Chapter 5

The views of the gatekeepers on the collapse of Trio Capital

5.1 The previous chapter noted the criticisms by the regulators of the role played by the gatekeepers in the case of Trio Capital. In a broad sense, gatekeepers include financial advisers, lawyers, auditors, custodians, actuaries, research houses, credit rating agencies and independent experts. The Australian Securities and Investments Commission (ASIC), in particular, was pointed in its criticism of the gatekeepers in the collapse of Trio. It largely attributed the collapse to the failure of the investment manager, the compliance committee, the compliance plan audit, the research houses, the custodians and the advisers to detect 'outright dishonest conduct'.[1]

5.2 Perhaps unsurprisingly, the various gatekeepers reject this criticism. This chapter presents their views. It focuses on the committee's evidence from WHK and KPMG as the auditors of Trio, the professional accounting body CPA Australia, the peak financial services bodies the Financial Services Council (FSC) and the Financial Planning Association (FPA), the Australia Custodial Services Association and the research house Morningstar.

WHK's view

5.3 WHK was the auditor of Trio Capital's financial statements 'for the year ending 2008 and also for the year ending 2009'.[2] In evidence to the committee, WHK explained that it acquired the business of the previous auditor, KPMG, and completed the 2008–09 audits using the same staff and methodology as had been used for the KPMG audits. WHK also noted that after it had acquired the business from KPMG, it requested the appointment of offshore auditors to help with the valuation of offshore investments.[3]

5.4 A significant portion of the evidence given to the committee by WHK was 'in-camera'. However, the Chief Executive Officer and Managing Director of the WHK Group, Mr John Lombard, did tell the committee that:

> The loss of moneys by investors is deeply regrettable, and in our view was directly caused by the conduct of Shawn Richard and other parties with whom he was associated and the apparent failures of Trio Capital to oversee

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1 Mr Greg Medcraft, *Committee Hansard*, Sydney, 6 September 2012, p. 1.

2 Mr John Lombard, Chief Executive Officer and Managing Director of the WHK Group, *Committee Hansard*, 4 November 2011, p. 3.

3 Mr John Lombard, Chief Executive Officer and Managing Director of the WHK Group, *Committee Hansard*, 4 November 2011, p. 3.

> his conduct as their agent. Mr Richard has acknowledged he misled the auditor, and the Trio Capital directors have acknowledged that they failed to properly discharge their responsibilities.[4]

5.5 WHK explained that as part of auditors' risk-based approach, there is a requirement to consider fraud. However, as Mr John Gavens, Principal of Audit and Assurance at WHK, told the committee, the purpose of the audit is not to detect fraud:

> The auditor makes inquiry, uses professional scepticism and identifies where fraud might occur in relation to a set of financial statements, both in terms of the misappropriation of funds or the misrepresentation of financial statements. Where the auditor does not identify fraud as a significant issue or does not believe that, by virtue of their inquiries, fraud is a major risk, then the auditor is not required to conduct further activities in relation to fraud. So the purpose of the audit is not to detect fraud. The responsibility for detection of fraud, as stated within the auditing standards, rests with those charged with governance and with management, and the auditor does have a responsibility to consider fraud. Where there are potential indicators of fraud then the auditor would conduct additional activities in relation to that. But they also need at all times to exercise professional scepticism in relation to whether fraud might exist.[5]

5.6 When asked how, in practice, 'professional scepticism' works, Mr Gavens responded:

> As part of the audit process the auditor would conduct, for example, an analytical review of financial information, they would review the minutes of the board meetings and of the committees and they would be aware of general economic financial conditions and particular conditions impacting on the organisation. They would review the culture within the organisation and make assessments of the integrity of management and the extent to which within an organisation there was a culture around overriding policies and procedures. So there is a range of those matters that are considered as part of the audit process which helps to inform the auditor about the likelihood of information being provided that may not be what it is represented to be. So it is by virtue of a range of processes and the accumulation of that information and the sharing of that information across the audit team that judgments are made in terms of the environment in which that audit has been conducted and the veracity of that evidence.[6]

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4 Mr John Lombard, Chief Executive Officer and Managing Director of the WHK Group, *Committee Hansard*, 4 November 2011, p. 2.

5 Mr John Gavens, Principal, Audit and Assurance, WHK, *Committee Hansard*, 4 November 2011, p. 2.

6 Mr John Gavens, Principal, Audit and Assurance, WHK, *Committee Hansard*, 4 November 2011, p. 5.

5.7 In the case of Trio Capital WHK told the committee that the major risks for the auditor would be 'the valuation of the financial instruments'.[7] He added: 'the major risks that the auditor would have concentrated on...would be in relation to valuation'.[8] This aligns with the ASIC Chairman's view that the key questions were whether the assets existed and if so, what was their value.

5.8 The committee asked the Managing Director of WHK, Mr Lombard whether there had been an internal review within WHK of the collapse of Trio and the auditing of the Astarra Strategic Fund and the ARP Growth Fund. Mr Lombard responded:

> There has been a review with the support of our legal team...
>
> I have not read it. The detail of that review is an audit document, I understand...
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> I understand the document itself is a detailed document of which I am not in a position to provide any—...
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> I have been in the role now for four months and about five days—...
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> Prior to that I did not live in the country; I was a non-resident. So I have been going through a significant background and learning curve myself on this. But I take this extremely seriously. I apologise that I am not an accountant or auditor, but I have our most senior person here today to answer those questions.[9]

5.9 The committee then asked Mr Gavens, as the Principal of Audit and Assurance within the company, whether he was aware of the WHK review. He responded: 'I am aware there is one; I have not seen it'. He added that he did not know at what level of the organisation the review had been carried out.[10]

5.10 The committee asked WHK whether it had been contacted by ASIC or the Australian Prudential Regulation Authority (APRA) regarding the Trio case. Mr Lombard replied: 'we have had a document notice from ASIC. That is the only information that we have received from them'.[11] He added:

> ...we are waiting for organisations like ASIC to complete processes that are currently underway...There have been questions about whether the individual is still working at WHK...the questions surrounding whether we

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7 Mr John Gavens, Principal, Audit and Assurance, WHK, *Committee Hansard*, 4 November 2011, pp 2–3.

8 Mr John Gavens, Principal, Audit and Assurance, WHK, *Committee Hansard*, 4 November 2011, p. 3.

9 Mr John Lombard, Chief Executive Officer and Managing Director of the WHK Group, *Committee Hansard*, 4 November 2011, p. 2.

