Investment & Financial Services Association Ltd
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6 May 2002

The Secretary
Parliamentary Joint Statutory Committee
on Corporations and Financial Services
Parliament House
CANBERRA ACT 2600

Facsimile: (02) 6277 5809

Dear Sir

Inquiry into the review of the Managed Investments Act 1998

I refer to the Committee's call for submissions on the above review by 3 May 2002. IFSA appreciates the opportunity to place its views before Committee members.

IFSA is the industry association for Australia's retail and wholesale fund managers, retail superannuation providers, life insurers and re-insurers. Currently, IFSA members hold more than $670 billion in funds under management on behalf of more than nine million superannuation and managed investment savers.

As you are no doubt aware, IFSA expressed its views on the issues raised by the Joint Committee, in its submission to the Government's Review of the Managed Investments Act, as conducted by Mr Malcolm Turnbull. I have attached a copy of that submission for your information.

IFSA also intends to address the questions raised by government in its recently released Consultation Paper on the above Review. These questions are directed at ascertaining which detailed proposals for reform and improvement, as canvassed by Malcolm Turnbull, should be adopted in any amending legislation.

At the broader level, the executive summary to the attached submission summarises IFSA's views on the effectiveness and integrity of the MIA regulatory regime in the following terms.

> "IFSA is strongly of the view that MIA has exceeded, expectations in terms of its success as an efficient and effective regulatory regime. This has been as a

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consequence of the very comprehensive and thorough analysis that preceded the drafting of the Bill [including a lengthy and intensive parliamentary scrutiny process] and strong commitment from industry and an active regulator.

MIA's principal success has been in the way it has driven compliance best practice at all levels of management in mainstream managed investment scheme operations. Acceptance and understanding of the importance and value of best practice compliance is now integral to top and senior management in the managed investments industry.

MIA and the consultation and review process which preceded it, has driven a much more productive relationship between industry and the regulator – one which has required each to develop a better understanding of what effective compliance means, in practical terms.

The result is a structurally flexible and very robust regulatory regime for managed investments.

The most fundamental change ushered in by MIA was the requirement, for each managed investment scheme, that there be a single responsible entity (RE) in which responsibilities, previously split between trustees and managers, be combined and imposed as statutory duties. The new regime also introduced other fundamental changes, in particular making compliance an integral part of day to day scheme operations and considerably enhancing the role and powers of the regulator.

The principal rationale for a single responsible entity model is that of providing certainty for investors and follows the ALRC finding that the former dual party system, while appearing to offer investors additional security through the presence of an independent supervising trustee, was subject to fundamental legal and commercial contradictions which rendered such protection largely illusory.

In imposing clear and non – delegable legal obligations on scheme operators and their directors MIA has, in effect, rendered the single responsible entity a "trustee" in the true sense of that word, ie an entity which is ultimately responsible and which, while it may privately contract out certain functions, cannot in any way delegate its ultimate liability in law for the exercise of those functions.

Introduction of MIA in 1998 gave great impetus to the already growing trend on the part of scheme operators to embrace more effective compliance and, importantly, spread the resulting benefits to investors in a much wider range of managed investments.

Prior to the advent of compliance plans, their scrutiny by ASIC and the requirement for external auditors to review RE compliance with such plans, the self-regulatory version of compliance monitoring was quite minimal by comparison with that which now exists."

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The important role of the former Parliamentary Joint Committee on Corporations and Securities in the process leading to the final form and enactment of MIA is also worthy of mention. The parliamentary process included one of the most intense and comprehensive examinations of a draft Bill ever undertaken by that Committee. Following such exhaustive scrutiny by the Committee, it came as no surprise to industry that the final MIA legislative package ended up being so well suited to its intended purpose.

Costs

The attached IFSA submission (at Appendix 2) also addresses the issue of costs in detail, with empirical data underpinning industry's contention that MIA is, by comparison, more efficient than the self regulatory, two party regime which preceded it.

The research report on costs, conducted by KPMG, concluded that, in the 5 year period from 1996 to 2000, industry delivered to consumers a 6% reduction in fees as measured by management expense ratios (MER) on managed investment products. In addition to the benefits from a more rigorous regulatory regime, industry passed on to consumers annualised savings of $26 million following the introduction of MIA in July 1998. This passing on of costs occurred during a period when considerable 'setting up' costs were incurred by newly created SREs.

The KPMG research report corrects many of the anecdotally based assertions made by various parties on the issue of costs and I commend this report to members of the Committee.

Developments Since the MIA Review

MIA has been instrumental in enabling industry to deal effectively with one very significant development since the time at which industry and other stakeholders made submissions to the Turnbull Review, last August/September. The tragic events of September 11th 2001 were the occasion of a major shock to world financial markets, impacting heavily on Australian investors through their direct exposure to international funds and through effects on Australian financial markets.

IFSA can vouch for the fact that, as a direct result of MIA, the Australian managed investments industry was well positioned to respond quickly, consistently and effectively to the events of 11 September.

The strong compliance focus within responsible entities, as demanded by the MIA regime, meant that boards and compliance committees of responsible entities were able to act quickly and decisively to protect the interests of all interest holders by freezing redemptions on funds severely affected by the above events. This was achieved by industry in consultation with the regulator. Prompt and consistent action by responsible entities was greatly facilitated by MIA, which has firmly entrenched the culture and practice of direct responsibility and accountability on the part of directors and officers of the companies (responsible entities) which are entrusted with the task of managing investors' funds.

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Industry responses to the events of 11 September 2001 resulted in avoidance of outcomes, the like of which so damaged investors' interests in the aftermath of earlier severe downturns, such as those which occurred in the late 1980's and early 1990's. On those occasions, confusion and delays resulting from the differences in views taken by managers and trustees and their respective legal advisers, resulted in many investors being advantaged at the expense of others. The conflicts between managers and trustees that occurred during the property trust collapses of 1990 – 1991 resulted in significant losses of confidence in the Australian managed funds industry. As you would no doubt be aware, litigation between investors, trustees and managers continued in some cases for many years.

Benefits for Superannuation

As noted in the IFSA submission, extension of the MIA provisions and culture to apply generally to wholesale schemes has had 'spillover' benefits for the administration and management of funds for super, non-super, corporate treasury, and offshore moneys. Principally, these benefits flow from the more focused and compliance centred operations of MIA regulated schemes.

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 (at para 4.107, page 45 of the report);

> "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. For example, the MIA requires a managed investments scheme to invest only in approved schemes. While under the Act an investment can still be made for example in a mushroom farm, this can only be done if structured under a MIA vehicle/arrangement which provides:
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> - the protection of having independent directors;
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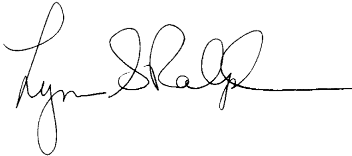
Beyond the above comments, and those which IFSA previously made in the attached submission, there is nothing further we would wish to raise with the Joint Committee at the present time. Should Committee members require any further information or input from IFSA, however, we would of course be pleased to oblige. For this purpose, please do not hesitate to contact either myself or Philip French (02 9299 3022; pfrench@ifsa.com.au).

I hope the Committee finds the above comments helpful.

Yours faithfully



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Submission to the

Review of the Managed Investments Act

1998

EXECUTIVE SUMMARY OF IFSA SUBMISSION

After a very successful transition to MIA, the managed investments industry has only recently switched its principal focus from transition to consolidating the regime and examining it for future improvement.

IFSA is strongly of the view that MIA has exceeded, expectations in terms of its success as an efficient and effective regulatory regime. This has been as a consequence of the very comprehensive and thorough analysis that preceded the drafting of the Bill and strong commitment from industry and an active regulator.

MIA's principal success has been in the way it has driven compliance best practice at all levels of management in mainstream managed investment scheme operations. Acceptance and understanding of the importance and value of best practice compliance is now integral to top and senior management in the managed investments industry.

MIA and the consultation and review process which preceded it, has driven a much more productive relationship between industry and the regulator – one which has required each to develop a better understanding of what effective compliance means, in practical terms.

The result is a structurally flexible and very robust regulatory regime for managed investments.

The most fundamental change ushered in by MIA was the requirement, for each managed investment scheme, that there be a single responsible entity (RE) in which responsibilities, previously split between trustees and managers, be combined and imposed as statutory duties. The new regime also introduced other fundamental changes, in particular making compliance an integral part of day to day scheme operations and considerably enhancing the role and powers of the regulator.

The principal rationale for a single responsible entity model is that of providing certainty for investors and follows the ALRC finding that the former dual party system, while appearing to offer investors additional security through the presence of an independent supervising trustee, was subject to fundamental legal and commercial contradictions which rendered such protection largely illusory.

In imposing clear and non – delegable legal obligations on scheme operators and their directors MIA has, in effect, rendered the single responsible entity a "trustee" in the true sense of that word, ie an entity which is ultimately responsible and which, while it may privately contract out certain functions, cannot in any way delegate its ultimate liability in law for the exercise of those functions.

Introduction of MIA in 1998 gave great impetus to the already growing trend on the part of scheme operators to embrace more effective compliance and, importantly,

spread the resulting benefits to investors in a much wider range of managed investments.

Prior to the advent of compliance plans, their scrutiny by ASIC and the requirement for external auditors to review RE compliance with such plans, the self-regulatory version of compliance monitoring was quite minimal by comparison with that which now exists.

MIA has been responsible for the spread of many of the compliance practices and structures, originally designed for retail schemes, to wholesale managed investments, directly benefiting superannuation investors.

Effective and accountable scheme governance under MIA is achieved through a number of interlocking mechanisms, including;

- the imposition of clear, statutory, trustee style duties on a single entity;
- the strict liability of the RE for the actions of its agents;
- the requirement for substantial compliance infrastructure within SRE's
- the independence of boards of directors and compliance committees
- a requirement for independent audit of SRE compliance;
- an active role reserved for the regulator in registering schemes, licensing RE's and monitoring compliance.

