs and charges

Differential fees

8.28 At present, paragraph 601FC(1)(d) provides that the responsible entity must treat members holding interests of the same class equally and members holding interests of different classes fairly. ASIC's Class Order 02/214 grants relief, subject to adequate disclosure, from the equal treatment provision for some differential fee arrangements as follows:

- fees may be varied or waived for a member switching from one scheme to another scheme managed by the same RE;
- fees may be banded or tiered for investors based on the amount they have invested in a scheme or schemes managed by the RE; and
- fees may be negotiated with professional investors.[18]

8.29 In its submission to the Turnbull Review, ASIC commented that an amendment to the legislation to provide for the substitution of a 'fair' treatment in lieu of an 'equal' treatment criterion should apply only to accommodate differential fee arrangements. ASIC proposed in relation to the amendment that:

> …[the amendment] would need to provide a framework within which investors are provided with adequate disclosure such that they are able to compare, in a meaningful way, the effect of differential fee arrangements. We would be concerned if allowing greater use of differential fees were to result in making consumer comparisons of fees more difficult. We believe that this disclosure should deal both with the ability to compare different fee structures available from the one offeror and also the effect of differential fee structures as between different offerors. We note, for example, that in the United States, mutual funds are required to provide examples of costs, in dollar terms, over sample periods of time.
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> Secondly, ASIC believes that it would be necessary for any such amendment to provide additional constraints beyond those which the words 'fair' or 'fairly' might otherwise suggest. We believe that it may be

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17 See ASIC Media and information release 01/352 *ASIC releases Ramsay Report on disclosure of fees and charges,* 25 September 2002. In this media release, ASIC announced the release of Professor Ian Ramsay's report, commissioned by ASIC, *Disclosure of Fees and Charges in Managed Investments, Review of Current Australian Requirements and Options for Reform.* ASIC said this report would 'facilitate further consultation by ASIC with industry and consumer representatives about the future direction of disclosure for investment products under the FSRA regime'.

18 Turnbull Review, p. 78.

> necessary that fairness be interpreted by reference to some economic justification; for example that a differential fee arrangement must be reasonable having regard to the difference between the cost incurred by the responsible entity in providing services to any member who is a party to a differential fee arrangement and the cost incurred in providing services to any member who is not a party to the arrangement. Imposing a disclosure requirement in relation to this requirement might also be an effective regulatory tool.[19]

8.30 At the hearing on 7 August 2002, ASIC confirmed the position taken in its submission to the Turnbull Review and commented that a legislative amendment to provide for a fairness test would 'remove the need for ASIC to deal with it by way of class order and allow the industry to proceed on a more secure basis'.[20]

8.31 Mr Russell Stewart, Partner, Minter Ellison Lawyers, commented that subsections 601GA(1) and (2) were open to the interpretation that the fees specified in a scheme's constitution could be maximum amounts thus allowing for variability at the RE's discretion. Mr Stewart said that ASIC appeared to read the provisions as referring to specific entry fees and management fees. He said that, not allowing an RE to exercise discretion, was causing fees to be higher than they otherwise would be. He cited the example, of an RE wanting to sell a product directly to the public as well as through an investment adviser. Where the RE was prepared to discount the entry fee for direct sales to the public, he said, it had to create a separate class of units for this purpose. This was an artificiality which 'create[d] accounting and reporting problems which seem to be unnecessary'.[21]

8.32 IFSA's views were similar to those expressed by Mr Stewart. IFSA considered that the equal treatment provision, as interpreted by ASIC, had adversely affected marketing in the industry, particularly where REs wanted to offer discounts to retail consumers. In its submission to the Turnbull Review, it commented that:

> IFSA strongly recommends that the equal treatment provision (section 601FC(1)(d)) be brought into line with the equivalent provision in the *Superannuation Industry (Supervision) Act 1993*. This would overcome the problems caused by ASIC's interpretation that entry and exit fees for schemes are part of the consideration to acquire interests and, therefore, subject to the equal treatment provision.

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19 ASIC's submission to the Turnbull Review, Part 2, pp. 1-2.

20 Mr Ian Johnston, *Committee Hansard,* 7 August 2002, p. 100.

21 *Committee Hansard*, 11 July 2002 p. 22. (Mr Stewart's evidence was given in a personal capacity and not as a representative of Minter Ellison Lawyers.) Paragraph 601GA(1)(a) says that the constitution of a registered scheme must make adequate provision for the consideration that is to be paid to acquire an interest in the scheme. Subsection 601GA(2) says, among other things, that any rights the RE is to have to be paid fees out of scheme property must be specified in the scheme's constitution.

> …ASIC's interpretation and policy leads to an inconsistency between investors who invest directly through the RE and those who invest via an intermediary…entry fees can be rebated…by an intermediary while a RE cannot waive or reduce fees for a retail investor who approaches them directly…[22]

8.33 Issues relating to differential fees have been included in the Department of the Treasury's consultation paper. At the hearing, the Department said it had not come to any decision about these issues.[23]

Recommendation 15

The Committee recommends that the *Corporations Act 2001* be amended to provide for a 'fair' treatment criterion in lieu of 'equal' treatment but only to provide for differential fees.

The Committee further recommends that what constitutes 'fair' treatment should be developed through consultation between the Department of the Treasury, ASIC and industry groups. The Committee notes that the Department is presently consulting with regard to this issue.