10 Mr John Gavens, Principal, Audit and Assurance, WHK, *Committee Hansard*, 4 November 2011, p. 6.

11 Mr John Lombard, Chief Executive Officer and Managing Director of the WHK Group, *Committee Hansard*, 4 November 2011, p. 2.

> have done a review of the file and those sorts of things...[W]e believe that we have acted—and I am advised that we have acted—correctly as auditors in accordance with Corporations Law and all of the associated standards. That is the advice I have received. Again, I am not an auditor, but the advice I have been given is that that is the case, and I accept that advice absolutely as the managing director of the company.[12]

Committee view

5.11 The committee finds much of WHK's public evidence to the committee unacceptable. In particular, it is surprising that the Managing Director of a company responsible for auditing the financial statements of a company involved in one of the most significant and serious fraud cases in Australian history, could not have read his own company's internal review of this experience. That he should appear before a parliamentary committee to give evidence on matters relating to the collapse of Trio Capital without having read and considered this review is insulting to the committee.

5.12 The committee notes that in February 2012, ASIC accepted an enforceable undertaking from former WHK auditor Mr Timothy Frazer. ASIC found that Mr Frazer failed to perform adequately and properly the duties of an auditor, and failed to ensure each audit was planned and performed 'with an attitude of professional scepticism'. In a 2008 audit, he had failed to ensure there was adequate evidence relating to the existence and valuation of investments, and did not have the requisite understanding of the ASF to identify and respond to risks of material misstatement. In a 2009 audit, ASIC found that Mr Frazer had failed to consider the professional competence of the other auditors upon whom he relied and whether the work of the other auditors was adequate for his purposes.[13]

KPMG's view

5.13 Chapter 2 also noted that KPMG was the auditor responsible for Trio Capital's compliance plan. Remarkably, its submission to an inquiry into the collapse of Trio Capital contained not one mention of Trio Capital.[14] Given that KPMG had responsibility for Trio's compliance plan, the committee finds this most peculiar. Again, the committee urges ASIC to thoroughly investigate the quality of KPMG's auditing in the Trio case, if it has not done so already.

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12 Mr John Lombard, Chief Executive Officer and Managing Director of the WHK Group, *Committee Hansard*, 4 November 2011, p. 7.

13 ASIC, 'Astarra Strategic Fund auditor prevented from auditing companies for three years', Media relase 12-22, 10 February 2012, http://www.asic.gov.au/asic/asic.nsf/byheadline/12-22MR+Astarra+Strategic+Fund+auditor+prevented+from+auditing+companies+for+three+years?openDocument (accessed 30 April 2012).

14 There was one reference in the opening paragraph to the submission being made to the 'Inquiry into the collapse of Trio Capital Limited'.

5.14 Notwithstanding its silence on matters relating to Trio, KPMG's submission does contain some useful comments on the adequacy of the current auditing framework. In particular, it considers the operation and regulatory framework of managed investment schemes, and the functions of compliance plans and compliance plan auditors. Significantly, the submission makes several observations regarding compliance committees and compliance plans that are similar in tenor to those made by ASIC.

5.15 The KPMG submission drew the committee's attention to the 'disaggregation of function, authority, accountability and oversight of MI schemes'. It noted that numerous parties now perform the key operations of these schemes other than the responsible entity. KPMG argued that:

> Whilst the Act [Corporations Act 2001] clearly points to the RE [responsible entity] as the entity responsible for the MI scheme's operation, the law also allows the RE to appoint an agent to do anything that it is authorised or required to do in connection with the MI scheme. In reality, this has permitted the business model to be defined by a disaggregation of functions, authority, accountability and oversight, giving rise to the potential for diminishing safeguards in the management of the scheme.[15]

5.16 KPMG suggested two contrasting possibilities to reduce this disaggregation of oversight. The first is to mandate a majority of truly independent directors of the responsible entity (RE) thereby removing the need for a compliance committee. The second option is to provide stronger legislative support for the operation of compliance committees which may include holding management accountable for acting on recommendations of the compliance committee.

Compliance committees

5.17 KPMG set out in its submission the role of compliance committees and compliance plans. In terms of compliance committees, it noted that their purpose is to independently monitor the area performing the primary compliance function of the RE and report on its functioning to the RE's board. However, it observed the independent operation of the committee may be compromised given:

> ...it is the RE who must ensure the proper functioning of the compliance committee according to one of the content requirements in a compliance plan, including adequate arrangements relating to the membership of the committee and how often it meets.[16]

5.18 KPMG also noted that compliance committees meet only a few times a year, leaving the RE's officers or employees better placed to detect breaches on a day-to-day basis. If these officers or employees are themselves deliberately concealing a

15 KPMG, *Submission 69*, p. 5.

16 KPMG, *Submission 69*, p. 5.

breach of the *Corporations Act 2001* or of the scheme's constitution, KPMG argued that the compliance committee's ability to detect such an issue may be impaired.[17] These concerns give weight to ASIC's suggestion to establish a register of employee representatives in the financial services industry (see chapter 4).

5.19 KPMG and ASIC also seemed to be in agreement that the current law does not require adequate detail in compliance plans. Chapter 4 noted the regulator's concerns that section 601HA of the Corporations Act allow for these plans to be set at a high level, without specific details. Similarly, KPMG's submission stated that the requirements in section 601HA:

> ...do not provide detailed qualitative standards. This allows the compliance plan to be drafted at a high level. Therefore literal adherence to the compliance plan may not always result in the objectives of the [Corporations] Act being met. Whilst ASIC may review compliance plans following their lodgement, ASIC is under no obligation to do so. It is possible that some REs believe that lodging a compliance plan with ASIC amounts to ASIC 'approving' the compliance plan, which is arguably not the case.[18]

5.20 In terms of the auditing of compliance plans, KPMG claimed that while section 601HG(2) of the Corporations Act requires the auditor of the plan to be a different person to the auditor of the RE's financial statements, this 'increases disaggregation in the oversight of the MI scheme'. Rather, KPMG argued that:

> Having one firm perform both roles provides a better opportunity for proper communication to occur. This is particularly relevant given the audit activity involved in fulfilling these audit responsibilities, including consideration of the RE's AFSL [Australian Financial Services Licence] compliance, will often be required to take place in the same time frame. Combining the different roles of auditing the scheme's compliance plan and financial statements and the RE's financial statements would create more effective visibility of the scheme's operation and the RE's broader commercial activities.[19]

5.21 KPMG argued that there is an opportunity to legislate more prescriptively about the drafting of the compliance plan, as well as what outcomes it is intended to deliver.[20]

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17 KPMG, *Submission 69*, p. 8.