These are backed up by the active involvement of ASIC which, in addition to administering its own comprehensive requirements at the time of scheme registration and licensing, is able to;

- check schemes for compliance at any time
- investigate where it has reason to believe that a contravention may have been committed
- direct that an RE give it information about its compliance plan
- require persons to give all reasonable assistance to its investigation and to appear for examination
- require the production of books
- obtain enforceable undertakings
- revoke or suspend RE licences
- require modifications to compliance plans
- deregister schemes
- instigate civil penalty proceedings
- prosecute offences.

MIA has also resulted in cost savings to consumers. Appendix 2 to the IFSA submission provides information on the effect of MIA on fees and charges paid by investors, as well as on industry costs, overall. The data reveals, inter alia, that since introduction of MIA on 1 July 1998, there has been an overall decline in the total weighted average MER of 2% (or 3 basis points). This reduction in MER translates to an annualised cost saving of approximately $26.8m.

Submission to the Review of the Managed Investments Act 1998

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IFSA
Submission to the Review of the Managed Investments Act 1998

1. Introduction

The Investment and Financial Services Association Limited (IFSA) has 100 members who invest over $660 billion on behalf of nine million Australians, through the provision of managed investments, superannuation, life insurance and other financial services.

IFSA member companies (RE) operate managed investment schemes overwhelmingly invested in marketable securities and commercial property, both domestically and overseas. The comments below, therefore, are based in large part on our experience of the operation of the managed investment provisions of the Corporations Act (MIA) as they apply to mainstream, unit trust schemes.

It should be emphasised that, while MIA came into effect over 3 years ago, the period from July 1998 to late 2000 saw both industry and ASIC applying significant resources to ensure a smooth transition for investors across the full spectrum of MIS. While this was achieved, industry has only recently switched its principal focus from transition to consolidating the regime and examining it for future improvement.

2. Overview

Passage of the MIA in 1998 followed the acceptance by Government of the principal recommendations of the Australian Law Reform Commission (ALRC) and Companies and Securities Advisory Committee (CASAC) in the report entitled "Collective Investments: Other People's Money" (The ALRC Report).

The most fundamental recommendation of the ALRC Report was that, for each managed investment scheme, there should be a single responsible entity (RE) in which the responsibilities, previously split between trustees and managers, be combined and imposed as statutory duties. The new regime also introduced other fundamental changes, in particular making compliance an integral part of day to day scheme operations and considerably enhancing the role and powers of the regulator.

IFSA is strongly of the view that MIA has fulfilled, even exceeded, expectations in terms of its success as an efficient and effective regulatory regime. This has been as a consequence of the very comprehensive and thorough analysis that preceded the drafting of the Bill and strong commitment from an industry engaged in a process of rapid growth and change during the 1990's.

From the perspective of IFSA members, MIA's principal success has been in the way it has encouraged and driven compliance best practice at all levels of management in mainstream managed investment scheme operations. Acceptance and understanding of the importance and value of best practice compliance is now integral to top and senior management in the managed investments industry. This is a quite different situation to that which existed prior to the events of the early 1990's and the ALRC Review ie when external compliance entities were often engaged by fund managers to undertake their role with as little "interference" in the business as possible.

MIA and the consultation and review process which preceded it, has also driven a much more productive relationship between industry and the regulator – one which has required each to develop a better understanding of what effective compliance means, in practical terms. The development of ASIC's MIA Policy Statements, in close consultation with industry, contributed enormously to the regulator's understanding of the managed investments industry. This process also impressed upon management teams the need to manage compliance as an integral part of each business.

The result is, we believe, a structurally flexible and very robust regulatory regime for managed investments. After 3 years under the regime, IFSA members have identified a few areas where improvements could usefully be made. These are set out at the end of this submission (Appendix 1).

3. Single Responsible Entity v Split Responsibility and Liability

In conducting its review of collective investments, the ALRC looked closely at the then two party structure of management company and trustee, concluding that it was fundamentally flawed, giving rise to confusion in the minds of investors and operators as to which party was ultimately responsible for the operation of a scheme.

In essence, the ALRC rationale for recommending a RE was based on its finding that the dual party system, while appearing to offer investors additional security through the presence of an independent supervising trustee, was subject to fundamental legal and commercial contradictions which rendered such protection largely illusory. In its view, the then prescribed interest laws rested on the outdated assumption that the relationship between manager and trustee was one in which the former was engaged by the latter, a situation which had not existed for many years prior to the ALRC Review.

The dual party system evolved in Australia during the 1950's, when corporate trustees, pooling funds, appointed professional managers to invest proceeds on their behalf. Legislation setting out the responsibilities of trustees and their appointed managers was passed in various States during the 1960's, with various refinement of the dual party regime being put in place during 1960's, 70's and 80's. This evolutionary process reflected the relatively modest growth of managed funds during those decades, until the spectacular growth of property/mortgage trusts during the mid to late 1980's.

The latter growth firmly established the primacy of professional asset and investment managers, who conceived investment schemes and sought public investment in such schemes, appointing trustees to 'supervise' them and act on behalf of trust investors. It

was at this time that the realities associated with 'who appointed who' and the relative powerlessness of 'supervising' trustees began to become more obvious, exposing significant weaknesses in the dual party structure and the fiction that trustees provided much more than custodial services.

The property and mortgage trust collapses of the late 1980's finally put paid to the fiction that trustees were able to supervise the activities of the managers who had appointed them in the first place. The litigation that ensued from these collapses highlighted the worst single feature of split responsibility, whereby the dual parties fought for years to deflect liability on to each other.

The ALRC Report, therefore, placed great emphasis on imposition of clear statutory duties and clear lines of responsibility for entities managing other peoples' money. The result, under MIA, is a regime which is very clear in its intent and operation.

Needless to say, 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.

4. Single Responsible Entity as Trustee – The Essence of MIA

In commenting on the former prescribed interest (dual responsibility) regime, the ALRC pointed to the use of trust terminology as having created a false impression that common law trust principles applied in full, obscuring the fact that trustees of prescribed interest schemes, unlike traditional trustees, did not bear ultimate responsibility.

In imposing clear and non – delegable legal obligations on scheme operators and their directors MIA has, in effect, rendered the single responsible entity a "trustee" in the true sense of that word, ie someone who is ultimately responsible and who, while they may privately contract out certain functions, cannot in any way delegate their ultimate liability in law for the exercise of those functions.

MIA imposes trustee style duties directly on the SRE through the statute rather than via prescribed covenants as was previously the case, making for far greater clarity and certainty as to who is responsible to investors and the extent of that responsibility.

5. Responsibilities, Obligations and Liability of Scheme Operators

The RE approach focuses sharply on the accountability of scheme responsible entities to their members by making the responsible entity liable to scheme members for anything that an agent it has appointed has done or failed to do, even if the agent was acting fraudulently or outside the scope of its authority or engagement.

The Government's rationale, and that of the ALRC, for not imposing a legislative requirement for external custodianship was to avoid any possibility of confusion as to ultimate responsibility for the safety of scheme assets and operations

The ALRC stated in this regard – "compliance risk will not be eliminated merely because the title to scheme assets is held by someone other than the operator. A bare custodian, for example, will provide little protection against misuse of scheme property because it will be required to deal with the property as instructed by the scheme operator".

While this was always intended to be the clear intention under MIA, some experts are, nevertheless, of the view that there remains some uncertainty about the extent (if any) of a custodian's accountability to scheme members. The terms of appointment of custodians vary widely from scheme-to-scheme and while, generally, custodians are merely the holders of property as agents for their RE clients and are not obliged to look into the circumstances of transactions, it is possible that this may not always hold true.

Further clarification of the role and duties of the custodian desirable

IFSA is of the view that the regime would be enhanced if the legislation were amended to resolve, in the negative, any doubt surrounding the questions as to whether or not a custodian;

(a) has duties directly to the members of a scheme, to act in their best interests,
(b) must make reasonable inquiries in relation to instructions given to it,
(c) can be held directly accountable to scheme members.

A recommendation to this effect is included at the end of this submission.

6. Strengthening of Compliance Culture and Practices under MIA

Prior to the advent of compliance plans, their scrutiny by ASIC and the requirement for external auditors to review RE compliance with such plans, the self-regulatory version of compliance monitoring was quite minimal by comparison with that which now exists.

Under the pre-1998 law, trustees had responsibilities to hold title to assets, monitor compliance by managers with trust deeds and, where breaches occurred, to take remedial action on behalf of scheme members.

Notwithstanding claims that trustee companies, as external compliance entities, undertook active and 'real time' monitoring of managers, most IFSA member companies have always maintained, and now re-confirm, that little meaningful compliance monitoring occurred under the dual entity regime. In fairness to trustee companies it should be said that, while managers had only to know about their own constitutions and obligations, individual trustee companies often 'administered' many hundreds of trust deeds and could not, realistically, be expected to provide genuine 'day-to-day' supervision.

As external compliance entities, removed from the business and its operational imperatives, trustees did not have the capability to assess the merits of asset allocation or transaction decisions taken by increasingly well-resourced, sophisticated and fast growing fund managers.

Annual reviews of fund managers conducted by trustees reportedly ranged from friendly 'discussions' to the distribution and collection of responses to standardised questionnaires – in some cases, but not all, trustees also sought supporting evidence for assertions made by fund managers. 'Annual' reviews were, in many cases, sporadic and inevitably some trustees were more focused than others on their own exposure to potential liability.

Throughout the 1990's, there was growing awareness in the managed investments industry of the ineffectual nature of trustee 'supervision', in the context of an increasingly competitive market and downward pressure on fees. Most mainstream fund managers were implementing better internal controls, through their own compliance plans. The pace and intensity of this trend increased in response to the loss of confidence following a number of high profile property and mortgage trust collapses, as well as the presence, in the form of the then ASC, of a more active and better resourced regulator.

During the 1990's, therefore, most fund managers developed risk management plans and systems for the purpose of ensuring that their asset allocation and other practices complied with the terms of their trust deeds and disclosure documents. These systems evolved over time into full-blown compliance plans, commensurate with the rapidly growing pools of assets they managed. Compliance programs became much more robust in order to try and ensure compliance with plans at all times (ie not just at review time).

