Parliamentary Joint Committee
on Corporations and Financial Services

Inquiry into the collapse of Trio Capital

May 2012

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Duties of the Committee

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

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

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

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

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

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

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Abbreviations and key definitions

AAM	Astarra Asset Management
ACC	Australian Crime Commission
ACCC	Australian Competition and Consumer Commission
ADI	Authorised Deposit-taking Institution
AFM	Astarra Funds Management Pty Ltd
AFP	Australian Federal Police
AFSL	Australian Financial Services Licence
AML/CTF Act	Anti-money Laundering and Counter-Terrorism Financing Act
APRA	Australian Prudential Regulation Authority
ASA 240	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
ASF	Astarra Strategic Fund
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AuASB	Auditing and Assurance Standards Board
AUSTRAC	The regulator for AML/CTF (above)
CALDB	Companies, Auditors and Liquidators Disciplinary Board
EFL	Exploration Fund Limited
EM	Explanatory Memorandum
EU	Enforceable Undertaking
FIO	Financial Intelligence Office
FOFA	Future of Financial Advice
FPA	Financial Planning Association

FSC	Financial Services Council
FSR Regime	Financial Services Regulatory Regime
FTR Act	Financial Transaction Reports Act 1988
GFML	Global Financial Mangers Limited
GS	Guidance Statement
PI	Professional Indemnity
PDS	Product Disclosure Statement
PPARP	Professional Pensions ARP Limited
PPPST	Professional Pensions Pooled Superannuation Trust
PSTM	PST Management Pty Limited
MIS	Managed Investment Scheme
RE	Responsible Entity
RSE	Registrable Superannuation Entity
SEC	Securities and Exchange Commission (US)
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SMSF	Self-managed superannuation fund
Self-managed superannuation fund	A complying superannuation fund under the *Superannuation Industry (Supervision) Act 1993* that has less than five members, each member of the fund is a trustee, each individual trustee is a member of the fund, no member of the fund is an employee of another member of a fund, unless those members are related, and if the trustee of the fund is a body corporate each director of the body corporate is a member of the fund.
SPAA	SMSF Professional Association of Australia
Trio Capital	Refers to all superannuation funds and managed investment schemes operating as part of the broader Trio Capital enterprise. A list is provided in Chapter 2.
VOFF	Victims of Financial Fraud
WGAM	Wright Global Asset Management
WGI	Wright Global Investments Pty Ltd

Executive summary

Superannuation in Australia is held and managed under the *Superannuation Industry (Supervision) Act 1993* (SIS Act). In June 2011, the total value of Australian superannuation assets was $1.34 trillion: 60.7 per cent of these assets was held in superannuation funds regulated by the Australian Prudential Regulation Authority (APRA); a further 30 per cent was held by self-managed superannuation funds; and the remaining 10 per cent comprised of exempt public sector superannuation schemes and the balance of life office statutory funds.[1]

In recent years, there have been three major financial collapses in Australia: Trio Capital, Westpoint and Storm Financial. In response to the collapse of Storm Financial, the Parliamentary Joint Committee on Corporations and Financial Services ('the committee') recommended extensive reforms to the regulation of the financial advice industry in Australia. Many of those recommendations have now been passed in the House of Representatives as part of the Future of Financial Advice (FoFA) reforms).

This inquiry has investigated the collapse of Trio Capital, which was the largest superannuation fraud in Australian history. Roughly $176 million in Australians' superannuation funds is lost or missing from two fraudulent managed investment schemes: $123 million from the Astarra Strategic Fund and $53 million from the ARP Growth Fund. Trio Capital was the 'responsible entity' for both schemes.

In the committee's view, the Trio collapse raises distinct, and in some ways more troubling, issues than those raised by the collapse of Storm Financial and Westpoint. Westpoint and Storm involved Australian investors being persuaded to put their money into investment vehicles which were much higher risk than was appropriate for—or understood by—most of the investors. Trio involved a fraud.

Nearly 6,090 Australians invested in Trio and lost their money despite the legislation in place under the SIS Act. 5,400 of those Australians had their money invested in Trio through APRA-regulated superannuation funds. Under the provisions of Part 23 of the SIS Act, investors in APRA-regulated funds received compensation totalling nearly $55 million. This was financed through a prepaid levy on all APRA-regulated superannuation funds.

Of the remaining 690 Trio Capital investors, 415 were direct investors and around 285 investors were in self managed superannuation funds (SMSFs). Under the SIS Act, these investors are not eligible for compensation: the Act excludes SMSFs from

1 Australian Prudential Regulation Authority, *Australian Superannuation Bulletin: Statistics, June 2011*, issued 29 February 2012, p. 5 http://www.apra.gov.au/Super/Publications/Documents/June%202011%20Annual%20Superannuation%20Bulletin.pdf (accessed 1 May 2012).

financial assistance where certain superannuation entities have suffered loss as a result of fraudulent conduct or theft.

As this report discusses, the committee is extremely troubled by both the nature and the scale of the Trio Capital fraud, and the impact they have had on the lives of hundreds of Trio Capital investors. The committee has received substantial evidence from some of those investors detailing their considerable financial losses and the physical and emotional toll of these losses have had on them and their families. In many cases, Australians who had saved for many years to provide for their retirement were defrauded of the entire balance of their retirement savings. It is particularly saddening that this fraud appears to have fallen heavily on many people who had made particular and conscientious efforts over many years to accumulate and manage savings so that they would not be required to rely on the pension.

The issue of compensation

While the committee respects the courage and testimony of those who reported their losses to the inquiry, it does not believe it is prudent at this time to protect SMSF investors from losses to theft and fraud in the way that APRA-regulated superannuation fund investors are covered under the SIS Act. SMSFs typically have more control over, and choice in their investment strategy and portfolio than investors in APRA-regulated superannuation funds.

These benefits of investing in SMSFs come with attendant responsibilities, one of which is to be alert to the risk or fraud and theft. Unlike APRA-regulated investors, SMSF investors do not have a professional management team to exercise this caution. It is clear to the committee that many of those who gave evidence unquestioningly accepted advice from a financial advisor and were completely unaware of how exposed their life savings were to theft and fraud. On balance, however, the committee does not support the introduction of a compensation scheme that places a levy on SMSF investors as it would expose all SMSF investors to the bad decisions and lack of appropriate caution and prudence of other SMSF investors.

The committee notes that the recently released government-commissioned review by Mr Richard St. John into a statutory compensation scheme for investors in financial services also recommended against establishing such a scheme. Among other things, the review argued that such a scheme would impose upon well managed product providers the obligation to bear losses incurred by badly managed or negligent providers.

Chapter 6 of the St. John report sets out some elements of how a statutory compensation scheme could work if government were to decide to proceed. The St. John report states that SMSFs would not be included in the scheme.

The committee considers that if such a scheme were to be introduced, it could possibly have assisted SMSF investors in the Trio Capital case. These investors lost their money because their SMSF invested in a managed investment scheme of which

Trio was the responsible entity. Under the scheme described in Chapter 6 of the St. John Review, it is in the committee's view likely that Trio would have been found to have failed to meet the relevant standard; Trio would have been liable to pay compensation to its investors; but being insolvent and unable to pay the compensation, the last resort scheme would have come into operation. SMSF investors (as well as direct investors) would have received compensation.

If the policy objections raised by Mr St. John to the operation of such a scheme can be overcome, the committee considers that it has merit and would have assisted to reduce the detriment suffered by innocent Australian investors in the Trio case.

The committee also considers that there is merit in establishing an insurance scheme into which SMSFs could 'opt-in', enabling them to have protection against loss by reason of fraud or theft.

The Trio Capital fraud

The committee's investigation revealed that a number of investment vehicles operated by Trio Capital appear not to have been legitimate investments but merely conduits through which investors' money was stolen. In November 2003, a reputable funds manager, Tolhurst, was acquired by new owners; it now appears that they made this acquisition with a view to defrauding Australian investors (particularly superannuation investors) of substantial sums of money.

The Trio fraud appears to have been designed to take advantage of vulnerabilities in the superannuation system. A key element of the scheme was to move the funds of Australian investors overseas. This had made it much harder for Australian auditors and others to verify the existence of the funds; for Australian liquidators to recover any remaining funds; and for Australian authorities to investigate and to pursue those who have carried out criminal conduct.

The key figures responsible for the Trio collapse appear to have escaped any criminal or other sanctions. The evidence suggests that the 'mastermind' was Mr Jack Flader, an American citizen, at one stage resident in Hong Kong and believed to live in Thailand. The committee heard evidence that he has a history of involvement with securities fraud. While ASIC and APRA accepted enforceable undertakings from a number of former Trio directors, only one former director—Mr Shawn Richard—has been jailed. There is no current investigation relating to Trio by the Australian Federal Police (AFP) or the Australian Crime Commission.

Missed signals

A key finding of this report is that key checks and balances in the Australian financial and superannuation system did not work to identify the existence of fraudulent conduct and to shut it down rapidly. It was left to an alert industry participant to uncover the Trio fraud.

In September 2009, Mr John Hempton, Chief Executive Officer at Bronte Capital Management and a former Treasury official, wrote a letter to ASIC Chairman, Mr Tony D'Aloisio. The letter alerted ASIC to the suspiciously smooth returns achieved by the Astarra Strategic Fund in the context of a turbulent financial environment. Mr Hempton's letter resulted in ASIC launching an investigation into the activities of certain Trio funds.

The regulators—APRA and ASIC—must take their share of the blame for the slow response to the Trio fraud. APRA conducted five prudential reviews between 2004 and 2009. It took no enforcement action as a consequence of any of these reviews. ASIC only began its investigation in October 2009 after Mr Hempton's tip-off.

From late 2008 to mid 2009, APRA was unable to obtain from Trio a valuation of certain Trio funds' assets. The committee questions how a trustee can be subject to what APRA describes as 'active supervision' over a period of six years and yet, when essential information was not forthcoming at the end of this period, APRA did not act quickly. For a risk based supervisor, as APRA is, the inability of a trustee to provide basic valuation information should have raised strong concerns.

The committee also has concerns at the length of time it took for ASIC to detect the fraudulent activity. It is particularly concerned that communication between ASIC and APRA was lacking in the months from late 2008 to mid-2009. It seems that APRA had not communicated to ASIC its requests for Trio to provide information. As a result, when ASIC commenced its active surveillance of hedge funds in June 2009, it did not seem aware that Trio was not providing the prudential regulator with basic facts about the existence of assets and their value. This information should have been communicated.

The committee also believes that the regulators missed key events that laid the platform for the Trio fraud. The first was the purchase of Tolhurst from its previous owners in late 2003 by interests associated with Mr Flader. The second event related to investments in Trio products via a pooled superannuation trust called Professional Pensions PST (PPPST). In 2004, the trustee of PPPST, the Trust Company, was replaced after expressing concerns at the new investment approach of the interests associated with Trio. These concerns were either not relayed to APRA or did not lead APRA to take action.

ARP Growth Fund

As late as 2008, audits of the ARP Growth Fund, as well as other managed investment schemes that were part of Trio's range of products, continued to certify the accounts as giving a true and correct report of the financial position of the Fund. This occurred even though the principal asset of the Fund was a contract held by a company in the British Virgin Islands, and the auditor did not independently verify the existence of the company or the value of the contract.

A key factual question is whether the principal underlying asset of the ARP Growth Fund ever existed and had value. ASIC and APRA gave evidence to the committee that they believed the contract did exist but its value fell to zero as a result of Bear Stearns' liquidation in the global financial crisis of 2008. The committee heard other evidence that if the contract did exist, then it would have retained value as a result of Bear Stearns' liabilities being assumed by JP Morgan.

The committee is not satisfied that ASIC and APRA are correct in their belief that the contract fell to zero, or that this is founded on a reasonable investigation. The committee is concerned that ASIC and APRA hold this view because they have failed to fully investigate the alternative possibility: there may have never been a contract and the ARP Growth Fund was a fraudulent venture.

The need for further investigation

The committee is surprised that there appears to have been very little follow up activity by APRA, ASIC and other authorities such as the AFP, to seek to recover outstanding moneys or to bring to justice those who have committed crimes which have led to great suffering on the part of Australian investors.

As best the committee can ascertain, there are no ongoing criminal investigations into the conduct of Mr Flader or others involved in developing and implementing this scheme. Mr Richard has been charged and convicted, but he appears only to be the local foot soldier of the scheme.

The committee has been unable to obtain clear answers or evidence from ASIC, APRA or the AFP as to whether any attempts have been made to bring charges against Flader and others, to have them extradited to Australia, or even as to whether their names are on a watch list for people passing through Australian airports. There have been no examinations on oath of Mr Flader or any person other than Mr Richard and Mr Eugene Liu.

ASIC has provided some limited funding to the liquidator PPB Advisory to allow it to investigate the status of the various offshore companies into which moneys were invested by ARP Growth Fund and other Trio entities. The committee strongly believes there needs to be a renewed focus and energy on the part of ASIC, APRA and the AFP into pursuing every avenue to seek redress for Trio investors and to bring to justice all involved in this scheme.

The committee wishes to see these agencies pursue criminal investigations into the key figures responsible for this scheme as a matter of high priority. ASIC must provide all necessary funding for PPB Advisory to pursue its investigation to a full conclusion, including where necessary conducting examinations on oath of figures such as Mr Flader and others it considers necessary as part of the investigation.

Financial advisers

Another issue which the Trio collapse raises—an issue also raised in the case of Storm—is the role of financial advisers. Many investors put money into Trio vehicles based on advice from financial advisers.

There are clear 'regional clusters' of victims of Trio based on the locality of operations of particular financial advisers, including Tarrants in Wollongong, 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.

The committee notes that an enforceable undertaking has been obtained from Mr Gresham, who advised a large number of his clients to put money into the ARP Growth Fund. Mr Gresham appears to have known and dealt with the principals of the fraud since at least 2003. If this is the only action which ASIC intends to take against Mr Gresham, the committee would be surprised and disappointed.

The conduct and involvement of the Wollongong-based Mr Ross Tarrant in advising 220 of his clients to invest in the ASF appears to have been in a different category to that of Mr Gresham. Nonetheless, Mr Tarrant was paid hefty commissions by recommending Trio to his clients. The committee recommends that ASIC investigate financial planners' and accountants' advice to SMSF investors in Trio Capital.

The committee notes the imminent reform of the financial advice sector through the implementation of the Future of Financial Advice (FOFA) legislation. Some of the financial advice given to Trio clients may have been in contravention of the 'best interests' test and conflicted remuneration provisions of the FOFA legislation.

However, these provisions would not protect against a circumstance where an adviser 'turns bad' and sets out to either defraud his clients or at the very least to concentrate on enriching himself while wilfully disregarding the evidence that the investment scheme into which he is putting his clients' money was fraudulent. In the committee's view, this is an accurate description of what occurred with Mr Gresham. In these cases, what is required is more effective enforcement of existing laws.

Auditors, custodians and research houses

From the evidence to this inquiry, the committee has identified 'expectation gaps' between what is expected of auditors, custodians and research houses and what they are actually responsible for doing.

It is of concern to the committee that auditors' approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist. Further, an auditor's assessment of a compliance plan and the work of the compliance committee as 'effective' essentially only means that they exist. Clearly in the case of

Trio, the requirement for the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.

The committee also notes that an enforceable undertaking was obtained from Mr Timothy Frazer, an auditor from the firm WHK. This is evidently an alternative to referring the matter to the Companies, Auditors and Liquidators Disciplinary Board for other disciplinary action. The committee questions whether this is an appropriate end to the matter. It agrees that a separate tribunal function is important but questions whether ASIC is making the best use of the Board and its role in maintaining professional standards.

The committee endorses ASIC's suggestion of an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval. The committee also supports ASIC's proposal to review the effectiveness of compliance plans and if necessary, require more detail to be provided in these plans.

Custodians appear to have a limited role in managed investment schemes of the kind conducted by Trio, and by many legitimate financial services providers. The custodian (in Trio's case, the National Australia Bank) does very little to protect the funds of investors. It makes no independent checks before transferring money offshore. Instead, the custodian simply acts on the instructions of the responsible entity.

The committee strongly supports ASIC's program to review custodian businesses and identify those issues requiring regulatory reform. In particular, the committee urges ASIC to consider the safeguards that a custodian could put in place to ensure it is able to identify and report suspicious transfers that do not trigger the anti-money laundering provisions.

The committee considers that the word 'custodian', particularly in product disclosure statements, is inappropriate. ASIC should find another term, such as a 'Manager's Payment Agent', which does not give unwarranted reassurance to investors.

Trio has also exposed misconceptions about the role of research houses. There appears to be a perception among some investors that research reports and ratings are a comment on future performance of a fund. This is not the case—the reports are solely an analysis of the past performance of the investment. There is a reasonable expectation among investors that research houses will verify the data upon which their reports and ratings are based. Again, this is not the case.

As was the case with the auditors, the custodians and to a lesser extent APRA, the research house Morningstar relied on the information provided by Trio without verifying whether the data was accurate. This is not to suggest that Morningstar acted improperly. Rather, it reflects the structure of the system, built as it is on the responsible entity providing information and acting honestly.

Better disclosure by managed investment schemes

The committee believes that greater disclosure of portfolio assets would help to improve monitoring of managed investment schemes, which would in turn assist in the earlier detection of fraud. It seems likely that had the regulators and gatekeepers had information about the underlying assets of the Trio Capital funds, the significant delay in APRA's requests for information in 2009 would not have occurred.

The committee therefore recommends that the government release a consultation paper to investigate the options for a statutory requirement for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. This requirement must be developed with a view to enabling scheme members to legally require specific information on the portfolio holdings of the registered managed investment schemes in which they have invested. This type of requirement would provide important information for the gatekeepers, the regulators and investors.

The committee notes the provisions contained in the recent exposure draft of the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012. The bill would provide APRA with an explicit power to require Registrable Superannuation Entity (RSE) licensees to provide investment information on their assets, or assets derived from their assets, that are invested by a managed investment scheme or a custodian of an RSE licensee. Where an RSE of a superannuation fund invests in a managed investment scheme, which in turn invests in another investment scheme, the information about the second scheme's assets must be provided to the RSE.

Self managed superannuation funds

The committee notes that SMSFs are subject to less stringent regulatory requirements under the SIS Act than APRA-regulated funds. The trustees of SMSFs are responsible for all decisions, and must make those decisions for the benefit of members, but SMSFs are not subject to the same prudential requirements as APRA-regulated funds.

Reflecting this more limited regulatory regime, SMSFs are not regulated by APRA. Instead, they are registered with, and overseen by, the ATO. The ATO's focus is on the SMSF's compliance with superannuation and taxation laws, not on prudential safeguards. That is, the ATO focuses on ensuring that SMSFs are not used as vehicles to avoid tax, that the SMSF has an investment strategy and that an independent auditor verifies annually that its investments have been made in accordance with that strategy. Unlike APRA-regulated funds, the ATO's role as regulator is not to ensure that the SMSF has appropriate risk management strategies.

The lack of stringent prudential regulation of SMSFs means that the role of finance professionals is extremely important in both the decision to set up an SMSF, in developing its investment strategy, in implementing that strategy and in complying with taxation laws and managing risk. Accountants' advice about the taxation implications and appropriateness of particular superannuation structures, such as

SMSFs, and financial planners' advice about the investment strategies and risks of such funds will generally be central to people's decisions about the structure of their superannuation affairs. While an SMSF investor and trustee will frequently use other finance professionals, such as auditors and actuaries, in their superannuation dealings, accountants and financial planners are generally people's entry point into the SMSF sector and, as such, occupy a key role in the sector.

The committee is concerned that some SMSF investors in Trio Capital seemed not only unaware that their investment was unprotected from theft and fraud, but unaware they had even established a self-managed fund. The committee considers that this highlights the need to improve financial literacy for those considering SMSFs. Similarly, there is a responsibility for accountants and financial advisers to better educate their SMSF clients and clearly communicate the risks and advantages of investing through these vehicles.

Protecting Australians' superannuation savings

In the committee's opinion, the Trio case exposes the significant vulnerability of the Australian superannuation savings system to targeting by criminals including offshore based criminals. Australia has one of the largest such savings pools in the world. Many Australians are disengaged from their superannuation savings. This is a product of a compulsory superannuation system, of many younger people having low balances, and of investors' inability to access their funds until they retire. The result is that many people will not pay close attention to how their funds are performing. In the case of Trio, Mr Gresham produced fictitious account statements for several years. Account holders had no reason to seek to withdraw the money and as a result, the fraud continued undiscovered for some time.

The committee believes there are significant policy steps required to better protect against the threat to Australia's superannuation system from criminals. These include:

(a) a dedicated focus within the AFP to detecting and combating superannuation fraud;

(b) more detailed scrutiny by APRA of the 'trigger points' at which criminals take control of superannuation vehicles;

(c) a much more vigorous criminal investigation, involving ASIC, APRA and the AFP, into the Trio fraud, with a view to pursuing the maximum available criminal sanctions against those responsible; and

(d) legislation to allow assets to be recovered from those personally involved in fraud and theft, with the proceeds to go towards compensating those who have lost money as a result of the fraud and theft.

List of Recommendations

Recommendation 1

3.77 The committee acknowledges the shortcomings, identified by Mr Richard St. John, of a statutory compensation scheme for consumers of financial services, and a scheme of financial assistance for investors in managed investment schemes along the lines of Part 23 of the *Superannuation Industry (Supervision) Act 1993*. However, the committee recommends that further efforts be made to investigate avenues to protect investors in the case of theft and fraud by a managed investment scheme.

The committee recommends that the government assist those who invested in the Professional Pensions Pooled Superannuation Trust (PPPST), and were induced to move their funds to the ARP Growth Fund.

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.

Recommendation 3

7.6 The committee recommends that the Australian Taxation Office include a clear, understandable, large print warning on its website that self managed superannuation fund trustees are not covered in the event of theft and fraud. This warning must be effectively communicated to all existing Self Managed Superannuation Fund trustees through the guidance material of the Australian Securities and Investments Commission.

Recommendation 4

7.8 The committee recommends that the guidance material provided by the Australian Taxation Office for Self Managed Superannuation Fund investors clearly state the difference between the protections and compensation arrangements for investors in funds regulated by Australian Prudential Regulation Authority as distinct from the limited protections available to Self Managed Superannuation Fund investors.

Recommendation 5

7.17 The committee acknowledges the Future of Financial Advice reforms, particularly the provisions addressing conflicted remuneration. Nonetheless, it recommends that ASIC conduct a specific and detailed investigation of both planners' and accountants' advice to SMSF investors in Trio Capital. This investigation must examine what information was provided to these investors regarding their duties and responsibilities, and whether they were informed—either verbally or in writing—that they are not entitled to compensation in the event of theft and fraud.

Recommendation 6

7.26 The committee recommends that the government consider whether current processes are adequate when there is a change of ownership or control of a company which holds an Australian Financial Services Licence, or whether there is a need for more detailed scrutiny of the new owner.

Recommendation 7

7.35 The committee recommends that the government investigate options to improve the oversight and operation of compliance plans and compliance committees. In particular, this investigation should focus on the need for:

- more detail to be included in compliance plans;
- qualitative standards by which compliance plan auditors must conduct their audits;
- liability for the responsible entity and its directors for any contravention of the compliance plan, rather than only for material contraventions, as is currently the case;
- legislative requirements as to experience, competence or qualifications for compliance committee members;
- regulatory or member oversight of the appointment of compliance committee members;
- an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval; and
- governance arrangements to be clearly stated in relation to the proceedings of the compliance committee.

Recommendation 8

7.44 The committee recommends that as part of its review of regulatory arrangements relating to custodians, ASIC should consider changing the name 'custodian' to a term that better reflects the current role of a custodian. This new term—reflecting the limited role of custodians—must be used in Product Disclosure Statements.

Recommendation 9

7.56 The committee recommends that the government release a consultation paper to investigate the best mechanism for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. The objective must be to enable scheme members to legally require specific information on the portfolio holdings of the registered managed investment schemes in which they have invested.

Recommendation 10

8.13 The committee recommends that the Australian Securities and Investments Commission provide all necessary funding for PPB Advisory to pursue its investigation to a full conclusion, including where necessary conducting examinations on oath of figures such as Mr Jack Flader and others it considers necessary as part of the investigation. The committee recommends that ASIC fund the phase 2 investigation by PPB Advisory as a matter of urgency.

Recommendation 11

8.26 The committee recommends that the Australian Federal Police, in cooperation with the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority, pursue criminal investigations into—and, where applicable, criminal sanctions against—the key figures responsible for defrauding investors in Trio as a matter of high priority.

Recommendation 12

8.36 The committee recommends that the government investigate the options for a scheme to recover assets from those found to be personally involved in fraud and theft, with the proceeds to go to those found to have been defrauded.

Recommendation 13

8.37 The committee recommends that the Australian Prudential Regulation Authority conduct an internal assessment of the adequacy and timeliness of its checks to monitor the ownership of superannuation vehicles. This process must review why key 'trigger points' in events that led to the collapse of Trio Capital were not identified.

Recommendation 14

8.38 The committee recommends that the Australian Federal Police consider the options to create an organisational focus on the matters pertaining to superannuation fraud. This should occur in close consultation with the Australian Crime Commission given its work in coordinating Task Force Galilee.

Chapter 1

Introduction

Terms of reference

1.1 On 23 June 2011, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into the collapse of Trio Capital and any other related matters. In accordance with the terms of reference, in conducting the inquiry the committee had particular reference to:

(i) the type of investment vehicles, funds and other products involved in Trio Capital, and the relevant regulatory regime;

(ii) the points of failure in relation to products or advice;

(iii) the relationship between self managed superannuation fund (SMSF) arrangements and regulatory coverage;

(iv) the role of the Australian Securities and Investments Commission (ASIC) in monitoring Trio Capital and any subsequent pursuit of directors, advisors and fund managers;

(v) the Australian Prudential Regulation Authority (APRA) regulatory relationship to Trio Capital and the use of SMSFs;

(vi) the access to compensation and insurance for Trio Capital investors including in circumstances of fraud;

(vii) the issue of fraud (in particular international fraud) in the collapse of Trio Capital and regulatory implications;

(viii) whether there are adequate protections against fraud for those who invest through self-managed superannuation funds as opposed to other investment vehicles;

(ix) the appropriateness of information and advice provided to consumers, and how the interests of consumers can best be served in regulated and unregulated environments;

(x) the role of ratings agencies and research organisations in product promotion and confidence; and

(xi) any other matters relevant to the collapse of Trio Capital in the further improvement of the financial services sector and consumer protection.

Conduct of the inquiry

1.2 The inquiry was advertised in *The Australian* newspaper, *The Australian Financial Review* newspaper, in the *Business Review Weekly* magazine and *Money Magazine*. Details of the inquiry were also placed on the committee's website.

1.3 The committee invited submissions from interested organisations, government departments, and individuals affected by the Trio Capital collapse. The committee also invited prominent individuals connected with Trio Capital, including Mr Shawn Richard, to make submissions to the inquiry. The closing date for submissions was 19 August 2011, however the committee continued to accept submissions received after this date from individuals affected by the collapse. The committee received 77 submissions, 9 of which were confidential. The list of submissions is in Appendix 1.

Mr Shawn Richard

1.4 In August 2011, during the course of this inquiry, Mr Shawn Richard, a former Trio Capital director, was jailed for engaging in dishonest conduct with respect to financial services. His is the only criminal prosecution in the criminal fraud to date. While Mr Richard did not make a submission to this inquiry, the committee was interested to seek his views on a number of matters relating to the Trio fraud.

1.5 On 29 March 2012, the committee requested Mr Richard's response to a series of ten questions. It received his responses on 27 April 2012. The questions and the responses are provided in Appendix 3. Mr Richard provided the committee with additional information on 9 May 2012. This is also included in Appendix 3.

Private briefings and public hearings

1.6 The committee held private briefings with Commander Peter Sykora, Manager Crime Operations and Mr Peter Whowell, Manager Government Relations of the Australian Federal Police (AFP); Mr John Hempton and Mr Richard Butler, private capacity; and Mr Richard St John, principal for the review of statutory compensation schemes operating in the financial services sector.

1.7 The committee held seven public hearings: Sydney on 30 August 2011; Thirroul (north of Wollongong) and then in Sydney on 6 September; Sydney on 23 September 2011; Canberra on 22 September; Canberra on 4 November and Sydney on 4 April 2012. A list of witnesses who gave evidence at the public hearings and the community forum is at Appendix 2. The list does not include witnesses who gave *in camera* evidence at the community forum.

The Victims of Financial Fraud

1.8 At the public hearing on 4 April 2012, a group called the Victims of Financial Fraud (VOFF) complained that they had not had the opportunity to discuss the matter of the Trio Capital fraud with officials from APRA and ASIC. The committee resolved at the hearing that it would write to the Chairman of APRA, Mr John Laker and the Chairman of ASIC, Mr Greg Medcraft, to request that these agencies discuss the matter of the Trio Capital fraud with representatives of VOFF.

1.9 On 10 April 2012, the committee wrote to the Chairmen to request that officials from their agencies meet with VOFF representatives. At the time of writing, the parties were making arrangements to do so. APRA advised the committee that it extended an invitation to meet with representatives of VOFF on 18 April 2012 but that this offer was declined. The committee does recognise that officials from APRA and ASIC were present at the public hearing in Thirroul on 6 September 2011 when several Trio investors gave evidence. It also notes that ASIC has already met with representatives from the ARP Growth Fund.

1.10 The committee will follow up on the progress of the regulators' discussions with VOFF at the forthcoming ASIC oversight hearing in June 2012, and (for APRA) through the Senate Estimates process.

Acknowledgement

1.11 The committee thanks those organisations and individuals that made written submissions, and those who assisted the committee through attending private briefings or by presenting evidence at public hearings or at the community forum.

1.12 In conducting the inquiry, the committee was particularly interested in the implications of the Trio Capital collapse for investors, especially investors in self-managed superannuation funds. The committee recognises the trauma experienced by investors affected by the Trio Capital collapse, and is grateful for the assistance that investors provided through sharing their stories and experiences with the committee.

1.13 Through the public hearings and the community forum, the committee sought to hear from a balanced selection of investors, advisers, regulators and individuals. Nevertheless, the committee acknowledges that there were individuals who wished to provide evidence, particularly at the community forum, but did not receive the opportunity to do so. The committee thanks these people for their willingness to assist the committee.

Privilege issue

1.14 During the course of the inquiry, a witness who presented evidence *in camera* drew the committee's attention to what appeared to be a widely distributed email, authored by a financial advisor, which strongly criticised the witness for providing evidence to the committee. The committee drew the financial advisor's attention to the protections afforded to witnesses under the Parliamentary Privileges resolutions, and informed the advisor that the committee would consider taking further action should the advisor continue with this or similar conduct. No further conduct was brought to the committee's attention.

Scope of the inquiry

1.15 While information about the experiences of persons directly affected by the collapse of Trio Capital greatly assisted the committee, the committee does not have the power to take action in individual cases. The committee's inquiry sought to determine whether improvements can be made to Australia's financial services sector and consumer protection regulations. While some of the committee's recommendations focus on pursuing the lost Trio funds and bringing those illegally involved with the scheme to justice, most of the recommendations address the broader issues of the transparency of the superannuation investment framework.

Cooper Superannuation Review

1.16 This inquiry occurs in the context of broader reforms to the Australian superannuation system arising from a 2010 review of the system chaired by Mr Jeremy Cooper.[1] The Cooper Review formulated ten guiding principles for developing superannuation policy. These included:

- recognising the importance of regulation in addressing prudential and other risks;
- the key objectives of transparency and disclosure to the operation of the system;
- providing members with choice, while recognising that greater choice entails greater responsibility; and
- ensuring that the superannuation system is supported by high quality research and data, as well as by intermediaries with high professional standards.

1.17 The Cooper Review's recommendations drew from these guiding principles.

1.18 Some of the Cooper Review's recommendations related to the SMSF sector, although these were 'not dramatic and largely relate[d] to compliance, audit, adviser competency and like measures'.[2] Among other matters, the Review recommended that SMSF trustees be prohibited from acquiring collectables and personal use assets, to ensure that all investments were made for genuine retirement income purposes.[3]

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1 Super System Review Panel, *Final Report*, 30 June 2010, Hhttp://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htmH (accessed 1 May 2012).

2 Super System Review Panel, *Final Report*, 30 June 2010, p. 16, Hhttp://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htmH (accessed 1 May 2012).

3 Super System Review Panel, *Final Report*, 30 June 2010, p. 247, Hhttp://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htmH (accessed 1 May 2012).

1.19 The Government did not implement this recommendation. Rather, through the *Superannuation Industry (Supervision) Amendment Regulations 2011 (No. 2)*, SMSF trustee investments in artwork, jewellery, antiques, artefacts, coins and a range of other collectables cannot be leased to, used by or stored in the private residence of a related party to the trustee of the SMSF, and any decision to store such investments must be accompanied by written reasons. These regulations came into effect on 1 July 2011, although they allowed SMSFs with existing assets a five year transitional period within which to comply.

Other related inquiries

1.20 In 2009, the committee conducted an inquiry into financial products and services. The inquiry was initiated in response to the collapse of a number of high profile financial product and service providers including Storm Financial and Opes Prime. The focus of this inquiry was on the role of financial advisers and their commission arrangements for financial product sales and advice.[4]

1.21 The inquiry catalysed the announcement of the Future of Financial Advice (FOFA) reforms in April 2010 to 'improve the trust and confidence of Australian retail investors in the financial planning sector'.[5] The FOFA reforms consisted of an eighteen month consultation period culminating with two bills,[6] the Corporations Amendment (Future of Financial Advice) Bill 2011 and the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011.[7] The bills were examined by the committee and the Senate Economics Legislation Committee which reported in February and March 2012 respectively.

1.22 The FOFA reforms adopted many of the recommendations made by the committee in its 2009 inquiry into financial products and services and also proposed several additional measures. The bills, which are currently before parliament, propose to amend the *Corporations Act 2001* to:

- place a requirement on providers of financial advice to obtain client agreement for ongoing advice fees every two years and to provide clients with enhanced annual disclosure fee statements;

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4 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, p. vii.

5 The Hon. Chris Bowen MP, (former) Minister for Financial Services, Superannuation and Corporate Law, 'Overhaul of Financial Advice', *Media Release No. 036*, 26 April 2010.

6 The Senate Economics Legislation Committee, 'Inquiry into the Corporations Amendment (Future of Financial Advice) Bill 2011 [Provisions] and the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 [Provisions]', March 2012, p. 7.

7 The Corporations Amendment (Future of Financial Advice) Bill 2011 was introduced into the House of Representatives on 13 October 2011; the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 was introduced into the House of Representatives on 24 November 2011.

- enlist changes to ASIC's licensing and banning powers, including the expansion of discretionary powers relating to individuals;
- impose a best interests duty on financial advisers when they interact with clients;
- ban the receipt of remuneration which could reasonably be expected to influence the financial advice provided to clients;
- ban the charging of asset-based fees on borrowed monies of clients (fees calculated as a percentage of client funds under advice); and
- ban volume-based shelf-space fees paid from fund managers to administration platform operators.[8]

1.23 The government responded to concerns raised by industry that the proposed commencement date for the bills did not allow for adequate implementation time as well as arguments that the FOFA reforms should commence in alignment with the Stronger Super reforms. The Hon. Bill Shorten MP, Minister for Financial Services and Superannuation announced in March 2012 that '[t]he reforms will commence from 1 July 2012, as originally announced, but the application of the provisions will be voluntary until 1 July 2013'.[9]

1.24 As part of the initial FOFA reforms announcement, the Government also commissioned Mr Richard St. John to review the need for, and costs and benefits of, a statutory compensation scheme for investors. This review was in response to recommendation 10 of the committee's 2009 inquiry. The closing date for submissions to the consultation paper for the review was 1 June 2011 and 28 submissions were received.[10]

1.25 Mr St John's review, which concluded in April 2012, examined the adequacy of arrangements by which investors may be compensated where they suffer loss as a result of misconduct by a financial services provider. The particular focus was on the position of retail clients who incur financial loss or damage as a result of a breach of a financial service licensee under Chapter 7 of the Corporations Act.

1.26 Chapter 3 of this report looks at the findings of the Richard St John review.

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8 The Senate Economics Legislation Committee, Inquiry into the Corporations Amendment (Future of Financial Advice) Bill 2011 [Provisions] and the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 [Provisions], March 2012, p. 2.

9 The Hon. Bill Shorten MP, Minister for Financial Services and Superannuation, 'Smoother transition for financial advice reforms', *Media Release No. 013*, 14 March 2012.

10 Treasury, 'Future of Financial Advice: Review of compensation arrangements for consumers and financial services – Consultation Paper', Hhttp://futureofadvice.treasury.gov.au/content/Content.aspx?doc=consultation/compensation_arrangements_CP/default.htmH (accessed 21 March 2012).

The role of APRA in relation to superannuation

1.27 As part of its broad prudential role, APRA is responsible for the prudential supervision of superannuation funds (excluding self-managed funds). APRA oversees the compliance of registrable superannuation entities (RSE) with the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act), as well as administering the licensing of RSEs. The licensing regime requires the trustees of superannuation funds that are not self-managed funds to obtain an RSE license before they can operate as a trustee of a superannuation fund.[11]

1.28 In order to obtain an RSE license, the trustee must comply with certain conditions, including meeting minimum standards of fitness and propriety and maintaining risk management strategies governing the trustee's operations and risk management plans for each fund under the trustee's control.[12]

1.29 APRA summed up its role in supervising RSEs in its submission to the committee:

> APRA's supervisory approach is based on the fundamental premise that the primary responsibility for financial soundness and prudent risk management within a superannuation fund rests with its board of directors and senior management. Our approach, therefore, is to attempt to work with these parties to resolve any issues and ensure that fund member interests are protected. APRA's role is to promote prudent behaviour by superannuation funds through a robust prudential framework of legislation and prudential guidance which aims to ensure that risk-taking is conducted within reasonable bounds and that risks are clearly identified and well managed.[13]

Registrable Superannuation Entities

1.30 As set out above, a trustee must obtain an RSE license before it is able to operate as the trustee of a superannuation fund. APRA maintains a register of all RSEs and RSE licensees. The trustee of an RSE (or of an RSE licensee) is required to:

(a) comply with the fund's governing rules and the SIS Act, which includes obligations to: act honestly in all matters concerning the superannuation entity; exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt

11 APRA, *Superannuation*, Hhttp://www.apra.gov.au/Super/Pages/default.aspxH (accessed 1 May 2012).

12 ASIC, *How do the RSE and AFS licensing application processes work together?*, 31 March 2011, Hhttp://www.asic.gov.au/asic/asic.nsf/byheadline/How+do+the+RSE+and+AFS+licensing+application+processes+work+together%3F?openDocumentH (accessed 1 May 2012).

