CHAPTER 4

INVESTOR PROTECTION AND TAX EFFECTIVE SCHEMES

Introduction

4.1 In this Chapter, the Committee considers the adequacy of measures for protecting investors in the mass marketed schemes market. Since the majority of those who invested in mass marketed schemes and who gave evidence to this inquiry participated in agribusiness and franchise schemes, this Chapter focuses on the measures that regulate the establishment, operation and promotion of those types of scheme. It also examines the measures for controlling the quality of advice provided to investors.

A preliminary note – distinguishing financial from taxation protection

4.2 The ATO's role is to determine the taxation implications of participating in a particular scheme. That is, its role is to determine whether or not an investor is entitled to claim a tax deduction in relation to his or her investment in a business or project.

4.3 It is the role primarily of Australian Securities and Investment Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC) to ensure that managed investment or franchise schemes are designed and operated in accordance, respectively, with the requirements of the Corporations Law and the Trade Practices Act. These requirements cover, among other things, matters such as the registration and constitution of schemes, compliance arrangements and structures, and disclosure documentation. They are designed to ensure that a participant's decision to invest in a particular business or scheme is made on the basis of adequate information, and that the business arrangements themselves are proper.

4.4 It is important to note that a scheme may be designed and operated in accordance with the requirements of Corporations or Trade Practices law, and yet an investor not be entitled to claim a tax deduction for their investment in it. Conversely, just because a scheme has an ATO product ruling does not mean that it is a good financial investment.

4.5 Clearly, however, considerations that count for a scheme being given a product ruling also count for it fulfilling the requirements of the Corporations Law. For example, one of the conditions for the tax deductibility of an investment is that it be investment in a genuine business, and the regulations for compliance, registration and so on are designed to monitor that a scheme is operating as such a business.

4.6 Comprehensive investor protection requires both that the investor can attain certainty about the ATO's view of the deductibility of expenses, and that the investor has access to information about the commercial viability of a business and is entitled

to redress if that information turns out to be inadequate, misleading, or based on false assumptions.

4.7 As discussed earlier and in the Committee's Second Report, investor protection in taxation terms is addressed by measures such as the ATO's product ruling system and proposed promoter penalties.[1] In this Chapter, the Committee concentrates on the measures in place to protect investors' financial interests.

Regulations governing schemes and conduct

4.8 There are three levels at which questions might be asked concerning the adequacy of controls on tax effective schemes, promoters and advisers. These levels are:

- the establishment and operation of the scheme itself;
- the disclosure to investors of relevant information; and
- the adequacy of advice provided to investors.

4.9 In what follows, the Committee outlines the measures currently in place to control the operation and sale of tax effective schemes at all three levels.

Scheme establishment and operation

4.10 Tax effective agribusiness schemes are a subset of managed investment schemes. Since 1 July 1998, managed investments have been governed by provisions of the Corporations Law introduced by the *Managed Investments Act 1998*.[2]

4.11 Prior to the adoption of that Act, the Corporations Law provided for a two tier regulatory framework for managed investment schemes. The funds or assets of a scheme were vested in a trustee and the scheme was managed on a day-to-day basis by a management company. Reports of both the Australian Law Reform Commission and the Companies and Securities Advisory Committee, and the Financial System Inquiry found that this two tier structure led to a confusion between the responsibilities of the trustee and the management company, with the risk of failures in information sharing and reduced investor protection. Both reports accordingly recommended that there be a single operator in relation to each scheme, to be known as a single responsible entity.[3] This recommendation was implemented through the *Managed Investments Act 1998.*

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1 The ATO has advised the Committee that it is currently consulting with community, industry and professional bodies on its proposed promoter penalties. ATO Additional Information, 31 October 2001, p.2.