8.34 Several other proposals were made for reducing costs. These concerned more technical issues regarding the streamlining of registrations, particularly with regard to multiple trusts, and the use of model constitutions and compliance plans. The Committee notes these issues are included in the Department of the Treasury's consultation regarding the Turnbull Review and believes this is an appropriate forum for their consideration.

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22 Submission no. 2, Attachment 1 (submission to the Turnbull Review), p. 19.

23 *Committee Hansard*, 7 August 2002, p. 86.

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.
>
> 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.
>
> 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:
>
> '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.
>
> 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]

The Committee's views

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

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

SUPPLEMENTARY REPORT

REVIEW OF THE MANAGED INVESTMENTS ACT

Summary

Labor and Democrat members of the Committee support the conclusions reached by the Committee as presented in the report.

However, Labor and Democrat members believe that Responsible Entities (REs) should be required to appoint an independent custodian of fund assets unless ASIC deems otherwise. This is consistent with world's best practice.

The appointment of an independent custodian should result in a significant increase in investor protection without any increase in costs, since the fee already paid to an RE for custody services would be redirected to the independent custodian.

General Comments

The MIA regime does not require the RE to appoint an independent custodian for fund assets unless directed to by ASIC. The MIA review supported the status quo arguing that mandating third-party custodians 'would not sit easily with the rationale for replacing the dual fund manager/trustee structure with a single RE'.[1]

However, the Committee heard evidence that the failure to appoint an independent custodian and therefore separate the management and control of fund assets undermines investor protection without providing any cost saving for investors and is out of step with the approach adopted in a large number of other regulatory jurisdictions.

In particular Standard and Poor's were quoted as saying that 'the failure to mandate that fund assets must be held in safekeeping by an independent custodian is of concern and in contrast to all other major financial centres in the world where an independent custodian is a minimum standard'.

The presence of an independent custodian would add to investor protection for two reasons. Firstly, unlike trustees, an independent custodian would provide a meaningful real-time check on fund manager compliance. Secondly, in the event of the failure of an RE, fund assets would be out of the control of the manager and therefore fully protected.

The appointment of an independent custodian should not result in any additional cost to the investor, since the fee currently paid to the RE for custody services would

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1 *Review of the Managed Investments Act 1998*, p. 30.

instead go to the independent custodian. The cost of custody may, in fact, be reduced because specialist custodians could achieve economies of scale.

Senator Penny Wong
Labor Senator for South Australia

Mr Alan Griffin MP
Australian Labor Party

Senator Stephen Conroy
Labor Senator for Victoria

Mr Anthony Byrne MP
Australian Labor Party

Senator Andrew Murray
Australian Democrats

APPENDIX 1

SUBMISSIONS RECEIVED

1. Mr J P McAuley
2. Investment & Financial Services Association Ltd (IFSA)
3. Trustee Corporations Association of Australia

3A. Trustee Corporations Association of Australia (supplementary submission)

4. CPA Australia and The Institute of Chartered Accountants in Australia (ICAA)

4A. CPA Australia and The Institute of Chartered Accountants in Australia (ICAA) (supplementary submission)

5. Australian Stock Exchange Limited (ASX)
6. Mr Russell Stewart, Minter Ellison Lawyers

6A. Mr Russell Stewart, Minter Ellison Lawyers (supplementary submission)

7. Trust Company of Australia Limited
8. Association of Independent Retirees, Inc
9. Dr Shann Turnbull
10. Mr Paul Dortkamp, Independent Compliance Committee Members Forum
11. Mr Bill Gibson
12. Professor Paul von Nessen
13. McCullough Robertson

APPENDIX 2

WITNESSES AT HEARINGS

__Thursday, 11 July 2002-Sydney__

Trust Company of Australia Limited
Mr Jonathan Sweeney, Managing Director
Mr Michael Britton, National Manager, Fiduciary Services

Mr Russell Stewart
Partner, Minter Ellison Lawyers (appearing in a private capacity)

__Friday, 12 July 2002-Sydney__

Investment & Financial Services Association Ltd
Ms Lynn Ralph, Chief Executive Officer
Mr Philip French, Senior Policy Manager
Mr Geoffrey Lloyd, Member, Regulatory Affairs Committee

Trustee Corporations Association of Australia
Mr Michael Shreeve, National Director
Ms Gai McGrath, General Counsel & Company Secretary, Perpetual Trustees Australia Limited
Mr Donald Christie, Managing Director, Equity Trustees Ltd

Mr Paul Dortkamp
Co-founder, Independent Compliance Committee Members Forum

Association of Independent Retirees, Inc
Mr Stanley Goodacre, Chair, Taxation and Investment Review Group
Mr Roger Valentine OAM LLB FCIS, Consultant Legal to National Council

__Wednesday, 7 August 2002__

Department of the Treasury
Mr Nigel Ray, Acting Executive Director
Mr Michael Rosser, Manager, Consumer Protection Unit, Financial System Division
Mr Dave Maher, Analyst, Financial System Division
Mr Brett Wilesmith, Analyst, Financial System Division

Australian Securities and Investment Commission
Mr Ian Johnston, Executive Director, Financial Services Regulation
Ms Pauline Vamos, Director, Licensing and Business Operations
Mr Sean Hughes, Director, Financial Services Regulatory Operations
Mr Michael Wall, Assistant Director, Legal and Technical Operations