18 KPMG, *Submission 69*, p. 9.

19 KPMG, *Submission 69*, p. 9.

20 KPMG, *Submission 69*, p. 15.

ASA 240

5.22 A further issue raised by KPMG concerns auditing standard ASA 240, titled 'the Auditor's responsibility to consider fraud in an audit of a financial report'.[21] ASA 240 was most recently prepared by the Auditing and Assurance Standards Board (AuASB) in June 2011. KPMG noted that ASA 240 does not comment on how fraud might be considered as part of a compliance plan audit.

5.23 Paragraph 4 of ASA 240 identifies that the primary responsibility for the prevention and detection of fraud lies with those charged with governance of the entity and management. It continues:

> It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.[22]

5.24 However, paragraph 5 of ASA 240 points out the 'inherent limitations' of an audit where there is the 'unavoidable risk' that despite proper planning and conduct of the audit, some material misstatements may be undetected. Paragraph 6 expands on these inherent limitations in the case of fraud, rather than from error. It states:

> ...the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine

21 Auditing and Assurance Standards Board, 'The Auditor's responsibilities relating to fraud in an audit of a Financial Report', Auditing Standard ASA 240, June 2011.

22 Auditing and Assurance Standards Board, 'The Auditor's responsibilities relating to fraud in an audit of a Financial Report', Auditing Standard ASA 240, June 2011.

> whether misstatements in judgement areas such as accounting estimates are caused by fraud or error.[23]

5.25 Further, KPMG drew the committee's attention to Guidance Statement (GS) 013—'Special considerations in the audit of compliance plans of Managed Investment Schemes'—which mentions fraud only in the context of 'inherent limitations'.[24] Under a section titled 'inherent limitations', GS 013 states:

> Because of the inherent limitations of any compliance measures, as documented in the compliance plan, it is possible that fraud, error, or non-compliance with laws and regulations may occur and not be detected. An audit is not designed to detect all weaknesses in a compliance plan and the measures in the plan, as an audit is not performed continuously throughout the financial year and the audit procedures performed on the compliance plan and measures are undertaken on a test basis.[25]

5.26 The committee contacted the AuASB for its comment on the issues raised by KPMG relating to ASA 240.[26] The Board noted in its view, ASA 240 is 'very robust' which reflects the expectations of audit regulators and standards setters in Australia and globally.[27] It added:

> Under successive Australian Auditing Standards...one of the overall objectives of the auditor in conducting a financial report audit is to obtain reasonable (but not absolute) assurance that the financial report taken as a whole is free from material misstatement, whether due to fraud or error. To achieve this, the auditor determines audit procedures that respond to the auditor's assessment of the risks of material misstatement whether due to fraud or error. Audit procedures are not specifically designed to detect fraud, but are designed by considering the risk of fraud.[28]

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23 Auditing and Assurance Standards Board, 'The Auditor's responsibilities relating to fraud in an audit of a Financial Report', Auditing Standard ASA 240, June 2011.

24 Auditing and Assurance Standards Board, 'Special considerations in the audit of compliance plans of Managed Investment Schemes', *Guidance Statement GS 013*, http://www.auasb.gov.au/admin/file/content102/c3/GS_013_12-08-09.pdf

25 'Special considerations in the audit of compliance plans of Managed Investment Schemes', Guidance Statement GS 013, http://www.auasb.gov.au/admin/file/content102/c3/GS_013_12-08-09.pdf (accessed 2 April 2012).

26 On 2 April 2012, the committee wrote to the Chairman of the AUASB requesting the Board's response to the issues raised in KPMG's submission relating to ASA 240. The Chairman responded on 20 April 2012. The committee thanks her for her prompt response.

27 Response from Chairman of the Auditing and Assurance Standards Board, Ms Merran Kelsall, 20 April 2012.

28 Auditing and Assurance Standards Board, *ASA 240: The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report: A chronology*, received from the AUSSB on 20 April 2012.

Professional scepticism

5.27 The committee notes that KPMG's submission makes no reference to paragraph 12 of ASA 240 or ASA 200, both of which relate to 'professional scepticism'. 'Professional scepticism' is an important concept and one that did not appear to have been observed by KPMG in its handling of Trio matters. Paragraph 12 of ASA 240 states:

> In accordance with ASA 200, the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.[29]

5.28 ASA 200 states:

> An attitude of professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents and responses to enquiries and other information obtained from management and those charged with governance. For example, an attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalising when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. When making enquiries and performing other audit procedures, the auditor is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management and those charged with governance are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.[30]

An expectations gap

5.29 KPMG considered that there is an 'expectations gap' between what the public believes is the work of a compliance plan auditor, and the work that by law he or she is actually required to perform. It suggested that this expectation gap could be reduced 'through AuASB and ASIC working together to provide additional guidance'. It added that greater guidance or prescription may be provided in terms of standards relating to

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29 Auditing and Assurance Standards Board, *Auditing Standard ASA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*, p. 11. http://www.auasb.gov.au/search-result.aspx?search=ASA%20240 (accessed 27 April 2012)

30 Auditing Standard ASA 200, *Objective and General Principles Governing an Audit of a Financial Report*, Issued by the Auditing and Assurance Standards Board, June 2007, Paragraph 23, p. 10. http://www.auasb.gov.au/admin/file/content102/c3/Compiled_ASA_200_-_27_June_2007.pdf (accessed 30 October 2011)

the conduct of a compliance plan audit.[31] This issue, and the matter of 'expectation gaps' more broadly, is considered in detail in chapter 7.