For most IFSA member companies, therefore, MIA represented a formalisation of many of the measures they were already implementing by 1998, both in response to the abovementioned catastrophes and also in anticipation of the new regime which, by 1998, had been in the wings for some 6 years (ie following release of the ALRC Report).

Introduction of MIA in 1998 gave great impetus to the already growing trend to more effective compliance and, importantly, spread the resulting benefits to investors in a much wider range of managed investments.

The long gestation of MIA, preceding litigation and effectiveness of the ASC combined also to ensure that responsible officers in SREs were made very aware of their accountability under the new regime.

IFSA members report that, as a direct consequence, RE boards take an active role in compliance requirements, which has flow-on benefits for governance, generally.
Some RE's also operate divisional compliance and/or risk management committees, which address and manage compliance issues at a more 'grass roots' level ie

administration, junior management. Since the advent of MIA, therefore, both the number and seniority of staff directly involved in the compliance process has contributed to ensuring a much broader understanding of, and commitment to, compliance.

7. Development of a Compliance Industry Under MIA

It is only in recent years that what could be described as a 'compliance industry' has evolved into a significant industry in its own right. In the financial services industry, in particular, there has been an increased focus on regulatory compliance through legislation, which has included direct references to, not just compliance requirements, but specific compliance processes and practices. MIA is the prime example of such legislation.

MIA requires the formation of an independent compliance committee (or independent Board) and the production of a compliance plan which must "set out adequate measures" as to how a responsible entity will ensure compliance with the law and its constitution.

MIA also requires that the responsible entity comply with those "adequate measures". The compliance committee and compliance plan auditor have independent functions to oversee not only that the measures documented are adequate, but that the responsible entity has complied with them. Both the compliance committee and compliance plan auditor are subject to legislative requirements to direct serious breaches to ASIC, if they are not satisfied that such breaches are being appropriately addressed by the responsible entity.

Professional service providers in the area of compliance audit confirm that the above requirements have significantly boosted the profile and power of the compliance function both within individual organisations and across industry as a whole.

MIA has also led to increased demands by financial services organizations for specialised skills to back up and assist those responsible for ensuring adequate compliance measures and compliance. According to IFSA service provider members, this demand has, in turn, driven an increased focus on compliance by legal and accounting firms. Some firms report that where, for example, compliance consultancy and advice services may have been handled from within existing risk management groups prior to 1998, this is no longer the case. Firms have established dedicated financial services compliance practices under the auspices of senior partners and directors.

One major service provider has advised, for example, that its compliance practice now comprises some 20 full time staff across Australia, with 75% of those staff specialising in the financial services industry. The same firm states that "MIA can be viewed as a catalyst for the development of this practice and, more recently, Privacy legislation and the Financial Services Reform Act have cemented its place".

While compliance covers a wide spectrum of activities, including corporate governance, ethics, reputation assurance, compliance framework reviews, compliance monitoring, compliance risk assessments and the use of technology tools, its backbone is regulatory compliance of the type driven by MIA. Again, professional service providers report that experience gained in the managed investments industry is rapidly being applied elsewhere, most notably in the superannuation industry, and other areas of financial services.

8. Benefits of MIA Extend to Wholesale Funds

One very important consequence of MIA has been the spread of many of the compliance practices and structures, originally designed for retail schemes, to wholesale managed investments.

Wholesale managed investment schemes are not required to be registered and can, therefore, be run by entities operating under a securities dealer's licence arrangement. With the MIA prohibition on registered schemes investing in unregistered schemes and the co-mingling of retail and wholesale moneys, increasingly, managers are making the decision to have all moneys managed under structures complying with the MIA provisions.

This extension of the MIA provisions and culture to apply generally to wholesale schemes generally has had spillover benefits for the administration and management of funds for super, non-super, corporate treasury, and offshore moneys. Principally, these benefits flow from the more focused and compliance centred operations of MIA regulated schemes.

9. Implications for Superannuation

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 (at para 4.107, page 45 of the report);

> "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. For example, the MIA requires a managed investments scheme to invest only in approved schemes. While under the Act an investment can still be made for example in a mushroom farm, this can only be done if structured under a MIA vehicle/arrangement which provides:

- the protection of having independent directors;
- compliance plans;
- prospectuses;
- continuous disclosure; and
- increased ASIC supervision."

10. Compliance Plans and the Compliance Audit Process under MIA

Under MIA, each scheme must have a plan that meets criteria set by ASIC and which is signed by the directors of the RE. A compliance plan is described in the explanatory memorandum to the MIA as;

> " ….. a document that will set out the measures that the RE will apply in operating the scheme to ensure compliance with the Law and the scheme's constitution. The compliance plan will set out the various checks and balances to be in place to ensure that the scheme is operated in accordance with the requirements of the scheme's constitution and the requirements of the Law".

Compliance plans must be lodged with ASIC and compliance by the RE with each plan is required under the Corporations Act (s602FC(1)(h)).

RE's are required by law to monitor their compliance with compliance plans. This monitoring responsibility is imposed on the board of directors where at least half of the directors are external directors and on the compliance committee where the board does not meet that requirement. In addition, an external auditor must audit compliance with the plan annually.

In our view the MIA requirement to have compliance plans independently audited, on an annual basis, justifies increased comfort on the part of investors as to the internal operations of scheme operators. According to IFSA service provider members, most of whom have been at the forefront of these developments, the process applied by audit professionals has combined the skills of the audit practice with the skills of the compliance practice. The approach adopted for the compliance plan audit, for instance, has usually been developed to include the key features of Australian Standard AS3806 – Compliance Systems requiring auditors to assess the effectiveness, not just of accounting controls, but also the adequacy of senior management commitment, culture, training, reporting and complaints handling.

The recommendations for improvements arising from compliance audits are assisting organisations to identify and deal with any weaknesses in their overall compliance

frameworks, as well as controlling breakdowns or breaches that require action. This ongoing interaction between the compliance plan audit and the SRE serves to improve the focus on compliance and the rigour with which it is applied. The statutory audit helps to ensure that an RE adopts a philosophy of continuous improvement, which addresses the latest developments and requires the compliance plan to be continually updated to reflect regulatory, business and operational changes.

The MIA requirements that a compliance plan be produced and then audited has, therefore, been instrumental in focusing organisations on the importance of the compliance framework and the implications of operating with an inadequate management system. Service providers report that the continuous dialogue between auditor, SRE and compliance committee has focused considerable attention on compliance improvements and driven a culture of continuous improvement throughout the managed investments industry.

From the RE perspective, the compliance plan audit requirement is reported as providing them with a very powerful incentive to continually review the relevance and effectiveness of compliance plans. IFSA member companies report that they undertake year-round work to ensure progress is being made in developing and improving compliance plans. The presence of compliance committees in most companies provides a focus for management in appreciating the importance of compliance and facilitates the development of a 'compliance culture' - much more effectively than did the 'presence' of an external compliance entity.

11. Effectiveness of Compliance – The Role of ASIC

ASIC's role in relation to compliance is a vital part of the MIA regime for managed investments. It is not always fully appreciated that, in addition moving the regulatory regime to one based on responsibility by a single entity, MIA also instituted another, equally fundamental change, in the pivotal role it allocated to the regulator.

The dual or multi entity model was essentially self-regulatory in character, with the ASC acting as a 'back up regulator' to the trustee companies. Under this regime, with its absence of direct statutory duties, neither the ASC or trustees had coercive powers of the kind that ASIC is able to exercise under MIA. Any powers that trustees may have had in theory were, in practice, severely constrained in their exercise by nature of the commercial relationships that existed between managers and trustees.

The MIA regime recognizes that, while day to day supervision of MIS operations can, in reality, only be accomplished by a system of internal checks and balances integral to day-to-day operations, via compliance plans, independent boards and compliance committees, the efficacy of these measures must be reinforced by the presence of statutory duties and an external regulator with investigative and coercive powers.

ASIC Powers

ASIC has extensive powers in relation to the establishment of managed investment schemes, as well as in relation to monitoring, and if necessary controlling, the

management and operation of such schemes. It also has extensive powers with regard to surveillance and investigation and access to a wide range of enforcement powers.

Under these various powers, ASIC is able to;

- check schemes for compliance at any time
- investigate where it has reason to believe that a contravention may have been committed
- direct that an SRE give it information about its compliance plan
- require persons to give all reasonable assistance to its investigation and to appear for examination
- require the production of books
- obtain enforceable undertakings
- revoke or suspend SRE licences
- require modifications to compliance plans
- deregister schemes
- instigate civil penalty proceedings
- prosecute offences.

ASIC actively assesses compliance plans at the time of lodgment ie as part of its assessment in deciding whether or not to register a MIS. This active consideration extends to assessment of whether or not a RE has designed measures which are "….adequate to address the risks of (an RE) not complying with its obligations (ASIC PS 132).

Together with its power to require modification of compliance plans ASIC has, therefore, been instrumental in ensuring that RE compliance plans are meaningful documents in relation to which levels of compliance can be properly audited.

The practical effect of ASIC's involvement in this regard has been to reinforce the abovementioned increase in awareness and understanding of the need for commitment to compliance with the law, scheme constitutions and ASIC licence conditions. IFSA member companies report that this commitment to compliance is now integral to the 'culture' of RE's operating at the 'financial assets' end of the market.

ASIC's broad and vital role in the MIA investor protection matrix makes it essential that the regulator is adequately resourced in the future. IFSA fully supports the way in which ASIC has approached administration of the regime since its inception.

12. ASIC Review of Surveillance Outcomes 2000 – 2001

ASIC's recently released Review of Surveillance Outcomes is illustrative of the importance and effectiveness of its role in the MIA regulatory regime. While this review related principally to smaller managed investment schemes ie mainly those with assets of less than $250 million, concentrating particularly on the small mortgage scheme sector, ASIC surveillance revealed a significant number of breaches of compliance plans, licence conditions and the law. It is very important to note with respect to ASIC's findings, however, that its surveillance was targeted ie that ASIC

concentrated its activities in areas where it most expected to find compliance weaknesses and breaches.