2 ASIC, Submission No. 853, p.3. The Managed Investments Act is inserted as Chapter 5C of the Corporations Law.

3 The Hon. Peter Costello MP, 'Managed Investments Bill 1997: Explanatory Memorandum', pp.4-5.

4.12 Schemes that were already operating at 1 July 1998 were given two years to meet the compliance requirements of this more stringent regulatory framework, although ASIC had discretion to extend that transitional period. In particular, ASIC advised that it 'has been prepared to grant relief to well-established schemes that are not open to new investment on the basis that those schemes have been complying with the Law as it stood and it would be an unreasonable cost imposed on the scheme and its investors to require them to transition'.[4] ASIC further advised that at least one scheme established prior to July 1998 has been unable to make the transition successfully because it failed to meet the requirements for obtaining the new responsible entity licence.[5]

4.13 Under the Managed Investments Act, a responsible entity proposing to establish and operate a scheme must obtain a security dealers licence from ASIC. ASIC advised the Committee that it has published a number of criteria against which it determines whether an applicant has the capacity and expertise to carry out the duties of the responsible entity efficiently, honestly and fairly and hence whether an applicant should be licensed. The criteria include:

- capacity to carry on a business;
- education and experience;
- good fame and character;
- engagement of agents;
- compliance;
- accountability; and
- meeting minimal capital requirements.[6]

4.14 Once a responsible entity has been granted a licence, it must then apply to register a managed investment scheme under Chapter 5C of the Corporations Law. A scheme can only be registered if it has a constitution and compliance plan that satisfy the Law. Further, registration of a scheme under Chapter 5C has the following statutory consequences:

- a requirement that the responsible entity must establish a compliance committee if less than half of the directors of the responsible entity are external;
- an obligation to audit the compliance plan annually;
- broadranging statutory duties on the responsible entity and its officers;

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4 ASIC, Submission No. 853, p.9.

5 Evidence, pp.755-756.

6 ASIC, Submission No. 853, p.3.

- the ability of ASIC to conduct surveillance checks;
- the ability of members to remove the responsible entity;
- the ability of ASIC or a member to apply to a court to appoint a temporary responsible entity to substitute for the original responsible entity; and
- limitations on the ability of members to withdraw from schemes which are not liquid.[7]

4.15 ASIC also noted that three aspects of the licensing process provide additional safeguards, particularly in relation to primary production schemes. First, since about July 1999, dealers licences for primary production schemes have been subject to a special condition designed to protect the rights of investors in relation to the land on which the scheme is operated. Second, most primary production operators have been licensed only for *named* schemes, rather than for *kinds* of schemes. ASIC can thus assess the licensee's capacity to operate each new scheme proposed by that operator. Third, many of these licences have a 'key person' clause, which means that the licence holder must inform ASIC if the relevant named person leaves the employment of the scheme operator.[8]

4.16 Franchises are excluded from the definition of 'managed investment schemes' in the Corporations Law, and are accordingly not regulated under that Law. ASIC advised that the reason for the exclusion of franchises is that historically a distinction was drawn between passive investments, and arrangements in which the prospects of a business succeeding were largely dependent upon the activities of investors.[9] In ASIC's words, the 'history reflects a view that typical franchisees do not require the extent of protection appropriate for passive investors'.[10]

4.17 Despite this view, a mandatory industry code for franchising was introduced on 1 July 1998 'in recognition of the strong growth of the franchising form of business and the power imbalance between franchisors and franchisees'.[11] This Franchising Code of Conduct is enforceable under the Trade Practices Act 1974 and is administered by the ACCC.

4.18 The Code is binding on all parties to franchise agreements and sets minimum standards of disclosure by franchisors. It requires all franchise agreements to provide for a complaints handling system.[12]

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7 ASIC, Submission No. 853, p.4.

8 ASIC, Submission No. 853, p.4.

9 ASIC, Additional Information, 14 September 2001, p.2.

10 ASIC, Additional Information, 14 September 2001, pp.2-3.

11 ASIC, Additional Information, 14 September 2001, p.3.

12 ASIC, Additional Information, 14 September 2001, p.3.

4.19 Aspects of the Code apply to franchises that existed prior to 1 July 1998, and the full Code applies to both existing and new franchise arrangements from 1 October 1998.[13]

Disclosure requirements

4.20 Chapter 6D of the Corporations Law regulates the disclosure of offers of interests in registered managed investment schemes. Where investments in such schemes are offered for sale, a disclosure document such as a prospectus is required. Exceptions to this requirement are listed under s708, and include small scale offerings, and offerings to sophisticated and professional investors.[14]