The Auditing and Assurance Standards Board's view

5.30 The AuASB provided answers to a set of written questions from the committee relating to the Board's role in collaborating with ASIC and APRA and developing standards that are 'international best practice' while fitting the Australian context. The Board noted that it conducts 'periodic liaison meetings' with senior staff of APRA and ASIC, as well as discussions 'from time to time' on a needs basis. It explained that over the past year, an ASIC Commissioner and an APRA Member have separately made presentations to the AuASB to discuss general issues relating to the application of auditing and assurance standards and issues relating to audit regulation.[32]

5.31 The AuASB mentioned that given the overlap between Guidance Statement (GS) 013—'Special considerations in the audit of compliance plans of Managed Investment Schemes—and ASIC's Regulatory Guide 132—Managed investments: Compliance plans—the Board has 'from time to time' raised in discussions with ASIC as to whether changes need to be made. It added: 'we have not received any recent advice from ASIC regarding the need to make changes'.[33]

5.32 However, the Board did emphasise that it is APRA's and ASIC's practice to maintain discussions with the AuASB at an 'in-principle' issues level, rather than raising issues specific to certain entities subject to their regulatory activities. Further, the Chairman of the AuSAB, Ms Merran Kelsall, emphasised that she was not able to make any specific comment on the circumstances of the Trio Capital collapse. She also noted that she could not comment on any evidence provided by accounting firms who were involved in the audit of the company.[34]

The Companies Auditors and Liquidators Disciplinary Board

5.33 Chapter 4 noted ASIC's view that where an auditor fails to conduct a compliance plan audit in accordance with the assurance standards, 'there would appear to be a prima facie case for ASIC to pursue the auditor in the Companies, Auditors and Liquidators Disciplinary Board (CALDB)'.[35] The committee's concern, however,

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31 KPMG, *Submission 69*, p. 14.

32 Response from Chairman of the Auditing and Assurance Standards Board, Ms Merran Kelsall, 20 April 2012.

33 Response from Chairman of the Auditing and Assurance Standards Board, Ms Merran Kelsall, 20 April 2012.

34 Response from Chairman of the Auditing and Assurance Standards Board, Ms Merran Kelsall, 20 April 2012.

35 ASIC, *Submission 51*, p. 45.

is that the regulators' preference appears to be for enforceable undertakings rather than disciplinary action through the CALDB. As the Chairman of the Board explained in an answer to a question taken on notice:

> ...in recent times, very few matters have been referred to the Board. The reason for this is a matter which needs to be addressed to ASIC or APRA, although to some extent, the use of enforceable undertakings would explain the reduction in the number of matters being referred.[36]

5.34 The CALDB emphasises the importance of the Board's independence from the processes of supervision, investigation and prosecution of auditors. The committee agrees that a separate tribunal function is important, but raises the question as to whether ASIC is making best use of the Board and its role in maintaining professional standards. The committee notes Treasury's June 2011 options paper titled 'the modernisation and harmonisation of the regulatory framework applying to insolvency practitioners'. The paper contains three options to reform the CALDB.[37] However, it did not deal with the use of enforceable undertakings to resolve disciplinary matters.

Committee view

5.35 The committee understands that the CALDB is entirely responsive to the matters it is referred by ASIC and APRA. In this context, it queries why ASIC has relied so heavily on enforceable undertakings in the past as opposed to referring a matter to the Board. The committee understands that an enforceable undertaking is generally an alternative to referring a matter to the Board.[38] Given the strength of ASIC's criticism of the gatekeepers in the Trio case (see chapter 4), and the extent of investor losses, it does seem peculiar that Mr Frazer's case (above) was not referred to CALDB.

The Trust Company

5.36 The Trust Company was appointed as the replacement responsible entity of nine managed investment schemes formerly operated by Trio. In its submission, it observed that the former operators of the Trio Funds did not appropriately deal with conflicts of interests that emerged in their capacity as trustee of superannuation funds, the responsible entity of the registered schemes, and as associates of the investment manager appointed to the Trio Funds. It stated:

> The Trio funds were layered with a series of cross-investments between super funds and registered schemes and between separate registered

36 Mr Howard Insall, Chairman, Companies, Auditors and Liquidators Disciplinary Board, *Answers to questions on notice*, Response received 30 April 2012, p. 5.

37 Treasury, *Options paper: a modernisation and harmonisation of the regulatory framework applying to insolvency practitioners*, June 2011, pp 76–78.

38 See Mr Howard Insall, Chairman, Companies, Auditors and Liquidators Disciplinary Board, *Committee Hansard*, 4April 2012, p. 4.

> schemes. We observed little evidence to suggest that these conflicts were adequately managed with the degree of appropriate caution a reasonable fiduciary would exercise discharging their obligations...There was a lack of evidence demonstrating that Trio Capital had effective governance, risk and compliance arrangements.[39]

5.37 Significantly, the Trust Company argued strongly against the single responsible entity regime. It claimed that Trio Capital was 'another example' of where the single responsible entity has compromised the interests of investors by acting in the interests of the promoter and failing to ensure independence. It added: 'a compliance committee does not provide any real time monitoring or check on the single responsible entity's actions and is similarly lacking in independence'.[40]

5.38 The Trust Company supported this view by noting that the responsible entity model has been a source of 'consternation, if not strong aversion from many overseas institutional investors, especially in the UK and Europe'. It noted that the potential for conflict in the single responsible entity regime is perceived to be unacceptable by many foreign investors and claimed that the regime is contrary to international investment standards.[41]

5.39 Others submitters, such as APRA, strongly defended the need for the responsible entity model, noting that a return to a dual responsible entity structure with a division between trustees and managers would dilute responsibility.[42]

The views of the financial advisers and planners

5.40 Recall from chapter 2 that financial advisers and planners played a key role in recommending Trio Capital to their clients. There are clear 'regional clusters' of victims of Trio based on the locality of operations of particular financial advisers, including Mr Ross Tarrant in Wollongong, the Seagrims in regional South Australia and Mr Paul Gresham on Sydney's North Shore. The committee does not know with certainty why these advisers recommended their clients use Trio products, but the evidence suggests that their recommendations were influenced by the high commissions paid by Trio.

5.41 This section notes the views of the peak financial advice groups as well as the views of Mr Tarrant.

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39 The Trust Company, *Submission 29*, p. 3.

40 The Trust Company, *Submission 29*, p. 4.

41 The Trust Company, *Submission 29*, p. 4.

42 Mr Keith Chapman, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 41.

The Financial Planning Association

5.42 The committee received submissions and took verbal evidence from both the Financial Planning Association (FPA) and the Financial Services Council (FSC).