ASIC's powers enabled it to quickly take a range of remedial actions on behalf of investors, at the same time encouraging greater levels of management commitment to compliance through the very real threat of further sanctions.

It is IFSA's view that, under a regulatory arrangement relying on private sector external compliance entities, such as that which existed previously under the pre – 1998 laws, the breaches identified and remedied by ASIC would never see the light of day, much less be remedied so swiftly. Publicity and remedial action such as that undertaken by ASIC as a result of its surveillance activities has a salutary effect in terms of driving senior management commitment to compliance, especially at the small and business scheme end of the management investment scheme sector, which has traditionally been an area of particular vulnerability for retail investors.

13. Scheme Governance and Accountability Under MIA

The cornerstones of effective and accountable scheme governance under MIA are;

- imposition of clear, statutory, trustee style duties on a single entity;
- strict liability of the SRE for the actions of its agents;
- requirement for substantial compliance infrastructure within SRE's
- independence of boards of directors and compliance committees
- requirement for independent audit of SRE compliance;
- active role reserved for the regulator in registering schemes, licensing SRE's and monitoring compliance.

Member Rights

The MIA provisions seek to provide a safe and accountable environment for investors who, by definition, are not involved in the day to day operations of schemes – an environment in which the structures and processes required by the law and active involvement of the regulator will serve to protect interest holder rights and interests, without their needing to exercise vigilance and judgement on their own behalf.

Under MIA, scheme members have rights to distributions, to enforce compliance by those operating the scheme and to receive certain information. In particular, members' statutory enforcement rights are extensive in situations involving breaches of the law or the constitution by the RE.

It should also be noted that the Financial Service Reform Act will further strengthen investor protection under the MIA provisions by introducing new rights of cooling-off and transaction confirmations, together with a compensation regime for retail investors.

Members do not, however, have the right to involve themselves with the management of the scheme – they are not empowered to give directions to the RE, which, under s601FB, has the duty to operate the scheme on their behalf.

Member Powers

In reserving only the most fundamental powers to voting by interest holders (see below) the regime acknowledges that the pillars of MIS governance are quite different to those that support the essentially self – regulatory governance regime for companies, in relation to which some commentators seek to draw overly simplistic analogies for governance purposes.

The MIA confers on interest holders the right to vote on fundamentally important matters, as follows;

- amending the scheme constitution (unless the RE reasonably considers the proposed change will not adversely affect members' rights);
- removing the RE;
- approving the appointment of a new RE;
- vetoing certain related party transactions;
- winding up the scheme.

Duties of SRE Officers and Compliance Committee Members

A wide range of duties is imposed directly on RE officers under section 601FD, including, under paragraph 601FD(1)(c), a particular duty to prefer the interests of scheme members, ie;

> "An officer of the responsible entity of a registered scheme must:
>
> (c) act in the best interests of the members and, if there is a conflict between the members' interests and the interests of the responsible entity, give priority to the members' interests;….."

This is a particularly important provision and one which is often overlooked by commentators seeking to import shareholder control mechanisms to MIA on the assumption that the latter regime does not deal adequately with potential conflicts of interest on the part of MIS directors.

MIA also provides for accountability by compliance committee members;

- Section 601JD(1) subjects compliance committee members to honesty, care and diligence duties with respect interest holders;
- Section 601JC(1) imposes a clear requirement on committee members to monitor, report and assess compliance;
- The latter section also effectively requires compliance committee members to report breaches of the compliance plan, subject to a materiality test ie anything that is likely to have a material adverse impact on unit holders must be reported by compliance committee members.

Managed Investment Scheme not directly Analogous to a Company

In drawing analogies with the company shareholder, commentators often ignore both the essential differences as between the legal position of unit holders in a trust and

shareholders in a company and the existing accountability measures that apply to operators of managed investment schemes.

As with the regime which preceded it, MIA is predicated on experience that investors will not seek to participate actively in the affairs of the trust. In the experience of IFSA members, this is in fact the case. The vast majority of investors in registered schemes deliberately seek to earn returns on their capital by placing it in the hands of expert investors – professional investors and managers who will invest, on their behalf, in underlying assets and enterprises. Such investors do not seek to involve themselves in the governance of their chosen schemes, in the normal course of events.

While it is not difficult to draw simplistic analogies between the rights of company shareholders and interest holders in registered schemes for the purpose of advocating greater levels of involvement by the latter, it is arguable as to whether closer alignment is justifiable.

Many of the powers reserved to shareholders are for the purpose of guarding against company directors unfairly resolving conflicts of interest - hence shareholder rights in relation to approval of directors' remuneration, for example. In relation to this example, directors' remuneration is not directly analogous to the fees received by RE's for operating managed investment schemes. A company director does not pay for the operation of the company out of his or her remuneration – such remuneration is a personal reward for undertaking the responsibility of directing the company. RE fees, on the other hand, cover the cost of all operational expenses for a scheme eg investment expenses, legal fees, compliance costs, audit costs, prospectus costs and costs associated with investor communications, etc.

Company directors are not subject to the same trustee style fiduciary duties as RE's and nor are they subject to the same strict regulatory regime. RE's are subject to a much more intense level of regulation than ordinary companies, both via ASIC, the statutory duties applying to their independent boards, compliance committees and compliance plan auditors.

14. Interest Holder Communications

IFSA is aware that some interest groups advocate the mandating of annual meetings of managed investment scheme interest holders as a means of strengthening governance under MIA. The principle rationale advanced for this position is that managed investment schemes are, to all intents and purposes, analogous to public companies. For the reasons set out below, IFSA does not concur with either the view or the rationale.

Firstly, the large costs associated with calling and organising unit holder meetings. The costs of notifying members and providing venues to accommodate very large numbers of investors (including video links) are paid directly out of investors' fund, and experience during the transition to MIA demonstrated clearly that such expenditure was invariably wasted – investors showed virtually no inclination to participate in meetings.

IFSA member companies were required, in relation to a great many funds, to hold unit holder meetings at the time of transition to MIA.

During this period, ASIC gave relief from the requirement to hold meetings to choose a responsible entity where a notice was sent out and, after 21 days, not more than 100 members, or members holding together 5% of units, had responded requesting that meetings be convened. (These thresholds are the same as those in section 252L of the Corporations Act for members to requisition a meeting).

Secondly, the inability of members, at a meeting or otherwise, to direct the trustee with regard to the carrying on of the business - the role of trustee is not directly comparable to that of a board of directors of a company. The latter owes its duty to the company itself not, as in the case of the trustee, directly to interest holders as beneficial owners of the property held on their behalf.

Thirdly, choosing an investment manager to make investment decisions on one's behalf is not directly analogous to investing directly in a business enterprise. If interest holders, for example, are not happy with a particular investment strategy, they can usually switch to a different strategy at minimal or no cost to themselves. For investors to have a say in decisions about investment strategies and decisions would run contrary to the very rationale for, and definition of, "Managed Investment Scheme", in the Corporations Act.

IFSA would not, therefore, support any move to require RE's of large, financial asset based schemes to institute regular meetings of interest holders.

Consumers should, however, be made aware of their rights and we would not oppose, for example, a requirement for annual accounts and reports to contain material drawing the existence of s252L to members' attention ie reminding members that, if they want an annual meeting to be held to discuss the accounts and the operation of the fund for the year, they can requisition a meeting if at least 100 members or members with at least 5% of units that can be voted, request it.

15. 'Small' Schemes, Business Schemes, Tax Effective Schemes

While not wishing to comment in detail on the effectiveness of MIA governance requirements in relation to small, business based schemes (eg tax effective schemes, agricultural schemes etc), IFSA appreciates that these may give rise to special concerns relevant to any review of governance and compliance issues. We expect ASIC would be best placed to comment on the effectiveness of MIA in relation to small schemes.

Speculative, tax-based schemes of the type scrutinised earlier this year by the Senate Economics References Committee should be clearly distinguished from mainstream managed investment schemes, notwithstanding that both are regulated under the provisions inserted into the Corporations Law by the MIA.

Negative experiences by investors and negative publicity in relation to such schemes have the potential to infect overall consumer attitudes to MIA regulated schemes,

generally. The investment community as a whole, therefore, has an interest in ensuring that consumers of these products are adequately protected.

The MIA definition of "managed investment scheme" encompasses a very broad range of investment arrangements, including mainstream public unit trusts (often referred to as managed funds/investments) and those schemes, which are often described as "enterprise schemes" (or "business schemes"), such as agricultural schemes, film schemes and small scale property developments. By virtue of the very broad scope of the relevant legal definition, both enterprise schemes and mainstream managed investments are regulated under the MIA provisions of the Corporations Act. Together with the fundraising and disclosure provisions, this provides for a rigorous regulatory regime for all managed investment schemes, be they small schemes or mainstream public unit trusts, notwithstanding their vastly differing characters.

16. Costs under MIA

It should be noted at the outset that the terms of reference for the ALRC Review was concerned only with the efficacy of existing and potential regulatory regimes and did not extend to consideration of the costs of different options addressed. The review was intended to address issues relevant to the efficiency and effectiveness of the then legal framework for collective investment schemes and whether there was a proper level of regulation of the various kinds of schemes.

The emphasis that was placed on costs during the period prior to introduction and passage of MIA was, in IFSA's view, quite inappropriate, deliberately diverting attention from far more important issues. Estimates publicised at that time were unverifiable and speculative. The real costs, however, are now known.

Costs - Current Research

The attached survey of managed investment costs, undertaken by KPMG for IFSA (Appendix 2) provides information on the effect of MIA on fees and charges paid by investors, as well as on industry costs, overall. The data reveals, inter alia, that since introduction of MIA on 1 July 1998, there has been an overall decline in the total weighted average MER of 2% (or 3 basis points). This reduction in MER translates to an annualised cost saving of approximately $26.8m.