13 APRA, *Submission 41*, p. 5.

morally bound to provide; and ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries);

(b) comply with the prudential requirements set out in its RSE licence;

(c) comply with its risk management strategies and plans;

(d) maintain adequate financial, technical and human resources to operate as a trustee under the SIS Act;

(e) maintain minimum standards of fitness and propriety for superannuation fund trustees;

(f) comply with a risk management strategy which is specific to the trustee and specific for any RSE for which the trustee acts in the capacity of trustee; and

(g) ensure that any outsourcing arrangements are conducted under proper and enforceable agreements.[14]

1.31 APRA periodically reviews RSEs for their compliance with their RSE license conditions, including compliance with the trustee's risk management strategy and plan.[15] Under section 29G of the SIS Act, APRA may cancel an RSE license if the licensee has breached a condition of its license.

1.32 It is important to note that an RSE license is different to, and separate from, an Australian Financial Services License (AFSL). While they share some common requirements, and an entity may be required to hold both in order to operate a superannuation fund, the focus of the two licenses is different.

1.33 An RSE license is a license to operate a superannuation fund. As outlined above, in assessing an application, APRA focuses on prudential standards, the fitness and propriety for office of the superannuation fund's trustees (and, if they are bodies corporate, their directors) and the operations, systems and resources (including risk management systems and financial resources) of the trustee to prevent or minimise loss.[16]

1.34 An AFSL, on the other hand, is a license, issued by ASIC, to operate a financial services business. A financial services business could include providing financial product advice or dealing in financial products such as interests in superannuation funds. ASIC focuses on consumer protection and market integrity. It

14 ASIC, *Submission 51*, p. 96.

15 ASIC, *Submission 51*, p. 97.

16 ASIC, *How do the RSE and AFS licensing application processes work together?*, 31 March 2011, Hhttp://www.asic.gov.au/asic/asic.nsf/byheadline/How+do+the+RSE+and+AFS+licensing+application+processes+work+together%3F?openDocumentH (accessed 1 May 2012).

assesses the ability of an entity, including its responsible managers, to provide efficient, honest, fair and competent financial services. ASIC also looks at the entity's compliance measures and client complaint handling procedures.[17]

The role of the responsible entity

1.35 Trio Capital was the 'responsible entity' for several managed investment schemes, which it used to invest superannuation funds for which it was the trustee. It is important to understand the legal obligations of the responsible entity of the managed investment schemes.

1.36 The *Managed Investments Act 1998*[18] introduced the concept of the responsible entity as a single point of accountability. This replaced the Prescribed Interests regime (part 7.12 of the former corporations law) where both the manager and the trustee were accountable.[19] The primary purpose of the 1998 reforms was to ensure that only one entity would be responsible to investors for the management of assets held under managed investment schemes.[20]

1.37 Under section 601FB of the Corporations Act, the responsible entity is liable for the operation of the scheme, in accordance with the scheme's constitution and the Corporations Act. Under section 601FC of the Corporations Act, the responsible entity's duties include the obligation to act honestly; to act in the best interest of members; to ensure all payments out of scheme property are made in accordance with the scheme's constitution; and to ensure the scheme property is valued at regular intervals appropriate to the nature of the property.[21]

1.38 The regulation of the responsible entity is the responsibility of ASIC. The managed investment scheme, including the name of the proposed responsible entity, must be registered with ASIC in certain circumstances, including where it has more than 20 members or where it was promoted by a person in the business of promoting such schemes.[22]

1.39 As noted above, ASIC has responsibility under the Corporations Act to grant and monitor AFSLs. Holding an AFSL is a pre-requisite for operating as a responsible entity. Under the Corporations Act, an AFSL holder must:

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17 ASIC, *How do the RSE and AFS licensing application processes work together?*, 31 March 2011, Hhttp://www.asic.gov.au/asic/asic.nsf/byheadline/How+do+the+RSE+and+AFS+licensing+application+processes+work+together%3F?openDocumentH (accessed 1 May 2012).

18 now Chapter 5C of the *Corporations Act 2001*

19 ANZ, *Submission 70*, p. 3.

20 ANZ, *Submission 70*, p. 3.

21 Corporations Act 2001, section 601FC, chapter 5C

22 Corporations Act 2001, section 601ED, chapter 5C

(a) comply with conditions on their licence and the financial services laws;

(b) provide financial services efficiently, honestly and fairly;

(c) have adequate arrangements to manage conflicts of interest;

(d) ensure representatives are adequately trained and competent, and comply with the law;

(e) have adequate resources (including financial, technological and human resources) to provide the financial services covered by their licence and to carry out supervisory arrangements;

(f) maintain the licensee's own competence, skills and experience;

(g) maintain internal and external dispute resolution systems where clients are retail consumers;

(h) maintain adequate risk management systems;

(i) properly handle client money (trust account and audit requirements);

(j) notify ASIC of significant breaches;

(k) have adequate arrangements to compensate retail clients for losses; and

(l) provide key disclosure documents.[23]

1.40 Chapter 5C of the Corporations Act anticipates that a responsible entity might not follow the rules set out in the managed investment scheme's constitution or the laws governing managed investment schemes. This part of the Act is summarised by ASIC in its submission:

> There are three mechanisms in Ch 5C to deal with the perceived compliance risk in a cost effective way. These are the requirements for:
>
> (a) each registered managed investment scheme to have a compliance plan setting out adequate measures for the responsible entity to apply to ensure the managed investment scheme complies with its legal obligations (s601HA);
>
> (b) the compliance plan to be audited annually by a registered company auditor or audit firm (s601HG); and
>
> (c) a compliance committee to be established where less than half of the directors of the responsible entity are external directors (s601JA).[24]

1.41 ASIC's submission commented on these three requirements. In terms of (a) (above):

> A compliance plan is a document designed to set out the various checks and balances to be established to ensure that a registered managed investment scheme operates in accordance with the requirements of its constitution and the Corporations Act. The Corporations Act does not specify what

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23 ASIC, *Submission 51*, p. 113.

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

> constitutes adequate checks and balances, with the intention being that the responsible entity develop and implement an appropriate set of compliance measures to address a minimum number of mandatory risks. The approach was intended to provide flexibility for responsible entities to create compliance measures that were tailored for the particular registered managed investment scheme.[25]

1.42 In terms of the annual audit of the compliance plan ((b) above), ASIC noted:

> The requirement to appoint a compliance plan auditor who audits the compliance plan annually operates as an independent external oversight of the responsible entity's compliance arrangements. The purpose of requiring an audit of the compliance plan is to ensure the compliance plan is current at all times.[26]

1.43 In terms of the purpose of the compliance committee ((c) above), ASIC explained:

> The compliance committee is intended to act as an intermediary between the operational compliance unit and board of directors in relation to compliance monitoring, assessment and reporting. Given ASIC's finite resources, the compliance committee also plays an important role as 'gatekeeper'.[27]

1.44 The committee recognises that these arrangements are designed to provide a strong governance framework for the managed funds that help the operators demonstrate probity and assist them to manage conflicts of interest. However, it has received considerable evidence that there are weaknesses in this framework. These issues are discussed in some detail in chapter 7 of this report.

Dual regulated entities

1.45 As chapter 2 discusses, Trio Capital was both a licensed superannuation fund trustee and the responsible entity for several managed investment schemes. ASIC noted in its submission that there are approximately 33 entities that hold both an AFSL to operate as a responsible entity and a RSE licence to operate as a registrable superannuation entity. These dual regulated entities are subject to oversight by both ASIC and APRA.

1.46 ASIC explained that there are two key differences in the obligations under the Corporations Act for dual regulated entities. Dual regulated entities are excluded by the Corporations Act from the obligations to have adequate resources (s912A(1)(d)) and adequate risk management systems (s912A(1)(h)). These exemptions are on the basis that dual entities are regulated under the SIS Act by APRA 'and it would be

25 ASIC, *Submission 51*, p. 36.

26 ASIC, *Submission 51*, p. 38.

27 ASIC, *Submission 51*, p. 38.

duplicative for ASIC to also require adequate resources or review risk management arrangements'.[28]

1.47 The committee notes that the government proposes in a forthcoming tranche of superannuation legislation to amend the Corporations Act so that RSE licensees that are also responsible entities of managed investment schemes would not be exempt from the Corporations Act requirements to have available adequate financial resources.[29]

Self managed superannuation funds

1.48 Many investors in Trio Capital did not invest as part of an APRA-regulated superannuation fund. Rather, they invested as a SMSF directly into the managed investment schemes for which Trio Capital was the responsible entity.

1.49 The Australian Taxation Office (ATO) defines 'self-managed superannuation fund' as a complying superannuation fund under the *Superannuation Industry (Supervision) Act 1993* that has:

- fewer than five members;
- each individual trustee of the fund is a fund member;
- each member of the fund is a trustee;
- no member of the fund is an employee of another member of a fund, unless those members are related; and
- if the trustee of the fund is a body corporate each director of the body corporate is a member of the fund.[30]

1.50 SMSFs are subject to less stringent regulatory requirements under the SIS Act than APRA-regulated funds. Trustees of SMSFs remain responsible for all decisions, and must make those decisions for the benefit of members, but SMSFs are not subject to the same prudential requirements as APRA-regulated funds. SMSF trustees are required to:

- make sure the sole purpose of the fund is to provide retirement benefits to the members;
- prepare and implement an investment strategy;

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28 ASIC, *Submission 51*, p. 96.

29 Draft Explanatory Memorandum, Superannuation Legislation Amendment (Further MySuper and transparency Measures) Bill 2012, p. 6. Hhttp://strongersuper.treasury.gov.au/content/exposure_drafts/super_legislation_amendment/downloads/Explanatory-Memorandum.pdfH (accessed 27 April 2012).

30 Australian Taxation Office, *Definitions*, Hhttp://www.ato.gov.au/corporate/content.aspx?menuid=6751&doc=/content/8153.htm&page=1#P995_83563H (accessed 28/07/2011).

- make investment decisions with respect to super and tax laws;
- accept contributions and pay benefits (pension or lump sums) in accordance with super and tax laws;
- ensure an approved auditor is appointed for each income year; and
- undertake administrative tasks such as lodging annual returns and record keeping.[31]

1.51 Reflecting this more limited regulatory regime, SMSFs are not regulated by APRA. Instead, they are registered with, and overseen by, the ATO. The ATO's focus is on the SMSF's compliance with superannuation and taxation laws, not on prudential safeguards. That is, the ATO focuses on ensuring that SMSFs are not used as vehicles to avoid tax, that the SMSF has an investment strategy and that an independent auditor verifies annually that its investments have been made in accordance with that strategy. Unlike APRA-regulated funds, the ATO's role as regulator is not to ensure that the SMSF has appropriate risk management strategies.

1.52 In its report, the Super System Review identified the reason for the regulatory focus on compliance, rather than prudential oversight as being because, in SMSFs, 'the trustees and members are one and the same people who have the incentive and responsibility to protect their own interests'. This alignment of interests is to be contrasted with the situation in an APRA-regulated fund. In such funds, the trustee is quite distinct from, and usually in a commercial relationship with, its members, and this requires more stringent safeguards to ensure that the interests of the trustee align with those of the members of the fund.

1.53 The close relationship between trustees and members of SMSFs has always been at the heart of the more relaxed prudential standards imposed on them, including when such funds were classed as "excluded funds" under the SIS Act and were subject to the oversight of APRA's predecessor, the Insurance and Superannuation Commissioner. Indeed, the 1997 Financial System Inquiry Final Report noted that while prudential regulation of the SMSF sector would be "impracticable", prudential and compliance standards could be improved by requiring the beneficiaries of SMSFs to be trustees of such funds.[32] This recommendation was implemented by the Superannuation Amendment Act (No.3) 1999 (Cth). It is important to note that this Act also moved responsibility for SMSFs from APRA to the ATO.

1.54 The lack of stringent prudential regulation of SMSFs means that the role of finance professionals is extremely important in both the decision to set up an SMSF, in developing its investment strategy, in implementing that strategy and in complying

31 Australian Taxation Office, 'How your self-managed superannuation fund is regulated', Hhttp://www.ato.gov.au/content/downloads/spr00162377n71454.pdfH (accessed 10 May 2012).

32 S. Wallis, *Financial System Inquiry Final Report*, March 1997, pp 333–334.

with taxation laws and managing risk. Accountants' advice about the taxation implications and appropriateness of particular superannuation structures, such as SMSFs, and financial planners' advice about the investment strategies and risks of such funds will generally be central to people's decisions about the structure of their superannuation affairs. While an SMSF investor and trustee will use other finance professionals, such as auditors and actuaries, in their superannuation dealings, accountants and financial planners are generally people's entry point into the SMSF sector and, as such, occupy a key role in the sector.

Report structure

1.55 This report has nine chapters:

- Chapter 2 presents the structure and operation of Trio Capital, particularly the Astarra Strategic Fund and the ARP Growth Fund for which Trio was the responsible entity. The chapter concludes with a chronology of key events in the operation and collapse of Trio Capital.
- Chapter 3 acknowledges the impact that the collapse of Trio Capital has had on investors. It also examines compensation arrangements for Trio investors in APRA-regulated superannuation funds as opposed to self-managed superannuation funds.
- Chapter 4 presents the views of the regulators: APRA, ASIC, the ATO and the Treasury.
- Chapter 5 details the views of the gatekeepers: the internal auditor, KPMG; the external auditor, WHK; the custodians, ANZ Custodian Services and the National Australia Trustees Ltd; the research house Morningstar; the Financial Planning Association, the Financial Services Council and the Wollongong-based financial adviser Mr Ross Tarrant.
- Chapter 6 provides the views of Trio Capital investors, particularly SMSF investors in Trio. The chapter highlights their criticism of the regulators, the auditors, the research houses and financial advisers. It notes that many of these investors set up an SMSF and invested in Trio simply because their accountant or financial planner advised them to do so.
- Chapter 7 identifies seven 'expectations gaps'—differences between what investors perceive to be the role of a gatekeeper or the protections within the system and what is actually the case.
- Chapter 8 argues the case that there needs to be a much more vigorous criminal investigation, involving ASIC, APRA and the AFP into the Trio fraud. It emphasises that these investigations must be conducted with a view to pursuing the maximum available criminal sanctions against those responsible.
- Chapter 9 summarises the committee's findings and views.

Chapter 2

The structure, operation and collapse of Trio Capital

Introduction

2.1 One of the key tasks before the committee in conducting this inquiry is to detail, publicly and systematically, the operation of Trio Capital and the events that led to its collapse. This chapter addresses that task. It is divided into five parts:

- the first looks at the structure and operation of Trio Capital, particularly the two fraudulent investments schemes for which Trio was the responsible entity;
- the second part focuses on the role of Mr Shawn Richard and Mr Jack Flader in orchestrating the Trio Capital fraud;
- part three notes the role of financial advisers in recommending the fraudulent Trio funds to investors, and raises the question of whether these investments were suitable for the type of investors;
- part four looks at how the Trio Capital fraud was uncovered and the response of the regulators, the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA); and
- the final part of the chapter presents a chronology of the events in the Trio Capital story from 2003 to 2012. This timeline serves as a useful point of reference to recap the evidence of the chapter and to guide the reader through subsequent chapters.

The structure and operation of Trio Capital

2.2 The structure and operation of Trio Capital form a complex story. Over time, the names of holding and subsidiary companies changed, the operation of these companies traversed international jurisdictions, and there was considerable cross investment between superannuation funds which included complex investments in property development companies and overseas hedge funds.[1] All these factors complicate a clear explanation of what happened with Trio Capital.

2.3 Figures 2.1, 2.2, 2.3 and 2.4 (below) aim to show how the different parts of Trio Capital operated. Figure 2.1 represents the basic structure of Trio Capital, based on information contained in submitters' and witnesses' evidence to this inquiry. Figures 2.2, 2.3 and 2.4 are drawn from PPB Advisory's submission, and reproduced with permission. PPB is Trio Capital's administrator.

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1 See the comments of Justice Peter Garling, Regina v Shawn Richard [2011] NSWSC 866, 12 August 2011, paragraph 28.

2.4 Trio Capital was both a licensed superannuation fund trustee and the 'responsible entity' for several managed investment schemes. Figure 2.1 (left box) shows that Trio Capital was the trustee of a series of superannuation funds: Astarra Personal Pension Plan; Astarra Pooled Superannuation Trust; Astarra Superannuation Plan; Employees Federations of NSW Superannuation Plan; and My Retirement Plan. These funds were regulated by APRA.[2] Investors in these funds were eligible for, and have received compensation (see chapter 3).

2.5 Figure 2.1 (right box) also shows that Trio Capital was the responsible entity for a number of managed investment schemes. Substantial amounts of money were invested in these schemes by the superannuation funds for which Trio Capital was the common trustee.[3] The managed investment schemes of central interest in this inquiry are the Astarra Strategic Fund (ASF) and the ARP Growth Fund. The former was used fraudulently, while there are serious questions about the legitimacy of the latter.

2.6 Several hundred people invested their superannuation savings directly into these managed investment schemes through the use of a self-managed superannuation fund (SMSF), rather than through the APRA-regulated superannuation funds for which Trio was the trustee. As chapter 3 of this report explains, those who lost money in Trio's managed investment schemes through an SMSF are not eligible for compensation.

2.7 Trio generated income from charging fees to each of the managed investment schemes and superannuation funds in respect of which it acted as a responsible entity or trustee. Trio's principal expenses comprised management fees payable to Astarra Funds Management (its parent company) and to third parties—custodians, investment managers and financial planning groups.[4]

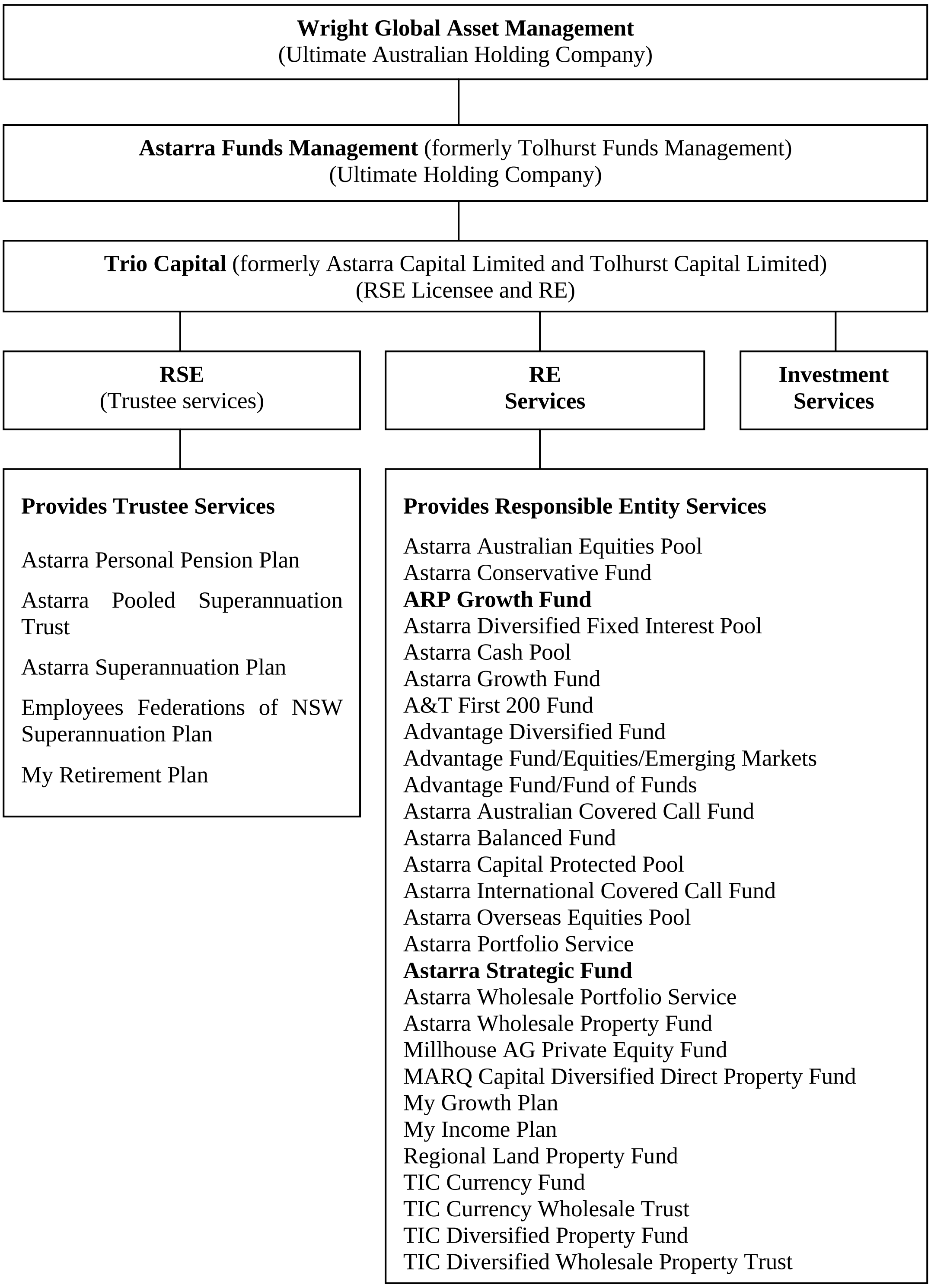
2.8 The majority of the managed investment schemes listed in Figure 2.1 were legitimate, providing appropriate returns to investors. However, the administrators' investigations concluded that five schemes had 'significant asset impairment'. These schemes were the ASF, ARP Growth Fund, Astarra Wholesale Portfolio Service, Astarra Portfolio Service and Astarra Overseas Equity Pool. There was some investment by Astarra Wholesale Portfolio Service, Astarra Portfolio Service and Astarra Overseas Equity Pool in the ASF which partly explains their asset impairment.

2 Funds choose to be regulated by APRA. An APRA-regulated fund must have a Registrable Superannuation Entity (RSE) licence.

3 *Report to creditors pursuant to section 439A of the Corporations Act 2001, Trio Capital Limited*, 8 April 2010, PPB, p. 12.

4 *Report to creditors pursuant to section 439A of the Corporations Act 2001, Trio Capital Limited*, 8 April 2010, PPB Advisory, *Submission 26*, p. 12.

Figure 2.1: Astarra Group Structure



2.9 The ASF was established as an Australian based hedge 'fund of funds'. Astarra Asset Management (AAM) was the investment manager of the ASF. A former director of AAM, who has now been jailed, described for the committee how the ASF operated:

> ...all discussions with the RE [responsible entity]/trustee relating to making investments were held at the very beginning, prior to the first investment being made. Following the establishment of the ASF, an investment management agreement between AAM and the RE was executed giving AAM the authority to invest monies according to the stated strategy and investment process, which was to invest in overseas hedge funds. Once the management was executed, the first investment as well as every other investment was executed without requiring any further discussions with the RE or Trustee.
>
> In other words, the RE/Trustee was completely reliant on this management agreement for all aspects of the fund's activities and played no role in relation to any investment decisions other than passing on AAM's instructions to the custodian. The process for sending monies to overseas funds was for AAM to e-mail the RE an instruction to invest in a particular fund which they then forwarded to the custodian for execution on the same day.[5]

2.10 While the ASF and the ARP Growth Fund had a common responsible entity in Trio, and had similar investment strategies, the funds operated separately. Significant monies from these schemes were invested in the British Virgin Islands in hedge funds controlled by a Hong Kong based American lawyer, Mr Flader. When these hedge funds collapsed, Australian investors' funds disappeared. The committee understands that Mr Flader is well-known to the United States Securities and Exchange Commission (SEC).

2.11 PPB Advisory found that overseas hedge funds represented the largest losses to Trio investors:

> The most significant losses to Trio investors relate to Category 3 investments (overseas hedge funds) which included:
>
> - approximately $123 million invested by the Astarra Strategic Fund (ASF) via Deferred Purchase Agreements in various overseas hedge funds; and
> - approximately $52 million invested by the ARP Growth Fund in Professional Pensions ARP Ltd.[6]

2.12 The ASF, with a value of approximately $123 million, had more than 6000 members.[7] The ARP Growth Fund, with a value of approximately $53 million, was

5 Mr Shawn Richard, *Answers to questions on notice*, received 27 April 2012, p. 2.

6 PPB Advisory, *Submission 26*, p. 7.

represented by 74 unit holders.[8] The Astarra Personal Pension Plan, Astarra Superannuation Plan, Employees Federations of NSW Superannuation Plan and My Retirement Plan had approximately 10 000 members. Of this number, over 5000 superannuation members were invested in the ASF.[9]

2.13 The principal focus of this inquiry has been on the operation of these two funds—the ASF and the ARP Growth Fund. The following sections examine how they were structured and operated by Trio and its directors.

Changing names

2.14 At the outset, the changing names of companies (and even people) involved in the Trio case needs to be clarified. The start of this story was in November 2003, when a reputable, mid-sized funds management business named Tolhurst Funds Management was purchased by Wright Global Asset Management Group (WGAM). The directors of WGAM, Mr Richard, Mr Matthew Littauer and Mr Cameron Anderson thereby became the directors of Tolhurst Funds Management. Tolhurst Funds Management was later renamed Astarra Funds Management. Tolhurst Funds Management had a subsidiary called Tolhurst Capital. In May 2004, Tolhurst Capital was renamed 'Astarra Capital'; in September 2009, Astarra Capital was renamed Trio Capital.

2.15 There were also name changes to the investment funds into which Trio, as the responsible entity, directed funds. In particular, AAM—the ASF's investment manager—was initially established as Absolute Alpha. The name changed in August 2009.

2.16 One of Trio's founding directors, Mr Cameron Anderson, owned a property development company called Silverhall. Silverhall was later renamed Ualan Property.

2.17 Even one of the key people involved in the Trio case changed his name. Mr Paul Gresham owned and controlled PST Management Pty Limited (PSTM), the company that acted as the investment manager of the ARP Growth Fund. ARP Growth Fund was a managed investment scheme run by Trio Capital. Mr Gresham recommended investments for ARP Growth Fund and its predecessor Professional Pensions Pooled Superannuation Trust (PPPST). Mr Gresham changed his name to Mr Tony Maher.

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7 ASIC, 'Grant of financial assistance—Trio and Astarra investors', http://www.asic.gov.au/asic/asic.nsf/byheadline/Grant+of+financial+assistance+-+Trio+and+Astarra+investors?openDocument (accessed 17 April 2012).

8 Mr Ron Thornton, President, Association of ARP Unitholders Inc., *Committee Hansard*, 30 August 2011, p. 18.

9 ASIC, 'Grant of financial assistance—Trio and Astarra investors', http://www.asic.gov.au/asic/asic.nsf/byheadline/Grant+of+financial+assistance+-+Trio+and+Astarra+investors?openDocument (accessed 17 April 2012).

The Trio Directors' investments

2.18 Figure 2.2 adds to the information in Figure 2.1, focussing on the interaction of investments between the ARP Growth Fund and the ASF. It shows how the monies in these funds were invested by three of the founding directors of Trio Capital: Mr Richard, Mr Anderson and Mr David Millhouse.

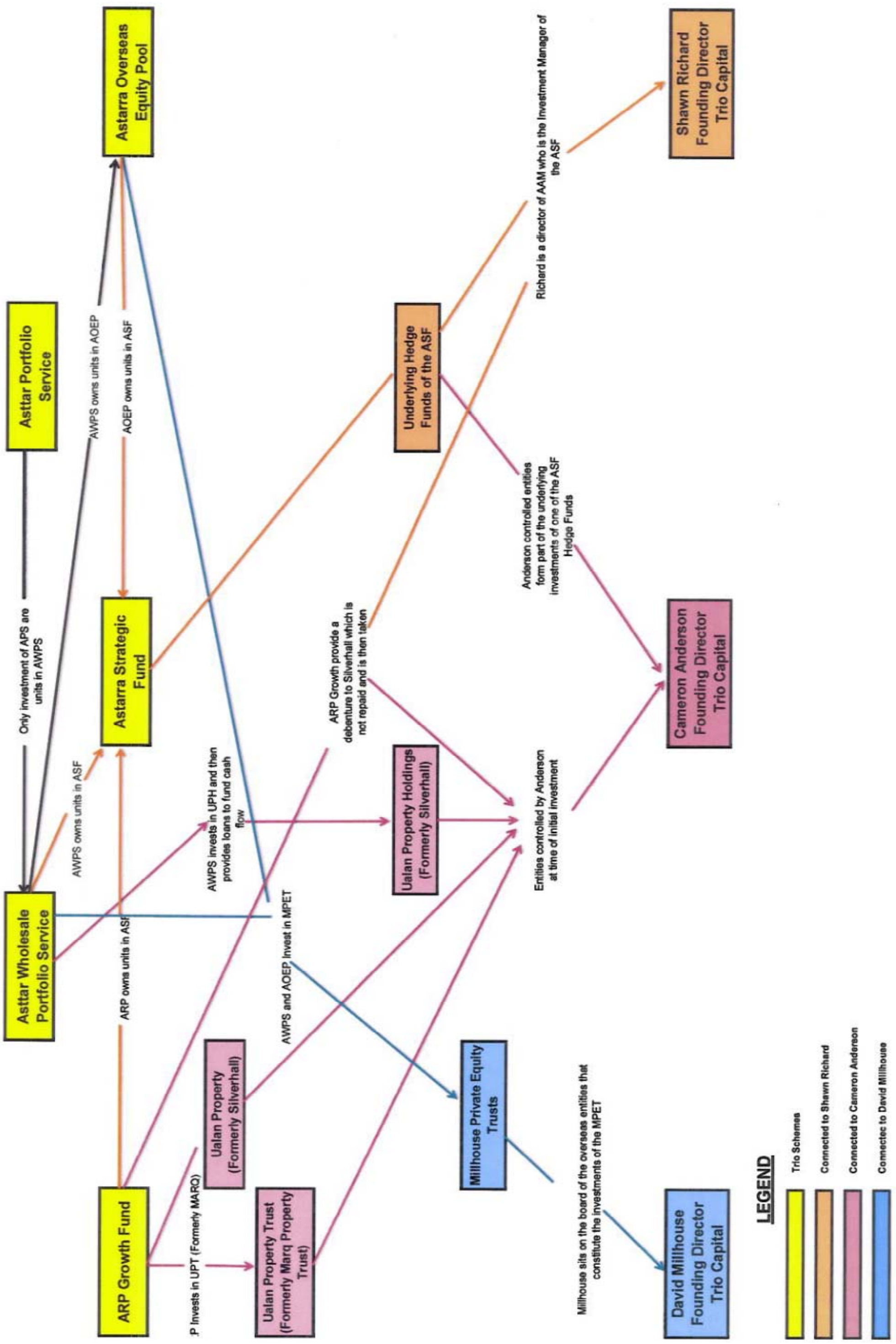
2.19 Figure 2.2 shows that the linkages between these funds and the involvement of Mr Richard and Mr Millhouse are relatively straightforward. Essentially, Mr Richard's influence came through investments in the underlying hedge funds of the ASF. Mr Richard was a director of AAM, the investment manager of the ASF. As explained more fully below, Mr Richard was jailed in August 2011 for engaging in dishonest conduct with respect to financial services.

2.20 Mr Millhouse's involvement was through the investment of Asttar Wholesale Portfolio Service and Asttar Overseas Equity Pool in Millhouse Private Equity Trusts. Mr Millhouse was a board member of the overseas entities that constituted the investment of this trust.

2.21 Figure 2.2 shows that Mr Anderson's involvement is considerably more complex, with monies from ARP Growth Fund and Asttar Wholesale Portfolio Service being invested through Mr Cameron's property trusts and holdings, and through the ASF and the underlying hedge funds of the ASF. At the time of writing, this company was in liquidation and Mr Anderson was answering allegations that his company had charged the ARP Growth Fund and ASF exorbitant asset management fees.[10]

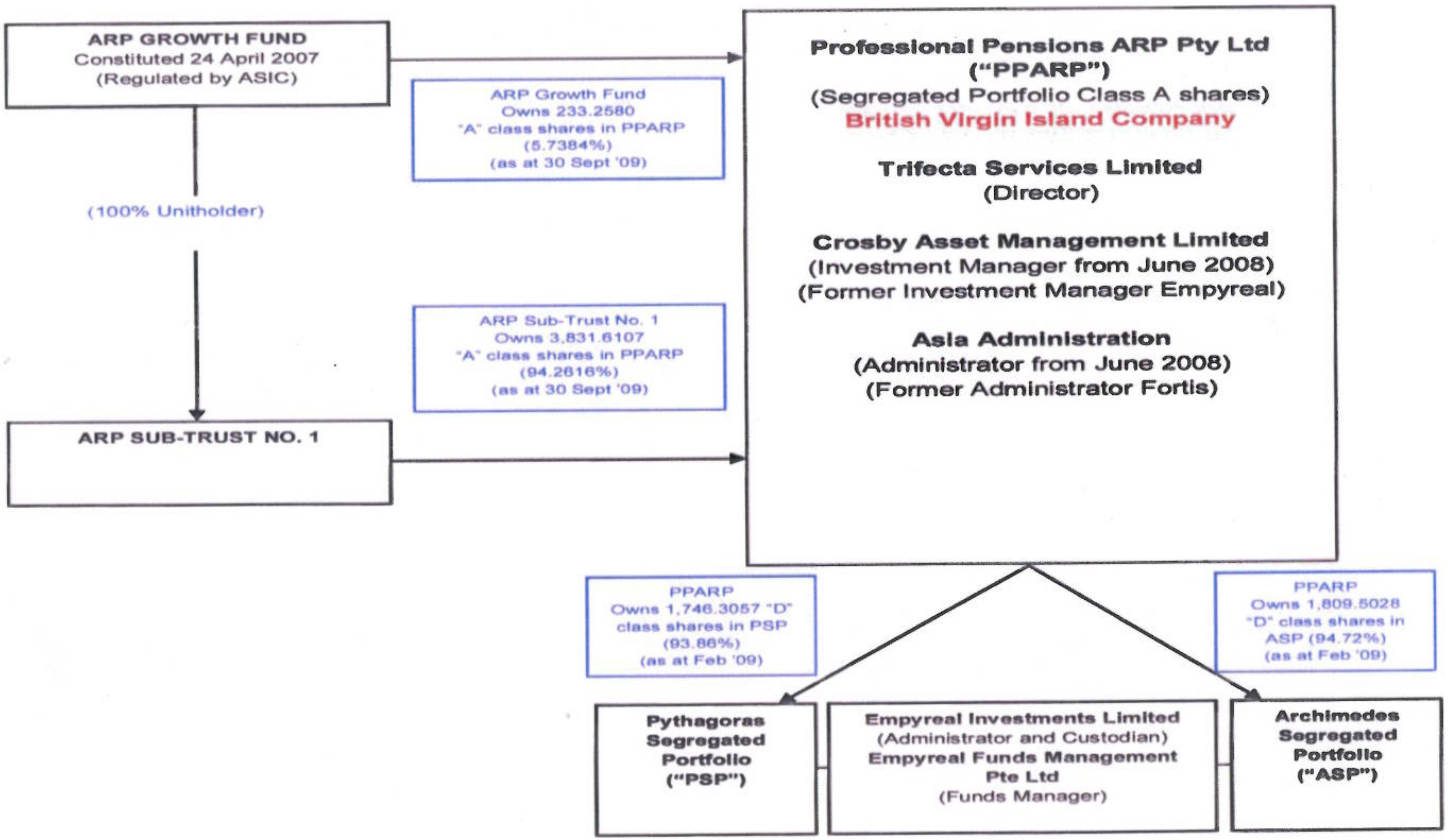
10 See Leonie Lamont, 'Ualan "loaded" super fees', *The Age*, 1 March 2012.

Figure 2.2 Interaction of Investments and Founding Directors of Trio [11]



11 Figures 2.2, 2.3, 2.4 were all provided by PPB Advisory as attachments to Submission 26.

Figure 2.3: Investment Structure of PPARP an Investment of ARP Growth Fund



ARP Growth Fund and Mr Paul Gresham

2.22 As noted earlier, Mr Gresham (later Tony Maher) was the owner and controller of PST Management Pty Ltd. PST Management acted as the investment manager for PPPST. Mr Gresham induced PPPST investors to move their funds into ARP Growth Fund, a managed investment scheme. This Fund replaced PPPST in July 2007. This effectively shifted investors from an APRA-regulated fund in PPPST to a SMSF investing directly in the ARP Growth Fund.[12] As chapter 3 discusses, this has excluded ARP Growth Fund investors from the government's compensation package.

2.23 Mr Gresham identified and recommended investments for PPPST and later ARP. He arranged for unit holders in PPPST to invest through a special purpose British Virgin Islands investment fund called Professional Pensions ARP Limited (PPARP). This fund purchased shares in the Archimedes and Pythagoras Segregated Portfolios of Empyreal SPC Limited (Empyreal), which was licensed as a professional fund in the British Virgin Islands. Empyreal was managed by Mr Philip York, who negotiated a 'swap agreement' on behalf of these two portfolios with Bear Stearns.[13]

2.24 The February 2012 enforceable undertaking accepted by ASIC from Mr Maher (formerly Gresham) stated that he had received undisclosed payments of more than $2 million arising from investments that he recommended for ARP and PPPST. The undertaking noted that in accepting these undisclosed payments, Mr Maher created a conflict of interest. In addition, the undertaking stated that Mr Maher was calculating on the value of ARP's investment in PPARP on his own and using a methodology that 'had no reasonable basis'. It was misleading for Mr Gresham not to disclose either of these matters to Trio because he knew that Trio would use these valuations to calculate the unit price of ARP.[14] ASIC stated that he had failed to undertake due diligence in recommending some investments in ARP/PPPST in circumstances where he knew that he had a conflict of interest.[15]

2.25 The operation of the ARP Growth Fund is illustrated in Figure 2.3. In its submission to this inquiry, PPB Advisory described these arrangements as follows:

> The major direct and indirect investments of the ARP Growth Fund were units in Professional Pensions ARP Limited (PPARP), a company registered in the British Virgin Islands.