4.21 Section 710 of the Corporations Law requires that prospectuses contain all the information that investors and their professional advisers would reasonably need to make a judgement about the rights and liabilities attaching to the securities offered, the assets and liabilities, financial position and performance, profits and losses of the managed investment scheme, and its commercial prospects.[15]

4.22 Mr Andrew Shearwood, Partner, Freehills, submitted that section 710 ‘cannot be any stronger’. He wrote:

> Disclosure requires a prospectus issuer to undertake a due diligence exercise to discover and disclose to potential investors *all* material information known to the issuer or that the issuer ought reasonably to have obtained and disclosed, by making inquiries.[16]

4.23 Section 728(3) further makes it an offence for a prospectus either to contain a misleading or deceptive statement or to omit information which has ‘a materially adverse effect on an investor’. Mr Shearwood noted that there are ‘significant penalties and the prospect of civil liability’ if a prospectus issuer breaches the prospectus provisions of the Corporations Law.[17]

4.24 Under the current law, there is no obligation for prospectuses to include financial forecasts or projections although it is common practice to include them. Mr Shearwood informed the Committee that there is an important distinction to be drawn between projections and forecasts. Forecasts represent what the directors consider will come true, and there is a statutory liability if they are wrong. Projections are a mathematical calculation of an outcome based on certain assumptions. The

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13 Trade Practices (Industry Codes – Franchising) Regulations 1998, Section 5.

14 ASIC, Submission No. 853, p.5.

15 Freehills, Submission No. 669, pp.1-2.

16 Freehills, Submission No. 669, p.2.

17 Freehills, Submission No. 669, p.2.

assumptions may either be 'best estimate' or 'hypothetical', and the accuracy of the projection depends upon the validity of the assumptions.[18]

4.25 Under the Financial Services Reform Act, some changes to the disclosure regime have been made. First, the concept of a prospectus or disclosure document is replaced with that of a 'product disclosure statement'. Second, the Act prescribes the content of certain standard information in the product disclosure statement, and additional information may be prescribed by the regulations. Mr Shearwood commented that under this regime the information required to be provided to investors could be made narrower than under section 710 of the Corporations Law, but there is also scope for the law to require the provision of industry specific information which would allow easier comparison between schemes in the same industry.

4.26 In a similar vein, ASIC noted the merits of requiring a 'key data summary' to be put in prospectuses so that investors have easy access to the promoter's contact details, and can compare fees, commissions, forecasts and so on between offerings.[19]

4.27 In recent years, the legislation concerning the monitoring of compliance with these requirements has gone through a number of changes. Historically, prospectuses were *registered* by the Corporate Affairs Commissions in each Australian state or territory and the registration process involved a comprehensive review of each prospectus against a checklist of content requirements. This process could take a significant amount of time, and when the Australian Securities Commission was established on 1 January 1991, the law concerning the registration of prospectuses was altered.

4.28 While prospectuses were still registered with ASC and, later, ASIC the onus of responsibility shifted. Rather than the regulator registering a prospectus only when it was satisfied that it met a detailed list of requirements, ASIC was required to register a prospectus within 14 days after lodgement. It could refuse to register a prospectus only if it was satisfied that the prospectus did *not* comply with the law. In place of a prescriptive checklist to be monitored by the regulator, investors were to be protected by the introduction of civil liabilities for the issuers of prospectuses which contained misstatements or serious omissions.

4.29 From 13 March 2000, the *Corporate Law Economic Reform Program Act 1999* (CLERP) introduced further amendments to the disclosure regime. Under CLERP, the issuer of a prospectus need only *lodge* (not register) the prospectus with ASIC. There is a 7 to 14 day period after lodgement during which both ASIC and the market are given time to review the document and during which 'an offeror must not accept applications for non-quoted securities … under the disclosure document'.[20]

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[18] Freehills, Submission No. 669, p.2.

[19] Evidence, p.765.

[20] ASIC, Submission No. 853, p.6.