5.43 The FPA argued that while financial advice 'is likely to have been a contributor to the instances of consumer loss', the key culprits were the product providers and the gatekeepers.[43] It identified a range of these gatekeepers including product manufacturers and fund managers, platforms, property schemes, ratings agencies and research houses, investment banks, auditors, accountants of product manufacturers, stockbrokers and future brokers, Australian Deposit-taking Institutions, insurance brokers and companies and regulatory agencies including ASIC and the Australian Competition and Consumer Commission (ACCC).[44]

5.44 In the FPA's assessment, the participants involved in the collapse of Trio Capital 'either did not detect, question or act' on the warning signs and/or high and abnormal risks associated with the products or provider. It argued that there is a need for better processes to detect and report concerns of high and abnormal risks of products and providers are needed across all financial services participants and gatekeepers to minimise the risks for consumers.[45]

5.45 The FPA argued that in terms of preventing a repeat of the Trio collapse and the factors that led to this collapse:

> ...few of the FoFA [Future of Financial Advice] regulatory enhancements will have any impact on the prevention of future similar events, as they have focussed too exclusively on the issues of adviser level activity and missed the opportunity to engage in a reform debate that would deliver transparent markets and product safety that would benefit all Australians, ultimately failing to deliver the effective consumer protection reform that FoFA promised.[46]

5.46 Indeed, the Association's submission produced a table presenting its view of the key problems with the Trio collapse and against each of these, whether the FoFA reforms will assist. The problems were grouped based on whether they relate to product providers, research houses, licensees, financial planners or the regulators. The FPA considered that FoFA would assist for only two of the 17 problems: the evidence of conflicted remuneration by some financial planners and the enhanced powers for ASIC to restrict entry into the AFSL regime.[47]

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43 Financial Planning Association, *Submission 46*, p. 1.

44 Financial Planning Association, *Submission 46*, pp 9–10.

45 Financial Planning Association, *Submission 46*, p. 13.

46 Financial Planning Association, *Submission 46*, p. 1.

47 Financial Planning Association, *Submission 46*, p. 11.

5.47 Accordingly, the FPA proposed 32 recommendations, which included:

- establishing a standard system for product category labelling;
- a comprehensive system of rating for product risk that ensures disclosure of key product risks;
- increasing the quality and type of disclosures required by product manufacturers;
- the introduction of a 'best interest' duty to apply to product manufacturers and fund managers to impose a duty on such providers to consider the interests of 'consumers as a whole';
- the introduction of a 'best interest' duty to apply to research houses to impose a duty on such providers to put the interests of the 'consumers as a whole';
- the introduction of a best interest duty to require AFSL holders to place the interests of the 'consumer as a whole' ahead of the interests of the licensee;
- a range of measures to strengthen the criteria, requirements and assessment process to gain an AFS;
- the development of a framework aligned with ASIC's 'Investing between the flags' concept (see chapter 6), to address the lack of disclosure by brokers and product providers in relation to complex financial products available to consumers, whether retail or non-retail clients; and
- that ASIC undertake a thorough review of the regulation of research houses operating in Australia, and a requirement that research houses publish all research reports they produce, whether they are used or not by product providers; and
- that Self-managed superannuation funds (SMSFs) obtain similar consumer protections as members of APRA regulated superannuation funds in respect to fraud and theft.[48]

The Financial Services Council

5.48 The FSC presented a very different view on the need for regulatory reform to respond to the issues raised by the collapse of Trio Capital. The committee asked Mr Martin Codina, the Director of Policy at the FSC, if in his opinion there was anything unique in the Trio collapse that required a legislative response. He replied:

> No... What gives us that view is that there are hundreds of fund managers in the country which are structured no differently to Trio and which continue to operate and comply with the law and have not resulted in the sort of collapse that Trio gave rise to...
>
> I think you have to ask: what data is there to support any alternative conclusion, particularly having come out of a global financial crisis, which

48 Financial Planning Association, *Submission 46*, pp 13–35.

> you would have thought would have exposed—as it did, and we all remember ASIC's evidence to the former inquiry of this committee; it clearly exposed some—flawed business models. But there has not been any suggestion or any evidence, and I have not seen any data, to suggest that what happened in this instance seems to be widespread or that we have a number of other cases before the courts.[49]

5.49 The FSC told the committee that any legislative response to Trio should wait until the FoFA and Stronger Super reforms have been fully implemented. As this committee noted in its inquiry into the FoFA legislation, the FSC supports the FoFA provisions to enhance ASIC's powers to refuse and revoke licenses and to ban individuals from the financial services industry. It believes that these reforms will 'significantly strengthen ASIC's ongoing compliance monitoring ability' and provide additional powers to act pre-emptively in situations of non-compliance before consumers suffer financial loss'.[50]

5.50 The FSC also expressed its support for the powers that APRA has to conduct investigations and issue directions. It noted that under the MySuper legislation, APRA will have a wider disclosure, efficiency and consumer-focused remit.[51] Notwithstanding its strong support for these reforms, the FSC told the committee in August 2011 that in its view, there is 'probably another year to 18 months' of reforms until these reviews will result in 'quite substantive reform' of the wealth management industry.[52] It agreed that given this substantial reform program, the government should wait to see how these provisions operate before considering what action is needed to address the issues raised by the Trio collapse. As it told the committee:

> ...in the light of all of the reviews and reform that we are currently working our way through, we do not see that there is a gap coming out of all of that that is particular to the subject matter of this inquiry, which is the Trio collapse, that requires some sort of a unique response or a top-up response to what is already being done.[53]

Mr Ross Tarrant—Tarrant Financial Consultants Pty Ltd.

5.51 Chapters 2 and 3 mentioned Mr Tarrant, who advised several of his clients to invest in the Astarra Strategic Fund (ASF) for which Trio Capital was the responsible entity. However, Mr Tarrant deflected the blame elsewhere: to the regulators, the

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49 Mr Martin Codina, Policy Director, Financial Services Council, *Committee Hansard*, 30 August 2012, p. 31.