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12 Mr Ron Thornton, President, Association of ARP Unitholders Inc, *Committee Hansard*, 30 August 2011, p. 19.

13 Mr Paul Gresham, *Submission 71*, p. 1.

14 Enforceable undertaking under section 93AA of the *Australian Securities and Investments Act 2001*, Mr Tony Maher (formerly known as Paul Anthony Gresham), p. 9.

15 Enforceable undertaking under section 93AA of the *Australian Securities and Investments Act 2001*, Mr Tony Maher (formerly known as Paul Anthony Gresham), p. 6.

> On 1 August 2006, Pythagoras Segregated Portfolio (PSP) and Archimedes Segregated Portfolio (ASP) entered into a Structured Fund Derivative contract with Bear Stearns International Limited ("Bears"). These contracts are referred to as "Total Return Swaps" whereby Bears agrees to pay the Portfolio an amount equal to the total market value of a basket of "Shares or other forms of interests in hedge funds and managed futures accounts" ("Basket Value") and the Portfolio agrees to pay Bears an amount by which the initial Basket Value exceeds the cash collateral deposited by the Portfolio ("Floating Rate Notional amount"). The initial cash deposited by the Portfolio as collateral must represent at least 40% of the "Equity Notional Amount" i.e. the initial Basket Value. If the Basket Value declines, more collateral must be deposited, or alternatively, Bears may redeem any investment it may have made to hedge its synthetic exposure. Bears, however, are under no obligation to make investments in any fund forming part of the Basket. The Portfolio has no investment in any fund; its investment is the value of the derivative contract to which it is counterparty to Bears. Both contracts were terminated effective 30 September 2008.
>
> Empyreal, in its capacity as Funds Manager, negotiated with JP Morgan to take over Bears obligations in March 2008.[16]

2.26 Notably, APRA argued that the funds in the ARP Growth Fund were lost due to the collapse of the investment bank and the global financial crisis rather than fraudulent activity:

> In the period June 2004 to July 2007, Trio was also the trustee of the Professional Pensions Pooled Superannuation Trust (PPPST). The PPPST was wound up in July 2007. Upon wind-up of the PPPST the members were provided with a new PDS and given the option to invest the redemption proceeds into the ARP Growth Fund, a managed investment scheme operated by Trio. This fund held substantial monies from self-managed superannuation funds (SMSFs), which were ultimately invested via a British Virgin Islands Segregated Mutual Funds Company in a number of derivative contracts with a US-based investment bank, Bear Sterns. These funds were lost due to the failure of Bear Stearns and the severe market movements during the Global Financial Crisis and not due to fraud.[17]

2.27 Chapter 8 of this report presents the evidence, and the committee's view, on the following questions: did the derivative contract between PPARP and Bear Stearns actually exist; were the ARP Growth Fund monies lost due to fraud or the collapse of Bear Stearns; and can the funds be recovered?

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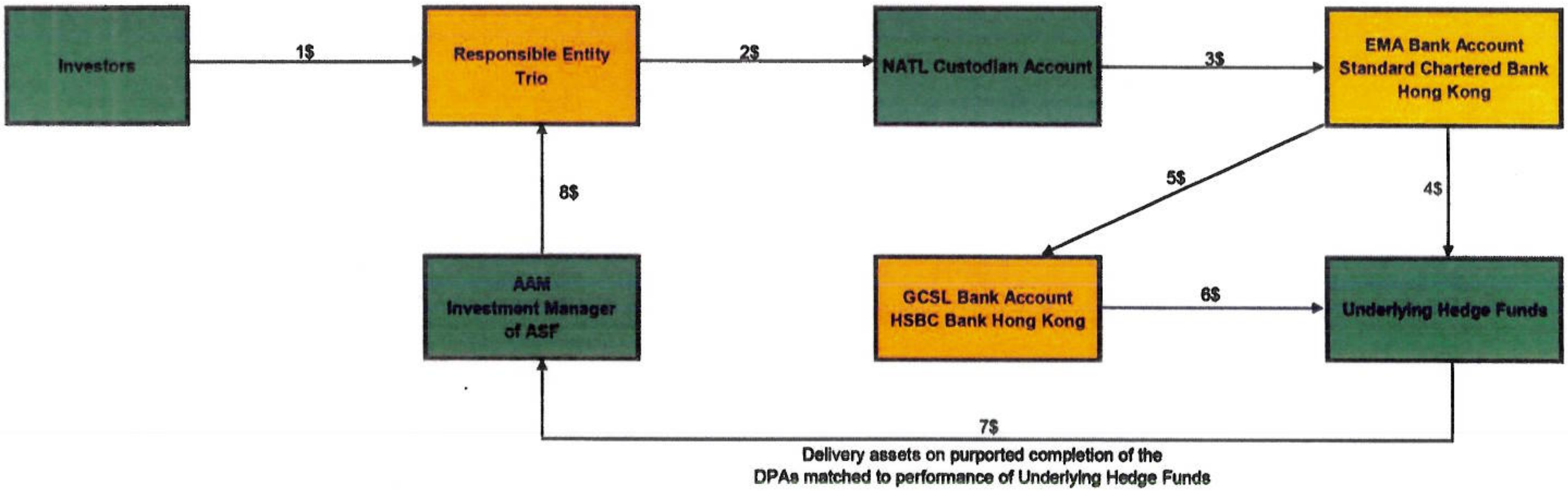
16 PPB Advisory, *Submission 26*, p. 8.

17 Australian Prudential Regulation Authority, *Submission 41*, p. 5. For a description of the issuance of the PDS, see Association of ARP Unitholders, *Submission 25*, p. 40.

Figure 2:4: Fund Flow Arrangements of the DPA Structure of the ASF



1$ Application Monies
2$ Investor Funds deposited into Trio Custodian Account
3$ Purchase price of DPA's
4$ Investment by EMA with proceeds of DPA's
5$ Funds in EMA Bank Account transferred to GSL Bank Account
6$ Possible investment into Underlying Hedge Funds
7$ Possible delivery of delivery assets by EMA to AAM
8$ Possible delivery of delivery assets by AAM to Trio

The flow of funds through the Astarra Strategic Fund

2.28 Figure 2.4 shows the flow of funds through the ASF. Investors paid money to Trio as the responsible entity, which then deposited the funds into a Trio Custodian Account. Trio initially appointed ANZ Custodian Services and then National Australia Trustees Limited (NATL). Their views of the collapse of Trio are presented in chapter 5.

2.29 The custodian's role was to pay the funds into the Hong Kong Bank Account of EMA International (EMA). The sole purpose of EMA was to allow the ASF, through its agent and investment manager AAM, to invest directly and indirectly in overseas hedge funds through a deferred purchase agreement (DPA).[18] The DPA provided that investments were to be held offshore until AAM requested the delivery of those investments or their equivalent money's worth. AAM would then transfer the assets or the monies to Trio.[19]

2.30 In its submission, PPB Advisory explained that the ASF:

> [C]omprised of a series of contractual rights obtained by a British Virgin Islands registered entity, EMA International Limited (EMA), to receive certain delivery assets in the future. The value of those delivery assets would be determined by the performance of five underlying off-shore hedge funds (the Underlying Funds) being:
>
> - Exploration Fund Limited (EFL)
> - Tailwind Investment Fund (Tailwind)
> - SBS Dynamic Opportunities Fund Ltd (SBS)
> - Pacific Capital Markets Cayman LDC (Pacific)
> - Atlantis Capital Markets Cayman LDC (Atlantis)
>
> The monies paid to EMA to acquire the contractual rights were, according to the documentation, then to be invested by EMA in the Underlying Funds...[20]

2.31 The link between the Exploration Fund Limited (EFL) and Trio Capital was explained as follows:

---

18 Under the terms of a Deferred Purchase Agreement, an investor will pay the purchase price on to acquire the delivery assets, which are typically listed shares or units. These assets are actually delivered some time later, often three to five years later. The number of delivery assets is determined by reference to the performance of a predefined underlying portfolio. See http://www.mcofinancial.com/Dictionary/Deferred%20Purchase%20Agreements.pdf (accessed 17 April 2012).

19 Australian Prudential Regulation Authority, *Submission 41*, p. 4.

20 PPB Advisory, *Submission 26*, p. 7.

> The EFL was a company incorporated in Saint Lucia, West Indies and operated as a hedge fund, although at the time of the initial investment, EFL was newly formed and had no operating history. The EFL appointed a Saint Lucia company, Global Financial Managers Limited (GFML) as investment manager and GFML delegated its duties in relation to Australian investors to Wright Global Investments Pty Limited (WGI). Mr Shawn Richard was a director, secretary and general manager of WGI. Mr Richard was also a director of Trio from 5 November 2003 to 15 November 2005 and a member of Trio's Investment Committee from February 2004 to December 2005 and December 2008 to August 2009. Mr Richard, through various corporate entities, was the ultimate owner of Trio.[21]

Mr Shawn Richard, Mr Jack Flader and the Trio fraud

2.32 Having explained these structures and the flow of investment money, the obvious question arises: how were these arrangements used to perpetrate fraud? In his judgment on Mr Richard, Justice Peter Garling of the New South Wales Supreme Court, provided the following statement of facts:[22]

- Mr Shawn Richard was, at various times, a director and the responsible officer and agent of Trio. Mr Richard was a director of Trio's immediate holding company, Astarra Funds Management Pty Ltd (AFM).
- The investment manager of the ASF, via agreements with Trio, was AAM. Mr Richard was a director of AAM. In addition, AAM was an authorised representative of Trio and Wright Global Investments Pty Ltd (WGI). Mr Richard was a director and the responsible officer of WGI.
- EMA was a 'special purpose vehicle' established to facilitate investments by the ASF in funds offshore. Mr Richard was in control of EMA.
- Mr Richard represented himself to investors as being the controller of Trio, WGI and AFM, when he was aware that these representations were false. The representation was false because at all times after July 2004, Mr Richard knew that Mr Jack Flader, a US citizen based in Hong Kong, was the ultimate controller of these entities and the business of the Trio Capital Group.
- Mr Richard used his positions with respect to Trio, WGI and AFM to arrange the transfer of Australian investors' monies from Trio Managed Funds in Australia, to overseas funds controlled by Flader ('Flader Controlled Funds'). The money was subsequently used to purchase shares in US companies at inflated prices, from foreign companies controlled by Flader ('Flader Vendor Companies'). The inflated share prices realised significant profits for the Flader Vendor Companies.

21 APRA, *Submission 41*, p. 4.

22 This statement has been abridged. *R v Shawn Darrell Richard* [2011] NSWSC 866 (12 August 2011), starting at paragraph 29.
http://www.lexisnexis.com.au/legal/auth/bridge.do?rand=0.3590918380238468

- The shares which were purchased were themselves only quoted on the Over-the-Counter Bulletin Board as unregulated US equity securities. This meant that they were vulnerable to share price manipulation, and often there was only restricted stock available for trading.
- From November 2006, when the directors of Trio became concerned and decided to cease its exposure to a particular Flader Controlled Fund (the EFL), Mr Richard participated in the creation of new offshore funds for Trio to invest in, all of which were controlled by Flader. He falsely represented to Trio and ASF investors that he was diversifying the portfolio to different investment managers from the original Flader Controlled Funds.
- The GSCL Group, of which Mr Flader was the Chief Executive Officer and Chairman, was the custodian of the assets of the Flader Controlled Funds at all material times. In addition, the GCSL Group, provided administration services to EMA.
- The only monies invested into the Flader Controlled Funds were those from the Trio Managed Funds, with two exceptions. The Australasian Conference Association Superannuation Trust and the Australian Baseball Federation Inc. directly invested in one of the Flader Controlled Funds.
- A large proportion of profits received by the Flader Vendor Companies, from the sale of shares purchased from Australian investors' monies deposited into the Flader Controlled Funds, were subsequently used to provide funds to Trio, WGI, AFM and AAM, by way of loans from other companies controlled by Flader ('Flader Funding Companies'). Mr Richard falsely represented to auditors of Trio, WGI, AFM and AAM that he controlled these funding companies.[23]

2.33 Later in the judgment, it was noted that Mr Richard's counsel accepted that an adequate description of the scheme was that it was:

> ...a scheme designed to divert Australian investors' money from superannuation and managed investment funds into overseas hedge funds contrary to the interest of the investors in return for significant undisclosed payments.[24]

2.34 PPB Advisory corroborated this description. The committee asked the company whether it had concluded there were no assets in the ASF because the underlying investments were a series of fraudulent hedge funds. It responded:

> They are fraudulent. We have received certain information, as part of secrecy provisions, from other regulators that point in the direction of

23 *R v Shawn Darrell Richard* [2011] NSWSC 866 (12 August 2011), starting at paragraph 29. http://www.lexisnexis.com/au/legal/auth/bridge.do?rand=0.3590918380238468

24 *R v Shawn Darrell Richard* [2011] NSWSC 866 (12 August 2011), starting at paragraph 29. http://www.lexisnexis.com/au/legal/auth/bridge.do?rand=0.3590918380238468

> where some of those funds may have ended up. As to whether there is a legal constructive trust argument to say those are the funds of the ASF, it is a very complex process. We certainly have not given up trying to recover the money. But it is not the money that was thought to have been invested through the structure as it was explained to the unit holders.[25]

2.35 The committee queried whether the structure of the ASF and the ARP Growth Fund was broadly similar given the investment was through a couple of intermediaries with, in each case, at least one company located in the British Virgin Islands, and the underlying investment merely a contractual right to receive payment if certain things happened. The Director of PPB Advisory, Mr Brett Manwaring, responded:

> Certainly, in the case of the ASF that is correct. In the case of the ARP Growth Fund, they do not even own the contractual rights. They are owned by a third interposing entity, whereby PPARP own shares in Empyreal. Empyreal is the party that owns those contractual rights. There are a whole series of parties that would need to be gone through, even to attach to those contractual arrangements. We have contacted all parties and sought to have the contractual rights assigned to us, as we understand we are the only investor. But, when you do not have voting rights, they can stand in the way of disclosing information.[26]

The role of financial advisers

2.36 Investors in the ASF and the ARP Growth Fund generally fell into two groups. The first group invested via the APRA regulated superannuation funds, shown in Figure 2.1. Trio was the common trustee of these funds. There were approximately 10 000 members in the four Trio superannuation funds (excluding the Astarra Pooled Superannuation Trust). Over 5000 of these superannuation members invested in the ASF and will receive (or have received) compensation (see chapter 3).

2.37 The second group invested via SMSFs. ASIC states that there are around 690 direct investors in the ASF not eligible for compensation (i.e.: not within an APRA regulated superannuation fund). Of this number, there were around 285 SMSFs. The others were individuals, corporations or trusts.[27] There were 74 unit holders in the ARP Growth Fund, all of which were SMSFs.

2.38 SMSF investors in the ASF and the ARP Growth Fund were typically recommended these investments by financial advisers. A Wollongong-based adviser, Mr Ross Tarrant, recommended the ASF to 220 of his clients. In his words, 'they have

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25 Mr Brett Manwaring, Director, PPB Advisory, *Committee Hansard*, 30 August 2011, p. 54.

26 Mr Brett Manwaring, Director; Mr Mark Robinson, Partner, PPB Advisory, *Committee Hansard*, 30 August 2011, pp 54–56.

27 ASIC, 'Grant of financial assistance—Trio and Astarra investors', http://www.asic.gov.au/asic/asic.nsf/byheadline/Grant+of+financial+assistance+-+Trio+and+Astarra+investors?openDocument (accessed 23 April 2012).

lost approximately $25 million as a direct result of my financial advice by including ASF into our client portfolios'.[28] In November 2011, ASIC banned Ross Tarrant for seven years for breaching financial services law.[29] Mr Tarrant is appealing this decision.

2.39 Mr Gresham, operating on Sydney's north shore, recommended the ARP Growth Fund to his clients. As noted earlier, the enforceable undertaking accepted by Mr Gresham stated that he had received undisclosed payments of more than $2 million arising from investments that he recommended for ARP and PPPST. For example, the undertaking noted that Mr Gresham did not disclose to Trio or unitholders in PPPST that he had an informal agreement with Mr Richard and Mr Littauer. This agreement provided for payments to be made to him in relation to PPPST investment in Huntleigh Investment Fund (later the EFL).[30]

2.40 Unlike other financial advisers who recommended Trio investments, Mr Gresham had had involvement with the key players in the Trio fraud. The undertaking accepted by Mr Gresham made clear that he had known Mr Richard, Mr Littauer and Mr Anderson since 2003, when he assisted them raise funds, loaned on commercial terms from his clients, to enable WGAM to purchase Tolhurst Funds Management. The undertaking also states that Mr Gresham met Mr Flader and Mr York in early 2004 through his relationship with Mr Richard and Mr Littauer.[31]

2.41 The committee believes that Mr Gresham's recommendation to invest in the ARP Growth Fund was based either on a deliberate attempt to defraud his clients, or at the very least to concentrate on enriching himself while wilfully disregarding the evidence that the investment scheme into which he was putting his clients' money was fraudulent.

2.42 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. Chapter 5 of this report examines the views of financial planners who recommended Trio Capital to their clients; chapter 6 canvasses various criticisms of their role.

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28 Mr Ross Tarrant, *Submission 35*, p. 1.

29 ASIC listed the ban on an online register but did not disclose the decision publicly.

30 Enforceable undertaking under section 93AA of the *Australian Securities and Investments Act 2001*, Mr Tony Maher (formerly known as Paul Anthony Gresham), p. 6.

31 Enforceable undertaking under section 93AA of the *Australian Securities and Investments Act 2001*, Mr Tony Maher (formerly known as Paul Anthony Gresham), pp 3–4.

The suitability of the Trio funds as an investment

2.43 For the committee, the overwhelming impression from the preceding discussion is of the complexity of the Trio Capital investment structure. It raises the following questions:

- was Trio an appropriate investment for 'mum and dad' investors with little knowledge or understanding of the investment structure, operation and risk?
- are complex managed investment schemes with multi-layered structures suitable for retail investors given the higher levels of risk and the difficulty for retail investors to understand and monitor the investment?

These are legitimate and important questions, notwithstanding the deliberate fraudulent activity of Mr Richard and Mr Flader, among others.

2.44 This issue of the suitability of the Trio schemes in turn raises important questions about the role of financial advisers in recommending Trio to their clients. First, and most obviously, did financial advisers understand the Trio investment structure and the risks involved? Second, did financial advisers understand that the various Trio schemes were linked through Trio as the responsible entity, or were they deceived on this as part of the Trio fraud?

2.45 The committee considers that multi-layered managed investment scheme structures are difficult for all but the most sophisticated and attentive retail investor to understand. Moreover, investors themselves will not be aware of their ultimate exposure and the risks of their investment. As ASIC explained:

> It is not an uncommon practice in the industry that a registered managed investment scheme invests in another managed investment scheme to gain particular exposure to underlying assets in a cost effective way (e.g. a retail feeder fund investing in wholesale funds that has greater economies of scale). It is therefore not necessarily unsuitable for retail investors to be indirectly invested in intermediary investment vehicles.
>
> However, the multiple layer structure may create difficulties in identifying an investor's ultimate exposure through an investment and the extent of exposure to a particular financial product or type of financial product that may arise indirectly through multiple investment vehicles. The risks associated with multiple layer investment can be exacerbated where multiple layer investment occurs in foreign jurisdictions where regulatory oversight is not as thorough.[32]

2.46 ASIC contrasted the position of an investor making a direct investment, with one investing in a managed investment scheme managed by a responsible entity:

> The suitability of an investment to an investor depends on the personal circumstances of the investor, including, for example, the risk appetite of

32 ASIC, *Submission 51*, pp 90–91.

> the investor, the risk profile of the investor's investment portfolio, the investor's investment horizon, the investor's ability to understand the risk characteristics of the product taking into account any advice the investor receives, and the investor's capacity to track the performance of the financial product, personally or through an adviser.
>
> In a direct investment situation, it is important that an investor makes an assessment of the product in light of these risk factors before investing, and then throughout the life of the investment.
>
> However, when an investor invests in a registered managed investment scheme managed by a responsible entity, or a professional investment manager acting on the responsible entity's behalf, the investor relies on the responsible entity to assess the risks of the particular financial products that the managed investment scheme invests in (the underlying assets) and implement strategies to manage such risks, consistent with any disclosures to the investor (e.g. by diversification). The investor still needs to assess the suitability of an investment in the registered managed investment scheme and, for this purpose, will generally be given a PDS.[33]

2.47 As ASIC pointed out, in many circumstances it will be perfectly appropriate for a retail investor to invest in a managed investment scheme. It noted that an investment in some assets through a registered managed investment scheme may be suitable for a retail investor, even in cases where direct investment by the retail investor is unsuitable. ASIC also noted that the complexity of the financial product, and the difficulty for the retail investor to monitor the investment, may be of lesser importance than the investor's confidence in the performance of the responsible entity.[34]

2.48 PPB Advisory queried the suitability of Trio for the type of investors it attracted. It observed that:

- The...hedge fund investments are extremely complex involving numerous interposing parties and several overseas jurisdictions...
- The structure of the hedge fund investments and the type of investors involved are in our view, incongruent.
- Trio (the other directors) did not appear to fully understand the nature of the investments or the risk profile.[35]

2.49 A combination of lack of understanding and deliberate misconduct led to poor governance arrangements. The Trust Company, which was the replacement responsible entity for some of the Trio funds, observed that:

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33 ASIC, *Submission 51*, p. 89.

34 ASIC, *Submission 51*, p. 89.

35 PPB Advisory, *Submission 26*, p. 8.

> ...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;
>
> Responsible entity of registered schemes; and
>
> Associates of the investment manager appointed to the Trio funds.
>
> ...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.
>
> The proven dishonest conduct by those responsible for the investment management of the Astarra Strategic Fund coupled with the enforceable undertakings offered by the directors of Trio Capital would prima facie demonstrate a lack of robust compliance and governance arrangements within Trio Capital.[36]

Committee view

2.50 It does seem likely that the complexity of the Trio structure was to some extent intentional, so as to camouflage the fraudulent activity. A key element of the scheme was to move the funds of Australian investors overseas, making it much harder for Australian auditors to verify the existence of the funds; for Australian liquidators to recover any remaining funds; and for Australian authorities to investigate and to pursue those who have carried out criminal conduct.

2.51 From a retail investor's point of view, this complexity of the Trio investment structure required investors to place their trust in the competence and judgment of the responsible entity. In this context, the role of financial advisers and planners in recommending Trio to investors is a matter that warrants close scrutiny. The committee finds it very difficult to see how the various Trio investment options were appropriate investments or an appropriate mix and spread of investments of different risk classes to provide for everyday Australians' retirement needs. Later chapters of this report argue that, to some extent, these financial advisers and planners should bear some blame for their role in recommending Trio as a suitable investment for 'mum and dad' investors.

The collapse of Trio Capital and the regulatory response

2.52 This section looks at how the Trio Capital fraud was uncovered and the response of ASIC and APRA. Chapter 4 examines the mindset and the rationale of the regulators in investigating the Trio fraud.

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

Alerting the authorities

2.53 In September 2009, Mr John Hempton, Chief Executive Officer at Bronte Capital Management and a former Treasury official, wrote a letter to ASIC Chairman, Mr Tony D'Aloisio. The letter alerted ASIC to the suspiciously smooth returns achieved by the ASF in the context of a turbulent financial environment. He argued in the letter that while it was possible that the ASF was a fraud, there was no proof of that. Mr Hempton's letter resulted in ASIC launching an investigation into the activities of certain Trio funds (see Table 2.2 above and chapter 4).

2.54 Mr Hempton wrote on his blog: 'there was no genius in my letter – everything could be found (fairly easily) on the internet – and the original tip-off came from a reader of my blog – who noticed links with a story I wrote up in March 2009'.[37] Nonetheless, the blog clearly shows Mr Hempton's persistence and insight in bringing his concerns to the attention of the media and ASIC. In early January 2010, he wrote the following:

> Six months ago a reader pointed me to a fund of hedge funds (called Absolute Alpha) based in Australia. I looked – and within forty minutes I became very concerned – but could not prove harm to the fund's investors. I tipped off the Sydney Morning Herald. The journalists at the Herald worked hard at the story but alas they too could not prove harm. Indeed a major bank misled them as to whether the assets were in (their) safe custody. The bank confirmed the assets were in custody – a statement they have now withdrawn. Obviously with a reputable third party vouching for the assets any hypothesis of harm was going to be hard to sustain. The Herald published nothing.[38]

2.55 He continued:

> I however remained suspicious – but could not easily do anything. For there to be something desperately wrong either the bank had to be a party or grossly negligent as to their custody of the assets. Absolute Alpha was a boutique fund manager loosely associated with – and partly owned – by a superannuation wrap provider called Astarra. Astarra is now called Trio. The wrap provider did all the superannuation compliance and in turn (claimed to) invest funds with other fund managers – mostly reputable managers. The relationship between Trio and some of the funds in which they were supposed to invest is complex.

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37 Mr John Hempton, 'A dark privatised social security story: Astarra, the missing money and how examining a fund manager owned by Joe Biden's family led to substantial regulatory action in Australia', *Bronte Capital*, 2 January 2010, http://brontecapital.blogspot.com.au/search?q=trio (accessed 17 April 2012).

38 Mr John Hempton, 'A dark privatised social security story: Astarra, the missing money and how examining a fund manager owned by Joe Biden's family led to substantial regulatory action in Australia', *Bronte Capital*, 2 January 2010, http://brontecapital.blogspot.com.au/search?q=trio (accessed 17 April 2012).

> The amount of money in Absolute Alpha was probably under 100 million. There were plenty of things that did not look right – but I did not think there was much I could do about it.
>
> So I let it go – though I did not forget about it.
>
> Later I tried to log into Absolute Alpha's website and it was dead. This (falsely) indicated my worst fear.
>
> Again I alerted the Herald.
>
> Alas it was not so simple. Absolute Alpha it seems had taken over the funds management of all the money in the Astarra wrap. They had renamed themselves Astarra. Astarra later renamed itself Trio. Astarra's website boasted of a billion dollars in funds under management...
>
> Anyway I wrote a letter to...ASIC laying out all my concerns and (implicitly) the method for testing my concerns were false. [I sincerely hoped I was wrong – and hoped the regulator would prove me incorrect by identifying and valuing the assets. I still sincerely hope all the money turns up in the British Virgin Islands.][39]

2.56 Mr Hempton did note that ASIC's actions in responding to his tip-off were 'exemplary'. He argued in his blog that ASIC did what the SEC in the US could not and 'act on a "Markopolos letter" within weeks'.[40] Mr Hempton explained that unlike the SEC in the Madoff case, ASIC did attempt to confirm the existence and value of the assets. Indeed, ASIC Chairman, Mr Greg Medcraft, made a point of highlighting these efforts in his evidence to the committee (see chapter 4). Mr Hempton noted that in putting a stop on all Astarra funds, ASIC acted to protect investors.

Regulatory action and enforceable undertakings

2.57 Chapter 4 of this report details the regulatory response to the tip-off from Mr Hempton. It also explains the mindset of the regulators in investigating Trio and the coordination of their activities.

2.58 It is useful here to sketch the regulators' actions. Table 2.1 (below) notes that ASIC commenced its investigation into the conduct of Trio officers on 2 October 2009. A fortnight later, it issued an interim stop order on Trio preventing offers, issues, transfers or sales of interests in the ASF and other managed investment schemes for which Trio was the responsible entity. In November 2009, ASIC froze pension payments and withdrawals from ARP Growth Fund.

39 Mr John Hempton, 'A dark privatised social security story: Astarra, the missing money and how examining a fund manager owned by Joe Biden's family led to substantial regulatory action in Australia', *Bronte Capital*, 2 January 2010, http://brontecapital.blogspot.com.au/search?q=trio (accessed 17 April 2012).

40 In 2005, Mr Harry Markopolos wrote to the Securities and Exchange Commission in the United States pointing out issues with Madoff Investments, run by Bernie Madoff.

Table 2.1: Enforceable undertakings

Date	Person / Company	Condition of EU	Agency accepting EU
March 2012	Mr John Godfrey	No expiry date	APRA
Feb 2012	Mr Paul Gresham / Tony Maher	Permanent ban	ASIC
Feb 2012	Mr Timothy Frazer, WHK auditor	3 years	ASIC
Sept 2011	Mr Keith Finkelde	6 years	APRA
Aug 2011	Mr Keith Finkelde	Prevented from any role in financial services for 4 years	ASIC
Aug 2011	Mr David O'Bryen	Prevented from any role in financial services for 4 years	ASIC
Aug 2011	Mr David Andrews	Prevented from any role in financial services for 9 years	ASIC
July 2011	Mr Rex Phillpott	15 years	ASIC
July 2011	Ms Natasha Beck	2 years	ASIC
Sept 2011	Mr David Andrews	10 years	APRA
Oct 2011	Mr David O'Bryen	Five and a half years	APRA
July 2011	Seagrims Pty Ltd, Peter and Anne-Marie Seagrim	suspension of the AFSL for 3 years	ASIC
June 2011	Kilara Financial Solutions	Commitment to modify aspects of compliance	ASIC

Sources: ASIC, Enforceable undertakings register, http://www.asic.gov.au/asic/asic.nsf/byheadline/Enforceable+undertaking+register%3A+list?openDocument and APRA Enforceable undertakings register, http://www.apra.gov.au/CrossIndustry/Pages/EnforceableUndertakings.aspx (accessed 1 May 2012)

2.59 APRA had conducted several prudential reviews of Trio between 2004 and 2009. In mid-2009, when information requested from Trio was not forthcoming, it conducted a further prudential review to ascertain the existence of overseas assets. When this information was not provided, APRA commenced an investigation in October 2009.

2.60 On 2 December 2009, APRA issued a 'show cause' letter on Trio as to why it should not be suspended or removed as trustee. On 17 December, APRA suspended Trio's licence as the trustee of its four superannuation funds and one pooled superannuation trust. APRA suspended Trio's licence as a result of numerous breaches of Trio's licence conditions, including:

> [F]ailure to provide the auditors reports for 2009; failure to submit quarterly returns due 5 November 2009; failure to adhere to custodial requirements; failure to exercise care, skill and diligence and failure to act in the best interests of beneficiaries; and failure to demonstrate due diligence on the

investment in the Exploration Fund Limited (EFL); and not being unable to satisfy APRA's concerns regarding the valuation of superannuation assets.[41]

A chronology of key events

2.61 Table 2.2 is a basic chronology of events relating to the operation and collapse of Trio. The timeline commences in early 2003, when ASIC issued an Australian Financial Services Licence to the ultimate Australian holding company, Wright Global Asset Management. It ends in March 2012, when APRA entered into an enforceable undertaking from another Trio Director, Mr John Godfrey.[42] The key events in Table 2.2 are:

- the purchase of Tolhurst Funds Management by Wright Global Asset Management in November 2003;
- the replacement of the Trust Company for Trio as the trustee of PPPST in June 2004;
- the registration of the ASF on 28 August 2005 and the ARP Growth Fund on 1 July 2007;
- Mr John Hempton's letter to ASIC Chairman, Mr Tony D'Aloisio, on 16 September 2009, alerting ASIC to potentially fraudulent activity in the ASF (see below);
- ASIC's investigation of the conduct of Trio from October to December 2009 (see chapter 4);
- APRA's suspension of Trio's licence as the trustee of four superannuation funds and one pooled superannuation trust on 17 December 2009 (see chapter 4);
- the winding up of the ARP Growth Fund in April 2010;
- the resolution of creditors to place Trio Capital into liquidation in June 2010;
- the government's decision in April 2011 to provide nearly $55 million in compensation for investors in APRA-regulated superannuation funds that were under the trusteeship of Trio Capital (see chapter 3); and
- the jailing of former Trio director Mr Richard in August 2011.

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41 APRA, *Submission 41*, p. 4.

42 APRA, Enforceable Undertakings Register http://www.apra.gov.au/CrossIndustry/Pages/EnforceableUndertakings.aspx (accessed 1 May 2012).

Table 2.2: Trio timeline[43]

Date	Event
Early 2003	ASIC issues Financial Services Licence to Wright Global Asset Management (WGAM)
2003	Mr Shawn Richard and Mr Anthony Littauer advises Mr Paul Gresham of their interest in acquiring a funds management business in Albury named Tolhurst Funds Management (later Astarra Funds Management) and Tolhurst Capital Limited (later Astarra Capital then Trio Capital)
November 2003	WGAM purchases Tolhurst Funds Management. Mr Shawn Richard, Mr Matthew Littauer and Mr Cameron Anderson (directors of WGAM) become directors of Tolhurst Funds Management
24 February 2004	PST Management Ltd becomes an authorised representative of Wright Global Investments Pty Ltd [controlled by Mr Jack Flader].
Early 2004	ASIC issues an Australian Financial Services Licence to Tolhurst Capital
May 2004	Tolhurst is renamed Astarra Funds Management. From May 2004 until September 2009, Trio operates as 'Astarra Capital Limited'
11 June 2004	Following a request by Paul Gresham, Trio becomes trustee of Professional Pensions Pooled Superannuation Trust (PPPST), replacing the Trust Company
2005	Morningstar commences publishing quantitative star ratings for some of the funds managed by Trio Capital Ltd (then known as Astarra Capital Ltd)
28 August 2005	Astarra Strategic Fund (ASF) is registered by Trio as a MI scheme through ASIC. Mr Shawn Richard is a director of Absolute Alpha, the investment manager of the ASF.
September 2006	KPMG conducts an audit of Astarra's Internal Compliance Plan
2006–2007	Research house Van Mac provides a report on Absolute Alpha giving it a 5 star rating
17 May 2007	Astarra Capital issues a product disclosure statement for ARP Growth Fund: Astarra is the Responsible Entity and PST Management Ltd is the Investment Manager. Both were linked to Jack Flader.
29 June 2007	Professional Pensions Pooled Superannuation Trust (PPPST) is wound up.
1 July 2007	The ARP Growth Fund is created to replace PPPST. Astarra Capital was also the Trustee of PPPST. Mr Gresham induced PPPST investors to reinvest in ARP.
September 2007	KPMG conducts an audit of Astarra's Internal Compliance Plan
30 May 2008	Mr Gresham resigns as a Director of PPARP and a new administrator is appointed
June 2008	Morningstar enters into a licensing agreement with Astarra Capital in June 2008, by which Morningstar is granted to Astarra Capital a non-transferrable, non-exclusive license to publish Morningstar Ratings on three of Astarra Capital's funds

43 Based on information in submissions provided by ASIC, APRA, PPB Advisory, ARP Unitholders, Mr Colin Warne, the enforceable undertaking accepted by Mr Paul Gresham and the ASIC and APRA websites.

Date	Event
September 2008	KPMG conducts audit of Astarra's Internal Compliance Plan
October 2008	APRA unsuccessfully seeks information about the valuation of Trio funds
6 February 2009	National Australia Trustees Limited is appointed by Trio as custodian, replacing ANZ Custodian Services
August 2009	Absolute Alpha is renamed as 'Astarra Asset Management' (AAM)
September 2009	KPMG conducts an audit of Astarra's Internal Compliance Plan
September 2009	Astarra Capital is renamed Trio Capital
16 September 2009	Mr John Hempton writes to the Chairman of ASIC expressing his concerns about the Astarra Strategic Fund
2 October 2009	ASIC commences an investigation into the conduct of Trio officers in relation to suspected contraventions of section 601FD of the Corporations Act
16 October 2009	ASIC issues an interim stop order on Trio preventing offers, issues, transfers or sales of interests in the ASF and certain other MI schemes for which Trio was the RE
November 2009	Pension payments and withdrawals from ARP Growth Fund are frozen by ASIC
2 December 2009	APRA issues a 'show cause' letter on Trio as to why it should not be suspended or removed as trustee
16 December 2009	Directors of PPB Advisory resolve to place Trio Capital and other associated companies (Astarra Funds Management Pty Ltd and ASI Pty Ltd) into voluntary administration.
17 December 2009	APRA suspends Trio's licence as the trustee of its four superannuation funds and one pooled superannuation trust
19 March 2010	Administrators approach the Supreme Court of NSW to have the following managed investment schemes wound up due to exposure to impaired assets: Astarr Wholesale Portfolio Service, Astarr Portfolio Service, Astarr Overseas Equities Pool, ASF and the ARP Growth Fund
April 2010	Report from liquidators PPB Advisory
April 2010	ARP Growth Fund is wound up by a court order issued by Justice Palmer
22 June 2010	Trio Capital is placed into liquidation by resolution of creditors
July 2010	PST Management is placed into liquidation
July 2010	Public examinations are undertaken in respect of Shawn Richard and Eugene Liu regarding the ASF.
29 July 2010	Initial report by PPB Advisory is lodged with ASIC regarding investigations into breaches by directors and officers of Trio Capital in relation to the ARP Growth Fund
3 August 2010	Ten schemes with minimal or no exposure to impaired assets are transitioned to Trust Company as the replacement Responsible Entity

Date	Event
7 December 2010	Mr Richard pleads guilty to two charges of dishonest conduct in the course of carrying on a financial services business and admits to a third charge of making false statements in relation to financial products.
13 April 2011	The Hon. Bill Shorten MP, Minister for Superannuation and Financial Services, issues a determination under Part 23 of the SIS Act, for a grant of $54,994,079 to be paid to the acting trustee ACT Super for payment to the members.
18 May 2011	PPB issues a report noting its investigations into the role of KPMG and WHK in auditing Trio Capital
24 June 2011	ASIC accepts an enforceable undertaking from Kilara Financial Solutions Pty Ltd (Kilara) to modify aspects of its compliance culture and to remedy past compliance concerns in the provision of financial advice to retail clients. Kilara recommends that retail clients switch their superannuation holding into another fund, My Retirement Plan, which invested in either My Income Pool or My Growth Pool. Trio was the responsible entity for My Retirement Plan.
July 2011	Mr Richard is formally convicted of dishonest conduct in relation to the Trio fraud.
4 July 2011	ASIC issues a media release stating that ASIC will hold the gatekeepers to account. ASIC enters into enforceable undertakings with former directors of Trio, Mr Rex Phillpott and Ms Natasha Beck, preventing them from working in the financial services industry for 15 years and two years respectively. APRA also accepts enforceable undertaking from Ms Beck.
5 July 2011	ASIC announces that it has suspended the AFS licence held by Seagrims Pty Ltd (Seagrims) until 27 November 2011. Mr Peter Seagrim and Ms Anne-Marie Seagrim, both of Port Augusta, who are the directors and responsible managers of Seagrims, are banned by ASIC from providing financial services for three years.
11 August 2011	ASIC enters into an enforceable undertaking with former chairman and director of Trio, Mr David Andrews, preventing him from acting in any role within the financial services industry for nine years. With the exception of a small private company in which Mr Andrews is sole director, Mr Andrews also agrees not to act as a director of any corporation for nine years.
12 August 2011	Justice Garling sentences Mr Richard to a total of three years and nine months imprisonment with a minimum term of two years and six months
24 August 2011	ASIC enters into enforceable undertakings with former Trio directors, Mr Keith Finkelde and Mr David O'Bryen, preventing them from taking part in the management of companies and providing financial services for four years each.
6 September 2011	APRA accepts enforceable undertakings from Mr Rex Phillpott for a period of 15 years and Mr David Andrews for a period of 10 years.
12 September 2011	APRA accepts enforceable undertakings from Mr Keith Finkelde for a period of six years.
27 October 2011	APRA accepts enforceable undertakings from Mr David O'Brien for a period of five and a half years.
1 February 2012	ASIC accepts an enforceable undertaking from Mr Gresham, permanently preventing him from working in the Aust'n financial services industry or managing a corporation.