4.30 As ASIC explained to the Committee:

> The history of law reform in this respect suggests a parliamentary intention to reduce the involvement of the regulator in reviewing disclosure documents, but correspondingly an increase in the responsibility for promoters.[21]

4.31 Quoting from Ford's Principles of Corporations Law, ASIC noted that the philosophy behind the new disclosure requirements is that investors should be provided with the information they require if they are to make 'an intelligent decision without the government having to adopt a paternalistic stance of judging the merits of the particular security'.[22]

4.32 Further amendments to Corporations Law in the Financial Services Reform Act continue this policy trend, with the removal of the requirement even to lodge prospectuses for unlisted managed investments.[23] Mr Ian Johnston, Executive Director, Financial Services Regulation, ASIC, told the Committee that under the FSR Act, 'We would be notified that a product disclosure statement had been issued, but it would not be lodged with us'.[24]

4.33 Questioned about the wisdom of that amendment, Mr Johnston commented that:

> … we have gone to great lengths to explain that we do not approve prospectuses, that we do not register prospectuses. There is an argument that says that the lodging of a prospectus with the regulator seems to create the impression in the minds of some investors that the regulator has had a role to play in somehow giving it a tick or otherwise … The disclaimer that is put in the prospectus, which at the moment says 'ASIC takes no responsibility for the contents of this prospectus', might in fact in some perverse way create the impression: 'That means they must have looked at it, if they are excluding their liability' … But the whole path down which the law is going is that it is a disclosure based regime and that the investor is supposed to make their own due inquiries, et cetera. It is not a regime that we designed, of course, but it is something that we would implement.[25]

4.34 Notwithstanding this policy trend, ASIC does review some 'high-risk' prospectuses in detail. It informed the Committee that in the period between 13 March 2000 to 17 November 2000 (since the introduction of CLERP) 61 primary production scheme prospectuses were lodged with ASIC and that, of these, 35% were identified

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21 ASIC, Submission No. 853, p.7.

22 ASIC, Submission No. 853, p.5.

23 Evidence, p.745.

24 Evidence, p.746.

25 Evidence, p.761.

as falling within the high risk category.[26] The issue of the compliance problems associated with primary production prospectuses and possible remedies will be addressed in detail later in this Chapter.

4.35 The Franchising Code of Conduct sets minimum standards of disclosure with the aim of achieving transparency in dealings between franchisors and franchisees. The disclosure document takes the form of an 'information memorandum', not a prospectus.

Quality of advice and sale of financial products

4.36 The final set of measures for controlling the operation and sale of tax effective schemes are the provisions regulating the conduct of those who advise on and deal in financial products.

4.37 In the main, investors in tax effective schemes took advice and purchased their investments through scheme promoters, or licensed financial advisers or their representatives.

4.38 Under the Managed Investments Act, scheme promoters must hold a licence to operate the scheme and must obtain a separate authorisation in order to give advice relating to a scheme.[27] Under the Corporations Law, financial advisers must be licensed by ASIC to provide advice to retail customers. ASIC may grant a licence only where it is satisfied that the relevant individual has appropriate educational qualifications and experience.[28]

4.39 Licensed financial advisers must disclose to their clients all commissions attached to the sale of particular financial products and hence any possible conflicts of interests. Further, under Section 851 of the Corporations Law, the so-called 'know your client' provisions require advisers to recommend products in the light of their knowledge of clients' individual needs and circumstances.[29]

4.40 The law allows a licensed dealer or adviser to issue a 'proper authority' to a representative, who is thereby authorised to act on behalf of the licensee. Responsibility for ensuring that such representatives comply with the law and possess appropriate educational qualifications and experience lies with the licensed dealer.[30]

4.41 Further, under the FSR regime, the licence holder must notify ASIC of any proper authorities that they issue and be responsible for ensuring that such

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[26] ASIC, Submission No. 853, p.7.

[27] There was a transition period between July 1998 and July 2000 designed to give scheme operators time to meet the competency requirements for obtaining an adviser's licence. During that time, operators were able to give advice without such a licence, but only in relation to their own schemes. Evidence, p.758.

[28] Freehills, Submission No. 669, p.8.

[29] Financial Planning Association of Australia Ltd (FPA), Submission No. 705A, p.8.

[30] Evidence, p.758.

representatives meet ongoing training requirements. ASIC will maintain a register of all proper authority holders.[31] It advised that, at 10 September 2001, the number of proper authority holders registered with ASIC is 38 894.[32] No proper authority is required by those selling franchise arrangements.