It should be noted that these cost savings are in nominal dollar terms and that, during the two years of operation under MIA, the operating economic environment has experienced an increase in the CPI (over two years) of about 4 per cent. In effect, therefore, the $54 million in savings would have been greater but for increases in underlying wage and other costs).

While we commend the attached report to the Review, as revealing some interesting trends over recent years, attention should not be diverted from the fact that by far the most important benefits accruing to consumers from MIA are the modernisation of Australia's managed investments industry and its vastly improved compliance regime and practices.

APPENDIX 1

IFSA Recommended Refinements to the MIA Provisions

1. **Role of the Custodian** – IFSA recommends that MIA be amended to make it absolutely clear that the custodian is not liable to investors when acting on instructions from the RE. The legislation should also be clear in stating that the custodian is not bound to inform itself of the terms of the scheme constitution, compliance plan or offer documents, nor required to take into account any of the contents of any of those documents, but bound to act only on the basis of the responsible entity's instructions, whether it has actual notice of those documents or not. This clarification would, in our view, save costs by obviating the need for custodians to factor in a cost of risk. More importantly, however, it would remove any lingering doubt as to who is responsible to investors.

2. **Liability for Agents** – IFSA recommends that the provisions be amended to modify the liability of the RE for losses caused to the scheme by the default of an agent where the RE can show that it has taken reasonable care and diligence in selecting the agent and monitoring it in the performance of its duties – ie, bring MIA into line with SIS requirements in this regard.

   Section 601FB of the Corporations Act imposes strict liability on responsible entities for the acts of their agents, even if an agent is acting fraudulently or outside the scope of its authority. Section 601GA(2) of the Law allows the responsible entity to state in the scheme's constitution that it may be indemnified, but only in relation to the proper performance of its duties. An improper act by an agent, for which liability would be imputed to the responsible entity, does not by its very nature amount to the proper performance of duty. The RE, therefore, must bear the risk of its agent's fraud or excess of authority, irrespective of its diligence.

   These provisions have caused practical problems in the operation of MIA, particularly in situations involving negotiations where a small or foreign fund manager, which does not have the resources to fulfil the duties of a responsible entity itself, wishes to contract with another party to jointly establish a scheme. Liability for any default by foreign sub-custodians is typically a subject of protracted debate, because it is not fair for either the RE or the fund manager to bear responsibility for this.

   Arguments to the effect that limiting the RE's liability for agents in the manner suggested is inconsistent with the concept of "single responsible entity" are not, in IFSA's view, correct. The same concept of single responsible entity is applied to superannuation trustees under SIS. While there is an equivalent of section 601FC of the Law in SIS (see the covenants in section 52 of SIS, in particular 52(1)(e) and 52(3)), there is no equivalent of section 601FB. Under SIS, the standard expected of superannuation trustees is that they must carefully choose and monitor agents. Section 56 of SIS entitles a trustee to be indemnified out of the fund in respect of any liability incurred while acting as trustee of the fund, except in the case of a

breach of trust (or if there is a civil penalty imposed) where the trustee has failed to act honestly, or intentionally or recklessly failed to exercise the required degree of care and diligence.

It is questionable whether the liability imposed on responsible entities of non-superannuation managed funds should be greater than that applying in the superannuation industry, where prudential regulation, tax concessions and prohibition on borrowing indicate that investors' funds are generally intended to be protected more closely. We recommend, therefore, that the liability of responsible entities for their agents be brought into line with the standard imposed on superannuation trustees.

3. **Compliance Plans** – the compliance process could, in our view, be made more efficient and more effective through a modification of the requirement for such plans to cover compliance with *all* provisions of the constitution and *all* provisions of the Corporations Act relevant to schemes. Such modification would enable the scope of plans to be reduced to require regular checking only in those areas where consumers are at significant risk eg fees, unit price calculations, custody, compliance with investment mandates.

4. **Fees and proper performance of duties** – IFSA recommends modification of section 601GA(2) to remove the reference to fees and the possible interpretation that these cannot be claimed by the RE unless it has properly performed all its duties – in its most extreme application, this interpretation of the present provision could preclude a RE from ever claiming fees in the event of having committed a breach not amenable to remedy by the payment of money eg late sending of a notice.

   Clearly, it is appropriate that the right of indemnity for liabilities and expenses should only be available in relation to the proper performance of duties by the responsible entity. This is consistent with the usual right of indemnity of a trustee out of trust property. The mixing of the reference to fees into this provision causes confusion, however. A possible interpretation of the provision is that fees cannot be claimed at all unless the responsible entity has properly performed all its duties. It has been argued that fees cannot be claimed unless the constitution specifically states that the fees are only available in relation to the proper performance of duties. We are unsure as to the possible meaning of such a clause in the constitution. There are two possible interpretations, however, both of which are absurd: the proportionate approach, whereby if a RE has stolen 10% of the money that it would be entitled to 90% of its fees, or the "all or nothing" approach which would hold that if the RE once commits a breach of duty, it is never again entitled to management fees. This second interpretation could be particularly problematic in the case of a breach which is not capable of remedy by the payment of money such as the late sending of a notice.

   IFSA suggests that it would be appropriate to amend the provisions to make fees the subject of a separate provision which says, simply, that the RE is not entitled to

be paid fees out of scheme property unless such fees are specified in the constitution.

5. **Voting – ASIC power to modify provisions** – IFSA believes it would be useful for_ASIC to have the power to modify the voting provisions to enable it to facilitate the setting up of certain commercial arrangements as registered schemes where (eg joint ventures) it is not always appropriate for voting rights to be proportionate to capital contributions.

   Section 253C(2) states that each member of a scheme has one vote for each dollar of the value of the total interests they have in the scheme. This requirement can be inappropriate in situations, such as joint venture arrangements set up as trusts where, for various commercial reasons, voting rights are not intended by the parties to be proportionate to capital contributions. In order to facilitate application of the MIA regime to a wider range of vehicles, therefore, it would be useful forASIC to have the power to modify the above provision in particular cases. One example where such modification would be reasonably required is where a joint venture trust needs to be set up as a registered scheme in order that another registered scheme be able to invest in it. In such a case it may well be desirable, for valid commercial reasons, for the joint venture trust to issue some non-voting units.

6. **Voting - Changing the responsible entity** - IFSA also recommends that ASIC be given power to reduce the voting threshold in relation to changing the RE. Section 601FL(1) provides for the RE to retire by calling a members' meeting and members voting (by extraordinary resolution) on choosing a new company to be the RE. This is an extremely cumbersome, expensive and often difficult method of replacing the RE. To obtain 50% of all possible votes of members, regardless of the nature of the scheme, makes it impossible to change in the case of some funds, and almost impossible for most.

   Also, section 601FC(1) could be amended to allow for the RE to be changed to another company in the same group without member consent (section 601FK already provides that a company cannot be the SRE unless it complies with section 601FA ie is a public company and holds a licence to operate a registered scheme). A change of RE operating a fund need not be any different to a change in key personnel within the same RE operating the fund, or a sale of the shareholding in the RE itself. The critical issue is investment style and a different company operating the scheme might acquire the investment personnel from the former RE and even if it does not, the new RE might nevertheless continue the same investment style.

7. **Related Party Provisions** – IFSA believes it would be useful, and would not compromise investor protection, to except transactions between a trust and its sub trusts from the related party approval requirements, in the same way that transactions between a public company and its closely held subsidiaries are excepted by section 214 of the Corporations Act;

8. **External Members of a Compliance Committee** – IFSA recommends that consideration be given to qualifying section 601JB(2) so that a person only fails to qualify as an external compliance committee member if they have had substantial business dealings "….which a reasonable person would expect to influence the member in the performance of their duties on the committee." There are many kinds of business dealing that might be regarded as "substantial" but which are not of a kind that would offend the principle underlying the provision. The present requirements exclude participation by many well qualified and worthy individuals.

9. **Equal Treatment Provision – Differential Fees** - IFSA strongly recommends that the equal treatment provision (section 601FC(1)(d)) be brought into line with the equivalent provision in SIS. 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.

   ASIC's interpretation of the equal treatment provision has adversely affected the ability of the managed investments industry to market its products and it has issued policy which restricts the ability of RE's to offer discounted fee arrangements to retail consumers. RE's are, as a result, unable to offer discounts to retail investors on entry fees for special offers, relationship rebates, for older or pensioner investors or for their own employees. The end result is that retail investors are prevented from accessing reduced entry fees for funds.

   IFSA members and their advisers have long maintained the view that entry fees are the property of the RE, not the scheme itself, and that the RE should be able to deal with them as such. We believe the current equal treatment provision inhibits competition in the managed investments industry, without promoting investor protection.

   ASIC's interpretation and policy also leads to an inconsistency as between investors who invest directly through the RE and those who invest via an intermediary. Currently, entry fees can be rebated to an investor by an intermediary while a RE cannot waive or reduce fees for a retail investor who approaches them directly (eg via the internet).

10. **Notification requirements re top 20 unit holders (Annual Returns by registered schemes – ss345 and 349).** Many IFSA members have expressed concern at the requirement in section 349 of the Corporations Act for a registered scheme to disclose the top 20 interest holders in schemes, as this information is confidential and commercially sensitive. Lodgement of an Annual Return with this information in it makes the information part of the public record and is likely to subject interest holders to unwanted invasions of privacy and unsolicited offers.

    This is of concern, in particular, to clients of IDPS - like schemes (master trusts), who do not invest in the master trust itself but, rather, through the master trust into a number of underlying investments. The amount invested through a master trust

may, in fact, amount to the total wealth of a particular client, rather than just a particular investment with a particular company.

IFSA, therefore, seeks either an amendment of section 349 to omit the requirement for disclosure of the top 20 interest holders or a regulation enabling schemes to withhold public disclosure of such information.

11. **Aggregation of voting interests and substantial shareholdings** - IFSA recommends that the substantial shareholding provisions of the Corporations Act be modified in their application to RE's of multiple schemes and associated RE's. Application of these provisions causes significant problems by virtue of shareholdings in associated entities being aggregated for the purpose of the substantial shareholding threshold.