Date	Event
10 February 2012	ASIC accepts an enforceable undertaking from ASF auditor, Mr Timothy Frazer of WHK. Mr Frazer will not act as a registered company auditor for three years.
5 March 2012	APRA accepts an enforceable undertaking with no expiry date from Mr John Godfrey, a former director of Trio. Mr Godfrey was a non-executive director of Trio from February 2005 until June 2007. He was also Chairman of the Board from June 2005 to February 2007.

Chapter 3

The impact on Trio Capital investors and the issue of compensation

3.1 This chapter considers the effect that the collapse of Trio Capital has had on investors. The committee received several submissions and took evidence from various people who were defrauded of their superannuation through their investment in Trio Capital. An important part of this inquiry is to acknowledge their story and their hardship.

3.2 The terms of reference for this inquiry direct the committee to address the issue of access to compensation and insurance for Trio Capital investors, including in circumstances of fraud. This second part of this chapter details the current compensation regimes in Australia for investors. It then considers the adequacy of compensation available to those caught by the Trio Capital collapse.

The impact on investors

3.3 This inquiry has gathered considerable evidence detailing the catastrophic effect that the collapse of Trio Capital has had on many investors. Forty-four of the 74 public submissions received by the committee were from individual submitters (or couples) who had been defrauded of their superannuation. The committee also held a community forum in Thirroul, north of Wollongong, to take evidence in public session from 11 Trio Capital investors.

The financial impact

3.4 The extent of the financial losses to investors was considerable. Mr Shayne and Mrs Tracey Bonnie from Wollongong told the committee that:

> Our position at the moment is that Astarra has pretty much wiped us out. We had $169,000 stolen from our self-managed super fund and another $57,000 stolen from money that we invested using a margin loan. Before we started all this, our previous super balance was about $300,000, which was 20 years of investing the maximum amount that we could the whole time. After the $169,000 was stolen we had to start selling off our superannuation portfolio at a loss to pay margin calls, of which we had had none up to that stage. We are now left with a balance of $60,000 in super. We also had to contribute extra cash into our super to prop up the other investments; otherwise, we would have lost them as well. So any extra contributions are gone now; we cannot access them until we reach retirement age.[1]

1 Mr Shayne Bonnie, *Committee Hansard*, 6 September 2011, p. 7.

3.5 Mr Nicholas McGowan also made a significant investment in the Astarra Strategic Fund (ASF). He told the committee that he and his wife had investments worth 'about $185,000 in super and nonsuper' in the Fund. He added:

> Due to the recent falls in the share market, we have been forced to sell our remaining investments outside of super in Australian shares, as our loan-to-value ratio imposed by the margin lender exceeded the maximum allowed. I have taken the time to calculate that we would not have had to sell shares if Astarra had not been a fraud. I had a conservative LVR [loan to value ratio] of 40 per cent when Astarra froze, and this would now be at 51 per cent if Astarra still had legitimate value. This is still about 30 per cent away from a margin call, even after the dramatic falls in the market we have seen in recent months.[2]

3.6 Mr Ian Hogg, a pharmacist, lost close to $300,000 in the Trio collapse. As a result:

> ...I will be working for the next five years approximately six days a week. Today it is costing me more money to come here because I am working as a relieving pharmacist. ...I lost $298,000, and there were other moneys which have obviously decreased because of the global financial crisis. So I am down to about 35 per cent of what I had and, as I say, I am 60.[3]

3.7 Another submitter, who asked for their name to be withheld, is also faced with significant losses:

> The collapse of Trio caused a write off of the value of our Astarra Strategic Fund “assets” leaving us with high loan to value ratios close to the buffer zone. With the recent downturn in the share market we were forced to first inject cash, then sell off a good portion of other shares to avoid a margin call.
>
> This has left us with an investment portfolio with a value about one quarter of where we started in 2007, and still with an outstanding loan amount to pay off. Our superannuation value has also been reduced to the level that it was about 20 years ago when we were new investors.[4]

3.8 Mr Ross Tarrant, who was responsible for advising many of those who lost money in the Trio Capital collapse, listed in his submission 25 people (by occupation and by relationship to Mr Tarrant) who had lost sums ranging from $602 183 to a little over $5000.[5]

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2 Mr Nicholas McGowan, *Committee Hansard*, 6 September 2011, p. 18.

3 Mr Ian Hogg, *Committee Hansard*, 6 September 2011, p. 23.

4 Name withheld, *Submission 56*, pp 1–2.

5 Mr Ross Tarrant, *Submission 35*, p. 2.

3.9 Mr Ron Thornton, the President of the Association of ARP Unitholders, noted that his 74 members incurred losses of approximately $58 million. He told the committee:

> All of the unit holders have self-managed superannuation funds and their loss represents the majority of their superannuation savings. This represents a financial wipe-out in their later years when they are unable to return to the workforce to fund their retirement, as 91 per cent are over 60 years of age and 68 per cent are over 65 years of age. Two years have elapsed since the collapse of Trio and unit holders have received no response with respect to where their superannuation investment is and how much, if any, remains.[6]

The emotional impact

3.10 In addition to significant financial losses, the Trio collapse also exacted a heavy social and psychological toll on investors. Mr Tarrant recognised the impact on these people:

> As advisor to 220 people who trusted me with their lifetime savings and future financial well being, they have now lost approximately $25 million as a direct result of my financial advice by including ASF into our client portfolios. The hardship, frustration, despair and heartache endured by these people is not able to be captured by words on pieces of paper or understood by those unaffected. The sleepless nights, worry, nervousness, disbelief and anger are the side effects to the reality that financial security has been lost, assets sold, and replaced with uncertainty and angst. Some people have taken on a second job, others are working overtime, some have extended retirement for another 5 or 10 years, some have returned to work and others are not as fortunate.
>
> All have had their mental and/or physical health affected with at least one suffering a heart attack. Most have had marital problems with at least one couple divorcing. As a self employed Accountant and Financial Advisor for in excess of 23 years, the people my advice has affected include people from all walks of life, some known to me personally, all known to me professionally.[7]

3.11 Mr Shayne and Mrs Tracey Bonnie explained the impact on them and their family:

> We haven't lost our house yet but we are living from month to month. Every couple of months we are reviewing our budget to see whether we can continue or need to sell up. We downsized our car and family holidays have

6 Mr Ron Thornton, President, Association of ARP Unitholders Inc., *Committee Hansard*, 30 August 2011, p. 18.

7 Mr Ross Tarrant, *Submission 35*, p. 1.

been scrapped. It is very hard explaining to our kids why life has changed so much.[8]

3.12 Mr John Telford, a Wollongong-based investor who suffered substantial financial losses, criticised the light sentence for Mr Richard given the significant financial and emotional toll on investors:

> I certainly paid more personally for Richard's crime and my punishment continues my lifetime. Richard was given a deal, no one offered me a deal. I could not attend the court case on Friday 12 August, so I do not know what unfolded in the proceedings. The newspaper coverage made no mention about a defense standing-up for the victims of this horrendous crime. ASIC and APRA did not present the suffering and anxiety Richard's devastating crime caused to the elderly retirees - some too old or infirm to reenter the work force.[9]

3.13 Mr Telford added:

> Had ASIC shown its own findings to the court, such as;
>
> > 'It found some investors suffered “catastrophic loss”, which meant “their life will never be the same”. Some felt prolonged anger, uncertainty, worry and depression. Several lost their homes and many had been seriously ill since the loss. Many went without food on occasion and avoided heating or cooling their home. Those who were ashamed to tell others of their plight had isolated themselves from friends and family, and the impact had created long-lasting marital strain.'
>
> such evidence could have illustrated the harm Richard's fraudulent crime caused and continues to have its impact.[10]

3.14 Another investor wrote:

> I have not alluded to the emotional stress that this whole affair has had on me, even writing this submission has got me all worked up again. I know that I am not as badly off as some people who have lost a lot more than I did, I can’t begin to understand how traumatised they must be.[11]

3.15 As did submission 55 from a couple who asked that their name be withheld:

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8 Mr Shayne and Mrs Tracey Bonnie, *Submission 1, Supplementary Submission B*, p. 2.

9 Mr John Telford, *Submission 66*, pp 2–3.

10 Mr John Telford, *Submission 66*, p. 3. The quote within this quote is sourced by Mr Telford as: 'Investors gutted by financial losses—study by Nicole Hasham', May 30 2011 http://www.illawarramercury.com.au/news/local/news/general/investors-gutted-by-financial-lossesstudy/2178201.aspx

11 Name withheld, *Submission 3*, p. 5.

> All of the drama has caused considerable mental anguish with sleepless nights and bickering which was worst [sic] than any financial loss.[12]

3.16 The fact that so many of those who made submissions asked for their name to be withheld, or for their submission to be confidential, is another indicator of the embarrassment and anguish that can accompany financial losses. The committee also acknowledges that the stated motivation for investing in the Trio Capital funds was to prepare adequately for retirement, and not to be a burden on future governments through drawing a pension.

3.17 Yet another individual who asked that their name be withheld put it this way:

> We, like so many other investors in SMSF's, were trying to get our superannuation and investments to the point where we could live off them in retirement comfortably with no reliance on a Government pension. We believed that we were doing everything correctly as desired by the Government to provide ourselves with a fully self funded future in retirement. Our retirement will now be reliant on the pension.[13]

Committee view

3.18 The committee is extremely troubled by the impact that the Trio fraud has had on a substantial group of Australians. The evidence presented above highlights the considerable emotional and financial burden on individuals and families. In many cases, Australians who had saved for many years to provide for their retirement were defrauded of the entire balance of their retirement savings, which in some cases exceeded $1 million. It is particularly saddening that this fraud appears to have fallen heavily on many people who had made particular and conscientious efforts over many years to accumulate and manage savings so that they would not be required to rely on the pension.

Compensation arrangements for investors affected by fraud or misconduct

3.19 The second part of this chapter deals with the matter of compensation. There are two statutory compensation schemes that are relevant to investors affected by the collapse of Trio Capital. The first, a compensation scheme under the *Corporations Act 2001*, exists for consumers who receive a financial product or service from Australian Financial Services Licensees (AFSLs). The second, established under the *Superannuation Industry (Supervision) Act 1993*, operates for superannuation funds regulated by the Australian Prudential Regulation Authority (APRA).

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12 Name withheld, *Submission 55*, p. 1.

13 Name withheld, *Submission 56*, p. 2.

Compensation under the Corporations Act 2001

3.20 Division 3 of Chapter 7 of the *Corporations Act 2001* (the Corporations Act) prescribes the obligations and duties AFSLs must observe. The obligations and duties of AFSLs, prescribed by Division 3 of Chapter 7 of the Corporations Act, include an obligation to 'do all things necessary to ensure that the financial services covered by the license are provided efficiently, honestly and fairly'[14] and require that the AFSL 'have a dispute resolution system' in place.[15]

3.21 In addition to those duties, Section 912B of the Corporations Act requires that AFSLs providing services to retail clients must have arrangements to compensate clients for any damage suffered due to a breach of a Chapter 7 obligation.[16] Subsections 912B(2)–912B(4) state that the compensation arrangements must:

> (2)(a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind—satisfy those requirements; or (b) be approved in writing by ASIC.
>
> (3) Before approving arrangements under paragraph (2)(b), ASIC must have regard to: (a) the financial services covered by the licence; and (b) whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue; and (c) any other matters that are prescribed by regulations made for the purposes of this paragraph.
>
> (4) Regulations made for the purposes of paragraph (3)(c) may, in particular, prescribe additional details in relation to the matters to which ASIC must have regard under paragraphs (3)(a) and (b).[17]

3.22 In its *Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees*, the Australian Securities and Investments Commission (ASIC) states that the requirement to have sufficient compensation arrangements in place is met by an AFSL having adequate professional indemnity insurance:

> If you provide financial services to retail clients, you must have arrangements for compensating those clients for breaches of Ch 7 of the Corporations Act. The primary way to comply with this obligation is to have professional indemnity (PI) insurance cover.[18]

3.23 The Guide also states that ASIC considers that adequate professional indemnity insurance:

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14 Paragraph 912A(1)(a), *Corporations Act 2001*.

15 Paragraph 912A(g), *Corporations Act 2001*.

16 Section 912B, Chapter 7, *Corporations Act 2001*.

17 *Corporations Act 2001*, section 912B

18 Australian Securities and Investments Commission, *Regulatory Guideline 126 – Compensation and insurance arrangements for AFS licensees*, December 2010, p. 4.

> ...depends on all the facts and circumstances—including the nature, scale and complexity of your business, and your other financial resources.[19]

3.24 The process for determining adequacy however is one of self-assessment:

> It is up to you to determine what is adequate PI insurance to meet your obligations under s912B and obtain such PI insurance...
>
> ...[W]e will not 'approve' your PI insurance arrangements.
>
> You should also have a process of ongoing assessment of your PI insurance to ensure it remains adequate.[20]

Compensation under the Superannuation Industry (Supervision) Act 1993

3.25 The *Superannuation Industry (Supervision) Act 1993* (SIS Act) also requires that superannuation funds make provision to make some measure of compensation for investors who incur losses as a result of the fraud or misconduct of a trustee(s).[21] Part 23 of the SIS Act makes provision for financial assistance for certain superannuation entities that have suffered loss as a result of fraudulent conduct or theft.[22] Section 229 prescribes that:

> (1) If:
>
> (a) a fund suffers an eligible loss after the commencement of this Part; and
>
> (aa) at the time it suffers the loss, the fund is:
>
> (ii) a regulated superannuation fund (other than a self-managed superannuation fund); or
>
> (iii) an approved deposit fund; and
>
> (b) the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits; a trustee of the fund may apply to the Minister for a grant of financial assistance for the fund.
>
> (2) The application must be in writing and be accompanied by such information as the Minister determines.
>
> (3) To avoid doubt, an application may be made under this section by a trustee of a self-managed superannuation fund as long as the fund met the requirements in subsection (1) at the time the fund suffered the loss to which the application relates.[23]

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19 Australian Securities and Investments Commission, *Regulatory Guideline 126 – Compensation and insurance arrangements for AFS licensees*, p. 15.

20 Australian Securities and Investments Commission, *Regulatory Guideline 126 – Compensation and insurance arrangements for AFS licensees*, December 2010, p. 15.

21 Section 227, Division 1, Part 23, *Superannuation Industry (Supervision) Act 1993*.

22 Section 227, Division 1, Part 23, *Superannuation Industry (Supervision) Act 1993*.

23 Section 229, *Superannuation Industry (Supervision) Act 1993*

3.26 Where an application is made, and the Minister is satisfied that the fund has suffered an eligible loss, the Minister can determine whether the public interest requires that a grant of assistance be made to the fund. In those situations where a grant of assistance is made the compensation paid can be recovered by the use of a levy on APRA-regulated superannuation funds and approved deposit funds.[24]

3.27 Part 23 of the SIS Act specifically excludes self managed superannuation funds (SMSFs) from this regime. Accordingly, SMSFs ability to claim compensation for fraud is limited to the provisions in the Corporations Act. As a result, SMSFs would be required to pursue compensation for fraud via a professional indemnity insurance claim against the AFSL, on whose advice they relied.

3.28 In its submission, Treasury explained the rationale for excluding SMSFs from Part 23 of the SIS Act:

> The financial assistance scheme under Part 23 of the SIS Act does not apply to SMSF trustees, on the basis that they have direct control over their superannuation savings. Consequently, SMSFs are not required to pay any financial assistance levy imposed on APRA-regulated superannuation funds when compensation is paid under the scheme.
>
> Excluded funds, the precursors of SMSFs, were specifically excluded from the financial assistance scheme when it was first introduced with the SIS legislation in 1993.
>
> The scheme has been reviewed several times over the past two decades. The reviews consistently confirmed the exclusion of SMSFs from the scheme.[25]

3.29 These reviews included the Financial System Inquiry (Wallis Inquiry) in 1997, the Review into the operation of Part 23 of the SIS Act in 2003 and the Super System Review in 2010.[26]

3.30 In case of Trio Capital, investors who suffered loss through an APRA regulated fund were eligible for compensation pursuant to Part 23 of the SIS Act. Those who had invested in Trio through an SMSF on the advice of an AFSL are limited to pursuing compensation through their financial advisor's professional indemnity insurance.

The government's compensation of Trio investors

3.31 On 13 April 2011, the federal government announced that based on the application of the acting trustee of the four Trio funds, ACT Super Management Pty Ltd, the government would be providing approximately $55 million in financial

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24 Treasury, *Submission 28*, p. 1.

25 Treasury, *Submission 28*, p. 2.

26 Treasury, *Submission 28*, p. 2.

assistance for Trio investors who had invested via an APRA-regulated fund. The then Minister for Financial Services and Superannuation, the Hon. Bill Shorten MP, stated:

> Over 5,000 victims of fraud from the collapse of Trio Capital Limited (Trio), will be compensated for their loss, following a Government decision announced today...
>
> Investors in APRA regulated funds deserve to be compensated by the Government when they lose their investments through fraud or other malfeasance by super fund trustees. I'm very pleased to be able to offer Trio investors this compensation...
>
> The assistance to the trustee, granted under Part 23 of the Superannuation Industry (Supervision) Act 1993, is for the Astarra Superannuation Plan, the Astarra Personal Pension Plan, the My Retirement Plan and the Employers Federation of NSW Superannuation Plan (the superannuation funds).
>
> Based on the application from the Australian Prudential Regulation Authority (APRA)-appointed acting trustee of the four superannuation funds, ACT Super Management Pty Limited, and advice from APRA, I am satisfied the four superannuation funds have suffered an eligible loss under the Act and the public interest requires a grant of financial assistance be made...
>
> The grant of financial assistance will be recovered by way of a levy on regulated superannuation funds under the Superannuation (Financial Assistance Funding) Levy Act 1993.[27]

3.32 It is important to note that the compensation arrangements do not prevent a loss being incurred. The effect of this compensation arrangement is to reallocate the losses suffered to APRA-regulated superannuation fund investors. Rather than the losses falling narrowly on a small group of investors, it is spread across all Australians who have invested in an APRA-regulated superannuation fund.

3.33 The committee believes that these arrangements are appropriate in a compulsory tax preferred retirement savings system, where individuals rely on prudentially regulated and licensed trustees. The mechanism is accepted by the superannuation funds, results in minimal cost to the totality of savings and is critical to maintaining ongoing confidence in the financial system.

27 The Hon. Bill Shorten, Assistant Treasurer, Minister for Financial Services and Superannuation, 'Financial Assistance to Trio's Superannuation Fund Investors', Media Release No. 51, 13 April 2011, http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/051.htm&pageID=003&min=brs&Year=&DocType=0, (accessed 8 November 2011).

The limits of the government's compensation package

3.34 Chapter 2 noted ASIC's estimate that there were around 690 direct investors in the ASF not eligible for financial assistance. Of these, around 285 are SMSFs and the balance either individuals, corporations or trusts.

3.35 The government's decision under provisions of the SIS Act to restrict compensation to investors in APRA-regulated funds involved in the Trio collapse received criticism from submitters to the inquiry. The basic argument is that investors in SMSFs should be covered for loss due to fraud or misconduct by an AFSL, in the same way that investors in APRA-regulated superannuation funds are currently protected.

3.36 As noted, SMSF investors in Trio acting on the advice of an AFSL are limited to pursuing compensation through their financial advisor's professional indemnity insurance. The avenue is provided for under the Corporations Act, although even here, they are restrictions. As the Association of Superannuation Funds of Australia noted in its submission:

> The current compensation arrangements under Chapter 7 of the Corporations Act 2001 (Corporations Act) are predicated upon the licensed financial services or product provider (financial provider) having in place adequate and sufficient professional indemnity insurance (PII) to assist in meeting a compensation claim. There will be circumstances, however, where PII is inadequate, or unavailable, to respond to a claim for compensation.[28]

The Richard St. John Review

3.37 A government-commissioned review of the need for, and costs and benefits of, a statutory compensation scheme has noted that there will be circumstances where professional indemnity insurance is insufficient and will not provide victims of fraud any compensation. In an April 2011 consultation paper, the review's principal, Mr Richard St. John, stated:

> There are some limits to the effectiveness of professional indemnity insurance as a mechanism for compensating retail clients who suffer a loss as a result of a licensee’s misconduct. As stated in RG 126, ASIC intends to administer the professional indemnity insurance framework to reduce the risk, as far as possible, that retail clients go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients. However, professional indemnity insurance is an imperfect mechanism to achieve this protection for consumers.
>
> In evidence to the PJC [Parliamentary Joint Committee on Corporations and Financial Services] Inquiry, ICA [Insurance Council of Australia] noted that it is problematic to try to make a commercial product into a

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28 The Association of Superannuation Funds of Australia Limited, *Submission 31*, p. 2.

> compensation mechanism. ASIC is also of the view that there are inherent limitations on the effectiveness of professional indemnity insurance as a compensation mechanism for retail investors who suffer loss.
>
> The obligation to meet a successful compensation claim rests with the licensee in question. If, for whatever reason, the licensee's professional indemnity insurance policy does not respond to such a claim, the licensee is left to meet the liability from its own resources.[29]

3.38 Similarly, the review also noted that there will be 'various circumstances' where a claim against a professional indemnity insurance policy cannot be paid, whether in full or in part, to the claimant. In these circumstances, the licensee remains liable to meet that claim from its own resources. It continued:

> The claimant is then exposed to the risk that the licensee will not be in a position to meet the claim owing to the closure of its business, insolvency or other reason. Where the licensee has become insolvent in the absence of insurance, the claimant's only avenue for compensation is through the liquidation process. As an unsecured creditor the claimant is unlikely to recover all, if any, of its claim.
>
> The essence of the problem for a claimant, where a licensee is not able to look to an insurer to cover a claim, is that the licensee may be insolvent (or become insolvent as a result of claims against it), is no longer trading or in a position to provide compensation.[30]

3.39 It is precisely this issue that has frustrated many SMSF investors in Trio seeking compensation, leading to calls for these investors to be covered under Part 23 of the SIS Act. Mr Paul Cohen, who lost his life savings in the collapse, commented on ASIC's admission that the professional indemnity insurance regime for AFSLs is inadequate:

> We have no compensation because we are a SMSF which is grossly unfair. In relation to my circumstances (the ARP Growth Fund) the total amount of Indemnity Insurance available in the various related entities policies is so small ASIC are not in a position to sue. This is puzzling as how could ASIC have complied with their own guidelines on adequate insurance for financial services licensees?[31]

3.40 In similar vein, Mr Roy and Mrs Barbara Fowler observed:

> ...ASIC has said that in the ARP collapse the total amount of Indemnity Insurance available in the various directors and entities policies (excluding Auditors we would think) is so small it is not a proposition to sue. If that is

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29 Richard St. John, *Review of compensation arrangements for consumers of financial services*, April 2011, pp 52–53.

30 Richard St. John, *Review of compensation arrangements for consumers of financial services*, April 2011, p. 56.

31 Mr Paul Cohen, *Submission 20*, p. 3.

> so, then how could ASIC have complied with its own regulatory guidelines on adequate insurance for financial services licensees?[32]

3.41 Mr Cohen also queried the consistency of ASIC's approach to retrieving funds, contrasting its response to retrieving funds from Trio's auditors with its response to other financial collapses. He wrote:

> In cases such as the Westpoint collapse ASIC it seems, took action against auditors to get investors funds and we ask that ASIC take this action against the auditors in the case of The ARP Growth Fund as well.
>
> We are the victims of what is described as the biggest superannuation scam in Australia’s history but unlike Westpoint and/or Storm there is no compensation for us. We relied on the regulator to ensure regulatory compliance and under ASIC’s nose the TRIO situation was allowed to occur.[33]

3.42 A submitter, who asked that their name be withheld, queried why compensation arrangements for SMSF investors in Trio should be any different from Trio investors through APRA-regulated superannuation funds:

> It is illogical and unfair to not compensate retail or SMSF investors...when the same Trio Capital and associate entities that were entrusted with retail investors funds were also involved with the superannuation investments that were compensated, and supposedly licensed and regulated by the Government bodies mentioned above. In other words, if the conduct of Trio Capital and its (mis)management of superannuation funds was such that it was necessary to compensate $55 million of those funds, then ordinary retail investors’ funds that Trio Capital also (mis)managed should also be due compensation.[34]

3.43 With reference to SMSF investors in Trio, the submitter underlined a qualitative distinction between market based losses and losses through fraud and theft. In the latter case, which was the Trio experience, the submitter cited strong grounds for compensation:

> Considering that we investors were doing the right thing by providing for our own future retirement needs, and the probability of fraud, also supports the need for Government compensation of all investors. The Astarra investment was not supposed to be a quick rich scheme; it was recommended by a Wollongong financial planner as a way of diversifying into international shares, with the argument that such diversification into international shares was necessary because the Australian share market was only 2% of the world’s market. Astarra was advised to be a fund that invested in international shares, and hence a reasonable assumption was

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32 Mr and Mrs Roy and Barbara Fowler, *Submission 17*, p. 3.

33 Mr Paul Cohen, *Submission 20*, p. 3.

34 Name withheld, *Submission 18*, p. 2.

> that a complete loss of the funds would be dependent upon all the international companies in the fund going bust. However, it would seem that no such foreign share purchasing occurred; rather, the funds were likely stolen. It is understood that investing involves market volatility, but the occurrence of loss through fraud is an entirely different matter.[35]

3.44 As Chapter 6 of this report emphasises, many SMSF investors were given advice by financial planners to invest in Trio. Many, if not most of these investors were unaware of the limits on compensation in the event of fraud. In any event, their investment primarily reflected the advice of their adviser, and their basic confidence in Australia's financial regulatory framework. The following extract from one submission gives a good sense of this mindset:

> We took their advice [financial planners], understanding the risks of our growth investment strategy, but confident in the knowledge that our loan to value ratio was not high and we had many years to retirement to weather any market downturns.
>
> My wife and I both rolled over our industry regulated superannuation funds into our SMSF. At the time we were not aware that SMSF's were not covered by fraud compensation, but if we were we would probably have proceeded anyway as we thought it inconceivable that any regulated and approved investment, managed fund, or licensed managers or directors in the Australian financial system could be fraudulent.[36]

A last resort compensation scheme

3.45 Following the collapse of several large financial service providers, most notably Storm Financial in 2009, this committee undertook an inquiry into financial products and services in Australia. During the course of its investigations, the committee formed the view that current compensation arrangements are inadequate, and that more work was needed to determine whether a statutory compensation regime would be cost effective and desirable in Australia. Accordingly, the committee recommended that the government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.[37]

3.46 As part of the Future of Financial Advice (FoFA) reforms announced on 26 April 2010, the government commissioned Mr Richard St. John to undertake a review to consider the need for, and costs and benefits of, a statutory scheme to compensate consumers of financial services. In announcing the review, the government identified that it was to be initiated in response to this committee's November 2009 recommendation. The final Richard St. John report was released in

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35 Name withheld, *Submission 18*, pp 2–4.

36 Name withheld, *Submission 56*, pp 1–2.

37 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, p. 146.

May 2012. The concluding part of this chapter presents some of the findings of that report and the committee's view on these findings

3.47 The SMSF Professionals' Association of Australia (SPAA) noted that the issue of financial loss due to misconduct or insolvency is not limited to superannuation, but is a broader issue affecting all investors. It argued that currently:

> In SPAA's view there is inadequate protection against misconduct and insolvency of an Australian Financial Services (AFS) licensee for those who invest through SMSFs as opposed to other investment vehicles. SMSF members are mostly retail investors who are less able to absorb investment losses when compared with larger funds of the kind regulated by APRA. SMSF members are similar and aligned to ordinary investors in the marketplace and are not similar to APRA regulated fund members.
>
> SPAA acknowledges that SMSF investors make a consensual decision to make their own investment decisions but in SPAA's view that should not result in SMSF members being left to fend for themselves if they lose money due to the misconduct or insolvency of an AFS licensee.[38]

3.48 The Association of Superannuation Funds of Australia (ASFA) supported the introduction of a last resort compensation scheme.

> Given that, within the financial sector, the consumer is the least able to withstand the loss caused by a financial provider's breach or misconduct, it would seem apposite to introduce a statutory scheme of last resort to compensate consumers for such losses, in circumstances where the financial provider is insolvent and therefore unable to pay the compensation.
>
> ASFA submits that such a scheme should be statutory and should be utilised only as a scheme of "last resort", where the financial provider whose breach or misconduct caused the loss, which gave rise to the successful claim for compensation, is insolvent.[39]

3.49 SPAA also supported the introduction of a last resort compensation scheme. It argued that this is needed to improve consumer trust and confidence in the financial services industry.[40]

3.50 Other organisations were critical of a last resort compensation scheme. The Financial Planning Association, for example, stated that it is:

> ...unable to support a proposal for a last resort compensation scheme until the regulatory and compensation framework is able to ensure that each participant in the financial services industry has responsibility and financial

38 SMSF Professionals' Association of Australia, *Submission 44*, p. 3.

39 The Association of Superannuation Funds of Australia Limited, *Submission 31*, p. 6.

40 SMSF Professionals' Association of Australia, *Submission 44*, p. 3.

> accountability to the end consumer for their role in ensuring the effective and ethical delivery of products and services.[41]

3.51 According to the FPA, this change requires a 'complete overhaul' of the existing financial services compensation regime, which attaches responsibility for compensation to the parties with a causal link to the fault.[42]

3.52 CPA Australia also raised concerns with the appropriateness of a last resort compensation scheme given dilemmas with equitably compensating investors and the potential for 'moral hazard':

> The difficulty with a universal compensation scheme for direct investors is who pays for it and should all investors be levied at the same rate irrespective of the risk they take on? If a levy is charged on all investment products, inequitable situations may arise where investors in conservative or low risk investment products or major institutions are funding a scheme they may never use and that is more likely to used by investors in ‘riskier’ investment products. Conversely, if a levy was limited to particular products the cost may well be prohibitive for individual investors.[43]
>
> ...
>
> Depending on the make-up of a universal compensation scheme, the potential ‘moral hazard’[44] would also need to be considered. Investors may be encouraged to make riskier investment decisions and product providers market more high risk products if they believed they may be compensated if these investments failed.[45]

3.53 The Australian Taxation Office (ATO), the current regulator of SMSFs, also expressed concern that the introduction of a last resort compensation could result in investors engaging in riskier behaviour. It argued:

> Across a large population of people such as SMSF trustees a level of incorrect or inappropriate, and borderline, claims will inevitably arise. The range of matters giving rise to such cases would be expected to include:
>
> —misunderstanding about the criteria for compensation (e.g. claims in relation to ‘poor’ professional/investment advice are likely – there is a fine line between a ‘bad’ investment and a fraud);

41 Financial Planning Association of Australia, *Submission 46*, p. 36.

42 Financial Planning Association of Australia, *Submission 46*, p. 36.

43 CPA Australia, *Submission 34*, p. 2.

44 Moral hazard refers to a situation where a party insulated from risk behaves differently from how it would behave if it were fully exposed to the risk – risk arises because a person will not bear the full consequences or responsibilities of their actions and therefore acts less carefully than they otherwise would.

45 CPA Australia, *Submission 34*, p. 2.

—attempts to give the greatest possible scope to the relevant criteria (e.g. would damage or tampering to an asset that reduces its value, perhaps to nil, amount to constructive theft of the value of the item?);

—where investments take a downturn, experience shows that some individuals can seek to engage in 'game playing' (e.g. given the absence of arms length arrangements between SMSFs and the individuals who run them, some individuals may be seek to interchange assets as between themselves and the fund where differing compensation arrangements apply).[46]

3.54 The ATO also highlighted that the introduction of a last resort compensation scheme would result in additional administrative and compliance costs, given that many cases would involve complex matters of legal interpretation.[47] It also anticipated difficult evidentiary issues, such as determining if losses were due to bad investments or actual fraud or theft. The ATO noted that to restrict the number of claims and the associated compliance and administrative costs, the government could restrict the type and the range of investments potentially subject to compensation, and/or restrict claims to material amounts over a specified threshold.[48]

The committee's view on SMSF investor compensation

3.55 Should there be a compensation scheme for those who invest through an SMSF and who lose money by reason of theft or fraud? There are several considerations that could bear on this question.

3.56 At face value, it may seem anomalous that there is no compensation scheme for SMSFs similar to the protections offered to investors in APRA regulated funds under Part 23 of the SIS Act. APRA regulated funds have the benefit of full-time professional managers, and yet the Act recognises that even these managers can fall victim to fraud in investing the money of their fund members. One could argue, therefore, that if there is a need for a compensation scheme covering money managed by professional managers, surely the need is even greater for money managed by individual investors. After all, SMSF investors will generally not have the same degree of professional skill as managers of APRA regulated funds.

3.57 Accordingly, a possible policy response would be to recommend a compensation scheme which provided compensation for money lost due to fraud or theft and was funded by a levy on SMSFs.

46 Australian Taxation Office, *Submission 27*, pp 3–4.

47 Australian Taxation Office, *Submission 27*, pp 3–4.

48 Australian Taxation Office, *Submission 27*, pp 3–4.

3.58 On balance, however, the committee does not support the introduction of a compensation scheme that places a levy on SMSF investors. It cites the following reasons:

- first, the whole notion of an SMSF is that—as its name suggests—the individual chooses to manage his or her own superannuation monies and act as the trustee of his or her own (small) fund. This brings with it greater risk and responsibility than being a member of an APRA-regulated fund. One of these responsibilities is to be alert to the risk of fraud and theft;
- second, SMSF investors, by definition, have chosen to 'go it alone'. A corollary of that choice is that if one investor does well and another does badly, there is no exposure to a levy or entitlement to compensate losses; and
- third, a compensation scheme should only be available in extreme circumstances. A system that effectively taxes the superannuation savings of all members to fund any losses incurred by any superannuation investor due to fraud or theft, must ensure that the circumstances in which the investor suffers loss or theft is minimised. With APRA regulated funds, the first line of defence against fraud and theft is a professional management team. By contrast, SMSF investors rely only on their own vigilance. Introducing a compensation scheme for SMSF investors would in effect expose all SMSF investors to bad decisions and lack of appropriate caution and prudence by other SMSF investors.

A levy on managed investment schemes

3.59 Another approach could be to examine the introduction of a compensation scheme for the situation where an investor in a managed investment scheme loses money by reason of fraud or theft on the part of the responsible entity of the managed investment scheme. A scheme along these lines could have provided protection to Trio investors. An SMSF investor who put money into the Astarra Superannuation Plan (of which Trio was the trustee), which was then invested in the ASF, would have been compensated through a levy on the ASF.

3.60 The committee recognises that the issues involved with a compensation scheme levying managed investment schemes would be complex. It raises the following questions:

- should the level of compensation be 100 cents in the dollar;
- should the compensation be funded by a levy on all managed investment schemes or only those in the same asset class; and
- how should fraud or theft be identified and who should make the determination?

The Richard St. John inquiry

3.61 In May 2012, the government-commissioned inquiry into a statutory scheme to compensate consumers of financial services delivered its final report.[49] Mr St. John concluded that it would be inappropriate to introduce a more comprehensive last resort compensation scheme. It argued that there would be an element of moral hazard if a last resort compensation scheme was introduced without a greater effort to put licensees in a position where they can meet compensation claims from retail clients. The report argued that this would reduce the incentive for stringent regulation of the compensation arrangements.

3.62 Instead, the St. John report concluded that priority should be given to improve the protection of retail clients through a more rigorous approach to compliance by licensees. In particular, it noted that the regulatory platform for financial advisers and other licensees needs to be more robust and stable before a safety net, funded by all licensees, is put in place.[50]

3.63 One of the report's key recommendations was that, to enable ASIC to play a more proactive role in administering the licensing regime with respect to compensation arrangements, it should be given clearer powers to enforce standards and to sanction firms. It recommended that one of these powers should be 'the ability to deal with disreputable industry participants'.[51] The report was unclear as to what these circumstances or these powers might be.