50 Financial Services Council, *Submission 30*, p. 4.

51 Financial Services Council, *Submission 30*, p. 5.

52 Mr Andrew Bragg, Senior Policy Manager, Financial Services Council, *Committee Hansard*, 30 August 2011, p. 30.

53 Mr Martin Codina, Director of Policy, Financial Services Council, *Committee Hansard*, 30 August 2011, p. 31.

auditors, the research houses, the custodians and the directors of Trio. In terms of the regulators, he stated:

> They trusted the financial regulatory framework in the most sophisticated financial market place in the world. This framework was overseen and controlled by government watch dogs APRA and ASIC. Despite the sophistication of our financial system overseen by ASIC and APRA we are all horrified to learn that our money was sent all over the world from the British Virgin Islands to Hong Kong to Belize to Anguilla and to the Cayman Islands and to Lichtenstein and to oblivion.[54]
>
> ...
>
> This entire scenario of devastation was only made possible by the incompetence and indifference of ASIC and APRA.[55]

5.52 In terms of the auditors, Mr Tarrant reasoned:

> The first place to look when fraud is discovered is the audit process. In this case, we had WHK, the fifth largest audit firm in Australia as the external auditor, and KPMG, one of the largest in the world, as the internal compliance auditor.
>
> Both internal and external auditors KPMG & WHK signed off that systems internally were all working properly and that assets and performance of the fund were fairly stated, giving a true and fair view. The auditor's opinion was unqualified and compliant with Australian Accounting Standards, the Corporations Regulations, as well as, with International Financial Reporting Standards.[56]

5.53 Indeed, Mr Tarrant's conclusion was that, in the absence of evidence that the auditors had raised concerns with ASIC, Trio was unable to determine the value of its funds, 'there must have been a breach of S601HS(H) of the Corporations Act'. He noted that while the auditors claimed that they had prepared their reports with due care and diligence, 'this representation would now appear to be false'.[57]

5.54 In terms of Trio's directors, Mr Tarrant drew the committee's attention to sections 601FC and 601FD of the Corporations Act relating to the duties of the responsible entity and the duties of officers of the responsible entity. He concluded that 'the indifference and incompetence of the directors of ASF and the disregard for the Corporations Law have created a fertile environment for a fraud to grow and prosper.'[58]

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54 Mr Ross Tarrant, *Submission 35*, p. 3.

55 Mr Ross Tarrant, *Submission 35*, p. 27.

56 Mr Ross Tarrant, *Submission 35*, p. 4.

57 Mr Ross Tarrant, *Submission 35*, p. 4.

58 Mr Ross Tarrant, *Submission 35*, p. 7.

5.55 In terms of custodians and trustees generally, Mr Tarrant was also sweeping in his criticism, claiming that their 'pivotal roles' have been 'completely removed'. He noted that while it seems the custodians held a Deferred Purchase Agreement, there was no proof of existence or value of investor assets.[59] He argued in his submission that:

> It was a condition of Trio's Financial Services Licence that any custodial agreement be in writing. The Inquiry should seek to review this agreement in an attempt to determine if the Custodian's both ANZ and NAB could have performed their role properly.[60]

The custodians' view

5.56 A custodian is responsible for the safekeeping of the assets of a third party client such as a managed investment scheme. It holds legal title to the assets of the client.[61] However, as ASIC noted in its submission, 'the custodian only acts on properly authorised instructions from its direct client or authorised agent' and that prime responsibility rests with the RE.[62] Further, custodians are not required to verify underlying assets in managed investment schemes, only the units in these schemes.[63]

National Australia Trustee Ltd and ANZ Custodian Services

5.57 In the case of Trio Capital, ANZ Custodian Services and the National Australia Trustees Ltd (a member of the NAB Group) were the trustees and custodians of the investor assets. National Australia Trustees was appointed by Trio as custodian on 6 February 2009 after ANZ decided not to continue as custodian for Trio.

5.58 In its submission, ANZ described the timing and nature of its decision to transfer its Trio Capital custodian duties to National Australia Trustees:

> In 2005, ANZ acquired the custody book of Trust Company Limited (Trust Company). As a result of this acquisition, ANZ replaced Trust Company as the custodian for custody clients of Trust Company that transferred to ANZ. Assets held by Trust Company as custodian for those clients were transferred to ANZ as custodian and were held by ANZ Nominees as sub-custodian. Trio Capital was one of Trust Company's customers that transferred to ANZ...[64]

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59 Mr Ross Tarrant, *Submission 35*, p. 7.

60 Mr Ross Tarrant, *Submission 35*, p. 7.

61 ASIC, *Submission 51*, p. 72.

62 ASIC, *Submission 51*, p. 72. See also Mr Stephen Tudjman, *Committee Hansard*, 23 September 2011, p. 12.

63 *Committee Hansard*, 23 September 2011, p. 15.

64 ANZ, *Submission 70*, p. 5.

> During 2008, as part of a strategic review of the custodian services business customers, ANZ made a commercial decision to exit arrangements with a number of smaller customers, including Trio Capital. The review included an analysis of the profitability of individual customers based on fees generated and operational costs to service those customers. The custodial arrangement with Trio Capital was terminated and Trio Capital appointed National Australia Trustees Limited (NAT) as its successor custodian in February 2009. In accordance with Trio Capital's instructions, ANZ commenced the transfer of assets held by ANZ on behalf of Trio Capital to NAT in February 2009. ANZ had transferred substantially all of the custodial assets held by it under the custody arrangements to NAT by September 2009.[65]

5.59 In terms of NAB's involvement as custodian in the Trio case, it told the committee that it followed standard practices and operating procedures in relation to asset value reporting. This included reviewing Trio's product disclosure statement documents to confirm dealings with a licensed custodian (ANZ Custodians), a site visit to client's place of business, identification and verification of all authorised signatories to the NAT custody accounts, confirmation of Trio's AFSL and ASIC registration and meeting the CEO and CFO on separate occasions to understand their business operations.

5.60 A key theme of the NAB's evidence to the committee centred on what custodians do and do not do, and some confusion about this delineation between REs and custodians. In its submission, it noted that as a custodian for a RE, it is responsible to the RE in accordance with its custody agreement. The custody agreement provisions clearly state that as a custodian, it will not act on instructions that are considered to be unclear, ambiguous or unlawful. It also noted that in acting as custodian, the NAB was not undertaking authorized deposit-taking institution (ADI) activities such as taking deposits.[66] This theme is revisited in chapter 7 on 'expectation gaps'.

5.61 NAB explained that the RE is responsible for investment and valuation risks of their assets. The custodian sources prices from various providers which can include the fund manager or administrator of the client's assets. Where the custodian cannot source a price it will accept a price upon receipt of a properly authorised instruction from the client. NAB explained that it does provide its clients with regular, online, on-demand reporting of their assets and publishes monthly information with respect to those assets that have not been repriced for at least 5 days. It added: 'In the case of Trio, we followed our standard practices and operating procedures in relation to asset value reporting'.[67]

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65 ANZ, *Submission 70*, p. 6.