4.42 There are a number of channels through which investors may seek redress if they believe they have been given inappropriate or negligent financial advice. These include internal dispute resolution schemes, external dispute resolution schemes (such as the Financial Industry Complaints Service), professional bodies (such as the Financial Planning Association) and ASIC.[33]

4.43 In relation to lack of compliance with the regulatory framework by financial advisers and their representatives, ASIC told the Committee that 'in the year before last' it had banned 50 investment advisers for 'a range of misconduct or misbehaviour, some of which would fall outside the ambit of this inquiry'. Mr Sean Hughes, Director, Financial Services Regulation (Regulatory Operations), ASIC, said:

> … we also took action in the civil courts, restraining some of those advisers from continuing to give advice to their clients, and in one case that springs to mind we had the person prosecuted and that person received a conviction.[34]

4.44 The Financial Planning Association (FPA) advised that its own disciplinary committee, which is chaired by an independent legal practitioner, also has the power to investigate investors' complaints and to impose sanctions ranging from censure, to fines, suspension or termination of FPA membership, and other educational or professional development training. The manager of FPA's Investigations Professional Standards section, Mr Michael Butler, stated that:

> Allegations to date in regard to these tax-effective investments represent only a very small portion of the complaints received. They are investigated in the same manner as any other complaint. The most recent finalised case resulted in the disciplinary committee suspending the membership of the member for a period of two years when charges relating to a failure to obtain sufficient client information to enable a suitable recommendation to be made and the failure to disclose risks in a manner the client could understand were upheld by the committee.[35]

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31 Evidence, p.760.

32 ASIC, Additional Information, 14 September 2001, p.6.

33 Evidence, p.637.

34 Evidence, p.746.

35 Evidence, p.638.

Compliance and tax effective schemes

4.45 In this section, the Committee outlines some of the concerns raised about the compliance of some tax effective schemes with the relevant regulatory requirements and the remedial or disciplinary action that has been taken against them.

4.46 In evidence to the Committee, ASIC expressed its concern primarily about agribusiness tax effective schemes, saying that 'certain agricultural investment schemes often marketed as tax driven schemes leave much to be desired in terms of their marketing, promotion and operation'.[36] ASIC told the Committee that, as a percentage of the managed investments industry as a whole, the compliance problems in the agribusiness schemes area were high. In fact, according to ASIC:

> … we expend a disproportionate amount of our resources on these schemes: some 30 per cent of our managed investment surveillance capacity for what is perhaps only five or six per cent of the managed investments market.[37]

4.47 The problems occur at the licensing, disclosure and operational stages, and relate to both past and present experience. For example, ASIC's submission related the following figures:

- 10% (19 of 187) primary production licence applications refused between 1 July 1998 and 30 November 2000 due to serious deficiencies;
- 21 out of 57 primary production prospectuses received over the 1999-2000 financial year required remedial action;
- since December 1998, ASIC has finalised 40 surveillances of primary production responsible entities. Of these, 18 entities were required to improve operational procedures and the compliance plan, 4 had additional licence conditions placed on them, and 6 had their licences revoked.[38]

4.48 More recently, since January 2001, ASIC took action over the following problems in this area:

- of six primary production licence applications received, one was refused, two were withdrawn, one was approved and two are still under assessment;
- of eight surveillances of primary production responsible entities, three required remedial action in the form of a licence returned, a condition placed on a licence and a change to operations and procedures;
- in relation to prospectuses, there were 11 interim stop orders (mainly issued because entities had no reasonable basis for projections made in their

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36 Evidence, p.39.

37 Evidence, p.744.

38 ASIC, Submission No. 853, pp.4-9.

> prospectuses), one final stop order and supplementary disclosure documents required from 44 entities.[39]

4.49 In addition to structural or organisational arrangements, two major areas of concern in agribusiness schemes which emerged from the evidence were:

- high up-front management fees and commissions; and
- overly optimistic projections and forecasts.

Fees and commissions

4.50 In relation to the question of high fees and commissions, there are two reasons for concern. One relates primarily to investor protection, and the other relates to the protection of the taxation revenue.