    Where there are a number of entities within a group holding shares in the same companies, the threshold can be reached very quickly at this group level, forcing scheme operators to sell shares in order to avoid breaching substantial shareholding limits. In light of the regulatory purpose of these thresholds (takeovers), the difficulties caused, for example to index funds, and the conflicts that can be created between acting in the best interests of scheme members and observing the shareholding limits, it is hard, in IFSA's view, to see the regulatory benefit.

12. **Definition of managed investment scheme/registration of a single scheme** - the definition of 'managed investment scheme' (section 9 of the Corporations Act) is extremely broad and can sometimes be difficult to determine where a scheme starts and where it finishes. This is problematic for ASIC, which is unwilling to register several trusts as a single managed investment scheme.

    Under section 601ED(3) ASIC can declare a number of schemes to be closely related, requiring each one to be registered. While it is clear from the explanatory memorandum to the MIA that this is an anti-avoidance provision, ASIC is reluctant to group several different trusts as a single registered managed investment scheme, which can be both inefficient and costly from an applicant's point of view. Legislative change is not necessary because ASIC has the necessary power but is reluctant to use it. It would be useful to have the views of the review on this issue.

13. **Ability to register umbrella constitutions** - IFSA recommends that the Act be amended to provide a facility for lodging model constitution provisions that can be incorporated by reference. The benefits of providing one constitution for a number of trusts would be simplicity and cost efficiency. Streamlining documentation would also make administration easier.

14. **Provision for Model Compliance Plans** – IFSA recommends that an amendment be made to permit lodgement of a 'model' compliance plan by a RE, which can, in whole or in part, be incorporated by reference. This would address a present problem, whereby incorporation by reference of a compliance plan for an existing scheme requires the RE to file a change for all other schemes which incorporate that plan by reference, in the event that the original scheme is terminated.

15. **Amending the Constitution** – IFSA recommends that section 601GC be amended to clarify that interest holders must approve changes to the constitution which adversely affect the following;

    - Distribution rights
    - Withdrawal rights
    - Voting rights
    - Rights to receive information
    - Rights in respect of scheme property.

    There is currently some uncertainty as to what is meant by "members' rights" in the context of this provision, which permits a RE to modify, repeal, or replace a constitution if it reasonably considers that the change will not adversely affect members' rights. Otherwise, a special resolution of interest holders is required to approve a change to the constitution.

APPENDIX 2

KPMG Cost Survey

This survey is attached as a separate document.

kpmg

Retail Registered Schemes
Fees and Charges

August 2001

This report contains 22 pages

IFSA01A-regschemsrptprs-O2808-LCB

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1 Executive Summary

This report is the first of a three-part report issued to IFSA in conjunction with the brief outlined in section 2. This part specifically focuses on the results of our analysis of the fees and charges an investor incurs through investing in registered managed investment schemes.

Our study identified the fees and charges incurred by an investor for access (entry), and advice investment management and administration.

With respect to investor advice and access fees we noted there exists a large variety of structures available to the investor. The publicly available data provides a guide as to the range of fees paid by an investor as a result of their entry to a scheme. What is actually paid by an investor cannot be determined since the exact entry fee paid by an investor depends on a number of factors. These factors include:

- extent of advice received by the investor from their respective adviser;
- nature of any fee rebates provided by the adviser to their respective investors ; and
- method of access into the scheme by the investor (ie. whether the investor has invested through a discount broker).

The data available therefore did not permit a quantitative analysis to be performed of access and advice fees. In spite of the above variables, we are still able to conclude that over the past five years the potential cost to an investor of entering a scheme has reduced as a result of widespread rebating by fund distributors and the evolution of low cost distribution channels such as discount brokers.

Fees for investment management and administration are bundled and included as part of the registered scheme's MER. For the period 1996 to 2000 we found there has been an overall reduction in the weighted average MER of 3.92% (or 6 basis points). This reduction translates to an annualised cost saving of approximately $53.5m. The weighted average MER excluding cash assets decreased over the same period by 6.25% (or 12 basis points).

Since the introduction of MIA on 1 July 1998, we found there has been an overall decline in the total weighted average MER of 2% (or 3 basis points). This reduction in MER translates to an annualised cost saving of approximately $26.8m.

With respect to the size of the MER, we noted that:

- MER's are asset class specific;
- asset classes which produced a higher range of expected return (and therefore arguably a higher risk premium) attracted a higher MER; and
- schemes that were actively managed attracted a higher MER than schemes that were passively managed.

2 IFSA Brief

This report has been prepared by KPMG who were engaged by IFSA to conduct an analysis of the levels and trends in fees and charges for retail managed investments products. In accordance with the agreed IFSA brief, KPMG were specifically engaged to:

- identify the fees and charges structures that operate in the Australian market for managed investments, superannuation, master trusts and wrap accounts, including their interaction with the advisory/access industry. Report on the development and trends of these fee structures over the past 5 years;
- identify fees and charges levels for managed investment products over the past 1, 3, and 5 year periods;
- report on future trends re the fees for managed investments, superannuation and master trusts & wrap accounts, including their interaction with the advisory industry;
- report on levels of fees in Australia relative to fees and charges in other overseas markets for comparable products over a 1, 3, and 5 year period;
- draw conclusions from the data in regard to "What drives fee levels?". Specifically, considering, funds under management, product value and performance;
- identify fee structures for competitive products such as DIY super and IDPS.

2.1 Research background

2.1.1 Overview

This report is the first part of a three part report issued to IFSA in conjunction with the brief outlined in section 2. This part specifically focuses on the results of our analysis of the fees and charges an investor incurs through investing in registered managed investment schemes ("registered schemes").

2.1.2 Products selected

Our analysis of schemes was undertaken on the basis of asset class. The following asset classes were separately identified:

- Domestic equity (both active and passive management)
- International equity
- Cash
- Domestic bond
- International bond

- Diversified funds

With respect to diversified funds, three categories were separately analysed using ASSIRT criteria. These categories were:

- Multi-sector 30 – Diversified income funds
- Multi-sector 70 – Diversified balanced funds
- Multi-sector 70+ - Diversified growth funds

For all asset classes selected, with the exception of international bonds, KPMG were able to obtain data for products, which in aggregate covered between 75-80% of the FUM[1] of that particular class. For the international bond asset class, the data obtained represented 50% of FUM[1] for that class.

2.1.3 Sources of data

Data was acquired through researching publicly available information over the past 5 years. With respect to registered schemes, the data was sourced from a combination of prospectuses and individual registered scheme financial statements.

2.1.4 Time horizon

Our analysis of registered schemes covered the five year period from 1996 to 2000.

2.1.5 Disclaimer

The statements and analysis in this report are provided in good faith but rely upon the information obtained as outlined above.

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[1] Using FUM per ASSIRT Market Share Report – December Quarter 2000

3 Overview of all fees and charges

As is shown by the following diagram consumers are charged fees for the following services:

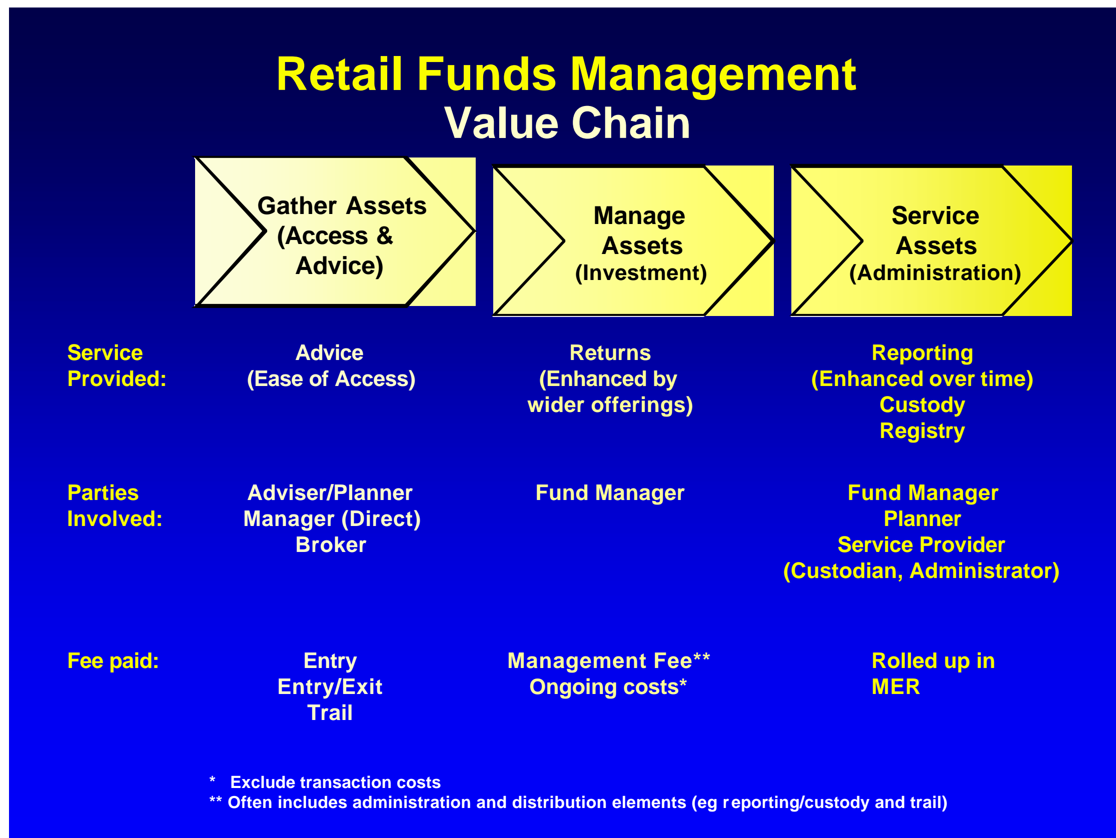
- access and advice;
- investment management; and
- administration.