66 National Australia Bank, *Submission 72*, p. 18.

67 National Australia Bank, *Submission 72*, p. 19.

The Australian Custodian Services Association

5.62 In its submission to this inquiry, the Australian Custodian Services Association (ACSA) distinguished between 'custodially held' assets and 'non-custodially held' assets. ACSA contended that:

> ...[T]he custodian is only responsible for those assets that are transferred to it (either by the trustee, the responsible entity, another custodian on appointment or by way of settlement following a purchase of assets by the trustee or responsible entity (or by an investment manager authorised to do so on their behalf)). These assets are known as 'custodially-held' assets. This means, that generally a custodian will take a transfer of the assets into its name as registered owner and record the asset into its custody records as being held on behalf of the client. The custodian will then undertake regular valuations of the client's assets and provide reports to the client on all custodially held assets as required under the custody agreement.
>
> If however, the assets of a fund or scheme are not purchased in the name of, or transferred to, the custodian, then these assets are deemed to be 'non-custodially held' assets. A trustee or responsible entity might choose to purchase assets for a fund of scheme but elect not to have these assets held by their appointed custodian for operational reasons. In this case, responsibility for these assets rests solely with the trustee or responsible entity.[68]

5.63 In the case of Trio, the funds were non-custodially-held assets.

5.64 In questioning NAB about its role as a custodian in the Trio case, the committee ascertained that a custodian may only know if the assets for which they are acting as custodian actually exist when they are asked to redeem the funds in order to make a payment. It was unclear whether this would need to be reported to the regulators and if so, who had the obligation to do so. Mr Stephen Tudjman, General Counsel MLC for the National Australia Bank, told the committee that he did not think there is any obligation on the part of the custodian to report an unusual transaction under the anti-money laundering legislation. He added:

> ...that might be a fertile area for the committee to consider: whether there ought to be an obligation to report to a regulator if the instructions from the RE carried out by the custodian have produced a result that there are no assets there. In the scenario you are identifying, the custodian says to the RE, 'You're singly responsible; you do it.' What are the additional checks and balances if the RE is not doing the job they should be doing?[69]

5.65 This issue is returned to in chapter 7 of this report.

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68 ACSA, *Submission 43*, p. 3.

69 Mr Stephen Tudjman, General Counsel MLC, National Australia Bank, *Committee Hansard*, 23 September 2011, p.16.

The view of research houses

5.66 Research houses are firms that provide objective, independent ratings, recommendations or opinions on a range of financial products including managed funds, superannuation funds and insurance products.[70] ASIC wrote in its submission that research houses have a 'gatekeeper' function in the market place. The research they produce can influence which products individual advisers recommend to their clients. ASIC noted that on this basis, research quality and transparency is important to ensuring that clients receive appropriate advice.[71]

Morningstar

5.67 A number of research houses were mentioned in submissions to this inquiry including Van Mac, Van Eyk, Aegis and Morningstar.[72] Morningstar was the only research house to contribute to this inquiry. In its submission, Morningstar stated that it had published quantitative Morningstar Ratings (star ratings) for a number of Trio/Astarra funds between 2005 and the market announcement of the detection of the alleged fraud in 2009. It relied on unit prices and distributions reported by Trio/Astarra to Morningstar. On the basis of this information, the Morningstar Ratings for the funds varied over time.[73]

5.68 Morningstar also noted that it had entered into a licensing agreement with Astarra Capital in June 2008 whereby it granted to Astarra Capital a 'non-transferrable, non-exclusive license' to publish Morningstar Ratings on three of Astarra Capital's funds. This agreement required Astarra to publish the Morningstar rating definition when publishing Morningstar Ratings. Morningstar did not itself publish a forward-looking Morningstar Recommendation for any of the Trio/Astarra funds.[74]

5.69 In verbal evidence to the committee, Morningstar confirmed that it does not seek to identify products that may be fraudulent. The CEO of Morningstar, Mr Anthony Serhan told the committee that his firm is not paid as an auditor or a forensic accountant.[75] As such, Morningstar accepts the information provided to it by

70 ASIC, *Submission 51*, p. 79.

71 ASIC, *Submission 51*, p. 79.

72 The committee acknowledges the cooperation given to the inquiry by Mr Anthony Serhan, Chief Executive Officer of Morningstar.

73 Morningstar, *Submission 33*, p. 7.

74 Morningstar, *Submission 33*, p. 7.

75 Mr Anthony Serhan, Chief Executive Officer, Morningstar, *Committee Hansard*, 23 September 2011, p. 22.

product providers at face value. It would only question the data when it sees 'something in the flow of that data that would suggest that it is out of sync'.[76]

5.70 The committee put to Morningstar that most people have the view that a Morningstar rating or any other rating system gives credibility to a particular fund or asset. Mr Serhan responded that the rating system is simply an assessment of what has been achieved. It is not an indicator of future performance and nor is it the only indicator of past performance. He told the committee:

> The issue comes down to people understanding what the rating is. I think that relying on a single point rating reference without actually understanding what that is is fraught with danger. We take disclosure very seriously. We have documentation on our website and in our materials. We are quite open about what a star rating is, how it is calculated and what it measures. We think in that context it is up to the people who consume our research to avail themselves of the information that we put out there about what it actually is and what it does measure. Transparency is an important part of our process.[77]

Research houses and fraud detection

5.71 An obvious question arising from the Trio case is whether the fraud could have been detected earlier. Chapter 2 noted that ASIC was tipped off by Mr John Hempton who noted the 'improbability of smooth investment returns recorded by the Astarra Strategic Fund'[78]. But should the regulators and the gatekeepers have been able to identify the fraud?

5.72 With the benefit of hindsight, the committee believes that important signals were missed. An analysis of the response of regulators to the Madoff fraud identified a similar pattern of indicators or red flags that were missed: none were in and of themselves the 'smoking gun'.[79] Mr Hempton stated:

> "I find something interesting: you pull on the piece of string and mostly you find a piece of string. But sometimes you find something attached," he said.

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76 Mr Anthony Serhan, Chief Executive Officer, Morningstar, *Committee Hansard*, 23 September 2011, p. 22.

77 Mr Anthony Serhan, Chief Executive Officer, Morningstar, *Committee Hansard*, 23 September 2011, p. 20.

78 'Blogger who blew the whistle on hedge fund', *Sydney Morning Herald*, 2 January 2010, http://www.smh.com.au/business/blogger-who-blew-the-whistle-on-hedge-fund-20100101-llq5.html (accessed 27 October 2011).