3.64 The St. John report did note that ASIC is able to take action on behalf of investors who have suffered a loss 'if it appears to be in the public interest to do so'. It identified cases where ASIC has succeeded in obtaining compensation for retail clients under section 50 of the ASIC Act. ASIC can take action to recover damages for fraud, negligence, default, breach of duty, or other misconduct. However, Mr St. John noted ASIC's position in choosing not to compensate Trio Capital investors under section 50 of the ASIC Act.

3.65 The St. John report did comment on compensation Trio Capital investors in APRA-regulated superannuation funds relative to the exposure of SMSF investors. The report stated:

> The policy rationale for the exclusion of SMSF trustees from Part 23 of the SIS Act is that, as trustees of their SMSF, they have direct control over their superannuation savings and unlike investors in other superannuation funds

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49 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. iii.

50 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. iv.

51 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 97.

> are in a position to protect their own interests. It would be difficult also to justify levying other funds for fraud perpetrated within a closely held SMSF. They are subject to a less onerous regulatory regime and are not subject to levies under the financial assistance provisions. It is understood that the assistance scheme in Part 23 has been affirmed in several reviews over the years. My own disposition is to regard SMSFs for this purpose as more akin to private investors than to the broader based APRA-regulated funds for the protection of whose members Part 23 is designed.[52]

3.66 Mr St. John argued that introducing a statutory scheme to underpin existing compensation arrangements would not in itself provide relief for consumers such as SMSF investors in Trio. He argued that the ability of these investors to claim compensation would still depend on them being able to show they had suffered loss as a result of a breach by a licensee of a relevant obligation (such as dishonest conduct). Further, he argued that it is 'questionable' whether the law could impose obligations on a licensee that would allow consumers to be compensated for the fraudulent impairment of the value of an asset.[53]

3.67 One option the committee has considered is to provide compensation for SMSF investors in the case of theft and fraud through imposing a levy on managed investment schemes. The St. John report questions the merit of this approach, however:

> Any move in that direction would, it is suggested, call first for a substantial upgrading of the regulatory regime for such schemes. It would be difficult to justify spreading the cost of investment losses through fraud across other scheme operators in circumstances short of some kind of prudential regime for those schemes.
>
> ...the regulatory treatment of managed investment schemes does not appear to provide a solid enough framework upon which to transfer to other licensees the cost of compensation for consumer loss resulting from licensee fraud. It would be difficult to justify a requirement for other licensees to pay compensation for a loss to consumers resulting from the deliberate actions of a fraudulent licensee for personal gain in the absence of some significant enhancement of the regulatory regime administered by ASIC.[54]

3.68 The committee agrees that there is a need to strengthen the regulatory regime for managed investment schemes (see recommendation 12). Mr St. John raises the possibility of imposing higher standards of risk management on managed investment

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52 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 97.

53 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 62.

54 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 62.

schemes. He noted that APRA regulated superannuation funds are currently required to have in place a risk management strategy dealing with the material risks of the trustees and each fund.[55] Imposing a similar system on management schemes, with independent assessment by an auditor, could help protect investors. However, Mr St. John adds that this system 'might be of limited value in circumstances where fraudulent conduct is endemic in the management and operation of a managed investment scheme'.[56]

3.69 In terms of whether SMSF investors in Trio Capital might be compensated through the retail client test in Chapter 7 of the *Corporations Act 2001*, Mr St. John argued the need for greater clarity on those circumstances in which trustees of SMSFs are treated as retail clients.[57]

Committee view

3.70 The committee notes that the recently commissioned St. John Review has considered the question of whether there should be a last resort scheme for financial services products, to compensate consumers of financial services in the event of loss suffered by reason of the product provider failing to operate to the appropriate standard. The St. John report recommends against such a scheme, amongst other things because it would impose upon well managed product providers the obligation to bear losses incurred by badly managed or negligent providers.

3.71 However, Chapter 6 of St. John's report sets out some elements of how such a scheme could work if government were to decide to proceed with such a scheme. The report states that SMSFs would not be included in the scheme.

3.72 The committee believes that if such a scheme were to be introduced, it could possibly have assisted SMSF investors in the Trio case. These investors lost their money because their SMSF invested in a managed investment scheme of which Trio was the responsible entity. Under the scheme described in Chapter 6 of the St. John Review, Trio would have been found to have failed to meet the relevant standard; Trio would have been liable to pay compensation to its investors; but being insolvent and unable to pay the compensation, the last resort scheme would have come into operation. SMSF investors (as well as direct investors) would have received compensation.

3.73 If the policy objections raised by Mr St. John to the operation of such a scheme can be overcome, the committee considers that it has merit and would have

55 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 63.

56 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 63.

57 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 65.

assisted to reduce the detriment suffered by innocent Australian investors in the Trio case.

3.74 Separately, the committee considers that there would be merit in establishing an insurance scheme to which SMSFs could 'opt-in', enabling them to have protection against loss by reason of fraud or theft. One possible way this could work would be for the ATO or ASIC, on behalf of the SMSF sector, to enter into arrangements with an insurer. The insurer would specify the amount of the premium it required to offer the insurance, and the premium would be collected from participating SMSFs each year, along with their tax, by the ATO, and paid to the insurer. The insurance policy would be written, as much as possible, so that the circumstances in which the SMSF could claim would be the same as the circumstances in which investors in an APRA regulated fund can claim compensation. Alternatively, the scheme could be administered by government.

3.75 The committee recommends that the government consider policy options for such an opt-in compensation scheme for SMSFs.

Specific compensation matters arising from Trio

3.76 The committee recommends that the government consider the specific question of compensation for those Australians who lost their SMSF balances as a result of the Trio collapse. In particular, several investors were induced to move their money from the Professional Pensions Pooled Superannuation Trust (PPPST) to the ARP Growth Fund in 2007. It is now known that ARP was a fraudulent scheme, leading to the money being lost. Given that Pooled Superannuation Trusts (PSTs) are regulated under the SIS Act and have the benefit of the compensation scheme in that Act, the question arises as to whether compensation is available because investors in PPPST lost money by reason of fraud or theft.

Recommendation 1

3.77 The committee acknowledges the shortcomings, identified by Mr Richard St. John, of a statutory compensation scheme for consumers of financial services, and a scheme of financial assistance for investors in managed investment schemes along the lines of Part 23 of the *Superannuation Industry (Supervision) Act 1993*. However, the committee recommends that further efforts be made to investigate avenues to protect investors in the case of theft and fraud by a managed investment scheme.

The committee recommends that the government assist those who invested in the Professional Pensions Pooled Superannuation Trust (PPPST), and were induced to move their funds to the ARP Growth Fund.

Chapter 4

The view of the regulators on the collapse of Trio Capital

Introduction

4.1 This chapter presents the view of the three main regulatory agencies—the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA)—on the collapse of Trio Capital. It details the regulators':

- key responsibilities in the oversight of the financial system;
- involvement in the Trio Capital case;
- apportionment of blame for the collapse of Trio;
- evidence that they communicated in their oversight of Trio; and
- suggestions to tighten the regulatory framework.

4.2 The chapter also presents the views of the Australian Taxation Office (ATO).

The key regulatory and oversight institutions

4.3 The following section outlines the responsibilities of APRA, ASIC and the ATO.

Australian Securities and Investments Commission

4.4 As chapter 1 noted, the regulatory framework for managed investment schemes and responsible entities was introduced in 1998 under Chapter 5C of the Corporations Act. It is a requirement that the Responsible Entity holds an Australian Financial Services Licence (AFSL) in operating the scheme, as part of providing a financial service under Chapter 7 of the Act.[1] It is ASIC's regulatory responsibility to grant and monitor AFSLs, oversee the registration of managed investment schemes, as well as risk based monitoring of conduct obligations under the *Corporations Act 2001*.[2]

4.5 Under the Corporations Act, responsible entities must meet minimum financial requirements to operate a managed investments scheme. ASIC's Regulatory Guide 166 states these requirements. They include that responsible entities must:

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1 KPMG, *Submission 69*, p. 6.

2 ASIC, *Submission 51*, p. 16.

- be solvent at all times;
- have total assets that exceed total liabilities;
- have sufficient cash resources to cover the next three months' expenses with adequate;
- cover for contingencies;
- provide an audit report for each financial year, including information about compliance with ASIC's financial requirements; and
- hold at all times minimum net tangible assets calculated on a sliding scale with a minimum requirement of $50,000 and a maximum of $5 million.[3]

4.6 The regulation of financial services providers has been designed to maximise market efficiency, with minimal regulatory intervention to protect investors.[4] As ASIC told the committee:

> The fundamental policy settings of the FSR [Financial Services Regulatory] regime were developed following the principles set out in the Financial System Inquiry Report 1997 (the Wallis Report). These principles are based on 'efficient markets theory', a belief that markets drive efficiency and that regulatory intervention should be kept to a minimum to allow markets to achieve maximum efficiency. The 'efficient markets theory' has shaped both the FSR regime and ASIC's role and powers.[5]

4.7 In describing the approach to regulation, ASIC stated:

> ...the underlying philosophy accepts that regulation is necessary to deal with factors that prevent the market operating efficiently (e.g. fraudulent conduct by market participants, information asymmetries and anticompetitive conduct). However, that regulation should be the minimum necessary to respond to market failures.[6]

4.8 Further, ASIC's submission noted that it 'seeks to balance investor protection with market efficiency', that consumer protection is afforded through conduct regulation and disclosure regulation and that:

> Efficiency, flexibility and innovation in the financial services industry are promoted by ensuring that these rules are at the bare minimum.[7]

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3 ASIC, *Regulatory Guide 166: Licensing, Financial requirements*, May 2012, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/RG166a.pdf/$file/RG166a.pdf (accessed 1 April 2012).

4 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, p. 7.

5 ASIC, *Submission 51*, p. 4.

6 ASIC, *Submission 51*, p. 12.

7 ASIC, *Submission 51*, p. 13.

4.9 ASIC sees its role as 'an oversight and enforcement body', adding:

> The FSR regime is largely self-executing: Australian Financial Services licensees and other participants are expected to comply with the conduct and disclosure obligations in the law. ASIC oversees compliance with these obligations and then takes appropriate enforcement action when there is non-compliance. ASIC's power to take action ahead of non-compliance is limited. [8]

4.10 In support of its role in relation to financial services regulation, ASIC uses a number of regulatory tools including: engagement with industry and stakeholders, surveillance, guidance, education, deterrence and policy advice.[9]

4.11 ASIC also has a role beyond the FSR regime.

> It also has responsibilities outside financial products and services regulation. ASIC is the corporate regulator, overseeing approximately 1.85 million Australian companies and their directors and officers. ASIC also regulates auditors, registered liquidators and credit providers.[10]

4.12 ASIC's role in relation to the collapse of Trio Capital was around the supervision of aspects that fall under the Corporations Act regime. These include amongst other things regulation of the responsible entity, supervision and regulation of the AFSL regime, supervision of the managed investment scheme environment, and regulation of compliance plan and risk management arrangements.

Australian Prudential Regulation Authority

4.13 Trio was a trustee holding a registrable superannuation entity licence under the *Superannuation Industry (Supervision) Act 1993*. As such, some of Trio's operations came under APRA's regulation.

4.14 APRA is the other key regulator involved in financial regulatory framework in Australia, and is 'the national regulator of prudential institutions—deposit takers, insurance companies and superannuation funds'.[11] In its submission to the inquiry, described its role and approach to supervision as follows:

> APRA's role is to promote prudent behaviour by superannuation funds through a robust prudential framework of legislation and prudential guidance which aims to ensure that risk-taking is conducted within reasonable bounds and that risks are clearly identified and well managed.

8 ASIC, *Submission 51*, p. 15.

9 ASIC, *Submission 51*, p. 15.

10 ASIC, *Submission 51*, p. 15.

11 Mr Jeremy Cooper, ASIC, *The integration of financial regulatory authorities – the Australian experience*, paper presented to 30th Anniversary Conference, 4 September 2006, p. 5.

> Unlike the banking and insurance sector, APRA does not have the power to issue prudential standards for superannuation funds.[12]

4.15 In supervising its financial institutions, including superannuation funds, APRA has developed a risk-based approach under which institutions facing greater risks receive closer supervisory attention. This enables APRA to deploy its resources in a targeted and cost-effective manner. The risk-based approach involves:

- licensing only those institutions that are likely to be able to meet their financial promises under all reasonable circumstances;
- regularly analysing the financial condition of institutions and reviewing their risk management to assess their relative risk of failure and whether they meet prudential requirements;
- responding to these assessments by tailoring APRA's supervisory activities to the risk profile of the institutions; and
- if necessary, taking enforcement action to protect the interests of beneficiaries or to make it clear that illegal or materially imprudent behaviour will not be tolerated.[13]

4.16 APRA's role in relation to Trio was as the regulator of registrable superannuation entities under the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

Australian Taxation Office

4.17 As chapter 1 discussed, the ATO also has a role as a regulator in relation to self-managed superannuation funds (SMSFs).

> The ATO administers the relevant superannuation laws for SMSFs, works with trustees to help them meet their obligations and verifies compliance. The ATO does not provide financial or investment advice, and does not undertake a prudential role similar to that undertaken by the Australian Prudential Regulation Authority (APRA).[14]

4.18 The Reserve Bank of Australia described the roles of the three regulators in relation to the SIS Act succinctly as follows:

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12 APRA, *Submission 41*, p. 5. The committee notes that the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 introduces the power for APRA to make prudential standards, amends section 52 of the Superannuation Industry (Supervision) Act 1993 to expand the duties for registrable superannuation entity (RSE) licensees, applies new trustee duties to RSE licensees of an RSE that offers a MySuper product and applies duties to the directors of corporate trustees. The committee reported on the provisions of this bill in March 2012.

13 APRA, *Submission 41*, pp 5–6.

14 ATO, *Submission 27*, p. 2.

> APRA regulates the superannuation funds' compliance with the prudential regulation and retirement income provisions of the *Superannuation Industry (Supervision) Act 1993*, while ASIC has responsibility for the other provisions. The Australian Taxation Office has responsibility for the regulation of excluded funds (i.e. funds that have less than five members).[15]

4.19 These three regulators, in addition to the gatekeepers described in detail in chapter 5 of this report, play an important role in shaping the events around the collapse of Trio Capital.

The regulators' view of the Trio Capital collapse

4.20 The remainder of this chapter presents the regulators' view of the collapse. Two points are clear. The first is both ASIC and APRA apportion significant blame for the collapse of Trio Capital on the gatekeepers, in particular the auditors. The second point is that, notwithstanding the role of these gatekeepers, there are lessons for both regulators including their communication with each other.

APRA's view

4.21 APRA gave verbal evidence to the committee on 30 August 2011 and 4 April 2012. At the first of these hearings, the Deputy Chairman, Mr Ross Jones, told the committee that before suspending Trio in December 2009, APRA had been seeking improvements in the management of superannuation funds by this trustee 'for a number of years'.

4.22 Indeed, APRA conducted no fewer than five prudential reviews of Astarra Capital between April 2004 and June 2009. Mr Greg Brunner, General Manager of Actuarial Market and Insurance Risk Services at APRA, gave the committee an overview of these reviews:

> We undertook a prudential review in April 2004 with the management and the board to set off some of the discussions about the trustees' application for a variation of instrument of approval. In November 2005 we held a prudential review which involved meetings with management and the trustee directors. This review covered a broad range of risk areas and involved discussion of the trustees' preparation for licensing. This was in the period in the run-up to the beginning of licensing for our registrable superannuation entities, the new licensing regime that had been put in place for superannuation funds. We had some preliminary discussions with the trustees about that...
>
> That was in November 2005. Then we conducted a prudential review in several stages between November 2006 and December 2006. This involved a review of the administration systems, an investment review and meetings,

15 Reserve Bank of Australia, website, http://www.rba.gov.au/fin-stability/reg-framework/apra.html , (accessed 1 November 2011)

> again, with board and management. The flavour of those was that they were fairly comprehensive reviews. Our prudential reviews involve detailed discussions not only with the trustees but usually with management as well, and sometimes other staff, within the fund. The next prudential review was held in August 2008. That one examined strategy, risk management, governance, investments and liquidity. Again it was quite a broad-ranging review at that time. Finally, a prudential review was held in June 2009 which examined governance, strategy and investments, including valuations and liquidity. They were the reviews.[16]

4.23 APRA's Deputy Chairman Mr Ross Jones told the committee that it was at APRA's request that the trustee directors 'had begun to address deficiencies in the valuation processes'. He noted that 'APRA had no reason to believe that the trustee directors were untrustworthy'.[17]

4.24 APRA pointed out that in 2007 and 2008, the relevant Trio funds had received audit signoffs. In 2008 and 2009, APRA sought further information from Trio regarding the valuations of certain investments. However, Trio's response was that as some of these assets were in unlisted overseas trusts, there would be delays in getting valuations.[18] APRA told the committee that when the relevant information was not received by mid-2009, it conducted a further prudential review to seek more information. In October 2009, when the trustee had not supplied APRA with all the information requested, 'an investigation was commenced'. In December 2009, APRA issued a 'show cause' letter asking why Trio Capital should not be suspended or removed as a trustee. An acting trustee, ACT Super, advised APRA that it would be submitting an application for compensation under Part 23 of the SIS Act.[19]

4.25 On 30 August 2011, APRA told the committee that it was currently supervising the trustee ACT Super and was also examining former directors of Trio. It noted that in addition to the enforceable undertaking (EU) against Ms Natasha Beck, it expected further EUs 'over the next weeks and months'.[20] As of late March 2012, APRA had obtained a further five EUs from Trio directors: Mr Rex Phillpott (15

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16 Mr Greg Brunner, Actuarial Market and Insurance Risk Services, Australian Prudential Regulation Authority, *Committee Hansard*, 4 April 2012, p. 9.

17 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 33.

18 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 33.

19 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 33.

20 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 30 August 2011, p. 40.

years), Mr David Andrews (10 years), Mr Keith Finkelde (six years), Mr David O'Bryen (five and a half years) and Mr John Godfrey (no expiry date).[21]

APRA's focus on trustees and governance

4.26 APRA told the committee that its main focus is on the conduct of trustees, not verification by auditors. It is APRA's responsibility under the superannuation legislation to ensure that superannuation trustees conduct their affairs with the appropriate level of fitness and propriety.[22]

4.27 APRA also noted that as a prudential regulator, its supervisory activities and processes are not based on the expectation that fund operators have engaged in fraudulent activity.[23] APRA does not look for fraud, nor does it routinely value underlying assets. Instead, up to a point, it relies on auditors for that function. APRA's oversight of the Trio funds was in relation to the valuation of the underlying assets in which the investments were made. Again, asset valuation is not APRA's core business.

4.28 Mr Jones described APRA's supervision of Trio Capital as 'active supervision' involving 'the standard collection of information but, more importantly, it involves on-site visits to the fund, an examination of the fund's investment policies and so on'.[24] He described APRA's regulatory approach in the case of Trio as follows:

> For a number of years we had had concerns—certainly not concerns about fraud, but we had concerns about the quality of the trusteeship of this fund—and for a number of years we had been trying to get the fund to improve the quality of its governance processes. That was what I would loosely describe as active supervision. You tend to find that, if you have circumstances with particular funds where you have some reservations about their activities, you tend to engage in a more intrusive and more intensive supervisory process than you might do with funds that you have a greater degree of confidence in. That was probably the case with this fund for a number of years.[25]

APRA and the auditors

4.29 The main theme of APRA's evidence to the committee was that, in a case like Trio, it is reliant on auditors to check the accuracy of the information that is supplied

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21 APRA, Enforceable Undertakings Register, http://www.apra.gov.au/CrossIndustry/Pages/EnforceableUndertakings.aspx, (accessed 30 April 2012).

22 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 41.

23 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 30 August 2011, p. 33.

24 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 34.

25 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 30 August 2011, p. 34.

to it. APRA told the committee that 'in all probability', the Trio fraud may have occurred 'well before 2009'. It also stressed that in 2007 and 2008, the fund received 'an unqualified audit sign-off'.[26] The strong implication is that the auditors should have detected the fraud and that APRA was reliant on the accuracy of the auditors' information and findings. As Mr Keith Chapman, Executive General Manager of APRA's Supervisory Support Division, told the committee:

> ...at the end of the day, what can anybody do to determine that the bit of paper/unit certificate/share script you have been given is actually a real document? We certainly do not get down to that level of detail. We tend to work our way down, as Mr Jones has indicated, from the trustee board to governance processes to, 'What are you doing underneath that?' and 'How do you verify?' The closest the system would get in that regard would probably be the external audit sign-off, but even then, as you know, the external audit does not go through and verify every single item of the accounts. It is done on a reasonableness basis.[27]
>
> ...in a normal situation when we talk to people we would get something like a spreadsheet. We say, 'What have you got your assets invested in?' It would be something like a spreadsheet which shows the sectors. Usually in the normal circumstance we would not go down to the individual holdings. We would do that where we had concerns that it was not a reasonable spread of exposure or diversification. To actually get to a situation where we are validating the assets I would suggest is when we have got to the end of the line which is what happened here...[28]
>
> The only process in the system where assets are validated at the specific level you are referring to is when the auditor does it and even then as I said the audit is still helicopter like rather than getting down to the nitty-gritty.[29]

4.30 The committee put to APRA that its prudential supervision role will not be effective if the information supplied to it by trustees is false. Mr Jones responded:

> Particularly, say, in the case of offshore investments, if the information that is supplied to APRA is false and, further, if it has been signed off and

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26 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 38. Chapter 5 notes that in February 2012, ASIC accepted an enforceable undertaking from WHK auditor Timothy Frazer for his role in audits into the ASF conducted in 2008 and 2009.

27 Mr Keith Chapman, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 34.

28 Mr Keith Chapman, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 33–34.

29 Mr Keith Chapman, Executive General Manager, APRA, Proof Committee Hansard, 30 August 2011, p. 35.

> approved by auditors, it would be very unlikely that APRA would have an independent ability to detect—[30]

4.31 In the case of Trio, however, APRA emphasised that the trustee was unable to supply the information on the nature of the investments: it had not falsified this information.[31] In this context, significantly, APRA queried whether it had given 'too much forbearance to the trustees' and gave the following response:

> In retrospect you can always reach a different conclusion but what I would say is that in all the other instances of our supervision over all the years—and I am not trying to hide away from the fact that this one went wrong—this process we have gone through that we have been describing has actually got the right result. We have had changes in trustee behaviour and changes in asset allocation.[32]

4.32 Crucially, APRA told the committee that it will take a closer look at the audit relationship:

> Looking back in retrospect, if you ask the trustees for valuations and details and they say, 'We're having difficulty getting to it,' and the auditor has signed off, you probably should haul the auditor in and have a serious heart-to-heart with the auditor about how they are doing that process. But that is certainly one of the areas that we have taken out of this, looking back: when do we make those sorts of calls?[33]

4.33 APRA also noted in its evidence that the government's Stronger Super reforms will impose additional duties on the directors of a trustee to act honestly and in the best interests of beneficiaries. It noted that APRA will be given a general prudential standards making power in relation to superannuation.[34] Further, as part of the Stronger Super reforms, APRA anticipated that it will have greater capacity to collect statistical data. While it doubted that this capacity would enable an assessment of stock by stock holdings, APRA did expect that the level of statistical detail would be looking at an investment option level.[35]

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30 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 34.

31 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 35.

32 Mr Keith Chapman, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, p. 35.

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

34 In March 2012, the committee examined the provisions of the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012.

35 Mr Keith Chapman, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority, *Committee Hansard*, 30 August 2011, pp 42–43.

Committee view

4.34 The committee highlights the fact that, despite having suspicions about the conduct of the trustees in 2005, it was not until 2009 that APRA issued a 'show cause' letter and eventually suspended the trustee. The committee makes the following two observations that may explain this significant delay.

4.35 First, as a prudential regulator, APRA does not look for fraud. By its own admission, in the case of Trio, its concern was not fraud but the quality of the trusteeship which, on a risk-based assessment, appeared not to be of great urgency. In this context, the committee also draws attention to APRA's statement that it has got 'the right result' in terms of changing trustee behaviour and asset allocation. This comment seems highly peculiar, even insensitive, given the significant losses suffered by investors and APRA's role as a prudential regulator.

4.36 Second, the committee recognises that the Trio case did require APRA to undertake tasks it did not normally undertake. APRA does not routinely value underlying assets but instead relies on auditors to examine individual holdings. The committee accepts that ultimately, APRA must rely on the auditors for accurate and reliable information on the presence of assets and their value. It also notes APRA's point that in 2007 and 2008, the relevant Trio funds did receive audit signoffs.

4.37 However, APRA should not be exonerated for its lack of action in the oversight of Trio Capital. The committee is concerned that APRA did not pick up key events that shaped the Trio fraud. These were the purchase of Tolhurst in November 2003 and the replacement of the Trust Company as the trustee of Professional Pensions Pooled Superannuation Trust in June 2004. The fact that these events roughly coincided with APRA's first prudential review of Astarra in April 2004, and were not identified as problematic, does raise serious questions about the quality of APRA's prudential reviews.

4.38 The committee also believes that questions must be raised as to why APRA delayed suspending Trio Capital when Trio could not value its assets in 2008. It does seem strange that a trustee can be subject to 'active supervision' over a period of six years and yet, when essential information was not forthcoming at the end of this period, the regulator did not act quickly.

4.39 To the committee's mind, the trustee's tardiness in responding to fairly basic information should have raised fundamental concerns. APRA should have acted more decisively, sooner. For a risk based supervisor—as APRA is—the inability of a trustee to provide basic valuation information should have raised strong concerns.

4.40 Trio investors' criticisms of APRA's role are discussed further in Chapter 5.

ASIC's view

4.41 In its submission to the inquiry, ASIC stated that it had conducted a review of its interactions with Trio Capital. The review 'confirmed that ASIC performed its role under the current financial services regulatory regime in relation to these events'.[36]

4.42 The specific detail of ASIC's involvement with the Trio Capital collapse is currently confidential.[37] Significantly, given APRA's view (paragraph 4.29), ASIC believes that it was not until December 2009 that the directors of the Astarra Strategic Fund ran the fund for fraudulent purposes. ASIC explained:

> ...I had examined Mr Richard very early in the piece and, basically, for ASIC to go away all he had to do was provide indisputable evidence of the veracity and worth of these investments. As time went by, the longer it took and nothing was forthcoming, the more confident I became, but there was never any situation where someone put on the table to me that this was a blatant fraud upfront. It took about three months, I would estimate. I had travelled to Hong Kong and interviewed people over in Hong Kong and it was after that, and that was in December 2009, that I became confident that the investments were not there. This is in the context of the Astarra Strategic Fund.[38]

4.43 In its submission to this inquiry, ASIC set out its enforcement action since commencing its investigation of Trio in 2009. This included:

- action taken against Mr Shawn Richard leading to his sentence of three years and nine months' imprisonment (with a minimum of two years and six months);
- an EU from Kilara Financial Solutions, which had recommended that retail clients switch their superannuation holding into the fund My Retirement Plan, for which Trio was the responsible entity;
- EUs with former Trio directors Mr Phillpott and Ms Beck;
- the suspension of the AFSL held by Seagrims Pty Ltd for three years;
- EU with former Trio Chairman and director Mr Andrews preventing him from acting in any role in the financial services industry for nine years; and
- EUs with former Trio directors Mr Finkelde and Mr O'Bryen preventing them from acting in any role in the financial services industry for four years.[39]

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36 ASIC, *Submission 51*, p. 11.

37 ASIC, *Submission 51*, p. 11. The committee took evidence in-camera from ASIC on 6 September 2011.

38 Mr Glen Unicomb, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 10.

39 ASIC, *Submission 51*, p. 18.

4.44 Mr David McGuinness, Senior Executive Leader at ASIC, gave the committee a brief chronology of ASIC's investigation into Trio Capital:

> In mid-2009, in the course of work we were doing in relation to hedge funds—in particular what we call the 'red flags project'—we identified some potential issues with Astarra and Trio. That was in about mid-2009. Shortly thereafter, in September 2009, we received a credible complaint that was directed to the former chairman.[40] The day after that complaint was received, members of ASIC met with Shawn Richard and compliance staff of Trio, and 10 days thereafter, I think—on approximately 2 October 2009—ASIC commenced using its formal powers and commenced a formal investigation. That then led to a collaborative approach with APRA in relation to investigating and taking action. Within a month or thereabouts, I think, we issued stop orders in relation to PDSs issued by Trio, and when it was appropriate to do so—I think it was in December 2009—we took steps, again in collaboration with APRA, to cancel the AFSL, or Australian financial services licence, of Trio. In between October and December 2009, we established, under the current chair, a task force of various parts of ASIC representing those from our stakeholder team areas that deal with investment fund managers, superannuation and investment banks, for example, and those that were conducting the hedge fund review, along with people from our financial adviser team and our deterrence teams.[41]

4.45 ASIC's Chairman, Mr Greg Medcraft, told the committee that by the time it had received a formal complaint about Mr Richard, the Commission already had narrowed down Trio as one of a number of hedge funds that it considered of high risk. ASIC's 'proactive surveillance' of the hedge fund sector began in response to the Bernie Madoff case in the United States. Mr Medcraft explained that in identifying the high risk hedge funds:

> We excluded those that were domestically managed, for example. We were really honing in—given the fact that the Madoff experience was through a series of overseas entities—on those which we considered to indicate higher risk...We were not focused on fraud. We were focused on verifying existence and value of assets. If you remember, the existence and value of assets was the issue with Madoff.[42]

4.46 In terms of ASIC's key interest in Trio Capital, the Chairman told the committee it was in the first instance concerned with whether the assets existed and secondly, whether the valuations were correct.[43]

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40 Mr Medcraft confirmed in evidence to the committee that the date of the complaint was 21 September 2011.

41 Mr David McGuinness, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 2.

42 Mr Greg Medcraft, *Committee Hansard*, 6 September 2011, p. 4.

43 Mr Greg Medcraft, *Committee Hansard*, 6 September 2011, p. 4.

ASIC's criticism of gatekeepers

4.47 ASIC's Chairman, Mr Greg Medcraft identified the role of gatekeepers as the main problem in the oversight of Trio. He told the committee:

> ...what happened in Trio and ARP—is a good example of what I think is gatekeeper failure. It does start with the responsible entities: the directors and the executors of the responsible entities, the investment manager, the compliance committee, the compliance plan audit, the research houses, the custodians, the advisers. What we had here was that, if you want, chain of gatekeepers. Many of those gatekeepers clearly came up short...
>
> Gatekeepers provide a key role in our regulatory system and when they fail in their role this can have serious consequences for investors, such as we have seen with what happened with Trio and Astarra. One of the most challenging tasks for a regulator is to identify so-called bad apples in industry, particularly when they are engaged in outright dishonest conduct. Gatekeepers are often the first in line in terms of defending against bad behaviour by perpetrators of issues in the system. Therefore, improving the regulation of gatekeepers is the key to ensuring the integrity of our system, and I think you will see that reflected in our forward work program...for example our work around research houses and custodians. [44]

4.48 Mr Medcraft added that this focus on the role of gatekeepers does not abrogate ASIC of its responsibilities as an oversight body. He told the committee that ASIC engages with industry and conducts surveillance, guidance, education, enforcement action and policy advice to government to serve the interests of retail investors. These activities were also emphasised in ASIC's submission.

4.49 ASIC told the committee that it was not aware that Trio's correspondence with APRA on 23 October 2008 had been passed on to ASIC. The Trio letter noted that it did not have available valuations for the Exploration Fund Limited. A search of ASIC's internal systems 'could not come up with information about such a referral'.[45]

Improving compliance plans and the role of auditors

4.50 Underpinning ASIC's criticism of gatekeepers in the Trio case is its broader concern with managed investment scheme compliance plans, auditors and committees. Its concerns with the current system of compliance plans are threefold:

- the requirements in section 601HA of the Corporations Act relating to the content of compliance plans are set at a high level rather than requiring detail on specific matters. As a result, ASIC argued that the plans are 'not being as effective as may have been intended'[46] and 'if someone has conducted the

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

45 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 5.

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

audit of the particular compliance plan, that is almost enough to get you over the line. There is no sort of detail about the work that needs to be done';[47]

- the liability for the responsible entity and its directors attaches to any contravention of the compliance plan, rather than material contraventions. ASIC claims that this can result in generic compliance plans with low standards, while still meeting the requirements of section 601HA; and
- the Corporations Act requires a compliance plan audit to be done, but does not impose any qualitative standards by which a compliance plan auditor must conduct their audits.[48]

4.51 In terms of compliance committees, ASIC highlighted that:

- there are no current legislative requirements as to experience, competence or qualifications for compliance committee members;
- there is also no regulatory or member oversight of the appointment of compliance committee members; and
- the Corporations Act does not specify many governance arrangements in relation to the proceedings of the compliance committee.[49]

4.52 ASIC told the committee that currently, the law 'seeks to treat all contraventions of compliance plans by officers of a responsible entity equally'. Minor breaches are treated the same as more serious breaches. ASIC argued that:

> ...it would be more sensible for the law to focus on material breaches rather than those minor breaches, because the way the law is constructed at the moment it almost drives people to go back to compliance plans at a very high level. They are concerned, and I can understand why they are concerned, about their own liability, but the way the regime works as a whole is that it is not operating in an optimal fashion to make sure that there is a strong compliance culture within responsible entities and there is a good system of checking around responsible entities.[50]

4.53 ASIC suggested several areas of possible reform to the role of auditors and compliance committees. It noted that in cases 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 CALDB'.[51] One of the striking features about the Companies, Auditors and Liquidators Disciplinary Board (CALDB), however, is how few matters ASIC does in fact refer to the Board. APRA

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47 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 5.

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

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

50 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 5.

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

has not referred one. Chapter 5 discusses the views of the Board about its role and workload.

4.54 Indeed, ASIC recognised in its submission that the assurance standards that are relevant to a compliance plan audit do not have the force of law. As such, there is no precedent for a successful action against a compliance plan auditor. ASIC suggested that the government could consider:

> (a) an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval; and
>
> (b) civil liability provisions for compliance plan audits.[52]

4.55 ASIC also identified possible reforms to improve compliance arrangements to increase the effectiveness of compliance plans, auditors and committees. In terms of compliance plans, it suggested:

- reviewing the effectiveness of the role of the compliance plan in the compliance framework;
- setting more detailed requirements for compliance plans; and
- introducing an approval process for compliance plan auditors and civil liability provision for compliance plan audits.[53]

4.56 In terms of compliance committees, ASIC noted that government could consider minimum requirements for these committees and their membership.[54]

4.57 The committee encourages ASIC to pursue its forward program of activities in relation to compliance arrangements (see chapter 7). The committee will monitor the implementation of these changes as part of its statutory parliamentary responsibility to oversee ASIC's work.

Granting AFS licences

4.58 Chapter 6 of this report canvasses various criticisms of ASIC by Trio Capital investors, not the least of which is that ASIC was responsible for granting Mr Richard an AFSL. In this context, perhaps the most significant aspect of ASIC's evidence was its criticism of the AFSL regime. In particular:

> ASIC's ability to protect investors by restricting entry into, or removing participants from, the financial services industry who might cause or contribute to investor loss is limited under the current FSR regime. This is because the current FSR regime:

52 ASIC, *Submission 51*, p 45.

53 ASIC, *Submission 51*, p 46.

54 ASIC, *Submission 51*, p 46.

- sets the threshold for obtaining an AFS licence relatively low and the threshold for cancelling an AFS licence relatively high; and
- focuses on the licensed entity rather than the directors, employees or other representatives.[55]

4.59 In terms of the threshold for obtaining and retaining a licence, ASIC noted that it 'must' grant an applicant a licence unless it can prove that certain statutory criteria are not met. Mr Price added:

> Perhaps unsurprisingly it is very difficult to prove that someone will not comply with their legal obligations in the future, because quite simply people do not go round sending emails saying, 'It is my intention not to comply with the obligations in the future.' The PJC recommendation from the Storm and Opes Prime inquiry was to change that particular provision broadly speaking to one that would say: 'ASIC may ban a person or it may not grant a licence if the person is not likely to comply with its obligations in the future.'[56]

4.60 In the Future of Financial Advice (FoFA) legislation, currently before the Parliament, the government essentially adopted the Parliamentary Joint Committee on Corporations and Financial Service's 2009 recommendations.[57] The Act amends the relevant sections of the Corporations Act to give ASIC greater discretion in granting and cancelling AFSLs.[58] The Explanatory Memorandum to the *Corporations*

55 ASIC, *Submission 51*, p. 21.

56 ASIC, *Committee Hansard*, 6 September 2011, p. 8.

57 See Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, recommendation 6, p. 139 and recommendation 8, pp 140–141.

Recommendation 6: The committee recommends that section 920A of the Corporations Act be amended to provide extended powers for ASIC to ban individuals from the financial services industry.

Recommendation 8: The committee recommends that sections 913B and 915C of the Corporations Act be amended to allow ASIC to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations under the licence.

58 http://parlinfo.aph.gov.au/parlInfo/download/legislation/bills/r4689_first-reps/toc_pdf/11217b01.pdf;fileType=application%2Fpdf#search=%22legislation/bills/r4689_first-reps/0000%22

Section 913B(1)(b) now states: ASIC has no reason to believe that the applicant ~~will not comply with~~ is likely to contravene the obligations that will apply under section 912A if the licence is granted;

Section 915(C)(1)(aa) now states: ASIC has reason to believe that the licensee ~~will not comply with~~ is likely to contravene their obligations under section 912A;

Section 920A(1)(ba) now states: ASIC has reason to believe that the person ~~will not comply with~~ is likely to contravene their obligations under section 912A;

Amendment (Future of Financial Advice) Bill 2011 stated that these amendments clarify that ASIC is not required to believe as a matter of certainty that the person will contravene the obligations in future. It added:

> In the 10 years since the introduction of the Financial Services Reform Act, interpretation of this provision has tended to a view that ASIC is required to believe, as a matter of certainty, that the person will contravene the obligations in future. Such a standard would be so onerous that it could result, in practice, in ASIC never being able to refuse a licence using this part of the test. This new formulation is designed to ensure that ASIC can more appropriately account for the likelihood or probability of a future contravention.[59]

4.61 ASIC's submission supported the amendments, noting that the change:

> ...would overcome some of the difficulty ASIC currently experiences when trying to assess whether an applicant will comply with its obligations and meet its licence conditions before it has commenced business. The proposed slightly lower standard (i.e. 'may not comply' or 'is not likely to comply') would enable ASIC to consider a wider range of matters than currently permitted and minimise this difficulty.[60]

4.62 In terms of how these amendments may have influenced the Trio case, Mr Price commented:

> Were those sorts of additional protections in place when the Trio matter was happening, or in another hypothetical matter, it may well have enabled ASIC to act at an earlier stage. But would that have prevented investor loss? I cannot tell you the answer to that. Even if ASIC makes a decision not to grant a licence or to remove someone from the industry there are appeal rights to the Administrative Appeals Tribunal and they do not always agree with the position that we adopt on these matters. Quite rightly, they put high regard on the fact that, if ASIC decides to exclude someone from an industry, that deprives them of their livelihood.[61]

4.63 The second point in paragraph 4.58 (above) notes ASIC's concern that the current licensing system is based on the entity, rather than individual directors,

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Section 920A(1)(d) now states: ASIC has reason to believe that the person is not of good fame or character; (This subsection had been repealed.)