4.51 Van Eyk Capital, an independent agribusiness research house, has suggested that a 'fundamental problem' in the agribusiness sector is 'the unacceptable and unsustainable levels of remuneration earned by the promoters, and by the people who actually sell the product contained within the offering document (ie. the financial advisers)'.[40]

4.52 According to van Eyk, despite the existing disclosure requirements in the Corporations Law, the real levels of fees and commission can still be hidden by a variety of means. The result is 'a significant imbalance between the returns offered to investors, and the often exorbitant returns accruing to both the promoters and their sales force'.[41] Van Eyk submitted:

> It is inconceivable to us how any project, or any business for that matter, can expect to be successful when between 70% and 80% of the funds invested are immediately diverted into what is basically non-productive expenditure … [W]e find it difficult to understand how both the ATO and ASIC rationalise such schemes to be 'commercial ventures' on a pre-tax basis when such a high proportion of the funds are not in fact utilised in actually growing or producing the crop.[42]

4.53 In short, van Eyk argued that the majority of agribusiness schemes are likely to fail commercially because not enough of the funds raised are 'going into the ground'. Investors will thus gain no return on the investment and a potentially viable industry sector will be brought into disrepute.

4.54 In addition to these alleged risks to the long-term viability of many agribusinesses and, hence, to investor returns, inflated up-front fees may also pose a

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39 Evidence, p.744.

40 Van Eyk Capital, Submission No. 691, p.5.

41 Van Eyk Capital, Submission No. 691, p.5.

42 Van Eyk Capital, Submission No. 691, p.8.

risk to the taxation revenue. That is, the higher the establishment and initial management fees, the greater the tax deduction able to be claimed by the investor. The ATO has submitted that in some cases these costs may be artificially geared so that, no matter what happens to the business itself, investors are guaranteed at least a 'tax profit' from their investment. That is one of the factors that is relevant to a determination that the investor's 'dominant purpose' in making the investment was to obtain a tax benefit, and hence to a determination that Part IVA applies.[43]

4.55 Witnesses from a range of agribusinesses disputed van Eyk's assessment of this matter. In particular, they disputed the claim that the agribusiness sector as a whole systematically overcharges for management fees and commissions. For example, representatives from The Barkworth Group, a mass marketed scheme growing and producing olive products, argued that van Eyk's reports did not address the reasons for some high up-front fees. Mr Mark Troy, Managing Director, acknowledged that the Barkworth prospectuses 'are notorious for having the highest charges'. He went on to say, however, that its charges were justified because Barkworth had committed itself not only to producing olives, but to establishing a brand in the marketplace. He claimed:

> We had to have a lot of investment in preparation for the major groves coming on stream. This required that we establish two or three years early the processing and marketing operations, and the prospectus provides that investors expect from us to buy in fruit from existing groves and process that produce into branded products and then market those products.[44]

4.56 In a similar vein, Great Southern Plantations Ltd also suggested that van Eyk did not sufficiently consider the whole life cycle of the businesses it criticised. Mr John Young, Chairman and Managing Director, said:

> They look at certain issues such as stumpage, which they have mentioned, and up-front establishment costs. What they do not look at is the long-term viability of the businesses, the cash flows and liquidity, the borrowing levels, the balance sheet, the whole box and dice. So we feel that their research is flawed in that regard …[45]

4.57 A difficulty in addressing this 'problem', to the extent that it exists, is that in general terms the level of fees and commissions is a matter for the market and what the market will bear. From ASIC's point of view, investor protection requires only that investors be *fully informed* of what those fees and commissions are. Even if, as van Eyk maintains, the profits made by some scheme promoters far outweigh the

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43 ATO, Submission No. 845, Attachment C, p.5.

44 Evidence, p.551.

45 Evidence, p.594.

returns on investment, there is in Mr Johnston's words 'no prohibition against charging high commissions'.[46]

4.58 ASIC conceded, however, that 'these schemes are generally sold on their tax benefits' and that 'on occasion, they are missold on those benefits'.[47] For that reason, ASIC has recently initiated action on two fronts to increase investor protection in this area. First, it has embarked upon a process of issuing 'safety checklists' for people considering investing in agribusinesses. For example, ASIC recently released such a checklist for the olive oil industry. The list contains, among other things, benchmarks for operating and establishment costs.