The level of total fees that a consumer pays is dependent upon the method and type of access and advice, investment management and scope of service that the consumer or their product demands.

It is also relevant to note that fees are received by more than one participant in the managed investments value chain.

The following diagram illustrates the nature of fees charged for each product and services offered and identifies the parties involved.

The products and services provided may be sourced either from within the one organisation or from different organisations.



3.1.1 Access and advice

Access and advice fees are paid to the party that introduces the investor to the scheme (eg: financial planner, discount broker, etc).

Access and advice fees are applied in one of two ways:

- up-front fees: or
- on-going ("trail") fees.

Up-front fees are levied once only at the date the initial investment is made. Trail fees are applied during the term of the investment.

An alternative to an upfront fee may be to charge an exit fee should the investor withdraw from the product within a specified time. The exit fee is stepped to reduce to nil over time, should the investor remain in the fund for greater than the specified time.

3.1.2 Investment management

Investment management fees are paid to the party which manages or invests the scheme property. The fees incurred for investment management are included as part of a scheme's management expense ratio ("MER").

The IFSA definition of MER and its inclusions is contained in Appendix 1. These fees are calculated as a percentage of the scheme's net assets and are quoted in annualised terms. The MER excludes all up-front and exit fees.

3.1.3 Administration

The range of administration services provided for investors in registered schemes includes:

- periodic consolidated and detailed investor level reporting;
- investor access to internet platforms for to up to date investment information and/or transactional facilities;
- comprehensive taxation reporting at the individual investor level;
- timely processing of investor transactions and/or enquires.

In the case of registered schemes, the cost of administration services is generally included in the scheme's MER, irrespective of which party provides the service.

4 Registered schemes

4.1 Overview

The fees and charges paid by an investor in a registered scheme for access and advice, investment management and administration are embodied in the entry fee and the MER.

As outlined below, depending upon the election made by the investor, entry fees may be paid separately at the time of initial investment or "wrapped up" in the MER. Fees for investment management are included in the MER. In addition, the cost of administering a registered scheme is generally bundled and included in the MER without separate disclosure to the investor.

4.2 Access and advice

Investors pay a fee for access and advice when initially investing in a registered managed investment scheme. This fee can be paid through one of two options:

- up front fee levied on the initial investment; or
- on going fee levied over the life of the investment.

Historically, the most common manner of entry for an investor into a registered scheme has been via a financial adviser. The service provided at this time was generally paid "up front" by the investor, based either on the time and expertise involved in the advice provided ("fee for service") or on the value of the investment ("upfront fee").

More recently, fee structures have been amended to provide investors and advisers with the option to lower (to nil in many instances) up front entry fees, and to replace this with a trail over the life of the investment. Where this "dial up" option is utilised the investor will usually incur a higher MER than an investor that has elected an entry fee option. The difference between the MER's in each case approximates the fee.

Where this alternative has been made available, the trail fee has been in the range of 0.33 to 0.60%, with the average being 0.44%.

The payment of a trail by the manager of a scheme to an adviser/broker may also take place without an election being made by the investor. In these instances the manager bears the cost of the trail, without a corresponding increase in the MER. This scenario has become increasingly evident with the evolution of new distribution channels, for example, the introduction of discount brokers.

4.2.1 Historical trends

The data which is publicly available provides a guide as to the range of fees paid by an investor as a result of their entry to a scheme. What is actually paid by an investor cannot be determined from these sources as, for example:

- upfront fees may be rebated;
- an adviser's fee for service will vary from situation to situation;
- where offered, the combination of entry fee and trail will vary from investor to investor.

The types and structure of the various fee options which are available to a retail investor are summarised in the following table.

Method of access and advice	Type of fee	Levy base	Term of fee	Access and advice fee paid by	Range of fee
Financial adviser	Fee for service	Time	Provision of advice	Investor	Various
	Up-front	Initial investment	Levied once only	Investor	Nil to 5%
	Trail (included in MER)	Investment value	Term of investment	Manager/ Trail may be dialled up by investor	0.33 to 0.60
Broker	Up-front	Initial investment	Levied once only	Investor	Nil to 5%
	Trail (included in MER)	Investment value	Term of investment	Manager	0.33 to 0.60
Direct	Up-front	Initial investment	Levied once only	Investor	1 to 5%

4.2.2 Buy/Sell spread

The price at which an investor enters or exits a scheme is usually subject to a buy/sell spread, typically in the range of 0.15 to 0.50%. This spread is designed to meet the costs incurred by the scheme in acquiring or selling investments at the time of entry or exit of an investor to or from the scheme. As a consequence, the spread is “retained” within the scheme and is not paid to any party involved in its operation. Investors of the scheme are therefore not disadvantaged by other scheme investors purchasing or redeeming their respective investments in the scheme.

4.3 Investment management and administration

The fees an investor pays for investment management and administration are bundled together and included as part of the management expense ratio (MER). KPMG's analysis of investment management and administration fees was performed by reviewing the trend in the MER[1] for registered schemes.

4.3.1 Historical trends

We performed an analysis of the historical trend in the size of the MER from 1996 to 2000 for all core asset classes of registered schemes, the results of which are contained in the following table.

Asset Class	Weighted Average MER[2]				
	1996	**1997**	**1998**	**1999**	**2000**
Domestic equity - active	1.88	1.87	1.84	1.81	1.78
Domestic equity – passive	N/A	N/A	N/A	1.29	1.15
International equity	2.05	2.04	2.02	2.01	1.95
Cash	1.08	1.08	1.07	1.06	1.04
Domestic bond	1.60	1.50	1.39	1.37	1.38
International bond	1.87	1.84	1.82	1.83	1.74
Diversified funds – Income	1.62	1.54	1.48	1.45	1.47
Diversified funds - Balanced	2.02	1.95	1.92	1.88	1.86
Diversified funds – Growth	2.00	1.96	1.89	1.91	1.85
Total weighted average MER	**1.53**	**1.53**	**1.50**	**1.49**	**1.47**
Total weighted average MER (ex cash)	**1.92**	**1.89**	**1.86**	**1.84**	**1.80**

[1] To maintain comparability where entry and nil entry fee alternatives were offered which resulted in a different MER for the same product, the entry fee option was used in the analysis.

[2] Weighted Average MER has been calculated using relative FUM weightings of the products in our sample for the respective asset class.

The results of our analysis indicate that MER's have declined by between 3.70% to 13.75% from 1996 to 2000. The total weighted average MER across all asset classes has declined by 3.92% or 6 basis points. This translates to annualised cost saving of approximately $53.5m.[3]

The total percentage decline per asset class from 1996 to 2000 is detailed in the following table.

Asset class	**Percent decrease**
Domestic equity – Active	(5.32)
Domestic equity – Passive	(10.85)
International equity	(4.88)
Cash	(3.70)
Domestic bond	(13.75)
International bond	(6.95)
Diversified funds – Income	(9.26)
Diversified funds – Balance	(7.92)
Diversified funds – Growth	(7.50)
Total weighted average MER	(3.92)
Total weighted average MER (ex cash)	(6.25)

As noted from the above table the size of the percentage decline in MER from 1996 to 2000 is not consistent across all asset classes.

It is important to note that the decline in passive domestic equity products was largely due to the introduction of a large foreign passive fund manager mid way through 1999. The MER for their suite of index products has only been reflected in 2000 data, which was their first full year of operation in the Australian market.

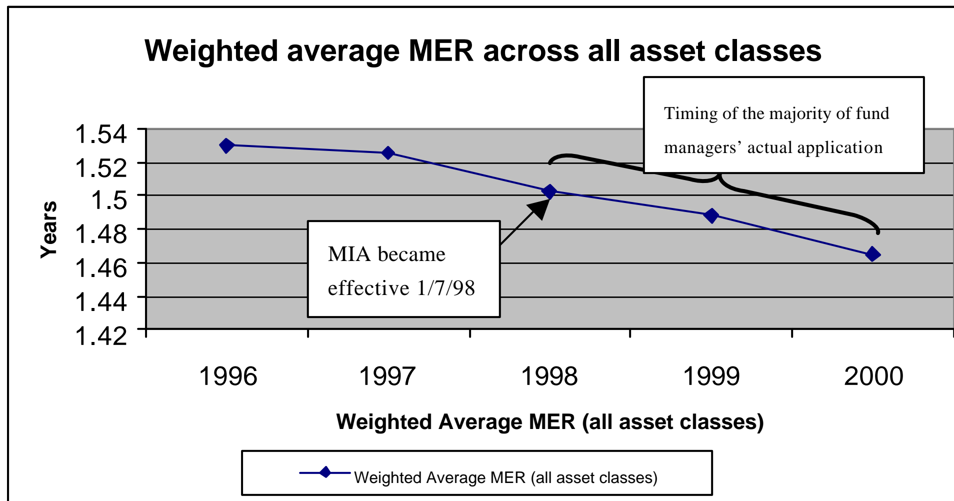
4.3.1.1 Introduction of MIA

The Managed Investment Act reforms became effective on 1 July 1998. However, transitional provisions provided a two year period from this date to register schemes with ASIC.

[3] Based on ASSIRT FUM data as at 31 December 2000

The more significant aspects of the introduction of the MIA were the removal of the trustee's responsibilities with respect to retail unit trusts and their replacement with a more rigorous compliance regime for responsible entities.

The following graph plots the timing of the introduction of MIA and the observed decline in total weighted average MER over time.



The table below indicates the fall in MER by asset class in the period subsequent to the introduction of the MIA.

Asset class	**Weighted Average MER**		**Basis point decrease**
	1998	**2000**	
Domestic equity - active	1.84	1.78	6
International equity	2.02	1.95	7
Cash	1.07	1.04	3
Domestic bond	1.39	1.38	1
International bond	1.82	1.74	8
Diversified funds - Income	1.48	1.47	1
Diversified Funds - Balanced	1.92	1.86	6
Diversified Funds - Growth	1.89	1.85	4
Total weighted average MER	**1.50**	**1.47**	**3**

As seen from the above table there has been a 3 basis point fall in the total weighted average MER since 1998. This translates to annualised cost savings of approximately $26.8m[5].