Section 920A(1)(da) now states: ASIC has reason to believe that the person is not adequately trained, or is not competent, to provide a financial service or financial services;

Section 920A(1)(f) now states: ASIC has reason to believe that the person ~~will not comply with~~ is likely to contravene a financial services law.

59 Explanatory Memorandum, Corporations Amendment (Future of Financial Advice) Bill 2011, p. 22.

60 ASIC, *Submission 51*, p. 28.

61 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 5.

employees or other representatives. In its submission to this inquiry and to the committee's inquiry into the FoFA legislation, ASIC drew attention to the fact that:

> Under the Corporations Act, a person or entity that carries on a financial services business in Australia must obtain an AFS licence from ASIC covering the provision of the relevant financial services, unless an exemption applies. A key exemption is for those who provide services as a representative of a licensee. Essentially, representatives are employees, directors, authorised representatives (including corporate authorised representatives) of the licensee. ASIC does not approve representatives. In addition, a person acting as an employee or agent is not themselves treated as providing the financial service of operating a registered management investment scheme.
>
> This means that the AFS licensing regime generally focuses on the AFS licensee, rather than the directors, employees or agents in relation to operating a registered management investment scheme or other representatives of that entity. However, officers involved in the decision making of a licensee are subject to tests of good fame and character (e.g. police checks) when a licence is granted. Also on grant of a licence, and at other times in surveillance, there is assessment of key persons nominated by the licensee for the relevant financial service business.[62]

4.64 In terms of Trio Capital, therefore, ASIC emphasised:

> ...we did not register Mr Richard. The relevant person being licensed here was Trio, not Mr Richard...
>
> The history is that the body that would become Trio already had a licence at the start of the financial services reform. Under the laws that were in place of the financial services reforms, which were around 2002 to 2004, anyone who had formerly had a licence basically got a licence under the new regime. Mr Richard became a director of that entity that already had a licence. As to your question about Mr Richard and what was known about Mr Richard, certainly I have read in a number of other submissions some concern perhaps about Mr Richard and what he may have done in the past. The critical question for us is: what concrete evidence do we have in respect of a particular person? That is question 1. Question 2 is: even if we have concrete evidence against a particular person, of what relevance is that ultimately to the fact that someone already has a licence and is in our regime and so forth?[63]

4.65 ASIC noted in jurisdictions such as Hong Kong, Singapore and the United Kingdom, there is more focus on the individual during the licensing process. However, it did not support a requirement to approve all individuals involved in the financial services industry, believing the costs would outweigh the benefits. ASIC did

62 ASIC, *Submission 51*, p. 22; see also ASIC, *Submission 28*, PJC inquiry into the Corporations Amendment (Future of Financial Advice) Bill 2011, pp. 7–8.

63 ASIC, *Committee Hansard*, 6 September 2011, p. 7.

suggest that a more complete register of advisers providing financial advice on Tier 1 financial products would enhance its efficiency conducting regulatory checks.[64]

Suitability of managed investment schemes

4.66 A further issue raised by ASIC in both its submission and in verbal evidence to the committee is whether there should be regulations and restrictions on investments in registered managed investment schemes. Currently, neither the *Australian Securities and Investments Commission Act 2001* nor the Corporations Act imposes any restrictions on the investment strategy of registered managed investment schemes. ASIC noted that in some international areas, there are discussions about whether those who manufacture financial products should have an obligation to ensure that the investment is not going to be unsuitable for the final investor.[65] It also stated that in Australia, restrictions had previously been in place:

> Before June 2007, registered managed investment schemes were prohibited from investing in managed investment schemes that were not registered under Ch 5C of the Corporations Act. The restrictions were intended to prevent a responsible entity from establishing or investing in unregistered managed investment schemes, including foreign collective investment structures, to avoid the protections for scheme assets that normally apply to registered managed investment schemes. ASIC provided limited exemptions to allow certain investments in managed investment schemes to be held, even though the managed investment scheme receiving the investment was not a registered managed investment scheme in a number of circumstances.
>
> The restrictions were removed by legislative amendment in recognition of registered managed investment schemes increasingly seeking to diversify their investments and that such investments are not generally made for the purpose of avoiding regulation. The restriction on what a registered managed investment scheme may invest in proved difficult to maintain in light of commercial pressures to allow many legitimate foreign investments.[66]

Committee view

4.67 The committee notes the various points that ASIC has made in relation to the limitations and restrictions on its role and believes that these are legitimate concerns. It therefore welcomes the recent FoFA reforms to sections 913, 915 and 920 of the Corporation Act lowering the threshold for ASIC to refuse and to revoke an AFSL. On the matter of ASIC's power to register an entity rather than an individual director,

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64 ASIC, *Submission 51*, p. 31. Tier 1 products exclude most general insurance products, basic deposit products, consumer credit insurance, non-cash payment products and First Home Saver Account deposit accounts.

65 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 9.

66 ASIC, *Submission 51*, pp 86–87.

there does appear to be a strong case to establish a register of employee representatives in the financial services industry.

4.68 As with APRA, the committee has concerns at the length of time it took for ASIC to detect fraudulent activity in Trio. It is particularly concerned that communication between ASIC and APRA was lacking in the months from late 2008 to mid 2009. ASIC's Chairman has emphasised that given the goal of 'efficient markets' and rectifying asymmetries of information, it is important for investors to have clear disclosure of the assets in a portfolio.[67] Yet, it seemed that APRA had not communicated to ASIC its requests for Trio to provide information. As a result, when ASIC commenced its active surveillance of hedge funds in June 2009, it did not seem aware that Trio was not providing the prudential regulator with basic facts about the existence of assets and their value. This information should have been communicated.

4.69 The committee is aware that the Memorandum of Understanding between ASIC and APRA contains sections on mutual assistance and coordination, information sharing and unsolicited assistance. The committee encourages the regulators to continuing sharing information, even where a request for the information has not been received.

The Australian Taxation Office's view

4.70 The third regulator is the ATO, which has responsibility for ensuring that investors in SMSFs comply with the SIS Act. The role of the ATO is to register SMSFs, to ensure they have an investment strategy and that they meet the basic prudential requirements set out in the SIS Act. In this context, the Commissioner of the ATO, Mr Michael D'Ascenzo, described the ATO's regulatory role as:

> to provide some assistance to trustees and approved auditors in relation to their obligations under the SIS Act and help them to comply with a range of obligations under the SIS Act and the Income Tax Assessment Act. What is I think critically different between what we do and what a regulator like APRA does is that APRA looks at the prudential requirements – in other words, the level of risk-taking that trustees of larger funds would undertake – whereas, for self-managed super funds, the ATO's obligation is to ensure that they have an investment strategy but the nature, effectiveness and risk of their investment is really a matter for the trustees, subject to certain rules in the law which say that certain investments are not able to be entered into.[68]

4.71 The ATO monitors SMSFs compliance mainly through the receipt of self-managed super fund annual returns. These returns include an income tax return, a regulatory return with details of fund assets and fund management issues, and a

67 Mr Greg Medcraft, *Committee Hansard*, 6 September 2011, p. 6.

68 Mr Michael D'Ascenzo, Commissioner, Australian Taxation Office, *Committee Hansard*, 23 September 2011, p. 33.

member contribution statement. In addition, the ATO noted that each SMSF is required to obtain an independent annual audit of the fund. Where there is a contravention, the auditor lodges an auditor contravention report with the ATO. The ATO told the committee that through this process, it also 'audits the auditors'.[69]

4.72 One of the key criticisms of the ATO from many SMSF investors in Trio Capital was that they were unaware they were investing in an SMSF. Of those who were aware, many were not familiar with their obligations and the regulatory protections (see chapter 6). Mr Brett Peterson, Acting Deputy Commissioner Superannuation at the ATO, told the committee: 'we send every trustee (of an SMSF) a letter welcoming them and outlining their responsibilities and pointing them to the range of support material we have'. He added that before a trustee or a fund can be registered, the ATO required the trustee to sign a declaration to certify that they understand the range of rules that apply to the management of an SMSF. Mr Peterson told the committee: 'I have never had anybody say to me that they were not even aware they had a fund. That is quite surprising'.[70]

4.73 The ATO told the committee that it is aware that the vast majority of SMSF investors lodge their registration 'through some kind of agent'. This is potentially a problem. Notwithstanding their name, SMSFs are often not managed by the trustee but by financial advisers and other intermediaries. In the case of a significant number of witnesses who gave evidence to this inquiry, it does appear that the key messages about trustees' obligations and exposures to risk—and even their participation in an SMSF—are not being properly communicated to trustees, either through the declaration form or through ATO guidance material.

4.74 The committee is concerned at the lack of knowledge of 'mum and dad' SMSF investors (see chapter 6). The ATO Commissioner recognised that while there is a 'vast difference' in the understanding and capabilities of trustees, the ATO provides 'a lot of information' and educational material to help SMSFs understand their obligations. This information was in response to ATO research conducted 'a number of years back' which showed there were 'quite a number of trustees who did not understand their obligations'.[71]

4.75 The ATO's submission to this inquiry contained only one passing reference to Trio. The committee did ask the ATO, in relation to Trio, whether the ATO requires documentary evidence from managed investment schemes to verify that the tax it is receiving from entities is the correct amount. The Commissioner replied:

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69 Mr Brett Peterson, Acting Deputy Commissioner Superannuation, ATO, Committee Hansard, 23 September, 2011, p. 34.

70 Mr Brett Peterson, Acting Deputy Commissioner Superannuation, ATO, Committee Hansard, 23 September, 2011, p. 35.

71 Mr Michael, D'Ascenzo, Commissioner, ATO, Committee Hansard, 23 September, 2011, p. 35.

> We would not have any specific information other than what is provided in the particular taxpayer's return or the fund return. It then becomes a question of whether our analytics and risk assessment procedures identify that group or that company as requiring further attention. So really unless there is some indicator that enables us to discern that what they have said in their return is incorrect, we would not know until we did an investigation. And we would not necessarily do an investigation until we had some indication that this was a high-risk company.[72]

4.76 In an answer to a question on notice, the ATO provided a breakdown of asset allocations in SMSFs. In June 2011, overseas managed investment schemes accounted for only 0.08 per cent of total Australian and overseas assets in SMSFs ($341 million of $418.5 billion).[73]

Is some fraud inevitable?

4.77 The regulators contended that even with the best regulatory system, it will be difficult to detect and intercept all fraud. Mr John Price, Senior Executive Leader at ASIC, told the committee that:

> ...if someone is minded to commit a fraud, whatever regulatory system you have in place may find it difficult if that person is determined and wilful to commit that fraud.[74]

4.78 APRA also noted that in cases where those committing fraud have established complex and elaborate systems to conceal and deceive, the role of the gatekeepers is difficult. It put this argument as follows:

> I think the real issue here is that, in a broad sense—without getting into details about Trio—if two or three people deliberately set up a very obscure process to commit a fraud, what are the chances that a lot of well-meaning but not necessarily inquiring people, be it the auditors, the board or other gatekeepers, can detect that problem? What we try to do is get the trustees to take a proper look at what it is they are doing... [I]t comes back in the real sense to whether there is a process that can be adopted to stop the couple of people deliberately setting up a fraudulent process and/or catch that soon thereafter with the gatekeepers. That is the significant challenge in this whole process.[75]

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72 Mr Michael, D'Ascenzo, Commissioner, ATO, Committee Hansard, 23 September, 2011, p. 36.

73 Received 4 November , 2011. Available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/trio/submissions.htm

74 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 6.

75 Mr Keith Chapman, APRA, *Committee Hansard*, 30 August 2011, p. 38.

4.79 In a similar vein, APRA commented that its anticipated new power to set prudential standards for superannuation funds was not a protection against all fraud. The Deputy Chair, Mr Ross Jones, told the committee:

> I certainly would never dare say that standards-making powers would eliminate fraud. If you have a set of individuals who are actively engaged in fraudulent activity, I do not believe that standards-making powers would make enough difference. We have seen examples of fraud in other industries here and overseas where you have quite substantial regulatory strengths and powers. It must reduce the likelihood of fraud, but I do not believe it can ever reduce fraud to zero.[76]

4.80 APRA made the broader point that there have been very few superannuation frauds in the past 20 years, with Trio Capital 'only the second major fraud'.[77] Mr Jones commented that to minimise their tax liability, many funds make overseas investments. He noted that often, these investments are in infrastructure assets which are 'not easily identifiable and quantified'.[78]

Committee view

4.81 The committee takes no exception to the general comment that no regulatory system can deter all fraud. That said, where fraudulent activity does occur, it is incumbent on the regulators to inquire what went wrong and what could be done to close any loopholes. This also applies to governments and their consideration of whether there is a need to amend the law.

4.82 The committee also believes that ASIC and APRA must exercise particular vigilance in their responsibilities to regulate and oversee superannuation investments and overseas managed investment schemes. The Australian superannuation pot is one of the largest in the world and, given the camouflage provided by the long-term nature of these investments, is potentially a ripe target for unscrupulous operators. In terms of overseas managed investment schemes, while they account for only a fraction of total Australian and overseas investments in SMSFs, they demand the regulators' full attention given their complexity and cross-jurisdictional component.

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76 Mr Ross Jones, Deputy Chair, APRA, *Committee Hansard*, 30 August 2011, p. 36.

77 Mr Greg Brummer, General Manager Actuarial, Market and Insurance Risk Services, Supervisory Support Division, APRA, *Committee Hansard*, 30 August 2011, p. 39.

78 Mr Ross Jones, Deputy Chair, APRA, *Committee Hansard*, 30 August 2011, p. 39.

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...
>
> I understand the document itself is a detailed document of which I am not in a position to provide any—...
>
> I have been in the role now for four months and about five days—...
>
> 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

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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]

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]

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

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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.

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.

Chapter 6

Investors' criticisms of the regulatory framework and the role of the regulators and gatekeepers

6.1 This chapter details the views of investors as to who they believe should be blamed for the collapse of Trio Capital. It highlights Trio investors' assumption that the regulatory framework would protect their investment, and their view that the regulators, the gatekeepers and financial advisers have failed them.

6.2 Chapter 3 of this report noted the significant financial losses and emotional distress of the investors who lost money in the collapse. This section presents investors' views as to who is to blame for the collapse of Trio Capital. These views are important for two reasons. First, they are important for the public record: the voice of these investors must be heard. Second, the views give an indication of discrepancies between investors' expectation of regulatory protection and auditing transparency and what these standards actually are. This issue of an 'expectations gap' is dealt with in chapter 7.

Investors' criticism of SMSF framework

6.3 In explaining why there is a different level of protection for investors in SMSFs, as opposed to investors in Australian Prudential Regulation Authority (APRA) regulated funds, the government has highlighted the trade-off between choice and risk. With Self-managed superannuation funds (SMSFs), there is greater choice and more control in constructing an investment portfolio, but with that comes responsibility to take necessary precautions.

6.4 This phrase derives from a December 2009 publication *Investing between the flags—A practical guide to investing*.[1] Upon releasing the guide, the then Chairman of Australian Securities and Investments Commission (ASIC), Mr Tony D'Aloisio, commented:

> It's just a metaphor but when you go swimming at the beach, you will reduce the risk of drowning if you swim between the flags, similarly, when you invest, you will reduce the risk of losing your money if you adopt the

1 ASIC, *Investing between the flags – A practical guide to investing*, http://www.moneysmart.gov.au/media/173788/investing-between-the-flags.pdf (accessed 27 October 2011)

> investing behaviours identified in this guide which has been developed over a long period of time.[2]

6.5 Ms Nicole McCann explained that her initial decision to invest in Trio Capital was based on an understanding that the regulatory framework was in place and there to protect her investment. She identified four aspects of this framework:

> Number 1: the fund was subject to supervision and due diligence of APRA, the government body charged with providing oversight and governance for financial service providers to minimise the likelihood of financial losses to depositors, policy holders and superannuation fund members. Number 2: the fund manager was appropriately licensed by ASIC, the corporate markets and financial services regulator. Number 3: a long history of public reports made by reputable research houses indicating solid performance of the fund. And No. 4: the financial advice presented to me by my adviser made a clear statement of risks and benefits of investing in the fund. It is my belief that I was entitled to rely upon ASIC and APRA having applied sufficient due diligence in reaching their respective decisions to license fund managers and to approve the fund for Australian marketplaces.[3]

6.6 Similarly, Ms Bent told the committee:

> We had our fund managed by a financial adviser and he thought that the way it was invested was not going very well. He called us in to have a discussion with him. He presented the reports of that fund's performance. I remember asking at the time: 'How do we know these people do the right thing and they're credible reports?' His response, which was quite reasonable, was their whole reputation relies on them being credible and accurate with their projections and with their reports. I trusted that. I also trusted that there were a number of regulatory bodies in place. In Australia surely checks and balances are in place looking after those funds and people cannot get licences if they are not of good character and have the skills to run them. Based on that and the reports from these investment houses, we agreed to move out that money.[4]

6.7 The committee heard from some witnesses who suggested that the system would be improved if there was notification as part of the investment documentation that the investor was moving from one part of the regulatory framework covered by compensation to another part that was not eligible for compensation. Ms Julia Fellows told the committee:

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2 Australian Securities and Investments Commission, 'Investing between the flags', *Media Release No. 244*, December 2009, http://www.asic.gov.au/asic/asic.nsf/byheadline/09-244MR+Investing+between+the+flags?openDocument (accessed 27 March 2012).

3 Ms Nicole McCann, *Committee Hansard*, Thirroul, 6 September 2011, p. 11.

4 Ms Sharon Bent, *Committee Hansard*, Thirroul, 6 September 2011, p. 16.

> Neither my husband nor I ever comprehended that there was less regulatory protection for self-managed funds in pooled investment arrangements than for individual superannuation accounts in industry, corporate or retail funds. Given our conservative approach, we would never have gone down the self-managed path if we had understood that this type of superannuation savings vehicle was not regarded by the Federal Government as deserving of the same safety net protection as other types of superannuation savings arrangements. This fact had never been made known to us – there had been no warning from the Government or the regulators that you invest, however prudently, in your own self-managed fund at your peril. In the event that you are the victim of fraud through absolutely no fault of your own - unlike the rest of the community's superannuation savings – your superannuation savings have no protection whatsoever. This seems contrary to Australia's proud international reputation as a country with guaranteed protection for all superannuation savings. Indeed, it seems incomprehensible to me that the Government would facilitate the establishment of SMSF arrangements to encourage the self funding of retirement, without putting in place the necessary regulatory protection to afford such arrangements security in the event of fraud.[5]

6.8 In evidence to the committee, Mr John Telford noted:

> ...five months after the Trio collapse...I received a letter from the Taxation Office to say that I was invited to a public seminar for self-managed super funds. I rang them up because I thought they had made a mistake. I told them, 'No, I am in a superannuation fund,' and they checked and said, 'No, you are in a self-managed super fund.' So I went along to that meeting and that is when I discovered the rules and regulations, where the trustee is ultimately responsible for his or her investments and information like that. That is pretty vital information. Why did I not get that before? I was never given the choice that there were two funds, and that one had insurance cover and the other one did not. That is pretty astounding.[6]

6.9 Even more alarmingly, Mr Warren Daley noted that he was moved from an APRA-regulated superannuation fund to an SMSF without any warnings of the higher risk. He told the committee:

> In July 2007 when we were moved from a pooled PST [pooled superannuation trust] to a SMSF, we were not advised by Regulators, Auditors, Custodians or Company Directors that we would be excluded from Commonwealth protection in the event of fraud of theft, there was nothing in the PDS [product disclosure statement] advising us of future risk exposure either. Why is it that the matter of Commonwealth sponsored

5 Ms Julia Fellows, *Submission 12*, p. 1.

6 Mr John Telford, *Committee Hansard*, Thirroul, 6 September 2011, p. 4.

> protection is not advised in all PDS or prospectus documentation with the Superannuation Industry?[7]

Investors' criticism of the regulators

6.10 Several submitters expressed frustration at the failure of the regulators and auditors to do their job properly. Mr Norman Upton, a long-time BHP coal miner, told the committee:

> The underlying causes of this collapse were fraud and dishonesty. This has already been proven in a court of law. The regulating bodies failed to have measures to protect exposed investors. In my view, ASIC, APRA, and the auditors, directors and regulators of Trio were deficient in their obligation to inform and, when needed, bring corrective measures at the earlier point of time.[8]

6.11 On this final point, Ms McCann was highly critical of the government for 'pointing the finger of blame' at advisers and those who invested through an SMSF, when responsibility should rest with ASIC, APRA, the auditors and industry research houses. She posed the following questions:

> How can it be that APRA can be considered to have completed sufficient due diligence checks and ongoing supervision of fund to discharge its statutory responsibility when it was aware for four years that the valuation of the fund could not be substantiated by the principals?
>
> ...
>
> What responsibility should be ascribed to the fund auditors (KPMG and WHK) who released an audit report which gave the fund manager Trio a high quality rating only three weeks before the fraud was uncovered?
>
> ...
>
> How can ASIC be considered to have properly discharged its obligations to conduct sufficient due diligence checks to provide protection to the Australian investment community when it issued a licence to Shawn Richard, who has since been found by the courts to have had no prior experience or qualifications?
>
> How can the financial planner be solely responsible for the failure when industry research houses such as Van Eyk and Morningstar were providing reports which gave the fund a high rating?
>
> How is it that the government can differentiate between victims of a fraud perpetrated by a group licensed by ASIC and supervised by APRA on the

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7 Mr Warren Daley, *Submission 22*, p. 2.

8 Mr Norman Upton, *Committee Hansard*, Thirroul, 6 September 2011, p. 9.

> basis of whether or not their investment vehicle was a supervised superannuation fund?[9]

6.12 Mr Russell Smith took aim at the role of auditors and APRA in the collapse of Trio Capital:

> Auditors are there to do their job...APRA said that there was gross incompetence on behalf of the directors. If there was gross incompetence on behalf of the directors of Trio, then there is gross incompetence on behalf of APRA in not being to apply the same rules themselves to ensure that those audits were done correctly and that the funds were a viable entity.
>
> The auditors over five years received millions of dollars in fees to audit these companies. They audited them and believed and stated that those funds were all there and that Trio Capital was a viable business and entity. Yet, having done those audits, we now find that there was fraud from day 1 of that company. If those audits had been done correctly, we would not have had the problem of fraud and loss of money from investors.
>
> If an audit company is held responsible and accountable for what they are doing, then these sorts of things will not have the potential to occur in the future. If they were held accountable for those funds and would have to pay the losses that were incurred, then I am sure that the audits would be done properly...If the legislation is changed and they are held accountable and responsible for their actions, then these frauds et cetera will potentially not happen. Therefore, there will not be the reliance on governments to support either part 23 type actions or, down the track, to have to help out pensioners and retirees who have lost their moneys and so have to go onto pensions.[10]

6.13 Mr Shayne Bonnie, who has lost significant superannuation savings as part of a SMSF investment in the Astarra Strategic Fund (ASF), was also critical of the action and inaction of the regulators and auditors. In evidence to the committee, he noted:

> APRA said...they did not respond when Trio could not provide valuations. Multiple times Trio did not give them valuations and there was no action taken. If they had taken action at any stage back then, then we would never have invested in Astarra, because we invested after the valuations were not received. ASIC, of course, licensed Shawn Richard. We know what has happened there. Research houses were giving glowing reports on Astarra. The research was presented to us by Tarrants. It was no different from research that you would see for BlueScope, BHP or Rio. The reports were glowing. Auditors were signing off on Trio. KPMG signed the most recent audit a couple of weeks before ASIC froze the fund. Now you have Trio directors in front of the courts. The auditors are supposed to be auditing the

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9 Ms Nicole McCann, *Committee Hansard*, Thirroul, 6 September 2011, p. 11.

10 Mr Russell Smith, *Committee Hansard*, Thirroul, 6 September 2011, p. 2.

process. These guys obviously were not following the process, and yet KPMG were telling us that they were.[11]

6.14 Mr Nicholas McGowan, who with his wife established a self-managed superannuation fund with a significant portion invested in ASF, was also scathing of ASIC. He told the committee:

> Our losses have come about by investing in a fund that was licensed by ASIC a licence, I understand, that was one of only 13 such licences granted the other such licences being granted mainly to banks. This licence was given to Shawn Richard a young Canadian traveller who claimed to have a finance degree from a Canadian university later to be proven a false statement. For ASIC to grant such a licence I would have expected that this fact would be cross-checked. The fact has emerged since that Richard was also connected to several suspect companies, schemes and individuals who had already been involved in defrauding investors in many other countries which was also not investigated by ASIC prior to giving him such a licence. If this had been done, surely the licence to manage investor funds would not have been granted.
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> ...
>
> To be defrauded by a government licensed fund means that we have no faith in a financial regulatory system, which we thought was the best in the world. We also feel that the government has a duty to reimburse all investors in Trio Capital funds, given that a government body in ASIC has allowed this fund to operate under a licence granted by them. The fund has been acknowledged as a fraud by Minister Shorten when he announced the compensation package for investors through APRA regulated superannuation funds. Our view was further strengthened and our disappointment heightened when we learned that APRA and ASIC had concerns about the unit pricing of the fund on three separate occasions, all prior to us investing, and nothing was done to intervene in the operations of the managed fund. If action had been taken and the fund frozen and investigated at the time, then all of us here today would not have lost the money we have.[12]

Investors' criticism of the auditors

6.15 The committee heard from several individual investors in Trio Capital that the gatekeepers failed to do their job properly. Chapter 4 noted that two of the three regulators apportioned significant blame for the collapse of Trio to the gatekeepers. It also noted the gatekeepers' rejection of these arguments.

11 Mr Shayne Bonnie, *Committee Hansard*, Thirroul, 6 September 2011, p. 7.

12 Mr Nicholas McGowan, *Committee Hansard*, Thirroul, 6 September 2012, p. 17.

6.16 Several submitters were highly critical of the role of the auditors in the collapse of Trio Capital. Mr Colin Warne, notably, wrote that:

> Each auditor stated that they were satisfied that the financial statements represented a true and fair account of the financial affairs of the fund...[but]...for six years, the funds issued audited financial statements that, arguably, were a fabrication.[13]

6.17 Another submitter, who withheld their name, stated:

> In our opinion the examination of the roles ASIC, APRA and the auditors such as KPMG & WHK played needs to be examined, these parties as far as we are concerned failed in their Duty of Care to the investors. They did not undertake or apply correct procedures or protocols when it came to compliance and/or auditing.[14]

6.18 Similarly, Mr Smith argued in his submission:

> In my opinion you are starting at the wrong end by focusing on the Financial Planners, instead of beginning your examination on the role, effect and impact of ASIC, APRA and the auditors such as KPMG & WHK who all failed in their Duty of Care to the investors. They did not undertake or apply correct procedures or protocols when it came to compliance and/or auditing.[15]

6.19 He directed further criticism at the auditors in his verbal evidence to the committee:

> I went through a financial planner organisation and, as in my statement to the committee, I do not hold anything against the financial planner. I believe they could not have done any more than they did to understand what the market was and what the companies were that they were investing in. They did their due diligence. They relied on all of the reports that came from either ASIC, APRA or the auditing companies to ensure that the investments were sound and correct.
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> ...
>
> You rely somewhat on looking at the documentation in terms of your return on those investments. We did receive statements on a regular basis as to where we were at with our investments. Those were being supplied through Trio to our financial planner and then on to us. Again, those statements were audited.[16]

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13 Mr Colin Warne, *Submission 38*, p. 2.

14 Name withheld, *Submission 13*, p. 1.

15 Mr Russell Smith, *Submission 4*, p. 1.

16 Mr Russell Smith, *Committee Hansard*, Thirroul, 6 September 2011, p. 3.

6.20 Mr Shayne and Mrs Tracey Bonnie were also critical of the role of the auditors:

> Auditors signed off on Trio. KPMG signed off on the most recent audit a few weeks before ASIC froze the fund. Trio directors are currently in front of the courts because of the way they ran their business and yet the auditors were telling us back then that Trio was compliant.[17]

Committee view

6.21 The committee believes that the capacity of auditors to identify and highlight fraud is limited. This is apparent from the evidence provided by the auditors' themselves to this inquiry. Based on the auditors' role in the Trio Capital case, the criticism expressed by many investors towards the audit certification process is very much understandable.

Investors' criticism of financial advisers

6.22 Unsurprisingly, many Trio Capital investors vented their frustration at financial advisers given that they invested on the basis of their adviser's recommendation. Mr John Telford told the committee that:

> Most of the people that are affected that I know of put their trust in a professional financial adviser. So I got on the telephone and I phoned around to different people that I know and I checked with people in a self-managed super fund and people in a regulatory fund, and most of them agreed with my misunderstandings of what I was in. I thought I was in superannuation. I did not even know that I was in a self-managed superannuation fund. If I had heard the name 'self-managed', I would not have thought that to be a noun or a product—something happening rather than a product. Also, I talked to people from both camps and nobody knew about fraud insurance or fraud or that your money can disappear. So I think that, on the one hand, the government bailed out for the regulatory and that was just a stroke of luck for those people that happened to be in the APRA regulated. For us that are missing out it seems like a difference was made out of information not available before this crisis happened in the first place. I would like to see that established—that there really is no difference between the two lots of investors.[18]

6.23 Another submitter, who asked for their name to be withheld, noted the difficulty of understanding the financial investment:

> I regret not being more financially sophisticated myself. Unfortunately I trusted the professional financial advisers in the way I trust medical

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17 Mr Shayne and Mrs Tracey Bonnie, *Submission 1, Supplementary Submission (b)*, p. 4.

18 Mr John Telford, *Committee Hansard*, Thirroul, 6 September 2011, p. 4. See also Mr John Telford, *Submission 66*, p. 1.

> professionals. In the same way that it is unreasonable to expect members of the public to have in-depth knowledge of neurosurgery, so is it unreasonable to expect members of the public to have in-depth knowledge of sophisticated and confusing financial matters. All of my energy has gone into trying to raise two children to become decent law-abiding citizens. I was mother and father to them. I did this while working fulltime instead of going on a parenting pension.
>
> I tried to educate myself on financial matters but simply did not have the time or energy to succeed.[19]

6.24 Ms Julia Fellows, on behalf of her mother, wrote:

> Unfortunately, neither my husband nor I were particularly knowledgeable at that time about complicated investment matters and so we put a high degree of trust in Mr ... as our investment manager.[20]

6.25 Mr Rodney Denniss, another SMSF investor in Trio, was asked whether upon moving his funds out of an industry fund to invest as an SMSF, he sought any advice from the industry fund about the risks. He responded:

> No, I did not. I just jumped at the opportunity to have some kind of input rather than having no input. When the opportunity arose, that was my intention. I just wanted to get a seat to have a look at what was going on. I guess I mainly wanted to have some kind of small involvement. I am sure I thought I would do better.
>
> ...
>
> I thought there was a slightly greater risk, but there is a risk in just generally investing each year. There is a risk element when I adjust the portfolio every year. If decisions were made to go with my adviser or to baulk at something and say, 'Maybe not that. Maybe something else,' not knowing what it was, if I baulked at something I would say that. This might be a naive belief and it seems that it is, but I thought that everyone in a super fund in Australia was pretty safe because we have regulatory bodies.[21]

6.26 Mr Denniss noted that no one had told him that as an SMSF he was not entitled to the same level of regulatory protection as APRA-managed funds. He did not ask about the level of regulatory protection he would receive as an SMSF as he assumed that given the compulsory superannuation system, the protections would be uniform.[22]

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19 Name withheld, *Submission 62*, p. 2.

20 Ms Julia Fellows, *Submission 12*, p. 1.

21 Mr Rodney Denniss, *Committee Hansard*, Thirroul, 6 September 2011, p. 21.

22 Mr Rodney Denniss, *Committee Hansard*, Thirroul, 6 September 2011, pp 21–22.

6.27 These issues of SMSF investor knowledge and understanding are revisited in chapter 7. They represent a significant challenge for the financial advice industry and for ASIC and the ATO.

Chapter 7

The 'expectation gaps' and some possible remedies

Introduction

7.1 The evidence of chapters 3, 4, 5 and 6 indicates that investors in Trio Capital were either unaware of, or had different expectations of the remit and function of the regulators, auditors, custodians, research houses and financial advisers. In evidence to the committee, these differences were termed 'expectation gaps'. These 'gaps' are as follows:

- first, and most significantly, most Trio investors in self-managed superannuation funds (SMSFs) seemed not to be aware that their investment was not protected to the same extent as investments made in Australian Prudential Regulation Authority (APRA) regulated superannuation funds. This has been a clear and recurring theme during this inquiry and is of particular concern to the committee;
- second and related, there is an expectation among investors that financial advisers will check the investments that they recommend to their clients, to ensure not only that there are prospects for good returns but that they are run legitimately;
- third, there is a lack of understanding as to how Australian Financial Services Licences (AFSLs) are issued. The AFSL attaches to the company, not the directors;
- fourth, both the regulators and investors have expressed frustration at the role of Trio Capital's financial statement and compliance plan auditors, particularly their inability to verify information. The auditors cite the limitations on their role and that the primary responsibility for detecting fraud rests with the responsible entity. They note that auditors can only obtain reasonable assurance that a financial report is free from material misstatement, whether caused by fraud or error;
- fifth, there is an expectation in the public mind that custodians will act to protect and secure the underlying investment. By contrast, Trio's custodian, the National Australia Trustee Limited, has noted that the custodian does not have the expertise to question underlying values of either domestic or offshore funds;
- sixth, there is a lack of understanding as to the claims made in the reports issued by research houses and in particular, whether the data provided by the responsible entity upon which these reports are based has been verified. There is also some confusion as to whether the ratings are intended as an indicator of future performance, or simply an assessment of past performance; and

- finally, Australian Securities and Investments Commission (ASIC) has noted that, compared to the United States and Europe, the level of underlying portfolio disclosure of managed investment schemes in Australia is very limited. Both ASIC and Morningstar have suggested there should be disclosure at asset level for registered managed investment schemes to help investors assess both the type of financial products they are exposed to, and the extent of that exposure.

7.2 This chapter discusses each of these gaps and makes several recommendations. It concludes by emphasising that addressing these expectation gaps will require a focussed effort on the part of ASIC, the Australian Taxation Office (ATO) and financial planning bodies, to educate SMSF investors about the inherent risks and complexities in managed investment schemes. These efforts must be made in conjunction with the actions proposed in this chapter's recommendations.

Informing and protecting SMSFs

7.3 The main 'expectation gap' in the Trio Capital collapse was the belief of many SMSF investors that they would be protected from, and compensated for, fraud and theft. The issue of compensation was considered in some detail in chapter 3. Chapter 6 noted that many investors expressed genuine surprise and shock that they did not enjoy the same protections as those afforded to investors in APRA-regulated superannuation funds. Some were even unaware they were investing in Trio funds through an SMSF. The committee notes that many, perhaps most, superannuation investors do not consider whether there is compensation available in the event of fraud and theft before they choose their superannuation fund (be it an APRA-regulated fund or an SMSF.

7.4 The committee acknowledges the anger and frustration of many SMSF investors in Trio Capital who were not aware that as an SMSF, they were operating in a different regulatory environment. The committee considers that, by and large, the problem was not that these SMSFs were investing recklessly, but that they were not informed of the risks.

7.5 The committee believes there are important steps that should be taken to remedy this situation. First, and most obviously, there is a key role for the ATO and ASIC to better inform SMSF investors of their responsibilities, their legal duties and their exposure to risk. At a minimum, the ATO's website must have a clear, understandable, large print warning placed on its website explaining that SMSF trustees are not covered in the event of theft and fraud.

Recommendation 3

7.6 The committee recommends that the Australian Taxation Office include a clear, understandable, large print warning on its website that self managed superannuation fund trustees are not covered in the event of theft and fraud. This warning must be effectively communicated to all existing Self Managed Superannuation Fund trustees through the guidance material of the Australian Securities and Investments Commission.

7.7 In addition, the committee believes that the guidance material provided by the Australian Taxation Office must explain the difference between the regulatory protections offered to members of APRA-regulated superannuation funds under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and the limited protections offered to SMSF investors under the *Corporations Act 2001* (Corporations Act).

Recommendation 4

7.8 The committee recommends that the guidance material provided by the Australian Taxation Office for Self Managed Superannuation Fund investors clearly state the difference between the protections and compensation arrangements for investors in funds regulated by Australian Prudential Regulation Authority as distinct from the limited protections available to Self Managed Superannuation Fund investors.

7.9 Notwithstanding the need for these warnings and disclosures, the obvious question arises as to whether this is at all an adequate response to the Trio case. There is a strong argument that while warnings and guidance materials for SMSF investors in relation to fraud may alert investors, they will not generally dissuade the investment. For one, the chances of losing superannuation money to fraud and theft in Australia remain statistically low. Moreover, when a financial adviser recommends the investment, the SMSF investor is naturally more concerned about the likely rate of return than the possibility of theft or fraud.