4.59 Second, ASIC is developing a campaign to target financial advisers who habitually 'recommend high risk or high commission paying products to determine whether they have met their obligations under the law to give advice which is appropriate to the need of their clients, with full and proper disclosure'.[48]

4.60 In other words, although there is no prohibition against schemes charging high establishment and management fees, there may be a prohibition against advisers recommending such products to clients if they do so solely for the sake of the commission they would receive. It is at that point in the market that ASIC may be able to exert some regulatory control.

4.61 From the ATO's point of view, the issue of allegedly excessive fees is also complex. As with ASIC, the ATO has 'no authority to limit the amount of profit that forms part of a particular fee'.[49]

4.62 According to the ATO, numerous Australian court judgements have 'made it plain that the role of the Tax Office is not to tell a person how to run their business, or how much they should pay'. The ATO continued:

> It is well established law that even business decisions the Tax Office may not agree with can still properly achieve a tax deduction. See for example the *Cecil Bros. Case* (1964) 111 CLR 430 – in this matter it was common ground that the taxpayer had quite deliberately made particular arrangements to purchase goods, from a non-arm's length company, at a price above that otherwise available in the market. However, the Full High Court allowed the claimed deductions to stand.[50]

4.63 For this reason, in determining whether a fee structure is such that a taxpayer's 'dominant purpose' for investing was to obtain a tax benefit, the ATO must

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46 Evidence, p.748.

47 Evidence, p.745.

48 Evidence, p.745.

49 ATO, Submission No. 845A, Attachment 1, p.1.

50 ATO, Submission No. 845A, Attachment 1, p.1.

consider the fees to be 'grossly excessive'. 'Grossly excessive' indicates, according to the ATO's submission, 'a level above – indeed perhaps several levels above fees that are merely excessive'.[51] Further,

> the Full Federal Court did not say that 'grossly excessive' fees are not deductible, only that they may be indicative of some other purpose, which may not support deductibility.[52]

Projections and forecasts

4.64 In relation to the question of projections and forecasts, van Eyk Capital again expressed concern that many agribusinesses make excessively optimistic, if not misleading, projections of future product yields and marketability in their prospectuses.[53]

4.65 As with the question of high up-front establishment costs, the accuracy of agribusiness projections and forecasts poses issues for both ASIC and the ATO. ASIC has a role in protecting investors against being misled about likely future returns, and the ATO must assess the validity of claims about the long-term profitability of a venture in order to satisfy itself that deductions are granted for expenses in a business with overall profit making intent.

4.66 The Committee took some evidence which supported van Eyk's assessment of problems in this area. For example, the Australian Managed Investments Association (AMIA), while advocating self-regulation by the agribusiness managed investments industry, conceded that:

> … this is anecdotal – during that period of genuine projects on the market, to sometimes compete with the more flamboyant projects on the market some sometimes had to not cook the books but certainly take a very rosy view of the likelihood of profits in the business and therefore may have put in not inflated figures but certainly more favourable figures than they would have done had the regulators been doing their jobs.[54]

4.67 The Committee also heard, however, that the mere failure of a project to meet its prospectus projections does not by itself demonstrate that those projections were irresponsibly inflated. For example, Mr Douglas Pollard, Managing Director, The Barkworth Group told the Committee:

> When we entered the industry in 1997, the supermarket audit of extra-virgin olive oils across the board revealed that the price was $14 per litre. That is the retail price of the packaged product … The dollar at that stage was about

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51 ATO, Submission No. 845A, Attachment 1, pp.1-2.