[5] Based on ASSIRT FUM data as at 31 December 2000

4.4 Drivers of management expense ratio

In addition to the factors considered in section 4.3 in relation to the observed decline in MER's, our brief also required consideration be given to factors such as performance and product value as potential drivers of fee levels.

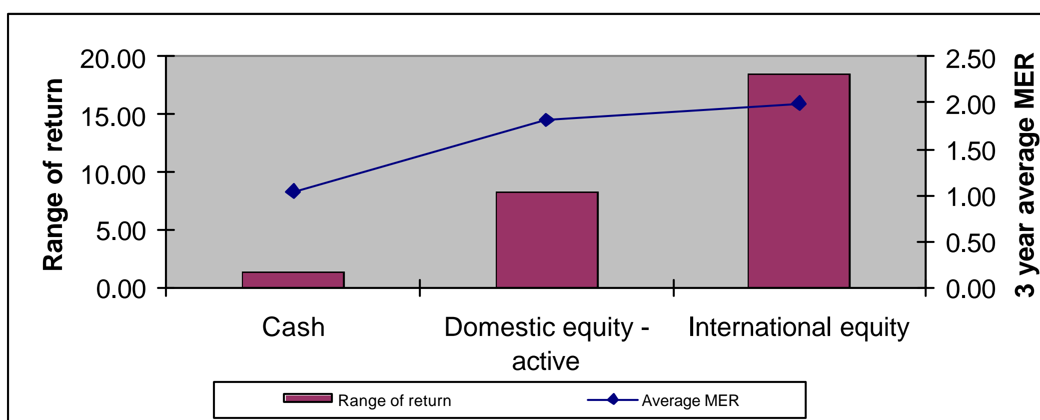
4.4.1 Range of expected return

The following graph compares the size of the MER to the range of expected return for the following asset classes:

- cash
- domestic equity – active ; and
- international equity

The range of expected return is defined as the percentage difference between return earned by the product within the sample that achieved the highest three year return and the return earned by the product within the sample that achieved the lowest three year return. Effectively, the range of expected return is a measure of the volatility in returns for the products included in the sample.

MER v Range of return over 3 years

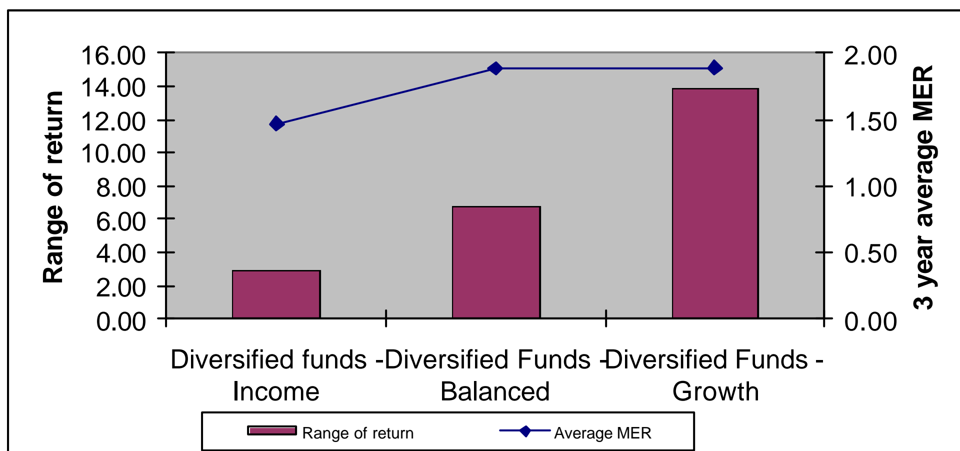


The above graph provides some evidence that there is a relationship between the MER and the range of expected return. This may suggest that the size of the MER for a particular asset class is in part related to the relative risk premium for the relevant class of asset.

For instance the above graph illustrates that the international equity asset class has demonstrated a greater volatility in returns than cash. The higher MER of this class is consistent with an argument that the higher risk asset classes command a higher degree of management expertise and effort in executing the investment management function. This translates into higher management costs associated with these classes of assets which have been passed onto the investor through the MER.

The following graph plots the range of expected return to MERs for diversified funds.

MER v Range of return over 3 years



In the above graph, the correlation between MER and range of return for diversified funds is less clear between balanced and growth asset classes. The reasons for this are uncertain and do not appear to relate to the strength of the product gradings between diversified balanced and diversified growth (as they appear to be supported by the relative range of expected returns).

4.4.2 Investment management style

The impact of management style on the MER is clearly evident by comparing the MER for actively managed products to passively managed (or index) products.

	Actively managed domestic equity	**Passively managed domestic equity**
Average weighted MER - 2000	1.78	1.15

This variance in MER may be attributed to the higher cost associated with monitoring and executing an active investment management style compared to the passive management style.

It is important to note also that the passive market in Australia is at a much earlier point in its product life cycle than the much more established actively managed equities products. Furthermore the introduction of established foreign passive fund managers into the index market has significantly reduced the MERs for passively managed investment products.

4.4.3 Goods and Services Tax (GST)

The review covers the periods 30 June 1996 to 30 June 2000. Given that the introduction of GST occurred on 1 July 2000, the study did not include the impact of GST.

The goods and services (including the management fee) consumed by a scheme are generally subject to GST. Schemes are generally permitted to claim a credit of 75% of the GST they incur.

The majority of current prospectus' reviewed disclosed that managers anticipated MER's to increase by approximately 2.5% as a result of GST. The increase in basis points from the impact of GST is therefore dependent on the respective MER. For example, applying this increase percentage to our weighted average MER data (from section 4.3.1), the implementation of GST would result in an increase in the total weighted average MER of approximately 4 basis points.[6]

[6] Calculated as 2.5% of 147 basis points.

A Appendix 1 - MER

IFSA defines the management expense ratio in IFSA Standard 4.00 as:

$$MER = \left(\frac{\text{Fees + Recovered expenses - ITC}}{\text{Average Scheme Size}} \right) \times 100$$

Fees include the following:

- management fee (excluding up-front and exit fees);
- fees of the trustee; and
- other fees which include:
  - local and overseas manager fees;
  - custodian fees;
  - audit fees;
  - trail commissions; and
  - amounts paid to ATO under GST reverse charge provision.

Recovered expenses are expenses incurred by the operation of the scheme, these include:

- transaction costs;
- brokerage;
- repair, maintenance and refurbishment costs;
- GST; and
- Government taxes and charges for transacting on investors account if paid out of the scheme;

But exclude the following expenses:

- Government taxes and charges for purchases and sales of securities (FID and BAD);
- income and other tax (excluding capital gains tax); and
- interest expense on specific borrowings.

ITCs are input tax credits received or receivable from the Australian Taxation Office.

B Appendix 2 - Detailed Asset Class Data

Domestic equity - active	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	1.88	1.87	1.84	1.81	1.78	7.77	13.14	16.76
Low	1.71	1.76	1.73	1.66	1.66	(3.36)	8.30	11.20
High	2.08	2.00	2.00	2.00	2.00	21.16	16.62	21.11
Spread	0.37	0.24	0.27	0.34	0.34	24.52	8.32	9.91

Domestic equity - passive	Weighted average MER		Return (years)
	1999	2000	1
Weighted average MER	1.29	1.15	7.75
Low	1.15	0.75	2.98
High	1.38	1.25	10.36
Spread	0.23	0.50	7.38

International equity	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	2.05	2.04	2.02	2.01	1.95	16.85	21.26	21.42
Low	1.50	1.50	1.50	1.50	1.50	(15.00)	8.00	14.30
High	2.40	2.34	2.36	2.36	2.23	51.83	26.54	24.03
Spread	0.90	0.84	0.86	0.86	0.73	66.83	18.54	9.73

Cash	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	1.08	1.08	1.07	1.06	1.04	5.06	4.37	4.55
Low	0.98	0.98	0.83	0.81	0.86	3.97	3.37	4.30
High	1.20	1.20	1.24	1.22	1.19	5.40	4.70	5.08
Spread	0.22	0.22	0.41	0.41	0.33	1.43	1.33	0.78

Domestic bond	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	1.60	1.50	1.39	1.37	1.38	6.58	5.94	8.25
Low	1.25	1.16	1.16	1.12	1.10	-3.36	4.90	5.46
High	1.83	1.77	1.88	1.88	1.83	12.71	14.99	14.14
Spread	0.58	0.61	0.72	0.76	0.73	16.07	10.09	8.68

International bond	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	1.87	1.84	1.82	1.83	1.74	12.02	7.08	8.58
Low	1.54	1.60	1.55	1.63	1.50	8.11	4.51	7.00
High	1.94	1.97	2.37	2.35	2.42	15.36	10.54	10.90
Spread	0.40	0.37	0.82	0.72	0.92	7.25	6.03	3.90

Diversified - Income	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	1.62	1.54	1.48	1.45	1.47	8.39	6.49	6.77
Low	1.44	1.3	1.17	1.12	1.09	5.91	5.40	6.10
High	2.11	2.09	2.06	2.09	2.04	10.22	8.35	8.92
Spread	0.67	0.79	0.89	0.97	0.95	4.31	2.95	2.82

Diversified - Balanced	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	2.02	1.95	1.92	1.88	1.86	8.60	9.24	10.11
Low	1.93	1.83	1.71	1.62	1.60	3.10	5.60	7.73
High	2.22	2.12	2.12	2.09	2.04	13.98	12.40	13.29
Spread	0.29	0.29	0.41	0.47	0.44	10.88	6.80	5.56

Diversified - Growth	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
Weighted average MER	2.00	1.96	1.89	1.91	1.85	14.64	14.19	9.35
Low	1.64	1.63	1.65	1.65	1.54	1.20	5.80	7.27
High	2.23	2.17	2.15	2.25	2.23	21.50	19.62	13.30
Spread	0.59	0.54	0.50	0.60	0.69	20.30	13.82	6.03