7.10 The committee notes that it is also difficult to envisage that a website warning or guidance material alone will lead SMSF investors to conduct the type of forensic analysis required to uncover a fraud of the sophistication of Trio before being burnt. Even Mr Hempton 'blew the whistle' well after the fraud had occurred and even then, was unsure whether there had in fact been fraudulent activity. Put simply, SMSF investors may not have the time, the insight or the knowledge to detect complex fraudulent activity.

7.11 The issue then becomes how SMSF investors can be protected in the rare event that they become a victim of fraudulent activity. On this matter, the committee makes two points. The first is to reiterate the recommendation in chapter 3 that the St John inquiry into a statutory compensation scheme for financial services must consider how compensation should work in investment structures where investors do not have the benefit of the SIS Act compensation scheme. As chapter 3 discussed, one option could be to place a levy on managed investment schemes covering SMSF investors for theft and fraud.

7.12 The committee's second proposal—potentially an alternative to an investment scheme levy—is to allow SMSFs that want to be covered for theft and fraud protection to do so through registering with APRA. This process would be subject to all necessary prudential licensing and knowledge requirements.

SMSFs and the role of financial advisers and planners

7.13 It is not surprising that many of those investors who lost money in the Trio Capital collapse directed their anger and frustration at the financial adviser, who recommended the investment. Chapter 6 presented these views. Quite apart from any expectation on the rate of return, investors expect that financial advisers will recommend an investment that is legitimately operated and properly regulated.

7.14 Following the introduction of the Future of Financial Advice (FoFA) legislation, financial advisers will have a fiduciary duty to act in the best interests of their clients and to put their clients' interests ahead of their own when providing advice. There is also a ban on the payment and receipt of certain remuneration which has the potential to influence the financial product advice given to retail clients.[1] Financial advisers will be required to make full and timely disclosure of commissions to investors. The provisions will in the future restrict certain conduct which appears to have been engaged in by advisers in the Trio case and which at that time did not breach any law.

7.15 However these provisions would not protect against a circumstance where an adviser 'turns bad' and sets out to either defraud his clients, or at the very least to concentrate on enriching himself while wilfully disregarding the evidence that the investment scheme into which he is putting his client's money was fraudulent. In the committee's view this is an accurate description of what occurred with Paul Gresham. The committee notes that if an adviser chooses to behave fraudulently or illegally, writing new laws will not add any protection; what is required is more effective enforcement of existing laws.

7.16 The committee highlights the fact that advisers, financial planners and in the majority of cases accountants, provide a critical entry point on establishment of an SMSF. It is concerning, on the evidence before the committee, that many Trio investors were not aware they were not entitled to compensation. This poses the fundamental question of what advice, if any, was provided by planners and

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1 See Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, February 2012, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/future_fin_advice/report/index.htm (accessed 20 April 2012).

accountants. The committee is particularly interested in establishing what advice was given to SMSF investors in Trio Capital by financial planners and advisers.

Recommendation 5

7.17 The committee acknowledges the Future of Financial Advice reforms, particularly the provisions addressing conflicted remuneration. Nonetheless, it recommends that ASIC conduct a specific and detailed investigation of both planners' and accountants' advice to SMSF investors in Trio Capital. This investigation must examine what information was provided to these investors regarding their duties and responsibilities, and whether they were informed—either verbally or in writing—that they are not entitled to compensation in the event of theft and fraud.

SMSFs and the role of the ATO

7.18 Another aspect of the issue of protecting SMSF investors concerns the role of the ATO. From the evidence in chapter 4, it is clear that (in contrast to APRA) the focus of the ATO is not on the level of risk-taking of SMSF investors, but on ensuring that there is an investment strategy which is not for the purpose of tax avoidance. In the Tax Commissioner's own words, 'the nature, effectiveness and risk of their investment is really a matter for the trustees, subject to certain rules in the law which say that certain investments are not able to be entered into'.[2]

7.19 The key point is that the ATO does not offer protection for SMSFs. Rather, it is the registration notice point for SMSFs, ensuring that SMSFs have a clear investment strategy and that they are not being used as vehicles for tax avoidance. Given this remit, the ATO is indifferent to the risks of fraud and theft to which SMSF investors are exposed. It is not its responsibility to minimise these risks.

Australian Financial Services Licensing arrangements

7.20 Another point of confusion for many Trio Capital investors related to AFSL arrangements. Chapter 4 noted that ASIC issues licences to the entity, rather than the individual. However, as chapter 6 observed, several Trio Capital investors criticised ASIC for giving an AFSL to Mr Shawn Richard. As one submitter argued:

> By investigating the role of ASIC and APRA you will find that had they correctly reviewed the licensing application information and PDS documents and undertaken Due Diligence and applied correctly their Duty of Care then Shawn Richard would never have been given a license and as a result Trio Capital would not have been established. As a final outcome the investors would have been protected from the eventual fraud.[3]

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2 Mr Michael D'Ascenzo, Commissioner, Australian Taxation Office, *Committee Hansard*, 23 September 2011, p. 33.

3 Name withheld, *Submission 13*, p. 1.

7.21 Mrs Fay Gammel made a similar observation:

> Why were Financial Licenses issued by the Regularity (sic) Authorities when the past history of a number of these operatives was known to be "dodgy"? Mr Shawn Richard seems to be a typical example.[4]

7.22 There is a clear expectation that undesirable elements should be kept out of the financial services sector through tighter regulation of licenses. However, as ASIC noted in its submission, there are limitations in the current licensing system:

> ASIC's ability to protect investors by restricting entry into, or removing participants from, the financial services industry who might cause or contribute to investor loss is limited under the current FSR [Financial Services Regulatory] regime. This is because the current FSR regime:
>
> - sets the threshold for obtaining an AFS licence relatively low and the threshold for cancelling an AFS licence relatively high; and
> - focuses on the licensed entity rather than the directors, employees or other representatives.[5]

7.23 The committee draws attention to the discussion in chapter 4 on the reforms to ASIC's licensing powers contained in the FoFA legislation, which passed in the House of Representatives in March 2012. The Bill would amend the relevant sections of the Corporations Act to give ASIC greater discretion in granting and cancelling AFSLs. Chapter 4 noted ASIC's comment that had these provisions been in place when the Trio fraud was happening, 'it may well have enabled ASIC to act at an earlier stage'.[6]

7.24 This will come as no consolation to Trio Capital investors. Nor will the FoFA amendments change the current situation of an AFSL attaching to the business, rather than individual directors. As chapter 2 noted, Shawn Richard, Cameron Anderson and Matthew Littauer, through their indirect control of Wright Global Asset Management, acquired the reputable funds manager Tolhurst (later AFM) in November 2003. ASIC issued Tolhurst an AFSL in March 2004 as part of the new licensing regime, thereby making Mr Richard, Mr Anderson and Mr Littauer the directors of a company with an AFSL.

7.25 In the committee's opinion, the Trio case does reflect a problem with the current licensing system. The fact that ASIC does not make checks when there are changes in ownership of an AFSL creates a loophole for a would-be criminal syndicate looking to acquire a reputable company holding an AFSL.

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4 Mrs Fay Gammel, *Submission 21*, p. 4.

5 ASIC, *Submission 51*, p. 21.

6 Mr John Price, Senior Executive Leader, ASIC, *Committee Hansard*, 6 September 2011, p. 5.

Recommendation 6

7.26 The committee recommends that the government consider whether current processes are adequate when there is a change of ownership or control of a company which holds an Australian Financial Services Licence, or whether there is a need for more detailed scrutiny of the new owner.

The role of auditors

7.27 A third and significant 'expectation gap' concerns the role of auditors. The views of Trio Capital's auditors—WHK, the external auditor and KPMG, the internal auditor—were canvassed in chapter 5 of this report. Chapters 4 and 6 presented criticisms of their roles by ASIC and APRA, and by Trio investors.

7.28 As discussed in chapter 4, the main theme of APRA's evidence to the committee was that, in a case like Trio, it is reliant on auditors to check the accuracy of the information that is supplied to it. APRA noted that in 2007 and 2008, the fund received 'an unqualified audit sign-off'.[7]

7.29 ASIC also offered pointed criticism of the role of the auditors in the Trio case, but noted that this was due to systemic failure. As ASIC's Chairman told the committee, 'there are checks and balances that we felt were built into the managed investment scheme (MIS) system that are just not working the way perhaps it was contemplated originally'.[8] Chapter 4 outlined ASIC's views on possible reforms to enhance the effectiveness of compliance plans and compliance committees.

7.30 Chapter 5 noted KPMG's view that there is an 'expectations gap' between what the public believe he work of a compliance plan auditor to be, and the work that by law the auditor is required to perform. Specifically, it argued that stakeholders often have erroneous expectations that: auditors are primarily responsible for the preparation and presentation of financial statements; that 'clean' audit opinion provides absolute assurance over the accuracy of the financial statements and guarantees the entity's future solvency; that auditors perform a 100 per cent check over all items recorded in the accounts; that auditors are to provide early warning regarding the possibility of a corporate collapse; and that an auditor's role includes detecting all fraud.

7.31 KPMG argued that these expectations contrast with the legal obligations of the auditing profession. In particular, it noted that auditing standards require an auditor to plan and conduct an audit to obtain 'reasonable (as opposed to absolute) assurance' that the financial statements are free from material error and fraud. This does not mean that auditors are required to certify or guarantee the accuracy of the financial statements or that the business model is sound. It added: 'there is a clear

7 Mr Ross Jones, Deputy Chairman, *Committee Hansard*, 30 August 2011, p. 38.

8 Mr Greg Medcraft, Chair, ASIC, *Committee Hansard*, 6 September 2011, p. 7.

opportunity for education and improving the understanding of the public at large as to the nature and scope of the auditor's role'.[9]

7.32 As chapter 4 noted, KPMG considered that the expectation gap could be reduced 'through AUASB and ASIC working together to provide additional guidance'.[10] It also argued that there could be greater guidance in terms of standards relating to the conduct of a compliance plan audit.

Committee view

7.33 The committee is particularly concerned at the 'expectation gap' between what is expected of auditors and what they are actually responsible for doing. This 'gap' relates to some fundamental issues. In particular, it is of concern that auditors' approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist. Further, an auditor's assessment of a compliance plan and the work of the compliance committee as effective essentially only means that they exist. Clearly in the case of Trio, the requirement for the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.

7.34 The committee believes that the government should investigate the areas that ASIC has identified to improve the operation of compliance plans and compliance committees. In particular, there is merit to the suggestion of an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval. In terms of compliance plans, the committee urges the government to examine ASIC's proposal to review the effectiveness of the role of these plans and if necessary, require more details to be provided in these plans. The committee also recommends that the government consider minimum requirements for compliance committees and the membership of these committees.

9 KPMG, *Submission 69*, p. 12.

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

Recommendation 7

7.35 The committee recommends that the government investigate options to improve the oversight and operation of compliance plans and compliance committees. In particular, this investigation should focus on the need for:

- **more detail to be included in compliance plans;**
- **qualitative standards by which compliance plan auditors must conduct their audits;**
- **liability for the responsible entity and its directors for any contravention of the compliance plan, rather than only for material contraventions, as is currently the case;**
- **legislative requirements as to experience, competence or qualifications for compliance committee members;**
- **regulatory or member oversight of the appointment of compliance committee members;**
- **an approval process for compliance plan auditors so that ASIC has the powers to remove or impose conditions on such approval; and**
- **governance arrangements to be clearly stated in relation to the proceedings of the compliance committee.**

The role of custodians

7.36 The Trio Capital collapse also exposed the limitations of the role of custodians (see chapter 5). Several submitters noted that the custodian had not performed its role properly as it had not verified the presence and the value of the underlying assets, and it had not protected the investment.

7.37 ASIC noted in its submission that 'there may be an expectation gap between what is legally required of custodians and what investors expect the custodian to be doing to safeguard their investment'.[11] It drew attention to its current review of custodians and flagged that one aspect of the review will be to consider whether custodians should be more proactive in identifying and reporting suspicious matters involving their clients.[12]

7.38 Chapter 5 noted the views of National Australia Trustee Ltd (NATL), ANZ Custodian Services and the Australian Custodian Services Association. All three drew the committee's attention to the system in which custodians operate, centred as it is on the responsible entity. ANZ wrote in its submission:

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11 ASIC, *Submission 51*, p. 77.

12 ASIC, *Submission 51*, p. 77.

> It has been suggested in submissions made to the Committee that a custodian is required to confirm the existence of a fund's underlying assets. This is incorrect. The custodian's role and function, as bare trustee, is to hold assets on behalf and upon instruction of the RE. Its duty, which is owed exclusively to the RE, is to act on proper instructions from the RE in relation to those assets. The role of the RE is to manage the assets of the scheme, including activities such as investment strategies and valuations. A custodian does not have discretion to choose whether or not to act on a proper instruction which is lawfully given by the RE. The custodian has no discretion regarding the investment or management of the custodial assets.[13]

7.39 Mr Leigh Watson, Executive General Manager of Asset Servicing at the NAB, told the committee:

> The custodian simply does not have expertise under the current regime, because it is not required to, around second-guessing or valuation of funds. Apart from reporting on values—either from independent sources, preferably, or from the manager RE who is responsible for that—the custodian simply does not have the expertise to question underlying values of offshore or even domestic funds. [14]

7.40 Chapter 5 noted that custodians 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. In this context, the NAB suggested that the committee may wish to consider whether there should be an obligation to report to a regulator if the instructions from the responsible entity carried out by the custodian found that assets did not exist.[15]

Committee's view

7.41 On the evidence before it, custodians appear to have a limited role in managed investment schemes of the kind conducted by Trio, and by many legitimate financial services providers. The custodian does virtually nothing to protect the funds of investors. It makes no independent checks before transferring money offshore. Instead, the custodian simply acts on the instructions of the responsible entity.

7.42 It is the committee's view that there is a clear expectation gap between what retail investors understand as the role of the custodian and what a custodian is legally required to do. The committee strongly supports ASIC's program to review custodian businesses and identify those issues requiring regulatory reform. In particular, the

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13 ANZ, *Submission 70*, p. 3.

14 Mr Leigh Watson, General Manager of Asset Servicing, National Australia Bank, *Committee Hansard*, 23 September 2011, p. 14.

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

committee urges ASIC to consider the safeguards that a custodian could put in place to ensure it able to identify and report suspicious transfers that do not trigger the anti-money laundering provisions.

7.43 In this context, the committee considers that the word 'custodian', particularly as used in product disclosure statements, is inappropriate. It urges ASIC to find another term, one which does not give unwarranted reassurance to investors. One option could be a 'Manager's Payment Agent'.

Recommendation 8

7.44 The committee recommends that as part of its review of regulatory arrangements relating to custodians, ASIC should consider changing the name 'custodian' to a term that better reflects the current role of a custodian. This new term—reflecting the limited role of custodians—must be used in Product Disclosure Statements.

The role of research houses

7.45 The collapse of Trio Capital has also exposed differences in the way investors and advisers view the work of research houses on the one hand, and the reality of how this work is conducted and how it should be interpreted on the other. There are two issues. First, there appears to be a perception among investors that research reports and ratings are a comment on future performance of a fund. This is not the case—the reports are solely an analysis of the past performance of the investment. Second, there is a reasonable expectation among investors that research houses will verify the data upon which their reports and ratings are based. Again, as chapter 5 explained, this is not the case.

7.46 As was the case with the auditors, the custodians and to a lesser extent APRA, Morningstar relied on the information provided by Trio without verifying whether the data was accurate. This is not to suggest that Morningstar acted improperly. Rather, it reflects the structure of the system, built as it is on the responsible entity acting honestly.

7.47 The committee notes that ASIC has been conducting a consultation process with a view to updating its Regulatory Guide on managing conflicts of interest for research report providers.[16] A consultation paper was released in November 2011 and the release of an updated regulatory guide is expected in May 2012. The consultation paper deals with issues including managing conflicts of interest, the methodology and transparency of the research and the quality of the research in terms of the resources devoted to it.

16 Regulatory Guide 79, *Managing conflicts of interest: An ASIC guide for research report providers*.

7.48 However, there is no mention in ASIC's consultation paper of the issue specific to research houses and the collapse of Trio; namely, that the data provided to research houses by the responsible entity is not independently verified. The committee believes that this is an important issue to consider. ASIC's planned work on the role of managed investment scheme compliance plans, auditors and committees would provide important assurances for research houses that their work is based on accurate data.

Better disclosure by managed investment schemes

7.49 The seventh and final 'expectation gap', and possible area for reform, relates to the disclosure requirements of managed investment schemes. Clearly, in the case of Trio, there was fraudulent activity perpetrated through the Astarra Strategic Fund (ASF) and the ARP Growth Fund. The question has arisen during this inquiry as to whether the regulators, the auditors, the research houses, the financial advisers and investors themselves would all benefit from better disclosure by the managed investment schemes of their asset portfolio holdings.

7.50 ASIC raised the possibility of whether there should be disclosure at asset level for registered managed investment schemes to help investors assess both the type of financial products they are exposed to and the extent of that exposure.[17] It noted that currently:

> [T]here is no current statutory requirement for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. Therefore, there is no means by which scheme members can legally require specific information on the portfolio holdings of the registered managed investment schemes in which they have invested. Absent the responsible entity providing this information on request of the scheme member voluntarily, investors cannot assess their exposure to particular assets associated with particular registered managed investment schemes and take this into account when considering whether or not they should continue to hold those investments.[18]

7.51 ASIC Chairman, Mr Greg Medcraft, raised this issue of the underlying portfolio level of disclosure in his evidence to the committee. He explained:

> At the end of the day, if you think about this system, the basic premise of the system is about efficient markets, and efficient markets are about making sure that there is not an asymmetry of information. I think here that, if you cannot actually find out what is in the underlying portfolio, it is a key weakness in terms of not having that information available to investors.[19]

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17 ASIC, *Submission 51*, p. 63.

18 ASIC, *Submission 51*, p. 63.

19 Mr Greg Medcraft, *Committee Hansard*, 6 September 2011, p. 6.

7.52 Mr Medcraft elaborated on this issue before a Senate Estimates hearing in October 2011:

> My view is that any investor—whether it be in a super fund or a managed investment scheme—should be entitled to see what the underlying assets of that fund are. As a former fund manager and banker, I think that every investor should have the fundamental right, whether it be with a non-disclosure agreement or whatever, to see what the underlying investments are. I think it is common sense.
>
> ...
>
> I think that is almost globally accepted because the investors' one has the most skin in the game; it is their money. From being overseas and in different markets, I was surprised when I came back to learn that our level of underlying portfolio disclosure in Australia was very limited when you compare it to markets like the United States or Europe. I think this was recognised in the Cooper review, which made recommendations to the government in terms of having underlying disclosure at six-monthly intervals to take a picture twice a year and have that available to investors. If we look at other markets, as I say, the United States has full portfolio level disclosure of funds on a quarterly basis within, I think, 30 days. It clearly can be done. It is done in other markets. I think it is quite important. Our system in Australia is a very open, free system and what we say to investors is that you have got to take responsibility for your investment decisions. I think that is consistent that investors taking responsibility should have access to that underlying portfolio. To that end, we have had very good discussions with industry groups in terms of looking at perhaps coming up with an industry standard for portfolio level disclosure. My preference is to see an industry standard develop in terms of portfolio level disclosure. I think it is actually quite important.[20]

7.53 Morningstar argued the need for greater disclosure and transparency of Australian fund managers and promoters of investment schemes, and in particular, 'comprehensive, periodic disclosure of the stocks, bonds, and other securities that make up the underlying portfolio holdings'.[21] It also noted that Australia lags behind global best practice in this area. Morningstar claimed that mandatory disclosure of portfolio holdings would:

> [A]ssist researchers, investors, financial advisers, and other market participants to detect deviation from stated investment mandates. Enhanced disclosure would also enable parties to gain a greater understanding of the characteristics and specific risks associated with the assets in which monies are being invested. The level of illiquid assets in a portfolio would also be more readily observed. Such disclosure would also provide greater

20 Mr Greg Medcraft, Chairman, ASIC, *Committee Hansard,* Economics Legislation Committee, Estimates, 20 October 2011, p. 99.

21 Morningstar, *Submission 33,* p. 8.

> opportunity for detection of undesirable investment manager behaviours such as excessive turnover.[22]

7.54 In an answer to a question placed on notice, Mr Shawn Richard acknowledged that the establishment of the ASF as a fund of hedge funds 'may have allowed for my employers to take advantage of the lack of transparency that comes with dealing in the hedge fund industry'.[23]

Committee view

7.55 The committee believes that greater disclosure of portfolio assets would help to improve monitoring of managed investment schemes, which would in turn assist in the earlier detection of fraud. It seems likely that had the regulators and gatekeepers had information about the underlying assets of the Trio Capital funds, the significant delay in APRA's requests for information in 2009 would not have occurred.

Recommendation 9

7.56 The committee recommends that the government release a consultation paper to investigate the best mechanism for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. The objective must be to enable scheme members to legally require specific information on the portfolio holdings of the registered managed investment schemes in which they have invested.

Concluding comment

7.57 The committee has recommended in this chapter a number of options to improve and to investigate the operation of the regulatory framework governing SMSFs and managed investment schemes. Some relate specifically to Trio; others relate to broader problems that the Trio collapse has exposed. The committee believes that all these recommendations warrant careful consideration. The end goal must be a system that promotes the education and understanding of retail investors and which enables the regulator and gatekeepers to monitor and detect fraud as efficiently as possible.

7.58 In addition to investigating the options for regulatory reform set out in the recommendations above, overcoming the various 'expectation gaps' will require improving investors' knowledge. Clearly, many SMSF investors in Trio Capital lacked basic knowledge of their responsibilities and the different regulatory settings between SMSF and APRA-regulated funds. As several investors have noted, the financial advice they received did not draw their attention to either the detail of their investment or the operating environment of SMSFs (see chapter 6). It is important that ASIC does

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22 Morningstar, *Submission 33*, p. 8.

23 Mr Shawn Richard, *Answers to questions on notice*, received 27 April 2012, p. 1.

conduct an investigation into the exact nature of advice to SMSF investors in Trio Capital (see recommendation 7).

7.59 More broadly, the committee notes that SMSFs have been an increasingly popular investment option for Australians over the past few years. With this has come the challenge of educating these investors about their responsibilities and the risks that come with having greater control over their investment through a self-managed fund.

7.60 The committee encourages ASIC, the ATO and the various financial planning bodies to focus on providing clear, accurate and well-circulated advice to SMSF investors through publications, guidance materials and PDSs. The committee acknowledges that ASIC has produced excellent guidance material, such as its 'Investing between the flags' publication. It also launched the National Financial Literacy Strategy in March 2011. Both initiatives are to be commended. As the superannuation landscape evolves, it is vital that this information is updated and widely disseminated.

Chapter 8

The need for further investigations to recover funds and prosecute wrongdoing

Introduction

8.1 As noted in chapter 2, part of the complexity of the Trio structure and the frustration of investors and regulators in being unable to recover the funds lies in the alleged mastermind of the fraudulent conduct being based overseas. Mr Jack Flader, a Hong Kong based former US lawyer, has been identified by the Australian regulators as the controller of all the offshore Trio funds. In total, $123 million in Australians' superannuation funds have not been able to be redeemed from Mr Flader's offshore funds.

8.2 In January 2011, it was reported that Mr Flader sold his business, Global Consultants and Services Ltd., to two Liechtenstein businessmen.[1] He is now, apparently, living in Thailand.[2]

8.3 The committee understands that Mr Flader has not broken any laws in Hong Kong. Further, the Australian Securities and Investments Commission (ASIC) has no jurisdiction in Hong Kong, although it has been reported that it has asked its counterpart in Hong Kong to interview Mr Flader.[3]

8.4 The committee emphasises that in the absence of a thorough investigation and prosecution, the allegations that Mr Flader was the lynchpin of the Trio fraud are only allegations. They remain unproven. That said, the committee does believe that considerably more can, and should, be done to track down the missing monies of Australian superannuation investors and investigate the role of Mr Flader and others.

Can ARP Growth Fund monies be recovered?

8.5 A key factual question before the committee is whether the principal underlying asset of the ARP Growth Fund—a derivative contract between British Virgin Islands company Professional Pensions ARP Ltd (PPARP) and the investment

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1 Stuart Washington, 'Flader link to father and son in $1 billion scam', *Sydney Morning Herald*, 25 January 2011, http://www.smh.com.au/business/flader-link-to-father-and-son-in-1b-scam-20110124-1a2v0.html (accessed 17 April 2012).

2 Tony Boyd, 'It's a joke , but no one's laughing', *Australian Financial Review*, 9 March 2012, p. 52.

3 Tony Boyd, 'It's a joke , but no one's laughing', *Australian Financial Review*, 9 March 2012, p. 52.

bank Bear Stearns—ever existed and had value. Was the contract and the underlying assets part of a fraud and if not, can the ARP Growth Fund monies be recovered?

8.6 the Australian Prudential Regulation Authority (APRA) gave evidence that it believed the contract did exist but its value fell to zero as a result of Bear Stearns' liquidation in the global financial crisis of 2008. In other words, it claimed that the money was lost as a result of a bad investment decision, rather than fraud:

> One of the difficulties in this is that some of the investments were just bad investments. The Bear Stearns transaction, as far as we can see, was just a really bad investment at a bad time that had a bad result. I know that was not your point—your point was you were talking about the audit sign-off—but I think it is important that we look at the totality here. Yes, there was a significant fraud; but, yes, there were also some really shocking investments in retrospect.[4]

8.7 The committee also discussed with PPB Advisory the question of whether the funds were recoverable or whether the money was lost with the collapse of Bear Stearns. The administrators told the committee:

> ...when you look at the actual investments of the ARP Growth Fund, you will see they are purely units in a thing called PPARP, which is a company registered in the BVI. Technically, under the product disclosure statement, that is the investment. What PPARP decides to invest in from that point of time is purely at the discretion of PPARP. It was disclosed to the unit holders that PPARP had elected to invest in a derivative swap agreement with Bear Stearns. It was outlined to those investors that that agreement was done through two segregated portfolios, administered by a company called Empyreal. There was no disclosure in any of the documents as to what the underlying investments would be, because it was actually designed as a so-called synthetic platform, which means you do not actually make investments but you are investing in the hedge fund market. If the market goes up in total value, you receive a return on your investment. If it goes down, then there may be calls up by Bear Stearns in terms of the equity that they have provided.[5]

8.8 PPB Advisory told the committee that it was not yet able to conclude that the underlying assets held by the ARP Growth Fund were non-existent. It noted that it would conduct further inquiries into this matter which would require the cooperation of the regulators in the British Virgin Islands, among others. Mr Manwaring noted:

> ...there is an awful lot of different connected parties who we would need cooperation from. We understand that, in the background, there may be other reasons why parties that may be involved in the process are being looked at by other regulators, and ours may simply be the pimple of other

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4 Mr Keith Chapman, ASIC, Executive General Manager, *Committee Hansard*, 30 August 2011, p. 39.

5 Mr Brett Manwaring, Director, Mr Mark Robinson, Partner PPB Advisory, *Committee Hansard*, 30 August 2011, pages 54–56.

> things. So we certainly do not have all the information to be able to ascertain how we could ever find out the actual answers at this point.[6]

8.9 The committee also asked PPB Advisory whether the acquisition of Bear Stearns by JP Morgan could mean that it is possible to proceed against JP Morgan to recover the lost value. Mr Manwaring responded:

> The party that is the counterparty to it, Empyreal, have stated that they have actually signed a settlement agreement with JP Morgan. We have never been provided a copy of that settlement agreement. We do know that the agreement itself was closed out. It was closed out in September 2008; that was the official date. Our understanding, based on the information we have received from both PPARP and Empyreal, is that an agreement was entered into between Empyreal and JP Morgan closing that agreement out, and a settlement was agreed to. We have never sighted that document. What is actually part of that settlement, we do not know.[7]

Committee view

8.10 The committee is not satisfied that APRA is correct in assuming that the PPARP–Bear Stearns contract did exist and that its value was wiped out with the liquidation of Bear Stearns in 2008. It is not clear to the committee that this view is based on a thorough investigation. Indeed, the committee is concerned that APRA holds this view because it has failed to fully investigate the alternative possibility: there may have never been a contract and the ARP Growth Fund was a fraudulent venture.

8.11 The committee believes there has not yet been a proper investigation into whether or not the ARP Growth Fund funds are recoverable. It is clearly an area that warrants further investigation. PPB Advisory has been funded by ASIC in phase 1 of its investigations into the collapse. In the committee's view, the phase 2 investigation also needs to be funded by ASIC. This should be done as a matter of urgency.

8.12 The committee heard that the cost of further investigation has been estimated at approximately $180,000. This is not an unreasonable cost given the imperative of making all possible efforts to recover the funds of Australian investor who have been defrauded.

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6 Mr Brett Manwaring, Director, Mr Mark Robinson, Partner PPB Advisory, *Committee Hansard*, 30 August 2011, pages 54-56.

7 Mr Brett Manwaring, Director, Mr Mark Robinson, Partner PPB Advisory, *Committee Hansard*, 30 August 2011, pages 54-56.

Recommendation 10

8.13 The committee recommends that the Australian Securities and Investments Commission provide all necessary funding for PPB Advisory to pursue its investigation to a full conclusion, including where necessary conducting examinations on oath of figures such as Mr Jack Flader and others it considers necessary as part of the investigation. The committee recommends that ASIC fund the phase 2 investigation by PPB Advisory as a matter of urgency.

The investigations of Australian crime-fighting agencies into Trio

8.14 The committee also has concerns that the various crime-fighting agencies should be doing more to seek to recover outstanding monies and bring to justice those who have committed crimes which have so badly affected Australian investors. There do not appear to be any criminal investigations into the conduct of Mr Flader or others involved in developing and implementing Trio's schemes.

The Australian Federal Police

8.15 The Australian Federal Police (AFP) has no current investigation into Trio. Indeed, Commander Peter Sykora, Manager of Crime Operations at the AFP, told the committee that the role of the federal police in investigating those involved with Trio overseas had been 'very minimal'. He explained:

> The first thing we did with ASIC was to assist them in a number of search warrants here in Australia. They have the investigative lead and they have the investigators to handle the investigation under the Corporations Act 2001. So we were only called upon to act as a facilitator for those search warrants, and the documents that were seized with regard to a certain individual were then passed to them for further investigation. ASIC then obviously came to us to facilitate some international inquiries, which we did throughout our office. I also understand that another agency was involved in Hong Kong. They reached out to the AFP through the International Liaison Officer Network, and we put them in touch with ASIC. That was as far as our involvement was concerned in that case.[8]

8.16 The committee asked Commander Sykora his view on whether there is currently a need for further work on the Trio case. He responded:

> I think the loss that has been seen throughout Trio is quite significant. But what we identified quite early on when ASIC approached us was that there was no Commonwealth broad per se for the AFP. This was a matter for ASIC to handle. However, in saying that, what we do see with a lot of our Commonwealth agencies here as well is that they can refer matters to us, particularly if they want to do it in a tripartite partnership—for want of a better term—with either the ACC or another government agency. We will

8 Commander Peter Sykora, Manager of Crime Operations, Australian Federal Police, *Committee Hansard*, 4 April 2012, p. 25.

> then assess that referral as per our case categorisation and prioritisation model. Then we will either accept or not accept the job.[9]

8.17 The AFP noted that it currently has a senior liaison officer posted in Hong Kong, where Mr Flader resides. It also told the committee that it has the powers to recover assets which are deemed to be proceeds of crime. However, the AFP would not sell those assets and would therefore not be able to deliver the proceeds to the victims of crime.[10]

The Australian Crime Commission

8.18 The Australian Crime Commission (ACC) has not conducted any specific investigations into the Trio case. Mr John Lawler, Chief Executive Officer of the Commission, told the committee:

> The ACC conducts special operations and investigations against Australia's highest threats from serious and organised crime. The ACC works with partners to disrupt, disable and dismantle serious and organised criminal syndicates. I need to say from the outset that the ACC has not undertaken any specific investigations into the activities of Trio Capital or the circumstances surrounding its collapse. However, the ACC has undertaken significant work on the issue of fraud, in particular international fraud, and can make a contribution to the committee, particularly against the inquiry's seventh, eighth and ninth terms of reference.[11]

8.19 The committee queried why—when in excess of $100 million of Australian investors' superannuation monies had gone missing and an auditor and five trustees had accepted some responsibility—the ACC had not looked into Trio. Mr Lawler responded:

> Well, there are two reasons for that. One of the reasons goes to...the scope and breadth of the commission's work, which can be ascertained from the website—a very extensive scope around narcotics, child exploitation, money laundering and the list goes on. The second reason is that, at its heart, the commission does not want to duplicate anything anyone else can or is doing. So if there is an agency or agencies with responsibility for pursuing particular matters then our view is that they should pursue the matters. If, as the particular police jurisdiction in the context of Project Galilee, reach a situation where they say traditional methods of law enforcement investigation and approach are not sufficient, it is then under our legislation that the commission can be brought into play. So there is a set statutory response level required before the commission can be engaged.

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9 Commander Peter Sykora, Manager of Crime Operations, Australian Federal Police, *Committee Hansard*, 4 April 2012, p. 25.

10 Commander Peter Sykora, Manager of Crime Operations, Australian Federal Police, *Committee Hansard*, 4 April 2012, p. 26.

11 Mr John Lawler, Chief Executive Officer, Australian Crime Commission, *Committee Hansard*, 4 April 2012, p. 19.

> That is a judgment for the agencies tasked with this sort of investigation and the regulation of this sort of matter in the first instance. If, for example, they feel that the powers of the commission could aid such an investigation then they are quite at liberty to bring those forward to us.[12]

8.20 The committee is aware that the ACC Board, which includes Commissioners from every state/territory police jurisdiction and the heads of key Commonwealth agencies—has established Task Force Galilee. This Task Force seeks to disrupt serious and organised investment fraud operations and the organised criminal groups behind them. It also aims to educate the Australian community about this type of investment fraud and the threat it represents.[13]

AUSTRAC

8.21 AUSTRAC is Australia's anti-money laundering and counter-terrorism financing (AML/CTF) regulator. It currently operates under section 209 of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act). AUSTRAC's role is to oversee compliance with the obligations of the AML/CTF Act and *Financial Transactions Report Act 1988* across various industry sectors. It collects and analyses financial information provided by regulated entities through financial transaction reports. This information is disseminated to Australian law enforcement, national security, human services and revenue agencies, as well as international counterparts, to assist in the investigation and prosecution of serious criminal activity including terrorism financing, organised crime and tax evasion.[14]

8.22 Significantly, it is the responsibility of gatekeepers, including auditors and custodians, to report suspicious matters to AUSTRAC. ANZ, the original custodian for Trio, noted that the AML CTF Act and the *Anti-Money Laundering and Counter-Terrorism Financing Rules 2007 (No. 1)* require participants in the financial services industry to make due diligence inquiries when taking on prospective clients, as well as carrying out suspicious matter reporting.[15] It added:

> The identification of suspicious matters is aided through transaction monitoring tools designed to detect abnormal or unusual behaviours based on certain typologies. ANZ provides guidance and training to staff to assist with the identification, and escalation, of suspicious matters.
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> Suspicious matters raised by ANZ staff are referred to a centralised ANZ team, ANZ Financial Intelligence Office (FIO), for further investigation. FIO acts as the escalation point to ensure that any suspicious matters sent to

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12 Mr John Lawler, Chief Executive Officer, Australian Crime Commission, *Committee Hansard*, 4 April 2012, pp 22–23.

13 Australian Crime Commission, 'Serious and organised fraudulent investment scams', http://www.crimecommission.gov.au/publications/crime-profile-series-fact-sheet/serious-and-organised-fraudulent-investment-scams (accessed 11 May 2012).

14 AUSTRAC, *Annual Report 2010–2011*, Agency overview, p. 1.

15 ANZ, *Submission 70*, p. 8.

> AUSTRAC contain complete and relevant information to assist in the broader management of financial crime. ANZ officers within FIO investigate each 'suspicious and unusual activity matter report' in order to determine whether a suspicious matter report should be provided to AUSTRAC as required under the AML CTF Act. For example, ANZ in the year to 30 September 2011 reported 1092 suspicious matters to AUSTRAC.[16]

8.23 The committee did not receive a submission, or take direct evidence from AUSTRAC. It does appear, however, that AUSTRAC was not given any significant information from the various gatekeepers alerting it to suspicious activity in Trio Capital. In this context, questions must be raised as to whether the gatekeepers—particularly the financial advisers and custodians—conducted due diligence when taking on prospective clients.

Committee view

8.24 The committee questions why one of the largest financial frauds in Australian history has not been more thoroughly investigated by agencies such as the AFP and the ACC. Chapter 5 noted that various gatekeepers pointed to others' responsibilities rather than their own. The evidence above similarly indicates that Australia's crime fighting agencies seem to have deferred responsibility to other agencies: the AFP to ASIC, and the ACC to the AFP among others. Notwithstanding the progress that the AFP, the ACC and AUSTRAC have made in coordinating their detection and response to international financial fraud, in the case of Trio and Mr Flader, there do not seem to have been satisfactory investigations.

8.25 The committee asks whether any attempts have been made to bring charges against Mr Flader and others, to have them extradited to Australia, or even as to whether their names are on a watch list for people passing through Australian airports. The committee believes that, unless there is compelling evidence that these efforts would be futile, there should be concerted action on these matters. Of course, ASIC and APRA have a crucial role to support and coordinate these investigations.

Recommendation 11

8.26 The committee recommends that the Australian Federal Police, in cooperation with the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority, pursue criminal investigations into—and, where applicable, criminal sanctions against—the key figures responsible for defrauding investors in Trio as a matter of high priority.

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16 ANZ, *Submission 70*, pp 9–10.

Is Australian superannuation an easy target?

8.27 Australia boasts the fourth largest funds management market in the world. One consultancy has estimated that in June 2011, 44.8 per cent of the $1.3 trillion in funds under investment managers were in the form of superannuation savings. It anticipated that in 2011–2012, the superannuation funds management industry would generate revenue of $9.42 billion from an estimated $532 billion in superannuation assets for which they provide investment services.[17] These figures are likely to increase over time, particularly given the imminent increase in the Superannuation Guarantee Charge from 9 to 12 per cent.