52 ATO, Submission No. 845A, Attachment 1, p.2.

53 Van Eyk Capital, Submission No. 691, pp.4-5.

54 Evidence, p.728.

> US72c. The dollar, as we all know, is about US51c at the moment. One would reasonably have expected the price of olive oil to be a lot dearer in Australian terms. In fact, across the board a supermarket audit reveals that it is now about $10 per litre. Taking into account the difference in the value of the currency, the price of olive oil has halved, so there has been dumping, which has made it harder for us to sell it …[55]

4.68 ASIC's guide for investors in olive schemes states that over the ten-year period (1990-2000) the price for olive oil on the Milan Bourse, the major trading centre for olive oil, fell 100 per cent in real terms, from AUD$8 to AUD$4.[56]

4.69 ASIC reported to the Committee that it has recently tightened its monitoring of prospectus forecasts and projections. Mr Johnston said:

> Since we last appeared before the committee, ASIC has issued a new interim policy statement on the use of forecasts and projections in disclosure documents. ASIC requires that any forward looking statements must be made on a reasonable basis. We have indicated that, where the forecast goes beyond two years, either a report by an expert or the existence of forward contracts supporting a stated price would satisfy the requirement. Somewhat ironically, many in the industry have criticised ASIC's policy as being too tough to meet.[57]

4.70 In addition to this requirement, both ASIC and some industry associations are developing benchmarks and codes against which particular scheme projections can be assessed.

4.71 For example, Mr Robert Rawson, General Manager, Forest Industries Group, Department of Agriculture, Fisheries and Forestry – Australia (AFFA), told the Committee that the plantation forestry industry is developing a code of practice for afforestation managed investment schemes. The code, he said, 'aims to have all the relevant information for a forestry project outlined in a manner that would allow investors to make a meaningful comparison between schemes. Particular emphasis is to be placed on the independent expert reports to back the predictions of future wood growth and timber royalties'.[58] Australian Forest Growers, the national association representing and promoting private forestry in Australia, emphasised its commitment to implementing the Code of Practice for Afforestation Managed Investment Schemes and its 'willingness to adopt a transparent and effective system of self-regulation'.[59]

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55 Evidence, p.550.

56 ASIC, Media Release, 21 August 2001.

57 Evidence, p.744.

58 Evidence, p.690.

59 Australian Forest Growers, Additional Information, 22 August 2001.

4.72 The Committee notes that ASIC's compliance focus is on trying to ensure that investors are not misled at the outset, and that non-compliant schemes are unable to get established.

4.73 ASIC told the Committee that if 'tax driven promoters breach the law we can take enforcement action (civil, administrative and criminal) but this can only take place after a thorough investigation, if we suspect an offence has been committed'.[60] It appears to the Committee that ASIC may lack the resources to pursue such investigations.

4.74 As outlined earlier in this Chapter, ASIC has undertaken quite extensive surveillance of agribusiness schemes since 1998, but the Committee is unaware that ASIC has prosecuted any promoters of mass marketed schemes whose investors have had their deductions disallowed by the ATO.

4.75 In expressing frustration at the high proportion of remedial action and surveillance activity expended on the agribusiness managed investments sector, ASIC noted that 'the question could be asked whether these schemes should be regulated in some other way'. Mr Ian Johnston said:

> We note that, in some jurisdictions, public offering of these types of investments is not permitted. While not at this stage advocating such a position in Australia, we do note that as a regulator we conduct a policy, disclosure and conduct regime which achieves particular results in the case of much of the regulated managed investments population but which does not achieve those results with this sector.[61]

4.76 The Committee endorses the development of industry benchmarks by both ASIC and industry associations, as well as ASIC's recent initiatives in relation to forecasting and the regulation of experts' reports. The Committee considers that these measures, combined with the ATO's product ruling system and the development of promoter penalties, should greatly improve the levels of investor protection in the mass marketed schemes market.

4.77 However, the Committee is concerned at ASIC's reports of the disproportionately high level of problems that continue to be associated with primary production schemes and at the apparent lack of resources for investigations and prosecutions where necessary. The Committee is also concerned that the current regulatory regime may be inadequate to control the promotion of franchise schemes.

Recommendation

4.78 The Committee recommends that the government seek advice from both ASIC and the ACCC on the question of the adequacy of the current measures for

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[60] ASIC, Additional Information, 14 September 2001, p.4.

[61] Evidence, p.745.

monitoring the schemes market, with particular reference to agribusiness and franchise schemes. This advice should address matters such as the role of specific industry associations and the Australian Managed Investments Association in ensuring that compliance and disclosure obligations are met, the development and publication of further benchmarking measures which draw on industry wide standards and expertise, and any other measures required to ensure the adequate protection of investors in this sector.

Senator the Hon Brian Gibson
Acting Chairman