79 Dr J Drew and Professor M Drew, *Ponzimonium: Madoff and the Red Flags of Fraud*, Griffith Business School, Discussion Papers—Finance, No. 2010-07, p. 10.

> "[There was] nothing that led to the uncovering of Astarra you could not find on the internet. This was not hard, I just did the work."[80]

5.73 As has been noted, there is no requirement for gatekeepers to check the underlying value of the assets that financial statements represent. However, it is not unreasonable to expect them to view sceptically financial statements, particularly those that appear 'too good to be true'.

5.74 The committee considered the possibility of whether an organisation could be formed with a charter to actively search for fraud, and whether there are currently the tools to support this endeavour. Morningstar was asked whether it is possible to track quantitatively the performance of a given fund against other funds in a way that could detect suspiciously good performance. It responded:

> I think it would be possible to construct a calculation that would help to identify funds that may require further investigation potentially.[81]

5.75 The committee then queried whether this system could make some judgment as to whether this good performance was a product of good managing, good luck or crooked behaviour. Morningstar replied:

> Yes, I believe that it is feasible. A lot of people use our database to do that, and they are not necessarily regulators. A lot of people use our database to start an investment decision-making process. And quite frankly, if there is a research analyst involved and you see those sorts of results, those are the three questions you ask yourself. Are they incredibly good? That is what you send your team in to try to understand. Or did they get lucky? And there are a lot of cases where we form a view around luck, yes.[82]

5.76 The committee asked ASIC for its view of Morningstar's response to these questions and whether the regulator believed it would be possible to develop an algorithm to highlight results that seemed 'too good to be true'. ASIC's Chairman responded:

> One of the criteria for identifying hedge funds for surveillance was whether results that we used in a logarithm were too good to be true. So we already use that in our surveillance. I think I have mentioned before that, in fact, we were in the process of undertaking surveillance on the sector at the same time that information came in on Trio. Those criteria were used; we took the criteria from the Madoff case, plus we added some others, and Trio was at the top of the list. We are in the process of actually getting more information from them in addition to what then came in to us.

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80 'Blogger who blew the whistle on hedge fund', *Sydney Morning Herald*, 2 January 2010, http://www.smh.com.au/business/blogger-who-blew-the-whistle-on-hedge-fund-20100101-llq5.html (accessed 27 October 2011)

81 Mr Anthony Serhan, Chief Executive Officer, Morningstar Australasia, *Committee Hansard*, 23 September 2011, p. 23.

82 Mr Anthony Serhan, CEO, Morningstar, *Committee Hansard*, 23 September 2011, p. 24.

> That is an element. There are other elements in terms of surveillance of hedge funds that are quite important in perhaps indicating that there are some problems. Return is one of them. We could probably give you some idea—we have to be careful about what we tell you in terms of how we are going to look at it. They are the general criteria.[83]

5.77 There was, however, some scepticism that an algorithm could be an all-powerful instrument to guide ASIC's decision-making:

> ...with the accounting surveillance project we look at 500 entities. There are about 2,200 listed entities and there are about 5,000—I think, off the top of my head—managed investment schemes. We do need to take a risk based approach.
>
> As to whether you could have an algorithm that would pick up these sorts of things, personally, I am a little bit sceptical. I have seen lots of algorithms in the regulatory world over the years and they do not always operate as you might think.[84]

5.78 Nonetheless, the committee believes that the (growing) complexity of investments in managed investment schemes does require a similarly complex and multidimensional approach to detecting fraud. This point was well made in a 2010 paper by Professor Michael Drew and Dr Jacqueline Drew of Griffith University:

> Our reflections on the Madoff case indicate that approaches to fraud, particularly those that seek to detect fraudulent activity as a result of Ponzi-like schemes, need to employ a multi-dimensional approach to fraud detection, acknowledging the complementarity of internal and external controls. If a system of fraud detection, which embodies a more proactive, preventative approach is to be achieved, further work needs to be done on developing a systematic approach which allows simple, effective and timely detection of multiple 'smoking guns'. In Madoff's case, the GFC was a significant trigger in uncovering a veritable cache of weapons.[85]

Committee view

5.79 The committee believes the active detection of investment fraud in relation to Australia's superannuation funds should be accorded high priority. It is quite possible that other fraudulent schemes exist among the 16 000 funds currently in the Australian market place. Clearly, the current system of gatekeepers did not work in relation to the Trio funds. There is no reason to believe that this system will be any more successful

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83 Mr Greg Medcraft, Chair, ASIC, at ASIC oversight hearing, *Committee Hansard*, 12 October 2011, p. 15.

84 Mr John Price, Senior Executive Leader, ASIC, at ASIC oversight hearing, *Committee Hansard*, 12 October 2011, p. 15.

85 Dr J Drew and Professor M Drew, *Ponzimonium: Madoff and the Red Flags of Fraud*, Griffith Business School, Discussion Papers – Finance, No. 2010-07, p. 10.

in detecting fraud in the future, particularly given the growing pool of superannuation funds under investment in Australia.

Recommendation 2

5.80 The committee recommends that consideration be given to improving the active detection of investment fraud through systems that can identify 'outlying' patterns in investment performance. To this end, the committee encourages partnerships between the regulators and experts in the private sector.

Concluding comment

5.81 The evidence presented in this chapter presents many of the gatekeepers that had responsibility for the oversight of the Trio case in a particularly bad light. Their role was often passive and unquestioning, relying on the information provided by the responsible entity and assuming that others in the regulatory framework would provide the necessary checks.

5.82 The committee believes that various aspects of the role that gatekeepers play within the financial services regulatory regime are in need of strengthening and improvement. It has particular concerns that gatekeepers are not notifying the regulators of suspicious behaviour, that there are inadequate mechanisms to check the accuracy of information provided by the responsible entity and that investors have an often mistaken belief in the quality and rigour of the services that the gatekeepers provide (see chapter 6).

5.83 The committee is pleased that ASIC recognises these various points of weakness and has a forward work program to address these issues. It urges ASIC to follow through on those areas it has identified as needing reform, particularly the regulatory guidance on and auditing of managed investment scheme compliance plans, the measures to strengthen the AFS licensing regime, the review of custodian businesses and options to improve the quality and independence of research reports. The committee will, as part of its statutory responsibilities to oversee the work of ASIC, monitor the implementation of planned changes.