8.28 While this is good news for both superannuants and the funds management industry, there is some belief that the size of the funds invested in Australian superannuation makes it a target for fraud. Media clichés like 'honey pot' are increasingly used to describe the amassed superannuation funds.[18] In the case of Trio, the fraud specifically and principally targeted superannuation savings, and appears to be designed to take advantage of vulnerabilities in the superannuation system.

8.29 The committee notes that Task Force Galilee was established partly in response to the threat that organised crime posed to Australia's superannuation savings, and that these savings are an attractive target for criminals. An ACC publication on Task Force Galilee stated:

> Organised criminal groups are attracted to the high levels of superannuation and retirement savings in Australia. The Australian economy is known to have been less affected by the global financial crisis than other nations, making those approaching retirement, an attractive target. In the next 20 years, a large number of Australians are expected to retire from active work and will have superannuation investments to manage. Raising awareness of fraudulent serious and organised investment scams is important in preventing people falling victim.[19]

8.30 The committee received little evidence during this inquiry on the extent to which the Australian superannuation system is vulnerable to sophisticated attempts to defraud this system and its investors. The Australian Custodial Services Association noted that 'the financial services industry is particularly vulnerable to the risk of international fraud'[20]. However, the Financial Services Council (FSC) took the

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17 IBISWorld, 'Superannuation Funds Management in Australia: A research report', April 2012, http://www.ibisworld.com.au/industry/default.aspx?indid=1890 (accessed 17 April 2012).

18 'Australian seniors warned of fraudsters increasingly targeting their $1.3 trillion superannuation', *Courier Mail*, 28 August 2011, http://www.couriermail.com.au/money/australian-seniors-warned-of-fraudsters-increasingly-targeting-their-13-trillion-superannuation/story-e6freqp6-1226123542266 (accessed 27 October 2011)

19 Australian Crime Commission, 'Serious and organised fraudulent investment schemes', *Fact sheet*.

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

opposite view. Asked whether the size of Australia's funds industry and the large pool of capital relative to population size made Australia a target for international fraudsters, the FSC replied:

> No. The Australian market internationally is regarded as being highly regulated and so it is probably the opposite to that. Notwithstanding we have the fourth largest pool of fund management assets globally, the fact that it is so heavily regulated, obviously relative to other markets, means that it is not seen as the destination of choice.[21]

8.31 In a similar vein, APRA argued that 'cases of fraud in the regulated superannuation sector are rare'[22], accepting perhaps that it is inevitable some people will always be tempted to defraud others no matter what regulatory boundaries are in place. Chapter 4 of this report noted APRA and ASIC's view that even the best regulatory system will be unable to detect and intercept all fraud. While this may be true, the committee emphasises that several things can and should be done to guard against a repeat of Trio.

Committee view

8.32 In the committee's opinion, the Trio case exposes the significant vulnerability of the Australian superannuation savings system to targeting by criminals, including offshore based criminals. The committee believes that several factors have contributed to making the system attractive to these criminal elements.

8.33 First, and most obviously, Australia does have a very large pool of superannuation savings. Second, many Australians are disengaged from their superannuation savings. This is a product of a compulsory superannuation system, of many younger people having low balances, and of investors' inability to access their funds until they retire. The result is that many people will not pay close attention to how their funds are performing. There is far less occasion for most people to check a superannuation account balance than there is to check their bank account balance. Detecting a fraud against a bank account is therefore more likely than it is against a superannuation account. In the case of Trio, Mr Paul Gresham produced fictitious account statements for several years. Account holders had no reason to seek to withdraw the money and as a result, the fraud continued undiscovered for some time.

8.34 In this context, the committee draws attention to a 2005 speech by Mr Jeremy Cooper, then Deputy Chairman of ASIC, in which he outlined the risks posed by fraudulent financial statements and steps that had been taken in the US to address this problem.[23] Mr Cooper stated:

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

22 APRA, *Submission 41*, p. 8.

23 Mr Jeremy Cooper, Deputy Chair, ASIC, speech entitled *Financial Statement Fraud: Corporate Crime of the 21st Century*, 8 June 2005

> One of the key US initiatives aimed at combating financial statement fraud was the requirement for internal controls mandated by section 404 of the Sarbanes-Oxley Act. This feature was not adopted in Australia and this remains one of the key points of difference between our two systems. There are some aspects of the quality review concept in AUS 206 [an auditing standard], but the key theme of 404, relating to the testing of internal controls, has no Australian equivalent.[24]

8.35 The committee believes there are significant policy steps required to better protect against the threat to the superannuation system from criminals. These include:

(a) the establishment of a dedicated superannuation fraud squad in the AFP;

(b) more detailed scrutiny by APRA of the 'trigger points' at which criminals take control of superannuation vehicles. In the case of Trio, the most obvious 'trigger points' were the acquisition of Tolhurst by the Trio directors and the decision by the Professional Pensions Pooled Superannuation Trust (PPPST) to remove the Trust Company as a trustee (see chapter 2);

(c) a much more vigorous criminal investigation, involving ASIC, APRA and the AFP, into the Trio fraud, with a view to pursuing the maximum available criminal sanctions against those responsible. This will send the message to others considering targeting the superannuation sector that they face significant consequences from doing so; and

(d) legislation to allow assets to be recovered from those personally involved in fraud and theft, with the proceeds to go towards compensating those who have lost money as a result of the fraud and theft.

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24 Mr Jeremy Cooper, Deputy Chair, ASIC, speech entitled *Financial Statement Fraud: Corporate Crime of the 21st Century*, 8 June 2005, p. 14.

Recommendation 12

8.36 The committee recommends that the government investigate the options for a scheme to recover assets from those found to be personally involved in fraud and theft, with the proceeds to go to those found to have been defrauded.

Recommendation 13

8.37 The committee recommends that the Australian Prudential Regulation Authority conduct an internal assessment of the adequacy and timeliness of its checks to monitor the ownership of superannuation vehicles. This process must review why key 'trigger points' in events that led to the collapse of Trio Capital were not identified.

Recommendation 14

8.38 The committee recommends that the Australian Federal Police consider the options to create an organisational focus on the matters pertaining to superannuation fraud. This should occur in close consultation with the Australian Crime Commission given its work in coordinating Task Force Galilee.

Chapter 9

Concluding comments

9.1 The collapse of Trio Capital was the largest superannuation fraud in Australian history. Roughly $176 million in Australians' superannuation funds is lost or missing from two fraudulent managed investment schemes: $123 million from the Astarra Strategic Fund (ASF) and $52 million from the ARP Growth Fund.

9.2 Trio was the responsible entity for both these schemes, as well as 23 other legitimate managed investment schemes. It was also the registrable superannuation entity and common trustee of five Australian Prudential Regulation Authority (APRA) regulated superannuation funds. These funds invested heavily in the various managed investment schemes.

9.3 Significant funds from the ASF and ARP Growth Fund were invested in hedge funds in the British Virgin Islands. These hedge funds were controlled by Mr Jack Flader, one of the masterminds of the fraud. It appears that when the hedge funds collapsed, Australian investors' funds disappeared. However, it is not clear whether the principal underlying asset of the ARP Growth Fund—a derivative contract between Professional Pensions ARP Limited (PPARP) and Bear Stearns—ever existed and had value.

Compensation issues

9.4 Nearly 5400 investors in the APRA-regulated funds that invested in these schemes received full compensation under the provisions of the *Superannuation Industry (Supervision) Act 1993 (SIS Act)*. In total, the compensation package of $55 million represents the largest payout for superannuation fraud in Australia. It was financed through a (prepaid) levy on all APRA-regulated superannuation funds.

9.5 The committee views this levy as an appropriate mechanism in a compulsory tax preferred retirement savings system, where individuals rely on APRA's prudentially regulated and licensed trustees. The levy results in minimal cost to the totality of superannuation savings and is critical to maintaining ongoing confidence.

9.6 There were around 690 direct investors in the ASF who are not eligible for compensation. Of these, around 285 investors were in self managed superannuation funds (SMSFs). The SIS Act excludes SMSFs from financial assistance where certain superannuation entities have suffered loss as a result of fraudulent conduct or theft.

9.7 As this report has emphasised, the committee is extremely troubled by both the nature and the scale of these losses, and the effect they have had on hundreds of investors. The committee has received substantial evidence from Trio Capital investors detailing their considerable financial losses and the physical and emotional toll of these losses on them and their families.

9.8 However, the committee does not believe it is prudent to protect SMSF investors from losses to theft and fraud in the way that APRA-regulated superannuation fund investors are covered under the SIS Act. SMSFs are, by their nature, different to APRA-regulated funds. They are typically individuals with considerably more control over their investment strategy and portfolio than APRA-regulated superannuation fund investors. This control and choice are the key appeals of SMSFs. SMSFs also avoid the high fees and commissions that investors in the various industry superannuation funds must often pay. (A statistical summary of SMSFs found that in 2008, the average operating expense ratio of the SMSF sector was 0.69 per cent compared to 1.2 per cent for the whole superannuation industry.)[1]

9.9 These benefits of investing in SMSFs come with attendant responsibilities, one of which is to be alert to the risk or fraud and theft. Unlike APRA-regulated investors, SMSF investors do not have a professional management team to exercise this caution. As chapter 3 of this report discussed, a compensation scheme for SMSFs would in effect expose all SMSF investors to poor investment decisions and a lack of prudence by other SMSF investors. A levy on SMSFs as part of a SMSF compensation scheme could be substantial.

9.10 Nonetheless, the committee does consider there is merit to investigating a scheme that places a levy on managed investment schemes to compensate SMSFs in the event of losses by reason of fraud and theft on the part of the responsible entity. A proposal along these lines should be considered as part of the current review of compensation arrangements for consumers of financial services.

9.11 The committee recognises that this scheme, if conceived and implemented, will be too late to assist those SMSFs that have lost substantial sums in the Trio Capital collapse. However, it urges the government to investigate the possibility of compensating investors in the ARP Growth Fund. As this report has noted, these investors were induced by Mr Paul Gresham to remove their money from a Pooled Superannuation Trust—which is regulated under the SIS Act—to invest directly as a SMSF in the fraudulent ARP Growth Fund. It may be that they are eligible to receive compensation.

Pursuing the funds and the criminals

9.12 The committee also reiterates that more must be done to investigate whether the missing Trio funds can be recovered, and to pursue criminal investigations into the key figures responsible for the fraudulent overseas Trio funds. To this end, the Australian Securities and Investments Commission (ASIC) must provide all necessary funding for PPB Advisory to pursue its investigation to a full conclusion. Mr Flader's evidence must be part of this investigation. The committee also questions whether an

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1 Australian Government, 'A statistical summary of self-managed superannuation funds', *Review into the governance, efficiency, structure and operation of Australia's superannuation system*, December 2009, p. 15.

enforceable undertaking is the only sanction that Mr Gresham deserves. It shares the surprise and disappointment of several submitters that this has been his only punishment to date.

9.13 The conduct and involvement of the Wollongong-based Mr Ross Tarrant in advising 220 of his clients to invest in the ASF was clearly different to that of Mr Gresham. Mr Gresham had had contact with the perpetrators of the fraud since at least 2003. Mr Tarrant was not aware of the fraud. Nonetheless, Mr Tarrant was paid hefty commissions by recommending Trio to his clients.

9.14 As this report proposes, the committee emphasises the need for ASIC to investigate financial planners and accountants' advice to SMSF investors in Trio Capital. The committee welcomes the imminent reform of the financial advice sector through the implementation of the Future of Financial Advice (FoFA) legislation. It notes that some of the financial advice given to Trio clients may have been in contravention of the 'best interests' test and conflicted remuneration provisions of the FoFA legislation.

The regulators

9.15 The committee is concerned that the two key regulatory agencies—ASIC and APRA—did not identify and pursue the Trio fraud until after Mr Hempton had sent his alert. Between 2004 and 2009, APRA conducted no fewer than five prudential reviews of Astarra Capital. However, these did not lead to any action. Moreover, the reviews were primarily motivated by a concern with governance related matters, rather than the events that laid the platform for the fraud to occur: the purchase of Tolhurst in 2003 and the replacement of the Trust Company as the trustee of Professional Pensions Pooled Superannuation Trust in 2004 (see chapter 2).

9.16 As chapter 4 also noted, APRA's response to Trio's inability to value the assets of the relevant funds in 2008–2009 was far too slow. The committee is critical of the apparent lack of communication between APRA and ASIC on this issue. When ASIC commenced its investigation of the hedge funds in June 2009, it did not seem aware that Trio was not providing APRA with basic facts about the existence of assets and their value.

The responsible entity and the gatekeepers

9.17 This inquiry highlights the importance of the regulatory framework governing managed investment schemes. The effectiveness and the efficiency of this framework to identify and investigate fraud, built as it is on compliance requirements and a series of gatekeepers, have been brought into question.

9.18 A key part of that system is the single responsible entity. The purpose of this single entity was to establish a single point of accountability to investors for the management of assets, instead of a system where both the manager and the trustee were accountable. Chapter 5C, subsection 601FC of the *Corporations Act 2001* establishes the duties of the responsible entity. Chapter 5C also establishes a supervisory structure of compliance plans and compliance committees to ensure that follows the rules set out in the managed investment scheme's constitution.

9.19 The strength of single responsible entity regime is its clean lines of accountability. With some notable exceptions, most submitters supported the regime primarily for this reason. However, the system can falter when the responsible entity stalls and deceives. In these circumstances, as the Trio case amply demonstrates, there are various points of systemic weakness relating to the role of the regulators, the auditors, custodians, research houses and financial advisors.

9.20 The story of Trio Capital's collapse is one of misplaced trust. Banks, acting as custodians, trusted the information they were provided by the responsible entity. The internal and external auditors also trusted the financial information given by Trio. Research houses are not required to check the underlying assets of the financial statements they rate. Financial advisers, with their limited resources, rely on the various gatekeepers to establish the veracity of the funds they recommend to clients. The clients, at the end of this chain, often lack the time, knowledge and resources to verify the worth of the funds in which they invest.

9.21 The regulators, custodians, research houses and financial planners all expressed their frustration at the inability of Trio's internal and external auditors to verify information in financial statements. The auditors cite the limitations on their role and emphasise that the primary responsibility for detecting fraud rests with the responsible entity. The committee strongly endorses ASIC's forward program to improve the rigour of compliance plans, the auditing of these plans and the composition and governance of compliance committees.

9.22 The committee also supports ASIC's work in relation to custodians. The collapse of Trio Capital has exposed the very limited role of custodians in Australia. The Trio custodians stated that they do not have the expertise to question underlying values of either domestic or offshore funds. The committee believes that ASIC should consider changing the name 'custodian' to a term such as a 'Manager's Payment Agent'.

9.23 The committee is also concerned that the reports and ratings of research houses are misunderstood by investors and give false security to investors. It is important that investors and advisers realise the limitation of custodians' role.

9.24 Improved oversight of the responsible entities of managed investment schemes by auditors, custodians and research houses is crucial. However, the committee also believes that to this end, it will assist if there is a statutory requirement for a responsible entity of a registered managed investment scheme to disclose its scheme assets at the asset level. Compared to the United States and Europe, the level of underlying portfolio disclosure of managed investment schemes in Australia is very limited. As Mr Shawn Richard noted:

> ...if a fund of hedge funds are unable to show the list of underlying assets purchased by a 3rd party manager, it will always be very difficult for all relevant parties to make the necessary checks in order to confirm whether the Australian manager is delivering on its stated strategy, risk profile and liquidity guidelines as well as detect fraud.[2]

9.25 The disclosure of specific information on portfolio holdings of managed investment schemes will improve confidence throughout the regulatory system. It will provide a greater level of assurance for internal and external auditors, custodians, research houses, the regulators, financial planners and investors themselves that the investment scheme is legitimate and well-based.

Draft legislation to improve transparency of superannuation assets

9.26 The committee is encouraged that in April 2012, the government released draft legislation which would require superannuation funds to publish on their websites details of the assets that the fund has invested in (among other matters). The draft Explanatory Memorandum states:

> Parties who invest assets of an registrable superannuation entity (RSE), or assets derived from assets of an RSE, will be required to notify the provider of the financial product that they must provide information to the RSE licensee that will allow the RSE licensee to comply with the requirement to publish portfolio holdings.[3]

9.27 The draft explanatory memorandum (EM) gives the case where a RSE licensee invests the assets of its fund through a custodian into a financial product provided by 'Managed Investment scheme 1'. Managed Investment Scheme 1 is a fund of funds, making investments into other managed investment schemes including a product offered by Managed Investment Scheme 2. The draft EM states that in this case:

- the custodian must notify Managed Investment Scheme 1 that the assets invested are those of the superannuation fund;
- Managed Investment Scheme 1 must subsequently notify Managed Investment Scheme 2 that it is investing assets derived from the assets of the superannuation funds; and
- Managed Investment Scheme 2 will have an obligation to provide information directly to ABC Super that is sufficient to identify its financial product and the value of ABC Super's investment.

2 Mr Shawn Richard, *Answers to questions on notice*, received 27 April 2012, p. 7.

3 Draft Explanatory Memorandum, Superannuation Legislation Amendment (Further MySuper and transparency Measures) Bill 2012, p. 28. Hhttp://strongersuper.treasury.gov.au/content/exposure_drafts/super_legislation_amendment/downloads/Explanatory-Memorandum.pdfH (accessed 27 April 2012).

9.28 The committee believes that these obligations are important. However, they deal with verifying assets between the RSE and the responsible entity of the investment scheme. As noted, it is also important that SMSF investors are protected by the responsible entity disclosing its scheme assets at the asset level to the regulators and gatekeepers.

A final note

9.29 The recommendations contained in this report are designed to enhance the responsible entity regime by improving access to, and verification of, information supplied by the responsible entity. It is of particular concern to ensure a rigorous and efficient system through which to check the presence and value of the assets of the managed investment scheme. This framework will enable fraud to be detected more readily by the regulators and the gatekeepers.

9.30 The committee believes that the recommendations contained in this report will improve understanding among retail investors of the roles and responsibilities of gatekeepers and in so doing, improve financial literacy levels. They will focus the minds of investors, regulators and gatekeepers on the need for a professional scepticism about the funds they are required to consider.

9.31 The committee views SMSFs as an important and attractive savings vehicle for those wishing to, and equipped to, exercise personal control over their retirement savings. The Trio Capital experience does not expose any significant concerns with SMSFs as a savings vehicle. There are concerns, however, with the lack of knowledge and sophistication of SMSF investors. There is a continuing need to improve their financial knowledge and understanding, and the quality of the advice that they receive.

9.32 The committee also believes that ASIC and APRA must exercise particular vigilance in their responsibilities to regulate and oversee superannuation investments and managed investment schemes investing overseas. The Australian superannuation pot is one of the largest in the world and, given the camouflage provided by the long-term nature of these investments, is potentially a ripe target for unscrupulous operators. In terms of managed investment schemes investing in overseas hedge funds, while they account for only a fraction of total Australian and overseas investments in SMSFs, they demand the regulators' full attention given their complexity and cross-jurisdictional nature.

Ms Deborah O'Neill, MP

Chair

Appendix 1

Submissions

1 Mr Shayne and Mrs Tracey Bonnie
1 1 Supplementary Submission
1 2 Supplementary Submission

2 Mr Phil Keeffe

3 Name Withheld

4 Mr Russell Smith

5 Mr Brian Larking

6 Dr Les and Mrs Jeanette Hardacre
6 1 Supplementary Submission

7 Mr John Clark

8 Mr Mal Nicholson

9 Mr David Gamosh

10 Mr Don Fox

11 Confidential

12 Ms Julia Fellows
12 1 Supplementary Submission

13 Name Withheld

14 Mr Stephen Bright

15 Confidential

16 Name Withheld

17 Mr Roy and Mrs Barbara Fowler
17 1 Supplementary Submission
17 2 Supplementary Submission

18 Name Withheld

19 Ms Rena Anderson

20 Mr Paul Cohen

21 Mr Terry and Mrs Fay Gammel
21 1 Supplementary Submission

22 Mr Warren Daley
22 1 Supplementary Submission

23 Mr E and Mrs M. Gaden
23 1 Supplementary Submission
23 2 Supplementary Submission

24 Mr Patrick Ginnane

25 Association of ARP Unitholders
25 1 Supplementary Submission

26 PPB Advisory

27 Australian Taxation Office

28 The Treasury

29 The Trust Company
29 1 Supplementary Submission

30 Financial Services Council

31 The Association of Superannuation Funds of Australia Limited

32 Australian Institute of Superannuation Trustees

33 Morningstar

34 CPA Australia

35 Mr Ross Tarrant

36 Confidential

37 Name Withheld

38 Mr Colin Warne

39 Mr Allan Broadhead

40 Mr Nick and Mrs Donna McGowan

41 Australian Prudential Regulation Authority

42 Confidential

43 Australian Custodial Services Association

44 SMSF Professionals' Association of Australia

45 Financial Ombudsman Service

46 Financial Planning Association of Australia

47 Industry Super Network

48 Confidential

49 Small Independent Superannuation Funds Association

50 Name Withheld

51 Australian Securities and Investments Commission

52 Confidential

53 Mr Ian and Mrs Lorraine Callaway

54 Mr Graeme Bradley

55 Name Withheld

56 Name Withheld

57 Name Withheld

58 Name Withheld

59 Mrs Heather Loosemore

60 Name Withheld

61 Confidential

62 Name Withheld

63 Mr Arthur and Mrs Jenny Taylor

64 Mr Peter Fieldsend

65 Name Withheld

66 Mr John Telford
66 1 Supplementary Submission

67 Name Withheld

68 Mr Des Scott

69 KPMG

70 ANZ

71 Mr Paul Gresham

72 National Australia Bank

73 Confidential

74 Ms Lynette Ross

75 Ms Dorothy Logan

76 Confidential

77 Name Withheld

Answers to Questions on Notice

1 Australian Taxation Office, public hearing, Sydney, 23 September 2011: Tables profiling users of SMSFs, received 4 November 2011

2 SMSF Professionals' Association of Australia, public hearing, 30 August 2011, received 24 February 2012

3 Companies Auditors and Liquidators Disciplinary Board, Public hearing, Sydney, 4 April, 2012, responses received 30 April 2012

4 Response to written questions, Mr Shawn Richard, received 27 April 2012 and supplementary remarks, received 9 May 2012

5 Answers to Questions on Notice from ASIC, received 11 May 2012

Additional information received

1 Additional information provided by Mr Peter Johnston, Executive Director, Association of Independently Owned Financial Planners

2 Additional Information provided by Morningstar

3 Response to adverse comment from the Trust Company

Appendix 2

Public Hearings

Witnesses

30 August 2011, Sydney

Financial Ombudsman Service
Ms Alison Maynard, Ombudsman Investments, Life Insurance and Superannuation

SMSF Professionals' Association of Australia (SPAA)
Ms Andrea Slattery, CEO
Mr Peter Hogan, Director

Association of ARP Unitholders Inc
Mr Ron Thornton, President
Mr Barry Tomkinson, Member
Mr Michael Robinson, Treasurer

Association of Superannuation Funds of Australia (ASFA)
Mr David Graus, General Manager, Policy and Industry Practice
Ms Fiona Galbraith, Senior Policy Adviser

Financial Services Council (FSC/IFSA)
Mr Andrew Bragg, Senior Policy Manager
Mr Martin Codina, Director of Policy

Australian Prudential Regulation Authority (APRA)
Mr Ross Jones, Deputy Chair
Mr Keith Chapman, Executive General Manager, Supervisory Support Division
Mr Greg Brunner, General Manager Actuarial, Market and Insurance Risk Services, Supervisory Support Division
Mr Stephen Glenfield, General Manager South West Region, Specialised Institutions Division

The Trust Company
Mr John Atkin, CEO
Mr Rupert Smoker, Head of Responsible Entity Services

PPB Advisory - Liquidators
Mr Brett Manwaring, Director
Mr Mark Robinson, Liquidator

6 September 2011, Thirroul, NSW

Community Forum Witnesses

Ms Sharon Bent

Mr Shane Bonnie

Mrs Tracey Bonnie

Ms Jennifer Butler

Mr Rodney Denniss

Mr Ian Hogg

Ms Nicole McCann

Mr Nicholas McGowan

Mr Russell Smith

Mr John Telford

Mr Norman Upton

6 September 2011, Sydney

Australian Securities and Investments Commission
Mr Greg Medcraft, Chairman
Mr John Price, Senior Executive Leader
Mr David McGuiness, Senior Executive Leader
Mr Glen Unicomb, Senior Executive Leader

22 September 2011, Canberra

(By teleconference)

Association of Independently Owned Financial Planners
Mr Peter Johnston, Executive Director

23 September 2011, Sydney

The Treasury
Mr Jim Murphy, Executive Director Markets
Mr Jonathan Rollings, Principal Advisor for Financial Systems
Ms Sue Vroombout, General Manger, Retail Investment Division
Mr Nigel Murray, Manager Personal Retirement Income Division

National Australia Bank
Mr Dick Morath, Chairman, GWM Advisor Services
Mr Stephen Tudjman, Head of MLC Legal
Mr Leigh Watson, Executive General Manager of Asset Servicing

Morningstar
Mr Anthony Serhan, CEO

Financial Planning Association
Dr Deen Sanders, Chief Professional Officer
Mr John Bacon, General Manager - Professional Standards
Mr Dante De Gori, General Manager - Policy and Government Relations

Australian Taxation Office
Mr Michael D'Ascenzo, Commissioner
Mr Brett Peterson, Acting Deputy Commissioner Superannuation

4 November 2011, Canberra

WHK Group Ltd
Mr John Gavens, Principal, Audit and Assurance, Crowe Horwath
Mr John Lombard, Chief Executive Officer and Managing Director

4 April 2012, Sydney

Companies, Auditors and Liquidators Disciplinary Board (CALDB)
Mr Howard Insall, Chairman

Australian Prudential Regulation Authority
Mr Greg Brunner, General Manager, AMIRS
Mr Louis Serret, General Manager Enforcement

Australian Crime Commission
Mr John Lawler, Chief Executive officer
Mr Warren Gray, National Manger, Intervention

Australian Federal Police
Commander David Stewart
Commander Peter Sykora

Appendix 3

Responses from Mr Shawn Richard

1. **Trio Capital was the Responsible Entity for Astarra Strategic Fund and other funds. And was also the Trustee for 5 superannuation funds. Was this framework of corporate and managed funds entities established for the purpose of fraud?**

Trio Capital's Framework as Responsible Entity (RE) and Trustee was already in place when the business was acquired in 2003. My understanding was and still is that this type of framework is typical / normal within the financial industry.

Upon reflection, the establishment of the Astarra Strategic Fund (ASF) as fund of hedge fund may have allowed for my employers to take advantage of the lack of transparency that comes with dealing in the hedge fund industry.

2. **What checks did this framework go through in order for it to be established?**

During the negotiations and immediately following the acquisition of Trio Capital, we were made aware of many of the ASIC and APRA regulatory requirements relating to operating Trio Capital. In my personal experience, the majority of any direct dealings with regulatory matters were handled by the compliance manager and the directors. If any of the regulatory matters concerned me, they were communicated to me by either the compliance manager or one of the directors.

In relation to becoming a director and responsible officer of Trio Capital following the acquisition, I remember being required by either the compliance manager or a director to supply the following:

- criminal background check
- bankruptcy check
- CV
- Evidence of PS 146 qualifications
- Conflict on interest register

When the ASF was established, I believe that the RE performed all normal and usual checks which relate to establishing a managed fund. This included legal and tax sign off.
Since the ASF was established as Australian based hedge "fund of funds", the checks and balances mostly related to AAM's activities in Australia.

I will expand more on the above comment throughout the document.

3. To your knowledge, what discussions were held between fund directors and the RE / trustees, and the custodians and RE/trustees, before monies were transferred in the overseas funds located in tax havens in the Caribbean?

As a director of Astarra Asset Management (AAM), all discussions with the RE/ trustee relating to making investments were held at the very beginning, prior to the first investment being made. Following the establishment of the ASF, an investment management agreement between AAM and the RE was executed giving AAM the authority to invest monies according to the stated strategy and investment process, which was to invest in overseas hedge funds. Once the management agreement was executed, the first investment as well as every other investment was executed without requiring any further discussions with the RE or Trustee.

In other words, the RE / Trustee was completely reliant on this management agreement for all aspects of the fund's activities and played no role in relation to any investment decisions other than passing on AAM's instructions to the custodian.
The process for sending monies to overseas funds was for AAM to email the RE an instruction to invest in a particular fund which they then forwarded to the custodian for execution on the same day.

Since I never had any direct communication with the custodian, I am unable to confirm any discussions between the RE / trustee and the custodian relating the transfer of monies. I can only confirm that when AAM sent instructions to Trio Capital for execution, they would often be processed on the same day.

4. To your knowledge, what discussions were held between fund directors and trustees, and the custodians and trustees before the monies on the offshore accounts were used to purchase shares in US companies from foreign companies controlled by Mr, Flader?

As mentioned in Question 3, The RE and Trustee fully relied on the investment management agreement virtually giving them no on-going role in relation to the investment decisions of AAM. Although the investment management agreement detailed many checks and balances to be executed by AAM, any monitoring of such checks and balances were not performed by the RE and the Trustee.

In my experience, Australian based fund managers (including REs and trustees) who invest in other overseas funds, are not involved in the decision making process of the underlying assets purchased by the overseas manager.

5. **The judgment of Garling J in Regina v Shawn Darrel Richard (2011) NSWSC866 states that you took active steps to conceal from trio and Trio investors your relationship with Mr. Flader, the existence of the interrelated network of companies and investment funds and your personal gains from the activities of Trio. What were these steps and what information did you provide to auditors, custodians and trustees, financial advisors and the Trio investment committee? Did any of these gatekeepers ask for further verifying information?**

In relation to the above mentioned concealments, please refer the statement of facts which was executed prior to my sentencing.

In relation to gatekeepers asking for further information:
<u>Auditors</u>:
From 2005-2008, the majority of the audit process was dealt with between the RE / trustee and Trio Capital in Albury.
During the audit process they asked AAM a few basic questions about our process and accepted our verbal representations. One of their only formal requirements was to reconcile the valuations received from overseas managers with Trio's valuations.
Following the GFC, the audit process of 2009 improved dramatically and their requirements were much more detailed, stringent and relevant

<u>Custodians</u>:
I can confirm that I, as a director of AAM, never had any direct communication with the custodian.

<u>Trustee/RE:</u>
Any further verifying information was the standard periodic regulatory checks and updates. The Trustee and RE had given authority to its investment committee in relation to performing all the appropriate checks and balance for AAM and the ASF.

<u>Investment committee:</u>
The investment committee asked from time to time for information relating to the ASF and additional information relating to the underlying investments made by the 3rd party managers. They however accepted the lack of transparency due to the fact that ASF was a hedge fund of fund and that lack of transparency was normal within the hedge fund industry.

6. **Did you select or influence the appointment of the directors of companies within the Trio Group? To your knowledge, did Mr. Flader?**

Prior to 2005, I was a director of Trio and some of its related entities. At that time I played a role in the selection of other directors. Once I was no longer a director of Trio Capital in 2005, I was not involved with the selection or influence of any of the directors of Trio Capital and I am not aware that Mr. Flader did either.

In other words none of the directors of Trio Capital at the time of its collapse were chosen by me nor were they known to me prior to their appointment

7. **How difficult was it to establish the fraudulent investment scheme? Did any of the regulatory checks and balances, including those listed below, make the perpetration of the fraud more difficult? Did it make it easier?**
   - **Obtaining an AFSL**
   - **Anti-money laundering / Proceeds of Crime checks**
   - **PDS**
   - **Trustees**
   - **Custodians**
   - **Auditors**
   - **Directors**
   - **Financial advisers**
   - **Research Houses**
   - **APRA**
   - **ASIC**

Participating in aspects of the scheme did not make the above mentioned regulatory checks and balances overly difficult to overcome. The main reason for this is that the vast majority of all checks and balances relating to Trio Capital and more specifically the ASF, was mainly relating to the fund's activities within Australia.

Therefore, the establishment of the ASF as a fund that invests in other overseas hedge funds resulted in the standards checks and balances becoming significantly diluted once investment funds left Australia which is where I believe the main contributing factors leading to Trio Capital's collapse occurred.

8. From your experience, what were the weak points in Australia's financial services regulatory framework?

- Upon reflection, one of the weaknesses in Australia's financial services regulatory framework was the general lack of understanding of the hedge fund space and its many complexities in terms of different structures and strategies.

  More specifically, the main problems with funds such as the ASF, which invested in other hedge funds, is the general acceptance throughout the whole financial industry that certain hedge funds can be exempt from offering the same required transparency as all other asset classes.
  In other words, once the manager invests with a 3rd party fund manager, many layers of scrutiny, checks and balances disappear.

  For example:

  - Still today, many fund of funds are only required to disclose their overall investment methodology in terms of selecting 3rd party fund managers.

  - The majority of them are unable to disclose the list of assets purchased and held by the 3rd party manager and get away by explaining the "type" of asset.

  - Some of them do not even disclose which managers they have selected.

  <u>This makes it very difficult for all relevant parties to make the necessary checks and balances in order to confirm whether the Australian manager is delivering on its stated strategy, risk profile and liquidity guidelines. It also makes it difficult to detect any dishonest conduct.</u>

  Although there are many successful hedge funds that do the right thing and offer great alternatives to traditional investments, considering the above observations would make it difficult in some cases to distinguish between good and bad.

- The APRA guidelines on superannuation liquidity requirements within the funds management industry is not scrutinised enough. Other than with Trio Capital, I have seen many examples including retail and industry superannuation funds which do not meet the APRA's minimum liquidity requirements. They simply do a good job at convincing the regulator that they do. This was proven during the GFC and still today I'm confident I could easily identify superannuation funds that would fail the liquidity test.

9. Did the Trio funds deliberately target self-managed superannuation funds and / or APRA regulated funds?

As with most fund managers, our goal was to establish relationships with the financial advisers who are the gatekeepers to investors. Since all advisors had different types of clients all with different risk profiles, we simply structured most of the Trio products including the ASF for it to receive both super and non-super investments.
Although the funds did receive both super and non-super monies, it became apparent that the majority of the financial planners recommended their clients to invest superannuation monies more so than non-super monies into our funds.

In other words, we targeted all types of investments including superannuation funds and APRA regulated funds as well as non super.

10. Given your experience and knowledge of the inner workings of Trio Capital, in what way do you consider Australia's financial services regulatory framework should be altered to increase the security Australian investors and superannuation funds.

- Unless the industry can force a dramatic increase in the transparency within certain areas of the hedge fund industry, there perhaps should be enforced limits or even prevention of exposure which superannuation funds can have into certain hedge funds.
  As previously mentioned, if fund of hedge funds are unable to show the list of underlying assets purchased by a 3rd party manager, it will always be very difficult for all relevant parties to make the necessary checks in order to confirm whether the Australian manager is delivering on its stated strategy, risk profile and liquidity guidelines as well as detect fraud.

- Stricter scrutiny regarding superannuation liquidity guidelines. Especially if the combination of hedge funds, private equity, fixed interest and unlisted property funds make up more than 25% of a superannuation portfolio which is often the case.
  (Note: just because a PDS says they are liquid, it doesn't mean they are. The liquidity status represented in a PDS usually assumes minimal redemptions and does not account for unusual events causing larger redemptions like we saw in the GFC)

Additional commentary

For the sake of providing clarity on an issue I feel is important, I wish to respectfully ask that you consider the following observations and commentary regarding the government compensation scheme relating to the ASF.

Through media reports, I understand that the government had agreed to provide compensation for certain superannuation investors of the ASF.

Although I haven't read the specific legislation which relates to the scheme, it seems that SMFS are excluded from being eligible in receiving compensation when fraud has occurred with their investments. I imagine this law was written with a basic assumption of the type of investor profile that constitutes a SMSF investor.

Having met hundreds of financial planners and/or accountants, I have seen for myself that there are 2 kinds of SMFS investors:

A Investors who are investment savvy, who wish to take control of their own investments and who have the skills to determine the risks of their investments.

B Investors setting up an SMSF simply because their accountant or financial planner had advised them to do so.
These people have no investment expertise and employ a financial planner to guide and advise them on all investments. They are 100% reliant on the financial planner's advice exactly the same as investors without an SMSF.

In relation to the ASF, I strongly believe that 95% of all investors had 1 thing in common; they were all 100% reliant on the advice of their financial planner to invest their superannuation monies into the ASF. The only difference is the fortune and misfortune of some investors having been advised on which vehicle to use to gain access to the fund.

In the specific case of the ASF, if the government has considered it appropriate to compensate superannuation investors, it should perhaps consider the circumstances mentioned above in relation to SMSF investors into the ASF.

I also wish to mention that I am aware of some SMSF investors who, on the advice of their financial planner, not only invested in the ASF but also used margin facilities to invest into the ASF, doubling their exposure.

Supplementary Remarks

In my previous submission, I communicated various observations and commentary regarding the collapse of Trio Capital.

Upon reflection into my first submission, I wish to provide additional commentary in order to avoid causing any potential misunderstandings.

In my opinion, financial planners should not be blamed in relation to the collapse of Trio Capital.

Financial planners along with their clients all had a justified expectation that the ASF had gone through multiple layers of checks and balances by all relevant industry participants prior to the product being made available to the public.

Additional layers of checks and balances were also performed by the financial planners. For example in my experience, financial planners relied on reputable research houses to conduct detailed due diligence on the ASF prior to any consideration.

Therefore, if a financial planner requires a product to have a minimum "recommended' rating by the research house before it makes it on an approved list, combined with all the many expected checks and balances by all the other industry participants which relate to a financial product, I find it difficult to lay much blame on a financial planner when a product fails.

On the subject of SMSFs, I also wish to clarify that in my opinion; financial planners were not at fault for recommending their clients to invest through an SMSF. I was simply making the point that in my opinion, SMSF clients did not have any material advantage compared to the other investors who received compensation from the government scheme.